

INTERNATIONAL FINANCE

COURSE CODE: M23EC03DE

Postgraduate Programme in Economics

Discipline Specific Elective Course

Self Learning Material



SREENARAYANAGURU
OPEN UNIVERSITY

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The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

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To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

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Pathway

Access and Quality define Equity.

International Finance
Course Code: M23EC03DE
Semester - III

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Semester- III

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SREENARAYANAGURU
OPEN UNIVERSITY

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Edition
April 2025

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ISBN 978-81-985949-0-7



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MESSAGE FROM VICE CHANCELLOR

Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed "blended format," a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The University aims to offer you an engaging and thought-provoking educational journey. The postgraduate programme in Economics builds on the undergraduate programme by covering more advanced theories and practical applications. The course material aims to spark learners' interest by using real-life examples and combining academic content with empirical evidence, making it relevant and unique. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university's student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.



Regards,
Dr. Jagathy Raj V.P.

01-01-2025

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BLOCK 1

**Introduction to
International
Finance**

UNIT 1

Overview of International Finance

Learning Outcomes

After reading this unit, the learner will be able to:

- understand the need and importance of international finance
- analyse the difference between international trade and international finance
- understand the benefit of studying international finance

Background

International trade has universal importance for our standard of living and our daily lives. International finance plays a crucial role in the global economy. It allows countries to buy and sell goods and services with each other and also enables them to invest in each other's economies. This is important because it helps countries to grow and develop their economies. International finance is different from international trade, which only involves the buying and selling of goods and services. International finance, on the other hand, involves the buying and selling of financial assets such as currencies, stocks, and bonds. By studying international finance, individuals can gain a better understanding of how the global economy works. This knowledge can be useful in a variety of careers, such as banking and investment. Additionally, studying international finance can help individuals make informed decisions about investments and other financial transactions. Overall, international finance is an important field of study that can provide individuals with a deeper understanding of the global economy and help them make informed financial decisions.

Keywords

International Finance, International Trade, Multi-National Corporations (MNCs)

Discussion

1.1.1 International Finance

- International financial resource flow

International finance refers to the flow of financial resources across national borders. It involves various activities such as investment, lending, borrowing, and currency exchange. International finance enables countries to access foreign capital, manage risk, and optimise returns on investment. For instance, a US-based company like Apple may invest in a manufacturing plant in China or borrow euros from a German bank to finance its European operations.

- Enabling global trade flow

International finance also facilitates global trade by providing financial instruments such as letters of credit, bills of exchange, and factoring. These instruments help mitigate risks associated with international transactions. For example, when an Indian textile exporter sells goods to a US importer, a letter of credit from a US bank guarantees payment to the exporter. Similarly, multinational corporations (MNCs) like Coca-Cola and Nike issue bonds in foreign markets to raise capital.

- Includes foreign exchange markets, international bond markets, and global equity markets

International finance encompasses various markets and institutions, including foreign exchange markets, international bond markets, and global equity markets. The foreign exchange market, for instance, enables companies to convert currencies for international transactions. For example, a Japanese tourist visiting Paris may exchange yen for euros at a currency exchange booth. Understanding international finance is crucial for businesses, investors, and policymakers to navigate global markets effectively.

1.1.1.1 Need and Importance of International Finance

- Managing global financial risks

Understanding international finance helps financial managers predict how global events impact their company to make informed decisions to benefit from positive changes and to protect their business from negative effects. The factors considering international finance are; Exchange rates (value of currencies), Interest rates (cost of borrowing), Inflation rates (price increases) and Asset values (worth of investments). These factors are connected. For example, a weaker currency (exchange rate drop) often means, higher



interest rates, increased inflation, and decreased asset values. By understanding these relationships, financial managers can make smart decisions.

- Exchange rates affect assets

A declining currency affects asset prices differently. Export-oriented companies' stock prices may rise, as they become more profitable. However, companies with foreign-currency debt may see their stock prices fall, as their debt increases in domestic currency. Understanding these connections between exchange rates, asset values, and liabilities is crucial, as foreign exchange risk interacts with other business risks. Exchange rate changes impact investors differently, depending on whether foreign currency asset values move in tandem or opposition.

- Global market interconnectedness matters

Studying international finance goes beyond understanding exchange rates' impact on asset prices and profits. Global financial market integration means that distant events – such as oil and gold price changes, election outcomes, conflicts, or peace agreements – have instantaneous worldwide repercussions.

- Global finance affects lives

International finance affects our lives. Global trade and investment influence currency values. A strong currency makes imports cheaper and boosts domestic buying power. When comparing living standards globally, a strong currency helps local incomes convert to higher values in U.S. dollars, allowing the country to rank higher in global living standards. Global citizens benefit from efficient capital allocation, as it maximises returns worldwide and allows investors to share extra profits.

1.1.1.2 Difference between International Trade and International Finance

- Cross-border trade exchange

International trade refers to the exchange of goods and services across national borders. It involves the buying and selling of products, raw materials, and services between countries. International trade aims to maximise economic efficiency by leveraging comparative advantages, economies of scale, and specialisation. Examples include exporting electronics from China to the US or importing coffee from Brazil to Europe.

International finance, on the other hand, deals with the flow of financial resources across national borders. It involves investment, lending, borrowing, and currency exchange.

- Flow of Global Capital

International finance facilitates global economic activity by enabling countries to access foreign capital, manage risk, and optimise returns on investment. Examples include investing in foreign stocks, borrowing in foreign currencies, or exchanging dollars for euros.

- Trade and finance are linked together

While international trade and finance are distinct, they are interconnected. Trade requires finance, as companies need financial instruments to facilitate transactions. Conversely, finance facilitates trade by providing access to foreign currency, credit, and investment. Exchange rates, interest rates, and financial regulations also impact trade. Understanding both international trade and finance is crucial for businesses and policymakers to navigate global markets effectively.

- Understanding international financial dynamics

1.1.1.3 Benefits of Studying International Finance

Understanding international finance is crucial for financial managers to navigate the complexities of global events and their impact on a firm's performance. This knowledge enables managers to anticipate and respond to changes in exchange rates, interest rates, inflation rates, and asset values, which are interconnected and can have a profound impact on a firm's profitability. For instance, a declining exchange rate is often accompanied by high interest rates and inflation, which can affect asset prices differently. While a weaker currency may boost the stock prices of export-oriented companies, it can also increase the debt burden of companies with foreign-currency-denominated debt. Therefore, international finance is not just an added layer of risk, but a distinct field that requires a deep understanding of the intricate relationships between exchange rates, asset values, and other financial variables. By studying international finance, managers can develop the expertise to mitigate risks and capitalise on opportunities, recognising that the impact of exchange rate changes on investors, for example, depends on the correlation between asset values and exchange rates. Ultimately, international finance offers a unique set of risks and management strategies that are essential for firms operating in a globalised economy.

- Global financial market interconnectedness

Studying international finance is important for many reasons beyond just understanding how exchange rates affect prices and profits. Because the world's financial markets are now closely connected, events that happen in one part of the world can quickly affect other parts of the world. For example,



changes in oil and gold prices, election results, wars, and peace agreements can all have instant effects on financial markets everywhere. This is because the world has become a single, interconnected financial community, where events in one country's stock market or interest rates can quickly impact other countries. As a result, it is no longer possible to focus on just one part of the financial system, because everything is now so closely linked.

1.1.1.4 The Rising Importance of International Finance

International finance has a significant impact on our daily lives and the overall well-being of a country. One important aspect of international finance is the value of a country's currency. A strong currency can greatly improve a country's standard of living. When a currency is strong, it can buy more goods and services from other countries, making imports cheaper. This means that citizens can afford to buy more foreign-made products, which can improve their overall quality of life. Additionally, a strong currency also makes domestic products that are traded globally more affordable for citizens. This is because citizens have to compete with foreigners to buy their own country's tradable products, so a strong currency gives them an advantage. Furthermore, when comparing living standards between countries, a rising currency can move a country up the rankings. This is because a country's income is converted into a common currency, usually the US dollar, to make comparisons. So, when a country's currency value rises, its citizens' incomes become worth more in global terms, improving their standard of living.

- Global currency impacts standards

When money is invested wisely around the world, everyone benefits. This is because investments can be made in the most promising projects globally, leading to higher returns. These extra returns can then be shared among investors worldwide. It is worth taking a closer look at how goods and money move around the world. By doing so, we can see the benefits of international trade and investment. It becomes clear that international finance plays a vital and increasingly important role in our global economy.

- International finance boosts growth

People and countries have been trading with each other for thousands of years. Looking at the records, we can see that international trade has grown faster than trade within countries. For example, since 1950, global trade has increased

- International trade drives growth

by about 6% every year, which is twice as fast as the growth of the global economy. In the 19th century, international trade grew incredibly fast, increasing by 25 times in the 100 years leading up to World War I. Even in the last 40 years, the value of international trade has tripled, showing just how important and growing international trade is (Table 1.1.1). Figure 1.1.1 shows how trade has become more important for several countries. It shows what percentage of each country's GDP comes from exports.

Table 1.1.1 Aggregate International Trade Versus GDP

Year	World Exports (billion US\$)	Exports/GDP (%)
1999	4945.9	16
1995	4531.7	15.7
1990	3070	14.2
1985	1610.8	13.7
1980	1541.3	14.7

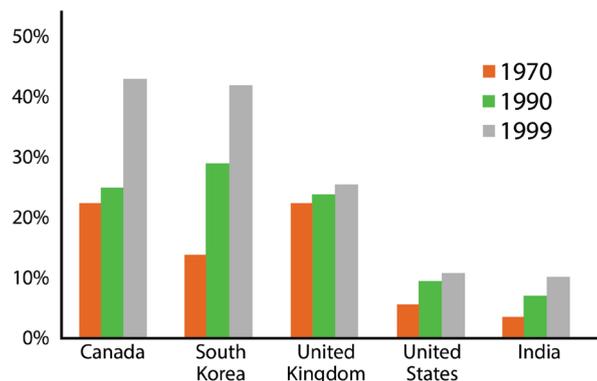


Fig. 1.1.1 Percentage of GDP arising from Exports

Source: National Account Statistics: Analysis of Main Aggregates, United Nations, New York, 2003.

There are two main reasons why international trade has grown so quickly:

- Trade growth driven factors

1. Countries have made it easier to trade and invest by reducing barriers like taxes on imports, limits on quantities, and controls on money movement.

2. Advances in communication and transportation technology have made the world feel smaller, reducing costs and making it easier to do business with other countries.

- Regionalisation simplifies trade

Many countries have formed groups to make trade easier. For example, the European Union (EU) is a group of over two dozen countries that includes Sweden, Malta, Portugal, and Greece. Another example is the North American Free Trade Agreement (NAFTA), which is a trade group made up of the United States, Canada, and Mexico. There are also other trade groups, such as the Association of South East Asian Nations (ASEAN), which includes countries like Indonesia, Malaysia, and Thailand. These groups have made it easier for countries to trade with each other, and as a result, more and more trade is happening within these groups. This trend is called regionalisation, and it has important effects on currencies. For instance, many countries in the EU have adopted the euro as their common currency. This helps reduce the costs and risks of exchanging money when doing business within the group. In fact, many countries have stopped using their old currencies, like the German mark and Italian lira, in favour of the euro.

- Technology reduces trade barriers

The cost of communicating and transporting goods and people over long distances has dropped dramatically. For example, the cost of making a long-distance phone call has decreased by more than 90% since the 1920s. This is because new technologies have made it possible to make calls more quickly and cheaply. In the past, long-distance calls had to be connected manually by operators, which took a lot of time. Now, calls can be connected instantly and automatically. Travelling for business has also become much cheaper and more convenient. It's almost as affordable for a US executive to meet a client in Asia or Europe as it is to meet another executive in a different US city. This is because air travel has become more efficient and cost-effective. The cost of shipping goods by air or sea has also decreased rapidly. This is because of advances in transportation technology, such as bigger and more efficient aeroplanes and ships. As a result, businesses can now easily

operate globally, leading to a huge increase in international trade and financial transactions.

Summarised Overview

International finance is about how money moves between countries, helping them get access to foreign funds, manage risks, and make the most of investments. Understanding international finance is crucial for businesses to navigate global events, reduce risks, and take advantage of opportunities. As the world becomes more connected, international finance plays a bigger role, with global trade growing faster than local trade. This growth is driven by fewer trade barriers, improved technology, and countries forming trade groups. By studying international finance, businesses can make informed decisions, manage global risks, and capitalise on opportunities in a world where economies are increasingly linked.

Assignments

1. What are the key differences between international trade and international finance? Provide examples to illustrate your answer.
2. Explain the need for international finance.
3. Discuss the benefits of studying international finance.
4. Explain the importance of international finance.
5. What is meant by regionalism?

Reference

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2. Paul R. Krugman, Maurice Obstfeld, and Marc Melitz (2018) "*International Economics: Theory and Policy*", Pearson (11th edition) (or 10th edition).

Suggested Reading

1. Copeland, L (2014) *Exchange Rates and International Finance* Harlow: Prentice Hall, (6th edition)
2. Davis, Donald, "*Notes on Competitive Trade Theory*", Columbia University (Pages 1-16) <http://www.columbia.edu/~drd28/Tex>



Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

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UNIT 2

Understanding International Financial Risk: Types and Implications

Learning Outcomes

After reading this unit, the learner will be able to:

- analyse different types of international financial risks that can impact investments and businesses
- understand how international financial risks can affect investments, businesses, and the economy as a whole
- develop effective strategies to minimise and manage international financial risk

Background

Managing international financial risks is very important for businesses and investors who operate globally. When companies do business in other countries, they face many risks that can affect their money and success. These risks can come from changes in exchange rates, government policies, and cultural differences. If companies do not manage these risks well, they can lose money, damage their reputation, and struggle to compete. To avoid these problems, businesses and investors need to understand the different types of international financial risks and know how to manage them. This includes risks such as exchange rate fluctuations, political instability, and variations in laws and regulations. By understanding and managing these risks, companies can protect their investments, stay competitive, and achieve their long-term goals. They can use strategies like diversifying their investments, hedging against risks, and following local laws and regulations.

Keywords

International Business Risks, International Non-Payment Risks, Cultural Business Risks, Exchange Rate Volatility



Discussion

- Managing currency exchange risk

1.2.1 Risk of International Finance

International trade comes with its own set of risks. One of the biggest risks is the uncertainty of exchange rates. When exchange rates change suddenly, it can affect the sales, prices, and profits of companies that import and export goods. For example, Japanese Electronics Company buys computer chips from the US for \$100 each. But if the yen suddenly becomes weaker compared to the dollar, the company will have to pay more yen for the same chips. For instance, if the exchange rate changes from 100 yen to 110 yen per dollar, the company will now pay 110,000 yen instead of 100,000 yen for 10 chips. This increase in costs can hurt the company's profits.

(i.e., Let's say a company is buying 10 chips, and each chip costs \$100.

Total cost in USD = 10 chips × \$100 = \$1,000

Exchange Rate 1: 100 yen per 1 dollar

At this rate, the company needs 100 yen to buy 1 USD.

So, to buy \$1,000, the company must pay:

$100 \text{ yen} \times 1,000 = 100,000 \text{ yen}$

Exchange Rate 2: 110 yen per 1 dollar

Now the yen has weakened (you need more yen to buy the same 1 USD).

So, to buy \$1,000, the company must now pay:

$110 \text{ yen} \times 1,000 = 110,000 \text{ yen}$

1.2.1.1 International Financial Risk-Types

Changes in exchange rates can affect the prices, sales, and profits of companies that import and export goods. But it's not always a straightforward effect. For example, if the British pound gets weaker compared to the US dollar, it might seem like Scottish whiskey would become cheaper for American buyers. But if the Scottish company raises its price in pounds

- Fluctuation effects on international trade currency

to keep up with the change in exchange rates, the price in dollars might stay the same. This shows that to understand how exchange rates affect businesses, we need to look at the bigger picture of inflation and how it relates to exchange rates. This means studying international finance from both a country-wide and company-level perspective.

- International business risks

Exporters and importers face many risks when trading internationally, and exchange rate changes are just one of them. Another major risk is 'country risk,' which means that a company may not get paid for its exports due to war, revolution, or other political or social events in the buyer's country. This risk also applies to investments made in other countries, and it's hard to get your money back or take legal action when something goes wrong. Additionally, foreign companies may want to pay but may be unable to pay due to unexpected government restrictions. Other risks of doing business abroad include not knowing if tariffs or quotas will be imposed or changed if local producers will get subsidies, or if non-tariff barriers like quality requirements will be put in place to favour local companies.

- Minimising international trade uncertainty

Over time, new ways of doing business have been developed to help companies manage the extra risks of trading internationally. For example, special contracts can protect importers and exporters from unexpected changes in exchange rates. Insurance and letters of credit can also reduce the risk of not getting paid when selling to foreign buyers. As international trade becomes more important for countries around the world, it is essential to learn about the tools and practices that can reduce risks. We also need to understand the underlying reasons for these risks, so we can navigate the world of international trade with confidence.

- Mitigating international non-payment risk

When companies sell goods or services to other countries, there is a risk that the buyer won't pay. This is called non-payment risk. For example, a Chinese company might sell textiles to a buyer in Nigeria, but the buyer might not have enough money to pay due to financial problems. This can cause big financial losses for the Chinese company, and they might not be able to get their money back. To avoid this, companies should check the buyer's credit history carefully, ask for payment in advance, or use special financial tools like letters of credit to protect themselves.

- Tariffs and quotas increase import costs, risks

When countries import or export goods, they face a risk called tariff and quota risk. Tariffs are taxes on imported goods, while quotas limit the amount of goods that can be imported. For example, if the US adds a 25% tax on steel imported from China, a US company buying that steel will have to pay 25% more, increasing its costs and reducing profits. Similarly, quotas can limit the amount of goods imported, causing shortages and higher prices. To avoid these problems, companies can find new suppliers, share tariff costs with suppliers, or sell goods in other countries without tariffs or quotas.

- Managing non-tariff obstacles

When companies trade internationally, they may face obstacles other than tariffs, known as non-tariff barriers. These barriers can include rules and regulations, product standards, labelling requirements, and licensing procedures that can make it hard or expensive to export or import goods. For example, a European company exporting food to the US may have to follow strict food safety rules, label their products in a certain way, and get certifications, which can increase costs and delay shipments. Similarly, a Chinese company exporting electronics to India may have to deal with regulations, testing, and certification procedures, and pay licensing fees, making it hard to enter the Indian market. To avoid these problems, companies can research and follow the rules, get necessary certifications and licenses, and work with local experts to navigate complex regulations.

- Managing logistical supply risks

Logistical and supply chain risks arise when problems occur in getting goods from one place to another. This can happen because of delays in shipping, mistakes in storing goods, damage to warehouses, problems with customs, or natural disasters. For example, a company sending electronics from China to the US might have problems like delayed shipments, damaged goods, or troubles related to customs. This can cause the company to run out of stock, lose sales, and hurt its reputation. To avoid these problems, companies can make plans to deal with potential problems, work with many suppliers, and invest in systems to manage inventory.

- Managing cultural business risks

When companies do business in other countries, they face cultural and language risks. This means they might misunderstand or offend local people because of differences in culture, customs, and language. For example, a US company might export products to a Middle Eastern country without knowing the local customs, causing unintended offence.

Similarly, a Chinese company might struggle to communicate with European customers due to language barriers. To avoid these problems, companies can research local cultures, provide language training, partner with local businesses, and teach employees about cultural sensitivity.

- Managing regulatory compliance risks

Regulatory and compliance risk happens when companies do not follow laws, rules, and industry standards. This can lead to fines, penalties, and damage to a company's reputation. For example, a company might export products to another country without following that country's rules, or a company might not protect customer data properly. To avoid these problems, companies should research and follow all relevant laws and rules, train employees in compliance, and regularly check to make sure they are following all the rules.

- Managing international financial risk

To avoid problems with international finance, companies and individuals need to be careful and plan ahead. This means researching the market and understanding the local rules and regulations. It is also a good idea to spread investments across different countries and industries to reduce risk. Companies can use special tools like hedging to protect against changes in currency and interest rates. Building relationships with local partners and staying informed about changes in regulations can also help. Additionally, using special financial tools like letters of credit and insurance can protect against non-payment and other risks. Finally, getting advice from experts in international finance can help individuals and companies make informed decisions and avoid problems.

1.2.2 Growing Global Interconnectedness of Financial and Physical Markets

- Globalisation of financial markets

As international trade has become more important, investing in other countries has also become more important. This includes investing in stocks, bonds, real estate, and businesses in other countries. Sometimes, foreign investors have become more important than domestic investors. For example, there have been times when foreign investors, such as those from Japan, China, and Germany, have bought more US government bonds than American investors. This has made it important for the US government and financial companies to pay attention to what's happening in other countries, so they can plan their sales of securities at the right time. Investors and borrowers are now thinking globally, and this has led to the creation of many new financial products that allow people to invest in

other countries. These products, such as international mutual funds, have become very popular and show how much financial markets have become global.

There are different types of investment funds that allow people to invest in other countries. For example, ‘International funds’ only invest in foreign countries, not in the US. ‘Global funds’ invest in both US and foreign assets. ‘Emerging country funds’ focus on investing in smaller countries like Thailand, Turkey, and Indonesia. Many people also buy foreign stocks and bonds directly, without using investment funds. The growth of global investment has also changed the real estate market and other markets. While investing globally can bring big rewards, it also comes with big risks. People can make a lot of money, but they can also lose a lot, depending on when and where they invest.

- Global investment fund options

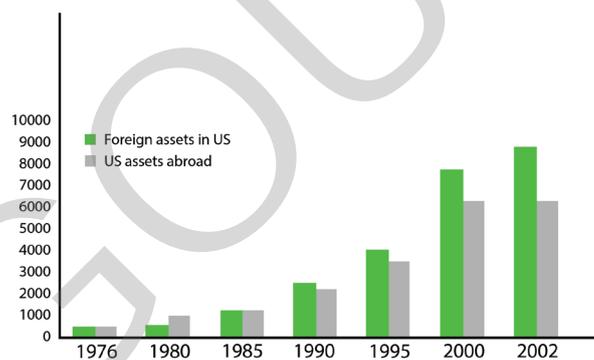


Fig.1.2.1 The growth in the globalisation of investment viewed from US perspective

1.2.3 Globalisation of Investment: The Costs Involved

The benefits of global investment come with a cost. This cost includes the risk of changes in exchange rates and country risks. When exchange rates change unexpectedly, it can be uncertain how much money you will have in your own currency. For example, imagine you are a US investor with £100 in a London bank. If the exchange rate is \$1.6 per pound, your £100 is worth \$160. But if the pound suddenly drops in value to \$1.5, your £100 is now only worth \$150. This can also affect debts. If you owed £100, the drop in value would actually help you, as you would only owe \$150 instead of \$160.

- Global investment currency risk

- Understanding exchange rate risk exposure

When you have money in a foreign bank account or owe money in a foreign currency, you face a risk called exchange-rate risk. This risk comes from not knowing what the exchange rate will be in the future, which affects how much your money is worth in dollars. But exchange-rate risk is not just limited to bank accounts and debts. It can also affect the value of other assets like foreign stocks, bonds, and property. For example, if you own a foreign stock, its value in dollars can change not only because of exchange rates but also because of changes in the stock's value in its local market. It is also important to note that just because an asset or debt is in a foreign country, it does not automatically mean it is subject to exchange-rate risk, and vice versa.

- Global market interconnectedness risks

As investments become more global, the risk of exchange rate changes also increases. Another risk is that financial markets in different countries are becoming more connected. This means that when one market goes up or down, others may follow, making it harder to spread risk by investing in different countries. There have been many examples of this happening. For instance, the Asian financial crisis in 1997-98 started in Thailand but quickly spread to other countries like South Korea, Malaysia, and Indonesia. The crisis even affected countries in South America, Europe, and North America. This spreading of financial crises from one country to another is called 'contagion.' It shows how closely connected the world's financial markets have become.

- Country risk includes political and financial threats

The growth of global investment has not only increased the importance of managing foreign exchange risks, but it has also exposed investors to a new risk called country risk. Country risk refers to the possibility that a foreign government might take control of or destroy an investor's property, or that a war or revolution might damage or destroy it. Additionally, country risk includes the possibility that a foreign government might change its tax laws or restrict an investor's ability to bring their money back home.

1.2.4 Greater Exchange Rate Volatility

- Managing exchange rate risk

The rapid growth of international trade and investment has made it essential for business students to learn about international finance. But there is another important reason why this knowledge is crucial. The value of different currencies can fluctuate greatly, creating a risk for businesses that operate globally. This fluctuation, known as exchange-rate volatility,

can sometimes increase even more than the amount of foreign trade and investment. This volatility makes it important for businesses to understand how to manage exchange-rate risk and navigate the complexities of international finance.

- Managing currency value risks globally

The value of currencies like the dollar, euro, and yen has been changing very quickly and unpredictably. This has been making news, even outside of the business world. Sometimes, it is because of problems in countries like Russia or the Middle East. Other times, it is because of economic news from a major country. As a result, huge amounts of money are being made and lost every day. This is happening more often than ever before, which means that understanding and managing the risks of these changing currency values is more important than ever. With international trade and investment becoming increasingly important, it is essential to know how to deal with these risks and protect your money.

- Factors behind exchange rate volatility

There is no clear reason why exchange rates have been changing so much. Some people blame the change to flexible exchange rates in 1973, but others argue that the old fixed-exchange-rate system would not have been able to handle the big shocks that have happened since then, such as sudden changes in oil prices, wars, and terrorist attacks. What is clear is that the increased flow of money around the world, made possible by new technologies, has played a role. This has allowed money to move quickly from one country to another in search of the highest returns or to find safety.

1.2.5 Growing Importance of Multinational Corporations

- Rise of multinational corporations

In addition to the growth of international trade and investment, multinational corporations have become increasingly important. This is because these companies are investing more and more across borders. In fact, this type of investment has grown four times faster than the global economy and three times faster than international trade. There are over 35,000 multinational corporations, with the largest 100 controlling approximately 16% of the world's productive assets. These massive companies have a lot of power, which has raised concerns among governments and the public. People worry that these companies might use their power to influence governments and take advantage of workers and consumers, especially in smaller countries. Even in the United States, the

world's largest economy, there are concerns about foreign multinational corporations gaining too much control.

Summarised Overview

Understanding international financial risk is crucial for investors and businesses operating globally. Various types of risks exist, including exchange rate risk, which arises from fluctuations in currency exchange rates affecting cash flows and returns. Country risk is another significant concern, encompassing political, economic, and social instability in a foreign country that can impact investments. Sovereign risk, transfer risk, operational risk, liquidity risk, inflation risk, interest rate risk, regulatory risk, and cultural and language risk are also pertinent considerations. These risks can have far-reaching implications, including reduced returns, increased costs, decreased competitiveness, reputation damage, and compliance issues. To mitigate these risks, it is essential to conduct thorough research, and understanding the local market, culture, and regulatory environment. Diversifying investments across different markets and asset classes can also help spread risk. Additionally, hedging against risks using financial instruments, continuously monitoring and reviewing international financial risks, and developing a comprehensive risk management plan are critical strategies for identifying, assessing, and mitigating international financial risks. By adopting a proactive and informed approach to risk management, investors and businesses can navigate the complexities of international finance and achieve their goals.

Assignments

1. Explain different types of international risk.
2. What are the implications of international financial risk?
3. Explain the concept of exchange rate risk and its impact on international trade and investment.
4. Analyse the different types of risk management strategies used in international finance.
5. What is the role of risk assessment in international finance?

Reference

1. Levi, M.D.(1996), *International Finance: The Markets and Financial Management of Multinational Business*, 3rdEdition, McGraw Hill International Editions, Finance Series.
2. Paul R. Krugman, Maurice Obstfeld, and Marc Melitz (2018) "*International Economics: Theory and Policy*", Pearson (11th edition) (or 10th edition).



Suggested Reading

1. Paul R. Krugman, Maurice Obstfeld, and Marc Melitz (2018) “*International Economics: Theory and Policy*”, Pearson (11th edition) (or 10th edition).
2. Kindleberger C P, *International Economics* (1973) Routledge, London

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

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UNIT 3

International Investment and Financing Decisions

Learning Outcomes

After completing this unit, the learner will be able to:

- analyse how costs affect investment and borrowing decisions
- understand how to manage money across different countries
- develop expertise in making strategic investment decisions in global markets
- assess the potential of foreign investments

Background

When companies do business globally, they need to make smart decisions about how to use their money. This includes deciding whether to invest in new projects or borrow money to grow their business. However, these decisions come with extra costs, such as fees and taxes that can affect how much money they make. To make things more complicated, companies also have to manage their cash flow, which means making sure they have enough money to operate their business every day. This can be especially tricky when doing business in other countries, where exchange rates, taxes, and other rules can be different. Investing in other countries can also be complex, but using special techniques like portfolio management, and capital asset pricing can help companies make informed decisions. Finally, when companies are thinking about investing in a new project in another country, they need to carefully consider whether it is a good idea. This involves looking at how much money they might make, how much risk is involved, and whether the project aligns with their overall goals. By carefully thinking through these decisions, companies can make smart choices that help them grow and succeed globally.

Keywords

Transaction Cost, Centralised Cash Management, Netting, Currency Diversification, Pooling, Portfolio Investment, Capital Asset Pricing, Capital Budgeting

Discussion

- Companies balance liquidity needs with investment returns

Companies, especially big ones with global operations, face uncertainty in managing their cash inflows and outflows. To stay flexible, they need to maintain liquidity, which means having enough easily accessible funds. Liquidity can come in various forms, such as cash, bank deposits, or short-term investments. While holding too much liquidity can mean missing out on potential earnings, there are many short-term investment options available that can help companies balance their need for liquidity with their desire to earn returns on their funds.

- Managing global working capital effectively

The main goals of managing working capital effectively in a global setting are two-fold. Firstly, companies aim to invest their short-term funds and cash in different currencies and countries to earn the highest possible returns. Secondly, companies seek to borrow money from various markets around the world to get the best interest rates and minimise their borrowing costs.

- Managing corporate liquidity effectively

To achieve their financial goals, companies must balance two key things: having enough cash on hand (liquidity) and minimising risks. Even companies that only operate locally may want to explore foreign markets to earn higher returns or borrow at lower costs. However, companies with global operations face additional challenges, such as managing cash flow across different countries and minimising costs and risks related to foreign exchange, politics, and taxes. This chapter will examine these issues and provide examples of how companies manage their cash flow globally.

Will start by examining whether companies should invest or borrow in their home currency or a foreign currency while managing foreign exchange risks using forward contracts. We will discuss the criteria for making these decisions, considering factors like transaction costs. Next, will examine whether



- Managing global cash flow risks

companies with international operations should manage their working capital locally or centrally. Will weigh the advantages and disadvantages of centralising cash management, highlighting the benefits of a coordinated approach.

1.3.1 Investment and Borrowing with Transaction Costs

- Evaluating investments with costs

Investment criterion with transaction costs refers to the process of evaluating investment opportunities while considering the costs associated with buying, selling, or exchanging assets. These costs can include: brokerage fees, commissions, exchange fees, taxes, and other expenses. When companies look at investment opportunities, they need to think about the extra costs involved. These costs, called transaction costs, can include things like fees, commissions, and taxes. To make a smart decision, companies need to compare the potential returns on investment to the costs of investing. This is called the investment criterion with transaction costs.

Here is how it works:

- Companies need to compare the potential returns on investment to the costs of investing

1. Companies look at the expected returns on investment, which is the profit they hope to make.
2. They then consider the costs of investing, including transaction costs.
3. By comparing the expected returns to the costs, companies can decide which investment is the best choice.
4. The goal is to choose the investment that earns the most money while keeping costs as low as possible.

Suppose a US-based company is considering investing £100,000 in a British business. The expected return on investment is 10%, which would earn the company £10,000 in profit,

However, the company also needs to consider the transaction costs involved in exchanging dollars for pounds. Let us say the exchange rate is 1 USD = 0.80 GBP, and the company needs to pay a 2% transaction fee to exchange its dollars for pounds.

To calculate the true return on investment, the company needs to subtract the transaction costs from the expected return.

Here is the calculation:

Expected return: £10,000

Transaction costs: 2% of £100,000 = £2,000

Net return: £10,000 - £2,000 = £8,000

In this example, the company needs to consider the transaction costs involved in exchanging dollars for pounds, which reduces the true return on investment from £10,000 to £8,000.

1.3.1.2 Borrowing Criterion with Transaction Costs

- Borrowing with added costs

Borrowing criterion with transaction costs means considering all the costs involved when borrowing money, including interest rates, fees, and other expenses, to make an informed decision. In other words, when a company needs to borrow money, it must consider not only the interest rate it will pay but also the additional costs associated with borrowing, like origination fees, commitment fees, interest rate spreads, currency exchange fees (if borrowing in a foreign currency) etc.

1.3.2 International Dimension of Cash Management

- Managing global cash flows

The international dimension of cash management refers to the process of managing money and cash flow across different countries and currencies. It is about dealing with the special challenges and benefits that come with managing money globally. International cash management involves several key activities. First, companies need to manage the risk of exchange rate fluctuations to protect their money. They also need to pool cash from different countries into one account to make the most of their money. Additionally, companies must predict their future cash needs in different countries and currencies. They also need to manage the process of buying and selling currencies for international trade and investment. Furthermore, companies must comply with different laws and regulations in each country. They also need to coordinate cash management activities across different time zones to ensure timely and efficient management. Finally, companies use specialised tools and technologies to manage their cash flows and liquidity across international borders.

1.3.2.1 Advantages of Centralised Cash Management

- The process of managing a company's cash flows and liquidity

In today's global business environment, effective cash management is major for companies to maintain liquidity, reduce costs, and increase profitability. Centralised cash management refers to the process of managing a company's cash flows and liquidity from a single, central location. This approach offers numerous advantages over decentralised cash management, where each business unit or subsidiary manages its cash flows.

1. Netting

- Streamlining global cash management

Big companies with offices in many countries can get confused about their money if each department handles its own finances. To avoid this, companies use a process called netting. Netting means adding up all the money coming in and going out in each currency, so the company can see its overall position. This helps the company make smart decisions and avoid unnecessary costs. By managing cash centrally, companies can also save money by reducing transaction costs. This happens when different departments have opposite needs in the same currency, allowing them to cancel out some transactions. The company can then manage its cash flow better by speeding up or slowing down payments.

- Managing cash flow timing

Leading and lagging are cash management techniques that involve moving payments forward or backwards in time. This helps companies match their income and expenses, reducing financial risks. For example, imagine a company called Aviva that needs to pay £1 million for denim on June 10. If Aviva is also expecting to receive £1 million for jeans from Britain around the same time, it might try to arrange the payment dates to match, avoiding financial exposure. If Aviva receives the payment for the jeans earlier than expected, it's called leading. If it delays a payment, it is called lagging.

2. Currency Diversification

- Reducing currency risk exposure

When a company manages its cash from a central location, it can not only balance its income and expenses in each currency but also consider how to reduce its foreign exchange risk. By having cash flows in multiple currencies, the company can spread out its risk, because exchange rates don't always move in the same direction. This means that the overall risk of the

company's cash flows is lower than the sum of the risks of each individual currency. In simple terms, diversifying cash flows across different currencies can help reduce the company's exposure to exchange rate fluctuations.

Let us say Aviva, a clothing company, buys fabric from Britain and sells its finished clothes in both Britain and Germany. Here are the details:

Tale 1.3.1 Example of Currency Diversification

	Germany(€)	Britain(£)
Denim Purchase	0	2,000,000
Jeans Sales	1,500,000	1,000,000

The payment for denim from Britain and the sale of jeans happen at the same time. Think of it like this: the money Aviva receives from selling jeans in Britain is like income from an investment, and the money Aviva pays for denim from Britain is like paying back a loan. Aviva can hedge exchange rate risks by selling forward £1.5 million and buying forward £1 million. Alternatively, the company can consider the correlation between the British pound and the euro against the US dollar. If the two currencies move together, Aviva can use this correlation to manage its exchange rate risks.

3. Pooling

Pooling is a cash management strategy where a company holds and manages its cash in a central location. This approach offers several benefits, including higher returns on investments due to economies of scale. By pooling its cash, a company can meet its cash needs anywhere in the world without having to maintain separate cash reserves in each country. This reduces the need for precautionary balances and minimises the risk of running out of cash. Pooling works because cash surpluses and shortages in different locations don't always happen at the same time. For example, if a company has a large cash outflow in Britain, it is unlikely to have a similar outflow in Australia or Japan at the same time. By pooling its cash, the company can use its central reserves to meet cash needs in different locations, reducing the need for large cash reserves in each country.

- Centralising cash management globally

4. Security Availability and Efficiency of Collection

When a company centralises its cash management in a major financial hub like London or New York, it gains additional benefits. These hubs offer a wider range of investment options and more efficient financial systems. To take advantage of this, companies can try to conduct as many transactions as possible in a major currency, such as the US dollar. They can also specify that payments be made to a specific bank branch or office in the financial hub. To ensure timely payments, companies can include penalties for late payments in their contracts. Additionally, using post-office box numbers and electronic funds transfer systems with multinational banks can speed up the collection of payments. This allows companies to quickly credit payments to their head office accounts, even if the payment is made at a foreign branch of the bank.

- Optimising international cash flow

1.3.2.2 Disadvantages of Centralised Cash Management

While centralising cash management in a major financial hub offers benefits, it is often not feasible to hold all cash in one location. Unpredictable delays in transferring funds to other countries can occur, making it essential to hold excess cash balances locally, especially for critical payments. Advance planning can help reduce these issues, but substantial allowances for potential delays should be made, particularly in countries with less efficient banking systems.

- Managing global cash flows

While it is theoretically possible to centralise working capital management, complete centralisation can be challenging due to the need for local representation to deal with local clients and banks. Multinational banks can facilitate centralised management, but local issues may still arise, requiring on-site attention. Therefore, firms must determine the optimal degree of centralisation for cash management and holdings, and decide which activities and currencies should be decentralised to balance global efficiency with local needs.

- Balancing centralised cash management

If interest parity were held exactly, cash management would be simplified, as borrowing and investing in different currencies or countries would have the same outcome. However, factors like transaction costs, political risk, liquidity preference, and taxes can cause deviations from interest parity. Each of these factors has distinct implications for working-capital management, affecting borrowing, investing, and cash flow decisions.

