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Principal Investigator	Co- Principal Investigator		Co- Principal Investigator and Technical Coordinator
Prof K V Bhanu Murthy Professor Department of Commerce University of Delhi Delhi-110007	**Dr Jaswinder Singh** Principal SGTB Khalsa College University of Delhi Delhi-110007	**Dr. R P Singh** Associate Professor SGTB Khalsa College University of Delhi	**Dr Vimal Rarh** Deputy Director, Centre for e-Learning and Assistant Professor, Department of Chemistry, SGTB Khalsa College, University of Delhi *Specialised in : e-Learning and Educational Technologies*
Paper Coordinator	**Content Writer**		**Reviewer**
Dr. Niti Bhasin Assistant Professor Department of Commerce University of Delhi Delhi-110007	**Dr. Niti Bhasin** Assistant Professor Department of Commerce University of Delhi Delhi-110007 **Ms. Priyanka Bedi** Research Scholar Department of Commerce University of Delhi Delhi-110007		**Prof K V Bhanu Murthy** Professor Department of Commerce University of Delhi Delhi-110007

Anchor Institute : SGTB Khalsa College, University of Delhi

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1. LEARNING OUTCOMES

After going through this module, you shall gather information to:

- Know about the Gold standard.
- Understand the transition from gold standard to the Bretton woods system and the collapse of Bretton woods system.
- Appreciate the types of exchange rate systems prevailing in the world today.
- Know about the European Monetary System.
- Understand the difference between fixed and flexible exchange rate systems.

2. INTRODUCTION

The group of rules, conventions and institutions that administer the international business, trade and investment are jointly called as international monetary system(IMS). The IMS provides the framework within which foreign exchange rates are ascertained. A foreign exchange rate is the price of one currency expressed in terms of another currency.

The existence of an efficient international monetary system is essential for a continuous charge of international business. Its main purpose is to facilitate the transactions between different countries.

This module gives a short account of the evolvement of IMS from the 19th century to the present day.

3. GOLD STANDARD

The gold standard was formally accepted as an IMS in the 1870s when major countries like United States, Germany and Japan adopted it. Great Britain was the first country to adopt it in 1821. Under this system, each country pegged its domestic currency to gold. In simple words, each country's currency was set in value per ounce of gold. For example, one ounce of gold was worth \$20.67 in United States and £4.24 in Great Britain. So the exchange rate between US dollar and pound sterling was determined as:

$$\frac{\$\,20.67 \text{ per ounce of gold}}{£4.24 \text{ per ounce of gold}} = \$\,4.87/£ \qquad (1£= \$4.87)$$

i.e. one pound was exchanged for \$4.87.

Under this system, each nation was allowed to change its currency into gold on demand and there were no restrictions on movement of gold from one nation to another. Each country maintained gold stocks to back the value of its currency. The payments between countries were mainly settled by exchange of gold. If a country imported more than it exported, gold moved out and vice versa. The gold standard facilitated automatic correction in balance of payment (BOP) disequilibrium of a country. For example, if Germany had a trade deficit (exports more than imports), then gold flowed out of Germany for settlement of trade leading to contraction in Germany's money supply. This brought down the prices in Germany making its goods cheaper and competitive. This in turn led to increase in demand for Germany's exports, thus wiping out the deficit.

3.1 SUSPENSION OF GOLD STANDARD

The gold standard was abandoned in 1914 with the onset of I World War. During the war, the countries started printing money to provide for the war activities. The countries restricted the disengaged movement of gold among nations and also put the convertibility of currency into gold on hold. The printing of currency resulted into inflation. The war also led to loss of workforce and productive capacity which pushed up the price levels further.

