International Financial System

From the time Bretton Woods became effective, it was inevitable it would break down. .. . It tried to achieve incompatible objectives: freedom of countries to pursue an independent internal monetary policy; fixed exchange rates; and relatively free international movement of goods and capital.

—Milton Friedman
The Gold standard (1880-1913)

• Gold has historically been used as money mostly for its ability to be a good store of value.

• Gold did not tarnish or erode easily and was fairly scarce. It was also a useful medium of exchange since it was desired by most people and could be transported in fairly small quantities.

• Gradually, the use of gold for money turned into the minting of coins whose face value typically was equivalent to the intrinsic value of gold.
Beginning in the late 19th century, the world moved away from gold coins to paper money, with the requirement that the paper was convertible into gold. A holder of a bank note could, if he/she so desired, exchange it for the equivalent weight in gold. By 1880, most of the major trading nations had adopted this monetary system.
The Interim Years

• The onset of the World Wars saw the end of the gold standard as countries, other than the U.S., stopped making their currencies convertible and started printing money to pay for war related expenses.

• After the Wars the focus shifted from external cooperation to internal reconstruction and events like the Great Depression further illustrated the breakdown of the international monetary system, bringing such bad policy moves such as a deep monetary contraction in the face of a recession.
BRETTON WOODS (1945-1971)

• Bretton Woods is a little town in New Hampshire, famous mostly for good skiing. In July 1944, the International Monetary and Financial Conference organized by the U.N attempted to put together an international financial system that eliminated the chaos of the inter-war years.

• The terms of the agreement were negotiated by 44 nations, led by the U.S and Britain. The British delegation was led by John Maynard Keynes, perhaps the most famous economist of the 20th century.
The main hope of creating a new financial system was to stabilize exchange rates, provide capital for reconstruction from the war and encourage international cooperation. What they settled on constituted the primary features of the Bretton-Woods agreement.

Features of the Bretton-Woods Agreement-

- The features of the Bretton Woods system can be described as a “gold-exchange” standard rather than a “gold-standard”. The key difference was that the dollar was the only currency that was backed by and convertible into gold. (The rate initially was $35 an ounce of gold)
Other countries would have an “adjustable peg” vis-a-vis the dollar: basically, they were exchangeable at a fixed rate against the dollar, although the rate could be readjusted at certain times under certain conditions. The dollar or the pound (British pressure added this clause!) could be used as reserve currencies for intervention in foreign exchange markets.

Each country was allowed to have a 1% band around which their currency was allowed to fluctuate around the fixed rate.
The IMF (the International Monetary Fund) was created with the specific goal of being the multilateral body that monitored the implementation of the Bretton Woods agreement. Its role was to hold gold reserves and currency reserves that were contributed by the member countries and then lend this money out to other nations that had difficulty meeting their obligations under the agreement.
But the increasing supply of dollars worldwide, meant that the credibility of the gold backing of the dollar was in question. U.S. dollars held abroad grew rapidly and this represented a claim on U.S. gold stocks and cast some doubt on the U.S.’s ability to convert dollars into gold upon request.

In 1971, the U.S. government “closed the gold window”

By 1973, the world had moved to search for a new financial system: one that no longer relied on a worldwide system of pegged exchange rates, i.e. Bretton Wood agreement collapsed.
Surprisingly, the collapse of the Bretton-Woods system did not lead to a widespread rush to adopt flexible exchange rates. Instead, the post Bretton-Woods era has mostly been about a search for individual or small group adaptations of fixed exchange rate or managed floating exchange rate arrangements.
Post –Bretton Woods Era

• In order to ensure new world economic order and peace, it was necessary to restore stability in monetary system at international level and find effective means to reconstruct the war ravaged economies of the European countries. But stable peace could be achieved only by diverting a part of the world resources to the undeveloped and under-developed poor countries of Asia, Africa and Latin America. An effective solution to the problem of economic reconstruction and development was necessary for ensuring world economy and for dismantling the complex trade and exchange restrictions that had grown during the previous decade.
• In order to abolish all trade and exchange restrictions effectively and to promote the multilateral trade system, IMF was established on December 27, 1945. It started functioning from March 1, 1947.
• The main objective of IMF is to grant loans in foreign currencies to member countries to correct any disequilibrium in their balance of payments, when disequilibrium is of temporary nature and likely to be removed in the earliest possible period.
According to the Article 1st of the agreement, the objectives of the IMF are-

• To promote international monetary cooperation through a permanent institution of the fund which provides the machinery for Consultation and Collaboration on international monetary problems.

• To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment and real income;
• To promote exchange stability and maintain orderly exchange arrangements among members by avoiding competitive exchange depreciation;

• To assist in the establishment of a multi-lateral system of payments in respect of current transactions between members and elimination of foreign exchange restrictions which hamper the growth of world trade.

• To create confidence among members by making the general resources of the fund temporarily available to them and providing opportunity to correct maladjustments in their balance of payments without resorting to the measures destructive of national or international prosperity.
International Liquidity

• International liquidity is generally used as a synonym for international reserves. Such reserves include a country's official gold stock, holdings of its convertible foreign currencies, SDRs and its net position in the IMF. It is the aggregate stock of inter-nationally acceptable assets held by the central bank to settle a deficit in the balance of payments of a country. In other words international liquidity provides a measure of a country's ability to finance its deficit in the balance of payments without resorting to adjustment measures.
IMF in 1970 introduced a scheme for the creation and issue of Special Drawing Rights (SDRs) as unconditional reserve asset to remove all the related problems of international liquidity. Now SDR is the principal source of international liquidity to its members.

