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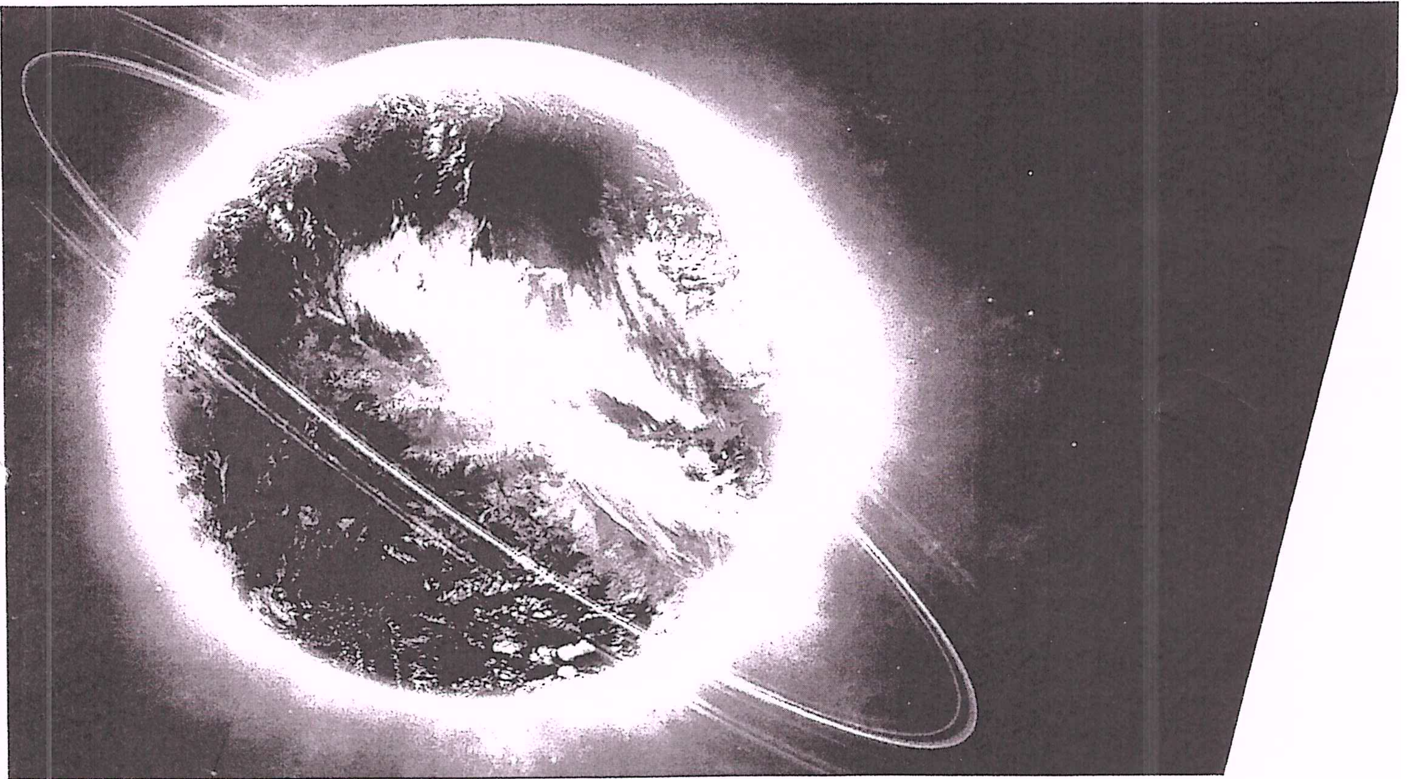

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'**अजिंठा**' या त्रैमासिकात प्रसिध्द झालेली मते मुख्य संपादक, संपादक मंडळ व सल्लागार मंडळास मान्य असतीलच असे नाही. या नियतकालिकात प्रसिध्द करण्यात आलेली लेखकाची मते ही त्याची वैयक्तिक मते आहेत.

तसेच शोधनिबंधाची जबाबदारी स्वत: लेखकावर राहील. हे नियतकालिक मालक मुद्रक प्रकाशक विनय शंकरराव हातोले यांनी अजिंठा कॉम्प्युटर ॲण्ड प्रिंटर्स जयसिंगपूरा विद्यापीठ गेट औरंगाबाद येथे मुद्रित व प्रकाशित केले.

