

Fixed exchange rate system of gold standard



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What is exchange rate? From the finding through investment dictionary, exchange rate can be defined as the one country's currency price expressed in another price of the country's currency. Also can be said, the rate can be exchange for another at one currency. For instance, the higher the exchange rate for one yen in terms of one euro, then the lower the relative value of the euro will be produced. The other finding through the financial and investment dictionary also provide same meaning with the investment dictionary. Investment dictionary states that at which one country currency the price can be converts into another country currency. The exchange rate between the U. S. Dollar and the British pound is different. The different can be found from the rate between the dollar and the Euro. For example, the exchange rates with a wide range of factors will generally influence change slightly each trading day. Some rates are fixed by agreement; which is known as fixed exchange rate.

A fixed exchange rate system is using by the gold standard. From the 19th century late until the World War I, the gold standard is operated. The gold standard operated as the primary monetary regime of international economy. A very clear advantage of the gold standard lay in its ability to eliminate or reduce exchange rate risk in order to facilitating trade and international investment; second is its ability as a self-equilibrating mechanism as well as to eliminate balance of payments problems for sure. The monetary authorities of each nation are required to operation of the gold standard. First, the money supplies of each country no matter in the form of bank notes or bank deposits. That form was directly linked to the gold reserves that held by the monetary authorities. Next, a pre-defined fixed rate

will be form from the exchange a specified weight of gold when the monetary authorities would always be willing to do. The countries such as Britain, Germany, France and the United States are linked their currencies to gold. This action occurs during the 19th century.

2. 3. 1 History of Exchange Rate System

The world exchange rate systems of the world have it own history shows that the world community has in fact change from the fixed exchange rates system to floating exchange rate system. There are different combinations of fixed exchange rate systems as well as floating exchange rates exist currently, the created for exchange rate regulating together with specific some economical instruments also.

Commodity money is a system that the most early existing in this world. This system happened when the development of production as well as a number of labor divisions. When appeared coins having an intrinsic value but not linked with commodity, until the 17th century there was no other monetary system exist. The value of the coin usually associated and combined with the gold in the coin with its content. The content of gold that in the coin can be found their exchange rate between different currencies and different coin because they are depend on each other.

Next to the commodity money is the paper money. Banks started issuing own bank notes in 17th century because bank notes had the same purchasing power as coins. This action was backed by banks with the precious metals. If people wished to convert these bank notes into precious

metals, they can do it with do not exist any forces. The backing was not 100%.

The idea of the gold standard appeared when the development of the fractional reserve banking as well as with the development of international relations. Most of the countries had an agreement during 1870. This agreement state that to base their exchange rates on gold standard. The amount of gold was backed by the bank for the banknote. As a result, the different countries' exchange rate equaled to the ratio of gold content; the gold standards are linked with the currencies. Since the gold content of each was fixed currency, this fixed exchange rate system existed until 1913. Credibility of the currency is most of the demand and purchasing power of a particular currency depended on it.

For the currency, none of the countries offered 100% backing for them; so the weaker countries or slower economical development countries had less credible currencies; this problem started appears after World War I. After the war and also undertaking speculative attacks, most of the countries were trying to increase the purchasing power of their currency by improving their economical condition as well as to decrease the purchasing power of other countries. The less countries' economies with the credible currency, it must affected by such attacks and also will worsened the state of economies. This situation already showed the weaknesses of fixed exchange rate system on it.

With the development of financial system and banking system, the backing of currencies has already shifted. The currencies shifted from gold standard

to backing by government with the debt instruments for example treasury bills. The purchasing power of a currency was the main variable that was credibility since we found that the currencies are less depended on the gold content. In currency exchange rates, instability is specified by economical fluctuations and crisis. Now the economical conditions had changed. The gold standards have to be return when the world community has undertaken. However they were not very successful until World War II.

After World War II, major countries adopted and used Bretton Woods system which continued the fixed exchange rates policy; from the gold standard with inefficient shift to the gold exchange standard. Compared to the US dollar, the exchange rates were fixed not to gold. By a specific exchange rate, it was linked with gold. Only in extreme cases the change of exchange rates which either devaluation or evaluation was allowed. This system already strengthened the position of the US and becomes a dominating economy. Besides, this system also affected the exchange rates of countries which having the weaker economies.

The creation of the International Monetary Fund (IMF) has been as an attempt and tries hard to solve this misbalance. The weaker economies countries were given loans with the specific conditions to improve economical state. Yet, the huge gap was formed between the exchange rates of dominating countries and the stability level. The existing exchange rate system of other countries needed to be improved.

The main controversy between domestic policies and the exchange rates is the fixed exchange rates ability offer for local and international trade

conditions with the relative stability and better conditions. Thus, the enterprisers and businessman could easily predict the rates in order to plan their work according to the rates that predict before. On the other hand, fixed exchange rates can eliminate instability and stimulate economical growth. Necessary for sound economical development can be as last condition that without any restrictions, governments have to conduct monetary and fiscal policies. This appearing crisis has been able to cope by government in order to reduce this factors and unemployment and also inflation.

