Chapter 01: THE HISTORY OF INTERNATIONAL MONETARY SYSTEM

1.THE HISTORY OF INTERNATIONAL MONETARY SYSTEM:

1.1.OBJECTIVES:

After studying this lesson you are able to:

- Comprehend the history of International Trade .
- Understand the stages of International Monetary System.
- Understand the importance of the international monetary system.
- Describe the reason of the Gold standard and why it failed.
- Describe the Bretton Woods Agreement and why it collapsed.
- Understand current monetary system.

1.2.INTRODUCTION:

International monetary system refers to the system prevailing in world foreign exchange markets through which global trade and capital movement are financed and exchange rates are determined. In simple terms the rules and procedures for exchanging national currencies are collectively known as the international monetary system.

It consists of sets of conventions, supporting institutions, internationally agreed rules, instruments, and procedures, of which all are interconnected in the international transfers of money that ease out international trade, cross border investment, the allocation of capital between nation states and all other international business matters.

The International Monetary System is part of the institutional framework that connects national economies; such a system allows producers to specialize in those goods for which they have better advantage, and serves to achieve profitable investment opportunities on a worldwide basis.

To sum it all, the international monetary system establishes the rules by which countries value and exchange their currencies.

1.3 FEATURES THAT INTERNATIONAL MONETARY SYSTEM SHOULD POSSESS

1.	Flow of international trade and investment according to comparative advantage
2.	Stability in foreign exchange and should be stable.
3.	Promoting Balance of Payments adjustments to prevent disruptions associated with temporary or chronic imbalances.
4.	Providing countries with abundant liquidity to finance short term balance of payments deficits.
5.	Should at least try avoiding adding further uncertainty.

6. Allowing member countries to pursue independent monetary and fiscal policies

1.4 HISTORY OF INTERNATIONAL MONETARY SYSTEM

The international monetary system that we experience today has evolved over a period exceeding over 150 years. In the evolution process, many monetary system came into existance that either failed due to their weakness or were reshaped to cope with the changing international economic order.Three such systems were used all over the world for many decades and had a great impact on the way how exchange rates between curriencies were to be established. These system were called as ‘ Exchange Rate Regimes’. They are:

1. **The Gold Standard (1816- 1914):** Which made valuation against Gold on a fixed basisavailable
2. **The Bretton Woods System (1945-1971):** Which made valuation against USD on a fixed basis available
3. **Flexible Exchange Rate System- 1978 to present:** Which made Variable valuation through market demand and supply forces.

1.5.THE GOLD STANDARD (1816- 1914):

The Gold Standard was the first universally put into use exchange rate system. It was popularised by the Bank of England and established all over the globe in 1870.The Gold standard consisted of Buying and selling of paper currency in exchange for Gold on the demand of any individual of firm.In this system Gold is hassle free transferred between countries. Participants in this system included France, UK, USA & Germany.

This is the first modern international monetary system, in this system weight of Gold was linked with each currency. Under Gold standard, each country had to publish the rate at which its currency could be converted to a weight of Gold.

The fundamental principle of the classical Gold standard was that each country should set a par value for its currency in terms of Gold and try to maintain its value. Thus, each country had to give the rate at which its currency would be converted to the weight of Gold. Also, the exchange rate between any two countries was determined by their Gold content.

-THE MAIN FEATURES OF THIS SYSTEM WERE AS FOLLOWS:

1. Every country was mandated to have a Central bank to act as a custodian of the country's monetary Gold reserve.
2. Every Central Bank was mandated to have exclusive rights to issue paper money under its area of working.
3. Every Central Bank was mandated to have a fixed official price for Gold .
4. Every Central Bank was mandated to have an irrevocable promise on each paper note to redeem the same on demand in terms quantity of Gold.
5. Every Central Bank was mandated to have an unconditional guarantee to buy and sell whatever quantity of Gold at a fixed price.
6. The total amount of money supply was required to be limited to the extent of monetary Gold reserve with the central monetary authority.