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Evolution of the International Monetary System

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Abstract

The present article tracks the evolution of the International Monetary System since the latter half of the nineteenth century. The article starts from the beginning of the gold standard and its economic effects and its eventual collapse before the world war I. Thereafter, it deals with The Interwar period from 1918 to 1939 and attempts to return to the gold standard. It then shifts to Gold Exchange standard and the system of fixed exchange rate. The transition stage and floating rates are discussed thereafter. Theory of optimum currency area, International reserve currencies, composite reserve currencies are dicussed lastly.

The international monetary system is the name given to the exsting arrangement among countries in relation to exchange rates and monetary flows. These arrangements comprise fixed exchange rates, floating exchange rates and commodity backed currency. The evolution of the international monetary system has taken place since currency trade between countries started. However, most modern discussions on international monetary system tend to begin in the latter half of the nineteenth century. It was during this period that the era of the gold standard started.

The Gold Standard : 1880-1914

It is generally believed that gold standard began somewhere between the 1880-1890 period. Under a gold standard, the currency of a country is valued in terms of a specific equivalent of gold in terms of purity and weight. As every currency is experessed in terms of gold value, it is linked with other currencies through a fixed exchange rate.

A country operating on gold standard has to undertake a commitment to buy and sell gold at a fixed price. If, the government of that country is not willing to do so, the value of its currency in terms of gold will see fluctuations. In such a scenario, the fixed exchange rate system will collapse.

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As the supply of gold is relatively fixed, long-term price stability is ensured. This is because of convertibility of currencies with gold, money supply could not increase without increase in the stock of gold. As the stock of gold was fixed, it would tend to produce stable prices.

The gold standard is often remembered for stable prices, economic growth and development of world trade and an orderly international monetary system. Those in disagreement with this view, tend to cite absence of major shocks such as war and other disturbances.

The gold standard provides an automatic adjustment mechanism for correction of balance of payments disequilibrium. A country with a deficit in the balance of payments would see gold outflows which would reduce the money supply and hence prices. A country with a balance of payments surplus would lead to gold inflows, increasing the money supply and thus the prices. The decrease in prices in the deficit country would lead to greater exports and the increase in the prices in the surplus country would reduce its exports, thus restoring the balance of payments equilibrium.

The Interwar Period 1918-1939

The first World War marked the end of the gold standard. When the war began, the private flows of gold stopped. It was considered unpatriotic to export gold due to considerations of war time financing. Central governments wanted their citizens to sell their gold holdings to the government. For most governments, the way to finance was to print new money, resulting in disturbing the exchange parity with gold.

As many European countries experienced high inflation during the war, it was impossible to have the old gold parities. However, the United States had seen a very low rate of inflation during the war and hence returned to the gold standard at the old parity. The First World war ended Britain's position as the dominant financial power. United States became world's Pre-eminent banking country. In the period immediately following the first World War, the Pound fluctuated greatly against the dollar due to differences in the Purchasing Power Parity between the two currencies.

Great Britain returned to the gold standard at the prewar parity with gold in 1925, though prices had risen substantially than before the war. The overvaluation of the pound adversely affected the British exports and resulted in a deflationary environment. As the gold was now cheap, people started exchanging pounds for gold reducing the money supply. This led to a rapid depletion of the gold reserves and ultimately the government declared the pound to be

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unconvertible. Great Britain thus ended its experiment with the gold standard. Once, the pound could no longer be converted, the market turned its attention to the American dollar. The U.S. government now faced a large demand to exchange gold far dollars. This resulted in the U. S. government to increase the official price of gold to $35 ounce per dollar.

The depression years saw a game of competitive devaluation among countries who wanted to stimulate their economices through increasing exports. Exchange controls were also resorted to by various countries to mainpulate net exports to increase GNP.

Gold Exchange Standard

At the end of World War II, the war-ravaged countries wanted a reform of the international monetary order based on co-operation and free convertibility of currencies. This led to an international conference at Bretton Woods, New Hampshire. The result of this conference was an agreement to tie the values of all currencies together. This agreement required each country to fix the value of its currency in terms of gold. As every currency had a defined gold value, all currencies were linked in a System of fixed exchange rates.

All countries in this system had to maintain the gold value of their currency within a range of +1 percent.

