Finance (Basics)

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Structure of lectures

- 1.Introduction to finance - ok
- 2.Financial markets - ok
- 3.Banks and bank systems - ok
- 4.Other financial institutions - ok
- 5.Present value of money - ok
- 6.Private finance;
- 7.Investments;
- 8.Corporate finance;
- 9.International finance - now;
- 10.International financial system - now;
- 11.Macroekonomic and financial indicators and information;
- 12.History of financial science;
- 13.Latest trends on financial markets.

The International Financial system

- **Global financial system – The International financial system,**
- The **global financial system** (**GFS**) is the financial system consisting of institutions and regulators that act on the international level, as opposed to those that act on a national or regional level.
- The main „players“ are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, e.g., central banks and finance ministries, private institutions acting on the global scale, e.g., banks and hedge funds, and regional institutions, e.g., the Eurozone.
- Deficiencies and reform of the GFS have been hotly discussed in recent years.

The International Financial System - History

- The history of financial institutions must be differentiated from economic history and history of money. In Europe, it may have started with the first commodity exchange, the Bruges Bourse in 1309 and the first financiers and banks in the 15th–17th centuries in central and western Europe.
- The first global financiers the Fuggers (1487) in Germany; the first stock company in England (Russia Company 1553); the first foreign exchange market (The Royal Exchange 1566, England); the first stock exchange (the Amsterdam Stock Exchange 1602).
- Milestones in the history of financial institutions are the Gold Standard (1871–1932), the founding of International Monetary Fund (IMF), World Bank at Bretton Woods, and the abolishment of fixed exchange rates in 1973.

International Institutions

- The most prominent international institutions are the IMF, the World Bank and the WTO
- The International Monetary Fund keeps account of international balance of payments accounts of member states.
  - The IMF acts as a lender of last resort for members in financial distress, e.g., currency crisis, problems meeting balance of payment when in deficit and debt default. Membership is based on quotas, or the amount of money a country provides to the fund relative to the size of its role in the international trading system.
- The World Bank aims to provide funding, take up credit risk or offer favorable terms to development projects mostly in developing countries that couldn't be obtained by the private sector. The other multilateral development banks and other international financial institutions also play specific regional or functional roles.

International Institutions

- The World Trade Organization settles trade disputes and negotiates international trade agreements in its rounds of talks (currently the Doha Round).

- Also important is the Bank for International Settlements, the intergovernmental organization for central banks worldwide. It has two subsidiary bodies that are important actors in the global financial system in their own right - the Basel Committee on Banking Supervision, and the Financial Stability Board.

- In the private sector, an important organisation is the Institute of International Finance, which includes most of the world's largest commercial banks and investment banks.

International Monetary Fund

- The **International Monetary Fund** (**IMF**) is the intergovernmental organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rate and the balance of payments.
- It is an organization formed with a stated objective of stabilizing international exchange rates and facilitating development through the enforcement of liberalising economic policies on other countries as a condition for loans, restructuring or aid.
- It also offers highly leveraged loans, mainly to poorer countries.
- Its headquarters are in Washington, D.C., United States.
- The IMF's relatively high influence in world affairs and development has drawn heavy criticism from some sources.

International Monetary Fund II.

- The International Monetary Fund was conceived in July 1944 originally with 45 members and came into existence in December 1945 when 29 countries signed the agreement, with a goal to stabilize exchange rates and assist the reconstruction of the world's international payment system.
- Countries contributed to a pool which could be borrowed from, on a temporary basis, by countries with payment imbalances (Condon, 2007).
- The IMF was important when it was first created because it helped the world stabilize the economic system. The IMF works to improve the economies of its member countries.
- The IMF describes itself as "an organization of 187 countries (as of July 2010), working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty".
- Members of the IMF are 186 of the UN members and Kosovo.
- Former members are: Cuba (left in 1964), and Taiwan (expelled in 1980 due to political reasons).
- The other non-members are: North Korea, Andorra, Monaco, Liechtenstein, Nauru, Vatican City and the rest of the states with limited recognition.
- All member states participate directly in the IMF. Member states are represented on a 24-member Executive Board (five Executive Directors are appointed by the five members with the largest quotas, nineteen Executive Directors are elected by the remaining members), and all members appoint a Governor to the IMF's Board of Governors.
- All members of the IMF are also IBRD members, and vice versa.

International Monetary Fund III.