-SPECIAL FEATURES OF GOLD STANDARD:

1. MINT PAR OF EXCHANGE:

The Mechanism for presenting exchange rates between currencies under the Gold Standard was called as Mint par of Exchange. Under this the exchange rates between two currency was given by the ratio of the official Gold price for the two currencies.

Example:

If 1 ounce of Gold in USA = USD 500
And 1 ounce of Gold in Germany = DEM 600
Then 1 USD = 600/500= 1.2000
Exchange rate shown in this manner was called 'CENTRAL EXCHANGE RATES' or 'MINT PARITIES'.

2. GOLD POINTS:

The Gold Standard called for fixed exchange rates .But due to imbalance in trade between countries on daily basis resulted in two exchanges rate available to the end users, one created by the market and the other based on Mint Parity. This made settlement possible in both Gold as well as currencies since both the country's Central bank were committed to buy and sell ample amount of Gold at their respective official prices. This created great oppournity between countries for Arbitrage by transfer of Gold reserve. Arbitrage between countries resulted in exchange rate to remain close to the central exchange rate. However Arbitrage transaction incurred cost in terms of insurance, transport etc., which created a zone within which transaction would take place at a cost less than the arbitrage cost. This created two extreme point called as upper and lower Goldpoints. Eachcurrency had these two set of Gold points.

Example:

Let us assume that due to demand for US Dollar the rate in Frankfurt was USD/ DEM= 1.3000, then if a person wanted to remit USD 500 would be required to pay: 500 x 1.3000= DEM 650 instead of DEM 600 as per the Mint Parity that we found in the earlier example. Here it would be profitable to pay in terms of Gold. If the arbitrage cost is DEM 10 per ounce of Gold, then the rate would improve till: 610/500=1.2200. Similarly, on the lower end the rate in the market would be restricted to 1.1800 (1.2000 +/- 0.0200). Thus 1.2200 and 1.1800 would represent the upper and the lower Gold points within which the exchange rate would move based on demand/ supply in the Frankfurt market. At all levels beyond this range it will benefited to settle the transaction in Gold.

3. PRICE SPECIE ADJUSTMENT MECHANISM:

As per the example mentioned in the Gold point it clearly shows that the matching component of demand / supply for currencies between two countries would get settled in terms of currency while the net trade imbalance will be settled in terms of transfer of Gold.

1.6 MERITS OR ADVANTAGES OF GOLD STANDARD:

1. Gold standard received positive views of the public much more easily than any other standard.
2. It was an easy system to introduce and operate.
3. Gold standard gave stable price level in the country. When the country is on Gold standard, currency cannot be over issued. So prices remain stable.
4. Gold standard provides currency which is universally acceptable
5. In international dealings Gold standard provides stability of exchange rates thereby making Gold standard very useful for the settlement of international transactions.
6. Gold standard cannot be secretly tempered with by the independent will of the government.
7. The deficit or surplus in the balance of payment is automatically brought into balance by import or export of Gold.

1.7 DEMERITS OR DISADVANTAGES OF GOLD STANDARD:

After the world war most of the countries on Gold standard did not obey the rules of Gold standard and even all the new forms of Gold standard failed to function smoothly. Following are the main defects of this system.

1. One serious defect in this system was that it worked smoothly in the period of peace, and prosperity while in the period of war and economic crises it has always failed.
2. Gold standard is an expensive standard and a luxury which all the countries cannot afford because a lot of precious metal is wasted.
3. Gold standard sacrifices the internal stability to external stability.

4.UnderGoldstandard the automatic working of the economic system is considered as a demerit.

