Evolution of exchange rate regimes in international arena economics essay

The international monetary system before the 1870’s can be characterized as ‘ Bimetallism’ because both gold and silver were used as international means of payment and the exchange rates among currencies were determined by either gold or silver contents. Countries that were on the Bimetallic standard often faced the well-known phenomenon referred to as Greshman’s Law. Since the exchange ratio between the two metals was fixed officially, only the abundant metal was used as money, driving more scarce metal out of circulation.

03. 01. 02. Classical gold standard: 1875-1914.

International Gold Standard exist during 1875 to 1914, when in most major countries, (1) gold alone is assumed of restricted coinage, (2) there is two-way convertibility between gold and national currencies at a stable ratio and (3) gold may be freely exported or imported. In order to support unrestricted convertibility into gold, banknotes need to be baked by gold reserve of a minimum stated ratio. In addition, the domestic money stock should rise and fall as gold flows in and out of the country.

Under the gold standard, exchange rate between two currencies will be determined by their gold content. Suppose dollar is pegged to gold at eight dollar per ounce, whereas one ounce of gold is worth sixteen Frances. In this situation, exchange rate is per dollar equals to two France. The two currencies will remain stable to that extent when the dollar and the France remain pegged to gold at given prices, misalignment of the Exchange rate under the gold standard will be automatically corrected by cross-border flows of gold. Under gold standard, international imbalances of payment will also be corrected automatically. This adjustment mechanism is referred to as the

price-specie-flow mechanism, which is attributed to David Hume, a Scottish philosopher.

For a few key shortcomings, some 80 years ago gold standard demise but it still has ardent supporters among academic, business, and political circles, which view it as an ultimate hedge against price inflation. Gold has a natural scarcity and no one can increase its quantity at will. Therefore, if gold serves as the sole base for domestic money creation, the money supply can not get out of control and cause inflation, if gold is used as the sole international means of payment, then countries' balance of payments will be regulated automatically via the movements of gold.

Gold Standard has some shortcomings i. e. 1. The supply of newly minted gold is so restricted that the growth of world trade and investment can be seriously hampered for the lack of sufficient monetary reserve. For this reason the world economy can face deflationary pressures. 2. Whenever government fined it politically necessary to pursue national objectives that are inconsistent with maintaining the gold standard, it can abandon the gold standard. In other words, the international gold standard has no mechanism to compel each major country to abide by the rules of the game. For such reasons, classical gold standard lasted 40 years. During this period, London became the center of the international financial system, reflecting Britain's advanced economy and its preeminent position in international trade.

03. 01. 03. Interwar period: 1915-1944.

World War-I ended the classical gold standard in August 1914, as major countries such as Great Britain, France, Germany and Russia suspended

redemption of bank notes in gold and imposed embargoes on gold exports. Freed from wartime pegging, exchange rates among currencies were fluctuating in the early 1920’s. During this period countries widely used ‘ predatory’ depreciation of their currencies as a mean of gaining advantages in the world export market.

The inter war period was characterized by economic nationalism, halfhearted attempts and failure to restore the gold standard, economic and political instabilities especially caused by Great Depression, bank failures and panicky flights of capital across borders. No coherent international monetary system prevailed during this period, with profoundly detrimental effects on international trade and investment.

03. 01. 04. Bretton Woods system: 1945-1972.

When World War-II was ending, representatives of 44 countries gathered at Bretton Woods, New Hampshire, in July 1944, to discuss and design the postwar international monetary system. After a threat bearing discussion and bargaining, representative succeeded in drafting and signing the Articles of Agreement of the International Monetary Fund (IMF), which constitutes the core of the Bretton Woods system. The IMF embodied and explicit set of rules about the conduct of international monetary policies and was responsible for enforcing these rules.

Under the Bretton Woods system, each country established a par value in relation to the US dollar, which was pegged to gold at $35 per ounce. Each country was responsible for maintaining its exchange rate with in 1 per cent of the adopted par value by buying or selling foreign exchange as necessary.

By the early 1960 the total value of the US gold stock, when valued at $35 per ounce, fell short of foreign dollar holdings. This naturally created concern about the viability of the dollar-based system, Efforts to remedy the problem centered on (1) a series of dollar defense measures taken by US government and (2) the creation of a new reserve asset, Special Drawing Rights (SDRs), by the IMF in 1970. Initially, the SDR was designed to be the weighted average of 16 currencies but in 1981, however, the SDR was greatly simplified to comprise only five major currencies: US dollar German Mark, Japanese yen, British pound and French Franc.

The SDR is used not only as a reserve asset but also as a denomination currency for international transactions. Since the SDR is a “ portfolio” of currencies, its value tends to be more stable then the value of any individual currency included in the SDR. The portfolio nature of the SDR makes it an attractive denomination currency for international commercial and financial contracts under exchange rate uncertainty.

In August 1971, President Richard Nixon suspended the convertibility of the dollar into gold and imposed 10 percent import surcharge. The foundation of the Bretton Woods system cracked under the strain.

In an attempt to save the Bretton Woods system, 10 major countries, known as the Group of Ten, met at the Smithsonian Institution in Washington, D. C., in December 1971. They reached the Smithsonian Agreement, according to which (1) the price of gold was raised to $38 per ounce, (2) each of the other countries revalued its currency against the U. S. dollar by up to 10 percent,

and (3) the band within which the exchange rates were allowed to move was expanded from 1 percent to 2. 25 percent in either direction.

