UNIT 1 INTERNATIONAL MONETARY SYSTEM AND INSTITUTIONS

Structure

1.0 OBJECTIVES

After studying this unit you should be able to:

- discuss the international monetary system
- explain exchange rate arrangements
- discuss world trade and regionalism
- discuss international financial system in developing countries
- describe the working of the European monetary system and
- have an overview of regional financial institutions.

1.1 INTRODUCTION

The need for flow of funds among nations arise because of two reasons (a) the trade between the nations and (b) the funds may be transferred from one country to another, both at government and private level for investment. The freedom to move funds across the nations are subject to many restrictions. To overcome the difficulties certain concepts, laws, rules and institutions are to be set up among the nations. This also essentially requires multilateral agreements so that the obligations of the nations are well defined. These concepts and institutions are divided into three categories : (1) international monetary system, (2) system of exchanging currencies, and (3) multilateral institutions regulating and stabilising the international monetary system.

In this unit, you will learn about the international monetary system, floating rate system, European monetary system. You will also learn about world trade and regionalism, international financial system and developing countries, and Asian currency crisis and at the end of the unit some of the regional financial institutions.

1.2 INTERNATIONAL MONETARY SYSTEM

We may define international monetary system as "a set of arrangements, rules, practices and institutions under which payments are made and received for international transactions across national boundaries".

The international "system" is concerned not with the supply of international money but with the relationships among a hundred or so currencies of individual countries and with the pattern of balance of payments relationships and the manner in which they are adjusted and settled.

Thus "the system" is broader than "monetary", in that it is concerned with trade relationships and fiscal and other national policies as well. But to call it a system is to impute more formality to it than it deserves, even though it embodies a set of rules enunciated in the Articles of Agreement of the International Monetary Fund. Thus one author had suggested that the appropriate term could be "international monetary order". But as the entity which we are discussing can be both disorderly and unsystematic, the term "International Monetary System", has come to be in vogue rather than more precise terms.

International monetary relations are governed not only by the Fund rules but also by agreements and consultations among nations through other international institutions like World Trade Organisation, (WTO), earlier General Agreement on Tariff and Trade (GATT), Organisation for Economic Co-operation and Development (OECD) and now European Monetary Union, (EMU), the Bank for International Settlements (BIS) and other international organisations.

A major reason why the international monetary system is afflicted with problems is that nations that participate in the functioning of the system are politically independent but economically and financially interdependent. This discrepancy defines the core function of the international monetary system. At its best, the system acts to reconcile the conflicting economic policies of politically independent members.

Thus to perform this reconciling function, the system is concerned, firstly, with those economic policies of its members that affect the other nations - with how nations act, deliberately or otherwise, regarding their balance-of-payments positions (each country's balance of payments being the mirror image of the rest of the world with it). Important policies here are those that affect exchange rates, since each country's exchange rate with another country is also the exchange rate of the other country with it. Secondly, the system is concerned how nations settle their accounts with one another, how they pay or receive money in some form to finance deficits and surpluses. Thirdly, the system is concerned with the amount and form of international money. In this respect its nature is similar to that of domestic monetary systems, though international money includes cash as well as other financial instruments.

In broad terms, the international monetary system involves the management of three processes (1) the adjustment of balance of payments positions, including the establishment and alteration of exchange rates; (2) the financing of payments imbalances among countries by the use of credit or reserves; and (3) the provision of international money (reserves).

1.3 NEED FOR INTERNATIONAL MONETARY SYSTEM

Any monetary system requires a set of rules of behaviour. The gold-standard system involved very little management at the international level. But the individual countries had to abide by a code of conduct. In the system of freely floating exchange rates, there is no provision for settling imbalances or providing reserves. This, however, requires a rule prohibiting official intervention in the foreign exchange markets. However in the present or in the future system, there would be a need for the day-to-day management at the international level. This is because of the fact of international interdependence. Today we live in a global economy. A global economy is characterised not only by the free movement of goods and services, but also by the free movement of ideas and of capital. The movements in exchange rates, interest rates and stock prices in various countries are intimately interconnected. There are certain benefits of the global economy, namely the international division of labour, economies of scale and the rapid spread of innovations from one country to another, non-economic benefits as the freedom of choice associated with the international movement of goods, capital and people, and the freedom of thought associated with the international movement of ideas.

However, global capitalism is not without its problems. These can be grouped under five main headings; the uneven distribution of benefits, the instability of the financial system, the incipient threat of global monopolies and oligopolies, the ambiguous role of the state, and the question of values and cohesion. These problems provide sufficient reason for international monetary system.

1.4 EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The idea of creating an international economic and monetary union has a long history. In spite of this, it remained for centuries only a dream for the simple reason that until 1940s, no government took a keen interest in any of the schemes proposed. In 1920s, a French economist, Nogaro, floated the idea of establishing an international bank to issue a new international currency. In 1929, Schacht, the President of the Reichsbank, the central bank of Germany proposed the creation of an international clearing union. In 1930, Keynes suggested a modified gold standard to be managed by a 'supranational bank' acting as the international bank of the last resort. Nothing happened, however.