- Centralised cash control strategies

1.3.2.3 Transaction Costs, Political Risk, Liquidity Preference, Taxes, and Cash Management

- Optimising foreign currency holdings

To minimise transaction costs, companies should consider keeping funds in the original currency received, especially if they anticipate needing the same currency for future payments. For instance, if a firm receives 2 million Korean won from a subsidiary in South Korea and expects to make a payment in won within a month or two, it is best to keep the funds in won, unless higher yields in other currencies can offset the double transaction costs of converting won to another currency and back to won.

- Minimising international transaction costs

Withholding taxes and tax rates on foreign exchange gains and interest income can impact international cash management decisions. Companies should avoid investing in countries with high withholding tax rates that exceed their domestic tax rate, as they may not receive full withholding tax credit. Conversely, investing in countries with currencies at a forward premium may be advantageous if foreign exchange gains are taxed at a lower rate than interest income. However, for multinational firms with extensive international operations, tax rates on foreign exchange gains and interest earnings are likely to be uniform, minimising the need to favour specific markets.

The factors affecting the location of working capital are summarised in Table 1.3.2 given below:

Table 1.3.2 Factors Affecting Working-Capital Management

Factor	Implication
Absence of forward market	Keep funds in the currency received if an anticipated future need exists
Transaction costs	Keep funds in the currency received
Political risk	Move funds to the domestic market
Liquidity requirements	Keep funds in the currency most likely to be needed in the future

Taxes

Avoid high withholding taxes and keep funds in appreciating currencies

1.3.3 Portfolio Investment

- Diversifying investment portfolios globally

Portfolio investment refers to investing money in a variety of assets, such as stocks, bonds, mutual funds, and real estate investment trusts (REITs), intending to earn a financial return. This type of investment involves diversifying across different asset classes, sectors, and geographic regions to reduce risk and does not involve actively managing or controlling the underlying assets. International investment offers individual investors a more efficient portfolio, providing higher expected returns and/or reduced risks compared to domestic investment alone. By diversifying internationally, investors can benefit from a better allocation of financial capital and a smoother wealth stream.

1.3.3.1 The Benefits of International Portfolio Investment

- Diversification reduces investment risk

Investors typically demand higher returns for taking on riskier investments. However, by spreading investments across different assets, investors can reduce risk. This is because different assets often perform differently, so when one asset loses value, another may gain. By choosing the right mix of investments, an investor can achieve the best possible return for a given level of risk. Additionally, the less correlated the investments are, the greater the benefits of diversification, allowing investors to minimise risk and maximise returns.

- Limited domestic diversification benefits

Within a country's economy, different investments do not always move in perfect synchronisation, allowing for some diversification benefits. However, the overall state of the economy tends to affect various investments similarly, limiting their independence. As a result, diversifying within a single country has its limits, and investors may not be able to reduce risk as much as they would like.

- International diversification reduces risk

Investing in different countries can provide more diversification benefits than investing only within one country. This is because countries have different economies and industries, and their business cycles don't always match. As a result, adding foreign investments to a portfolio can reduce risk, even if the expected

returns are lower. For example, a US investor might include British stocks in their portfolio to reduce risk, even if they offer lower returns than US stocks.

The benefits of international portfolio investment are as follows:

1. Diversification: Investing in different countries and asset classes can help reduce the risk of your investments. This is because different markets and asset classes often perform differently. By spreading your investments across different markets and asset classes, you can reduce your exposure to any one particular market or sector.

2. Higher Returns: Investing in international markets can provide higher potential returns than investing only in your home country. This is because some international markets may be growing faster than your home market, or may offer higher returns due to different economic conditions.

- International portfolio investment boosts returns and reduces risk

3. Reduced Risk: Investing internationally can help reduce the overall risk of your portfolio. By spreading your investments across different markets and asset classes, you can reduce your exposure to any one particular market or sector. This can help you ride out market ups and downs and achieve more stable returns.

4. Easier to Sell: Investing in international markets can provide easier access to cash when you need it. This is because some international markets may be more liquid than your home market, meaning you can buy and sell investments more easily.

5. Protection from Currency Fluctuations: Investing internationally can help protect your investments from changes in currency values. This is because currency fluctuations can affect the value of your investments. By investing in international markets, you can potentially reduce your exposure to currency risk.

6. Access to New Investment Opportunities: Investing internationally provides access to new markets and sectors that may not be available in your home country. This can help you diversify your portfolio and potentially earn higher returns.



7. Improved Investment Performance: Investing internationally can help optimise your investment portfolio and achieve your investment goals more effectively. By investing in a diversified portfolio of international investments, you can potentially earn higher returns, reduce risk, and improve your overall investment performance.

1.3.4 International Capital Asset Pricing

International Capital Asset Pricing (ICAPM) is a financial tool that helps investors understand how to balance risk and potential returns when investing globally. It builds on the traditional Capital Asset Pricing Model (CAPM) to account for the unique risks and opportunities of international investments. The main question in international finance is whether investments are priced based on a global market or separate local markets. If it is a global market, the expected returns on investments will be based on their risk level when part of a diversified global portfolio. This means that while diversifying globally is still beneficial, the expected returns on foreign investments will be fair for their level of risk. On the other hand, if investments are priced in separate local markets, their returns will be based on the risk level of their local market. This means that if an investor can find a way to invest in a foreign market that is normally closed to them, they may be able to earn higher returns.

- Pricing global investment risk

1.3.4.1 The Domestic Capital Asset Pricing Model (CAPM)

The Capital Asset Pricing Model (CAPM) is a widely used financial framework that helps investors grasp the intricate relationship between risk and expected returns within a domestic market. This model, pioneered by William Sharpe in 1964, is grounded in the fundamental principle that investors inevitably demand higher returns as compensation for assuming greater risk. The CAPM formula integrates three pivotal components to estimate the expected return on an investment. Firstly, the risk-free rate (R_f) represents the return on an investment devoid of any risk, such as U.S. Treasury bonds. Secondly, the expected market return (R_m) denotes the anticipated return on the overall stock market. Lastly, beta (β) serves as a quantitative measure of an investment's systematic risk relative to the broader market. By leveraging the CAPM formula, $R_i = R_f + \beta_i (R_m - R_f)$, investors can accurately

- Measuring investment risk returns

determine the expected return on investment and make well-informed decisions regarding their investment portfolios.

1.3.4.2 The International Capital Asset Pricing Model, ICAPM

The International Capital Asset Pricing Model (ICAPM) is an extension of the traditional Capital Asset Pricing Model (CAPM) that incorporates international investments and risk factors. ICAPM helps investors understand the relationship between risk and expected return for international investments.

The ICAPM model consists of several key components. The global market portfolio is a portfolio that includes all investable assets worldwide. International beta measures the systematic risk of an investment relative to the global market portfolio. Country-specific risk refers to the risk associated with investing in a particular country, such as political risk, economic risk, and currency risk.

- Pricing international investment risk

- Takes into account the international beta, country-specific risk premium, and the expected return on the global market portfolio

The ICAPM formula is an extension of the traditional CAPM formula. It takes into account the international beta, country-specific risk premium, and the expected return on the global market portfolio. The formula is:

$$R_i = R_f + \beta_i (R_m - R_f) + \lambda_i (R_p - R_f).$$

This formula helps investors calculate the expected return on an investment based on its international beta, country-specific risk premium, and the expected return on the global market portfolio.

- Managing international investment risk

ICAPM provides a framework for investors to understand the risks and returns associated with international investments. It suggests that investors should diversify their portfolios globally to minimise risk and maximise returns. ICAPM also highlights the importance of managing country-specific risk factors and currency risk when investing internationally. Overall, ICAPM is a useful tool for investors who want to understand the risks and returns associated with international investments. It provides a framework for investors to make informed investment decisions and manage their portfolios effectively.

1.3.4.3 Segmentation versus Integration of Capital Markets: A Graphical View

- Integrated versus segmented capital markets

The implications of integrated versus segmented capital markets in terms of the risk-return framework that is used frequently in the domestic context to describe diversification benefits can be explained in the below diagram.

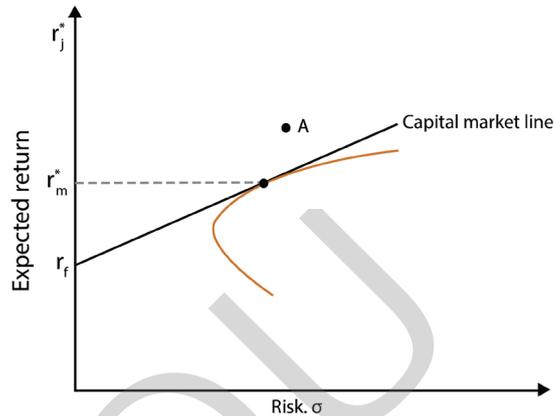


Fig 1.3.1 Investments Balance Risk and Return

Figure 1.3.1 shows how investments balance risk and return. The vertical axis shows expected returns, and the horizontal axis shows total risk. The curved line on the graph shows the best combinations of risk and return that can be achieved with different investments. The point where the curved line meets a straight line drawn from the risk-free interest rate is called the market portfolio. This straight line is called the capital market line, and it shows the expected returns and risks of combining a risk-free asset with a portfolio of investments. In simple terms, this graph helps investors understand how to balance risk and return, and how to make the best investment choices.

- Balancing risk and return

If global markets are connected, the risk-free interest rate and expected market return in figure 1.3.1 refer to the global market. This means that investors can benefit from investing in the global market portfolio, which offers the best balance of risk and return. If an investor does not hold the global market portfolio, they may be taking on unnecessary risk and missing out on potential returns. On the other hand, if global markets are separate, investors may be able to earn higher returns by investing in foreign markets, as these investments are not priced by the domestic market. This means that investors

- Diversifying for optimal returns

can potentially earn higher returns by diversifying their investments globally.

1.3.4.4 The Potential Gain from Integration of Capital Markets

Combining stock market indexes from different countries can create a more efficient investment portfolio. For example, a portfolio with the same level of risk as the US market, but with international diversification, could potentially earn a return that is 8% higher than the US market return. This means that investors could earn a higher return without taking on more risk. The benefits of international diversification are substantial and can be further enhanced by regularly reviewing and adjusting the portfolio, as well as protecting against currency fluctuations. Figure 1.3.2 shows the potential gain from the integration of capital markets.

- Investors earn a higher return without taking on more risk

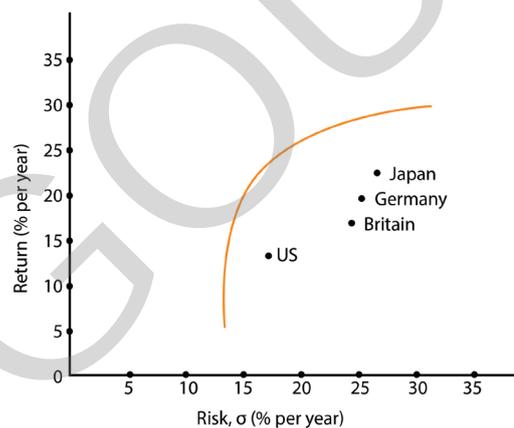


Fig 1.3.2 The Potential Gain From the Integration Of Capital Markets

1.3.5 Capital Budgeting for Foreign Investments

Capital budgeting is a comprehensive process that enables organisations to plan, evaluate, and select long-term investment projects that align with their strategic objectives. It involves identifying and evaluating various investment opportunities, such as new projects, expansions, or acquisitions, and selecting the ones that are expected to provide the highest returns, while also considering factors such as risk, cash flow, and strategic alignment. The capital budgeting process typically involves several steps, including identifying investment opportunities,

- Enables organisations to plan, evaluate, and select long-term investment projects

- Evaluating long-term investment projects

evaluating them using techniques such as net present value (NPV), internal rate of return (IRR), and payback period, selecting the most profitable projects, allocating resources, and monitoring and evaluating the performance of the selected projects. By following this process, organisations can make informed investment decisions, allocate their resources effectively, manage risk and uncertainty, and ensure that their investments align with their overall mission and objectives.

1.3.5.1 Difficulties in Evaluating Foreign Projects

- Evaluating foreign investment risks

Evaluating foreign projects is a very difficult task. As more and more businesses and investors want to expand globally, they need to carefully think about the potential risks and rewards of investing in foreign projects. Investing in foreign projects can be very attractive, but it also comes with many challenges. For example, businesses need to understand the local laws and regulations, manage the risks associated with changes in currency values, and adapt to different cultural and market conditions. To succeed in evaluating foreign projects, businesses and investors need to have a deep understanding of these challenges and be able to make informed decisions. Despite the challenges, foreign projects can offer many benefits, and understanding the difficulties involved in evaluating them is crucial for success in the global market. The difficulties in the evaluation of foreign projects are as follows.

1. Currency Risk

- Managing foreign currency exposure

When evaluating foreign projects, one of the biggest challenges is dealing with currency risk. This means that the project's financial performance can be affected by changes in the exchange rate between the local currency and the foreign currency. For example, if the local currency weakens against the foreign currency, the project's revenues may decrease, even if the project is performing well. To manage this risk, investors need to carefully consider the potential impact of currency fluctuations on the project's financial performance.

2. Inflation and Purchasing Power Parity

- Managing Inflation and Currency

Inflation and purchasing power parity (PPP) can also create challenges when evaluating foreign projects. Inflation can affect the project's costs and revenues, while PPP can impact the project's competitiveness. For instance, if the local inflation rate is high, the project's costs may increase, which

could reduce its profitability. Similarly, if the local currency is overvalued, the project's exports may become less competitive, which could impact its revenues.

3. Different Accounting Standards

- Comparing foreign accounting standards

Foreign projects often use different accounting standards, which can make it difficult to compare financial statements and estimate the project's financial performance. For example, some countries may use International Financial Reporting Standards (IFRS), while others may use US Generally Accepted Accounting Principles (GAAP). To overcome this challenge, investors need to carefully review the project's financial statements and adjust them to ensure consistency with their accounting standards.

4. Language and Cultural Barriers

- Overcoming cultural language barriers

Language and cultural barriers can also create challenges when evaluating foreign projects. Communication difficulties can lead to misunderstandings, while cultural differences can impact the project's management and operations. For instance, if the project's management team does not speak the same language as the investors, it can be difficult to communicate effectively and make informed decisions. Similarly, cultural differences can impact the project's labour relations, supply chain management, and customer relationships.

5. Regulatory and Legal Risks

- Managing regulatory legal risks

Foreign projects are often subject to different regulatory and legal frameworks, which can create significant risks. For example, changes in government policies or regulations can impact the project's operations, while legal disputes can lead to costly litigation. To manage these risks, investors need to carefully review the project's regulatory and legal environment and ensure that they comply with all relevant laws and regulations.

6. Risk of Expropriation

- Safeguarding assets against expropriation

Foreign projects are also at risk of expropriation or nationalisation, which can result in significant losses. Expropriation occurs when a government takes control of a project or asset without providing fair compensation. To manage this risk, investors need to carefully evaluate the

project's political risk and ensure that they have adequate protection against expropriation.

7. Lack of Data and Transparency

- Overcoming data transparency challenges

Foreign projects often lack transparency, and data may be scarce or unreliable. This can make it difficult to estimate the project's financial performance and manage its risks. To overcome this challenge, investors need to carefully review the project's financial statements and seek additional information from the project's management team or other sources.

8. Differences in Taxation

- Navigating foreign tax regimes.

Foreign projects are often subject to different tax regimes, which can impact the project's cash flows and returns. For example, some countries may have higher or lower tax rates, while others may offer tax incentives or exemptions. To manage these risks, investors need to carefully review the project's tax environment and ensure that they comply with all relevant tax laws and regulations.

9. Exchange Control Risks

- Overcoming exchange control challenges

Foreign projects may be subject to exchange control risks, which can limit the ability to repatriate funds. Exchange controls can restrict the flow of capital into or out of a country, which can impact the project's cash flows and returns. To manage these risks, investors need to carefully review the project's exchange control environment and ensure that they comply with all relevant regulations.

10. Country Risk

- Assessing country risk exposure

Foreign projects are exposed to country risk, which includes factors such as political instability, economic uncertainty, and social unrest. Country risk can impact the project's operations, cash flows, and returns. To manage these risks, investors need to carefully evaluate the project's country risk and ensure that they have adequate protection against potential losses.

11. Difficulty in Estimating Cash Flows

- Forecasting international cash flows

Estimating cash flows for foreign projects can be challenging due to factors such as different market conditions, regulatory environments, and cultural differences. To overcome this challenge, investors need to carefully review the project's

financial statements and seek additional information from the project's management team or other sources.

12. Difficulty in Estimating Discount Rates

- Determining international discount rates

Estimating discount rates for foreign projects can also be challenging due to factors such as different interest rates, inflation rates, and risk premiums. To overcome this challenge, investors need to carefully review the project's financial environment and seek additional information from the project's management team or other sources.

- Evaluating foreign investment risks

To sum up, evaluating foreign projects is a tough task because of many challenges. These challenges include dealing with different currencies, inflation rates, and accounting rules, as well as overcoming language and cultural barriers. Additionally, foreign projects are subject to different laws and regulations, and there is always a risk that the government might take control of the project. All these challenges make it hard to predict how much money the project will make and how much risk is involved. Therefore, it is key for investors and project evaluators to carefully think about these challenges and find ways to minimise them. By doing so, they can make smarter decisions and increase the chances of success for foreign projects.

Summarised Overview

Understanding international financial risk is vital for investors and businesses operating globally. Various types of risks exist, including exchange rate risk, which arises from fluctuations in currency exchange rates affecting cash flows and returns. Country risk is another significant concern, encompassing political, economic, and social instability in a foreign country that can impact investments. Sovereign risk, transfer risk, operational risk, liquidity risk, inflation risk, interest rate risk, regulatory risk, and cultural and language risks are also pertinent considerations. These risks can have far-reaching implications, including reduced returns, increased costs, decreased competitiveness, reputation damage, and compliance issues. To reduce these risks, it is essential to conduct thorough research, and understand the local market, culture, and regulatory environment. Diversifying investments across different markets and asset classes can also help and mitigate risk. Additionally, hedging against risks using financial instruments, continuously monitoring and reviewing international financial risks, and developing a comprehensive risk management plan are critical strategies for identifying, assessing, and reducing international financial risks.



By adopting a proactive and informed approach to risk management, investors and businesses can navigate the complexities of international finance and achieve their goals.

Assignments

1. How do transaction costs affect a company's investment and borrowing decisions?
2. What are the key challenges of managing cash flows for a company operating globally?
3. Explain how the International Capital Asset Pricing Model (ICAPM) helps investors make informed decisions about portfolio investments in global markets.
4. A company is considering a Foreign Direct Investment (FDI) project in a new country. What are the key factors the company should consider when evaluating the project's viability using capital budgeting techniques?
5. Explain the difficulties in the evaluation of foreign projects.

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BLOCK 2

**International
Financial Markets:
Segments and
Instruments**

UNIT 1

International Financial Markets

Learning Outcomes

After completing this unit, the learner will be able to:

- know about foreign exchange market
- distinguish between the international bond market, international equity market, international money market, and international credit market
- analyse the workings of International markets

Background

Global financial markets are integral to the functioning of economies, facilitating capital flows, investment, and risk management across borders. As businesses and governments increasingly engage in international trade and investment, they require efficient financial systems to manage currency exchange, funding needs, and investment opportunities. The evolution of these markets has been driven by economic globalisation, technological advancements, and regulatory frameworks that ensure transparency and stability. The interconnected nature of financial markets means that fluctuations in one market can have ripple effects across others. For instance, changes in exchange rates can impact bond and equity markets, while credit market conditions influence borrowing costs and investment decisions worldwide.

Keywords

Foreign Exchange Market, International Bond Market, International Equity Market, International Money Market, International Credit Market



Discussion

- Deals with supply and demand for foreign currencies

2.1.1 Foreign Exchange Market

Similar to how the prices in an economy are determined by the interaction of buyers and sellers, exchange rates are shaped by the supply and demand for foreign currencies. These transactions are conducted by households, businesses, governments and financial institutions that engage in international trade and investments. The marketplace where these transactions occur is known as the foreign exchange market.

2.1.1.1 Key Participants in the Foreign Exchange Market

Several entities play a significant role in foreign exchange trading. These include:

1. Commercial Banks

- Involves in most of the international transactions

Commercial banks form the backbone of the foreign exchange market. Nearly all large international transactions involve the movement of funds through commercial banks, making them central to currency exchange. Banks also engage in interbank trading, where they buy and sell currencies among themselves. These transactions occur at wholesale rates, which differ from the less favourable retail rates offered to corporate clients. Large commercial banks provide liquidity and facilitate efficient transactions for multinational corporations by aggregating orders and reducing transaction costs.

2. Corporations

Companies with international operations often need to conduct transactions in multiple currencies. For instance, an American company having branches in India may need Indian rupees to pay workers in its Indian-based facility. If it has U.S. dollars, it must buy rupees in the foreign exchange market to pay for the employees.

3. Non-bank Financial Institutions

- Participation in foreign exchange trading

Deregulation in financial markets has allowed non-bank institutions, such as asset management firms, pension funds, and insurance companies, to participate in foreign exchange trading. Institutional investors frequently trade currencies to hedge risks and maximise returns.

4. Central Banks

Central banks play a crucial role in the foreign exchange market by intervening to influence exchange rates. Though their direct transactions may not be large, central banks impact market trends as traders closely observe their activities for signals about future economic policies. Other government agencies may also participate in foreign exchange trading, but central banks remain the most active official entities in this market.

- Looked up by other banks for trends

2.1.1.2 Characteristics of the Foreign Exchange Market

Foreign exchange trading is a global activity, occurring in financial centres viz. such as London, New York, Tokyo, Frankfurt, and Singapore. The market is characterised by the following features:

- Volume of foreign exchange increased

i. High Trading Volume

The volume of foreign exchange trading has expanded significantly over the years. With globalisation, the volume of foreign exchange increased

- Real time communications ensure round the clock function

ii. Continuous Trading Across Time Zones

The foreign exchange market operates 24 hours a day, connecting major financial centres across different time zones. With real-time communication via telephone, fax, and internet, financial hubs function as an integrated global marketplace. Economic news impacts currency values instantly, leading to rapid market responses. Traders in New York, for example, can remain active in the market even after local business hours, due to their affiliates in other time zones.

- Quick correction in price differences between the exchange centres

iii. Arbitrage and Market Efficiency

Due to global connectivity, significant price discrepancies between financial centres are rare. If exchange rate differences emerge, traders quickly exploit arbitrage opportunities. For example, if the euro is priced at \$1.1 in New York but \$1.2 in London, a trader could buy €1 million in New York for \$1.1 million and sell it in London for \$1.2 million. However, the increased demand for euros in New York and higher supply in London would swiftly eliminate this price gap.

iv. Dominance of the U.S. Dollar as a Vehicle Currency

While transactions can occur between any two currencies, the U.S. dollar plays a dominant role in global foreign exchange



- Most of the inter-bank trading takes place in U.S. dollar

markets. In 2001, approximately 90% of interbank currency trades involved the U.S. dollar. Even when trading between two non-dollar currencies, banks often use the dollar as an intermediary to reduce transaction costs. Due to its widespread use, the U.S. dollar is termed as a vehicle currency. Even now, more than 85 per cent of transactions involve U.S. dollars. The euro has also been emerging as a vehicle currency.

2.1.2 International Bond Market

- A bond is an agreement between two persons, one at receiving and the other at paying end

Despite the inherent complexity of the bond market, a bond itself is relatively simple and may even seem somewhat unexciting compared to a stock. A stock, after all, represents a share of a company's wealth, and evaluating it requires an assessment of the company's overall worth. In contrast, a standard bond is essentially an agreement in which one party is obligated to make a series of cash payments, while the other party is entitled to receive them. Bonds come in a wide range of forms, with financial engineers continuously developing innovative fixed-income securities.

Despite the inherently global nature of debt financing, a unified international bond market has yet to be established. Instead, the bond market is categorised into three distinct groups:

- Bond market categorised in to domestic, foreign and euro bonds

1. **Domestic Bonds** – Issued locally by a domestic borrower, these bonds are typically denominated in the local currency.
2. **Foreign Bonds** – Issued in a local market by a foreign borrower, these bonds are also usually denominated in the local currency. Their issuance and trading are regulated by the local market authorities.
3. **Eurobonds** – Underwritten by a multinational syndicate of banks, these bonds are primarily placed in countries other than the one in whose currency they are denominated. Unlike domestic and foreign bonds, Eurobonds are not traded on a specific national bond market.

2.1.3 International Equity Market

- Equities issued outside the domestic market

A company can finance its operations through the issuance of debt and equity. With globalisation and increased cross-border capital flows, companies now have the opportunity to raise funds from international markets. When equity shares are issued outside the issuer's domestic market, they are known

as international equities or Euro equities. These equities are commonly issued in the form of American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs).

- Examples – ADR, GDR

A non-U.S. company issues ADRs to raise equity capital from U.S. markets. ADRs represent the underlying shares of the issuing company and are typically traded on major U.S. stock exchanges such as the American Stock Exchange (AMEX), the New York Stock Exchange (NYSE), or Nasdaq. Conversely, GDRs are issued to raise equity capital from international markets outside the U.S., and they are predominantly traded on the London Stock Exchange. These instruments have gained popularity among both issuers and investors due to their numerous advantages.

Let us see the benefits.

A. Benefits to the Issuer

- Issuing equity on foreign stock exchanges helps companies expand their investor base, leading to greater stock price stability.
- International markets enable companies to raise larger amounts of capital, which may not be possible through domestic markets alone.
- Raising funds in foreign markets brings in foreign exchange, which is crucial for economic development.
- The cost of raising capital through international equity is generally lower, typically around 3-4% of the issue amount.
- Listing equity on foreign exchanges increases the company's international reputation and market presence.

- Broadened Investor Base, Access to Larger Capital, Foreign Exchange Inflow, Lower Fundraising Costs

B. Benefits to the Investors:

- Investors do not bear foreign exchange risk when investing in international equities.
- Investing in foreign markets allows investors to either increase their returns for a given level of risk or lower their risk for a given level of return.

- No Foreign Exchange Risk, Diversification Benefits



2.1.3.1 Process of Raising Equity Capital in International Markets

When a company plans to raise equity capital in international markets, it first decides on various aspects of the issue, including the issue size, pricing, target market, and regulatory requirements. A lead manager, typically an investment bank, is appointed to oversee and organise the share issuance process. The lead manager assists the issuing company in selecting the appropriate depository (American or Global) through which the shares will be routed, advises on the details of the issue, and evaluates potential risks. Once approved by the lead manager, the issuing company prepares a prospectus and other necessary documents while obtaining regulatory approvals.

- Decides on aspects of issue of equity

Steps in the Issuance Process

1. The issuing company deposits the shares with a custodian bank, which is located in the domestic country. This bank is appointed by the depository in consultation with the issuing company.
2. The domestic custodian bank requests the foreign depository to issue the shares in the form of depository receipts. Before issuance, the ratio of depository receipts to underlying shares is determined.
3. The market price of depository receipts is influenced by factors such as earnings potential, industry fundamentals, and macroeconomic conditions.
4. The depository, located in an international financial centre, issues depository receipts after receiving relevant information from the issuing company. ADRs are issued by an American depository, while GDRs are issued by a global depository.
5. Upon receiving proceeds from GDR issuance, the depository transfers funds to the custodian bank, which then transfers them to the issuing company. The names of investors are recorded in the shareholder register.
6. Investors can surrender their GDRs by returning them to the depository. The depository informs the custodian bank, which issues share certificates in exchange for GDRs and sells them. The custodian bank converts the proceeds into a foreign currency and pays the foreign investors.

- Steps - Depositing Shares with a Custodian Bank, Surrendering of GDRs, Issuance of Depository Receipts

2.1.3.3 Key Documents Required for International Equity Issuance

Several important documents are involved in the process:

- **Prospectus:** Provides details about the issuing company, its management, and the share issue.
- **Depository Agreement:** Agreement between the issuer and the depository outlining the terms for share conversion into GDRs and back.
- **Underwriting Agreement:** Contract between the issuing company and underwriters, ensuring the subscription of shares.
- **Custodian Agreement:** Agreement between the custodian and the depository regarding shared safekeeping and conversion processes.
- **Trust Deed:** Defines the roles and responsibilities of trustees in servicing the issue.
- **Listing Agreement:** Agreement with the stock exchange, ensuring investors will get clarity on the secondary market for the issue.
- **Subscription Agreement:** Agreement between the lead manager and syndicate members outlining their commitment to subscribe to the issue.

- Prospectus, Agreements, Trust Deed

2.1.4 International Money Market

The International Monetary Market (IMM) was established in December 1971 and officially launched in May 1972. However, its origins can be traced back to the dissolution of the Bretton Woods system, particularly through the 1971 Smithsonian Agreement and President Nixon's suspension of the U.S. dollar's convertibility to gold. The IMM Exchange was created as a distinct division of the Chicago Mercantile Exchange (CME) and, as of 2009, stood as the world's second-largest futures exchange. The primary objective of the IMM is to facilitate currency futures trading, a relatively new financial product at the time. Initially explored by academics, these futures were designed to establish a freely traded exchange market, enhancing global trade among nations.

- Designed to establish a freely traded exchange market currency trading

The first experimental futures contracts were traded against

- The dollar is the first futures contract and the German Deutschmark/ Japanese Yen pair is the first cross-currency futures contract

the U.S. dollar and included major currencies such as the British pound, Swiss franc, German Deutschmark, Canadian dollar, and Japanese yen. In September 1974, the French franc was added to the list. Over time, the scope of IMM expanded to incorporate additional currencies, including the Australian dollar, euro, and various emerging market currencies such as the Russian ruble, Brazilian real, Turkish lira, Hungarian forint, Polish zloty, Mexican peso, and South African rand. A significant development occurred in 1992 when the German Deutschmark/Japanese yen pair was introduced, marking the first cross-currency futures contract. However, these early achievements also came with challenges.

- Primary transactions between Central Banks and Large institutions

The International Money Market serves as a hub for global currency transactions, primarily conducted between central banks and large financial institutions. These transactions are typically denominated in gold or U.S. dollars, which act as a global benchmark. The core operations of the international money market revolve around government and institutional borrowing and lending, making it a crucial component of the financial system. The market operates under the framework of monetary policies governing international transactions, ensuring smooth currency trading between nations. This exchange process, commonly referred to as foreign exchange (forex) trading, involves the buying and selling of currencies on a massive scale. Unlike stock markets, where individual investors participate, the international money market is dominated by major financial entities, leading to significantly large fund transfers. Investments in this market are considered low-risk, but as a result, they offer modest returns. The most preferred investment avenues within the international money market include money market mutual funds and treasury bills, both of which provide stability and security for investors.

- Facilities exchange of debt securities and short term commercial paper

2.1.5 International Credit Market

The international credit market is a marketplace that facilitates the exchange of debt securities and short-term commercial paper, enabling companies and governments to raise capital by allowing investors to purchase these financial instruments. The level of activity in credit markets is often viewed as a key indicator of investor sentiment. A surge in government bond purchases, for example, typically signals that investors are seeking safer alternatives due to concerns about the stock market.

In terms of dollar value, the credit market significantly surpasses the equity market. Consequently, the condition

- Signals financial trend

of the credit market serves as a crucial barometer of overall market stability and economic health. Many analysts consider the credit market a leading indicator, often likening it to the ‘canary in the coal mine’ because signs of financial distress usually emerge in the credit market before affecting the equity market.

- Issues bond to raise credit

When corporations, national governments, or municipalities require funding, they issue bonds. Investors who purchase these bonds effectively lend money to the issuers. In return, issuers compensate investors by paying periodic interest. Upon maturity, the bonds are repurchased by the issuers at face value. However, before maturity, investors have the option to sell their bonds to other investors at prices that may be above or below their face values, depending on market conditions.

Summarised Overview

The Foreign Exchange (Forex) Market is the global marketplace for trading currencies, where exchange rates are determined based on supply and demand. It facilitates international trade, investment, and economic stability by allowing businesses and investors to convert one currency into another. The Forex market operates 24/7 and is influenced by factors such as interest rates, inflation, political stability, and economic data.

The International Bond Market enables corporations, governments, and financial institutions to raise capital by issuing bonds denominated in foreign currencies. Investors purchase these bonds to earn interest income and diversify their portfolios. Similarly, the International Equity Market provides companies with access to global investors by issuing shares in foreign stock exchanges, thereby increasing liquidity and raising capital beyond domestic markets. The International Money Market specialises in short-term financial instruments such as treasury bills and commercial paper, facilitating liquidity management for businesses and financial institutions. Lastly, the International Credit Market plays a vital role in long-term financing by allowing governments, corporations, and individuals to borrow funds globally, influencing economic growth and investment flows.

Assignments

1. Explain the role of the Foreign Exchange Market in global trade and investment.
2. Compare and contrast the International Bond Market and the International Equity Market in terms of their functions and impact on capital raising.
3. How does the International Money Market support businesses and financial institutions in managing liquidity?



4. Discuss the significance of the International Credit Market in economic development and financial stability.
5. Analyse how fluctuations in exchange rates influence the performance of international bond and equity markets.

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UNIT 2

International Bonds and Other Various Instruments

Learning Outcomes

After completing this unit, the learner will be able to:

- distinguish between Foreign bonds, Euro bonds, and global bonds
- know about various instruments of the international bond market
- comprehend short-term and medium-term instruments in the bond market

Background

The international bond market plays a crucial role in global finance by enabling governments, corporations, and financial institutions to raise capital from investors worldwide. Bonds are fixed-income securities that represent a loan made by an investor to a borrower, typically issued for long-term financing. International bonds can be classified into foreign bonds and Eurobonds. Foreign bonds are issued in a foreign country's financial market using that country's currency. Eurobonds, on the other hand, are issued in a currency different from the country in which they are sold, offering flexibility to both issuers and investors. Another key category is global bonds, which are simultaneously issued in multiple markets, increasing their accessibility to a diverse range of investors. Beyond these classifications, various specialised bond instruments cater to different financial needs. Floating rate notes (FRNs) have interest rates that adjust periodically based on market conditions, making them attractive in volatile interest rate environments. Along with this, there are many instruments such as convertible bonds, and cocktail bonds, Euro notes, Euro Commercial papers.

Keywords

Foreign Bonds, Euro Bonds, Global Bonds, Floating Rate Notes, Convertible Bonds, Cocktail Bonds, Euro Notes, Euro Commercial Papers

Discussion

2.2.1 International Bonds

- Bond issued in a country other than the issuer's country

Beyond domestic or local bond markets, there exists a flourishing dominion of international bond markets. An increasing number of companies seek to raise capital internationally, while many investors are attracted to purchasing bonds from foreign issuers to diversify their portfolios and potentially achieve higher returns. An international bond is defined as a bond issued in a country other than the issuer's domestic country. These bonds are classified into three broad types viz. euro bonds, foreign bonds, and global bonds.

- Exposed to currency fluctuations, interest rate fluctuations, exchange rate volatility

International bonds are exposed to several risks, including inflation, interest rate fluctuations, default, downgrade, currency exchange volatility, liquidity concerns, and overall market instability. A crucial factor when investing in international bonds is the impact of currency fluctuations on total returns. Depreciation or appreciation of the foreign currency in which the bond is denominated can either reduce or enhance an investor's returns.

- Depreciation of foreign currency at the time of maturity creates a loss

Let us see an example of currency depreciation of the U.S Dollar (USD). A U.K.-based investor purchases a one-year U.S. dollar-denominated bond with a \$12,000 par value. The bond is trading at par, offers a 3% annual coupon, and has a one-year maturity. At the time of purchase, the exchange rate is \$1 = £1.7, meaning the investor pays £20,400 for the bond. By the bond's maturity, the USD has depreciated, with the new exchange rate at \$1 = £1.4. Upon converting the maturity proceeds, the investor receives only £16,800, resulting in a loss of £3,600 due to currency depreciation. However, the coupon payment of \$360 provides partial compensation. At the new exchange rate, this amounts to £504. The net loss on this investment is £3,600 - £504 = £3,096, reflecting a loss of 15.18% on the initial investment of £20,400.



Now, let us see the advantages and disadvantages of investing in international bond markets.

Advantages and Disadvantages of Investing in International Bond Markets

The major advantages are given below.

- Access to foreign markets

i. Portfolio diversification: Exposure to different economies reduces the impact of domestic market volatility.

ii. Access to foreign markets: Investors can tap into higher yields or more stable economic conditions abroad.

iii. Hedging opportunities: Useful for mitigating risks associated with domestic investments.

The following are the major disadvantages.

- Higher risk and liquidity concerns

i. Currency fluctuation risk: Changes in exchange rates can significantly impact returns.

ii. Country risk: Political or economic instability in the issuer's country may affect bond performance.

iii. Liquidity concerns: International bonds often have lower liquidity compared to domestic bonds.

iv. Higher transaction costs: Due to cross-border investment processes and conversion fees.

2.2.1.1 Foreign Bonds

- Debt instruments issued in a domestic market by a foreign borrower

Foreign bonds are debt instruments issued in a domestic market by a foreign borrower, typically denominated in the local currency of that market. These bonds are subject to the regulations and supervision of the local financial authorities, ensuring compliance with domestic financial laws and standards. Historically, international bond markets were dominated by foreign bonds, which were issued, placed, and traded in markets outside the issuer's country of incorporation.

Foreign bonds have a rich history and are often distinguished by unique, region-specific names. Some of the examples of foreign bonds are given below.

- Yankee Bonds - issued in the United States
- Samurai Bonds - issued in Japan
- Rembrandt Bonds - issued in the Netherlands

- Bulldog Bonds - issued in the United Kingdom

- Yankee Bonds - issued in the United States
- Samurai Bonds - issued in Japan

Ninety years ago, international bond markets were made up exclusively of foreign bonds. Following World War I, the global economic scenario was marked by a strong U.S. economy and a robust U.S. dollar. During this period, international capital markets primarily channelled European savings into the U.S. economy. As a result, issuance activity in other regions remained relatively small. This trend solidified the dominance of the U.S. foreign bond market, known as the Yankee bond market, a dominance that only strengthened after World War II.