On July 1974, the value of one unit of SDR was fixed on the basis of a 'Basket of Currencies' of 16 countries. In 1978, the currencies of Denmark and South Africa were excluded from the basket of currencies and the currencies of Iran and Saudi Arabia were included. In 1981, the value of SDR was again fixed in five currencies in which American dollar, British pound, Mark of Germany, Franc of France and Japanies yen were included.
• At present, the value of currency of every country is fixed in SDR. Mutual Exchange rates of different currencies can be increased or decreased according to the demand and supply in the market and thus, the par value system started by IMF has been ended by the floating rate system.
European Economic Community

- An arrangement used briefly in Europe after the collapse of the [Bretton Woods System](#) in which European currencies were permitted to vary ±1% against each other (thus the [snake](#), but ±2.25% against the dollar (the [tunnel](#)).

- An adjustable peg system was born among the countries belonging to the European Economic Community (EEC). This was a snake created in 1972, designed to keep the EEC countries’ exchange rates within narrower bands of 1.125% while they maintained the wider bands of 2.25% against the currencies of other countries. Hence the designation [Snake in the Tunnel](#) is used.
• In 1979, the snake became the European Monetary System (EMS), with all EEC countries except Britain joining the club.

• It proposed a combination of adjustable peg with wider bands.

• The feature that distinguished EMS from the snake was the European Currency Unit (ECU), a SDR-like basket of currencies which was to play the role of the unit of account for transactions among the member central banks. The ECU was the precursor of the common currency Euro which the twelve member countries of EMU now share.
• The EMS had operating mechanisms which guided member countries’ intervention in the foreign exchange markets to maintain the bilateral rates within the permissible bands and financial agreements which provided reserves to member countries whose currencies came under pressure from time to time.

• Monetary union has been envisaged as a part of the move towards creating a single economic zone in Europe with complete freedom of resource mobility within the zone, a single currency and a single central bank.
Finally, the single currency “Euro” came into existence on Jan 1, 1999. The parities of the eleven member currencies against the Euro were irrevocably fixed on Dec 31, 1998. Subsequently, on Jan 1, 2001 Greece joined the Euro group.
European Investment Bank

• The European Investment Bank (EIB), established in 1958, is the European Union's long-term lending institution. As a policy-driven Bank, the EIB supports EU priority objectives, notably European integration and social cohesion, through its financing operations.

• As the ‘Bank of the European Union’, the EIB’s mission is to make a difference to the future of Europe and its partners by supporting sound investments which further EU policy goals.
• The European Investment Bank is owned by the 27 EU countries. It borrows money on the capital markets and lends it at a low interest rate to projects that improve infrastructure, energy supply or environmental standards both inside the EU and in neighboring or developing countries. In 2008, the EIB raised nearly €60 bn. The EIB works on a non-profit basis.
Services by EIB

• Loans: granted to viable capital spending programmes or projects in both the public and private sectors. Recipients range from large corporations to municipalities and small businesses.

• Technical assistance: provided by a team of expert economists, engineers and specialists to complement EIB financing facilities.

• Guarantees: available to a wide range of bodies, e.g. banks, leasing companies, guarantee institutions, mutual guarantee funds, special purpose vehicles and others.

• Venture capital: requests for venture capital should be addressed directly to an intermediary.
Lending within the EU

• About 90% of loans go to programmes and projects within the EU.
• The EIB has 6 priority objectives for lending, set out in the Bank’s business plan:
  • Cohesion and convergence
  • Support for small and medium-sized enterprises (SMEs)
  • Environmental sustainability
  • Implementation of the Innovation 2010 Initiative
  • Development of Trans-European transport and energy networks (TENs)
  • Sustainable, competitive and secure energy
World Bank

• The World Bank was originally established to support reconstruction in Europe after World War II, but has since reframed its mission and expanded its operations both geographically and substantively.

• Today, the Bank's mission is to reduce poverty. It has over 184 member countries and provides over $24 billion annually for activities ranging from agriculture to trade policy, from health and education to energy and mining.
• The World Bank provides funding for small and big projects, as well to promote economic and policy prescriptions it believes will promote economic growth.

• For example, part of the over $300 million the Bank is currently providing the West African country of Niger funds health programs addressing HIV/AIDS and irrigation. However, the Bank also promotes more controversial projects in the country, like privatization of state enterprises.
• The World Bank is not a bank in the common sense of the word. A single person cannot open an account or ask for a loan. Rather, the Bank provides loans, grants and technical assistance to countries and the private sector to reduce poverty in developing and transition countries.

• The World Bank Group is actually comprised of five separate arms. Two of those arms - the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) work primarily with governments and together are commonly known as "the World Bank".
• Two other branches - the International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) - directly support private businesses investing in developing countries. The fifth arm is the International Center for Settlement of Investment Disputes (ICSID), which arbitrates disagreements between foreign investors and governments.

• World Banks’ major contribution in India