Unfortunately, these conditions cannot be achieved in the economical system. It is because one of the conditions always not compatible with other conditions. For instance, if chooses free and unlimited currency conversion and also fixed exchange rate policy, unable to provide domestic interfere to control economical misbalances. Besides, also becomes very easy vulnerable to outer economical interventions as well as speculative attacks. Next, if strong domestic policy provided by the state and ability to controls the appearing economical troubles for example unemployment and inflation and also at the same time this strong domestic policy offers free and unlimited currency conversion as well, the desired level of exchange rate will be unable to keep. It is because require devaluing or revaluing the national currency by the changing of economical conditions and changing demand for the currency. Lastly, if strong domestic policy and fixed exchange rates chosen by the state to reach economical stability, to preserve the exchange rate, there have to limit the amount of currencies converted that in the proper scope.

Thus, the appeared of three main exchange rate systems are depend on three main factors, which are fixed exchange rate system, flexible exchange rate system, and also managed exchange rate system which are combined both systems that mentioned before.

The Bretton Woods system only existed until 1973. In 1971, an attack on the US dollar was occurring; it significantly overvalued against other currencies for sure. However, the US government did not try to protect their dollar value. As a result, we can found that the floating of dollar exchange rate started. Although there was an attempt and try to return back to the fixed rate system in 1973, but it is unsuccessful as a rewarded because dollar value were lined with other currencies strongly. Thus the fixed exchange rate to floating exchange rate have been gradually shifted in the world exchange rate system. The different in this shifted is in different parts over the world, also it specified three distinct types of exchange rate systems with emergence and different combinations of these types.

Because US support self-adjusting market idea; therefore floating exchange rate system are very supported by the US government. Next, the European community has chosen fixed exchange rate system as their direction towards because there has mostly provided the policies in order to regulating their economy as well as intervening into market mechanism; and in 1999 common currency was towards.

In 1979, the European Monetary System (EMS) has been established, including 15 European countries, and provides a fixed exchange rate compared to other currencies. Double rate between the currencies is not just

a fixed exchange rate to allow flexibility. The system also allows in some cases, exchange rate changes. Obstacles for the small and weak countries have been more volatile than the leading countries. Since the development of this system, the euro has been established for all currency, the euro has been fixed in 1999, and finally in 2002 all were by the euro.

Asia, most countries choose their exchange rate stability, and introduced policies, the value of their currencies against the dollar to fluctuate around it, the dollar value of a small scope. In the 20th century, the currency can explain the period from 1957 to 2001 by the exchange rate between the dollar and the pound.

There are three major currencies such as dollars, Euros and yen and other currencies that exist today in some way from those related. These three exchange rate systems development; the country, use and management of exchange rate regime needs, developed a number of policies to maintain economic stability. The use of currency board is one of long-term life policies. The concept of the currency board is the full support of the international monetary reserves.

As the country needs to take advantage of a fixed exchange rate system, one of the main international currency reserves to pay for the instability of the excess demand for foreign currency. The main reason, resulting in non-equilibrium of the national economy requires the international monetary reserves cannot make up the excess demand, therefore, cannot be expected to maintain a fixed exchange rate levels. This problem can be avoided currency board. For example, banks can only as much as possible the state's

money problems, because it can make up the international monetary reserves. The system has proven their ability and survival, but they are still vulnerable to a fixed exchange rate system, like all speculative attacks. However, Argentina and Hong Kong currency board to tell us that these systems can, at least in the short term. Exchange rate management can be used for any currency is pegged to a currency or basket of currencies used in other economic instruments. This instrument can not only save money within a specific region in accepting different currencies in use, but also to let the currency float freely on all other currencies.

2. 3. 2 Advantages and Disadvantages of Fixed Exchange Rate System

Advantages of Fixed Exchange Rate System

First of all, much greater stability will be offer by the fixed exchange rates for the enterprisers and stimulate international trade as well. Since the exchange rates stay stable and always state on the same level, thus the importers and also the exporters can plan their policy without worry about depreciation or appreciation of the currency issue.

Fixed exchange rates also can make the producers more disciplined. It is because quality of their production must they are keep up as well as to control the costs of the proto stay competitive compared to international enterprisers. With the fixed exchange rates, governments are allowed to decrease inflation level and also stimulate international trade and also economical growth in the long period as well.

Next advantage of fixed exchange rate system is believed that fixed exchange rates can stimulate the reduction of speculative activity worldwide. This statement is considered the real conditions, using the exchange rate for foreign and domestic dealers profits. This situation indicates that we looked at, monetary and fiscal policies, trying to protect those who often need to maintain economic stability, domestic producers.

The gold standard with fixed exchange rate system will reduce risk in international trade. Buyers and sellers of commodities in the international community can agree to maintain a fixed exchange rate price. They do not, then the exchange rate changes are subject to risks and resolved before the contract. Greater certainty should help to encourage investment.