5. The changes in output of Gold can bring changes in the prices level.

6. In the Gold standard independent monetary policy is adopted.

1.8 DEMISE OF THE GOLD SYSTEM:

In 1914 at the break of the first world war crushed the first economic order of the world.With the outbreak of war, normal commercial transactions between the Allies (United Kingdom, Russia, and the united kingdom) and the Central Powers (Germany , Ottoman Empire , and the Austria-Hungary) ceased. The economic pressures of war caused country after country to suspend their pledges to buy or sell Gold at their currencies' par values.

1.9 THE BRETTON WOODS SYSTEM (1945-1971):

The bretton Woods System was also known as IMF's Fixed Exchange Rate System. There was an agreement conference which was held by representatative of 45 major economies at Bretton Woods, USA, in July 1944 to establish a new exchange Rate System based on stability and flexibility which would be used globally after second World War. It created the formation of two international Multi- lateral institution namely,

- IMF(international monetary finance) and
- World bank to promote international financial stability.

IMF had agenda to enhance global growth and stability of the economy while the world bank had a main function of lending to nations destructed by the world war.

Brettons woods system arosed due to the impacts of world war II that created unemployment ,inflation, and an unstable political condition. Every country was struggling to rebuild their war-torn economy.

The Bretton Woods system was a dollar-based Gold exchange standard which made USD the key currency.The fixed exchange rate were regulated by intervation of central banks in the form of purchase and sales and of dollars with the IMF providing the foreign exchange rate.

1.10.THE MAIN FEATURES OF THIS SYSTEM WERE AS FOLLOWS:

1. Along with Gold, The USD was given the status of Universal reserve Asset. This meant that the along with Goldreserve, countries could issue domestic money against USD reserves. The value of USD was fixed at 1 ounce of Gold=USD 35.
2. Each country was allowed to have a 1% band around which theircurrency was permitted to fluctuate around the fixed rate. Except on the rare occasions when the par value was allowed to be readjusted.
3. The US Federal Reserve Bank gave a Gold Convertibility Clause which stated an unconditional guarantee to buy and sell unlimited.

4. Other countries could have their currencies exchangeable at a fixed rate against the dollar, though the rate could be readjusted at some times under certain conditions. On account of this, the system was viewed as 'The adjustable Peg System'.
5. Each member country was required to fix a Parity value for its currency against USD.
6. The USD was considered as a universal vehicle currency. Allcurrencies were pegged to USD at a fix parity rate. This made cross relationships also constant.

Example:

Parity: 1 USD = DEM 1.75
Parity: 1 USD= GBP 0.50
Therefore GBP 0.50= DEM 1.75
Therefore 1 GBP= DEM 1.75 /0.50 = DEM 3.50

This cross rate would remain fixed within the allowed variation range of(+/-) 1% from the derived rate. GBP/DEM 3.5350 and 3.4650 would be the upper and lower support level.

7. Thissystemintroduced a new concept called as Centralbank Intervention with a view of ensuring protection of parity rates.
8. The IMF was established with the specific goal of being the multilateral body that looked after the implementation of the Bretton Woods agreement.
9. The concept of dual exchange was abolished.
10. Reserve currency country were able to use monetary policy for its own domestic policy purposes while other countries were unable to use monetary policy for domestic policy purposes. Therefore a reduction in the country's reserve would cause an increase in the reserve currency and force the other central banks to lose external reserves. So the reserve country can affect both the output in other countries as well as output in its country through changes in its monetary policy.

1.11 ADVANTAGES OF BRETTON WOODS SYSTEM:

1. Non Volatility of exchange rates removed a great deal of rigidity from international trade and investment transactions
2. It gave a great deal of discipline on the participating nations economic policies.
3. The technical aspects of the system had some realistic implications on the participating countries.
4. The main difference was that the dollar was the only currency that was backed by and convertible into Gold on Bretton Woods system while on Gold standard other currencies were also allowed to be convertible into Gold.