- Helps in cross border investment

For many years, the Yankee bond market was the largest and most influential foreign bond market. However, in recent years, it has been overtaken by the Swiss franc (CHF) foreign bond market, reflecting shifts in global investment preferences and economic conditions. It is important to note that the growth of the Yankee bond market was hindered between 1963 and 1974 by the U.S. Interest Equalisation Tax, which aimed to reduce capital outflows. Despite this, other foreign bond markets, such as those in Japan, the United Kingdom, and the Netherlands, have maintained a significant share of the international bond market, offering investors diverse opportunities for cross-border investment.

The early markets shared several features that are standard in today's bond markets:

- i. Issuers were often foreign governments or private sector utilities, such as railway companies.
- ii. Bond issues were subscribed to by both retail and institutional investors.
- iii. The connection between issuers and investors was facilitated by continental private banks and established London merchant houses.
- iv. Underwriting and the syndication of underwriting risk were common practices, with bond structures resembling those in place today.

- Issued by governments or big private sector
- Buyers and sellers are connected via banks and underwriting done by security houses

A practical example of a foreign bond issuance occurred in August 2015, when Apple Inc. issued bonds worth AUD 2.25 billion, exclusively for the Australian market. This bond issuance was managed by a syndicate of major securities houses, with Goldman Sachs, Commonwealth Bank, and Deutsche Bank acting as lead managers.



2.2.1.2 Euro bonds

- Long-term debt securities
- Issued outside borrower nation in a currency different from the issuer nation

Eurobonds are long-term debt securities issued outside the borrower's country to raise capital in a currency different from the one used in the country where the bonds are sold. For example, a U.S. corporation might issue bonds in London denominated in euros or U.S. dollars. It is important to distinguish Eurobonds from foreign bonds. Foreign bonds are sold in a foreign country but are denominated in that country's currency. An example would be a U.S. multinational selling bonds in England denominated in pounds sterling. In contrast, Eurobonds are issued in a foreign country but denominated in another currency.

- Eurobonds do not require collateral

The major centres for the international bond market include London, Frankfurt, New York, and Tokyo. A key difference between Eurobonds and most domestic bonds is that Eurobonds are typically unsecured, meaning they do not require collateral. Another financial instrument in this space is 'Euronote,' a medium-term debt security that falls between short-term Eurocurrency loans and long-term international bonds. Corporations, banks, and countries use Euronotes to borrow medium-term funds in a currency other than that of the country where the notes are sold.

- Issued in multiple currencies

Some Eurobonds are issued in multiple currencies, giving lenders the option to be repaid in different currencies, and providing exchange rate protection. Lenders may accept a lower interest rate in exchange for this benefit. These bonds are underwritten by multinational syndicates of banks and placed mainly in countries other than the currency of denomination, and they are not traded on any specific national bond market. In September 2015, Apple issued EUR 2.8 billion in bonds in London, underwritten by an international syndicate led by Goldman Sachs and Deutsche Bank. Although denominated in euros, the bonds were traded primarily in London and other international markets.

- Remarkable growth having denominated in many currencies

The Eurobond market has experienced remarkable growth over the past 30 years. Initially, in the early 1960s, it was primarily a Eurodollar bond market, with USD bonds issued outside the U.S. Today, the market includes bonds denominated in all major and several minor currencies, reflecting its global reach and importance.

2.2.1.3 Global Bond

- Issued in a currency other than the currency of the country where it is offered

Global bonds are debt instruments issued in a currency different from the domestic currency of the country where the bond is offered. This financial innovation allows companies to raise capital from international markets, improving liquidity and reducing borrowing costs. For instance, a German corporation may issue a Japanese yen-denominated bond in London or a US dollar-denominated bond available to investors in both the United States and Japan.

- Ensures more liquidity

One of the primary motivations behind global bonds is to overcome the liquidity challenges associated with Eurobond markets. Historically, Eurobond issuers have sought to access the more liquid domestic markets of the United States and Japan. By broadening the investor base and offering larger bond sizes, issuers can improve liquidity, narrow trading spreads in the secondary market, and ultimately lower their funding costs. A crucial condition for this liquidity is the presence of committed market makers in each participating market.

- World Bank initiated the first global bond issuance

A notable historical milestone was the World Bank's 1989 global bond issuance, which addressed a fundamental barrier to accessing the U.S. foreign market: the bearer nature of Eurobonds. A study conducted by the World Bank in 1988 revealed that investor anonymity was not a critical concern for many international investors. This finding was pivotal, as more than a third of non-resident holdings of USD-denominated debt were in U.S. Treasury bills or other registered domestic securities. Building on this insight and leveraging regulatory changes in the United States, the World Bank launched a ground-breaking Eurobond issue, simultaneously placed in the U.S. foreign and Eurodollar bond markets, with a record-breaking issue size of USD 1.5 billion. This issuance, recognised as the first global bond, featured a registered form that complied with U.S. regulations and was exempt from the registration requirements of the Glass-Steagall Act.

The success of this inaugural global bond was evident in its trading performance. The World Bank's global bonds achieved lower yields than both their U.S. domestic bonds (by 10-20 basis points) and their USD Eurobonds (by 5-10 basis points). Consequently, the World Bank has since adopted global bonds as its primary means of raising bond finance. A

- An Issuer's reputation and credit perception affect the success of a bond offering

critical element in the success of global bond offerings is the issuer's homogeneous credit perception across international markets. The World Bank, for instance, enjoys a uniformly favourable reputation worldwide, which facilitates the seamless distribution and trading of its global bonds. In the U.S., such issues are managed by dealers specialising in government-sponsored agencies, ensuring market confidence and efficient execution.

2.2.1.4 Types of Instruments in International Bond Markets

The international bond market offers a wide variety of financial instruments, catering to different risk appetites and investment strategies. Some of the key types include the following.

- **Fixed-rate bonds:** Offer a stable interest payment throughout the bond's tenure.
- **Floating-rate bonds:** Interest rates fluctuate based on benchmark rates.
- **Convertible bonds:** These can be converted into a predetermined number of shares of the issuing company.
- **Fixed-rate bonds with equity warrants:** Include an option to purchase shares at a specific price.
- **Zero-coupon bonds:** Issued at a discount and pay no interest until maturity.

- Diversity of bonds having different interest rates and strategies

The diversity of bonds available to both international and domestic investors has expanded remarkably due to recent innovations, particularly with the advent of bonds carrying variable interest rates and complex optional clauses. This development has significantly improved the attractiveness and flexibility of bond markets. Despite the proliferation of these innovative instruments, the majority of issues in the international bond market continue to be fixed interest bonds.

The most popular instruments in international bond markets are:

i) Floating Rate Notes (FRNs): Floating Rate Notes are medium-term debt instruments that, in structure, resemble straight bonds, except for their interest base and calculation methods. The distinguishing feature of FRNs is that the

- Medium-term loans with coupon rates reset at intervals

coupon rate is reset at regular intervals typically every three months, six months, or one year in alignment with prevailing short-term money market rates. The coupon rate is composed of a benchmark money market rate, such as the London Interbank Offered Rate (LIBOR) for six-month deposits, plus a margin that reflects the issuer's creditworthiness. FRNs often include a prepayment option for the issuer, offering strategic advantages for managing debt obligations. Issuers favour FRNs due to their lower pricing compared to bank loans and longer maturities relative to straight bonds, while investors are attracted to the periodic coupon adjustments that provide strong capital protection. Historically, FRNs originated in Italy during the 1970s and have since become a cornerstone of the global bond market.

- Option to convert, beneficial in volatile markets

ii) Convertible Bonds: Convertible bonds are hybrid instruments that carry fixed interest rates but offer the option to convert into equity shares at a specified period. These bonds are particularly appealing in volatile market conditions, providing a safer and more protective investment avenue. For borrowers, convertible bonds offer a lower cost of capital owing to their relatively lower interest rates compared to traditional debt instruments. Post-conversion, these bonds help reduce the debt-equity ratio, strengthening the financial structure of the issuing firm. For investors, convertible bonds provide a dual advantage viz. fixed interest income prior to conversion and equity ownership post-conversion, allowing them to capitalise on potential capital appreciation. Convertible bonds are typically issued in periods of high interest rates and uncertain fixed-rate bond markets, with issuers benefiting from reduced funding costs and the potential of not having to repay the principal if conversion rights are exercised.

- Currency diversification

iii) Cocktail Bonds: Cocktail bonds are unique instruments denominated in several different currencies, offering inherent benefits of currency diversification to investors. By investing in cocktail bonds, investors automatically mitigate currency risk, gaining exposure to multiple foreign exchange markets within a single financial instrument. These bonds are particularly attractive to international investors seeking to balance risk and return across different economic regions and monetary policies.

2.2.1.5 Short-term and Medium-term instruments

A. Euro Notes

Euro notes are medium-term financial instruments that serve as a bridge between short-term Eurocurrency bank loans and long-term international bonds. They are commonly used by corporations, banks, and countries to secure medium-term funding in a currency other than that of the country where the notes are sold. Euro notes typically have a maturity period of less than one year and are issued by companies to meet their short-term financial needs. One of the advantages of Euro notes is their cost-effectiveness; they are placed directly with investors, reducing intermediary fees. The documentation required for issuing Euro notes is minimal, making them a convenient and flexible option for borrowers.

- Medium-term – cost-effective

When a company plans to raise funds through Euro notes, it appoints a facility agent or lead manager. The lead manager advises on the particulars of the issue, underwrites the notes, and sells them with the help of placing agents. The issuance of Euro notes involves three main cost components as given below.

- **Underwriting Fee:** Paid to the underwriter for assuming the risk of the issue.
- **Management Fee:** Covers structuring, pricing, and documentation of the issue.
- **Margin on Notes:** This can be a spread above or below LIBOR (London Interbank Offered Rate) or incorporated into the price of the notes.

Key documents required for issuing Euro notes include the underwriting agreement, paying agent agreement, and an information memorandum detailing the issuer's financial position. These documents accompany the Euro notes and ensure transparency. Settlement can occur via physical delivery or through international clearing houses.

- The lead manager underwrites notes

B. Euro Commercial Papers (ECP)

Euro commercial papers (ECPs) are unsecured short-term debt instruments with a maturity of up to one year. Unlike Euro notes, ECPs are not underwritten. These instruments are issued by highly creditworthy and top-rated companies

- Short-term
- unsecured

to raise short-term funds. ECPs are issued outside the home country in the currency in which they are denominated. They usually carry market-based interest rates (such as LIBOR) and can vary in amount, typically ranging from US \$10 million to over US \$1 billion. ECPs are sold either at a discount (with no coupon payments) or on an interest basis. Placement agents are typically involved in arranging these issues.

To streamline transactions and avoid physical delivery, ECP settlements are done through clearing houses such as Cedel (Luxembourg), First Chicago (London), Euroclear (Brussels), and Chase Manhattan (London).

Advantages of Euro Commercial Papers are as follows;

- **Cost-effectiveness:** Often priced below or near LIBOR, making them a cheaper source of funds.
- **Minimal Documentation:** Simplifies the issuance process.
- **Flexibility:** Can be quickly tailored to meet the needs of both borrowers and investors.

C. Medium-term Euro Notes

Medium-term Euro notes (MTNs) are financial instruments used by banks, sovereign entities, and international agencies to raise medium-term funds. While companies can meet medium-term funding needs by rolling over short-term Euro notes, this approach involves recurring time and costs. MTNs eliminate this issue by providing funding for a longer period without frequent redemptions and reissuance. MTNs fill the gap between short-term Euro notes and long-term Euro bonds, with a typical maturity period ranging from one year to five to seven years. They are issued at either a fixed or floating interest rate and are generally not underwritten.

- Used by banks, sovereign entities and international agencies

Summarised Overview

Foreign Bonds are issued by a foreign entity in a domestic market, denominated in the currency of the host country. Examples include Yankee bonds (issued in the U.S.), Samurai bonds (issued in Japan), and Bulldog bonds (issued in the U.K.). Euro Bonds are bonds issued in a currency different from the currency of the country where they are issued. For instance, a bond issued in Europe but denominated in U.S. dollars whereas global bonds are bonds that can be traded in multiple markets simultaneously, offering issuers access to



a larger pool of investors. These bonds enhance liquidity and diversify the investor base.

Floating Rate Notes (FRNs) refer to debt instruments with variable interest rates, adjusted periodically based on a reference rate (e.g., LIBOR or EURIBOR). They reduce interest rate risk for investors. Bonds that can be converted into a predetermined number of shares of the issuing company, offering the benefits of fixed income and equity participation are convertible bonds. Cocktail Bonds are hybrid instruments combining features of different bonds, such as fixed and floating interest rates, designed to meet specific investor preferences. Euro Notes are short-term promissory notes issued in the international market, providing quick financing options. Euro Commercial Papers (ECPs) are short-term debt instruments with maturities typically under a year, used for working capital or short-term funding needs. Medium-Term Euro Notes (MTNs) are Flexible debt instruments with maturities ranging from one to five years.

Assignments

1. Explain the differences between foreign bonds, Eurobonds, and global bonds. Provide real-world examples of each and discuss their significance in international financial markets.
2. Discuss how the Floating Rate Notes (FRNs) and Convertible Bonds help both issuers and investors manage risk and return in volatile financial environments.
3. Discuss the role of Euro Notes, Euro Commercial Papers (ECPs), and Medium-Term Euro Notes (MTNs) in international money markets. How do these instruments differ in terms of maturity, liquidity, and risk?
4. How do these hybrid instruments combine features of other bond types, and what advantages do they offer to multinational corporations and investors?
5. Evaluate the impact of global economic conditions on the issuance and performance of international bonds, including Eurobonds and global bonds. What strategies can companies adopt to reduce currency and interest rate risks when issuing these bonds?

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1. Dominick Salvatore, (2013, 11th Edition) *International Economics*, John Wiley & Sons
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3. Levi, M.D. *International Finance: The Markets and Financial Management of Multinational Business*, 3rd Edition, McGraw Hill International Editions, Finance Series, 1996

Suggested Reading

1. Soderstein BO and Geffry Reed, (2006) *International Economics*, Palgrave, Mc Milan
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3. Copeland, L (2014) "*Exchange Rates and International Finance*" Harlow: Prentice Hall, (6th edition)

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SGOU

UNIT 3

Global Capital Market and International Reserves

Learning Outcomes

After completing this unit, the learner will be able to:

- aware of global capital market
- understand and distinguish between GDRs, ADRs, FIIs, and FDIs
- understand international reserves

Background

The global financial system is built on the interaction of various markets, institutions, and investment mechanisms that facilitate capital movement across borders. At its core, the global capital market enables the exchange of financial assets such as stocks, bonds, and currencies among investors, businesses, and governments worldwide. This system allows economies to access foreign capital, diversify investments, and enhance economic growth. A fundamental understanding of financial markets includes the differences between money markets and capital markets. A money market is for short-term financial instruments and a capital market is for long-term investment securities. Another important aspect of global finance is the role of international reserves, which are foreign assets held by central banks to stabilise currencies and support economic stability. The Euro currency market is a key component of international finance, allowing deposits and loans in a currency outside its home country, providing liquidity and investment flexibility. Furthermore, companies raise capital globally through financial instruments like Global Depository Receipts (GDRs) and American Depository Receipts (ADRs), which enable foreign firms to trade their shares in international stock markets.

Keywords

Global Capital Market, International Reserves, Euro Currency Markets, Global Depository Receipts, American Depository Receipts



Discussion

2.3.1 Global Capital Market

- External financing role of commercial banks declines with exposure to third-world debt

Since the 1980s, the role of commercial banks as a major source of external finance for developing countries has significantly diminished. This decline can be attributed to the following reasons. During the 1980s, international banks experienced substantial financial losses due to their exposure to third-world debt crises. This experience made banks more cautious about lending to developing countries, prompting a shift in their financing strategies. In response to these crises, global financial regulators introduced capital adequacy norms, such as the Basel Accords. These regulations required banks to maintain higher capital reserves, making it more difficult and costly for them to take on additional risk through new asset acquisitions. As a result, the global capital markets have grown both in size and structure at an unprecedented pace, filling the gap left by the retrenchment of commercial banks. Institutions raise a significant portion of their funds from these markets, reinforcing their importance in global finance.

- ECM issues shares and raises funds & DCM issues bond to raise the debt

At its core, a global capital market is a platform where savings meet investment. Savings can come from private individuals, pension funds, hedge funds, and other entities seeking returns on their capital. The two primary forms of investment opportunities in these markets are Equity Capital Markets (ECM) and Debt Capital Markets (DCM). Here ECMs are where companies raise funds by issuing shares, offering investors a stake in the company and DCMs are where entities issue bonds to raise debt, with fixed or floating returns for investors.

- Global financial hubs - New York Stock Exchange, London Stock Exchange, Tokyo Stock Exchange, Luxembourg Stock Exchange

The capital markets are divided into the primary market, where new securities are issued and sold for the first time, providing capital directly to the issuer, and the secondary market where, existing securities are traded among investors, providing liquidity and market pricing. The trading and issuance of these instruments take place in several key global financial hubs, including the New York Stock Exchange, London Stock Exchange, Tokyo Stock Exchange, and Luxembourg Stock Exchange. Global Financial Crisis (2008) shows that the collapse of Lehman Brothers and subsequent market turmoil demonstrated the interconnectedness of global financial

institutions and the critical role of capital adequacy norms.

2.3.2 International Reserves

International reserves refer to reserve funds that central banks hold and exchange among themselves on a global scale. These reserves serve as a universally accepted form of payment between central banks and can take the form of gold or widely recognised currencies such as the U.S. dollar or the euro. Many nations utilise international reserves to support their financial obligations, including local currency and bank deposits. Another significant component of international reserves is Special Drawing Rights (SDRs), which were introduced by the International Monetary Fund (IMF) in 1969. This initiative emerged due to concerns regarding the limitations of gold and the U.S. dollar as the sole mediums for settling international transactions. SDRs play a crucial role in enhancing global liquidity by supplementing standard reserve currencies. The credibility of SDRs is backed by the full faith and credit of IMF member governments.

- Funds held with Central Banks and exchanged at the global level

Essentially, an SDR is an artificial currency, often described as a basket of national currencies. IMF member countries possessing SDRs can exchange them for freely tradable currencies, such as the U.S. dollar or the Japanese yen, through mutual agreements or voluntary swaps. Additionally, the IMF can direct economically stronger nations with substantial foreign currency reserves to acquire SDRs from financially weaker member states. Countries can also borrow SDRs from IMF reserves at favourable interest rates, typically using them to improve their balance of payments. Beyond being an auxiliary reserve asset, SDRs also serve an internal accounting function within the IMF, where they act as the unit of account. The IMF determines the value of SDRs in U.S. dollars based on a weighted basket of major global currencies, including the Japanese yen, U.S. dollar, British pound sterling, and the euro.

- SDR is an artificial currency, often described as a basket of national currencies

Foreign exchange reserves, similar to international reserves, are financial assets held by central banks in foreign currencies. These reserves can consist of foreign banknotes, bank deposits, government securities, bonds, treasury bills, and other financial instruments. In common usage, the term 'foreign exchange reserves' may also encompass gold reserves and IMF funds. Central banks employ foreign exchange reserves to secure liabilities linked to their national currency and to influence monetary policy. These reserves provide a government with

- Reserves held by CBs in foreign currencies, bonds, gold



greater flexibility and resilience in times of market volatility. For instance, if one or more currencies experience a sudden crash or devaluation, a central bank can mitigate the impact by leveraging reserves held in more stable or higher-valued currencies. This strategic approach helps stabilise economies and shields them from severe market disruptions.

2.3.3 Euro Currency Market

Eurocurrency refers to commercial bank deposits held in a currency outside the country of its issue. For instance, a deposit denominated in U.S. dollars in a British commercial bank (or in a British branch of a U.S. bank) is known as a Eurodollar. Similarly, a pound sterling deposit in a French commercial bank or a French branch of a British bank is called a Eurosterling. A deposit in euros in a Swiss bank is simply a Euro deposit, as the term 'Euroeuro' may be avoided. These deposits are typically borrowed or loaned by major international banks, corporations, and governments seeking to manage liquidity or invest funds. The market where such borrowing and lending occur is called the Eurocurrency market.

- Bank deposits held in currency outside the country of issue

Initially, the market dealt exclusively with U.S. dollars, earning the name Eurodollar market. Over time, other major currencies such as the German mark, Japanese yen, British pound, French franc, and Swiss franc also became common in these transactions. As the practice spread beyond Europe to financial hubs like Tokyo, Hong Kong, Singapore, and Kuwait, as well as the Caribbean (e.g., the Bahamas and the Cayman Islands), such deposits became known as offshore deposits. Despite this global expansion, the term Euro deposits is still often used generically. This market, functioning 24 hours a day, allows any foreign deposit held in a nation's bank to be considered as Eurocurrency if it is exempt from domestic banking regulations.

- Offshore deposits

The Eurocurrency market primarily deals with short-term funds, typically maturing in less than six months. Its size is measured in two ways: 'gross size and net size.' Gross size includes interbank deposits, which represent transfers of Eurocurrency funds between banks rather than a net increase in the available funds. Net size excludes these interbank deposits, providing a clearer picture of the actual lending capacity to nonbank customers. However, due to the interbank market's significance, gross size is often considered a more appropriate measure of the market's scale.

- Includes short-term funds

- Reasons for growth - higher interest rates abroad, convenience for international corporations, bypassing domestic credit restrictions

The Eurocurrency market has experienced remarkable growth over the past four decades, driven by several factors. Before the abolition of Regulation Q (a federal reserve regulation that sets capital requirements for banks in the USA in 1986, U.S. banks faced interest rate ceilings on deposits, often below the rates offered by European banks. This differential attracted short-term dollar deposits to European banks, creating Eurodollars. Companies find it efficient to hold short-term balances in the currency they need for payments, with the U.S. dollar playing a key role as the primary international vehicle currency. Firms can circumvent domestic credit limitations by borrowing in the Eurocurrency market.

- Attractive conditions for both depositors and borrowers

Eurocurrency markets offer attractive conditions for both depositors and borrowers. They are as follows.

- **Higher Interest Rates on Deposits:** European banks pay higher rates than U.S. banks because they can lend at even higher rates.
- **Narrow Lending-Borrowing Spreads:** Due to fierce competition, lower operating costs (from the absence of reserve requirements), economies of scale, and risk diversification, Eurobanks often provide better rates than their U.S. counterparts.
- **Interest Parity:** Arbitrage in the Eurocurrency market ensures that interest parity is generally maintained.

The rapid expansion of the Eurocurrency market poses several challenges such as:

- Rapid expansion of the Eurocurrency market poses several challenges

- **Undermining Domestic Stabilisation:** National governments' efforts to manage domestic credit and inflation can be thwarted when firms borrow in the Eurocurrency market.
- **Market Volatility:** Large and frequent flows of Eurocurrency funds across international financial centres contribute to foreign exchange and interest rate instability.
- **Lack of Regulation:** Since the market operates largely outside the control of national regulatory authorities, a global recession could render some banks insolvent, potentially triggering international banking crises reminiscent of those seen in the 19th and early 20th centuries. Effective regulation requires multilateral cooperation, but competitive pressures among nations make this difficult to achieve.

2.3.4 American Depository Receipt (ADR)

An American Depository Receipt (ADR) is a negotiable certificate denominated in U.S. dollars, representing a non-U.S. company's publicly traded equity. Introduced in the late 1920s, ADRs were designed to facilitate American investment in overseas securities and to help non-U.S. companies gain access to the American financial markets. ADRs are classified into three levels, each based on regulatory requirements and the privileges associated with the company's issuance.

- ADRs are negotiable certificates denominated in U.S. dollars

i. ADR Level-I

- This is often the initial step for a company entering the U.S. public equity market.
- It allows issuers to expand the market for their existing shares, diversifying their investor base.
- Minimal disclosure to the Securities and Exchange Commission (SEC) is required, and the issuer is not mandated to comply with U.S. Generally Accepted Accounting Principles (GAAP).
- Level-I ADRs are traded on the U.S. Over-the-Counter (OTC) market.
- Companies issuing Level-I ADRs are not permitted to raise fresh capital or list their stock on any national stock exchange.

- Minimum disclosure needed, not permitted to list stock

ii. ADR Level-II

- This level allows companies to further broaden their investor base for existing shares.
- Unlike Level I, significant disclosures to the SEC are required.
- Companies can list their stock on the American Stock Exchange (AMEX) or the New York Stock Exchange (NYSE), necessitating compliance with the specific listing requirements of these exchanges.

- Allowed to list stock

iii. ADR Level-III

- This level is utilised when a company seeks to raise fresh capital through a public offering in the U.S. capital markets.

- Adhere to GAAP

- The company must register with the SEC, meet the listing requirements of AMEX/NYSE, and adhere to U.S. GAAP.

ADRs are financial instruments issued by U.S. banks that provide indirect ownership of a certain number of shares of a foreign firm, which are held on deposit in a bank located in the firm's home country.

The key advantages of ADRs over direct ownership include:

- Easy conversion

- Investors are relieved of concerns regarding the delivery of stock certificates and the conversion of dividend payments from foreign currencies into U.S. dollars. The depository bank handles these transactions automatically.
- Financial reports from the foreign firm are forwarded to investors by the depository bank, in exchange for a relatively small service fee.
- Typically, non-Canadian firms utilise ADRs. For instance, by year-end 1993, all 13 Mexican firms listed on the NYSE traded through ADRs.
- The first-ever ADR issued by an Indian firm was launched in March 1999, when Information Technology Ltd. floated its ADRs, which were received positively in the U.S. market.

- GDRs represent publicly traded equity shares denominated in local currency

2.3.5 Global Depository Receipts (GDRs)

Global Depository Receipts (GDRs) are negotiable financial instruments that represent publicly traded equity shares denominated in local currency. By legal definition, a GDR is any instrument in the form of a depository receipt or certificate created by an Overseas Depository Bank outside India and issued to non-resident investors. These instruments are backed by the issuance of ordinary shares or foreign currency convertible bonds of the issuing company. Typically, a GDR is denominated in US dollars, while the underlying shares are expressed in the local currency of the issuer.

- GDRs can be converted into equity shares

At the request of the investor, GDRs can be converted into equity shares through the cancellation of the GDRs, facilitated by the depository, and the sale of the underlying shares in the domestic market via the local custodian. From the date of issuance, GDRs are considered as common equity of the issuing company, conferring rights to dividends and voting privileges. The company transacts with a single entity, the Overseas Depository, for all transactions, with voting rights



exercised by the depository in accordance with the agreement between the issuing company and GDR holders.

2.3.5.1 Issuance of GDR

The issuance of GDRs involves a systematic sequence of activities, as outlined below:

a. Shareholder Approval

The process begins with obtaining shareholder approval, as the issuance of an equity instrument like a GDR requires a clear mandate. The terms of the issue must be determined before seeking this approval. Authorisation from the Board of Directors is necessary to initiate a Euro-issue and convene a general meeting. A committee of directors is typically formed and empowered to approve the offering memorandum, fix the issue price, open and operate a bank account outside India, and notify the stock exchange about the relevant board meeting and its decisions. Subsequently, shareholders must approve the issue through a special resolution passed at a general meeting, under Section 81 of the Companies Act, 1956. This section stipulates that if a company proposes to issue capital more than two years after its formation or one year after its first share allotment (whichever is earlier), it must first offer such issues to its existing shareholders.

- Authorisation Board of Directors is necessary to initiate a Euro-issue

b. Appointment of Lead Manager

A crucial element of the Euro - issue, the Lead Manager serves as the link between the government, investors, and the issuing company. The success or failure of a Euroissue often hinges on the effectiveness of the lead manager. Therefore, selecting a competent lead manager is a critical task. The process involves preliminary meetings with merchant bankers, who are evaluated based on parameters such as marketing ability, market research capabilities, market-making potential, track record, fee structure, and placement skills. A 'beauty parade' - presentations by various merchant bankers - helps the company make its final choice, with government approval required for the appointment. Once appointed, the lead manager provides strategic advice to the company, considering the company's needs, industry dynamics, international financial markets, economic conditions, and the terms of the issue. These terms include the quantum of the issue, type of security (in this case, GDRs), conversion stages, equity share pricing, interest rates, and redemption dates.

- Lead Manager serves as the link between the government, investors, and the issuing company

c. Finalisation of Issue Structure

- India's foreign exchange reserves were insufficient to cover even a fortnight's imports

After the issue structure is formalised in consultation with the lead manager, the company must obtain final government approval. For this, the company needs to furnish comprehensive information about the entities involved in the GDR issue and relevant parameters. The emergence of GDRs in India can be traced back to the early 1990s, a period marked by a severe balance of payments crisis. At the time, India's foreign exchange reserves were insufficient to cover even a fortnight's imports. With international institutions unwilling to lend due to India's non-investment credit rating, the government, following World Bank recommendations, permitted fundamentally strong private corporations to raise funds from international capital markets through equity or equity-linked instruments. This shift necessitated modifications to the Foreign Exchange Regulation Act (FERA), allowing foreign investors to hold up to 51% of a company's equity capital, with permissions beyond this limit granted on a case-by-case basis.

2.3.6 Foreign Institutional Investment (FII)

- Investment by foreign institution through purchase of financial instruments

Foreign Institutional Investment refers to the investment made by foreign institutions in the financial markets of a country, primarily through the purchase of shares, debentures, and other financial instruments. These foreign entities often include mutual funds, insurance companies, pension funds, hedge funds, and investment banks that seek to capitalise on the potential returns offered by the host country's stock market.

FII's play a significant role in the global economy, facilitating the flow of capital across borders and contributing to the liquidity and efficiency of financial markets. By investing in foreign equity and debt instruments, these institutions not only diversify their investment portfolios but also provide much-needed capital to the host country's economy, thereby promoting economic growth and development. In India, Foreign Institutional Investments are regulated and monitored by the Securities and Exchange Board of India (SEBI). SEBI mandates that all FIIs be registered with it to participate in the Indian stock markets. This regulatory framework helps ensure transparency, investor protection, and the orderly functioning of financial markets.

One defining characteristic of Foreign Institutional Investment is its short-term nature. Unlike Foreign Direct Investment (FDI), which involves long-term investments in physical

- FIIs are focused on generating quick profits through the buying and selling of financial instruments

assets such as factories, infrastructure, or businesses, FIIs are typically focused on generating quick profits through the buying and selling of financial instruments. This transient nature of FIIs has earned them the nickname “hot money” or “fly-by-night money,” as these investments can enter and exit a market swiftly, often in response to changing economic conditions, political events, or global market trends. While FIIs can bring positive impacts such as increased market liquidity, better stock price discovery, and improved corporate governance, their short-term focus can also introduce volatility into the financial markets. A sudden withdrawal of FII capital, for instance, can lead to sharp declines in stock prices and foreign exchange reserves, posing challenges for economic stability.

2.3.7 Foreign Direct Investment (FDI)

- Long-term investment in another country

Foreign Direct Investment refers to an investment made by a company or individual from one country into business interests located in another country. This form of investment typically entails acquiring a significant stake in a company or establishing new business operations, such as subsidiaries, joint ventures, or branches. Unlike Foreign Portfolio Investment (FPI), which focuses on short-term trading of shares or securities, FDI involves a long-term interest in the management and operations of the company.

FDI can be broadly categorised into three primary types, each reflecting the nature of the business relationship and the level of operational integration between the investing company and its foreign counterpart:

- A company establishes the same type of business operation in a foreign country as it runs in its home country

1. Horizontal FDI: This occurs when a company establishes the same type of business operation in a foreign country as it runs in its home country. For example, a U.S.-based fast-food chain like McDonald’s opening new outlets in France represents horizontal FDI, as it expands its business within the same industry and offers similar products.

- A company acquiring a complementary business in another country

2. Vertical FDI: This type of investment involves a company acquiring a complementary business in another country, often to secure essential raw materials or components. For instance, a German car manufacturer such as BMW investing in a foreign company that produces specialised car parts exemplifies vertical FDI, ensuring a steady supply for its assembly lines.

- A company invests in a foreign business that is unrelated to its core operations

3. Conglomerate FDI: In this case, a company invests in a foreign business that is unrelated to its core operations. This usually takes the form of a joint venture, as the investing company may lack experience in the new business area. A good example would be a U.S.-based technology firm like Apple investing in a foreign fashion brand, diversifying its portfolio beyond consumer electronics.

FDI can be undertaken through different entry methods, most notably Greenfield and Brownfield investments. These methods reflect distinct approaches to entering foreign markets and expanding business operations. They are given below.

- Greenfield Investment – investment in new business

- **Greenfield Investment:** This involves establishing a new business operation from the ground up in the host country, such as building new plants, offices, or manufacturing facilities. This approach offers investors full control over the business setup and operations.

- Brownfield Investment – investment in existing business

- **Brownfield Investment:** In contrast, a Brownfield investment occurs when a foreign investor acquires or merges with an existing company in the host country. By leveraging existing infrastructure and operations, the investor can quickly expand their market presence without starting from scratch.

Several critical factors influence the decision to invest in a foreign country. These determinants help investors evaluate the viability and potential of establishing a long-term presence in the host country. Key factors include:

- Determinants help investors evaluate the viability and potential of establishing a long-term presence

i. Market Size and Growth Potential: Countries with large and expanding markets attract more FDI as companies seek to tap new consumer bases and scale their operations.

ii. Political Stability: A stable political environment reduces risks related to policy changes, expropriation, or social unrest that could affect investments.

iii. Legal and Regulatory Framework: A clear, investor-friendly regulatory environment, including well-defined property rights, tax incentives, and transparent governance, encourages foreign investment.

iv. Infrastructure: High-quality infrastructure, such as transportation, telecommunications, and energy, reduces operational costs and enhances efficiency, making the

host country more attractive.

v. Cost of Labour and Resources: A skilled workforce and affordable labour costs are significant factors for companies considering manufacturing or service operations abroad.

vi. Ease of Doing Business: Streamlined processes for starting a business, obtaining permits, and repatriating profits increase a country's attractiveness to foreign investors.

- India is one of the largest recipients of FDI

India stands out as one of the largest recipients of Foreign Direct Investment among emerging economies, offering several strategic advantages such as a growing consumer market, a skilled workforce, and favourable government policies. The framework for foreign investments in India is governed by specific laws and regulations designed to facilitate and regulate FDI inflows. An investment qualifies as FDI if it involves acquiring at least 10% or more of the post-issue paid-up capital of a company. The Foreign Exchange Management Act (FEMA) governs FDI in India, providing the regulatory framework for foreign exchange and investment. It is administered by the Reserve Bank of India (RBI). Issued by the Department for Promotion of Industry and Internal Trade (DPIIT) under the Ministry of Commerce and Industry, this policy outlines the rules, guidelines, and procedures for FDI.

Summarised Overview

The global capital market facilitates the flow of financial assets across international borders, enabling corporations, governments, and investors to raise and allocate capital efficiently. A crucial component of this system is international reserves, which consist of foreign currencies, gold, and assets held by central banks to stabilise economies and support exchange rates. The Euro currency market plays a significant role in international finance, allowing for the deposit and lending of currencies outside their home countries, enhancing liquidity and investment opportunities.

Financial instruments such as Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) provide foreign companies with access to international stock markets, helping them raise capital while offering investors diversified opportunities. Additionally, Foreign Direct Investments (FDIs) contribute to economic growth by injecting foreign capital into emerging markets, improving infrastructure, and fostering economic stability. These components collectively shape the modern global financial landscape, promoting investment, economic integration, and capital mobility across nations.

Assignments

1. Explain the role of international reserves in stabilising a country's economy.
2. Discuss the significance of the Euro currency market in global financial transactions.
3. Compare and contrast GDRs and ADRs in terms of their structure and benefits for investors.
4. How do FIIs and FDIs contribute to the economic development of a nation? Provide examples.
5. Analyse the impact of global capital markets on emerging economies.

Suggested Reading

1. Soderstein BO and Geffry Reed, (2006) *International Economics*, Palgrave, Mc Milan
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BLOCK 3

**International
Monetary Systems**

UNIT 1

International Macroeconomic Policy under Gold Standard -The Bretton Woods System and IMF

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the evolution of the International Monetary System
- analyse the working of the Bretton Woods System
- evaluate the working of the IMF

Background

The international monetary system has undergone significant transformations since the late 19th century. From the gold standard to the present day, the system has evolved in response to changing global economic conditions and the needs of its member countries. A pivotal moment in this evolution was the establishment of the Bretton Woods System in 1944, which created a framework for international monetary cooperation and established the International Monetary Fund (IMF) and the World Bank. The Bretton Woods System played a major role in shaping the global economy in the post-World War II era. However, it eventually collapsed in 1971, leading to a shift towards a more flexible exchange rate system. Today, the IMF continues to play a key role in promoting international monetary cooperation, facilitating global trade, and providing financial assistance to countries facing economic difficulties.

Keywords

Gold Standard, Price-Specie-Flow Mechanism, Bretton Woods System, International Monetary System, Exchange Rate Systems, WTO, IMF

Discussion

- International monetary systems, shape open-economy macroeconomic policies and performance

3.1.1 International Macroeconomic Policy under Gold Standard

The international monetary systems, spanning from 1880 to the present, shape open-economy macroeconomic policies and performance. Essentially, an international monetary system comprises rules, customs, instruments, facilities, and organisations facilitating global transactions. These systems can be categorised based on exchange rate determination or international reserve asset forms. Exchange rate systems include fixed rates with narrow or wide fluctuation bands, adjustable pegs, crawling pegs, managed floats, and freely floating rates. Alternatively, international reserve systems are classified into three types: the gold standard, where gold is the sole reserve asset; the pure fiduciary standard, based on currencies like the dollar; and the gold-exchange standard, combining gold and fiduciary standards.

3.1.1.1 The Gold Standard

- Each country set a fixed gold value for its currency

The gold standard existed from 1880 to 1914. Each country set a fixed gold value for its currency and was prepared to buy or sell gold at that price. This fixed gold content led to fixed exchange rates, known as mint parity. For example, under the gold standard, a £1 gold coin in the United Kingdom contained 113.0016 grains of pure gold, while a \$1 gold coin in the United States contained 23.22 grains. This implied that the dollar price of the pound, or the exchange rate, was $R = \$/\text{£} = 113.0016/23.22 = 4.87$. This is called the mint parity. However, exchange rates could fluctuate somewhat due to gold shipping costs between countries. These fluctuations occurred within a narrow range, called the gold points.