- The International Monetary Fund was conceived in July 1944 during the United Nations Monetary and Financial Conference. The representatives of 45 governments met in the Mount Washington Hotel in the area of Bretton Woods, New Hampshire, United States, with the delegates to the conference agreeing on a framework for international economic cooperation.
- The IMF was formally organized on December 27, 1945, when the first 29 countries signed its Articles of Agreement. The statutory purposes of the IMF today are the same as when they were formulated in 1943.
- The IMF's influence in the global economy steadily increased as it accumulated more members. The number of IMF member countries has more than quadrupled from the 44 states involved in its establishment, reflecting in particular the attainment of political independence by many developing countries and more recently the collapse of the Soviet bloc.
- In 2008, faced with a shortfall in revenue, the International Monetary Fund's executive board agreed to sell part of the IMF's gold reserves.
- At the 2009 G-20 London summit, it was decided that the IMF would require additional financial resources to meet prospective needs of its member countries during the ongoing global financial crisis.

IMF - Members' quotas and voting power, and board of governors

- Major decisions require an 85% supermajority. The United States has always been the only country able to block a supermajority on its own.
- The voting power (2,220,817 votes in total). The 27 member states of the European Union have a combined vote of 710,786 (32.07%).
- On October 23, 2010, the Ministers of Finance of G-20, governing most of the IMF member quotas, agreed to reform IMF and shift about 6% of the voting shares to major developing nations and countries with emerging markets.

World bank

- The **World Bank** is an international financial institution that provides leveraged loans to developing countries for capital programs.
- The World Bank has a stated goal of reducing poverty. By law, all of its decisions must be guided by a commitment to promote foreign investment, international trade and facilitate capital investment.
- The World Bank differs from the World Bank Group, in that the World Bank comprises only two institutions: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), whereas the latter incorporates these two in addition to three more: International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), and International Centre for Settlement of Investment Disputes (ICSID)

World Bank - History

- John Maynard Keynes represented the United Kingdom at the conference, and Harry Dexter White represented the United States.
- The World Bank is one of five institutions created at the Bretton Woods Conference in 1944. The International Monetary Fund, a related institution, is the second. Delegates from many countries attended the Bretton Woods Conference. The most powerful countries in attendance were the United States and United Kingdom, which dominated negotiations.
- Although both are based in Washington, D.C., the World Bank is, by custom, headed by an American, while the IMF is led by a European.

1945–1968

- From its conception until 1967 the bank undertook a relatively low level of lending. Fiscal conservatism and careful screening of loan applications was common. Bank staff attempted to balance the priorities of providing loans for reconstruction and development with the need to instill confidence in the bank.

- The Marshall Plan of 1947 caused lending by the bank to change as many European countries received aid that competed with World Bank loans. Emphasis was shifted to non-European countries and until 1968, loans were earmarked for projects that would enable a borrower country to repay loans (such projects as ports, highway systems, and power plants).

World Bank - History

1968–1980

- From 1968 to 1980, the bank concentrated on meeting the basic needs of people in the developing world. The size and number of loans to borrowers was greatly increased as loan targets expanded from infrastructure into social services and other sectors.
- These changes can be attributed to Robert McNamara who was appointed to the presidency in 1968 by Lyndon B. Johnson. McNamara imported a technocratic managerial style to the Bank that he had used as United States Secretary of Defense and President of the Ford Motor Company.
- McNamara shifted bank policy toward measures such as building schools and hospitals, improving literacy and agricultural reform.
- McNamara created a new system of gathering information from potential borrower nations that enabled the bank to process loan applications much faster. To finance more loans, McNamara told bank treasurer Eugene Rotberg to seek out new sources of capital outside of the northern banks that had been the primary sources of bank funding. Rotberg used the global bond market to increase the capital available to the bank. One consequence of the period of poverty alleviation lending was the rapid rise of third world debt. From 1976 to 1980 developing world debt rose at an average annual rate of 20%.

World Bank - History

1980–1989

- In 1980, A.W. Clausen replaced McNamara after being nominated by US President Jimmy Carter. Clausen replaced a large number of bank staffers from the McNamara era and instituted a new ideological focus in the bank.
- Lending to service third world debt marked the period of 1980–1989. Structural adjustment policies aimed at streamlining the economies of developing nations (at the expense of health and social services) were also a large part of World Bank policy during this period. UNICEF reported in the late 1980s that the structural adjustment programs of the World Bank were responsible for the "reduced health, nutritional and educational levels for tens of millions of children in Asia, Latin America, and Africa".

1989–present

- From 1989, World Bank policy changed in response to criticism from many groups. Environmental groups and NGOs were incorporated in the lending of the bank in order to mitigate the effects of the past that prompted such harsh criticism. Bank projects "include" green concerns.

World Bank - Members

- The International Bank for Reconstruction and Development (IBRD) has 187 member countries, while the International Development Association (IDA) has 168 members. Each member state of IBRD should be also a member of the International Monetary Fund (IMF) and only members of IBRD are allowed to join other institutions within the Bank (such as IDA).

