# Academic Script

**Introduction:**

Hello friends. In the last session we saw various types of exchange rate regime and how the gold standard system and the gold exchange standard system functions. During the time when First World War was going on the international trade and the monetary system was on a stand still. Over the period when the war was going on, efforts to establish a stable exchange rate mechanism were initiated. The first step towards this was a conference that was held in the Brettonwoods whereby the various institutions such as the IMF and World Bank were established. In this session we will see in detail various events that led to the establishment of the Brettonwoods system of exchange rate determination.

## Brettonwood system

The First World War was an event which disrupted the peaceful environment of the world. The events of the world war caused huge losses to the various parties which were involved. With a view to establish world peace again, the countries involved in the First World War signed the Treaty of Versailles.

According to this treaty, the allies levied the entire blame of the losses incurred by all the countries involved on Germany and it was held accountable for it. By signing this treaty, Germany was to accept the responsibility for the damages of the war. As a result, Germany had to pay 132 Billion Marks as compensation to the various countries that were involved.

Moreover many trade and military restrictions were levied on Germany whereby it was not allowed to increase its army, trade in arms and ammunitions, undertake any type of activity whereby the resultant would be an expansion in its territory. It was also prohibited to acquire new arms and ammunitions. The allies to their best possible efforts tried to restrict the growth of Germany’s domination on the European Continent.

As Germany was prevented from undertaking international trade by the economic situation of the country started to get worse. In the initial years after the war, Germany received support from USA and it was able to rebuild its economy. But with the collapse of the American Economy and in the year of 1929 after the Wall Street Crash and the Great Depression of 1930 resulted into stoppage of the assistance that it was receiving from USA. During this period, the banks in America were under huge pressure and were suffering losses. As a result, they demanded Germany to return the money back to them.

Germany was not able to make the payments and its major businesses failed and as a result, majority of the German Population was rendered unemployed during the years between 1929 to 1933.

In the meantime, Germany was also not able to pay its installments for the damages caused by the war. Due to this the relations between Germany and the other European countries were strained. Further, the allies also alienated the USSR in the Treaty of Versailles in spite of the fact that USSR was on the side of the allies and it suffered the maximum damage during the world war. The citizens of the both these countries felt that injustice was done to them.

Exploiting this resentment towards the Treaty of Versailles, Adolf Hitler gained popularity and came into power by becoming the Chancellor of Germany. Under his leadership, Germany started to violate the provisions of the treaty and rapid expansion of the military was initiated.

The treaty of Versailles was not so strong enough to prevent Germany from attaining its previous position. Moreover the allies were more interested to protect their own interests and on many instances, they turned a blind eye on the activities that Germany was undertaking which were in violation of the Treaty of Versailles as they were not affected by those activities. As a result, Germany continued to increase its dominance in the continent as it started to expand its territory.
In the meantime, to establish itself as an economic power along with a military power and to isolate Britain and its allies and to cut the money supply to them, Germany started to force the other countries with surplus to undertake trade with it. As a

result, the free trade undertaken between the various countries was hindered by Germany.

On the other hand, Britain was also putting obstacles in the free trade between the countries. While undertaking trade with its various trading partners, Britain used to put forward a condition that the excess pounds earned by the trading members was to be deposited in a bank in England only. The trading partners were not allowed to repatriate not only the profits earned by them but also the money they had earned by undertaking trading activities with Britain. This move was undertaken by Britain so that it is able to restrict the flow of Pound Sterling out of the country. With these methods, Britain was able to maintain its position in the world trading platform.

But across the sea, USA favored free trade as it was experiencing difficulties in getting foreign business due to the restrictions which were levied on the trade by England and Germany. USA wanted to earn more by undertaking more international trade but the countries were not ready to trade with each other as by that point hostility between the countries had increased to a level where no compromise was possible.

The world peace was violated when the Second World War began with the declaration of war by France and Britain on Germany when it proceeded to annex Poland. As a result the International monetary system was again put in jeopardy. The war in Europe ended with the invasion of Germany by the Allies and the Soviet Union surrendering on 8$^{th}$ May, 1945. Japan's refusal to surrender resulted in atomic bombing in Hiroshima and Nagasaki and the war in Asia ended with the surrender of Japan on 15$^{th}$ August, 1945.

