INTERNATIONAL FINANCE

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International Monetary System

- ✓ International monetary systems are *sets of internationally agreed rules, conventions and supporting institutions, that facilitate international trade, cross border investment and generally there allocation of capital between nation states.*

- ✓ International monetary system refers to the system prevailing in world foreign exchange markets through which international trade and capital movement are financed and exchange rates are determined.

Features that IMS should possess

- Efficient and unrestricted flow of international trade and investment.
- Stability in foreign exchange aspects.
- Promoting Balance of Payments adjustments to prevent disruptions associated.
- Providing countries with sufficient liquidity to finance temporary balance of payments deficits.
- Should at least try avoid adding further uncertainty.
- Allowing member countries to pursue independent monetary and fiscal policies.

Requirements of good international monetary system

- ✓ **Adjustment** : a good system must be able to adjust imbalances in balance of payments quickly and at a relatively lower cost;
- ✓ **Stability and Confidence**: the system must be able to keep exchange rates relatively fixed and people must have confidence in the stability of the system;
- ✓ **Liquidity**: the system must be able to provide enough reserve assets for a nation to correct its balance of payments deficits without making the nation run into deflation or inflation.

STAGES IN INTERNATIONAL MONETARY SYSTEM

1. **Bimetallism:** Before 1875
2. **Classical Gold Standard**: 1875-1914
3. **Interwar Period:** 1915-1944
4. **Bretton Woods System:** 1945-1972
4. **The Flexible Exchange Rate Regime:** 1973-Present

Bimetallism: Before 1875

- A "double standard" in the sense that both gold and silver were used as money.
- Some countries were on the gold standard, some on the silver standard, some on both.
- Both gold and silver were used as international means of payment and the exchange rates among currencies were determined by either their gold or silver contents.
- **Gresham's Law** implied that it would be the least valuable metal that would tend to circulate.

Gresham's Law

Gresham's law is an economic principle that states:

"if coins containing metal of different value have the same value as legal tender, the coins composed of the cheaper metal will be used for payment, while those made of more expensive metal will be hoarded or exported and thus tend to disappear from circulation."

It is commonly stated as: "**"Bad" (abundant) money drives out "Good" (scarce) money"**

Gresham's Law Contd…

The law was named in 1860 by Henry Dunning Macleod, after Sir Thomas Gresham (1519–1579), who was an English financier during the Tudor dynasty. However, there are numerous predecessors.

The law had been stated earlier by Nicolaus Copernicus; for this reason, it is occasionally known as the **Copernicus Law**.

Gold Standard

During this period in most major countries:

- Gold alone was assured of unrestricted coinage
- There was two-way convertibility between gold and national currencies at a stable ratio.
- Gold could be freely exported or imported.

The exchange rate between two country's currencies would be determined by their relative gold contents.

Rules of the system

- Each country defined the value of its currency in terms of gold.
- Exchange rate between any two currencies was calculated as X currency per ounce of gold/ Y currency per ounce of gold.
- These exchange rates were set by arbitrage depending on the transportation costs of gold.
- Central banks are restricted in not being able to issue more currency than gold reserves.

Classical Gold Standard : Exchange rate determination

For example, if the dollar is pegged to gold at U.S.$30 = 1 ounce of gold, and the British pound is pegged to gold at £6 = 1 ounce of gold, it must be the case that the exchange rate is determined by the relative gold contents

$$\$30 = £6$$

$$\$5 = £1$$