World Bank - Voting Power

- In 2010, voting powers at the World Bank were revised to increase the voice of developing countries, notably China.
- The countries with most voting power are now:
  - the United States (15.85%),
  - Japan (6.84%),
  - China (4.42%),
  - Germany (4.00%),
  - the United Kingdom (3.75%),
  - and France (3.75%)
- Under the changes, known as 'Voice Reform - Phase 2', other countries that saw significant gains included Brazil, India, South Korea and Mexico.
- Most developed countries' voting power was reduced.
- United States', Russia's and Saudi Arabia's voting power was unchanged

World Bank - Poverty Reduction Strategies

- For the poorest developing countries in the world, the bank's assistance plans are based on poverty reduction strategies; by combining a cross-section of local groups with an extensive analysis of the country's financial and economic situation the World Bank develops a strategy pertaining uniquely to the country in question.
- The government then identifies the country's priorities and targets for the reduction of poverty, and the World Bank aligns its aid efforts correspondingly.
- Forty-five countries pledged US$25.1 billion in "aid for the world's poorest countries", aid that goes to the World Bank International Development Association (IDA) which distributes the gifts to eighty poorer countries. While wealthier nations sometimes fund their own aid projects, including those for diseases, and although IDA is the recipient of criticism

World trade Organization

- The **World Trade Organization** (**WTO**) is an organization that intends to supervise and liberalize international trade.
- The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948.
- The organization deals with regulation of trade between participating countries;
  - it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments.
- Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986-1994).

World Trade Organization

- The organization is currently endeavoring to persist with a trade negotiation called the Doha Development Agenda (or Doha Round), which was launched in 2001 to enhance equitable participation of poorer countries which represent a majority of the world's population.
- However, the negotiation has been dogged by "disagreement between exporters of agricultural bulk commodities and countries with large numbers of subsistence farmers on the precise terms of a 'special safeguard measure' to protect farmers from surges in imports.
  - At this time, the future of the Doha Round is uncertain.

ITO and GATT

- The WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), was established after World War II in the wake of other new multilateral institutions dedicated to international economic cooperation — notably the Bretton Woods institutions known as the World Bank and the International Monetary Fund.
- A comparable international institution for trade, named the International Trade Organization was successfully negotiated.
- The ITO used to be a United Nations specialized agency and would address not only trade barriers but other issues indirectly related to trade, including employment, investment, restrictive business practices, and commodity agreements.
- But the ITO treaty was not approved by the U.S. and a few other signatories and never went into effect
- In the absence of an international organization for trade, the GATT would over the years "transform itself" into a *de facto* international organization

Trading System Principles

- The WTO establishes a framework for trade policies.
- It does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy games. Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. **Non-Discrimination**. It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas.
   - The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members.
2. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets.
   - A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization.

Trading System Principles II.

3. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO.
5. **Safety valves**. In specific circumstances, governments are able to restrict trade. There are three types of provisions in this direction: articles allowing for the use of trade measures to attain noneconomic objectives; articles aimed at ensuring "fair competition"; and provisions permitting intervention in trade for economic reasons.

Bank for International Settlements

- The **Bank for International Settlements** (**BIS**) is an intergovernmental organization of central banks which "fosters international monetary and financial cooperation and serves as a bank for central banks."
- It is not accountable to any national government. The BIS carries out its work through subcommittees, the secretariats it hosts, and through its annual General Meeting of all members.
- It also provides banking services, but only to central banks, or to international organizations like itself.
- Based in Basel, Switzerland, the BIS was established by the Hague agreements of 1930.
- It has representative offices in Hong Kong and Mexico City

BIS - Organization of Central Banks

- As an organization of central banks, the BIS seeks to make monetary policy more predictable and transparent among its 57 member central banks.
- While monetary policy is determined by each sovereign nation, it is subject to central and private banking scrutiny and potentially to speculation that affects foreign exchange rates and especially the fate of export economies.
- Failures to keep monetary policy in line with reality and make monetary reforms in time, preferably as a simultaneous policy among all 57 member banks and also involving the International Monetary Fund, have historically led to losses in the billions as banks try to maintain a policy using open market methods that have proven to be unrealistic.

BIS – Role in Banking Supervision

- Central banks do not unilaterally "set" rates, rather they set goals and intervene using their massive financial resources and regulatory powers to achieve monetary targets they set.
  - One reason to coordinate policy closely is to ensure that this does not become too expensive and that opportunities for private arbitrage exploiting shifts in policy or difference in policy, are rare and quickly removed.
- Two aspects of monetary policy have proven to be particularly sensitive, and the BIS therefore has two specific goals:
  - to regulate capital adequacy and make reserve requirements transparent.