This was to be achieved by participating central banks by buying and selling their currencies in the foreign exchange market. When a country was experencing difficulty maintaining its exchange rate due to balance of payments equilibrium, it could ask for financing from International Monetary Fund, created at the Bretton Woods conference. The main task of the IMF was to monitor the operation of the system and to disburse short-term loans to countries faced with short-term balance-of-payments deficits. In cases where a country was facing fundamental disequilibrium in the balance of payments, it was allowed to devapue its currency. This system can be described as a gold exchange standard because the dollar was convertible into gold for holders of dollars such as central banks and treasuries.

The Bretton Woods system worked well in the 1950's and early sixties. After that, there were several dollar crises starting with 1960. The USA had been facing large balance of payments deficits since the 1950s. It led to huge accumulation of dollars in various central banks of the world. Doubts and concerns over the large of stockpiles of dollars led prompted some central banks to exchange their dollar assets for American gold reserves which began depleting. This to speculation that the devaluation of dollar was imminent. Co-operation among central banks

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imparted a measure of stability to the gold prices. However, pressure on the dollar persisted. This problem could have been solved through revaluing the currencies of countries running balance of payments surpluses, these countries refused to do so orgwing instead for the United states to correct the disequilibrium its balance of payments.

The failure to adjust the exchange rates in the face of altered economic conditions spelled doom for the gold exchange standard. The problems of the oversupply of dollars finally led USA to declare the dollar to be inconvertible into gold.

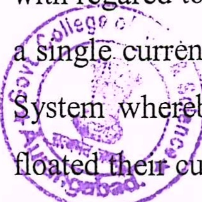
The Transition Phase

In 1971, an important international monetary conference was convened at the Smithsonian Institute in Washington D.C. to readjust foreign exchange rates of major currencies. The agreement envisaged the dollar per-gold exchange value to be increased to 38 dollars per an ounce of gold. At the same time surplus countries revalued their currencies upward. After this change, the System was to operate with fixed exchange rates with the central banks would buy and sell their currencies to maintain a band of + 2.25 percent for thier exchange rates.

The Smithsonian agreement provided a temporary respite from the foreign exchange crisis. currency speculators began to put downward pressure on the pound and lira. In 1972 great Britain allowed the pound to float, breaking away from the fixed exchange rate system. In 1972 and 1973 there was massive selling of dollars by currency speculators. This led to more fall in the value of the dollar. Despite this devaluation, speculative flows of dollar persisted and more and more countries opted out of fixed exchange rates.

Floating Exchange Rates

Though it is said that there is a floating rate system, the exchange rates have been determined by other factors than the free-market forces of demand and supply. In this System, the central banks intervence in the foreign exchange market, to determine a politically favourable exchange rate apart from the one determined by free-market forces of demand and supply. This system is described as one of managed float. However, this system is not adopted by all countries with regared to their exchange rate practices. There are some countries which peg their currency to a single currency or a basket of currencies. European countries had formed a European Monetary System whereby they maintained fixed exchange rates among themselves and at the same time floated their currenceis jointly against the rest of the world.



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Choosing Betwen Different Exchange Rate Systems

A fixed exchange rate system is much like the gold standard. In a fixed exchange rate system all the countries fix the values of their currencies in terms of a single currency such as the dollar and thereby fix the exchange rate of their currency in terms of all other currencies.

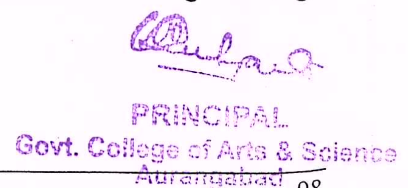
Under a system of flexible exchange rate, the external value of a currency is determined by the market forces of demand and supply. Appreciation or depreciation of the currency will take place according to the relative change in demand and supply of that currency.

Both these systems have their advantages and disadvantages. One advantage of the flexible or floating exchange rate system is that, under it, a country can follow an independent macroeconomic policy. Under fixed exchange rate, each country has to attune its macroeconomic policy to maintain a rate of inflation similar to the countries with whose currencies the value of its own currency is linked. If this condition is violated, the Purchacing Power Parity among the currencies becomes increasingly misaligned. The failure to maintain this condition was a major source of problems under the Bretton Woods System of fixed exchange rates.

However, some economists have argued that differing inflation rates between countries is an undersirable aspect of the floating exchange rate system. They point out that fixed exchange rates moderate the inflationary policies of the countries. An international discipline is imposed on the their inflationary policies. They also argue that flexible exchnage rates also lead to what is termed as destabilising specullation. It refers to the phenomenon of wider exchange rate fluctuation due to speculation than would be the case if there was absence of speculation. However, there is no evidence that such speculation has ever been a servious problem.