The Smithsonian Agreement lasted for little more than a year before it came under attack again. Clearly, the devaluation of the dollar was not sufficient to stabilize the situation. In February 1973, the dollar came under heavy selling pressure, again prompting central banks around the world to buy dollar. The price of gold was further raised form $38 to $42 per ounce. By March 1973, Europe and Japanese currencies were allowed to float, completing the decline and fall of the Bretton Woods system. Since then, the exchange rates among such major currencies as the dollar, the mark, the pound and the yen have been fluctuating against each other.

03. 01. 05. The Flexible Exchange Rate Regime: 1973-Present.

The flexible exchange rate regime that followed the demise of the Bretton Woods system was ratified in January 1976 when the IMF members met in Jamaica and agreed to a new set of rules for the international monetary system. The key elements of the Jamaica Agreement include:

Flexible exchange rates were declared acceptable to the IMF members, and central banks were allowed to intervene in the exchange markets to iron out unwarranted volatility.

II. Gold was officially abandoned (i. e., demonetized) as an international reserve asset. Half of the IMF's gold holdings were returned to the members and the other half was sold, with the proceeds to be used to help poor nations.

III. Non-oil-exporting countries and less-developed countries were given greater access to IMF funds.

The IMF continued to provide assistance to countries facing balance-of-payments and exchange rate difficulties. The IMF, however, extended assistance and loans to the member countries on the condition that those countries follow the IMF's macroeconomic policy prescriptions. This " conditionality," which often involves deflationary macroeconomic policies and elimination of various subsidy programs, provoked resentment among the people of developing countries receiving the IMF's balance-of-payments loans.

Following the U. S. presidential election of 1980, the Reagan administration ushered in o period of growing U. S. budget deficits and balance-of payments deficits. The U. S. dollar, however, experienced o major appreciation throughout the first half of the 1980s because of the large-scale inflows of foreign capital caused by unusually high real interest rates available in the United States. To attract foreign investment to help finance the budget deficit, the United States had to offer high real interest rates. The heavy demand for dollars by foreign investors pushed up the value of the dollar in the exchange market.

The value of the dollar reached its peak in February 1985 and then began to persistent downward drift until it stabilized in 1988. The reversal in the exchange rate trend partially reflected the effect of the record-high U. S. trade deficit, about $160 billion in 1985, brought about by the soaring dollar. The downward trend was also reinforced by concerted government

interventions. In September 1985, the so-called G-5 countries (France, Japan, Germany, the U. K. and the United States) met at the Plaza Hotel in New York and reached what became know as the Plaza Accord. They agreed that it would be desirable for the dollar to depreciate against most major currencies to solve the U. S. trade deficit problem and expressed their willingness to intervene in the exchange market to realize this objective. The slide of the dollar that had begun in February was further precipitated by the Plaza Accord.

As the dollar continued its decline, the governments of the major industrial countries began to worry that the dollar may fall too far. To address the problem of exchange rate volatility and other related issues, the G-7 economic summit meeting was convened in Paris in 1987. The meeting produced the Louvre Accord, according to which:

The G-7 countries would cooperate to achieve greater exchange rate stability.

b. The G-7 countries agreed to more closely consult and coordinate their macroeconomic policies.

The Louvre Accord market the inception of the managed-float system under which the G-7 countries would jointly intervene in the exchange market to correct over or under valuation of currencies. Since the Louvre Accord, exchange rates have become relatively more stable.

03. 02. Present Scenario of Floating Exchange Rate in International Arena:

There is no unanimous consensus among economists and monetary authorities on prefect exchange rate for a particular economy. Even a perfect system may become imperfect over the time. Above all over the past two decades many developing countries have shifted from fixed exchange rate systems (pegging to a single currency, such as the dollar, or to a basket of currencies) to more flexible arrangement.

In the mid-1970s, 86 percent of developing counties had some type of pegged exchange rate. At the mid 1990s, fewer than half did. Almost one third of countries now claim to have independently floating rate (although some of them undoubtedly engage in " dirty floating", using official intervention to guide exchange rate on the sly), floating system exchange rate is determined by market force that demand for and supply of foreign currency in a particular economy. IMF and US Treasury department is sole proprietor of the floating exchange rate. Without considering time, place and party they preach, pursue and push system especially to the developing countries.

03. 03. Chose the best one:

There is no perfect exchange-rate system, what is best depends on a particular economy's characteristic. A useful analysis in the IMF's World Economic outlook (1997) considers some of the factors, which affect the choice.

Size and openness of the economy

Inflation rate

Labor-market flexibility

Degree of financial development

The credibility of policy maker

Capital mobility.

03. 04. Dirty becomes dearest

There are two types of floating rate. One is independent floating another one is managed floating some one called it “ dirty floating”.

Figure-05: Free Floating vs. Managed Floating.

Source: IMF. 2004. Exchange Arrangements and Exchange Restrictions

After the prolonged consequences of East Asian financial crisis, monetary authorities are favoring “ dirty” one. The figure shows that in 2000 there were 50 countries in independent floating and only 27 countries in managed floating. After two years, in 2002 the number of managed floating countries raised to 44 and number of independent floating fall to 42 and in 2003, managed floating exchange rate is followed by 50 countries.