Fixed exchange rate system also helps to introduce of economic management disciplines to help. As the burden or adjustment to the balance of pain is a domestic economic problem, the Government has a built-in incentive not to follow the policy of inflation. If the government chooses to follow the policy of inflation, the unemployment rate and the results of the international balance of payments problems will become less competitive as the economy.

Fixed exchange rates can eliminate destabilizing speculation as well. Speculation flows can be very destabilizing for an economy; thus the incentive to speculate is very small when the exchange rate is fixed.

Disadvantages of Fixed Exchange Rate System

In the main disadvantage of fixed exchange rate system is vulnerable to the economic system, highly speculative attacks. Any experience of an economy and oversupply, whether national or foreign currency and local banks if they cannot fill the existing gap between resources and needs of the over demand, fixed rate needs to change. This has reduced the fixed exchange rate system, the positive role of the exchange rate, reducing the currency's credibility.

One more disadvantage of this system is if the government supports the exchange rate with artificially, which is means changed economical condition are not adjusted, the development of the country's economy will not get as efficient as it could be if the rate was adjusted to the situation. Moreover, interest rates which directly depend on the exchange rate can stop possible economical growth in case to market needs.

When the national currency in the international currency peg a number of other conditions, there are very significant, these countries rely on the conditions of economic stability. In this case, the government has to solve the currency tied to the economic problems of countries. The possibility of this situation led to improve the country less the same time and money of the European state of the economy has shaken the markets of these countries concerned in good condition.

Fixed exchange rate system does not automatically balance of international payments adjustment. Therefore, a floating exchange rate should be addressed without government intervention and the domestic economy and balance of payments imbalances. If there is a deficit, then the currency fell,

the will of the people to restore competitiveness. However, in a fixed exchange rate system, the issue must be resolved in the aggregate demand levels. As the decline in aggregate demand, people consume fewer imports and a decline in the price level will make it more competitive.

Foreign exchange and fixed exchange rate system of reserves required by large-scale shares. Under a fixed exchange rate, large foreign currency reserves held by the Government to maintain a fixed exchange rate; the opportunity cost of these reserves.

In addition, fixed exchange rates will lead to loss of freedom within the policy. Need disposable exchange rate fixed exchange rate policy; the economy may not be the best. Interest rate and other policies may be set to the value of the exchange rate, rather than the more important macroeconomic goals, such as inflation and unemployment.

Fixed interest rate was not stable. Countries tend to follow a fixed exchange rate mechanism in different economic policies. The result is often different from the rate of inflation. For example, some countries have very low inflation and competitiveness, but on the other hand, others will have high inflation, not competitive. Competitive states will be pressure in severe.

2. 3. 3 Exchange Rate Regime

What is an exchange rate regime? The exchange rate regime is the way that countries use to manage its currency. The exchange rate regime measure in respect to foreign currencies and the foreign exchange market as well as

closely related to monetary policy. They are generally dependent on most of the same factors.

We can find that fixed exchange rate, floating exchange rate, and linked exchange rate are the basic types of exchange rate regime. Mostly currencies are more widespread such as the U. S. dollar and the euro. Now, let us discuss more deeply each type of the exchange rate regime.

A fixed exchange rate is a type of exchange rate regime wherein ties this currency with another currency. So, we can say that this currency value is matched to the other currencies value. Sometimes, gold is another measure of value. The currency with the stabilize the value of a currency are usually a fixed exchange rate is used. This action can bring the two countries' trade and investments easier and more predictable. It is very useful for small economies. It can be used to control inflation a fixed exchange rate, which is help a government from using domestic monetary policy. Thus, a macroeconomic stability can be achieved. If no including the countries using the Euro, there are no major economic players using a fixed exchange rate. The use of euro currencies of the countries still exists today.

On the other hand, floating exchange rate also called as fluctuating exchange rate is a type of exchange rate regime where the market dictates the movements of the exchange rate. According to the foreign exchange market, currency's value is allowed to fluctuate. A currency that uses a floating exchange rate is also known as a floating currency. For a developing country, it is not possible to maintain the stability in the rate of exchange for its currency in the exchange market. Because floating exchange rates can be

automatically adjusted, enable a country to dampen the impact of shocks and foreign cycles. It is also to preempt the possibility of having a balance of payments crisis. However, fixed exchange rates may be preferable in certain situations. It is because they have greater stability and certainty. A bank will normally intervene to stabilize the currency. Thus, the exchange rate regimes of floating currencies may more technically be known as a managed float. A central bank might allow a currency price to float freely between a price ceiling and price floor.

Lastly, a linked exchange rate system is a type of exchange rate regime to link the exchange rate of a currency to another. This exchange rate unlike fixed exchange rate system which means government or central bank does not actively interfere in the foreign exchange market. They are not allowing to controlling supply and demand of the currency as well as to influence the exchange rate.