Research has indicated that there are systematic differences between countries with fixed exchange rates and those with flexible exchange rates. One such important differences is the difference in country size. Large countries are less willing to follow a fixed exchange rate with foreign currencies. The reason is that because foreign trade constitutes a smaller fraction of GDP of larger countries, they are not too concerned about the foreign exchange rate.

Another factor in choosing a particular exchange rate for the economy is the relative openness of an economy. The more open an economy is, more likely it is to follow a pegged exchange rate. A closed economy, on the other hand, will choose a flexible or floating exchange rate.



High inflation countries need to allow their currencies to depreciate to keep their princes compasable to other countries. These high-inflation countires will choose floating rates where exchange rate will depreciate periodically to adjust for the rise in inflation.

The Theory of optimum Currency Area

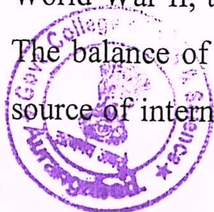
A currency area is an area where the exchange rates between the currencies of the countries in that area are fixed and floating exchange rates exist with currencies outside that area. The "Optimum" currency area is the best collection of countries to achieve some objective such as full employment and price stability. According to one approach, an optimum currency area is marked by a costless mobility of factors of production across countries. If factors can move easily and cheaply from an area with low demand for them to an area with high demand for these factors, the equilibmium will be restored as unemployment in one area is removed by employment in the other area.

Internatioanl Reserve Currencies

There are only a few currenceis which play the role of resserve currency in the world economy. A currency can be a reserve currency if it performs all or some of the functions traditionally assigned to money. They are i) A unit of Account 2) A medium of exchange and a 3) A store of value. The market forces determine a currency's International role a not governmental fiat.

International reserves are used for settling internatioanl debts. During the era of the gold standard, gold was an important part of international reserves of various countries. During the period of gold exchange standard, internatioanl reserves comprised both gold and a reserve currency, the U.S. dollar. The reserve currency country was required to hold gold balances as a collateral for out-standing balances of the currency held by foreigners. The currency holders abroad thereafter were free to convert the currency into gold if they so desired. Howerver, if the convertibility of a currency is suspect or large amounts of currency are presented to be exchanged for gold, the sytem tends to break down.

This was the fate of the gold exchange standard under the dollar. After the end of the World War II, the countries of the world demanded dollars to be used as an international reserve. The balance of payments deficits in the U.S.A. provided the rest of the world with dollars as a source of international reserves. As the rest of the world developed and matured, continuing U.S.



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deficits were not matched by a growing demand for dollars. The demand to convert dollars into gold and depleting gold reserves led to dollar being declared non-convertible into gold.

There are other currencies also that serve as a reserve currency, though dollar is still the most important reserve currency. However, the share of the dollar in international reserves has been falling and the share devoted to other currencies like the Yen and Euro has been rising.

Composite Reserve Currencies

A composite currency is an artificial currency. It is expressed as an average of several international currencies. Examples of such currencies include the SDR or the European currency Unit prior to the Euro. Countries may choose to denominate their transaction or peg thier currency to a composite of currencies. There are many reasons why a country may choose to do so. If a country's trade is diversified across other countries instead of being concentrated with a single currency, it might be more sensible to link its currency to an average exchange rate of the currencies of its trading partiners. The other reason is that the value of the composite currency is more stable than that of the single currency.

The SDRs were begun as issues of new internatioanl reserves to the member countries of the IMF. The value of SDR is expressed in terms of the values of five major currenceis of the world.

The SDRs were not in a physical form. They were merely accounting entries at the IMF. Hence SDRs were traded officially between the central banks of the world. If a particular central bank faced a shortage of certain currency, it could exchnage the SDRs allocated to it for the desired currency. Recently the use of SDRs in the private sector has expanded and many banks have issued SDR denominated deposits and loans.

As we have seen, several European countries used to follow a co-operative exchange rate agreement known as the European Monetary System. In March 1979, the European countries participaring in the EMS, introduced a composite currency unit called European currency Unit. The ultimate goal of these countries was to see ECU evolve into a common European currency. The ECU was the official Unit of account for the EU and used for the EC budgets and transactions. Like the SDR, the ECU was not in a physical formnd are accounting entries whose ownership is transferred by credits and debits in the books of accounts of the participant countries.

Unlike the SDR, the private sector use of the ECU had seen growth over time. Due to diversification effect, the ECU witnessed a stable value over time than a ny single currency.

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