- Exchange rates were fixed by gold points

Under the gold standard, exchange rates were determined by supply and demand within set limits, called gold points. If a currency's value falls too low, gold exports would stop the decline. This happened when a country's balance of payments showed a deficit, which was settled with gold. Conversely, if a currency's value rose too high, gold imports would halt the rise, indicating a balance of payments surplus. Since countries had limited gold reserves, deficits could not continue indefinitely and had to be corrected quickly to maintain economic balance.



3.1.1.2 Price-Specie-Flow Mechanism

- Self-correcting economic balance system

The gold standard's adjustment mechanism, explained by Hume, was the automatic price-specie-flow mechanism. Under this system, a deficit nation's money supply decreases, while a surplus nation's money supply increases. This led to lower prices in the deficit nation and higher prices in the surplus nation. As a result, the deficit nation's exports increased and imports decreased, eliminating the balance-of-payments deficit. The opposite occurred in the surplus nation. This automatic adjustment limited a nation's ability to use monetary policy for full employment without inflation. However, classical economists believed the economy naturally tended toward full employment without inflation.

3.1.1.3 Gold Standard and the Outbreak of World War I

- After World War I, the gold standard was temporarily abandoned

After World War I, the gold standard was temporarily abandoned, leading to unstable exchange rates. Attempts to revive it in the 1920s ultimately failed due to inadequate economic adjustments, destabilising capital flows, and the Great Depression. The UK's return to the gold standard in 1925 and France's subsequent demands for gold payments led to the UK's abandonment of the gold standard in 1931, followed by the US in 1933.

- Exchange rate chaos showed that flexible rates can cause instability

Following the gold standard's collapse, countries engaged in competitive devaluations from 1931 to 1936, attempting to boost exports and reduce unemployment. However, this strategy ultimately failed, and exchange rates returned to pre-devaluation levels by 1936. The period also saw increased trade restrictions and a decline in international trade, ultimately ending with the onset of World War II. The exchange rate chaos between World Wars I and II showed that flexible rates can cause instability. This led to a new monetary system after World War II with more stability.

3.1.2 The Bretton Woods System

In 1944, a conference of 44 nations was held in Bretton Woods, New Hampshire, to create a new international monetary system for the post-World War II era. They created the International Monetary Fund (IMF) to promote cooperation, set trade, and finance rules, and provide loans to countries facing temporary

- Bretton Woods creates IMF

economic challenges. The US proposal, led by Harry White, was ultimately adopted over an alternative plan proposed by John Maynard Keynes, which suggested creating a global clearing union that would issue a new currency called “bancor.” The IMF was launched on March 1, 1947. It started with 30 founding member countries. Today, the IMF has 187 member countries. Only a few countries, such as Cuba and North Korea, are not part of the IMF. The Bretton Woods system and the IMF are actually referred to as the “Twin Bretton Woods Institutions” or simply the “Bretton Woods Twins”.

- Bretton Woods system combined gold and currency exchange

The Bretton Woods system (1944) combined gold and currency exchange. The United States set the value of gold at \$35 per ounce and promised to exchange dollars for gold. Other countries then linked the value of their own currencies to the US dollar, which in turn was linked to gold. These countries managed their exchange rates to stay within a narrow range, allowing their currencies to fluctuate by no more than 1% against the dollar.

- BW system combined gold and currency exchange

For example, suppose Japan wanted to import goods from the United States worth \$100 million. Japan would pay for these goods in yen, but the US exporter would want dollars. But under the Bretton Woods system:

1. Japan’s central bank would exchange yen for US dollars at the a fixed exchange rate (e.g., 360 yen per dollar).
2. The US dollars received by Japan’s central bank would be backed by the US promise to exchange dollars for gold at \$35 per ounce.
3. The US exporter would receive the \$100 million, which was ultimately backed by the US gold reserve.

- International economic cooperation established

In short, this system combined gold and currency exchange, providing stability and confidence in international trade and finance.

After World War II, countries aimed to make their currencies exchangeable. They agreed to remove trade barriers and limit restrictions on international capital flows. The IMF provided short-term loans for temporary trade deficits, while the World Bank and affiliates offered long-term development aid. This system stabilises international trade and finance, promoting global economic growth.



3.1.2.1 Working of the Bretton Woods System

- Stable international monetary order

The Bretton Woods System functioned by establishing a stable international monetary order, where countries pegged their currencies to the US dollar, which was convertible to gold at a fixed price of \$35 per ounce. This created a system of fixed exchange rates, where countries could either choose to peg their currency to the dollar directly or peg to another currency that was already pegged to the dollar. The IMF played a major role in maintaining the stability of the system by providing short-term loans to countries facing temporary balance of payments deficits, allowing them to stabilise their currency without resorting to drastic measures such as devaluation. In addition, the World Bank offered long-term development loans to countries for reconstruction and development projects. Countries were required to maintain a stable exchange rate and implement policy adjustments if they faced persistent balance of payments deficits, ensuring that the system remained stable and facilitated international trade and investment.

- Bretton woods monetary mechanism

The Bretton Woods System operated through a series of mechanisms. Countries began by pegging their currencies to the US dollar, which was convertible to gold, fixing their exchange rates. As countries traded goods and services, capital flowed across borders, and they tracked their balance of payments, including trade balances, capital flows, and foreign exchange reserves. If a country faced a temporary balance of payments deficit, it could borrow from the IMF to stabilise its currency. For countries with persistent deficits, adjustment mechanisms were implemented, such as devaluing their currency or introducing strictness measures, to restore balance and stability to their economies.

- Bretton Woods system US trade deficits and dollar devaluation fears

3.1.2.2 Collapse of the Bretton Woods System

The Bretton Woods system ended in 1971 due to US trade deficits and dollar devaluation fears. President Nixon acted by suspending dollar-gold convertibility and imposing an import surcharge. The Group of Ten nations responded with the Smithsonian Agreement, devaluing the dollar, revaluing other currencies, and widening fluctuation bands.

The 1972 US trade deficit reignited dollar speculation, leading to a 10% devaluation in February 1973. European nations briefly experimented with joint floating currencies (“the snake”). As speculation continued, major nations adopted

managed floating exchange rates in March 1973, which remains the current system. In short, the US trade deficits of 1970-71 triggered the Bretton Woods collapse, but underlying issues included:

- The dollar crisis led to the collapse of BW system

1) **Liquidity:** insufficient international reserves

2) **Adjustment:** difficulties in balancing trade

3) **Confidence:** eroding trust in the system

Mostly, liquidity grew from increased foreign exchange holdings, mainly US dollars, which sustained up the system.

3.1.3 The International Monetary System: Present and Future

- Managed floating exchange system

The managed floating exchange rate system replaced Bretton Woods in 1973. Monetary authorities now intervene to stabilise exchange rates. The Jamaica Accords in 1976 changed the way countries managed their money. Before, people worried that countries would lower the value of their money to gain an unfair trade advantage. However, the Accords allowed countries to control their exchange rates and made global trade more stable. These new rules took effect in April 1978 and are still in use today.

- Evolution of global exchange rate systems

By 2012, half of IMF member nations chose flexible exchange rates, covering most global trade. Others adopted dollarization, currency boards, or pegged currencies. The US largely avoided intervening in foreign exchange markets. Europe made big changes, creating the European Monetary System in 1979 and the European Central Bank in 1999. Countries now hold US dollars and other reserves to stabilise their currencies. Although gold is no longer a main reserve asset, it is still important and its price has fluctuated over time.

- In the managed float system, nations hold international reserves to stabilise exchange rates

In the managed float system, nations hold international reserves (mostly dollars) to stabilise exchange rates. The US lifted its gold ownership ban in 1975. Gold prices fluctuated, reaching \$1,896.50/oz. in 2011. The IMF sold gold to help poor nations and phased out gold as a reserve asset, but it still holds significance. The Special Drawing Rights (SDRs) value was adjusted from \$1 (pre-1971) to reflect dollar devaluations. The Special Drawing Rights (SDRs) are a unique international reserve asset created by the International

- Currency reserve management

Monetary Fund (IMF) to augment the existing reserve assets of its member countries. Established in 1969, SDRs play a major role in promoting international monetary cooperation, supporting economic development, and reducing reliance on the US dollar as a global reserve currency. In 1974, it was tied to a currency basket for stability. Today, the SDR represents a weighted average of four major currencies (US dollar, euro, yen, and pound) and is valued at \$1.5353 (2021). The IMF uses SDRs to track international reserves.

3.1.3.1 IMF Current Operation

- Financial capacity expansion of IMF

The IMF has undergone significant changes. Member nation's quotas have increased several times, boosting total resources to \$369.2 billion (from \$8.8 billion in 1947). Members typically pay 25% of quota increases in SDRs or approved currencies, and the remaining 75% in their own currency. New members follow the same payment structure. Additionally, the "gold tranche" is now known as the "first-credit tranche." The IMF has increased its lending capacity through Renewing and expanding the General Arrangements to Borrow (GAB) 10 times since 1962, introducing the New Arrangement to Borrow (NAB) in 1997, Increasing swap arrangements (\$54 billion) and standby arrangements (\$92 billion). By 2011, the IMF could lend up to SDR \$564.2 billion. Borrowing rules were relaxed, and new credit facilities were added. IMF loans are now in SDRs, with initial fees, and interest rates based on loan duration, facility used, and market rates. Beyond exchange rate surveillance, the IMF now helps members address structural issues.

The IMF also offers various credit facilities to support members:

- Credit facilities offered by IMF

1. **Extended Fund Facility (EFF, 1974):** Long-term structural reforms for balance of payments issues.
2. **Supplemental Reserve Facility (SRF, 1997):** Short-term crisis assistance for market confidence issues.
3. **Compensatory and Contingency Financing Facility (CCFF, 1963):** Medium-term support for export shortfalls or import excesses.
4. **Flexible Credit Line (FCL, 2009):** Crisis prevention assistance.
5. **Precautionary Credit Line (PCL):** Wider access to preventive support.

6. Post-Catastrophe Debt Relief (PCDR) Trust: Debt relief for poor countries after catastrophic natural disasters.

7. Systematic Transformation Facility (STF): Long-term support for structural balance of payments issues, promoting poverty-reducing growth.

- IMF credit growth

IMF lending has evolved significantly. Today, member countries can access up to 200% of their quota annually (600% cumulatively). Initially, industrial nations dominated Fund borrowing (over 50% in the first 20 years), using loans for short-term balance-of-payments issues. Since the 1980s, developing countries have become the primary borrowers, with medium-term loans addressing structural problems. Outstanding IMF credit and loans grew from \$14 billion (1980) to \$41 billion (1986) and \$100 billion (2011).

- IMF's debt crisis response

In response to the 1982 debt crisis in developing countries, particularly Latin America, the IMF provided debt relief and rescue packages. To receive help, countries had to implement austerity measures such as reduced government spending, money supply growth, and wage increases. These conditions, aimed at promoting exports and self-sustainability, sparked widespread protests, government upheavals, and criticism that the IMF ignored social needs and political consequences. To address these concerns, the IMF has become more flexible, offering medium-term loans to address structural issues, bridging its traditional focus on short-term stability with the World Bank's long-term development goals.

3.1.3.2 Challenges in Current Exchange Rate Systems

- Current international monetary system faces challenges

The current international monetary system faces three major interconnected challenges:

- a. Exchange rate volatility and misalignments, leading to economic uncertainty.
- b. Lack of coordination among industrial nations, hindering global economic stability.
- c. Inadequate prevention and management of international financial crises.

Since 1973, exchange rates have been highly volatile, with large swings and prolonged misalignments. This instability



- Exchange rates instability discourages international trade and investment

discourages international trade and investment. The managed floating exchange rate system has been marked by significant deviations from equilibrium rates over extended periods. Notable examples include the US dollar's sharp appreciation from 1980 to 1985, followed by a precipitous decline from 1985 to 1987. Similarly, the yen-dollar exchange rate experienced substantial fluctuations between 1995 and 2011. The euro, introduced in 1999, also underwent a rollercoaster ride, marked by significant volatility until 2008.

- Currency stability initiatives

The extreme fluctuations in exchange rates have led to unsustainable trade deficits, calling for protectionism, and renewed demands for reforms to the international monetary system. To address these issues, experts have proposed measures such as target zones for major currencies and increased policy coordination among leading nations. The debate has shifted from a binary focus on fixed versus flexible exchange rates to a more nuanced discussion of optimal flexibility and policy cooperation. In response, major economies have increased their cooperation to address exchange rate issues, as seen in the Plaza Agreement, Louvre Agreement, and joint responses to global crises such as the 1987 stock market crash and the 2008-2009 recession.

However, challenges persist, including the large “dollar overhang” (foreign-held dollars) and “hot money” flows facilitated by Eurocurrency markets. Proposals, such as converting foreign-held dollars to SDRs through an IMF substitution account, remain unresolved due to issues like interest rates and repayment procedures. For now, the dollar will likely remain the dominant international currency.

Summarised Overview

The international monetary system has undergone significant transformations over time. Initially, the Gold Standard (1879-1939) was adopted, where currencies were pegged to gold, and countries maintained gold reserves to back their currency. The Price-Specie-Flow Mechanism facilitated automatic balance of payments adjustments, as gold flows between countries helped to correct trade imbalances. However, the Gold Standard had limitations, including its inability to accommodate economic growth and its vulnerability to economic shocks. The Bretton Woods System (1944-1971) was established to address the shortcomings of the Gold Standard. This system created a dollar-gold exchange standard,

where the US dollar was pegged to gold, and other countries pegged their currencies to the dollar. The IMF and the World Bank were also established to provide financial assistance and guidance to countries. However, the Bretton Woods System collapsed in 1971 due to the US's inability to maintain the dollar's peg to gold. The current International Monetary System is characterised by a flexible exchange rate regime, where countries can choose their own exchange rate systems. Exchange Rate Systems, including fixed, flexible, and managed floats, enable countries to manage their currencies and respond to economic shocks. The IMF continues to play a crucial role in providing financial assistance and guidance to countries facing economic difficulties.

Assignments

1. How are exchange rates determined under the gold standard?
2. Discuss the factors that contributed to the collapse of the Bretton Woods system.
3. Explain the role of the International Monetary Fund in promoting global financial stability.
4. Explain the operation of IMF.
5. Explain the challenges in the current exchange rate system.

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Suggested Reading

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU

UNIT 2

The Rise of Global Trade Co-operation

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the formation of GATT
- know about different rounds of GATT
- understand the objectives and functions of WTO

Background

Between the two World Wars, global economic relations worsened. After World War I, countries tried to return to normal by reviving the gold standard and promoting free trade. However, this system failed, particularly during the Great Depression of the 1930s. Countries like Britain struggled with overvalued currencies, leading to competitive currency devaluations and trade restrictions. Many nations turned inward, focusing on self-sufficiency and bilateral trade agreements. After World War II, the allied nations, especially the US and the UK, sought to avoid past mistakes. In 1944, the Bretton Woods conference laid the groundwork for a new global economic order, built around three key institutions: the International Monetary Fund (IMF), the International Trade Organisation (ITO), and the International Bank for Reconstruction and Development (IBRD), aimed at promoting stability, cooperation, and growth. The IMF helps countries solve short-term money problems, smoothing out the balance of payment issues. The ITO focuses on the “real” side of trade, promoting fair rules for global trade and aiming for free trade. Meanwhile, the IBRD directs international investments to where they’re needed most. Initially, it helped rebuild countries after World War II, but now it mainly assists less-developed countries (LDCs) in getting capital from wealthier nations. Efforts to manage the global economy have had mixed results. International trade policy remains a contentious issue. While progress has been made in reducing tariffs, new challenges have emerged, such as non-tariff barriers, trade-distorting domestic policies, service



trade concerns, developing country preferences, foreign investment restrictions, and intellectual property.

Keywords

GATT, WTO, Most-Favoured-Nation, Reciprocity, Neo-Mercantilism, Regional Trade Blocs, The Multi-Fibre Arrangement, Dumping, Triffin Dilemma, Beggar Thy Neighbour Policy

Discussion

3.2.1 General Agreement on Tariffs and Trade (GATT)

In 1946, while discussing the International Trade Organisation's (ITO) charter, a group of countries sought immediate tariff reductions. The United States led the effort, drafting a document on tariffs and trade. Twenty-three nations met in Geneva, agreeing on mutual tariff cuts that became the GATT. Initially, GATT was meant to be a temporary step towards establishing the ITO, incorporating many of its proposed principles and commitments. The ITO never materialised despite a charter being drafted at the 1947-48 Havana conference. The US and Britain disagreed on the organisation's authority over governments, leading to a stalemate. Since the US Senate did not ratify the charter, no other country did either. As a result, the GATT became the default framework for global trade. Headquartered in Geneva, the GATT Secretariat was less ambitious than the proposed ITO but still promoted multilateral trade negotiations and dispute resolution among member countries.

• Birth of GATT

• GATT replaces ITO

The failure to establish the ITO showcased the significant influence of the United States in shaping the post-war global trading system. The structure and negotiations of the GATT were heavily influenced by the US, the dominant trading nation, and its domestic politics.

GATT was an international agreement that aimed to increase global trade by reducing barriers like taxes on imports (tariffs),

- Aimed to increase global trade by reducing barriers

limits on imports (quotas), and government support (subsidies). After World War II, GATT helped create a more open global trading system, until it was replaced by the WTO in 1995.

After World War II, countries wanted to avoid repeating the protectionist policies that worsened the Great Depression. They aimed to promote free trade and reduce tariffs and restrictions. When plans for an ITO fell through, 23 Western nations signed the GATT in 1947. GATT's goal was to create a fair and open global trading system, encouraging economic cooperation and growth.

3.2.1.2 The Objectives of the GATT

The GATT was created with three main goals: to establish a framework for international trade, progressively eliminate trade barriers, and prevent countries from taking unilateral actions. GATT succeeded in:

1. Creating a trade framework
2. Reducing tariffs, especially among developed countries

Despite its efforts to promote free trade, GATT faced several challenges. One major issue was the persistence of non-tariff barriers, which limited trade and hindered economic growth. Additionally, countries like the United States took unilateral actions, imposing measures against nations deemed to be engaging in "unfair" trade practices. These actions undermined the multilateral spirit of GATT and created tensions among member countries.

- GATT faced several challenges

- GATT fosters global cooperation

The GATT consists of 38 Articles, divided into four Parts. Part I outlines member countries' obligations. Part II establishes fair trade practices, including tariff procedures and technical conditions. Part III covers agreement application and amendments. Part IV, added in 1965, focuses on LDCs trade. GATT negotiations occur in rounds, with all members meeting simultaneously. Initially, major trading partners made bilateral concessions, which were then transformed into multilateral agreements based on GATT's core principles.

3.2.1.3 The Principles of the GATT

The GATT is founded on the Principle of Fairness, ensuring that all member countries are treated equally in trade. Article

- The GATT is founded on the Principle of Fairness

It enshrines the “most-favoured-nation” (MFN) rule, which prohibits countries from giving preferential treatment to one nation without extending it to all GATT members. This means that any special trade deals, trade protections, or quotas must be applied equally to all members, with limited exceptions for non-GATT members or specific situations outlined in other articles.

a) The Most-Favoured-Nation (MFN)

The MFN principle is important for global trade. It ensures that all countries are treated equally and have the same opportunities. If one country gets a better trade deal, the MFN principle requires that all countries get the same deal. This promotes fair and equal trade. However, there are some exceptions to this rule, such as free trade areas and customs unions. These exceptions allow for flexibility in trade agreements. The MFN principle boosts confidence among countries and promotes trade liberalisation. It ensures that countries negotiate fairly and that tariff reductions are “bound”, meaning they are confirmed and won’t change.

- Promotes fair and equal trade

b) Non-Discrimination

The GATT aims to promote fair and equal trade among its member countries. The MFN clause plays a crucial role in achieving this goal by ensuring that countries negotiate fairly and transparently. The clause requires that any trade agreement made with one country must be matched if a better deal is made with another country. This boosts confidence and encourages trade liberalisation. Furthermore, the national treatment clause ensures that imported goods are treated equally to domestic goods, facing the same taxes and regulations inside the country.

- Ensuring that countries negotiate fairly and transparently

The MFN clause largely exists due to the United States’ strong commitment to this principle. In the 1930s, Secretary of State Cordell Hull championed the MFN clause as a key part of his mission to combat rising protectionism and promote free trade. Hull saw the MFN principle as fair, equal, and aligning with American values. By embracing this principle, the US positioned itself as a moral leader in international trade.

- GATT promotes fair practices

c) Reciprocity

Reciprocity is a key principle in GATT negotiations, although

- Mutual exchange of benefits

it's not formally defined. Simply, reciprocity means that when one country receives a trade concession from another, it should offer a similarly valuable concession in return. For example, two countries might agree to reduce tariffs on each other's exports, keeping their bilateral trade balance unchanged. This mutual exchange of benefits promotes fair and balanced trade.

- Balance in trade concessions

The concept of reciprocity in international trade has its roots in 1930s US policy, specifically the Reciprocal Trade Agreements Act of 1934. After the US raised tariffs in 1930 (Smoot-Hawley Tariff), other countries retaliated, harming US trade. Secretary of State Cordell Hull convinced Congress that to reduce foreign tariffs on US goods, he needed to offer equivalent access to the US market. This approach, known as reciprocity, aimed to balance trade concessions and promote mutual benefits.

- GATT ensures fair trade

d) Transparency

GATT's Article XI prohibits direct trade controls, such as quotas, except in specific situations like balance-of-payments crises. This ban exists because quotas are less transparent than tariffs. Tariffs provide clear information to exporters about market barriers, allowing them to decide supply volumes. Quotas create uncertainty about allowed export volumes and revenue. Additionally, tariffs' price increases are obvious to consumers, whereas quotas' effects may be hidden. For example, a 20% tariff clearly raises domestic prices by 20%. Quotas' impact is less apparent, making it harder for consumers to recognise and lobby against import restrictions.

- GATT supports free trade

3.2.1.4 The GATT and Neo-Mercantilism

GATT's principles have been criticised for reflecting old-fashioned mercantilist ideas like exports are good, imports are bad and balanced trade is best. But economists say that reducing tariffs helps everyone, countries should cut tariffs freely, without needing compensation. This highlights the difference between mercantilist and other economists' views on trade. The GATT principles acknowledge the complex political and economic landscape, where governments face pressure from domestic industries to protect them from imports. To balance this, the reciprocity clause empowers export-oriented sectors to advocate for trade liberalisation. By doing so, reciprocity effectively counters protectionist pressures, prevents countries from exploiting lower export

tariffs without offering concessions, and maintains balanced trade. This approach safeguards against adverse economic effects, including unfavourable balance-of-payments and terms-of-trade, ultimately promoting sustainable and mutually beneficial trade.

3.2.1.5 The MFN Clause and Discrimination Against Countries

Applying the same tariffs to all countries does not necessarily mean equal treatment. Even if a country like the United States applies the same tariff structure to all nations, it can still inadvertently discriminate between them. For instance, if the US imposes a high tariff on cocoa, a product primarily exported by Ghana, but a low tariff on Scottish sweaters, it effectively favours the UK over Ghana. Tariff changes can also favour some countries over others. If the US lowers tariffs on industrial goods, but African States can't produce those goods, it does not help them. What seems fair in theory can be discriminatory in practice. Additionally, changing tariffs can have varying effects depending on economic circumstances. Economists consider the big picture, while lawyers focus on equal treatment, leading to different perspectives.

- Imposing same tariff have varying effect on countries, considering their economic circumstances

The Most-Favoured-Nation (MFN) principle has an interesting implication when viewed from a political perspective. It can be seen as a form of extreme nationalism, where all foreign countries are treated equally, but distinctly from one's own nation. This approach prioritises protecting domestic producers over fostering cooperation with specific foreign nations. The MFN principle groups all foreign producers together, disregarding cultural, geographical, or political ties, and grants them equal access to the domestic market. This seems to combine two contrasting philosophies: nationalism (prioritising one's own nation) and egalitarianism (treating all foreign nations equally).

- MFN limits trade equality

3.2.1.6 Exceptions to the GATT

The General Agreement on Tariffs and Trade (GATT) allows for certain exceptions to its rules. These exceptions include situations where countries are facing economic difficulties, need to impose special tariffs, or require specific treatment for certain goods. Additionally, countries are permitted to take action in response to unfair trade practices. However, some domestic policies have been difficult to address through GATT

- GATT allows trade exceptions

negotiations, resulting in their being sidestepped.

a) Regional Trade Blocs

- Article XXIV supports forming free trade areas and customs unions

GATT's Most-Favoured-Nation (MFN) principle has a key exception, the Article XXIV. This article allows countries to form free trade areas and customs unions, but with two important conditions. Countries, in the first case, in these partnerships can't increase tariffs or trade barriers with non-member countries. In the second case the partnerships must cover almost all trade between member countries. This exception promotes regional economic integration while ensuring fair trade with other GATT member countries.

- US Marshall Aid Program and the Organisation for European Economic Co-operation enabled the formation of free trade areas

After World War II, GATT allowed European countries to form customs unions and free trade areas to help rebuild their economies. The US supported this effort through the Marshall Aid Program and the Organisation for European Economic Co-operation. This helped Western Europe recover quickly and promoted economic integration, which eventually led to the establishment of the European Union.

Marshall Aid Program helped to the formation of NATO

The Marshall Aid Program was a US-led initiative launched in 1948 to rebuild war-torn Europe after World War II. Named after Secretary of State George Marshall, the program provided over \$12 billion in economic assistance to 16 European countries. Its objectives were to rebuild infrastructure, stimulate economic growth, promote trade and cooperation, and foster democratic institutions. The program played a crucial role in Western Europe's rapid recovery and contributed to the establishment of NATO and the European Union, making it one of the most successful US foreign policy initiatives.

- Formation of regional trade blocs

Since the GATT's creation, customs unions and free trade areas have multiplied. Among developed nations, notable examples include, the European Community (EU), the European Free Trade Area (EFTA), and the US-Canada Free Trade Area. In developing countries, regional trade partnerships have also emerged for e.g. Latin American Integration Association (ALADI Caribbean Community (CARICOM), Association of South-East Asian Nations (ASEAN), West African economic groups (CEAO, MRU, and ECOWAS), Central African Customs and Economic Union. These regional alliances aim to boost economic cooperation, reduce trade barriers, and promote growth among member countries.



b) Regional Tariff Preferences

- MFN attains tariff preference for specific country groups

The Most-Favoured-Nation (MFN) principle has another exception: tariff preferences for specific country groups. Existing preference systems before GATT's signing were allowed to continue. One notable example was the Commonwealth preference system, used by the UK, which caused disagreement with the US. However, this system is no longer significant.

- GATT permits preferential trade

The GATT allows special trade agreements between developed countries and their territories or former colonies. For example, the Lome Convention enables trade between European Community members and some of their former colonies. Additionally, the Generalised System of Preferences (GSP) lets developed countries reduce trade restrictions for Less Developed Countries (LDCs) without expecting anything in return. The GATT approved the GSP through a 10-year exemption in 1971 and later through the Tokyo Round's enabling clause.

c) Dumping

- GATT fights unfair dumping

GATT's Article VI helps countries deal with unfairly priced imports, known as "dumping." To take action, a country must prove two things, that the goods are sold too cheaply and that this hurts local industries. If proven, the country can impose a special tax, called a countervailing duty, to make things fair. However, it's hard to prove that a country is not dumping, and some countries might misuse these laws to restrict fair trade.

d) The Multi-Fibre Arrangement

- Regulation of Textile Trade

The textile trade market is highly regulated. In the 1950s, developed countries had too much production capacity, while new countries like Japan, Hong Kong, and India entered the market. To manage this, countries like the UK made bilateral agreements to limit imports. In 1961, GATT created a multilateral deal, the Short-Term Arrangement on Cotton Textiles, to oversee textile trade. Its main goals were to ensure fair access to developed markets and prevent sudden import surges that could disrupt markets. The Short Term Arrangement only lasted for a year, but it was quickly replaced by a new agreement called the Long Term Arrangement. This new agreement kept many of the same rules as the Short-Term Arrangement, but it also added some new features to control the

growth of imports. This was meant to be a temporary solution, and it was originally supposed to last for five years. However, it was renewed twice, first in 1967 and again in 1970, which meant it stayed in place for a longer period.

- MFA Textile Agreement

In 1974, the Long Term Arrangement was replaced by a new agreement called the Multi-Fibre Arrangement (MFA). The Multi-fibre Arrangement (MFA) was a landmark international trade pact that regulated the global textile and clothing trade for over three decades, from 1974 until its eventual expiration in 2005. The MFA had 40 countries signing up, including the European Community, and it covered trade in both natural and man-made fibers. This agreement covered about 75% of the world's textile trade. The MFA was supposed to end in 1992, but its deadline was extended because of ongoing trade talks in the Uruguay Round. The MFA continued the same approach as previous agreements, allowing countries to limit imports and control the growth of imports.

3.2.1.7 GATT and Agriculture

- Uruguay Round addressed agricultural trade under the purview of GATT

Agriculture, heavily influenced by government policies, remains a challenge for the GATT. Most developed countries support their farmers through measures like tariffs, import quotas, export subsidies, and production subsidies. These policies impact trade, but until the Uruguay Round, countries considered domestic farm programs untouchable, giving agriculture special treatment within GATT. This meant agricultural trade was exempt from normal rules on market access and export competition. The Uruguay Round Round faced disagreements, especially between the US and Europe, due to conflicting agricultural policies.

3.2.1.8 GATT and Services

GATT previously ignored service trade, but the US pushed for its inclusion in the Uruguay Round, citing its export potential. Other developed countries eventually joined in, while Less Developed Countries remained sceptical, fearing it might distract from their key concerns.

3.2.1.9 The GATT Rounds (1947 -1961)

The countries that were part of GATT would meet regularly to talk about reducing trade barriers, quotas, and tariffs. From 1948 to 1994, they had several rounds of negotiations. The first

- Earlier GATT rounds focused on reducing tariff

few rounds, from 1947 to 1962, focused mainly on reducing tariffs, which were seen as a major obstacle to international trade. These rounds took place in different cities: Geneva (1947), Annecy (1949), Torquay (1950-51), Geneva (1955-56), and Geneva again (1960-62), also known as the Dillon Round.

- Later, GATT rounds focused on non-tariff barriers, ITR

The General Agreement on Tariffs and Trade (GATT) held numerous rounds of negotiations from 1946 to 1994, aiming to reduce trade barriers among member countries. Starting with the inaugural London Round in 1946, subsequent rounds in Havana (1947), Annecy (1949), Torquay (1951), and Geneva (1956) progressively expanded participation and tariff reductions. The later rounds, including the Dillon Round (1960-61), Kennedy Round (1964-67), Tokyo Round (1973-79), and Uruguay Round (1986-94), broadened the scope to address non-tariff barriers, services, intellectual property, and developing countries' concerns. The culmination of these efforts was the Uruguay Round, which resulted in significant agreements and the establishment of the World Trade Organization (WTO) in 1994, marking a major milestone in global trade liberalisation.

3.2.2 World Trade Organisation (WTO)

- WTO establishes global trade

The World Trade Organisation (WTO) was established as a result of a long process that began with the creation of the General Agreement on Tariffs and Trade (GATT) in 1947. The WTO was officially formed after eight years of negotiations, known as the Uruguay Round, which took place from 1986 to 1994. This led to the creation of new rules for international trade, including agreements on agriculture, services, and intellectual property rights. Additionally, the WTO established a system for resolving trade disputes and reviewing trade policies.

3.2.2.1 WTO Ministerial Conference

- WTO's top decision body Ministerial Conferences, meets at least every two years

The World Trade Organisation (WTO) has a top decision-making body called the Ministerial Conference, which meets at least every two years. All WTO member countries attend this conference, which has the power to make decisions on any trade-related issue. Since the WTO was established in 1993, there have been nine Ministerial Conferences, held in various locations around the world, including Geneva, Hong Kong,

Cancun, Doha, Seattle, Singapore, and Bali, with the most recent one taking place in Bali in 2013.

3.2.2.2 Objectives

1. To promote free trade: WTO aims to promote free trade and economic cooperation among its member countries.

2. To reduce trade barriers: WTO works to reduce or eliminate trade barriers, such as tariffs, quotas, and other restrictions.

3. To increase economic growth: By promoting free trade and reducing trade barriers, WTO aims to increase economic growth and development.

4. To improve living standards: WTO aims to improve living standards by increasing economic growth, reducing poverty, and promoting sustainable development.

5. To promote fair competition: WTO promotes fair competition among countries and companies, ensuring that trade is conducted in a fair and transparent manner.

- WTO promotes fair trade

3.2.2.3 Functions

1. Trade Negotiations: WTO provides a platform for countries to negotiate trade agreements and reduce trade barriers.

2. Dispute Settlement: WTO has a dispute settlement mechanism to resolve trade disputes between countries.

3. Trade Policy Review: WTO reviews the trade policies of its member countries to ensure that they comply with WTO agreements.

4. Technical Assistance: WTO provides technical assistance to developing countries to help them build their capacity to participate in international trade.

5. Monitoring Trade Policies: WTO monitors the trade policies of its member countries to ensure that they comply with WTO agreements.

6. Providing a Platform for Cooperation: WTO provides a platform for countries to cooperate on trade-related issues and

- WTO facilitates global trade



to address global trade challenges.

7. Promoting Transparency and Accountability: WTO promotes transparency and accountability in international trade by requiring countries to notify and consult with each other on trade-related issues.

3.2.3 The Concept of Triffin Dilemma

- The reserve currency creates a dilemma

The Triffin Dilemma is a concept in international economics that highlights a key problem for any country whose currency is used as the global reserve currency. The dilemma arises from the tension between the needs of the global economy and the domestic economic policies of the country issuing the reserve currency.

- Reserve currency facilitates trade

A global reserve currency plays a crucial role in facilitating international trade and investment. Historically, the US dollar has held this position, widely used by countries for global transactions and as a store of value. For countries around the world to conduct international trade, they need access to a reserve currency. This means the issuing country (like the United States) must make its currency available to the global economy.

- The reserve currency creates debt

To meet global demand for its currency, a country like the US must run a trade deficit, importing more than it exports. This means borrowing from other countries by issuing more currency, resulting in increased debt. To finance this debt, the US essentially prints more money and runs deficits, relying on other countries to continue lending.

- Global currency dilemma

The global economy relies heavily on a reserve currency, like the US dollar, for international trade and investment. To meet this demand, the issuing country must provide a large amount of its currency, usually by borrowing and running trade deficits. However, this can harm the country's domestic economy, leading to inflation, currency devaluation, and decreased economic stability. This creates a conflict: to meet global demand for its currency, it must take on debt and run trade deficits, but this can ultimately harm its own economy, exposing it to risks like inflation, higher interest rates, and currency instability.

The Triffin Dilemma highlights a problem. When a country's currency is used worldwide, it must print more money to meet demand. This can lead to financial troubles and decreased

- Reserve Currency face Currency confidence crisis

- Dilemma-reserve currency raising country needs to both supply enough currency to world and keep its domestic economy stable

- Harming others for gain

trust in the currency. This dilemma affects global stability. If countries lose faith in the main currency, they might look for alternatives, like the Euro or gold, to avoid relying on an unstable currency.

The US dollar is still the main reserve currency, but the Triffin Dilemma remains. As the world economy becomes more connected, it's a challenge to balance the need for global liquidity with the economic health of the country issuing the reserve currency. The Triffin Dilemma has led to discussions about alternatives to the US dollar, such as a global currency or a system based on multiple currencies. These proposals aim to reduce the risks of relying too heavily on one country's currency. The Dilemma highlights a fundamental conflict: the need for the country issuing the reserve currency to supply enough currency to the world, while managing the economic risks of borrowing and running trade deficits. This creates a delicate balance and raises questions about the sustainability of the current global financial system.

3.2.4 Beggar Thy Neighbour Policy

The Beggar Thy Neighbour Policy is an economic strategy where one country tries to improve its economy at the expense of others. This is usually done by changing trade or financial policies to lower unemployment, increase exports, or boost the economy, but these actions end up hurting other countries. The term "beggar thy neighbour" means that one country's gains come by creating problems for other countries, forcing them to bear the economic costs. This policy is often linked to protectionism, currency devaluation, and trade barriers that negatively impact other nations.

3.2.4.1 Key Elements of the 'Beggar Thy Neighbour' Policy

- **Currency Devaluation:** A country can deliberately lower the value of its currency to make its exports cheaper globally. This helps the country's export business, but makes other countries' goods more expensive, hurting their exports and causing trade problems.
- **Restrictive Trade Policies:** Countries may use tariffs, quotas, or other limits to restrict foreign goods and help local businesses. These measures aim to reduce imports and encourage people to buy local products, which can help the local economy. However, these restrictions can harm

other countries that rely on exporting goods to the country imposing these limits.

- Key elements- conscious devaluation, imposition of restrictive trade policies, monetary and fiscal stimulations for domestic economy

- **Monetary Policy Manipulation:** Countries may lower interest rates or engage in other forms of monetary stimulus to boost domestic demand. While this can reduce unemployment and promote economic growth within the country, it might attract foreign capital, potentially creating capital flows that destabilise the economies of other nations.
- **Subsidies and Trade Barriers:** A government may introduce subsidies to domestic industries to make their goods cheaper on the international market or provide incentives to encourage domestic consumption. At the same time, they may impose barriers to prevent foreign goods from entering their market, thereby “begging” their them by reducing foreign trade opportunities.

3.2.4.2 The Historical Perspective

The most famous example of Beggar Thy Neighbour policies occurred during the Great Depression of the 1930s. As global trade and economic activity slumped, many countries turned to protectionist measures in an attempt to shield their economies from the downturn. These policies included:

- Tariffs (such as the Smoot-Hawley Tariff in the United States), which raised duties on imported goods to protect domestic industries.
- Currency devaluations, particularly by countries like the UK and France, aimed at making exports cheaper but hurting their trading partners’ ability to compete in global markets.

- Protectionism exacerbates global crisis

Rather than solving the global economic crisis, these policies led to a cycle of retaliation, where countries imposed similar measures on each other, exacerbating the global depression and reducing international trade even further.