During the 1930s, the interrelated developments which took place, contributed to a change in official attitudes in industrial countries towards the international economic order. The collapse of the international economic system at the beginning of 1930s, followed by the Great Depression, the rise of fascism and the Second World War destroyed the old order which was created by trial and error before 1914 in response to growing international economic integration. Events demonstrated that industrial countries, particularly, were too advanced, specialised and interdependent and some sort of a new economic order had to be thought of. Post-war recovery could not be left to the slow and haphazard processes of the market forces. Vested interests which could have resisted an international economic order for fear of losing the national sovereignty in individual countries, were too shell-shocked and marginalised by the disastrous events during the 1930s and 1940s to put up an effective resistance to fundamental far-reaching changes.

Thus British, American and other plans, finally culminated in a blue print which was developed at the Bretton Woods conference for the establishment of international organisations such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) popularly known as the World Bank.

Lord Keynes, a principal architect of the system, said in his closing address at Bretton Woods in 1944, "We have been learning to work together. If we can so continue, this nightmare, in which most of us here present have spent too much of our lives, will be over. The brotherhood of man will have become more than a phrase".

Before discussing how the international financial system has performed during the half a century, we briefly discuss the international monetary system before the First World War.

1.4.1 The Gold Standard

The international monetary system that operated prior to the 1914-18 war was termed as the gold standard. Then the countries accepted the major assets gold and sterling in settlement of international debt. A unit of a country's currency was defined as a certain weight of gold (e.g. a pound sterling could be converted into 113.0015 grains of fine gold and the U.S. dollar into 23.22 grains. Through these gold equivalents, the value of the pound was 113.0015 / 23.22 times, (or 4.885 times that of the dollar. Thus 4.885 dollars was the 'par value' of the pound).

A country is said to be on the gold standard when its central bank is obliged to give gold in exchange for its currency when presented to it. The gold standard was the foundation of the international trading system. The currency of a country was freely convertible into gold at a fixed exchange rate. International debt settlement was to be in gold. When a country had a surplus in its balance of payments, gold flowed into its central bank. Thus the country with a balance of payments surplus could expand its domestic money supply without having the fear of insufficient gold to meet its liabilities. When the money supply increased, prices increased, hence the demand of exports fell, the balance of payments surplus was reduced.

On the other hand, when a country had a deficit in its balance of payments, gold flowed outside the country. Thus the deficit country had to contract the money supply with the reduction in its gold stocks. The prices of commodities decreased. Its exports become more competitive and the deficit automatically got corrected, as increase in exports resulted in gold inflows.

It is argued that the system based on the gold standard provided stability and an automatic adjustment mechanism. Since the value of gold relative to other goods and services does not change much over long periods of time, the monetary discipline imposed by the gold standard was expected to ensure long-run price stability. The data on wholesale prices reveals that prices at the beginning of the World War I in 1913 were roughly the same as they had been in the previous one hundred and fifty years. However, the long-run stability includes alternative periods of inflation and deflation. During Napoleonic wars, prices shot up and later in the nineteenth century they fell down remarkably.

It is argued that even during the gold standard system the central banks, rather than allowing gold flows to adjust their domestic money supplies, intervened by varying their interest rates or expanding domestic credit. Similarly, deflationary mechanism, inherent in the gold standard, depressed employment but widespread unemployment was prevented by massive migration of the people to other countries. Nevertheless, the period from 1880 to 1914 during which the classical gold standard prevailed in most countries was a remarkable period. There was rapid expansion of virtually free international trade, exchange rates and prices were stable, free flow of labour and capital across political borders encouraged economic growth and world peace.

1.4.2 The Interwar Years 1914-1939

The gold standard broke down during World War I. Initially the international trading and payments system was dominated by flexible exchange rates. The gold standard was briefly reinstated from 1925-31 as the Gold Exchange Standard. Under this, the central banks of individual countries would exchange home currency for the currency of some other country on the gold standard rather than gold itself. In 1931, England departed from the gold standard in the face of massive gold and capital outflows. The gold exchange standard was finished. It was replaced by the use of independent and uncoordinated trade policies of individual countries. These included managed exchange rates, devaluations of currencies and protectionism. The result was a 'beggar-thy-neighbour' trade war in which nations cheapened their currencies in order to increase their exports at other's expense and reduce imports. The Great Depression was the result. Output and employment levels in individual countries came down for a decade. Only the extreme event like the World War II could kick-start the economy again.