By the end of the world war, the world leaders recognized that there was a need to have an international organization to regulate the international monetary system. With regards to this view, John Maynard Keynes from Britain and Herry Dexter White of the USA independently started to draft a proposal of one such organization. After the negotiations between these two countries was undertaken, the Allies were invited and after consulting them, "Joint Statement by Experts on the

Establishment of an International Monetary Fund," was published, and delegates from eight countries were invited to meet in Atlantic City to develop the draft proposal for the Bretton Woods Conference which was held between June 15-30, 1944.

From July 1-22, 1944 the Bretton Woods Conference formally known as the United Nations Monetary and Financial Conference was held in Mount Washington Hotel in Bretton Woods, New Hampshire where 730 delegated from 44 allied nations met to form an organization with an aim to regulate the international monetary system and to maintain a financial order in the period after the conclusion of the world war.

The main outcomes of the conference were:

1. The Creation of International Monetary Fund (IMF):

One of the most important outcomes of the Brettonwoods Agreement was the establishment of the International Monetary Fund. The basic purpose of this fund is to maintain the exchange rate stability and to ensure that the trade between the countries is undertaken in a smooth manner.

2. The creation of International Bank of Reconstruction and Development:

Another outcome of the Agreement was the establishment of the International Bank of Reconstruction and Development, also popularly known as The World Bank. It was established to ensure that the reconstruction of world after the war is undertaken in a speedy manner. Moreover, The World Bank also provides aid for the developmental activities which are undertaken.

Under the Bretton Woods agreement the few aspects were agreed by the member countries which were as follows:

1. The system of adjustable pegged foreign exchange rates was introduced. Under this system, all the countries decided that the US Dollar would be the acceptable currency for world

trade. All the other countries would be fixing the rate of their currency according to the rate of US Dollar.

2. The member countries also decided that their currencies would also be convertible for trade related and other current account transactions. This was agreed so as to ensure that the trading activity between the member countries remain unhindered.

3. If the exchange rate determined was not favorable to a country's balance of payment position of that country then the particular government can revise the exchange rate in the range of 10 percent without the objections of IMF.

4.All the member countries also agreed that they would also subscribe to the IMF's capital.

**Exchange rate determination under the adjustable peg system**

The IMF established a new exchange rate regime which was termed as adjustable peg system. Under this system the rate of each currency was determined against US Dollar and the rate of the US dollar was fixed against Gold. The exchange rate of US Dollar was fixed at a level of 35 US Dollar against 1 ounce of gold.

The member countries determined the exchange rate against US Dollar. In order to provide flexibility, a margin of +1 to -1 was fixed wherein the exchange rate could fluctuate. This provision was not allowed to US Dollar and it had to maintain the exchange rate at a stable range. In case if the exchange rate fluctuated beyond this range, the monetary authority of that country either had to buy or sell the US Dollar to re-establish the exchange rate at the earlier rate.

Further the member countries were prohibited to levy any trade restrictions. Only in transitional period such restrictions could be imposed by a member country. The foreign currency holding of the member country also were divided into two parts: gold holding and US Dollar holding. The main reason for holding these reserves was to use them when there would be fluctuations in the exchange rate.

Say for example if there is a Balance of Payment deficit then these reserves would be used by the country to meet the shortfall. On the other hand if there is a balance of payment surplus, then there would be an increase in the reserve that are held by the country.

## Creation of SDRs

The special drawing rights (SDR) were created by IMF in 1969 as a reserve asset in context of the Bretton Woods exchange rate system. The SDR is a potential claim on freely usable currencies of the IMF members. The countries which were holding SDRs can obtain freely usable currencies in exchange of SDRs in any of the two ways:

1. by voluntary exchange between the members

2. IMF designating members with strong external positions to purchase the SDRs from members with weak external positions.

In the initial days the SDR was equal to 0.888671 grams of fine gold which was equal to the value of the one US dollar. But after 1973, the SDR was defined as a basket of various currencies. the freely usable currencies included U.S. Dollar, Euro, the Chinese Renminbi, Japanese Yen, and Pound Sterling.

The value of the SDR in US dollar terms was determined daily and posted on the website of IMF. The basket of the currencies considered as freely usable currencies are revised once every five years by the Executive Board. This revision can be done earlier if a premature review is required to consider the changed circumstances.

The rate of interest that would be charged from a borrowing member would be used by the IMF to pay the lending member. The interest on SDR is determined every week. The SDR allocation would be as per the member countries proportion to their IMF Quota. These allocations would be costless, unconditional and an asset which is considered as an international asset.

In case if a member’s holding increases beyond the allocated SDRs then it will earn interest on it but if its SDRs fall below the allocations then the member has to pay interest to the IMF.