3.2.4.3 Impact of Beggar Thy Neighbour Policies

1. Short-Term Benefits for the Implementing Country:

Countries that use “beggar thy neighbour “ policies might see some short-term benefits. They might sell more exports, have lower unemployment, and see their economy grow. For example, making their currency

- Short term economic gains

worth less can make their exports cheaper and more attractive to other countries, giving their economy a temporary boost.

- Trade wars harm growth

- Tensions rise between nations

- Retaliation sparks trade wars

- Trade wars damage economies

2. Negative Effects on Global Trade: These policies often lead to a breakdown in global cooperation and can cause a reduction in international trade. As one country increases tariffs or subsidies, other nations may respond by doing the same, leading to a trade war. This harms global economic growth as countries restrict access to markets and trade.

3. Increased Tensions between Countries: When one country's economic policies harm others, it often leads to diplomatic and economic tensions. Countries that are negatively affected by these policies might retaliate, leading to a cycle of actions and counteractions that escalate trade conflicts and damage international relationships.

4. Retaliation and Trade Wars: The “beggar thy neighbour” approach often leads to retaliatory actions. For example, if one country devalues its currency, other countries may feel forced to do the same to remain competitive. This can lead to a race to the bottom, where countries keep devaluing their currencies or raising tariffs, ultimately harming all countries involved.

5. Long-Term Economic Damage: Although these policies may provide short-term economic relief to the implementing country, they can harm long-term growth. Retaliatory actions from other countries can lead to decreased international cooperation and undermine global supply chains. Moreover, trade wars can lead to higher costs for consumers and businesses, reducing overall welfare.

3.2.4.4 Modern-Day Examples

While beggar thy neighbour policies were more common in the 1930s, countries still engage in these types of behaviours.

- Modern beggar thy neighbour policies include currency wars and tariff wars

- **Currency Wars:** A country might deliberately devalue its currency to make its exports more competitive. This can lead to a competitive devaluation where other countries also devalue their currencies, which can destabilise international markets.
- **Tariff Wars:** In recent years, there have been trade ten-



sions, particularly between major economies like the United States and China, where tariffs and trade restrictions are imposed in an attempt to protect domestic industries or gain trade advantages. For example, the US-China trade war saw both countries imposing tariffs on each other's goods in retaliation for perceived unfair trade practices.

3.2.4.5 The Global Perspective and Avoiding Beggar Thy Neighbour

Economists generally agree that beggar thy neighbour policies are harmful in the long run because they reduce overall global welfare. Rather than creating economic growth for everyone, these policies tend to cause a zero-sum game, where one country's gain is offset by another country's loss. To avoid this, global cooperation and trade agreements (such as those formed under the World Trade Organisation, or WTO) aim to reduce protectionism and encourage policies that benefit all countries. International cooperation ensures that countries can pursue economic growth without harming others, promoting the idea of positive-sum games where all parties benefit through trade and cooperation.

- Global cooperation promotes growth

Summarised Overview

This unit introduces the key concepts of international trade and finance, including the General Agreement on Tariffs and Trade (GATT) aimed to reduce tariffs and trade barriers, establish rules for international trade, and foster economic development. The World Trade Organisation (WTO) built upon GATT's objectives, promoting free trade, economic cooperation, and improved standards of living. However, the Triffin Dilemma highlights a fundamental conflict in the international monetary system, where a country's currency is used as a global reserve currency, creating tension between supplying enough currency for global liquidity and managing economic risks. Furthermore, the Beggar Thy Neighbour (BTN) policy, where a country seeks to improve its economy at the expense of others through protectionist measures, currency devaluation, or export subsidies, can lead to trade wars and reduced international cooperation, ultimately harming global economic growth.

Assignments

1. Discuss the objectives, principles, and achievements of GATT.
2. Explain the objectives and functions of WTO.
3. Analyse how the Triffin Dilemma affected the country's economic policies and international relations.
4. Analyse the impact of Beggar Thy Neighbour policies on international trade and economic cooperation.

Suggested Reading

1. Kindleberger, C P -*International Economics* (1973) Routledge, London
2. Carbaugh, R J (2008) - *International Economics*, (11th Edition) Thomson South Western, New Delhi.
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1. Soderstein BO and Geffry Reed, (2006) *International Economics*, Palgrave, Mc Milan
2. Levi, M.D. *International Finance: The Markets and Financial Management of Multinational Business*, 3rd Edition, McGraw Hill International Editions, Finance Series, 1996.
3. Dominick Salvatore, (2013, 11th Edition) *International Economics*, John Wiley & Sons

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU

UNIT 3

Regional Economic Integration and Currency Arrangements

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the concept of Optimum Currency Areas (OCAs)
- discuss the effectiveness of customs unions
- know the importance of policy coordination with floating exchange rates

Background

The increasing globalisation of trade and finance has created a complex web of economic relationships between countries, driving the need to study topics such as optimum currency areas, currency unions, customs unions, and policy coordination with floating exchange rates. The rise of new economic powers like China, India, and Brazil has also led to a shift in global economic governance, emphasising the importance of international policy coordination to promote sustainable growth and address economic instability. As a result, understanding these concepts is essential for policymakers, economists, and business leaders to navigate the complexities of international economics and make informed decisions.

Keywords

Economic Integration, Optimum Currency Areas, Customs Unions, Floating Exchange Rates



Discussion

3.3.1 Theory of Optimum Currency Areas

The Optimum Currency Area theory was created by Robert Mundell and Ronald McKinnon in the 1960s. This theory helps us understand the debate between fixed and flexible exchange rates. An Optimum Currency Area is a group of countries that share a single currency or have fixed exchange rates with each other. These countries' currencies may then fluctuate in tandem relative to those of non-member countries. For example, different regions within a country automatically share the same currency, making them an Optimum Currency Area. Imagine the United States, Canada, and Mexico using the same money, called the 'Americo.' This would make it easier for people and businesses to buy and sell things across borders, without having to exchange money. It would also help the countries work together better economically, since they would have the same monetary policy. When countries share a single currency, it removes the uncertainty that comes with changing exchange rates. This makes it easier for businesses to trade and invest with each other, and to specialise in producing certain goods. It also encourages companies to think of the entire region as one big market, which can help them produce goods more efficiently and at a lower cost.

- Single currency boosts trade, stability and efficiency regionally

3.3.1.1 Advantages of Optimum Currency Area

When countries in an optimum currency area have fixed exchange rates, they are more likely to have stable prices. This happens because economic shocks in one region can be balanced out by other regions, making the overall economy more stable. As a result, people are more likely to trust and use money, and less likely to rely on bartering. Additionally, having a single currency or fixed exchange rates saves countries money on things like managing exchange rates, protecting against currency fluctuations, and exchanging currencies for trade and travel.

- Fixed exchange rates promote stability, trust and savings

3.3.1.2 Disadvantages of Optimum Currency Area

One of the biggest downsides of an optimum currency area is that each country can not make its own economic decisions based on its unique needs and preferences. For example, if

- Shared currency limits policy freedom

one region is struggling with high unemployment, it might need to increase government spending and cut interest rates, while a more prosperous region might need to do the opposite to control inflation. However, workers can move from poorer areas to richer ones, and poorer areas can receive investment and aid from richer ones. Despite some drawbacks, most experts agree that poorer countries or regions are better off joining an optimum currency area than going it alone.

- Successful currency area needs mobility, similarity, cooperation

An optimum currency area is more likely to be beneficial if certain conditions are met. These conditions include: (1) people and resources can easily move between countries, (2) the countries have similar economies and structures, and (3) they are willing to work together on economic policies. The goal of an optimum currency area is to make the most of the benefits of having a single currency, while minimising the drawbacks. However, it is not easy to measure the exact benefits and costs of joining an optimum currency area for each country or region.

3.3.1.3 European Monetary System (1979–1998)

- EMS aimed for stability, struggled without policy co-ordination

In 1979, the European Economic Community (EEC) created the European Monetary System (EMS) to promote monetary integration among its members. The EMS had three main features: it created a new currency unit called the European Currency Unit (ECU), allowed member countries' currencies to fluctuate within a certain range, and established a fund to help members with balance-of-payments problems. When a member country's currency fluctuated too much, it had to take corrective steps to control it. If the currency reached its limit, the country with the weak currency and the country with the strong currency would share the burden of intervening to stabilise the exchange rate. Member countries of the European Monetary Cooperation Fund (EMCF) were given a quota, which they paid partly in gold and partly in US dollars, in exchange for European Currency Units (ECUs). The value of ECUs grew quickly as countries converted more dollars and gold into ECUs, making ECUs a stable and important international currency. From 1979 to 1992, the European Monetary System (EMS) had 11 currency realignments. Countries with high inflation, like Italy and France, had to devalue their currencies to stay competitive with low-inflation countries like Germany. This showed the weakness of the EMS, which tried to control exchange rates without coordinating economic policies among

member countries. From 1979 to 1992, the European Monetary System (EMS) had 11 currency realignments. Countries with high inflation, like Italy and France, had to devalue their currencies to stay competitive with low-inflation countries like Germany. This showed the weakness of the EMS, which tried to control exchange rates without coordinating economic policies among member countries.

3.3.1.4 Transition to Monetary Union

- Delors plan outlined steps to European Monetary Union

In 1989, a committee led by Jacques Delors proposed a three-stage plan to achieve monetary union in Europe. Stage one (1990) aimed to converge economic policies and remove capital movement restrictions. Stage two (1994) established the European Monetary Institute, a precursor to the European Central Bank. Stage three (1997 or 1999) would introduce a single currency and transfer control over monetary policy to the European Central Bank, limiting national sovereignty over money supply and budget policies.

- Maastricht Treaty set conditions for Euro adoption

The Maastricht Treaty set five strict conditions for a country to join the European Monetary Union. These conditions included: an inflation rate no more than 1.5% higher than the average of the three countries with the lowest inflation; a budget deficit below 3% of GDP; government debt below 60% of GDP; long-term interest rates no more than 2% higher than the average of the three countries with the lowest inflation; and a stable exchange rate. By 1991, only France and Luxembourg met all these conditions, while others like Germany and Italy did not qualify due to high deficits and debt. However, by 1998, most European Union countries had met the conditions, paving the way for the introduction of the Euro single currency.

- EU advanced monetary union despite challenges and reservations

The European Union's (EU) journey towards monetary union was marked by significant milestones, including the creation of the Stability and Growth Pact (SGP) in 1997, which aimed to ensure fiscal discipline among member states by limiting budget deficits to 3% of GDP. However, the SGP's effectiveness was tested when Germany, a key proponent of the pact, breached the deficit limit in 2003, leading to a relaxation of the rules in 2005. Meanwhile, the United Kingdom expressed reservations about the EU's plans for greater economic and political integration, opting to maintain control over its fiscal policies and refusing to adopt the euro. Despite these challenges, the Maastricht Treaty paved the way for the establishment of the

European Central Bank (ECB) in 1998 and the introduction of the euro in 1999, representing a major step towards achieving monetary union in Europe.

3.3.1.5 Creation of the Euro

In 1999, the European Monetary System transformed into the European Monetary Union (EMU), introducing the euro as a common currency and a unified monetary policy led by the European Central Bank. On January 1, 1999, the euro became the official currency of 11 European countries. Greece joined in 2001, while the UK, Sweden, and Denmark opted out. The creation of the euro marked a historic milestone, as it was the first time a large group of countries voluntarily gave up their individual currencies for a shared one. From January 1, 1999, the euro was used in financial markets and for new investments, and official statistics were reported in euros. However, euro banknotes and coins were not introduced until 2002. Until then, the euro existed only as a unit of account, not as a physical currency that people could use in their daily lives.

- Euro becomes a common currency in 1999

3.3.2 Customs Union

A Customs Union is an agreement between countries to remove taxes and restrictions on goods traded between them. They also agree on a common tax rate for goods imported from outside countries. This makes trade easier, faster, and more efficient. Examples include the European Customs Union and the Southern African Customs Union.

Jacob Viner was the first to study the theory of customs unions. He used a simple model to show that forming a customs union can sometimes increase welfare, but other times decrease it. His work was important because it showed that customs unions are not always beneficial and that they can harm a country's welfare in certain situations. He introduced two important concepts viz; trade creation and trade diversion. To understand these, imagine three countries producing the same product with different costs. By focusing on how a customs union affects resource allocation and welfare, Viner's analysis helps us understand how trade creation and trade diversion work.

- Countries remove trade barriers, adopt common external tariff

- Viner showed customs unions can benefit or harm welfare

The production cost of commodity X in three countries

Country	A	B	C
Production Cost	50	40	30

- Tariffs make imports costlier

To explain these concepts, let us consider three countries A, B, and C, that all produce the same product, but at different costs, using their respective currencies. Country A can produce the product for \$ 50, Country B produces it for \$ 40, and Country C produces it for \$ 30. If Country A imposes a 100% tariff on imports, the cost of goods from other countries increases. Therefore, consumers in Country A have the following choices: they can buy local goods from Country A for \$ 50, import from Country B (with the tariff) for \$ 80 ($\$ 40 + 100\%$ tax), or import from Country C (with the tariff) for \$ 60 ($\$ 30 + 100\%$ tax). Since importing is much more expensive, consumers in Country A will prefer to buy local goods at \$ 50, even though imports from B and C would be cheaper without the tax.

- Customs union lowers costs, leading to trade creation

Now, if Country A forms a customs union with Country B, they remove the tax on goods traded between them, but Country A still applies the tax to imports from Country C. As a result, consumers in Country A can now choose between: buying local goods for \$ 50, importing from Country B at the new price of \$ 40 (since there is no tax between A and B), or importing from Country C at \$ 60 (still taxed). Since Country B's goods are now cheaper at \$ 40 compared to local goods at \$ 50, consumers in Country A will begin importing from Country B. This is an example of trade creation, where Country A benefits by importing cheaper goods from Country B, improving economic efficiency.

- Customs union redirects trade, causing economic inefficiency

However, if Country A originally had a 50% tax on imports, consumers in Country A would have the following options: buying local goods for \$ 50, importing from Country B at 60 \$ (after the 50% tax), or importing from Country C at \$ 45 (after the 50% tax). Since Country C's goods are the cheapest at \$ 45, consumers in Country A would normally prefer to import from Country C. But after forming the customs union, the price of imports from Country B drops to \$ 40 (no tax). Now, despite Country C's goods being cheaper at \$ 45, consumers in Country A begin importing from Country B instead of Country C. This is trade diversion, where Country A imports from a more expensive supplier (Country B) instead of a cheaper

one (Country C) because of the customs union. This results in inefficient resource use and reduces Country A's overall welfare. Thus, we can say that a customs union can promote trade creation, making goods cheaper and more efficient, it can also lead to trade diversion, where a country ends up importing from more expensive suppliers instead of cheaper ones, thereby reducing economic efficiency and welfare.

3.3.2.1 A Case of Both Trade Diversion and Trade Creation

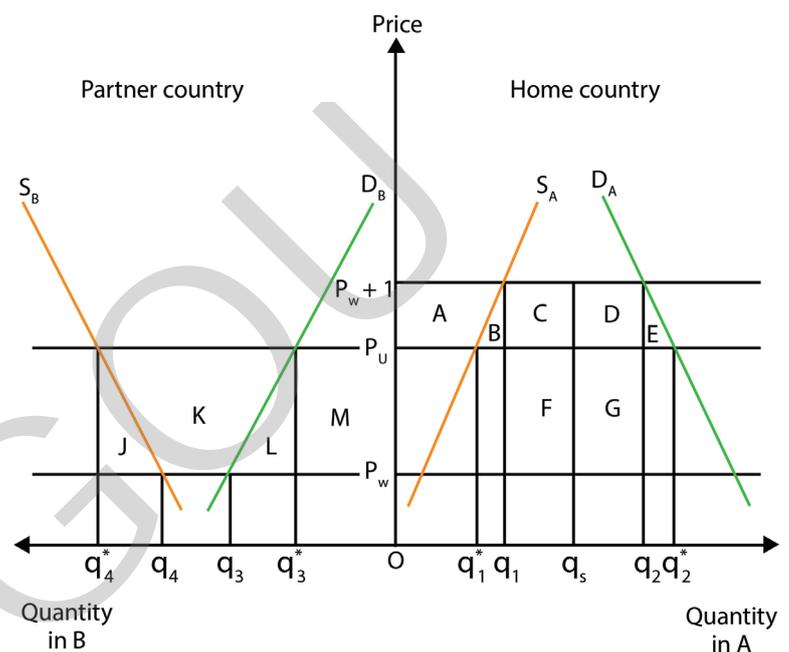


Fig 3.3.1 Trade Diversion and Trade Creation

- Two-country customs union: trade and price effects

The figure 3.3.1 illustrates the effects of a customs union. It is a simple illustration involving two countries, Country A (the home country) and Country B (the partner country), producing a single good. These two countries are economically small compared to the rest of the world, and due to this they cannot influence the world price (P_w), but they are relatively large compared to each other. This setup allows us to examine how trade patterns and prices are affected when the two countries form a customs union.

Before the formation of the customs union, Country A imposes a tariff on imports from the rest of the world, making the effective price of foreign goods $P_w + 1$, where P_w is the world

- Country A imports from both B and the rest of world

price and '+1' represents the tariff. On the right panel of the graph, which represents Country A, the demand curve (D_A) slopes downward and the supply curve (S_A) slopes upward, with quantity measured from left to right. At the tariff-inclusive price P_w+1 , consumers in A demand quantity q_2 . However, domestic producers supply only q_1 units. The remaining quantity ($q_2 - q_1$) must be imported. Part of this demand is met by imports from Country B (up to $q_s - q_1$), and the rest ($q_2 - q_s$) is imported from the rest of the world despite the higher price due to the tariff.

- Country B exports surplus at fixed world price

In Country B, represented in the left panel of the graph, the quantity axis runs from right to left. Therefore, although the domestic supply curve (S_B) and demand curve (D_B) visually appear reversed, S_B is actually upward-sloping and D_B is downward-sloping in economic terms. At the world price P_w , Country B produces q_4 and consumes q_3 . The surplus quantity ($q_4 - q_3$) is exported to international markets, including Country A. Since Country B is a small country in world markets, it accepts P_w as the given price and has no incentive to alter its output or pricing depending on the destination of exports.

- After the customs union, Country A imports only from B

Once the customs union is formed between countries A and B, tariffs on internal trade between them are abolished, although tariffs on imports from the rest of the world remain. As a result, the internal price within the union adjusts to a new level, P_u , which lies below the earlier tariff-inclusive price P_w+1 but remains above the world price P_w . This price drop leads Country A to shift all its imports to Country B, fully eliminating trade with the rest of the world. Imports from the rest of the world are no longer competitive because they are still subject to the tariff, making them more expensive than imports from Country B. Consequently, Country B redirects all its exportable surplus ($q_4 - q_3$) to Country A, where it can now sell at the higher price P_u , instead of the lower world price P_w .

The formation of the customs union results in both trade creation and trade diversion. Trade creation occurs because Country A now replaces part of its higher-cost domestic production with lower-cost imports from B. This is shown by the reduction in domestic output from q_1 to q_1^* , with the difference ($q_1 - q_1^*$) now being imported from B. This enhances efficiency and improves resource allocation. On the other hand, trade diversion occurs because Country A stops importing from the

- Customs union causes trade creation and diversion

rest of the world, which offered goods at the lower world price P_w , and instead imports from Country B at a higher price P_u . The quantity diverted from the world market to B is $(q_2 - q_5)$, which represents a shift from a more efficient to a less efficient source due to the customs union preference.

Additionally, the lower price P_u encourages an expansion in consumption in Country A. As the good becomes more affordable, total consumption increases from q_2 to q_2^* . The increase in consumption, represented by $(q_2^* - q_2)$, further adds to the volume of imports from Country B.

- Welfare depends on gains outweighing trade-related losses

The overall welfare impact on Country A depends on the balance of gains and losses from these changes. Consumers benefit from the lower price, gaining consumer surplus areas labeled A, B, C, D, and E in the graph. However, domestic producers lose out due to reduced sales, corresponding to area A, and the government loses tariff revenue, represented by areas C, D, F, and G. The net welfare effect is positive if the gains from trade creation (area B) and increased consumption (area E) outweigh the losses from trade diversion (area G) and the less favourable terms of trade with the partner country (area F).

- Customs union benefits depend on relative country gains

Country A is more likely to benefit from the customs union if the union price P_u is close to the world price P_w , if it did not import much from the rest of the world before the union, and if its supply and demand are highly responsive to price changes. If the home country (A) gains, the customs union as a whole also gains. However, even if A loses, the customs union may still be beneficial if Country B's gains exceed A's losses. Since the rest of the world is excluded from this union, it does not participate in these trade gains or losses. Global welfare improves only if the customs union as a whole brings more benefits than costs.

3.3.3 Policy Co-ordination with Floating Exchange Rates

In a world where exchange rates are allowed to fluctuate freely, countries have more flexibility to make their own decisions about monetary policy, such as setting interest rates and regulating the money supply. This independence can be beneficial, but it also creates challenges. When countries make their own monetary policy decisions without considering

- Floating exchange rates offer flexibility but cause co-ordination challenges

the impact on other countries, it can lead to conflicts and coordination problems. For example, one country's decision to lower interest rates might lead to a surge in imports from another country, causing trade imbalances and economic instability. This section delves into the complexities of policy coordination in a world with floating exchange rates, exploring the issues and challenges that arise when countries pursue independent monetary policies.

- Currency value fluctuates based on market forces

The value of currencies is determined by market forces, with exchange rates fluctuating based on supply and demand. Governments and central banks do not directly intervene in this process. Instead, they utilise economic policies to manage their domestic economy and collaborate with other countries to prevent economic disruptions and maintain global stability.

3.3.3.1 Important Aspects of Policy Coordination with Floating Exchange Rates

1) Monetary Policy and Exchange Rates

- Monetary policy affects trade

Central banks use interest rates and money supply as the tools of monetary policy. When they adopt an expansionary policy, such as lowering interest rates, the domestic currency tends to lose value. This makes exports cheaper and imports more expensive, which can help boost the economy. However, it can also have negative effects on other countries, making their goods more expensive and potentially leading to trade tensions or competitive currency devaluations.

2) Fiscal Policy and Exchange Rates

- Fiscal policy impacts trade

Government spending and tax cuts can boost domestic demand, leading to higher interest rates and a stronger currency. This makes exports more expensive, but attracts foreign investors. Globally, one country's fiscal expansion can benefit other countries by increasing demand for their exports. However, large fiscal imbalances can pose a risk to global financial stability.

Co-ordinating economic policies is challenging due to:

1. **Conflicting national interests:** Countries prioritise domestic goals over global stability, making agreement difficult.

- Barriers to global co-ordination

- 2. Time delays and uncertainty:** Economic policies take time to show effects, and predicting their global impact is hard, leading to potential policy mismatches.
- 3. Economic power imbalances:** Larger economies like the US or EU have more global market influence, creating unequal coordination efforts.

Examples of Policy Coordination

Three notable examples of international economic policy coordination are:

- 1. Plaza Accord (1985):** Major economies agreed to lower the US dollar's value, reducing trade imbalances and tensions.
- 2. Global Financial Crisis (2008-2009):** Worldwide, central banks and governments worked together to stabilise the economy with coordinated interest rate cuts, bailouts, and liquidity injections.
- 3. COVID-19 Pandemic (2020):** Global policymakers coordinated large-scale economic stimulus and monetary easing, but faced challenges like vaccine distribution and financial imbalances.

The Policy Coordination Conundrum

When countries have floating exchange rates, changes in one country's monetary policy can affect other countries. For instance, if a country adopts an expansionary monetary policy, its currency may lose value, making its exports cheaper and more attractive to other countries. While this might seem beneficial to the country with the weaker currency, it can actually lead to trade imbalances and tensions with other countries, which may see their own exports becoming less competitive. To avoid these negative consequences, countries need to work together and coordinate their policies to minimise the spill over effects and promote a more stable and balanced global economy.

- Monetary policy spillovers require coordination to avoid imbalances

Summarised Overview

The study of international economics includes several key topics that explore the complexities of economic integration and cooperation among nations. The theory of optimum currency areas examines the ideal conditions for a single currency to be used by multiple countries, considering factors such as economic symmetry, labour mobility, and fiscal policy coordination. Currency unions, such as the Eurozone, involve the adoption of a single currency by multiple countries, aiming to promote economic integration, stability, and growth. Customs unions, like the European Customs Union, aim to reduce trade barriers among member states, promoting free trade and economic cooperation. Finally, policy coordination with floating exchange rates is crucial for countries to manage their exchange rates and coordinate monetary policies to achieve economic stability and growth, while also mitigating the risks of currency fluctuations and economic shocks.

Assignments

1. Discuss the theory of optimum currency areas and its relevance to the European Monetary Union (EMU). Discuss the advantages and disadvantages of a single currency for EMU member states.
2. Explain the advantages and disadvantages of the Optimum Currency Area.
3. Explain the impact of customs unions on trade creation and trade diversion.
4. Compare and contrast the European Monetary Union (EMU) with another currency union, such as the East African Community (EAC).
5. Explain the important aspects of Policy Coordination with Floating Exchange Rates.

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.



SGOU

UNIT 4

The International Monetary System: Crisis and Reform

Learning Outcomes

After completing this unit, the learner will be able to:

- realise the chronology of economic crisis in emerging markets
- identify the causes, consequences, and policy responses to the 2008-09 global financial crisis and Great Recession
- know about current international economic problem other than crisis

Background

The world's financial system has had many big problems in recent years. These problems have affected international trade, economic growth, and financial stability. One of the biggest problems was the 2008-09 Global Financial Crisis. It started with a housing market bubble in the United States and spread to the rest of the world. Many countries experienced a big decline in economic activity, and many people lost their jobs. The crisis showed that the world's financial system had some big weaknesses. For example, many countries relied too heavily on the US dollar, and there was not enough regulation of financial institutions. Countries that were still developing, like Brazil and China, were especially hard hit by the crisis. They experienced big economic contractions, and their currencies lost value.

Since the 2008-09 crisis, the world has faced many other economic challenges. One of the biggest problems is income inequality. Another problem is protectionism, which means countries put barriers to trade with other countries. Climate change and environmental degradation are also big concerns. The COVID-19 pandemic has made all of these problems worse. It has caused widespread lockdowns, disrupted supply chains, and led to a big decline in economic activity. Other challenges include the ongoing problems in the



Eurozone, the rise of China and other developing countries, and the growing importance of digital trade and the digital economy. To address these challenges, countries need to work together and come up with new solutions. They also need to make sure that economic growth is sustainable and benefits everyone.

Keywords

Financial Crisis, International Monetary System, Global Financial Crisis, Great Recession

Discussion

3.4.1 Financial Crisis and International Monetary System

By the late 1960s, the Bretton Woods system, which fixed exchange rates, was showing signs of strain. The US was experiencing rising inflation due to increased government spending and monetary growth. This inflation spread to other countries, including those in Europe. As the US increased its money supply, other countries automatically increased theirs to maintain fixed exchange rates, importing US inflation in the process. To control inflation and stabilise their economies, countries had to abandon fixed exchange rates and let their currencies float, as they could not simultaneously control inflation and maintain fixed exchange rates.

- End of Bretton Woods to control inflation countries abandon fixed exchange rate system

In 1970, the US economy entered a recession, and as unemployment rose, investors became convinced that the value of the dollar would have to decrease compared to other major currencies. To fix the economy and balance trade, the US needed to make its exports cheaper by reducing the value of the dollar. There were two ways to do this: either the US could experience deflation (a decrease in prices) while other countries experienced inflation, or the value of the dollar could simply be decreased. The first option seemed painful, so investors expected the second option to happen, leading to a massive sell-off of dollars in the foreign exchange market.

- To reduce the trade deficit, the US lowered the value of the US dollar

After several failed attempts to stabilise the international monetary system, the major industrialised countries decided to let their currencies float against the US dollar in March

- In March 1973, major industrialised countries shifted from fixed to floating exchange rates

1973. This meant that the value of their currencies would be determined by supply and demand in the foreign exchange market, rather than being fixed at a certain rate. At the time, this change was seen as a temporary solution to deal with speculative currency movements. However, it ended up being a permanent change, marking the end of fixed exchange rates and the beginning of a new era of fluctuating exchange rates and increased uncertainty in international trade and finance.

3.4.2.1 Early Indicators of Crisis: 2007-2008

The global economy was thriving, with emerging markets reaping the benefits of substantial capital inflows and soaring commodity prices. As a result, many emerging economies experienced rapid growth, driven by strong exports, industrial growth, and significant foreign direct investment.

- Financial stability at risk due to rising cost and inflation

In 2007, the US housing market collapsed, causing many people to default on their mortgages. At first, it seemed like only rich countries would be affected, but soon people around the world started losing confidence in the economy. Around the same time, prices for things like oil, food, and metals skyrocketed. Some countries like Russia, Brazil, and South Africa benefited from this because they exported these goods. However, countries like India and Turkey, which relied on imports, struggled with rising costs and inflation.

3.4.2 Chronology of Economic Crisis in Emerging Markets - 2008-09

The 2008-2009 economic crisis had a profoundly devastating impact on emerging markets, sparking a global financial meltdown that originated from the US subprime mortgage crisis. As the crisis rapidly unfolded, emerging economies were severely affected, facing an unprecedented array of challenges that threatened their very foundations. The sudden drying up of trade finance severely curtailed international trade, while the sharp decline in commodity prices decimated the export revenues of many emerging markets. Furthermore, the reversal of capital flows led to a massive outflow of foreign investment, causing currencies to plummet and interest rates to soar. As a result, emerging markets experienced a sharp contraction in economic activity, a precipitous decline in investor confidence, and a significant increase in poverty and unemployment, leaving deep scars that would take years to heal.

- Emerging markets were severely hit by the 2008–2009 global financial crisis, which disrupted trade



3.4.2.2 Global Crisis Deepens: Mid-2008

- In 2008, the financial crisis, marked by surging oil prices, triggered capital outflows from emerging markets

In mid-2008, the financial turmoil in advanced economies began to have a ripple effect on global markets, including emerging economies. A significant turning point came in March 2008, when Bear Stearns, a major US investment bank, was rescued by JP Morgan Chase with Federal Reserve support. This event triggered a collapse of confidence in global financial systems, leading global investors to become increasingly risk-averse and pull funds out of riskier emerging markets. Furthermore, commodity prices peaked in June 2008, with oil prices reaching an all-time high of \$147 per barrel, putting a strain on the budgets of oil-importing countries like India and Turkey. This price shock had a double-edged effect: while resource exporters gained short-term revenues, it amplified inflation globally, causing widespread economic disruption and exacerbating the financial crisis.

3.4.2.3 The Crisis Spreads to Emerging Markets: Late 2008

- Many emerging markets sought IMF assistance due to the 2008 financial crisis

In late 2008, the global financial crisis hit emerging markets hard. This happened after Lehman Brothers, a big US bank, went bankrupt in September 2008. The bankruptcy caused a global financial meltdown, and emerging markets faced big problems. Investors from other countries quickly pulled their money out of these markets, causing stock markets to crash and currencies to lose value. For example, Brazil's stock market fell by over 40% in just a few months. At the same time, commodity prices like oil dropped sharply. Oil prices fell from a high of \$147 per barrel in mid-2008 to below \$40 per barrel by December 2008. This hurt countries that relied on exporting oil and other resources, like Russia, Brazil, and Nigeria. Many emerging markets, such as Ukraine, Hungary, and Iceland, had to ask the International Monetary Fund (IMF) for emergency help because they were running out of foreign currency and had too much debt.

3.4.2.4 Early 2009: The Depths of the Downturn

The global economy suffered a severe downturn, with both rich and poor countries experiencing a decline in economic activity. As people and businesses around the world stopped buying things, international trade came to a near standstill. Countries that relied heavily on exports, such as China, Malaysia, and Mexico, saw their exports drop drastically -

- Global bottom economy hits

China's exports, for example, fell by over 20% in early 2009. Some countries, like Hungary and Ukraine, faced serious debt problems because they had borrowed money in foreign currencies, which became much more expensive to repay when their own currencies lost value. As a result, many countries in Eastern Europe needed emergency loans from the International Monetary Fund. The crisis also led to widespread job losses, particularly in industries that relied on exports and construction. This caused poverty and social unrest to rise in countries like India, Brazil, and South Africa.

3.4.2.5 Recovery in Sight: Mid-2009

- Stimulus packages, interest rate cuts, and G20 support helped emerging markets recover from the financial crisis

As the global economy struggled, governments and central banks around the world worked together to stabilise markets. They implemented policies to boost economic growth, such as increasing government spending and cutting interest rates. This helped emerging markets, especially in Asia, to recover quickly. For instance, China's massive \$586 billion stimulus package in November 2008 helped to increase investment in infrastructure and domestic demand, which aided recovery across Asia. Central banks in emerging markets also cut interest rates sharply to stimulate growth. In April 2009, the G20 summit in London pledged over \$1 trillion to support struggling economies, which boosted investor confidence and led to a return of capital flows to emerging economies. As a result, foreign investment started flowing back into emerging markets by mid-2009, attracted by low prices and improving economic prospects. Stock markets in countries like India and Brazil bounced back strongly, recovering a significant portion of their losses by the end of the year.

- Resource-dependent nations struggled due to low commodity prices during the crisis period

The global financial crisis had a big impact on emerging markets. One major effect was that many emerging market currencies lost a lot of value compared to the US dollar. For example, the Brazilian Real and South African Rand lost 30-50% of their value in late 2008. This made it harder for these countries to import goods and services. Another problem was that global trade collapsed, which hurt countries that relied heavily on exports, like such as Mexico and China. These countries saw experienced a big significant drop in orders and revenues. Some countries, like Turkey and Argentina, relied heavily on foreign investment, but when investors got scared and pulled their money out, these countries faced serious liquidity crises. Countries with high levels of debt, like Ukraine, Hungary, and

Latvia, struggled to pay back their debts and had to ask the International Monetary Fund (IMF) for help. When the global economy finally started to recover, some emerging markets recovered faster than others. Countries in Asia, like China and India, bounced back quickly because their governments took strong action and their domestic economies were strong. On the other hand, countries that relied heavily on exporting natural resources, like oil and minerals, took longer to recover because the prices of these commodities stayed low for a long time.

3.4.3 Global Financial Crisis and Great Recession

The 2007–2008 Global Financial Crisis (GFC) remains one of the most severe economic downturns in recent history. Its impact extended far beyond the financial sector, affecting economies, employment, trade, and public confidence around the world. What initially appeared as a domestic issue within the U.S. housing market quickly escalated into a global economic crisis. At the heart of the collapse was not one single error but a chain reaction involving multiple actors viz common borrowers, commercial banks, investment banks, credit rating agencies, and insurance companies. Together, their actions transformed a seemingly stable financial system into a system prone to collapse.

- The impact of the financial crisis affecting public confidence

The crisis began with ordinary individuals, often referred to as the common man, who took out loans from commercial banks to purchase homes. Many of these loans were subprime mortgages. A subprime mortgage is a type of home loan given to borrowers who have poor credit histories, low income, or high debt levels, making them less likely to repay the loan on time. These borrowers do not qualify for regular (“prime”) mortgages due to their high risk. These risky loans were approved widely, largely because commercial banks did not intend to keep them. Instead, they partnered with investment banks, selling them the loans, which were then bundled into financial instruments known as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs).

- Many of the loans are included in the subprime mortgage category

To sell these risky products to investors, investment banks collaborated with credit rating agencies, which were expected to assess the risk level objectively. However, motivated by profit and sometimes under direct pressure, many credit

- Credit rating agencies gave incorrect ratings to financial assets

rating agencies gave high ratings (such as AAA) to these toxic products. This false sense of security misled investors including pension funds, global banks, and individuals into believing they were buying safe and secure investments, when in fact they were extremely risky. These high-risk securities were then sold globally, embedding the financial system with assets backed by borrowers who were unlikely to repay. When housing prices fell, many homeowners defaulted, causing the value of MBS and CDOs to crash. Financial institutions holding these assets faced massive losses, leading to a credit crunch, collapsing stock markets, and widespread panic. One of the most affected sectors was the insurance industry, especially AIG, which had sold billions in credit default swaps (CDS) insurance contracts on these mortgage products. When the defaults began, AIG did not have the capital to cover its obligations, leading to near-collapse and a major government bailout.

- This crisis highlights the danger of greed, lack of regulation, and blind trust in financial innovation without proper oversight.

In conclusion, the Global Financial Crisis was the result of systemic failure at multiple levels: irresponsible lending by commercial banks, complex financial engineering by investment banks, conflicted credit ratings, and unregulated insurance practices. The common man, often unaware of the risks, was both a victim and a participant. This crisis highlights the danger of greed, lack of regulation, and blind trust in financial innovation without proper oversight. The lessons learned continue to shape modern financial regulation and economic policy today.

3.4.3.1 Effects of the 2007–2008 Financial Crisis on the World Economy

After the Great Depression, the world faced one of the worst financial crises in 2007–2008. This crisis quickly spread and affected banks, businesses, and economies around the world. In this discussion, we will explore the effects of the crisis

1. Collapse Of Financial Institutions

One of the immediate impacts of the 2007–2008 financial crisis was the collapse of major financial institutions. A key example was the bankruptcy of Lehman Brothers in September 2008, which shocked global markets. To prevent further collapse, governments were forced to bail out major firms like AIG, Citigroup, and RBS. This triggered a widespread loss of trust in banks and the financial system. As fear grew, banks became

- Collapse of major financial institutions leads to a shortage of liquidity across the world

cautious and started restricting loans due to rising defaults and the presence of toxic financial assets. The situation worsened when interbank lending froze, creating a serious shortage of liquidity across the world. At the same time, global stock markets suffered heavy losses, indices like the Dow Jones dropping by more than 50%, which led to huge declines in pension funds, retirement savings, and investments, deepening the financial turmoil.

2. Effects On Developing and Emerging Economies

The 2007–2008 financial crisis also had serious effects on developing and emerging economies. As global investors panicked, they pulled their money out of emerging markets, a situation known as capital flight. This sudden withdrawal caused many local currencies to lose value, making imports more expensive and increasing inflation. At the same time, foreign investment dropped sharply, which slowed down economic growth in countries like India and Brazil that rely heavily on external funding. In addition, low-income countries suffered from a decline in remittance flows, as people working abroad lost jobs, and international aid also decreased, further weakening these economies during a time of global financial stress.