After the termination of the first world, the countries started returning back to the gold standard. After the world war, the \$ became stronger and European countries became weak. As a result, US became the first nation to adopt the gold standard back in 1919. The Great Britain adopted it in 1925; and France and Switzerland in 1928. The US made continuous efforts to fully revive the gold standard. But all the efforts to reinstate the gold standard came to a halt with the starting of great depression in 1929. There was substantial outflow of gold from Great Britain due to recurring BOP deficits. Britain's gold stocks were depleting at a very fast pace and it became impossible for them to retain gold standard. So in September 1931, the Government of Britain bought an end to the convertibility and let the pound float. Many countries like Japan, Austria, and Sweden followed suit by the end of 1931. Investors started preferring gold to foreign currency denominated securities. This affected the US gold reserves adversely and led the US government to disregard the gold standard in April 1933.

4. BRETTON WOODS SYSTEM

In July 1944, while the Second World War was still going on, the representatives of 44 nation states met at Bretton Woods, New Hampshire to design a new IMS. An agreement was reached to establish two multinational institutions-

- IMF (International Monetary Fund) to monitor IMS, maintain exchange rate stability and oversee national monetary policies and also provide financial cooperation to member countries for meeting short term BOP shortfall.
- IBRD (International Bank for Reconstruction and Development) was established to primarily finance the post war reconstruction of the member countries.

After the end of Second World War, US was holding about 74% of the world's gold stock and accounted for about half of the world's real GNP. So under the Bretton woods system, each country agreed to fix the par value of its currency in relation to US dollar. This par value determined the exchange rate among different currencies. The US dollar was in turn pegged to gold at $35 per ounce. US dollar was the main reserve currency held by central banks and the only currency that was directly convertible to gold. Each country was required to maintain the market value of its currency within ± 1 percent of its adopted par value by purchasing or selling foreign exchange as necessary. However, the member countries were allowed to alter the par value of its currency if it faced "fundamental disequilibrium" in the balance of payments. For changes upto 10 percent, IMF approval was not required. But for changes beyond 10 percent IMF approval was necessary.

This system was addressed with different names such as fixed parity system, par value system, pegged exchange rate system and dollar based gold exchange standard.

4.1 COLLAPSE OF BRETTON WOODS SYSTEM

During 1960s, US undertook welfare programs. The increase in government expenditure was financed by raising the domestic money supply, which led to inflation. With increased money supply, people started spending more. Consequently, the demand for imports increased while exports became uncompetitive (due to increased prices of US goods). Thus, US BOP swung into deficit. The member countries began to lose confidence in dollar and started converting their dollar reserves into gold. The gold stock with US treasury began to fall drastically.

To supplement the existing reserves and to reduce the pressure on dollar, the IMF in 1970 also created international reserve asset called as SDR (Special Drawing Rights) which could be utilized by the countries for making payments internationally. The SDRs were allocated to all the member countries in proportion to their quotas.

All the attempts to solve the disparities failed. US BOP continued to deteriorate. The dollar stood overvalued against German mark and Japanese yen as a result of which the German and Japanese central banks had to make massive intercession in the foreign exchange market to maintain their par values. As a result of all this, in August 1971, the then US President Richard Nixon terminated the convertibility of dollar into gold and also levied a surcharge of 10 percent on imports until the revaluation of other currencies against dollar.

This shook the foundation of Bretton Woods System. In order to save and restore Bretton Woods System, in December 1971, a conference was held at Smithsonian Institute in Washington DC. They reached an agreement to make following changes:

- Shift in the parity value of gold from US dollar 35 per ounce of gold to US dollar 38 per ounce.

- Other eminent currencies were revalued upwards against US dollar.
- The band for fluctuation from par value was widened from ±1 percent to ± 2.25 percent.

The Smithsonian Agreement could not go far as the devaluation of dollar was not sufficient to preserve the situation. In February 1973, the parity value of dollar was again revised upward from 38$ per ounce to 42$ per ounce. By March 1973, the eminent currencies were allowed to float and the Bretton Woods System came to an end.