In order to meet their obligations, the members can sell their SDRs to adjust the composition of their assets. The IMF acts as an intermediary between the members and ensures that the SDRs are exchanged freely in usable currencies.

One of the concerns of this system was the outflows of the reserves money. The IMF in order to counter it, recommended to its member nations to either adopt expenditure reducing policies or to devalue their currency.

Initially this system was considered to be flawless and the countries involved in the system were able to undertake the trading without any difficulties. But in practice this system was more or less a modified version of the gold standard system.

One of the drawbacks of the system was that the US Government had to change gold and return US Dollars against it as and when any country has a need for US dollars.

In the year 1973, the US Government started to find it very difficult to meet the world demand of the US Dollars. In addition to meeting this requirement, US Government also needed finance to meet other obligations. Among them the major ones included the finance that had to be raised for the new development programs as well as the expenses that it had to undertake to meet the expenses for the Vietnam War. Moreover, during this period the oil prices also increased.

Due to all these reasons the US Government had to put more money in circulation which was constantly moving out of the country to meet the demands of the other countries. During these situations, other countries started to feel that US might not be able to meet the demand of US Dollars. The main reason behind this assumption was that the Gold reserves of US were not sufficient to back the US Dollars that were in circulation.

**Smithsonian Agreement**

During this period, the countries which were holding the US Dollar started to insist that their holdings should be converted into Gold. But the gold reserves which were with US were very limited. In the month of December in 1971, then US President, Richard Nixon announced that US was unilaterally suspending the conversion of US Dollar into Gold.

Due to this suspension of conversion of US Dollars into Gold, the US Dollars were rendered to be just a fiat currency. Fiat currencies are such currencies which are backed by Government Guarantee rather than any asset such as gold.

This shock to the world monetary system was termed as the "Nixon Shock".

As a result, the countries which were holding the US Dollars which were now not backed by any gold security. This shock given by the US was known as the "Nixon Shock".

The Nixon Shock had the following implications:

1. The result of the Nixon Shock was that the Bretton Woods system came to an end as US Government said that it would not from that point of time convert gold into US Dollar or vice Versa.

2. As the Bretton Woods system came to end, the US Dollar was also allowed to float freely against all the currencies. As a result, US Government was also allowed to flexibly decide and alter its currency exchange rate.

3. One of the measures taken to prevent the increasing inflation by the US Government in its country was to fix the prices and the wages temporarily.

4. To improve the Balance of Payments of the United State, a tariff of 10% was imposed on the imports that were undertaken. This was done as a measure to prevent the outflow of US Dollars from the country.

As a result of these measures, the international monetary system was again at the verge of being imbalanced. In order to restore equilibrium, the allies of ten industrial countries met in Smithsonian Institution in Washington DC. They signed an agreement under which the US agreed to peg its Dollar at 38 US Dollars per ounce of Gold. The trading bands were also revised to 2.25% increase or decreases. In relation to the reduction in the value of the US Dollar, the other countries decided to appreciate their currency. The aim was to stabilize the world financial system using just the Special Drawing Rights.

Under this agreement, the nations also agreed that the maintenance of stability of the exchange rates was not just the responsibility of United States of America but it was a collective responsibility of all the member countries. Further the members also agreed that the various trade restrictions which were imposed to restrict the trade between the countries have to be reduced. They also agreed that to maintain world peace, the military burden would be shared.

But in spite of this, the confidence in the Bretton Woods system could not be restored. The central banks of various countries had accumulated huge reserves of US Dollars and the US Treasury had to devalue the dollar again on February 12, 1973 by 10% which made 42 US Dollars equivalent to an ounce of Gold. Within a month's time all the major currencies were floating against dollar and this brought an end to the Bretton Woods system of exchange rate determination.

## Conclusion

In this session we covered various events which led to the evolution of the Bretton Woods system. We also covered the various institutions which were established as a result of the agreement. We covered the role of each of these institutions. We also saw as to how the exchange rates were determined under the adjustable peg system. Then we covered the various problems which were inherent in the Brettonwood's system of exchange rate determination. We discussed in detail the creation of Special Drawing rights. Further we looked at how the settlements would be undertaken under the SDR system. Then we saw the events which led to a phenomenon referred as the "Nixon Shock" and the various efforts by the ten industrial countries to again restore the balance in international monetary system. We also saw various problems that the US Treasury was facing when US Dollar was used as a standard for determining the exchange rates. Then we covered the various aspects which led to the downfall of the Bretton Wood system of exchange rate determination. I hope that you have understood all these aspects.

Thank you.