- Global investors pulled their money out of emerging markets

3. Long-Term Impact of the 2007–2008 Financial Crisis

In the long term, the financial crisis led to several deep and lasting impacts on the global economy. One major consequence was the sharp rise in public debt, as governments spent heavily on bailouts and economic stimulus programs, resulting in large fiscal deficits. This eventually triggered sovereign debt crises in several countries, including Greece, Spain, and Ireland, where governments struggled to manage their growing debt levels.

- Recession raises the rate of public debt

Another major outcome was the widening of income inequality. Wealthier individuals were able to recover faster because they held assets like stocks and property, which rebounded in value, while working-class wages either stagnated or declined, leading to rising frustration and social unrest. These economic stresses also contributed to political and social changes, including the growth of populist movements and increasing opposition to globalization. As a result, many people began to question the effectiveness and fairness of neoliberal economic

- Recession has increased inequality

policies that had shaped the global economy for decades.

4. Unemployment

- The financial crisis has increased the unemployment rate

One of the most devastating effects of the financial crisis was the sharp increase in unemployment. As businesses faced falling demand and financial losses, millions of workers around the world lost their jobs. In the United States, unemployment reached a peak of 10% in October 2009, the highest rate in decades. Europe experienced similar struggles, with long-term unemployment rising significantly as many people remained jobless for months or even years. The job market recovery was slow, and the crisis left lasting damage on employment levels and job security across both developed and developing economies.

5. Trade Decline

- The global financial crisis caused a sharp decline in international trade

The global financial crisis caused a sharp decline in international trade, which deeply affected the world economy. According to the World Trade Organisation (WTO), global trade volume fell by over 10%, marking one of the steepest drops since World War II. As demand for goods and services collapsed in major economies, export-oriented countries like China, Germany, and other manufacturing-heavy nations experienced a significant decline in exports. Factories reduced production, supply chains were disrupted, and many businesses involved in international trade faced serious losses, further deepening the global recession.

6. Global Economic Recession

- Sharp contraction in GDP across many major economies

The 2007–2008 financial crisis triggered a severe global economic recession, leading to a sharp contraction in GDP across many major economies, including the United States, the United Kingdom, Japan, and Germany. As businesses struggled, consumer spending dropped, and financial institutions faced severe losses, these countries saw their economies shrink significantly. According to World Bank data, the global economy contracted by 1.7% in 2009, marking a rare and deep downturn. This widespread recession highlighted the interconnectedness of the global economy and the far-reaching consequences of financial instability.



3.4.3.2 Policy Responses to the 2007–2008 Financial Crisis

1. Monetary Policy

In response to the 2007–2008 financial crisis, central banks around the world, including the Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of England (BoE), took aggressive measures to stabilise their economies. One of the first steps they took was to cut interest rates to near zero in an effort to encourage borrowing and spending. This was intended to make it cheaper for businesses and consumers to take out loans, which would, in turn, stimulate economic activity. However, as the crisis deepened and traditional monetary policies proved insufficient, these central banks turned to more unconventional methods. One such tool was Quantitative Easing (QE). QE is a non-traditional monetary policy in which a central bank, like the Federal Reserve or the European Central Bank, purchases large amounts of government bonds and other financial assets from commercial banks. The purpose of QE is to inject liquidity into the financial system, especially when interest rates are already very low and cannot be reduced any further. By increasing the money supply, QE aims to stimulate lending and investment. With more money available in the system, it becomes easier for businesses to borrow and invest, and for individuals to take out loans. This, in turn, encourages spending and helps boost economic activity.

- QE helps to stimulate lending and investment

2. Fiscal Stimulus

In addition to monetary policy measures, governments around the world implemented massive fiscal stimulus packages to counteract the recession. For example, the United States introduced the \$787 billion Recovery Act in 2009, which aimed to stimulate economic activity by increasing government spending and providing tax cuts. These stimulus efforts were designed to boost demand, create jobs, and support struggling sectors like infrastructure, healthcare, and education. By directly injecting money into the economy, governments hoped to jumpstart growth, reduce unemployment, and prevent further economic contraction.

- Fiscal stimulus packages include increasing government spending and providing tax cuts

3. Financial Regulation Reforms

After the financial crisis, important regulatory reforms were introduced to prevent a similar disaster from happening again. In the United States, the Dodd-Frank Wall Street Reform

- Financial regulation reforms promote transparency in the financial system

and Consumer Protection Act was passed in 2010. This law aimed to improve oversight and transparency in the financial system. It introduced stricter rules for banks, with the goal of protecting consumers and limiting the risks posed by large financial institutions. On a global level, the Basel III framework was put in place. Basel III introduced tougher rules for banks, particularly requiring them to hold more capital as a buffer against financial shocks. These reforms were designed to make banks stronger and better able to handle financial crises, reducing the chances of risky behavior that could harm the global economy.

3.4.4. Other International Economic Problems

1. Eurozone Debt Crisis (2010–2015)

- The Eurozone Debt Crisis is due to excessive government borrowing and structural limitations of the Eurozone

Following the global financial crisis, several countries within the Eurozone, notably Greece, Ireland, Portugal, Spain, and Italy, experienced severe sovereign debt problems. These issues were rooted in years of excessive government borrowing, weak fiscal policies, and the structural limitations of the Eurozone, where monetary policy was centralised but fiscal discipline was not enforced uniformly. As investor confidence declined, borrowing costs soared for these nations, prompting international bailouts from institutions like the European Central Bank, the International Monetary Fund, and the European Union. In exchange for financial assistance, affected countries were required to implement harsh austerity measures, which led to high unemployment, social unrest, and long-term economic stagnation. The crisis revealed critical weaknesses in Eurozone governance and led to significant reforms in EU fiscal oversight.

2. U.S. – China Trade War (2018–2020)

- U.S.–China Trade War created uncertainty for businesses around the world

The trade conflict between the United States and China emerged as a significant economic issue under President Donald Trump’s administration. It began with the U.S. accusing China of engaging in unfair trade practices, including intellectual property theft, forced technology transfers, and trade imbalances. In response, the U.S. imposed tariffs on a wide range of Chinese goods, prompting China to retaliate with tariffs of its own. This tit-for-tat escalation disrupted global trade flows and created uncertainty for businesses around the world. The economic impact was felt in rising production costs, reduced investment, and slowed growth in both economies and their trading partners. The conflict underscored the fragility of

global trade networks and intensified calls for reforming the World Trade Organisation.

3. COVID-19 Pandemic Economic Crisis (2020–2021)

- The COVID-19 Pandemic Economic Crisis results global GDP fall, and unemployment rates rise

The COVID-19 pandemic triggered one of the most profound global economic crises in recent history. As countries imposed lockdowns and restricted movement to curb the virus's spread, economic activity plummeted across sectors, especially in services, tourism, travel, and retail. Global GDP shrank dramatically, and unemployment rates soared. In response, governments and central banks launched massive stimulus packages and liquidity measures to stabilise markets and support households and businesses. Despite these interventions, the pandemic revealed major vulnerabilities in healthcare infrastructure, global supply chains, and economic inequality. Efforts by international bodies such as the G20 and the IMF played a crucial role in coordinating financial support and offering debt relief to low-income countries.

4. Global Supply Chain Disruptions (2021–2022)

- Combination of labour shortages, port backlogs, and container scarcities is the major reason for supply chain disruption

In the aftermath of the COVID-19 crisis, global supply chains faced unprecedented disruptions. The combination of labour shortages, port backlogs, container scarcities, and production halts in key sectors like semiconductors led to widespread delays and shortages. Businesses that had long relied on just-in-time inventory models found themselves struggling to meet demand. These disruptions not only caused delivery delays but also fueled inflation as product prices increased due to scarcity. Governments and corporations began rethinking their dependence on global supply chains, with increased interest in diversification, reshoring, and supply chain resilience strategies.

5. Energy Crisis & Inflation Surge (2021–2023)

- In 2021- 2023 energy crisis raises the inflationary pressures around the world

As the global economy rebounded from the pandemic, energy demand soared, leading to significant price increases. This situation was further exacerbated by Russia's invasion of Ukraine in early 2022, which triggered geopolitical tensions and economic sanctions, particularly affecting oil and natural gas supplies to Europe. These developments led to a spike in global energy prices, which fed into broader inflationary pressures. Many countries experienced a cost-of-living crisis as food and energy prices surged. Central banks responded by tightening monetary policy, raising interest rates to control inflation, which in turn raised borrowing costs and heightened

fears of a global economic slowdown.

6. Russia-Ukraine War (2022–Present)

The war between Russia and Ukraine has had significant global economic repercussions beyond the immediate conflict zone. Both nations are major exporters of commodities such as wheat, corn, and natural gas. The war disrupted these supply lines, contributing to food insecurity in many developing countries and intensifying global inflation. Sanctions against Russia, combined with retaliatory export restrictions, led to volatility in energy and commodity markets. In addition to its humanitarian toll, the conflict forced many countries to reconsider their energy strategies, increase defence spending, and realign geopolitical and trade partnerships, further complicating the global economic landscape.

- The Russia-Ukraine War disrupted the supply chain, raising concerns about food security in many developing countries

7. Debt Distress in Developing Countries

In recent years, several developing nations, including Sri Lanka, Zambia, Ghana, and Pakistan, have faced severe debt distress. These countries struggled with high levels of external debt, compounded by weak currencies, rising interest rates globally, and declining foreign reserves. The burden of servicing debt became unsustainable, prompting some nations to seek bailouts from the International Monetary Fund and restructure their debt with international creditors. The situation reignited discussions around the fairness and efficiency of the global debt system, with calls for reforms to the Common Framework and more transparent lending practices, especially concerning loans from non-traditional lenders like China.

- Developing Countries struggled with high levels of external debt

8. Global Inflation and Monetary Tightening (2022–2023)

The surge in global inflation during this period, driven by supply chain issues, energy shocks, and rebounding demand, forced central banks in advanced economies to raise interest rates sharply. The U.S. Federal Reserve, the European Central Bank, and others implemented aggressive monetary tightening to curb price rises. While these measures helped slow inflation, they also increased borrowing costs for governments, businesses, and consumers. The stronger U.S. dollar, resulting from rate hikes, placed additional pressure on emerging markets by making dollar-denominated debt more expensive to service. These dynamics sparked concerns about potential recessions, financial instability, and the widening gap between advanced and developing economies.

- Global Inflation driven by supply chain issues



Summarised Overview

The global economy has faced many challenges in recent years. One of the biggest problems was the financial crisis of 2008-09, which was caused by excessive borrowing and deregulation. This led to a global recession, high unemployment, and decreased economic growth. The international monetary system, which is the system of exchange rates and monetary policies between countries, was also affected. Emerging markets, such as Mexico, Asia, and Argentina, have experienced economic crises in the past, including debt crises and financial crises. The 2008-09 global financial crisis was a major setback for the global economy, but governments and central banks responded with monetary and fiscal policies, regulatory reforms, and international cooperation. However, there are still many current international economic problems that need to be addressed, including income inequality, climate change, international trade tensions, and global debt, and migration and refugee crises. These problems require continued international cooperation and collective action to resolve.

Assignments

1. Explain the key events and causes that led to the 2008–09 Global Financial Crisis and discuss its impact on the international monetary system.
2. Examine the chronology of the economic crisis in emerging markets during 2008–09.
3. Analyse the role of International Financial Institutions (IFIs) in addressing the global financial crisis.
4. Evaluate the other international economic problems that emerged following the global financial crisis of 2008 and their long-term implications on global trade and finance.
5. Explain the key events and causes that led to the 2008–09 Global Financial Crisis and discuss its impact on the international monetary system.

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Suggested Reading

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.



SGOU

BLOCK 4

**International Financial
Institutions and India**

UNIT 1

International Financial Institutions

Learning Outcomes

After completing this unit, the learners will be able to:

- understand the roles and functions of ADB, UNCTAD, IDA, and AIIB
- discuss the impact of these institutions on global economic stability
- know the financing mechanisms and programs provided by these institutions to developing countries
- discuss the goals and operational strategies of these institutions

Background

In today's interconnected world, no nation operates in complete isolation. Globalisation has led to a complex web of trade, investment, and financial flows among countries. When a financial crisis occurred in 2008, its impact was felt across continents, highlighting the interconnected nature of the global economy. Domestic financial institutions, such as central banks (e.g., Reserve Bank of India or Federal Reserve in the United States), commercial banks, and development banks, manage a nation's monetary policies, regulate financial markets, and support economic growth. International financial institutions extend these roles across borders.

After World War II, institutions like the International Monetary Fund (IMF) and the World Bank were established to rebuild war-torn economies, stabilise exchange rates, and promote international trade. However, many developing countries face challenges like inadequate infrastructure, limited access to capital, and technological backwardness. For instance, countries in sub-Saharan Africa or parts of South Asia struggle with high poverty rates and insufficient infrastructure. International institutions such as the International Development Association (IDA) aim to address these issues by providing concessional loans and grants. Organisations like the United Nations Conference on Trade and Development (UNCTAD) focus on promoting equitable trade and sustainable development.

Keywords

International Financial Institutions, Financial Aid, Global Economy, International Trade, Multilateral Lending, Financial Assistance Programs, Debt Financing, Global Financial System, Infrastructure Financing

Discussion

4.1.1 International Financial Institutions and their Functions

- Promoting global economic stability

International Financial Institutions (IFIs) are key entities in the global financial system, established to promote economic stability, development, and cooperation among nations. These institutions are founded and governed by multiple countries, reflecting their multilateral nature and shared goals. IFIs play an essential role in addressing economic challenges such as poverty, inequality, and financial crises by offering resources, policy advice, and expertise. Their influence spans across both developed and developing nations, as they work to bridge economic disparities and promote sustainable development. With globalisation increasing the interconnectivity of economies, IFIs have become indispensable in facilitating international collaboration, ensuring financial stability, and addressing global challenges like climate change and pandemics. They act as key players in driving progress toward a more equitable and strong global economy.

IFIs have distinct characteristics that define their role and influence in the global financial system. A key feature is their multinational membership, which ensures that they operate on a global scale, representing the interests of both developed and developing nations. Member countries contribute resources and participate in decision-making processes, allowing IFIs to address a diverse range of economic challenges. This collaborative framework enables the pooling of financial resources and expertise to handle problems. Another significant characteristic is providing financial support to member countries. IFIs offer a variety of financial instruments, including loans, grants, and concessional

- International Financial Institutions (IFIs) address economic challenges and global issues

financing, made for specific needs such as economic crises, natural disasters, or developmental projects. This financial aid is often accompanied by technical assistance to ensure that resources are used effectively. IFIs are also known for their policy advice and advocacy, playing a major role in shaping global economic policies. By monitoring global economic trends and conducting research, they provide evidence-based recommendations to help member nations implement effective reforms. Additionally, they engage in capacity building by offering training programs and technical support to improve the institutional and administrative capabilities of governments. Lastly, IFIs emphasise global collaboration and coordination. They act as platforms for promoting dialogue and partnerships between nations, private entities, and civil society. This collaborative approach allows them to address transnational issues such as climate change, trade disputes, and financial regulation, ensuring a unified response to global challenges.

- Promoting regional economic integration

The roles and functions of IFIs are multifaceted, reflecting their significant impact on global economic governance. One of their primary roles is to ensure economic stability by providing financial assistance to countries facing crises. During economic downturns or financial imbalances, IFIs offer short-term loans and support programs to stabilise economies and prevent crises from escalating. Their role in stabilising exchange rates and addressing fiscal deficits has been vital in maintaining global financial order. Another key function of IFIs is their support for development financing. They fund large-scale infrastructure projects, social programs, and capacity-building initiatives in low- and middle-income countries. These investments promote economic growth, reduce poverty, and improve living standards in underdeveloped regions. By focusing on long-term development goals, IFIs help nations achieve sustainable progress. IFIs also serve as advisors on economic policy through policy coordination and guidance. They promote consistency in macroeconomic policies across nations, facilitating trade and investment while addressing country-specific challenges. Their recommendations often aim to improve economic capacity, improve governance, and promote equitable growth. Moreover, IFIs play a key role in addressing global challenges. They mobilise resources and expertise to combat climate change, pandemics, and other pressing global issues. Through partnerships with governments and international organisations, they design and

implement strategies to address these challenges effectively. Finally, IFIs encourage regional cooperation by funding cross-border projects that promote economic integration. Initiatives such as regional trade agreements, transportation networks, and energy grids strengthen economic ties among nations, promoting stability and growth in interconnected regions. Through these diverse roles, IFIs contribute significantly to a more strong and equitable global economy.

- Promoting growth, reducing inequality

IFIs are indispensable pillars of the global economic framework. They not only provide financial aid but also act as advisors and catalysts for economic growth and stability. By addressing economic crises, promoting sustainable development, and international cooperation, IFIs have significantly contributed to reducing poverty and inequality worldwide. However, their effectiveness is sometimes questioned due to criticisms related to conditionalities, governance structures, and environmental impacts. Moving forward, reforms aimed at increasing inclusiveness, transparency, and accountability can help IFIs better serve the needs of a diverse and interconnected world. As economies continue to face complex challenges, the role of IFIs in economic stability and equity will remain important for achieving long-term global prosperity.

4.1.2 Asian Development Bank (ADB)

- Promoting Asia-Pacific prosperity

The Asian Development Bank (ADB) is a regional development bank established to promote economic growth and cooperation in the Asia-Pacific region. Founded on 19 December 1966, ADB has played a key role in addressing development challenges across Asia and the Pacific. Its headquarters are located in Manila, Philippines, and its operations include a wide range of economic and social development initiatives. The primary mission of ADB is to promote a prosperous, inclusive, strong, and sustainable Asia and the Pacific while eradicating extreme poverty. ADB's vision is development that is socially inclusive, environmentally sustainable, and economically viable. Despite the region's progress, challenges such as poverty, inequality, and environmental degradation remain major concerns.

ADB began with 31 members and has expanded its membership to 69, comprising 49 members from Asia and the Pacific and 20 from outside the region. Membership is open to countries that are members or associate members of the United Nations

- Membership expand to Asia - Pacific and these are members of UN and its agencies

Economic and Social Commission for Asia and the Pacific (UNESCAP). Additionally, other regional and non-regional developed countries that are members of the United Nations or its specialised agencies are also eligible to join the bank. This broad membership base reflects ADB's commitment to promoting inclusive development and regional cooperation.

- Sources fo Fund: International bond market, member countries

ADB raises its capital from a variety of sources to fund its development initiatives. These include international bond markets, contributions from its member countries, retained earnings from lending operations, and repayments of loans. To increase its development impact, ADB employs co-financing mechanisms, which leverage resources from official, commercial, and export credit sources. This approach enables ADB to maximise the scale and reach of its projects, addressing critical development challenges across the Asia-Pacific region.

- Allocate funds for rural development, promotion of Renewable energy, sustainable development

ADB plays a key role in promoting development across a wide array of sectors essential for economic growth and social progress. In agriculture and rural development, the bank focuses on improving food security and rural livelihoods, addressing the critical needs of populations dependent on agriculture. In the energy sector, ADB prioritises the promotion of renewable energy and the establishment of sustainable energy systems, aiming to meet the region's growing energy demands while mitigating environmental impacts. Sustainable and efficient transport networks are another key focus, facilitating better connectivity and economic integration. In water and urban development, ADB works to ensure access to clean water and increase urban infrastructure, improving the quality of life in rapidly growing cities. Its education and health initiatives aim to strengthen human capital by expanding access to quality education and healthcare services. ADB actively supports trade and market development, encouraging regional market integration and improving trade policies to drive economic growth.

- Efficient, accountable governance structure

ADB's governance structure is designed to ensure efficient decision-making and accountability. The Board of Governors, the highest policy-making body, comprises one representative from each member country. The Board of Directors oversees the bank's financial operations, reviews policy documents, and approves loans and technical assistance, ensuring that ADB's objectives align with its mission. The management team,

led by the President and supported by six Vice-Presidents, oversees various departments and operational functions. Since January 17, 2020, Masatsugu Asakawa has been serving as ADB's President.

The ADB's functions are aligned with its mission to promote sustainable and inclusive development. These include:

1. Providing Financial Assistance

- Extent Financial Assistance via loans, grants, investment in priority sector and technical assistance

- **Loans:** ADB provides loans to governments and private entities for projects and programmes that foster economic and social development.
- **Grants:** Financial support is extended to countries and regions, particularly for projects that are less commercially viable but key for development.
- **Equity Investments:** ADB invests in enterprises and projects to stimulate economic activities and encourage private sector growth.
- **Technical Assistance:** ADB supports member countries in project preparation, implementation, and advisory services.

2. Policy Dialogue and Advisory Services: ADB facilitates dialogues with member governments to help them design and implement effective developmental policies. Advisory services are provided to improve governance and policy frameworks.

- Provide advisory services, regional development and cooperation, helps in strategic developments

3. Capacity Building: ADB assists in building institutional capacity to implement development projects effectively and achieve long-term goals.

4. Promotion of Public-Private Partnerships (PPPs): By collaborating with private sector players, ADB helps bridge the gap in infrastructure and services, enabling shared developmental responsibility.

5. Supporting Regional Cooperation and Integration: ADB promotes regional integration through cross-border initiatives that promote trade, investment, and connectivity, benefiting multiple countries.

6. Focus on Strategic Development Areas: ADB prioritises several pressing issues, including:

- **Climate Change and Resilience:** Promoting renewable



energy, low-carbon transport, and climate-adaptive agriculture.

- **Gender Equality:** Mainstreaming gender equality across its projects.
- **Sustainable Infrastructure Development:** Building infrastructure for energy, transport, and urban development.
- **Digital Transformation:** Supporting digital connectivity and technology-driven development.
- **Human and Social Development:** Addressing education, health, and poverty alleviation.

• \$23.6 billion transformative impact

ADB has consistently delivered impactful projects that have transformed lives across Asia and the Pacific. In 2023, the bank committed \$23.6 billion in total operations, with \$16.4 billion coming from co-financing arrangements, including trust funds. Additionally, \$3.8 billion was allocated to private sector commitments. These efforts have significantly advanced climate-resilient adaptive, renewable energy adoption, poverty alleviation, and gender mainstreaming. ADB's initiatives have also strengthened trade and regional cooperation, facilitating economic integration and shared prosperity among member countries.

• ADB's strategy 2030 - strategy for inclusive growth

Despite its remarkable achievements, ADB faces several pressing challenges. Rising debt levels in developing countries, the escalating impacts of climate change, and persistent poverty and inequality continue to pose significant hurdles. To address these issues, ADB has adopted Strategy 2030, which emphasises promoting innovation, increasing private sector involvement, and increasing regional cooperation. By implementing these strategies, ADB aims to build a strong and inclusive Asia-Pacific region, ready to tackle future challenges and seize emerging opportunities. ADB remains a foundation of development in the Asia-Pacific region. With a focus on inclusive and sustainable growth, ADB continues to tackle major global challenges such as climate change, poverty, and inequality. Its commitment to innovation, partnership, and strength ensures its relevance in driving socio-economic transformation across the region.

4.1.3 United Nations Conference on Trade and Development (UNCTAD)

The United Nations Conference on Trade and Development (UNCTAD) is a specialised body of the United Nations established in 1964. Its primary goal is to address trade, investment, and development issues, especially for developing countries, and to promote their equitable integration into the global economy. UNCTAD plays a major role in promoting sustainable development through its activities in policy analysis, consensus-building, and technical assistance. The organisation operates as a central platform to address global economic challenges and develop strategic responses to these challenges, particularly for the least developed countries and those in economic transition. Based in Geneva, UNCTAD's permanent secretariat ensures that its mission is carried out effectively, with the Conference meeting every four years to guide policy direction. The early 1960s saw growing concerns among developing nations regarding their marginal role in international commerce. This led to the demand for a dedicated conference to address these challenges and implement global actions. The inaugural UNCTAD meeting in 1964 in Geneva formalised the organisation, making it a permanent entity within the United Nations. UNCTAD's founding mission was to address the disparities between developed and developing nations. The first Secretary-General, Raúl Prebisch, emphasised the importance of trade as a driver of development. Over the decades, UNCTAD has adapted to a rapidly changing global landscape, focusing on emerging issues such as digital transformation, climate change, and rising inequality. Rebeca Grynspan from Costa Rica was appointed as the eighth Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) on September 13, 2021. She made history as the first woman to hold this prestigious position.

- UNCTAD aims to promote inclusive and sustainable development by addressing the economic challenges faced by developing countries

4.1.3.1 Structure of UNCTAD

- **The Conference:** The Conference is UNCTAD's highest policymaking body, meeting every four years to establish priorities and set work programs.
- **The Trade and Development Board:** This executive body oversees the implementation of the Conference's decisions and manages operations between sessions.

- Structure includes there seperate bodies



- **The UNCTAD Secretariat:** As part of the UN Secretariat, this body carries out policy analysis, monitors implementation, and facilitates information exchange and technical cooperation.

4.1.3.2 Objectives of UNCTAD

UNCTAD aims to achieve a wide array of objectives that align with its development mandate. These include:

- Aims to integrate trade, utilise resources sustainably, protect consumers and promote partnership for development

1. **Promoting Economic Diversification:** Helping countries reduce their dependence on commodities by diversifying their economies and exploring new sectors for growth.
2. **Reducing Financial Vulnerability:** Assisting countries in managing their exposure to debt and financial volatility.
3. **Encouraging Innovation and Technology:** Supporting the adoption of digital technologies and fostering innovation and entrepreneurship to boost economic competitiveness.
4. **Advancing Trade Integration:** Enabling countries to benefit from the international trading system by addressing barriers and facilitating cross-border trade.
5. **Sustainable Resource Utilisation:** Encouraging the effective use of natural resources to combat climate change and ensure environmental sustainability.
6. **Protecting Consumers and Competition:** Monitoring regulations to prevent consumer abuse and ensure fair competition.
7. **Building Partnerships for Development:** Supporting global partnerships to enhance coherence in global economic policymaking and ensuring that trade delivers development gains to all.

- Conduct activities related to trade, investment, technology

4.1.3.3 The activities of UNCTAD

1. UNCTAD conducts cutting-edge research on trade, investment, and development issues. Its insights help countries address macroeconomic challenges, such as high debt levels and economic inequality. The organisation's analysis has been instrumental in identifying opportunities for growth and policy interventions.
2. UNCTAD provides a forum for member states to engage in dialogue and build consensus on major economic and trade issues. This process ensures that countries can

collaborate on strategies to address shared challenges, such as climate change and global economic instability.

3. To enable countries to control trade, investment, and technology for sustainable development, UNCTAD offers technical assistance in various areas:

- Trade logistics and infrastructure.
- Science, technology, and innovation.
- Investment promotion and enterprise development.

UNCTAD publishes several flagship reports that provide valuable insights into global trade and development trends:

1. Trade and Development Report: Analyses global economic trends and their impact on development.

2. World Investment Report: Focuses on global investment patterns and their implications for sustainable development.

3. Least Developed Countries Report: Examines the challenges faced by the world's poorest countries and offers strategies for their development.

4. Technology and Innovation Report: Highlights advancements in technology and their potential to drive economic transformation.

5. Commodities and Development Report: Explores the role of commodities in development and strategies for resource management.

6. Information Economy Report: Focuses on the digital economy and its impact on development.

In the face of pressing global issues such as growing inequality, climate change, and the digital divide, UNCTAD has positioned itself as a key player in promoting inclusive and sustainable growth. The organisation emphasises the promotion of human rights and equality by advocating for gender equality, youth empowerment, and the right to development as foundational principles for progress. Additionally, it actively supports member states in achieving the Sustainable Development Goals (SDGs) by 2030, particularly through the implementation of innovative trade and investment policies. UNCTAD also plays a major role in encouraging sustainable practices and aiding countries in transitioning to greener economies to better adapt to climate change. UNCTAD remains a pivotal institution in addressing the challenges faced by developing countries in

- UNCTAD publishes key flagship reports that focus on supporting least developed countries (LDCs) and promoting sustainable growth

- Inclusive and sustainable growth in a innovation



the global economy. By promoting equitable trade, promoting innovation, and advocating for sustainable development, UNCTAD ensures that the benefits of globalisation are shared broadly. Its continued focus on tackling issues such as inequality, climate change, and digital transformation deepens its relevance in the 21st century.

4.1.4 International Development Association (IDA)

- The International Development Association (IDA) is a branch of the World Bank and supports low-income countries

The International Development Association (IDA) is a division of the World Bank, established in 1960, with the aim of supporting low-income countries. IDA provides grants and concessional loans that help these countries invest in their future, improve living conditions, and create safer, more prosperous communities. It is the largest source of aid for the world's 78 low-income countries, especially focusing on basic social services like health, education, clean water, and sanitation.

The key functions of IDA are:

1. Lending on Concessional Terms: IDA loans have low interest rates or zero interest and repayment periods of 30 to 40 years. Many low-income countries receive part or all of their funding as grants, which do not require repayment, particularly those at higher risk of debt distress.
2. Debt Relief: IDA offers significant debt relief through initiatives such as the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI).
3. Financing: The IDA replenishes its resources every three years with contributions from its donor countries. The most recent replenishment, IDA20, concluded in December 2021, providing a record \$93 billion for fiscal years 2022-2025.

- To qualify for IDA support, countries must have a GNI per capita below a set threshold and lack creditworthiness to access international markets

To be eligible for International Development Association (IDA) resources, countries must meet specific criteria. The first requirement is that a country's Gross National Income (GNI) per capita must fall below a certain threshold, which is updated annually. For the fiscal year 2025, this threshold is set at \$1,335. This ensures that IDA resources are directed towards the poorest countries in the world, which are in most need of financial support. In addition to the poverty threshold, another

key criterion for eligibility is a lack of creditworthiness. This refers to countries that are unable to borrow from international capital markets at reasonable terms due to their economic conditions. These countries typically lack the ability to secure loans at market rates, making them dependent on concessional financing from IDA.

- IDA allocates funds based on a country's income level, policy performance, and commitment to development

The allocation of IDA funds to eligible countries is determined by several factors, primarily income levels and economic performance. Countries with lower GNI per capita generally receive more significant financial support. Additionally, the policy frameworks that these countries implement to promote economic growth and poverty reduction are also important in determining the amount of aid they receive. Countries that demonstrate a commitment to sound economic policies and sustainable development are likely to receive larger allocations from IDA resources. IDA projects are implemented by the borrower country government with support from the World Bank. These projects are closely monitored for progress and impact, with regular assessments to measure outcomes and effectiveness. The Independent Evaluation Group (IEG) of the World Bank assesses about 70 projects annually to evaluate their success.

The most recent, IDA-20 focuses on building a greener, stronger, and inclusive future. It emphasises:

- IDA focuses on development of human capital, climate change, countries facing instability and gender equality and employment

- **Human Capital Development:** Improving education, health, nutrition, and social safety nets.
- **Climate Change:** A significant portion of funding is allocated to addressing climate change, helping countries adapt and preserve biodiversity.
- **Fragility and Conflict:** Increased support for countries facing instability, particularly in the Sahel, Lake Chad, and Horn of Africa regions.
- **Job Creation and Gender Equality:** Focus on gender inclusion, job creation, and tackling gender inequality.

Key focus areas for IDA20 include several critical areas aimed at addressing both current and future challenges faced by eligible countries. One of the primary focuses is debt sustainability and transparency, ensuring that countries do not become overburdened by debt and are able to manage their financial obligations responsibly. Transparent debt



- IDA20 focuses on debt sustainability, governance, crisis preparedness, climate change, and human capital development, with a strong emphasis on supporting Africa's long-term growth and stability

management practices are key to maintaining long-term economic stability. Another important focus area is governance and institutional strengthening. IDA seeks to increase the capacity of governments and institutions to implement effective policies and programs, promoting good governance and reducing corruption. Strengthening these institutions is essential for ensuring that resources are used effectively to promote development and poverty reduction. IDA20 also emphasises crisis preparedness. This includes helping countries better prepare for and respond to future crises, such as pandemics, economic shocks, and natural disasters. By building strong and improved response mechanisms, IDA aims to reduce the impact of these crises on vulnerable populations. A special focus on Africa is central to IDA20's strategy, with approximately 70% of IDA funding directed towards the continent. The funding will specifically address areas critical to Africa's sustainable development, including climate change adaptation, which aims to help countries reduce and adapt to the effects of climate change. Additionally, there is a strong emphasis on human capital development, which includes improving health, education, and skills to empower the population. Infrastructure and governance are also key priorities, as strengthening both physical infrastructure and institutional capacity will be crucial for Africa's long-term growth and stability.

- Supporting vulnerable nations during crises

IDA's financing strategy is based on a leveraging model, where donor contributions are used to generate a much larger pool of funding. For example, every \$1 donated is leveraged into nearly \$4 in financial support, significantly increasing the resources available for development projects in eligible countries. This model allows IDA to maximise the impact of donor funds and support a wide range of initiatives aimed at reducing poverty and promoting sustainable development. As of now, 78 countries qualify for IDA resources. These countries are spread across different regions, including Africa, East Asia, South Asia, Europe, and Latin America. India graduated from the IDA in fiscal year 2014 and is no longer eligible for IDA concessional loans. The diversity of these regions reflects IDA's global reach and commitment to supporting the world's most vulnerable nations. IDA also plays a major role in emergencies, providing rapid financial support and technical assistance to countries facing crises. Through tools like the Crisis Response Window (CRW), IDA has supported countries through natural disasters, conflicts,

and public health emergencies, including the Ebola outbreak and the COVID-19 pandemic. This approach ensures that countries have the resources needed to recover and rebuild in the face of unexpected challenges.

IDA's global influence is notable, particularly in the areas of leadership and collaboration. IDA leads in post-conflict and crisis recovery, guiding countries through the difficult process of rebuilding their economies and institutions. It adopts a collaborative approach, working with multiple sectors, countries, and organisations to address complex global challenges. Additionally, IDA is committed to sustainability, providing long-term solutions that ensure continued development, even after immediate crises have subsided. IDA also plays an important role in debt management and policy. It helps countries manage their debt effectively and ensures that they remain financially sustainable. Through initiatives like the Sustainable Development Finance Policy, IDA promotes debt transparency, strengthens debt management, and supports fiscal sustainability. These efforts help prevent countries from becoming overburdened by debt, which could undermine their long-term development goals. IDA's support is key in helping the world's poorest countries overcome development challenges, providing financial assistance, knowledge, and technical support. Through its concessional loans, grants, and debt relief, IDA has become a foundation of global development efforts, focusing on sustainable growth, poverty alleviation, and improved living conditions across developing countries.

- Debt management for long-term growth

4.1.5 Asian Infrastructure Investment Bank (AIIB)

The Asian Infrastructure Investment Bank (AIIB) is a regional financial institution established to promote sustainable economic growth in Asia. The AIIB focuses on providing financing for infrastructure projects with an emphasis on green infrastructure, sustainability, innovation, and connectivity. It aims to address the significant infrastructure financing gap in Asia, estimated to be USD 26 trillion by 2030. AIIB's primary goal is to promote economic development by enhancing infrastructure connectivity, creating wealth, and improving access to essential services like energy, transport, and digital infrastructure. AIIB's mission is to contribute to the economic and social development of Asia by investing in sustainable

- Promoting sustainable Asian infrastructure growth



infrastructure projects. It seeks to achieve regional prosperity through partnerships that encourage private and public sector investment in key infrastructure sectors, such as energy, transport, and water. By facilitating access to development funds, AIIB also helps countries tackle pressing issues like climate change, poverty, and environmental degradation. The bank also strives to promote regional cooperation, working alongside other international financial institutions like the World Bank and the Asian Development Bank.

The major goals and objectives of AIIB are as follows:

- **Sustainable Infrastructure:** AIIB's primary goal is to promote sustainable infrastructure by providing financing for projects across various sectors, including energy, water, transport, and communications.
- **Economic Development:** It aims to contribute to the economic prosperity of Asia by creating wealth and improving infrastructure connectivity.
- **Regional Cooperation:** The AIIB seeks to build partnerships and promote cooperation to address regional development challenges, working alongside other global financial institutions.
- **Private Investment:** It focuses on mobilising private and public capital for developmental purposes, especially in sectors where private funding is limited.

- Expanding global infrastructure influence

AIIB was founded in 2016 with 57 members, including 37 regional members and 20 non-regional members. By the end of 2020, the bank had expanded its membership to 103 countries, representing around 79% of the global population and 65% of global GDP. Membership is open to countries that are members of the World Bank or the Asian Development Bank, as well as non-sovereign entities from member countries. The largest shareholder of AIIB is China, holding nearly 27% of the voting shares, followed by India with 7.6%. This distribution highlights China's leading role in the bank, though its operations are guided by a collective governance structure that includes input from all member countries.

AIIB operates with a strong governance structure designed to ensure transparency, accountability, and efficiency. The highest decision-making body is the Board of Governors, which comprises one governor and an alternate governor

- Efficient multilateral development governance

appointed by each member country. This board meets annually to discuss strategic decisions, such as the approval of new members and major policy initiatives. The Board of Directors oversees the day-to-day operations of the bank, managing its strategy, budget, and policies. It comprises 12 members, with nine elected by regional members and three by non-regional members. The Senior Management Team, led by the President, is responsible for executing the bank's business and policies. The President, currently Jin Liqun, is supported by five vice presidents who manage different operational areas such as policy, strategy, investment operations, finance, and administration. AIIB also benefits from the advice of the International Advisory Panel (IAP), a group of experts appointed by the President to assist in the development of policies and strategies.

- Investing in sustainable infrastructure development

AIIB prioritises investments in infrastructure projects that promote sustainable development, particularly in areas such as energy, transport, and water. The bank has financed projects aimed at improving connectivity within and between countries, including cross-border infrastructure projects like roads, railways, ports, and telecoms. For example, AIIB has supported rural road connectivity in India, benefiting millions of residents by improving mobility, education, and livelihoods. Moreover, AIIB actively seeks to mobilise private sector funding to complement public investments, ensuring that its projects have a lasting impact on economic development. The bank's commitment to sustainability and environmental protection is reflected in its emphasis on green infrastructure, which aligns with global efforts to combat climate change. India is one of the largest shareholders of AIIB and the biggest beneficiary of its investments. With projects across various sectors such as energy, water, and transport, India has secured significant financing for infrastructure development. Notable projects include the Bangalore Metro Rail and the approval of a \$500 million COVID-19 Emergency Response Fund to strengthen health systems in India. This highlights AIIB's role in supporting critical infrastructure projects during times of crisis.