5. EXCHANGE RATE REGIME SINCE 1973

After the end of Bretton Woods System, IMF constituted a committee to evolve a new monetary system. The committee members came out with a new set of rules which were formally accepted by all member countries in a meeting at Jamaica in January 1976. With this came the system of flexible exchange rates where the exchange rate is not fixed by government authorities rather it is determined by the forces of market i.e. supply and demand of the currencies in the international market. Under the new exchange rate system, a country can choose from one of the following options:

5.1 MANAGED FLOAT SYSTEM: In this system of managed floating, a country's monetary authorities interfere directly or indirectly to stabilize the exchange rate and to keep it within desired limits. It is also known as dirty floating. In case of direct intervention, the monetary authorities attempt to stabilize the exchange rate by purchasing and selling foreign currency in the domestic market. When it buys foreign currency, its demand increases and the domestic currency depreciates against foreign currency. When it sells foreign currency, its supply increases and the domestic currency appreciates against foreign currency. In case of indirect intervention, the monetary authorities bring changes in the interest rates to stabilize the exchange rates and flush out the excess volatility. Some of the countries which are following this system are India, Russia, Egypt, Singapore, Thailand and Czech Republic.

5.2 FREE FLOAT SYSTEM: Under this system, the exchange rate is determined solely by the market forces and it does not involve intervention. However, in practice some intervention is found in the system of free float as well, typically to prevent any unnecessary fluctuations in the exchange rate. This system is also known as clean float or independent float system. Some of the countries following this system are United States, United Kingdom, Japan, Switzerland, Australia, Brazil, Canada and Mexico.

5.3 CRAWLING PEG SYSTEM: This system is a synthesis of fixed and floating exchange rate system. Under this system, the country establishes the par value of its currency in relation to a foreign currency and then allows the par value to change gradually along with changes in the factors like inflation. A country can either peg its currency to a single currency or to a basket of currencies. Countries like Jordan, Bahamas, Iraq, Lebanon, Maldives, Saudi Arabia and Qatar have pegged their currencies to a single currency. Countries like Fiji, Libya and Morocco have chosen basket of currencies for pegging.

5.4 CURRENCY BOARD ARRANGEMENT: A country following this system has a currency board which pegs the domestic currency to a foreign currency and allows the unlimited exchange of domestic currency for the foreign currency at the fixed exchange rate. In this system, the currency board is required to build reserves of the foreign currency (at the fixed exchange rate) equivalent to the amount of domestic currency it has issued. With this system, the money supply can be controlled effectively because additional currency will be issued only if there are foreign currency reserves to back it. It also helps to keep check on inflation. The example for this system includes Hong Kong pegged to US dollar.

5.5 TARGET ZONE ARRANGEMENT: In this system, a cluster of nations with common goals and interests agree to either maintain exchange rates within a specified band or to replace their domestic currency with a common currency. An example of this system is European Monetary System which was introduced in 1979.

6. EUROPEAN MONETARY SYSTEM

After the demise of Smithsonian agreement, 6 Western European nations which were the members of European Economic Community, agreed to maintain the parity values of their currencies within a band of ±1.125 percent as against ± 2.25 percent prescribed in the Smithsonian Agreement. The EEC currencies moved together closely within the band because of which the system came to be known as 'snake'.

The snake could not function smoothly for long because of the variance in the economic structure and performance of the member countries. Thus in an attempt to bring greater degree of stability and to deepen the economic integration between the member countries, the 'snake' was replaced with the European Monetary System (EMS) in March 1979. The European Currency Unit (ECU), the predecessor of Euro, was also established in 1979. ECU was created as the weighted average of the member country's currencies and the weights were determined on the basis of the country's GDP and foreign trade. ECU was the monetary unit of the EMS and it determined the exchange rate among the member country currencies.

The EMS was based on parity grid system where the exchange rate between any two currencies was determined on the basis of their weights or share in ECU basket. A fluctuation band of ±2.25 percent was prescribed. During the initial years, a number of adjustments were made in the EMS. But due to differing economic conditions and policies of member nations, the parity grid experienced serious damage. In September 1993, the band for fluctuation was widened to ±15 percent. Hence, to address the recurring problems in EMS, the European Union Members met at Maastricht and signed the Maastricht Treaty. The member countries agreed to replace their Individual currencies by a common currency by January1, 1999 and also to harmonize their fiscal, monetary and exchange rate policies to achieve greater convergence.