BIS – Role in Banking Supervision

- The BIS provides the Basel Committee on Banking Supervision with its twelve-member secretariat, and with it has played a central role in establishing the Basel Capital Accords of 1988 and 2004.
- There remain significant differences between US, EU and UN officials regarding the degree of capital adequacy and reserve controls that global banking now requires.
- Put extremely simply, the US as of 2006 favoured strong strict central controls in the spirit of the original 1988 accords, the EU was more inclined to a distributed system managed collectively with a committee able to approve some exceptions.
- The UN agencies especially ICLEI are firmly committed to fundamental risk measures: the so-called triple bottom line and were becoming critical of central banking as an institutional structure for ignoring fundamental risks in favour of technical risk management.

System of Exchange Rates

- Rate of exchange: the charge for exchanging currency of one country for currency of another
- The amount of one currency that a person or institution defines as equivalent to another when either buying or selling it at any particular moment; The rate at which one currency can be exchanged for another, usually expressed as the value of the one in terms of the other
- In finance, the **exchange rates** (also known as the **foreign-exchange rate**, **forex rate** or **FX rate**) between two currencies specify how much one currency is worth in terms of the other. It is the value of a foreign nation’s currency in terms of the home nation’s currency.
- For example an exchange rate of 91 Japanese yen (JPY, ¥) to the United States dollar (USD, $) means that JPY 91 is worth the same as USD 1.
- The foreign exchange market is one of the largest markets in the world. By some estimates, about 3.2 trillion USD worth of currency changes hands every day.

Exchange Rates

- An exchange system quotation is given by stating the number of units of "quote currency" (price currency, payment currency) that can be exchanged for one unit of "base currency" (unit currency, transaction currency).
- For example, in a quotation that says the EUR/USD exchange rate is 1.2290 (1.2290 USD per EUR, also known as EUR/USD), the quote currency is USD and the base currency is EUR.
- Quotes using a country's home currency as the price currency (e.g., 25.45 CZK =EUR 1.00) are known as direct quotation or price quotation (from that country's perspective) and are used by most countries.
- Indirect quotation

Currency

- **Currency depreciation** is the loss of value of a country's currency with respect to one or more foreign reference currencies, typically in a floating exchange rate system.
- It is most often used for the unofficial increase of the exchange rate due to market forces, though sometimes it appears interchangeably with devaluation. Its opposite is called **appreciation.**

- **Revaluation** means a rise of a price of goods or products. This term is specially used as revaluation of a currency, where it means a rise of currency to the relation with a foreign currency in a fixed exchange rate. In floating exchange rate correct term would be appreciation.
- The antonym of revaluation is devaluation. Altering the face value of a currency without changing its foreign exchange rate is a redenomination, not a revaluation.

Cross Rate

- The currency exchange rate between two currencies, both of which are not the official currencies of the country in which the exchange rate quote is given in.
- This phrase is also sometimes used to refer to currency quotes which do not involve the U.S. dollar, regardless of which country the quote is provided in.
- For example, if an exchange rate between the Euro and the Japanese Yen was quoted in an American newspaper, this would be considered a cross rate in this context, because neither the euro or the yen is the standard currency of the U.S.
- However, if the exchange rate between the euro and the U.S. dollar were quoted in that same newspaper, it would not be considered a cross rate because the quote involves the U.S. official currency.

Cross Rate

- You have two rates (exchange rates):
  - For example direct quotation in CZK:
- CZK/EUR = 25,058
- CZK/USD = 17,023
- cross rate must be USD/EUR $USD / EUR = \frac{CZK / EUR}{CZK / USD}$
  so USD/EUR = 1,472

- Indirect quotation: $EUR / USD = \frac{CZK / USD}{CZK / EUR}$
  so EUR/USD = 0,6793

Example - Cross Rate

CZK/EUR	24,650
CZK/USD	18,063
CZK/JPY	0,2107
CZK/CAD	17,739
CZK/HKD	2,330
CZK/CHF	18,293
CZK/GBP	28,917

Example – Cross Rate

	EUR	USD	JPY	CAD	HKD	CHF	GBP
EUR	-	1,3647					
USD	0,7328	-					
JPY			-				
CAD				-			
HKD					-		
CHF						-	
GBP							-

SDR

- Special Drawing Right.
- An artificial currency unit based upon several national currencies.
- The Special Drawing Right serves as the official monetary unit of several international organizations including the International Monetary Fund, and acts as a supplemental reserve for national banking systems.
- For members of the IMF, the Special Drawing Rights can be used to settle trade balances between countries and to repay the IMF. An IMF member country has to supply its own currency to another member country in exchange for SDRs, unless that country already holds a certain specified amount of SDRs.

- Thank you for your attention