1.12 REASONS FOR THE FAILURE OF BRETTON WOODS SYSTEM:

1. This system did not provide any revision in the price of Gold. So duringinflation it became uneconomical to produce Gold. This lead to stoppage of Gold production in various countries which lead to lack of development in the Gold reserve which had a negative impact on international liquidity.
2. This system did not provide any provision for revaluation of parity due to which surplus countries like Japan and West Germany continued to enjoy export competitiveness against the US economy.
3. This system did not provide any provision for a revision in the price of Gold in terms of USD. Because of which it was not possible to devalue the US dollar despite of continues deficit in the trade. If at all the US dollar would be devalued then it would have had adverse impact on all the countries having USD reserve.
4. The prolonged trade deficit of the US create an oversupply of USD in the international financial market which reduced the acceptance of the USD. When the Gold convertibility Clause was appealed, the US authorities could not discharge their commitment to redeem its USD against Gold. This failure on the part of US leads to the collapse of the Bretton Woods System in 1971.

1.13.THE COLLAPSE OF THE BRETTON WOODS SYSTEM:

On 15th of August 1971, The President Nixon expelled the system of convertibility of Gold and dollar and decided for floating exchange rate system and by March 1973, the major currencies started to float against each other in which values were determined by demand and supply in the foreign-exchange market. The world moved from a Gold standard to a dollar standard from Bretton Woods to the Smithsonian Agreement. Increase in the growth in the amount of printed dollars further faded the faith of this system and the dollars role as a reserve currency. By 1973, the world had already taken a step forward to search for a new financial system,"one that would no longer rely on a worldwide system of pegged exchange rates".

1.14.THE SMITHSONIAN AGREEMENT (1971):

Smithsonian Agreement was an agreement signed in 1971 that updated some of the rules of the 1944 Bretton Woods agreement to retain and defend the Bretton Woods System. The agreement was so named because the meeting took place at the Smithsonian Institution in Washington D.C. The US agreed to raise the official price of the Gold from $35 to $38 i.e.7.9% devaluation of USD. The agreement was supposed to help devalue the United States dollar, but upon looking back the changes appear to have only helped temporarily.

Currencies were usually valued on either a fixed rate which was set by the government or on a floating rate, where by the free market used to determine the value of the currency. Fixed rates were usually more stable while floating rates would

fluctuate wildly. The Group of Ten currencies (those of the USA, United Kingdom, Canada, France, West Germany, Italy, Holland, Belgium, Sweden, and Japan) on Dec. 17 and 18, 1971, met at the Smithsonian Institution in Washington, D.C., and agreed on an agreement to re-introduce the Bretton Woods System with certain modification. The main modification of this arrangement was as follows:

1. The US dollar was devalued to 1 ounce of Gold from $35 to $38 i.e.7.9% devaluation of USD.
2. The US was released from any provision of the Gold ConvertibilityClause.
3. European Economic Community (EEC) agreed to maintain their exchange rates within a range of 2.25 per cent of parity with each other.
4. Dollar was devalued by nearly 10 per cent in relation to the other G-10 countries.
5. On the whole, all other countries were required to to change and revise and fix new parities against the USD.

The main reason for these changes was to help US reduce their trade deficit and provide greater export competitiveness to the US economy and also to re-introduce fixed price for Gold convertibility. However , even with these modification US suffered a record breaking deficit in 1972 which resulted in further devaluation of the US Dollar to 1 Ounce of Gold = USD 42.22.

On the whole the Smithsonian Agreement proved only to be a temporary solution to the international currency crisis. A second devaluation of the dollar (by 10 per cent) was announced in February 1973, and with a short span the EEC countries and Japan decided to let their currencies float. During the same period the OPEC group Countries increased crude oil prices by several hundred per cent which resulted in creating of trade deficit among several economies. The Smithsonian Agreement was consequently abandoned in March 1973.

Since then various models of exchange rate system have been applied by many policy makers and academicians. Different countries have tried various varieties in different ways. All the systems tried or suggested are modifications of fixed or floating systems.