- Supporting developing nations' infrastructure needs

AIIB's initial capital was set at \$100 billion, with 20% of it paid in by the member countries and the remaining 80% held as callable capital. AIIB has formed partnerships with other international financial institutions like the World Bank and the Asian Development Bank, improving its ability to fund large-scale infrastructure projects. This collaboration has



enabled the bank to expand its reach and influence within the global financial system. AIIB was proposed by China as a response to the dominance of Western financial institutions like the World Bank and the IMF. The bank is designed to serve as an alternative source of financing for infrastructure projects in Asia and beyond, with an emphasis on meeting the needs of developing countries. Although AIIB has been seen by some as a challenge to the existing financial order, it also works in coordination with other multilateral institutions, complementing their efforts to address global development challenges.

Summarised Overview

International Financial Institutions (IFIs) are essential components of the global economic system, designed to promote financial stability, economic development, and international cooperation. These institutions emerged in response to global economic challenges, particularly after World War II, and have since expanded their roles in supporting developing nations. IFIs such as the Asian Development Bank (ADB), the United Nations Conference on Trade and Development (UNCTAD), the International Development Association (IDA), and the Asian Infrastructure Investment Bank (AIIB) serve distinct functions in financing infrastructure, promoting equitable trade, and alleviating poverty. Through financial assistance programs, policy recommendations, and collaborative initiatives, these institutions contribute to economic growth, crisis management, and regional integration. Their influence is widespread, ensuring that countries, particularly those in economic distress, receive the necessary resources to foster sustainable development.

ADB focuses on infrastructure development and economic growth in the Asia-Pacific region by providing concessional loans, grants, and technical support. It prioritises sectors such as energy, transport, and urban development, aiming for a more resilient and inclusive regional economy. UNCTAD, on the other hand, specialises in global trade and investment policies, supporting developing nations through research, consensus-building, and advisory services. It emphasises economic diversification, technology transfer, and fair-trade practices to integrate developing economies into the global market. IDA, a subsidiary of the World Bank, offers concessional loans and grants to low-income nations, ensuring financial aid for essential services such as health, education, and infrastructure. AIIB, a newer institution, primarily funds large-scale infrastructure projects in Asia, promoting sustainable and green development initiatives. These institutions collectively shape the global financial landscape, though they are often criticised for governance structures, loan conditionalities, and their impact on national sovereignty. Despite their significant contributions, IFIs face several challenges, including geopolitical influences, financial constraints, and criticisms regarding the effectiveness of their interventions.

While they have successfully mobilised resources to support global economic stability, their policies sometimes generate debate over fairness and inclusivity. The need for reforms, particularly in terms of governance transparency and equitable decision-making, remains a critical area of discussion. IFIs must continuously evolve to address emerging challenges such as climate change, global pandemics, and economic crises, ensuring that their financial mechanisms align with the needs of both developed and developing nations.

Assignments

1. Describe the role of International Financial Institutions (IFIs) in promoting global economic stability.
2. Explain the functions and objectives of the Asian Development Bank (ADB) in the Asia-Pacific region.
3. Discuss the importance of UNCTAD in supporting trade and development for emerging economies.
4. Discuss the financial assistance programs provided by the International Development Association (IDA).
5. How does the Asian Infrastructure Investment Bank (AIIB) contribute to infrastructure development in Asia?

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Space for Learner Engagement for Objective Questions

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UNIT 2

New International Economic Order and Debt Crisis

Learning Outcomes

After completing this unit, the learners will be able to:

- understand the concept and significance of the New International Economic Order
- know the international debt problem
- discuss the debt relief measures and international strategies in addressing the debt crisis
- understand the impact of North-South dialogue in promoting global economic equity and cooperation

Background

The global economy is characterised by sharp differences between the wealthier, industrialised nations of the Global North and the developing countries of the Global South. The issue of international debt has been a recurring challenge for many countries in the Global South. During the 1970s and 1980s, several nations, including Brazil, Mexico, and Nigeria, borrowed heavily to fund development projects. However, global events like oil price shocks and rising interest rates made it difficult for these countries to repay their debts. This led to the Latin American debt crisis, where nations had to negotiate restructuring agreements with creditors while grappling with severe economic hardship at home. Amid these challenges, developing nations began advocating for a New International Economic Order (NIEO) during the 1970s. Spearheaded by the Non-Aligned Movement and supported by organisations like the Group of 77 (G77), the NIEO called for reforms to make the global economy more equitable. It demanded fairer trade terms, increased development aid, and greater control over natural resources for developing countries. Although the NIEO did not achieve all its objectives, it highlighted the need for systemic change to address global inequalities.

The North-South Dialogue emerged as an essential platform for discussing these economic disparities. Negotiations between the industrialised nations of the North and the developing countries of the South sought to bridge the economic divide. Initiatives like the Earth Summit in 1992 and more recent agreements, such as the Paris Climate Accord, demonstrate ongoing efforts to address shared challenges like poverty, climate change, and sustainable development. By examining these global trends and historical developments, one can better understand the complexities of international economic relations and the constant efforts to create a more balanced and inclusive global order.

Keywords

New International Economic Order (NIEO), Global Economic Relations, International Debt Crisis, Debt Relief Measures, North-South Dialogue, Financial Aid, Debt Restructuring, Economic Reforms, Structural Adjustment, International Finance

Discussion

4.2.1 New International Economic Order (NIEO)

The idea of a New International Economic Order (NIEO) was first introduced by Raul Prebisch and other economists in the 1950s and 1960s. However, it was in April 1974 that the United Nations General Assembly formally endorsed the concept. During its sixth special session, the Assembly committed to “urgently working toward the establishment of a new international economic order based on equity, sovereign equality, common interest, and cooperation among all nations, regardless of their economic or social systems. This order would address existing inequalities, correct injustices, close the gap between developed and developing nations, and foster steady economic and social development, peace, and justice for current and future generations.” This commitment from the UN acknowledged that the existing economic framework was unjust and unsustainable, emphasising the need for a new global system grounded in fairness and cooperation.

- Bridging developed-developing nation gaps

The objectives of the NIEO are clearly outlined in UN documents and resolutions. These objectives can be categorised into four main areas:

- 1. Issues Related to Assistance:** For a just global economic system to emerge, developed countries must show



- Developed nations are expected to increase aid to LDC's

greater understanding and support for the aid needs of less developed countries (LDCs). By cooperating more generously, developed nations can help reduce poverty and promote balanced regional development. In this context, developed nations are expected to provide unconditional and progressively increasing aid to LDCs, aiming for a minimum of 0.7% of their Gross National Product (GNP). The UN emphasised the importance of continuing and expanding international programmes, such as vocational training, development of national personnel, and management skills. Additionally, the transfer of technology from LDCs to developed countries should be controlled to prevent the negative effects of brain drain. Debt restructuring for poorer nations is essential, as is providing special support for landlocked, least-developed, and island nations. Furthermore, international efforts should continue toward achieving total disarmament, freeing up resources that could be redirected toward development in poorer countries.

- NIEO improves international trade

2. Issues Related to Trade: A core aspect of the NIEO is improving the conditions of international trade, ensuring that developing countries gain access to growing opportunities to expand their exports. This would help them earn sufficient export revenues to address chronic balance-of-payments deficits and achieve steady growth. Trade-related goals of the NIEO include improving the terms of trade for LDCs, adopting integrated commodity programs, creating international food programs, diversifying, and expanding LDC export potential, strengthening trade relations between countries with differing social and economic systems, increasing economic and technical cooperation among LDCs, and reforming the international monetary system. The reform should also focus on ensuring greater participation from LDCs in the IMF decision-making process and facilitating larger transfers of resources from global institutions like the World Bank and IMF.

- NIEO aims to establish technology transfer mechanism

3. Issues Related to Industrialisation and Technology: A significant objective of the NIEO, as outlined by the UN, is to reshape the approach to industrialisation and technology transfer. Developed and developing countries should negotiate the relocation of industrial capacities to the developing world, particularly in industries with high labour content, resource-based industries, and those utilising locally available raw materials. Additionally,

the NIEO aims to establish mechanisms for the transfer of technology from advanced nations to developing ones. This involves reviewing international patent laws, easing access to both patented and non-patented technologies, expanding support for research and development within LDCs, and exercising greater control over technology imports. The regulation and supervision of transnational corporations is also a priority, along with improving the competitiveness of natural resources that face competition from synthetic alternatives.

4. Social Issues: The NIEO also addresses various social issues that can be handled through mutual cooperation between developed and developing nations. These social goals, as identified by the UN, include:

• Global cooperation for equitable development

- Achieving a more equitable distribution of income and raising employment levels.
- Providing health services, education, and better cultural standards, while enhancing the qualifications of the workforce.
- Integrating women into the development process and ensuring the well-being of children.
- Recognising the sovereignty of nations over their natural resources and their right to control and nationalise their exploitation.
- Offering compensation for the negative impacts of foreign occupation, colonialism, or apartheid on national resources.
- Establishing a system of consultation to promote industrial development.
- Restructuring the economic and social dimensions of the United Nations.

4.2.2 North-South Dialogue

A key requirement for establishing a new and equitable international economic order is the promotion of close and cooperative economic relationships between developed countries and less-developed countries (LDCs). In April 1974, the United Nations General Assembly passed a resolution committing itself to urgently work towards the creation of

- North-South dialogue for equity

a new international economic order. This resolution led to the initiation of discussions between the developed nations, referred to as the 'North,' and the less-developed countries, referred to as the 'South.' Since the 1960s, the developed and less-developed countries have engaged in continuous negotiations concerning the economic issues faced by each group. These discussions have occurred in forums such as the United Nations Conference on Trade and Development (UNCTAD), General Agreement on Tariffs and Trade (GATT) meetings, and every global economic summit. The ongoing exchanges between the rich and poor countries have come to be known as the North-South Dialogue.

The key issues addressed in these dialogues include:

1. Reduction of tariff barriers.
2. Provision of financial assistance.
3. Market access and the establishment of the NIEO.
4. Terms of trade.
5. Stabilisation of primary product prices.
6. Transfer of technology.
7. Addressing the burden of international debt.
8. Reforms to the international monetary system.
9. Government's role in economic activities.
10. Role of the private sector.

- Political conditions stall economic equity

Both the North and the South have maintained rigid opinions on their respective perspectives. As a result, the North-South Dialogue has often been marked by conflict rather than co-operation, which affects the potential for establishing a new economic order. While there has been limited progress in areas such as tariff reductions, preferences for LDC products, stabilisation funds, and debt relief, other areas have seen little advancement from the perspective of the LDCs. Developed countries have often conditioned economic and trade concessions on political and other unrelated factors.

The North-South Dialogue can only move forward if it is pursued with a spirit of mutual interest and cooperation in settings such as the World Trade Organisation (WTO) meetings and other international economic forums. The North-South Dialogue refers to negotiations between developing nations, mostly in Asia, Africa, and Latin America, and the industrialised countries of North America and Western Europe

- UNCTAD platform for economic reform

during the 1970s. This process aimed to address changes in the international economic system. After World War II, many Latin American countries grew increasingly frustrated with U.S. trade and tariff policies. At the same time, nationalist movements across Asia and Africa led to widespread decolonisation. By 1960, the United Nations membership had increased to 100 countries, and by 1979, it increased to 150. This expansion shifted the balance of power in the UN General Assembly and led to the establishment of the United Nations Conference on Trade and Development (UNCTAD) in 1964. UNCTAD provided a platform for the 'Southern' nations to propose new economic policies and engage with industrial democracies in the 'North.' The term 'North-South Dialogue' distinguished this from the East-West conflict of the Cold War and stressed the importance of development issues. Several factors increased the willingness of industrialised nations to negotiate with the South. One key factor was the rising influence of oil-producing countries in the Arab world. Additionally, the U.S. defeat in the Vietnam War demonstrated that even powerful nations were not immune to failure, prompting a reevaluation of global power dynamics. The dialogue also coincided with a period of reduced East-West tensions, allowing more attention to be paid to development.

- NIEs sought global economic reform

The Newly Industrialising Economies (NIEs) argued that the international economic system was in favour of developed countries, at the expense of the developing world. Newly Industrialising Economies (NIEs) are countries transitioning from developing to developed status, experiencing rapid industrialisation, export-led growth, and rising urbanisation. First-generation NIEs like South Korea, Taiwan, Hong Kong, and Singapore developed rapidly in the late 20th century, followed by second-generation NIEs such as Malaysia, Thailand, Indonesia, and the Philippines. They sought a restructuring of the global economic order to correct this imbalance. The North-South Dialogue addressed critical issues such as trade and tariffs, international finance, foreign aid, and the governance of multinational corporations and international institutions. During the 'era of détente' in the 1970s, industrialised nations were more open to cooperation, though this willingness reduced as Cold War tensions reappeared in the late 1970s. As U.S.-Soviet conflicts intensified, the focus shifted back to the Cold War, side-lining development concerns.

- North-South Dialogue lost momentum slowly

By 1980, the UN-based discussions had lost momentum, and despite ongoing discussions, they failed to present a solution. The success of the North-South Dialogue is viewed differently by economists. Some argue that Southern proposals for global economic reform were unrealistic or overly beneficial to certain segments of the Third World. Others suggest that these proposals were extreme by design to establish a strong negotiation position with the North. However, the implementation of these proposals through UNCTAD was always unlikely, as they required the North to give up significant power. The dialogue can also be seen as a political struggle between the world's 'haves' and 'have-nots,' giving the South a platform to unite and challenge the North's dominance in global affairs.

The North-South divide has been challenged on multiple fronts. Differences in political, economic, and demographic factors complicate the idea of 'South.' The liberalisation of China and growing regional cooperation in Asia led to a shift in economic power. By 2015, most of the Global South, except for roughly 60 nations, had shown progress in terms of income growth, diversification, and participation in the global market. Globalisation has also shifted the focus away from the North-South divide as the primary framework for international economic development. Institutions like the IMF, World Bank, and WTO, along with various UN agencies, now approach the relationship between globalisation and inequality from different perspectives. Nevertheless, some still question the effectiveness of globalisation as a model, emphasising the continued importance of nation-states and regional trade relations.

The conferences on the North-South dialogue include:

- Globalisation redefines the North-South divide

1. Paris Conference (1975-77)
2. Brandt Commission (1977)
3. Cancun Conference (1981)
4. Uruguay Round and Dunkel Proposal (1986-1991)
5. Prithvi Conferences (1992 & 1997)
6. International Human Rights Conferences (1993)

Some economists suggest that increased international trade and capital flow could narrow the North-South divide. By promoting more equitable trade and investment, developing countries could further their economic growth. Countries like Brazil, which have experienced rapid development, are also

- Trade narrows the global divide

providing increasing amounts of South-South aid. Brazil's \$1 billion in annual aid has helped it emerge as a leader in sharing knowledge and expertise with other developing countries, positioning it as a 'global model in waiting.' The UN has also played a role in bridging the divide through initiatives like the Millennium Development Goals, which aimed to achieve poverty reduction, universal education, gender equality, healthcare improvements, and environmental sustainability by 2015. While the North-South Dialogue has faced numerous challenges and its prospects for a full transformation of the international economic order remain uncertain, the evolving global landscape and increased co-operation between developing nations point toward potential avenues for addressing the long-standing disparities in the world economy.

4.2.3 International Debt Crisis

- Unsustainable borrowing threatens stability

The international debt crisis has become one of the most pressing issues facing the global economy, with far-reaching consequences for economic stability, development, and sustainability. Over the past few decades, the growth in global debt has been largely driven by the increased borrowing from both the public and private sectors worldwide. Governments, corporations, and households have increasingly depended on debt to finance their expenditures, investments, and consumption, particularly during times of economic crisis. While debt can fuel growth and development, excessive and unsustainable borrowing has led to heightened risks, including defaults, financial instability, and measures that hurt economic growth. The global debt burden has grown substantially, with debt levels now exceeding three times the size of the world's GDP. Current data suggests that, by 2024, global debt had reached a staggering USD 315 trillion, exacerbating existing vulnerabilities-especially in developing nations.

- Debt servicing squeezes development budgets

The 2024 International Debt Report (IDR), released by the World Bank, paints a clear picture of the external debt challenges faced by low- and middle-income countries (LMICs). The World Bank's International Debt Report 2024 indicates that the external debt of low- and middle-income countries (LMICs) reached \$8.8 trillion at the end of 2023, marking an 8% increase since 2020. This rise in external debt has been driven by several factors, including higher interest rates, inflation, depreciating currencies, and geopolitical instability. The World Bank attributes this growth to the financial pressures placed on developing countries, resulting

from tightened monetary policies, particularly in high-income countries, that led to interest rates reaching a 20-year high. For instance, Bangladesh and India witnessed a sharp increase in interest payments, exceeding 90% in 2023. These rises in debt servicing costs place huge pressure on national budgets, particularly in sectors key for long-term development, such as healthcare, education, and environmental sustainability.

- High borrowing rates deepen debt crisis

One of the key findings of the IDR 2024 is the substantial rise in debt servicing costs. In 2023, LMICs collectively spent USD 1.4 trillion on debt servicing, an unusual level, with interest payments rising by 33% to USD 406 billion. These increased costs have been worsened by rising borrowing rates. Loans from official creditors doubled to over 4%, and private creditors raised their rates to 6%, the highest in 15 years. The rise in borrowing costs has significantly affected the ability of developing nations to meet their debt obligations, creating a vicious cycle of borrowing to meet debt payments, further deepening their financial issues. The financial pressure from these high debt servicing costs has forced many governments to cut investments in key development sectors. As a result, the developmental goals, particularly those related to health, education, and environmental sustainability, are increasingly at risk.

- Private creditors reduce lending

The role of private and official creditors has evolved in the current debt scenario, according to the IDR. As global credit conditions worsened, private creditors reduced their lending to International Development Association (IDA)-eligible countries, forcing many of these nations to pay more in debt servicing than they were receiving in new loans. For example, private creditors in 2023 contributed USD 13 billion more in debt servicing than new loans. In contrast, multilateral lenders such as the World Bank played a more supportive role, providing USD 51 billion more in loans than they collected in debt repayments. This contrast highlights the increasingly important role of multilateral institutions in reducing debt pressures on developing economies. The situation is particularly alarming for IDA-eligible countries, which are among the world's poorest nations. These countries collectively paid USD 96.2 billion in debt servicing in 2023, including a record USD 34.6 billion in interest payments, the highest since 2014. The burden is felt most acutely in countries where debt servicing consumes a significant portion of export earnings. On average, nearly 6% of export earnings went toward interest payments

in these nations, with some countries allocating up to 38%. This puts these economies in a risky position, where their ability to invest in essential public services, infrastructure, and development initiatives is severely constrained.

- Rising debt diverts resources

UNCTAD has also highlighted the global debt crisis, with its 2024 “World of Debt” report providing a complete overview of the rising debt burden across the world. According to UNCTAD, the global debt level is set to reach USD 315 trillion by 2024, nearly three times the world’s GDP. This rise in debt has been fuelled by the aftershocks of the COVID-19 pandemic, which led to increased borrowing for economic stimulus packages and relief measures. Additionally, inflationary pressures resulting from rising food and energy prices, compounded by geopolitical tensions and climate change-related costs, have further worsened the debt burden, especially in developing countries. UNCTAD’s report highlights significant regional disparities in the growth of public debt. While debt in developed nations has grown at a slower pace, debt in developing nations has grown, now accounting for 30% of global debt, up from 16% in 2010. This rapid growth in developing countries’ debt is a cause for concern, as it is growing twice as fast as in developed nations. This disparity is further compounded by the rising costs of debt servicing, which now consume an average of 8% of government revenues in many developing countries. This shift is diverting much-needed resources away from social programmes, infrastructure development, and climate change mitigation efforts.

- Debt crisis hurts climate action

One of the most alarming aspects of the global debt crisis, according to UNCTAD, is its impact on climate financing. Many developing countries now spend a higher percentage of their GDP on debt servicing (2.4%) than on climate-related initiatives (2.1%). This imbalance poses a serious threat to global efforts to tackle climate change. To meet the targets set by the Paris Agreement, developing countries need to invest up to 6.9% of their GDP in climate action by 2030. However, the growing debt burden makes it difficult for these nations to prioritise climate investments, affecting their ability to reduce and adapt to the impacts of climate change. The rising debt burden faced by developing countries calls for urgent global co-operation and reform. Both the World Bank and UNCTAD emphasise the need for comprehensive global financial reforms to prevent a widespread debt crisis.

- Multilateral cooperation essential for stability

The 2024 International Debt Report and UNCTAD's World of Debt Report both give a concerning picture of the growing global debt crisis. With rising debt levels, higher borrowing costs, and rising debt servicing pressures, the financial stability of many developing nations is increasingly at risk. The situation demands urgent reforms in debt management, greater multilateral co-operation, and a shift toward sustainable financing solutions. Without these, the global debt crisis could continue to deepen, affecting economic development and worsening inequalities. International debt management must be reformed to ensure that developing countries can meet their debt obligations while still investing in their future growth and sustainable development.

4.2.4 Debt Relief Measures

- Debt relief measures are essential tools in addressing the financial struggles faced by countries,

Debt relief measures are essential tools in addressing the financial struggles faced by countries, particularly Least Developed Countries (LDCs), which often find themselves trapped in cycles of unsustainable debt. These measures aim to reduce the debt burden, foster economic growth, and ensure financial stability. Over the years, various initiatives have been implemented, reflecting the evolving nature of global economic challenges.

1. **Rescheduling of Debt:** A conservative approach often advocated by advanced nations involves rescheduling debt payments. This process postpones interest and principal payments or adds arrears to the principal. While it offers temporary relief, it does not adequately address deep-rooted debt crises.
2. **Growth-Oriented Structural Economic Reforms:** At the 1985 IMF-World Bank meeting, the Baker Plan was introduced by the U.S. Treasury Secretary James Baker. The plan proposed \$20 billion in new loans over three years for debtor nations that agreed to implement growth-oriented economic reforms. However, its scope was limited to countries in the Western Hemisphere and had minimal impact elsewhere.
3. **Debt Reduction Facility:** In 1989, the World Bank established a \$100 million facility to support poor countries undergoing structural adjustment programs. This initiative aimed to assist nations in buying back or exchanging commercial debt at reduced values. However, eligibility was restricted to countries receiving International Development Association (IDA) assistance,

and grants were capped at \$10 million, limiting its overall effectiveness.

- 4. Debt Write-Off:** The demand for debt write-offs by LDCs led to the 1989 Brady Plan, which introduced mechanisms like debt buybacks, exchanging old debt for new bonds at discounted rates, and lowering interest rates. The Commonwealth Finance Ministers in 1990 proposed writing off two-thirds of the poorest countries' debt (worth \$18 billion) and extending repayment periods. The Paris Club in 1991 agreed to a 50% reduction in the net present value of consolidated debt-service payments. These measures, while helpful, did not fully resolve the debt burden as overall debt levels continued to rise.
- 5. Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI):** Launched in 1996 by the IMF and World Bank, the HIPC Initiative targeted debt relief for the world's poorest countries. The MDRI, introduced in 2005, complemented this effort by cancelling 100% of eligible debts for nations completing the HIPC process.
- 6. Debt Service Suspension Initiative (DSSI):** In response to the COVID-19 pandemic, the G20 introduced the DSSI in 2020, suspending \$12.9 billion in debt-service payments for participating countries until December 2021. This initiative provided temporary financial relief during a global crisis.
- 7. Common Framework for Debt Treatments:** Launched in 2020, the Common Framework aimed to offer more structured debt treatments beyond the DSSI, focusing on countries with unsustainable debt levels. It seeks to ensure timely and coordinated debt restructuring efforts involving all creditors.
- 8. Debt-for-Nature Swaps:** These agreements allow countries to reduce their external debt in exchange for investments in environmental conservation. For example, Ecuador's 2024 initiative facilitated debt swaps aimed at protecting the Amazon rainforest.
- 9. IMF Surcharge Policy Revisions:** In 2024, the IMF reduced borrowing costs for member countries by \$1.2 billion annually, making debt servicing more manageable. This measure involved lowering surcharges and raising loan thresholds, offering financial relief to borrowing nations.

Debt relief measures play a major role in reducing the



- Debt relief enables sustainability

financial distress of indebted nations, promoting economic stability, and supporting sustainable development. While significant progress has been made through initiatives such as the HIPC, and MDRI, and innovative mechanisms like debt-for-nature swaps, challenges persist. The ongoing need for comprehensive, inclusive, and forward-looking solutions is evident as the global economy evolves. By aligning debt relief efforts with broader goals like poverty reduction and environmental conservation, the international community can pave the way for a more equitable and resilient financial future.

Summarised Overview

The global economic system has long been characterised by disparities between industrialised nations (Global North) and developing economies (Global South). These economic imbalances stem from historical legacies such as colonialism, trade dependence, and structural inequalities in international financial institutions. In response, the concept of the New International Economic Order (NIEO) emerged in the 1970s, advocating for a more equitable distribution of global wealth, improved trade terms for developing nations, and increased control over natural resources. The NIEO sought to restructure the global economy by addressing the unfair advantages held by developed countries, promoting technology transfer, and ensuring stable commodity prices. Despite strong support from the Group of 77 (G77) and non-aligned nations, the NIEO faced resistance from developed economies, limiting its effectiveness in achieving long-term reforms. Alongside these efforts, the North-South Dialogue was established to facilitate negotiations between developed and developing nations regarding economic co-operation and trade. Discussions centred on reducing trade barriers, stabilising commodity prices, increasing foreign aid, and reforming the international monetary system. However, the dialogue often faced political resistance, as developed countries were hesitant to compromise their economic dominance. While some agreements on tariff reductions and financial aid were reached, major structural changes in global trade and finance remained unfulfilled. Globalisation has further complicated the North-South divide, with emerging economies such as China, Brazil, and India gaining economic power while some regions continue to struggle with financial instability.

The international debt crisis remains a constant challenge, particularly for low- and middle-income countries burdened with unsustainable borrowing and rising debt servicing costs. Factors such as high interest rates, inflation, and global financial shocks have exacerbated debt distress, limiting countries' ability to invest in social and economic development. Debt relief measures, including the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), have provided some relief by reducing debt burdens and allowing for economic restructuring. However, new challenges continue to arise, requiring innovative financial solutions and stronger international cooperation to prevent future crises. Addressing global debt effectively demands coordinated efforts from international institutions, creditor nations, and borrowing countries to ensure long-term financial sustainability.

Assignments

1. What were the objectives of the New International Economic Order (NIEO)?
2. Describe the significance of the North-South Dialogue in international trade relations.
3. Explain the major causes and consequences of the international debt crisis.
4. What are the key debt relief measures implemented by international financial institutions?
5. How have globalisation and economic reforms influenced the North-South divide?

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UNIT 3

India's Global Investment, Trade, and Debt

Learning Outcomes

After completing this unit, the learner will be able to:

- understand international investment in India's economic growth and development
- know the effects of external debt on India's economy and its management
- discuss the role of international institutions in India's trade policies and economic development

Background

International investment plays a major role in shaping a country's economic path. Historically, nations like China and Brazil have attracted substantial foreign investments, which have fuelled their industrial growth, technology transfers, and infrastructure development. India, too, has attracted foreign capital, particularly in sectors such as technology, manufacturing, and renewable energy. Understanding the factors that attract foreign investment, such as political stability, market size, and favourable policies, is key to appreciating its implications for nations. External debt is another key aspect. Many developing countries, including Argentina and Sri Lanka, have faced debt crises due to over-borrowing and poor debt management. It is key to understand how countries borrow from international markets and institutions like the International Monetary Fund (IMF) or World Bank, and the potential risks and benefits associated with such borrowing. For example, while external debt can finance essential infrastructure projects, excessive debt may lead to economic instability and dependence.

The role of international trade in economic development cannot be overstated. Countries like South Korea and Germany have showcased how strategic trade policies and export-driven growth can transform economies. An understanding of major international trade organisations like the World Trade Organisation (WTO) is also beneficial, as these entities govern trade rules and resolve disputes between nations. International



institutions such as the IMF, World Bank, and United Nations Conference on Trade and Development (UNCTAD) have played major roles in the economic development of many nations. The Marshall Plan for post-World War II Europe, led by international institutions, serves as a historical example of how coordinated efforts can rebuild economies. In the Indian context, these institutions have provided critical support through loans, grants, and policy advice to facilitate development projects and reforms.

Keywords

International Investment, External Debt, Global Trade, Foreign Portfolio Investment (FPI), International Trade Agreements, World Trade Organisation (WTO), Infrastructure Development, Trade Liberalisation, Sustainable Development

Discussion

4.3.1 International Investment in India

India's external sector has shown remarkable strength amidst global challenges, including geopolitical tensions, rising inflation, and economic slowdowns in major economies. In 2023-24, while merchandise exports faced downslides due to weaker demand from trading partners, services exports played a key role in reducing the overall trade deficit. The trade deficit reduced significantly to USD 78.1 billion from USD 121.6 billion in 2022-23, aided by lower prices of imported commodities, including crude oil. These developments reflect India's ability to adapt to evolving global conditions and leverage its competitive advantages.

- Trade deficit narrows significantly

Foreign Portfolio Investment (FPI) inflows in 2023-24 stood at an impressive USD 44.1 billion, showing strong investor confidence in India's economic prospects. Factors such as sustained economic growth, a stable business environment, and proactive policy measures contributed to this trend. The inflows helped stabilise the Indian Rupee within a manageable range of ₹82 to ₹83.5/USD, with the Rupee emerging as one of the least volatile currencies among emerging markets in

2023-24. This stability highlights India's strong external sector shock absorbers, including healthy foreign exchange reserves, sustainable external debt indicators, and a market-determined exchange rate. While global Foreign Direct Investment (FDI) declined by 2% in 2023 to USD 1.3 trillion, India remained a preferred destination for foreign investment. Global economic uncertainties, with protectionist policies in advanced economies, caused challenges to FDI flows globally. However, India's large consumer market, improved logistics performance, and stable policy environment helped it attract steady inflows. The government's focus on trade facilitation and reducing logistics costs further improved India's appeal as an investment destination, as reflected in the country's improved ranking in the World Bank's Logistics Performance Index, moving up from 44th in 2018 to 38th in 2023. The services sector has been a base of India's economic growth, with exports expanding at a compound annual growth rate (CAGR) of more than 14% over the last three decades. India has emerged as the seventh-largest services exporting country globally and is a leader in areas such as IT and technology-enabled services. The IT sector alone contributed 48% to total services exports in 2023-24. Additionally, India has become a hub for Global Capability Centres (GCCs), which provide high-value-added services such as innovation, product development, and operations management. As of 2023, India housed over 1,600 GCCs, generating substantial export earnings and contributing significantly to the GDP.

- India's strong FPI inflows

India's participation in Global Value Chains (GVCs) has been on the rise, reflecting its integration into global supply chains. The share of GVC-related trade in India's gross trade increased to 40.3% in 2022, up from 35.1% in 2019. This growth has been driven by rising investments in medium and high-technology manufacturing sectors, such as electronics, automotive components, and pharmaceuticals. For instance, Apple assembled 14% of its global iPhones in India in 2023-24, showcasing the country's growing role as a manufacturing hub. Furthermore, India's backward GVC participation increased, enabling the country to add more value to its exports.

- India's growing GVC integration

India views Free Trade Agreements (FTAs) as essential tools for trade liberalisation and economic integration. Recent FTAs with countries such as the UAE and Australia have opened new opportunities for Indian exporters. These agreements



- India's FTA-driven trade growth

aim to provide zero-duty market access, improve trade relations, and facilitate the diversification of India's export markets. Despite the progress, India faces challenges such as global economic uncertainties, restrictive trade practices, and geopolitical tensions. However, significant opportunities exist in leveraging India's large domestic market, improving trade infrastructure, and enhancing integration into global markets. Initiatives like the Districts as Export Hubs (DEH) program are fostering regional exports by promoting unique district-specific products and enabling local businesses to access international markets. India's external sector is well-positioned to navigate global uncertainties and capitalise on emerging opportunities. Continued efforts to increase competitiveness, improve trade-related infrastructure, and integrate micro, small, and medium enterprises (MSMEs) into global supply chains will be critical. With a diversified export basket, strong policy support, and a focus on quality and innovation, India is set to strengthen its position as a global investment and trade hub.

4.3.2 India and External Debt

- India's ability to attract international funding increases while maintaining sustainable debt levels

India's external debt is a major aspect of its economic framework, reflecting its interaction with global financial markets and reliance on external financing for development and growth. As of March 2024, the total external debt stood at \$663.8 billion, a 6.4% increase from the previous year. This increase highlights India's ability to attract international funding while maintaining sustainable debt levels. The rise in external debt is attributed to higher commercial borrowings, foreign portfolio investments (FPIs), and non-resident Indian (NRI) deposits, showing the country's attractiveness to both institutional and individual investors. Despite this growth, the country has demonstrated strong management of its external obligations through wise policies and strong macroeconomic indicators.

The major highlights regarding India and its external debt are as follows:

- Reduced debt to GDP shows a controlled borrowing strategy

1. External Debt-to-GDP Ratio: The external debt-to-GDP ratio is a fundamental measure of debt sustainability. For India, this ratio declined to 18.7% in March 2024, compared to 19% in March 2023. This reduction reflects the government's focus on economic growth surpassing the rise in external liabilities. The decline shows a

controlled borrowing strategy and the economy's ability to absorb external shocks.

- Forex reserves act as a buffer against vulnerabilities

- Appreciation of dollar resulted in valuation gain

- Sovereign debt borrowings increased

- Private sector's increasing role in accessing global financial markets

- US dollar remained the largest component

- India's debt structure skewed towards long term debt

2. Forex Reserves Coverage: India's foreign exchange reserves act as a buffer against external vulnerabilities. Covering 97.4% of the total external debt as of March 2024, up from 92.7% in the previous year, the reserves ensure the country's capacity to manage short-term external obligations and currency volatility. This strong reserve position highlights India's financial stability and strength in an uncertain global environment.

3. Valuation Effects: The appreciation of the US dollar against the Indian Rupee and other major currencies resulted in a valuation gain of \$8.7 billion. Without this gain, the actual increase in external debt would have been \$48.4 billion instead of \$39.7 billion, further emphasising the importance of currency movements in external debt dynamics.

The composition of India's external debt is as follows:

1. Sovereign Debt: Sovereign debt, which includes borrowings by the government and public sector units, amounted to \$148.7 billion in March 2024, reflecting an 11.5% increase. This growth was largely driven by FPIs investing in government securities, indicating confidence in India's fiscal stability and economic prospects.

2. Non-Sovereign Debt: Non-sovereign debt totalled \$515.1 billion, accounting for 77.6% of total external debt. This segment includes borrowings by private corporations, financial institutions, and others. Its growth of 5% was fuelled by commercial borrowings, NRI deposits, and trade credits. This indicates the private sector's increasing role in accessing global financial markets.

3. Currency Composition: The composition of external debt highlights the dominance of foreign currency borrowings. The US dollar remained the largest component at 53.8%, followed by the Indian Rupee at 31.5%. The high share of Indian Rupee debt, mainly in the form of NRI deposits and investments in domestic securities, provides a natural shield against currency risk.

4. Maturity Profile: India's external debt structure is skewed towards long-term debt, which constituted 81.5% of the total. This ensures a more stable repayment schedule and reduces refinancing risks. Short-term debt, mainly trade credits, accounted for 18.5%, down from



the previous year, reflecting better risk management in volatile capital flows.

The sector-wise contributions towards India's external debt are as follows:

- Sector-wise contributions towards India's external debt

- 1. General Government:** The government sector saw an increase in external debt due to a rise in investments in treasury bills and bonds by FPIs. This reflects global confidence in India's macroeconomic stability and fiscal policies.
- 2. Non-Financial Corporations:** Non-financial corporations held \$248.1 billion in external debt as of March 2024, a 2.2% increase from the previous year. This growth was supported by commercial loans and foreign investments in corporate bonds. These borrowings enable businesses to finance large-scale investments and improve their competitiveness globally.
- 3. Deposit-Taking Corporations:** Banks and financial institutions contributed significantly to external debt, with their liabilities rising to \$186.8 billion, driven by a 9.4% increase in NRI deposits. Additionally, securitised borrowings by commercial banks grew by 82%, emphasising the sector's growing reliance on global funding sources.
- 4. Central Bank:** The Reserve Bank of India's external liabilities remained minimal at \$0.2 billion, reflecting the central bank's conservative approach towards external borrowings.

The key debt indicators are:

- Debt service ratio, short term debt to forex reserves and trade credit are three debt indicators

- 1. Debt Service Ratio:** The debt service ratio, which measures the share of debt repayments in current receipts, increased to 6.7% in 2023-24 from 5.3% in the previous year. This rise indicates a higher outflow for principal and interest payments, though it remains manageable given India's robust foreign exchange earnings.
- 2. Short-term Debt to Forex Reserves:** The ratio of short-term debt to forex reserves declined to 19% in 2024 from 22.2% in 2023, highlighting improved liquidity and reduced vulnerability to short-term external shocks.
- 3. Trade Credit:** Short-term trade credit, constituting 96.3% of the total short-term debt, fell by 4.6%. This shows a control in import financing requirements due to subdued global trade.

The recent trends in external borrowing are as follows:

- 1. Commercial Borrowings:** At \$250.4 billion, commercial borrowings remain the largest component of India's non-sovereign debt. A 13.3% increase in this segment reflects India's improved access to global financial markets and favourable borrowing terms.
- 2. NRI Deposits:** These deposits reached \$151.9 billion, growing by 9.4%, showcasing the continued trust of the Indian diaspora in the country's economic stability.
- 3. Concessional Debt:** Concessional borrowings accounted for 7.5% of total external debt, down from 8.2% in 2023. This shift indicates a growing reliance on market-based financing.