The member countries were required to meet the following criteria:

- Keep the fiscal deficit to GDP ratio below 3 percent.
- Keep the government debt to GDP ratio below 60 percent.
- Achieve high degree of price stability.

The European Central Bank (ECB) was established in 1998 with its headquarters in Frankfurt, Germany. Its works in conjunction with the national central banks to achieve price stability and is also responsible for smooth conduct of monetary policy. Finally, on January 1, 1999 Euro was created and eleven out of fifteen EU countries gave up their national currencies and adopted Euro. These eleven countries were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The EMS became the European Monetary Union (EMU). In January 2002, Euro notes and coins were issued and by the end of February 2002, local currencies were completely replaced by Euro.

7. FIXED VS. FLEXIBLE EXCHANGE RATE SYSTEM

- In fixed exchange rate regime, the exchange rate is determined by the government whereas in flexible exchange rate system, the exchange rate is determined by the market forces of demand and supply.
- In fixed exchange rate system, the exchange rates are periodically adjusted by the government to keep them in line with the changing macroeconomic variables like inflation, whereas in flexible exchange rate regime, the exchange rates adjust automatically to the changes in the market factors.
- In fixed exchange rate system, the government needs to keep large amount of reserves to maintain the exchange rate at the desired level. Whereas, in flexible exchange rate, there is no such requirement.
- In fixed exchange rate system, the exchange rates are fixed and stable but may lead to market distortions in the long run. On the other hand, in flexible exchange rate regime, exchange rates fluctuate but remain stable around the equilibrium in the long run

❖ *KEY BENEFIT OF FLEXIBLE EXCHANGE RATE SYSTEM*

The key benefit of flexible exchange rate system is automatic external adjustments and national policy autonomy. With fixed exchange rate system, the government has to devise the necessary fiscal and monetary policies to correct the BOP disequilibrium at the existing exchange rate. So government will remain occupied in maintain the exchange rate and will not be able to address the other important economic objectives. So the government loses its policy autonomy.

But external balances will be achieved automatically as long as the exchange rate is established by the market forces of demand and supply. As a result, there will be no need for the government to take any policy actions to correct the disequilibrium in the balance of payment.

So, the government will be able to use its fiscal and monetary to pursue other economic goals and objectives.

8. SUMMARY

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International monetary system is a set of rules, conventions and institutions that govern the international business, trade and investment. It defines the framework within which the exchange rates are determined.

First internationally accepted exchange rate system was the gold standard. Under this system, the currencies were pegged to gold and two way convertibility was guaranteed. This system contained an automatic mechanism for correction.

Gold standard collapsed during the first world war because the countries suspended free convertibility into gold. After the war, it was readopted by countries but it could not go on for long due to the great depression in 1929. So it was finally abandoned in the 1930s.

The Bretton Woods system of fixed exchange rate was established in 1944. The agreement also established two multilateral institutions namely, IMF and IBRD. Under this system, US dollar was the reserve currency and the only currency convertible into gold. All other countries were required to fix the par value of its currency in terms of dollar. A fluctuation band of ±1% was established. However, for significant changes in the par value, IMF approval was necessary.

In 1960's the US experienced severe balance of payments deficit due to which US dollar stood overvalued. Attempts were made to prevent the collapse of Bretton Woods in the Smithsonian Arrangement. But the arrangement could not go on for long and the Bretton Woods system finally collapsed in 1973.

Since 1973, the floating exchange rate regime was adopted by countries with following options: managed float system, free float system, crawling peg system, currency board arrangement and target zone arrangement. Different member countries have adopted systems that suit their own convenience and their macroeconomic fundamentals.

Six westerns European nations agreed to maintain parity values within a fluctuation band of ±1.125%. This system was known as "snake" and was replaced by European Monetary System in 1979. Economic Currency Unit was established as the basket currency and the exchange rate between any two currencies was determined on the basis of their weights in ECU basket. Finally, in 1992 the countries signed an agreement to adopt a common currency by the end of January 1, 1999.

Fixed exchange rate system differs from flexible exchange rate systems on several counts like determination, adjustment of balance of payment deficit and requirement to hold reserves.