India ranks 24th globally in external debt, with indicators such as debt-to-exports and debt-to-GDP ratios placing it among the more sustainable economies. Compared to many low- and middle-income countries, India's external debt remains modest, supported by strong reserves and prudent policies. India's external debt management policy is guided by a sensible and forward-looking framework designed to ensure sustainability and stability. A key emphasis is placed on encouraging non-debt flows, such as equity investments and direct foreign investments, over debt-based inflows. This approach minimises the burden of repayment obligations while promoting long-term economic growth and flexibility. Additionally, the government maintains a controlled reliance on short-term debt, recognising its potential volatility. By limiting exposure to short-term liabilities, India reduces the risk of sudden capital flight and enhances financial stability. The policy also incorporates a calculated approach to external commercial borrowings (ECBs), ensuring that such borrowings are not only within permissible limits but also utilised effectively for productive purposes. This measured strategy helps maintain a healthy debt-to-GDP ratio and minimises vulnerabilities. Furthermore, India places significant importance on building and maintaining strong foreign exchange reserves. These reserves act as a buffer against external shocks, ensuring the country can meet its international payment obligations without undue stress. Together, these policies create a balanced framework for managing external debt, enabling India to remain strong amid global economic uncertainties. While India's external debt is well-managed, global risks like geopolitical tensions, fluctuating commodity prices, and tightening monetary policies in advanced economies could

- India manages debt sustainably



impact borrowing costs. Domestically, balancing the need for infrastructure financing with debt sustainability will remain crucial. Continued reliance on long-term borrowings and a diversified creditor base will help India maintain its strong external debt profile.

4.3.3 Developments in India's Trade

India's external sector demonstrated remarkable strength during 2023-24, overcoming significant geopolitical challenges. The Economic Survey 2023-24, tabled by the Union Finance Minister Smt. Nirmala Sitharaman highlights several achievements and trends that emphasise India's growing prominence in global trade and economic stability. The overall trade deficit in 2023-24 witnessed a substantial decline to USD 78.1 billion from USD 121.6 billion in 2022-23. This improvement reflects India's strong external sector performance, despite global uncertainties and challenges in international trade dynamics. Strong growth in services exports and moderated merchandise imports were pivotal in achieving this outcome.

- Trade deficit narrows significantly

India emerged as the seventh-largest services-exporting country globally in 2022, an impressive rise from its 24th position in 2001. The share of India's services exports in world trade has grown significantly from 0.5% in 1993 to 4.3% in 2022. India now ranks second in telecommunication, computer, and information services exports, underscoring its position as a leader in the global IT and business services market. Expansion of Global Capability Centres (GCCs), which increased from 760 in 2012 to over 1,600 by March 2023. GCCs have significantly contributed to India's services exports, particularly in software, travel, and business services. Software and IT services exports, along with business services, accounted for 26% of services exports in 2023-24.

- India emerged as the seventh-largest services-exporting country in the world in 2022

India maintained a steady performance in merchandise trade, despite low global demand. Merchandise exports crossed USD 776 billion in 2023-24, while imports reached USD 898 billion. Consequently, the merchandise trade deficit narrowed to USD 238.3 billion in 2023-24 from USD 264.9 billion in 2022-23. Growth in exports of engineering goods, electronics, and pharmaceuticals, shows India's increasing role in high-value and technology-intensive sectors. A notable increase in capital goods imports, indicating heightened industrial activity and

- India maintained a stable performance in merchandise trade in 2023-24, leading to a decline in the merchandise trade deficit

investment in production infrastructure. Expansion in product-specific exports, such as defence equipment, toys, footwear, and smartphones, supported by government initiatives like the Production Linked Incentive (PLI) scheme.

- India's participation in Global Value Chains (GVCs) improved significantly, highlighting its expanding role as a global supplier in production networks

India's participation in Global Value Chains (GVCs) saw a notable improvement, with GVC-related trade constituting 40.3% of India's gross trade in 2022, up from 35.1% in 2019. This growth has been driven by increased backward GVC integration, reflecting India's increasing role as a supplier in global production processes. Investments in sectors such as electronics, apparel, toys, and semiconductors are supported by the PLI scheme and the Districts as Export Hubs (DEH) initiative. India's logistical infrastructure has shown marked improvement, as highlighted by the increased Logistics Performance Index (LPI) ranking. Several initiatives have been instrumental in reducing trade costs and improving efficiency. The PM GatiShakti National Master Plan and the National Logistics Policy (NLP) have streamlined logistics operations, with digital reforms like the Unified Logistics Interface Platform (ULIP) playing a crucial role. Other measures include railway electrification, improved port logistics under NLP Marine, and reduced processing times at land ports.

- CAD shrinks, forex reserves surge

India's Current Account Deficit (CAD) was reduced to USD 23.2 billion (0.7% of GDP) in 2023-24, a significant improvement from USD 67 billion (2% of GDP) in 2022-23. Rising net services receipts, which grew from USD 143.3 billion in 2022-23 to USD 162.8 billion in 2023-24. Record-high remittances from overseas Indians, reaching USD 106.6 billion in 2023-24 and projected to grow further to USD 124 billion in 2024. Net capital flows increased to USD 86.3 billion in 2023-24 from USD 58.9 billion in 2022-23, driven by strong Foreign Portfolio Investment (FPI) inflows of USD 44.1 billion. India also recorded the highest equity inflows among emerging market peers during 2023-24, with sectors like financial services, healthcare, and automobile components attracting significant investment.

India's global trade landscape is marked by a mix of challenges and opportunities that shape its economic path. One of the major challenges is the reduced demand from key trading partners such as the European Union (EU). This decline in demand can be attributed to factors such as economic slowdowns, shifts in consumption patterns, and geopolitical uncertainties.



- India's global trade strategy and economic strength

Additionally, India faces rising trade costs and volatility in commodity prices, which can ruin the competitiveness of its exports. These challenges are further compounded by the dynamic shifts in global trade policies, with protectionist measures and changing trade alliances making it harder for India to maintain its trade volumes. However, India has adopted a range of strategic measures to address these challenges and strengthen its position in global trade. A key initiative is the expansion of the Production-Linked Incentive (PLI) scheme, aimed at incentivising domestic manufacturing in sectors such as electronics, textiles, and pharmaceuticals. By strengthening the manufacturing base, India can reduce dependency on imports and boost exports. Moreover, India is actively signing new Free Trade Agreements (FTAs) with various countries and regions, creating more favourable trade terms and market access. Another key factor is the focus on infrastructure development, particularly in logistics, transportation, and digital connectivity. Improved infrastructure not only improves trade efficiency but also attracts foreign investment, providing a competitive edge in global markets..

4.3.4 Role of International Institutions in The Economic Development of India

- Global institutions boost India's growth

International institutions play a key role in shaping the economic development path of countries across the globe. In India, these institutions have been instrumental in facilitating economic growth, structural reforms, poverty alleviation, and the development of key sectors. Organisations such as the International Monetary Fund (IMF), the World Bank, the International Development Association (IDA), the International Finance Corporation (IFC), the Asian Development Bank (ADB), and the World Trade Organisation (WTO) contribute significantly to India's economic development by providing financial assistance, technical expertise, policy guidance, and promoting global trade integration. Through financial loans, grants, and policy advice, these institutions help India address challenges such as infrastructure deficits, economic imbalances, and social development needs. Additionally, their influence in shaping India's trade policies, investment climate, and institutional reforms has been a key driver of India's economic growth over the past few decades. This interaction between India and international institutions emphasises the importance of global partnerships in achieving sustainable economic development in a rapidly changing world.

4.3.4.1 India and the International Monetary Fund (IMF)

- IMF establishment and India's role

The International Monetary Fund (IMF) was established in 1944 at the Bretton Woods Conference to address economic instability caused by the Great Depression and World War II. Its primary objectives are to promote global monetary cooperation, ensure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty worldwide. India has been a founding member of the IMF since December 27, 1945, with an initial quota of \$400 million, giving it a 2.6% voting share. Since then, India's relationship with the IMF has evolved significantly, reflecting changes in the country's economic trajectory and policy priorities.

- India's IMF reliance, reforms, transition

In the early years following independence, India relied on the IMF for financial support to address economic challenges such as foreign exchange shortages and balance of payments (BoP) deficits. These issues arose due to limited industrialisation and high import dependency, particularly during the implementation of the Second Five-Year Plan (1956–1961), which prioritised rapid industrialisation. In 1957, India availed its first IMF loan to meet BoP shortfalls. The 1966 devaluation of the Indian rupee was another significant event in the India-IMF relationship. Under IMF advice, this measure was adopted to tackle chronic trade deficits and foreign exchange crises, although it drew significant domestic criticism for its perceived impact on economic sovereignty. The 1980s marked a crucial phase in India's engagement with the IMF. By the late 1980s, India faced a severe BoP crisis worsened by rising fiscal deficits, external debt, and external shocks such as the Gulf War. In 1991, India approached the IMF for assistance, leading to a \$2.2 billion loan under the Extended Fund Facility. This was a turning point, as it was accompanied by structural adjustment reforms that transformed the Indian economy. These reforms included the devaluation of the rupee, liberalisation of trade and industrial policies, and a reduction in fiscal deficits. These measures not only helped stabilise the economy but also laid the foundation for India's subsequent economic liberalisation and sustained growth. In the post-reform era, India's dependence on IMF loans has significantly diminished, reflecting its improved economic strength and foreign exchange reserves. India has transitioned from being a borrower to a contributor to the IMF's resources. For instance, in 2012, India pledged \$10 billion to the IMF's



crisis fund, highlighting its growing role in global financial governance. The IMF continues to play a vital role in India's economic policymaking through Article IV Consultations, where it assesses the country's economic policies and offers recommendations. Recent consultations have highlighted India's achievements in digital transformation, fiscal consolidation, and efforts to address climate change.

The IMF also provides India with technical assistance and training in key areas such as public finance management, tax reforms, and financial sector oversight. During crises, such as the COVID-19 pandemic, the IMF supported developing countries, including India, by offering policy guidance to reduce economic disruptions. However, India's relationship with the IMF has not been without challenges. One key criticism is the strict conditions attached to IMF loans, which often instruct severe measures that can negatively impact growth and social welfare. Furthermore, India has called for governance reforms in the IMF, as its voting share does not adequately reflect its economic size and influence on the global stage. The IMF has significantly influenced India's economic path, especially during critical points. The IMF has also provided technical assistance to India in areas such as tax reforms, financial sector regulation, and monetary policy. Its capacity-building programs have helped India strengthen its institutional frameworks and adapt to global economic changes. Moreover, by advocating for sound macroeconomic policies, the IMF has supported India's efforts to achieve sustainable and inclusive growth. India's relationship with the IMF has evolved over the decades from a borrower-dependent nation to a significant stakeholder in global financial stability. While the IMF played a key role in addressing India's early economic challenges, the country's reduced dependence on IMF loans and its active contributions to the organisation's resources reflect its emergence as a major player in the global economy. Despite occasional criticism, the IMF continues to be an important partner in India's economic journey, offering both financial and technical support.

- IMF shapes India's journey

4.3.4.2 India and the World Bank

India has maintained a longstanding relationship with the World Bank since its establishment in 1944. As one of the founding members, India joined the institution on July 1, 1944, during the Bretton Woods Conference. This early membership, even before attaining independence in 1947, highlights the

- India became a member of the World Bank on December 27, 1945, after signing the Articles of Agreement formulated during the Bretton Woods Conference held in July 1944

transitional government's foresight in recognising the need for international financial assistance to achieve development goals. India received its first loan from the World Bank in 1949, amounting to \$34 million, for the rehabilitation and expansion of its railways. This loan marked the beginning of a mutually beneficial partnership focused initially on infrastructure development and later expanding to encompass education, healthcare, poverty alleviation, and sustainable development.

The role of the World Bank in India's economic development can be explained as follows:

1. Infrastructure Development

- **Transportation and Energy:** World Bank funding has supported major infrastructure projects, including the Bhakra-Nangal and Damodar Valley dams, which improved irrigation, electricity generation, and flood control. Investments in road, rail, and port infrastructure facilitated seamless connectivity essential for economic growth.
- **Urban Development:** Modern urban infrastructure projects have been funded to improve city planning, housing, and public utilities.

2. Poverty Alleviation and Social Development

- **Rural Development:** Initiatives such as the Integrated Rural Development Program (IRDP) have empowered rural communities through credit access, skill development, and market integration.
- **Education:** Programs like Sarva Shiksha Abhiyan (SSA) have increased access to elementary education for millions, with the World Bank contributing significantly to funding.
- **Healthcare:** Targeted projects have addressed maternal and child health, the eradication of diseases, and the strengthening of healthcare systems.

3. Agricultural Reforms and Food Security

- **Green Revolution Support:** The World Bank played a major role during India's Green Revolution, funding irrigation projects, introducing high-yield variety seeds, and supporting agricultural research.



- **Food Security:** Increased agricultural productivity has helped India transition from a food-deficient nation to a major global food producer.

4. Economic Reforms and Structural Adjustment

- **Liberalisation:** During the 1991 balance of payments crisis, the World Bank provided financial assistance and policy advice to stabilise India's economy. Structural reforms supported by the Bank included trade liberalisation, fiscal discipline, and attracting foreign investment.

5. Sustainable Development and Climate Action

- **Renewable Energy:** Investments in solar energy projects like the Rewa Ultra Mega Solar Power Project highlight the World Bank's role in promoting clean energy.
- **Climate Resilience:** The Bank has supported sustainable urban planning, climate-resilient agriculture, and energy efficiency programs to mitigate environmental challenges.
- **Education:** Launched in 2001, the Sarva Shiksha Abhiyan (SSA) is one of the most ambitious educational initiatives in India, aimed at providing free and quality elementary education to all children in the 6-14 age groups. The World Bank played a major role in this initiative, by contributing over \$2 billion to the program's various phases. By focusing on the universalisation of elementary education, SSA has made education accessible to 200 million children, particularly in rural and underserved areas.
- **Rural Connectivity:** The Pradhan Mantri Gram Sadak Yojana, launched in 2000, is another key initiative supported by the World Bank, aimed at improving rural connectivity through the construction of all-weather roads. With a total funding contribution of \$1.8 billion from the World Bank, this program has connected millions of rural inhabitants to mainstream economic activity, healthcare, and education. The program has benefitted over 8 million people by providing access to better transport infrastructure, which has in turn facilitated better access to markets, health services, and education. However, the implementation of rural road projects has been challenging, particularly in remote areas, due to difficult terrain, poor maintenance, and issues related to land acquisition.

- India's poverty reduction and development efforts

The World Bank has also been involved in a number of

- World Bank's healthcare support

healthcare projects across India, aiming to improve access to and the quality of health services. Notable examples include the Uttarakhand Health Systems Development Project and the Tamil Nadu Health System Reform Program. These initiatives have worked to strengthen state-level health systems by improving infrastructure, upgrading healthcare facilities, and increasing the capacity of healthcare providers. By focusing on maternal and child health, improving immunisation coverage, and addressing communicable diseases, these projects have made significant progress in improving health outcomes. Despite progress, challenges such as underfunding, resource constraints, and disparities in healthcare delivery between urban and rural areas remain persistent issues.

- World Bank projects criticised

While World Bank-funded projects in India have contributed to significant improvements in education, infrastructure, and health, they have also faced considerable criticism, particularly concerning environmental and social impacts. Some large-scale infrastructure projects funded by the World Bank, such as dams and industrial developments, have been accused of causing environmental degradation, displacing communities, and disrupting ecosystems. Critics argue that these projects often fail to adequately consider the long-term environmental costs and the displacement of vulnerable populations, leading to social tensions and loss of livelihoods. In some cases, local communities have been forced to bear the brunt of these negative impacts without sufficient compensation or resettlement options, leading to protests and opposition.

- Economic reforms' mixed impact

The economic reforms of the 1990s, which were supported by the World Bank, played a pivotal role in transforming India's economy through liberalisation, privatisation, and the reduction of government intervention in the economy. However, these reforms also had significant social costs. The reduced focus on welfare spending, combined with cuts in subsidies for essential services, had adverse effects on vulnerable populations, including the poor, rural communities, and marginalised groups. While the reforms succeeded in stimulating economic growth and attracting foreign investment, they led to rising income inequality and increased unemployment in certain sectors, such as agriculture and manufacturing. The social safety nets that were supposed to reduce these impacts were often insufficient, leading to widespread social distress in certain regions. Critics argue that the World Bank and other international financial institutions



did not adequately address the negative social consequences of these reforms, particularly in terms of protecting the most vulnerable sections of society. The partnership between India and the World Bank has yielded numerous positive outcomes in terms of poverty reduction, export growth, and infrastructure development. However, the associated challenges, including environmental damage, social displacement, and the uneven benefits of economic reforms, highlight the need for a more inclusive approach that balances economic growth with social equity and environmental sustainability.

4.3.4.3 India and the International Development Association (IDA)

The International Development Association (IDA) is a key component of the World Bank, established in 1960 with the aim of providing concessional loans and grants to the world's poorest countries. IDA's role is to alleviate poverty and promote economic development by providing financial resources, expertise, and technical assistance. India, as one of the largest and oldest recipients of IDA aid, has significantly benefitted from its partnership with the association, which has played a major role in the country's economic growth and development over several decades. This relationship can be analysed from a historical perspective, and an understanding of IDA's involvement in India's development is essential to assess its long-term impact. IDA is a part of the World Bank Group (WBG), distinct from the IBRD (International Bank for Reconstruction and Development), which lends at market-based rates, IDA provides concessional (low-interest or grant-based) lending, mainly to the poorest countries.

- IDA plays an important role in India by giving low-interest loans and grants to support development

India was a founding member of the IDA in 1960. In the initial years, India was emerging from the shadows of colonial rule and the country faced immense challenges, including poverty, inequality, and low levels of industrialisation, making it a natural beneficiary of concessional loans from institutions like IDA. At that time, India's economic strategy was focused on rapid industrialisation, poverty alleviation, and self-sufficiency. In the early stages, the IDA's financial support was significant in providing India with the necessary resources to fund large-scale development projects, especially in agriculture, infrastructure, and rural development. As India was among the poorest nations in the world at the time, it qualified for loans under IDA's terms, which provided a lower interest rate and

longer repayment periods compared to conventional loans. The initial funding was allocated to sectors such as irrigation, rural development, and agriculture to address the country's pressing need for food security and economic stability.

- The IDA's financial support is primarily used for agriculture, infrastructure, and rural development

Over the decades, India has continued to receive significant assistance from IDA to support various developmental programs. The role of IDA in India's development can be broadly divided into key areas such as infrastructure, human development, poverty alleviation, and economic reforms.

1. Infrastructure Development: One of the major contributions of IDA to India's economic development was in the area of infrastructure. For example, the IDA funded large irrigation projects in India to improve agricultural productivity, particularly in water-scarce regions. The establishment of a vast transportation network, including roads, railways, and ports, was also supported by IDA assistance, helping boost trade and connectivity across the country. This support was crucial in facilitating India's transition to a more industrialised economy.

2. Poverty Alleviation and Rural Development: IDA's focus on rural development projects has been central to its mission in India. The agency has consistently provided financial resources for programs aimed at improving rural infrastructure, providing microfinance, and promoting self-help groups (SHGs). These efforts have been instrumental in addressing the needs of India's rural population, which remains the most vulnerable to poverty. Moreover, the social safety net programs funded by IDA have helped reduce disparities in income and access to basic services like healthcare, education, and sanitation.

3. Education and Health: Another major area where IDA has contributed to India's development is in human capital formation. The association has supported programs aimed at improving education, healthcare, and sanitation. For instance, IDA funding has helped improve primary education access and quality, with a focus on marginalised communities. Similarly, in healthcare, IDA has been involved in financing the expansion of basic health services, maternal and child health programs, and nutrition initiatives.

4. Environmental Sustainability: With a growing population and rapid industrialisation, environmental



sustainability has become a key concern for India. IDA's support has been critical in financing initiatives for environmental conservation, particularly in the areas of water resources management, biodiversity preservation, and climate change mitigation. Projects like the National Ganga River Basin Project, which aims to clean and preserve the Ganges River, have benefited from IDA funding and support.

- India transitions from recipient to contributor

India's relationship with the IDA has evolved over the years. While it was primarily a recipient of funds in the earlier stages, India's increasing economic growth and transformation have led to a shift in its role. In recent years, India has contributed to IDA's replenishment cycles and has become more engaged in global development discussions. India's active participation in international forums, such as the G20, has allowed it to influence the development agenda within IDA, especially in advocating for the needs of developing countries facing poverty and inequality. India's continued involvement with IDA shows its commitment to sustainable development, poverty eradication, and international cooperation. The country has used IDA's concessional funding to implement its flagship programs like the Pradhan Mantri Jan Dhan Yojana (financial inclusion), Swachh Bharat Abhiyan (clean India mission), and the Pradhan Mantri Awas Yojana (housing for all). These programs, while primarily driven by domestic policy, have been supported by the financial and technical expertise that India has garnered through its longstanding relationship with IDA.

- IDA aided India's economic transformation

India's economic liberalisation in the 1990s marked a turning point in its relationship with international financial institutions, including IDA. During this period, India began adopting market-oriented reforms, such as reducing trade barriers, privatisation of state-owned enterprises, and deregulation of industries. IDA played a role in providing financial support for some of these reforms, particularly in areas like poverty reduction, human capital development, and rural infrastructure. The agency's assistance helped mitigate some of the short-term challenges that arose from these reforms and provided the country with resources to manage the social impact of the transition. IDA's support has contributed significantly to India's progress toward achieving its development goals. Since its inception, India's GDP growth has been remarkable, moving from a low base of around 3-4% annual growth in the early years to an average of around 6-7% in recent decades.

India is now considered one of the world's largest and fastest-growing economies, thanks to its broad-based development strategy supported by IDA.

- IDA shaped India's development journey

India's partnership with the IDA has played a pivotal role in shaping the country's economic development. From its initial days as a recipient of concessional aid to its current role as a growing economy and contributor to IDA's funding, India has benefited immensely from its association with the institution.

4.3.4.4 India and the International Finance Corporation (IFC)

The International Finance Corporation (IFC) is one of the five institutions that form the World Bank Group. Established in 1956, the IFC's primary objective is to promote private sector investment in developing countries, with a focus on alleviating poverty and promoting sustainable economic growth. Its role is important in providing finance for development projects that are not typically funded by traditional financial institutions, especially in emerging economies. The IFC aims to stimulate private sector investment by offering financial products, advisory services, and technical assistance. India's relationship with the IFC dates back to its formation in 1956. The country, as a member of the World Bank, was one of the early beneficiaries of the corporation's financial products. Initially, India's engagement with the IFC was driven by the need to stimulate private-sector investment in an economy that was largely dependent on state-led industrialisation. The country had just gained independence in 1947 and was undergoing a massive transformation with an emphasis on building infrastructure and industries to achieve self-sufficiency. India's collaboration with the IFC expanded over the decades, particularly as the country began to liberalise its economy in the 1990s. During this period, India introduced several economic reforms, including market liberalisation, reducing trade barriers, and encouraging FDI. These efforts aligned well with the objectives of the IFC, which had been advocating for a more significant role of the private sector in promoting growth in developing countries.

- The IFC aims to stimulate private sector investment by offering financial products, advisory services, and technical assistance

The IFC's role in India has been multifaceted. They can be explained as follows:

1. **Providing Long-term Capital:** The IFC has provided long-term financing for projects that promote economic



growth and development in India. It focuses on sectors such as infrastructure, renewable energy, agriculture, and manufacturing. Through equity investments and loans, the IFC has contributed to the growth of Indian industries and the creation of jobs.

2. Supporting Private Sector Growth: One of the key contributions of the IFC has been to support the private sector in India. By providing financing to small and medium-sized enterprises (SMEs), the IFC has helped improve access to capital, thereby encouraging entrepreneurship. The corporation's focus on strengthening corporate governance and promoting transparency has also had a positive impact on the Indian business landscape.

3. Promoting Sustainable Development: The IFC has been instrumental in promoting sustainable development in India. It has supported projects in the renewable energy sector, such as solar power and wind energy, helping India reduce its dependence on fossil fuels and address environmental concerns. By financing green projects, the IFC plays a key role in India's commitment to the United Nations' Sustainable Development Goals (SDGs).

4. Technical Assistance and Advisory Services: In addition to financing, the IFC offers both technical and advisory services to both the public and private sectors. The corporation provides expertise in market dynamics, risk management, and institutional capacity building. For instance, the IFC has worked closely with India's banking sector to improve financial inclusion by supporting microfinance institutions and other inclusive finance initiatives.

- The IFC's efforts have been aligned with India's development priorities, such as job creation, infrastructure development, and environmental sustainability

The major areas of collaboration between India and the IFC are as follows:

1. Infrastructure Development: The IFC has been actively involved in financing infrastructure projects in India, including transportation, urban development, and water supply. These projects are essential to supporting India's growing population and its rapid urbanisation. The IFC has also supported the development of smart cities and affordable housing.

2. Renewable Energy: As part of India's strategy to reduce its carbon footprint and combat climate change, the IFC has provided substantial financing for renewable energy projects. These projects include wind energy, solar power, and hydroelectric projects, which are crucial to

India's energy transition.

- 3. Financial Inclusion:** The IFC has worked with Indian banks and financial institutions to promote financial inclusion, particularly for marginalised groups such as rural populations and women. By supporting microfinance initiatives and promoting digital finance, the IFC has played an essential role in increasing access to financial services in India.
- 4. Agriculture and Rural Development:** The IFC has supported the agricultural sector in India by investing in value chains, improving productivity, and promoting agro-processing industries. These efforts have helped increase the income levels of rural populations and contributed to rural development.

The relationship between India and the IFC has been a key driver of economic development. Through its financial support and advisory services, the IFC has played a significant role in promoting India's transition from a largely agrarian economy to a more diversified one, with a focus on industrialisation, services, and technology. The IFC's efforts have been aligned with India's development priorities, such as job creation, infrastructure development, and environmental sustainability. India's economic liberalisation in the 1990s, which included opening up to foreign investment, was a turning point in the country's relationship with the IFC. The corporation's investments helped India become one of the world's fastest-growing economies in the decades that followed. The partnership with the IFC has also facilitated India's integration into the global economy, particularly through foreign direct investment (FDI) and international trade.

- IFC fuelled India's economic growth

- IFC boosted India's sustainable development

The impact of the IFC's involvement in India can be seen across multiple dimensions. The projects financed by the IFC have contributed to higher productivity, job creation, and overall economic growth. The corporation's focus on sustainable development has also ensured that economic growth is not achieved at the expense of the environment. By providing financing to SMEs and promoting sound business practices, the IFC has helped foster a more vibrant and competitive private sector in India. The corporation's support for corporate governance reforms has contributed to a more transparent and efficient business environment. The IFC's focus on financial inclusion, rural development, and poverty reduction has had a positive impact on the lives of millions of people in India. Its investments in health, education, and infrastructure have



helped improve living standards, particularly in underserved regions. The collaboration between India and the IFC has been instrumental in shaping India's economic path. Through its continued partnership with India, the IFC will continue to contribute to the country's economic development, with a particular emphasis on private sector growth, infrastructure development, renewable energy, and social inclusion.

4.3.4.5 India and the Asian Development Bank (ADB)

The Asian Development Bank (ADB) was established in 1966 with the aim of promoting social and economic development in Asia. It was founded by 31 countries with the goal of promoting sustainable development, reducing poverty, and improving economic integration across Asia. India, being one of the founding members, played an integral role in the establishment of the ADB and continues to be one of its key stakeholders. The bank's primary function was to provide loans and grants for the development of infrastructure, poverty reduction, and regional cooperation. Over the years, India has evolved as one of the largest recipients of ADB funding, benefiting from the bank's financial assistance, technical expertise, and knowledge exchange. India's relationship with ADB has been guided by its economic priorities and developmental needs. In the post-independence era, India's development challenges were huge, with poverty, underdevelopment, and a lack of infrastructure being major barriers to progress. The historical context of India's engagement with the ADB can be understood through the lens of India's ambitious developmental strategies, such as the Five-Year Plans initiated in the early years of independence, and its shift towards a more open economy in the late 20th century.

- The Asian Development Bank (ADB) was established with the aim of promoting social and economic development in Asia in 1966

India's involvement with the ADB has been multifaceted, with the ADB providing significant assistance for a wide range of projects across various sectors of the Indian economy. Over the decades, ADB's role has expanded from providing financial support to more integrated developmental cooperation. This has included:

- 1. Infrastructure Development:** ADB has supported infrastructure projects in sectors such as energy, transport, and urban development. Projects like rural electrification, highway development, and water

management have been funded through loans, grants, and technical assistance. For instance, the National Highway Development Project (NHDP) has benefited from ADB's financial assistance, enhancing India's road network, and connecting remote areas to economic hubs.

2. Poverty Alleviation and Rural Development: ADB has prioritised projects aimed at reducing poverty, particularly in rural and backward regions of India. It has provided loans for rural development programs, including improving agricultural productivity, ensuring access to clean drinking water, and promoting microfinance initiatives. Programs such as the Rural Water Supply and Sanitation Program have directly impacted millions of lives by improving basic services in rural India.

3. Social Sectors: Health, education, and social welfare projects have been a key area of focus in ADB's cooperation with India. The North Eastern Region Community Resource Management Project (NERCORMP), which is aimed at improving the livelihoods of the marginalised communities in Northeast India, is an example of how the ADB is contributing to social development.

4. Environmental Sustainability and Climate Change: In recent years, ADB has placed an increasing emphasis on environmentally sustainable projects in India. With growing concerns about climate change, ADB has financed renewable energy initiatives, water conservation programs, and sustainable urbanisation projects. For example, ADB has funded solar power projects and energy efficiency programs that aim to reduce India's carbon footprint.

5. Policy and Institutional Support: Apart from financial support, ADB also plays a significant role in India by offering technical assistance in the form of expertise in areas such as governance reforms, financial sector reforms, and institutional capacity building. This support has been crucial in shaping policies that are aligned with India's long-term growth objectives.

- The partnership between India and the ADB has played a major role in the economic development of India, especially in terms of infrastructure development, poverty reduction, social welfare, and environmental sustainability

The Asian Development Bank has been instrumental in India's economic development, particularly since the 1990s, when India embarked on economic liberalisation and market reforms. ADB's role in this period has been very important in several key areas:

- **Financing Economic Reforms:** ADB supported India's macroeconomic reforms, especially in the liberalisation of



trade and investment policies. It provided loans for structural reforms that led to the opening up of the economy and modernisation of various sectors, such as banking, agriculture, and industrial development.

- **Economic Growth:** Through strategic investments in critical sectors, ADB has helped fuel India's growth path. For instance, ADB's support in improving infrastructure has helped stimulate economic activity by facilitating faster trade, improving energy efficiency, and enhancing transportation networks. These projects have contributed to the country's growing GDP and have made India an attractive destination for foreign investments.
- **Regional Cooperation and Integration:** As a member of the ADB, India has benefitted from regional cooperation projects that promote cross-border trade and economic collaboration in South Asia. India's engagement with its neighbours through ADB-funded projects has contributed to regional economic integration, improved connectivity, and greater stability in the region.
- **Sustainable Development Goals (SDGs):** ADB's alignment with India's focus on achieving the SDGs is another key aspect of its involvement. With a focus on inclusive growth, sustainability, and resilience, ADB's projects have helped India move closer to meeting several of the SDGs, particularly those related to poverty eradication, clean water, affordable energy, and quality education.

The partnership between India and the Asian Development Bank has played a major role in the economic development of India, especially in terms of infrastructure development, poverty reduction, social welfare, and environmental sustainability. India has benefited greatly from ADB's financial resources, technical expertise, and policy guidance, which have supported the country's transition to a more open and competitive economy. As India continues to grow, the collaboration with ADB is likely to deepen, especially in light of the evolving global challenges such as climate change, sustainable development, and regional economic integration. The partnership between India and ADB exemplifies how multilateral financial institutions can contribute to the economic development of emerging economies.

- ADB fuelled India's sustainable growth

4.3.4.6 India and the World Trade Organisation (WTO)

The World Trade Organisation (WTO) is an international body that governs global trade, providing a platform for negotiating trade agreements and resolving trade disputes between its member nations. India's relationship with the WTO has played a significant role in shaping its economic policies and development path. The WTO was established in 1995, succeeding the General Agreement on Tariffs and Trade (GATT), of which India had been a part since its inception in 1948. India's involvement with the WTO and its role in shaping the global trading system has been key in India's post-liberalisation economic growth. India's history with the global trading system can be traced back to its involvement in the GATT, which aimed to reduce global trade barriers through negotiations and agreements. India was one of the founding members of the GATT and actively participated in its rounds of negotiations, advocating for the protection of developing countries' interests. However, during the early years of independence, India followed a protectionist trade policy that prioritised self-sufficiency, leading to a restrictive trade regime. The historical shift in India's economic policy occurred in 1991 when the country faced a balance of payments crisis, which led to the adoption of economic liberalisation measures. These reforms included reducing tariffs, opening up sectors to foreign investment, and embracing global trade norms. India joined the WTO in 1995, and this marked a major shift in its trade policy. The establishment of the WTO symbolised India's transition from a protectionist stance to a more open, market-driven approach to trade.

- WTO shaped India's trade liberalisation

India's role in the WTO has been marked by both challenges and achievements. As a developing country, India has focused on defending the interests of the global south within the organisation. India has advocated for the inclusion of special provisions for developing countries, such as flexible trade rules and preferential access to markets for their goods and services. India has been active in shaping the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement, arguing for the protection of access to affordable medicines for the public, especially for those living with HIV/AIDS. India has also played a key role in the Doha Development Agenda (DDA) negotiations, which aimed to address the trade imbalances between developed and developing countries. India

- India championed developing nations' interests



was part of a coalition of developing countries that sought to reform the WTO's agricultural trade policies, particularly by demanding the reduction of agricultural subsidies provided by developed countries that were harmful to the agricultural sectors of developing nations like India. The WTO's stance on agricultural subsidies became a significant issue for India, as it impacted its farmers and agricultural exports. India has also been at the forefront of advocating for the needs of LDCs in the WTO. In several trade negotiations, India has emphasised the importance of ensuring that the economic interests of the LDCs are not overshadowed by the demands of industrialised nations. India's participation in multilateral trade agreements has reinforced its leadership in the global south and its commitment to promoting fairer global trade practices.

India's economic development since joining the WTO can be attributed to the transformative impact that global trade liberalisation has had on its economy. The opening up of the Indian economy allowed for increased FDI, higher export growth, and greater integration into global value chains. India's entry into the WTO provided the country with greater access to international markets, helping to boost its exports in sectors such as information technology, textiles, and pharmaceuticals. The WTO has facilitated India's rise as an exporter of services, particularly in sectors like IT and software. India has benefited from the General Agreement on Trade in Services (GATS), which has enabled it to become a global leader in the outsourcing and business process outsourcing (BPO) industries. By allowing Indian firms to offer services in foreign markets, the WTO has been instrumental in expanding India's service sector, which now accounts for a significant share of the country's GDP. The WTO's dispute resolution mechanism has provided India with an avenue to challenge unfair trade practices by other countries. For example, India successfully contested the anti-dumping duties imposed by the United States on its steel products, which was a win for Indian exporters. The WTO's trade dispute settlement system has allowed India to assert its rights and protect its industries against unfair trading practices. On the other hand, India has also faced challenges due to the WTO's agreements, particularly in the areas of agriculture, intellectual property, and trade-related investment measures. The agricultural subsidies provided by developed countries have made it difficult for Indian farmers to compete on an equal footing in global markets. The TRIPS agreement, which requires countries to enforce intellectual

- India's entry into the WTO provided the country with greater access to international markets, helping to boost its exports in sectors

property rights, has raised concerns in India's pharmaceutical sector, where access to affordable medicines has been a major issue. India has had to balance its obligations under the WTO with its domestic priorities of poverty reduction and public health.

- WTO shaped India's trade dynamics

India's engagement with the WTO has had a great impact on its economic development. While it has led to increased trade and investment flows, it has also compelled India to navigate the complexities of international trade rules. India's active participation in the WTO has allowed it to shape global trade policies to some extent and defend the interests of developing countries. However, it has also had to address the challenges posed by the global trading system, particularly in sectors like agriculture and intellectual property. The WTO has provided India with opportunities to expand its economy and improve its trade relations, but it has also presented challenges that require careful balancing of global commitments with domestic priorities. As India continues to grow as a global economic power, its role in the WTO will remain central to its development strategy.

Summarised Overview

India's integration into the global economy has been driven by foreign investment, trade, and external debt management. Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) have played a key role in driving industrial growth, technology, and infrastructure development. India has implemented policies like trade liberalisation and investment incentives to attract global investors, especially in sectors like Information Technology (IT). Despite global economic challenges, India has maintained steady investment inflows, showcasing its strength as a leading investment destination. India's strategic positioning in Global Value Chains (GVCs) has been crucial for its economic growth, especially in sectors like electronics, automotive components, and pharmaceuticals. Initiatives such as the Production Linked Incentive (PLI) scheme, Free Trade Agreements (FTAs) with countries like the UAE and Australia, and the Districts as Export Hubs (DEH) programme have supported India's trade expansion. However, challenges like fluctuating global demand, rising trade deficits, and supply chain disruptions remain. India's external debt, standing at \$663.8 billion in March 2024, is primarily composed of commercial loans, sovereign debt, and NRI deposits. It has prudently managed this debt with long-term borrowings, reducing refinancing risks. Foreign exchange reserves cover nearly 97.4% of this debt, providing a financial buffer against external shocks.

International institutions, such as the IMF, World Bank, and ADB, have played a crucial role in India's development. These institutions have provided financial support, policy guidance, and technical expertise to help address challenges like infrastructure deficits



and poverty. The IMF, in particular, has helped India with public finance management and economic reforms, though India has called for reforms in IMF governance. The World Bank has funded major infrastructure projects and supported rural development, while the ADB has focused on poverty alleviation and sustainable development. India's relationship with the International Finance Corporation (IFC) has promoted private sector investment in infrastructure and renewable energy, while the WTO has played a key role in facilitating India's trade growth. Through collaborations with these institutions, India has strengthened its economic position on the global stage.

Assignments

1. Discuss the role of India's external sector in driving economic growth.
2. Evaluate India's external debt management strategy.
3. Discuss the key developments in India's external sector.
4. Critically evaluate the role of the IMF in shaping India's economic development.
5. Discuss the role of the World Bank and the International Development Association (IDA) in India's economic development.
6. Examine the role of the International Finance Corporation (IFC) in India's economic development.
7. Discuss the role of the Asian Development Bank (ADB) in India's economic development.
8. Discuss the impact of India's participation in the WTO on its economic policies, trade dynamics, and development

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

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ISBN 978-81-985949-0-7



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