1.4.3 Bretton Woods, IMF and the World Bank

As mentioned above, towards the end of the World War II the outline of the post-war international monetary system had already been agreed upon. This was largely the result of the intensive work during the war by Lord Keynes and his colleagues in U.K. and Harry Dexter White in U.S.A. Keynes, the foremost economist of his generation, the writer of "General Theory of Employment, Interest and Money" (1939) had joined the Treasury during the War. He and White, of the U.S. treasury exchanged drafts and a compromise proposal was agreed to at the international conference held in Bretton Woods, New Hampshire, U.S.A. in June 1944. This agreement, signed by 44 nations, was the constitution, the Articles of Agreement of the International Monetary Fund. The World Bank (The International Bank for Reconstruction and Development) was established at the same time.

1.4.4 The IMF Agreement

The key provisions of the Bretton Woods Agreement were as follows :

A new permanent institution, the International Monetary Fund (IMF), was to be established to promote consultation and collaboration on international monetary problems and to lend to member countries in need due to recurring balance of payments deficits.

Each Fund member would establish, with the approval of the IMF, a par value for its currency and would undertake to maintain market exchange rates for its currency within one per cent of the declared par value. Countries that freely bought and sold gold in international transactions were "deemed" to be adhering to the requirement that they maintain the exchange rates within the one per cent margins. Thus the U.S.A., the only country that met this condition, was not expected to intervene in the foreign exchange market. Other countries would intervene by buying and selling the dollars against their own currencies, to keep the rates within one per cent of their parities with the dollar.

Members would change their par values only after having secured the Fund approval. This approval would be given only if the country's balance of payments was in "fundamental disequilibrium". Exchange rate adjustment was not to be undertaken lightly. Temporary and cyclical imbalances were to be financed out of reserves or through borrowings from the Fund. Only a long and continuous loss of reserve assets in support of an exchange rate would be evidence of this fundamental disequilibrium.

After a transitional period, currencies would be convertible i.e. countries would undertake to redeem balances of their currencies acquired by other members. Such convertibility would be either gold or the currency specified by the member requesting conversion.

Each IMF member country would pay into the IMF pool, a quota, one quarter of which would be in gold and the remainder in its own currency.

The Fund would be in a position to lend countries in deficit, out of its holdings of gold and other currencies arising from the subscriptions of its members in relation to their quotas (to be determined according to each member's size in the world economy). But the Fund was not to lend to finance outflows of capital.

If a country's currency became 'scarce' in the Fund, the latter could authorise other countries to adopt exchange controls on imports and other current account purchases from the surplus country. (This sanction against countries in large surplus was offered by Americans in response to a charge by Keynes that the proposed system was asymmetrically severe to countries in deficit.)

1.4.5 World Bank

Bretton Woods established both the IMF and the World Bank. The IMF was given powers to force even its largest and the most influential members to observe the stabilisation/adjustment rules. It could do so in the case of a deficit country when asked as the lender of the last resort. In the case of a surplus country it could do it by declaring its currency 'scarce' and allowing the other member countries the right to impose restrictions on transactions with the country whose currency had been declared scarce, though the 'scarce currency clause' was never used in practice.

The IMF dealt with short-term aspects of economic activity taking the financial measures to facilitate high levels of employment and income. It did not address itself to the problem of long term development of the international economy. The World Bank was created, therefore, to perform this function. Its task was to assist and supplement private international investment. It was an international development finance institution. It served countries at different levels of development and with different political systems. It lent out of the funds placed at its disposal by the member countries. Thus as Keynes noted "The Fund was really a bank and the Bank a fund."

The charters of these two institutions tried to create the basic framework of supra-national institutions required to manage the economic and financial behaviour of a large number of countries who were economically interdependent. The problem, that the Bretton Woods Agreement could not solve then and now, was the central one of how to effectively run an internationally integrated international economy; how to ensure, in the absence of a world parliament and government, that supranational institutions perform the role that such a system demands. The system operated from the late 1940s till now departed in a number of respects from the original blue-print produced at Bretton Woods.

1.5 WORKING OF THE BRETTON WOODS SYSTEM : AN OVERVIEW (1946-1971)

Initially the system worked extremely well. After the advent of the Cold War, the United States had to take over its management in 1947 to prevent a major international and political crisis when the economies of industrial countries had disintegrated after the War. The U.S. policies ensured a steady injection of dollars into the world economy to facilitate the adjustment of imbalances in international payments. It helped, in this way, to preserve the system of fixed exchange rates among industrial economies almost for two decades.

Massive U.S. assistance to other countries started with the European Recovery Programme (Marshall Aid as known the name of the the U.S. Secretary of State) and other official transfers in the late 1940s. The countries in Western Europe and Japan recovered economically as a result of these programmes. While official grants and loans were reduced after 1950s, the military spending and investment abroad of the U.S.A. increased. In a sense, like the United Kingdom before 1914, the United States provided other countries with its currency on a scale that facilitated the growth of world output, trade and investment without compromising the confidence the dollar enjoyed internationally. Thus during the first decade after Bretton Woods there was no occasion for the IMF to apply the scarce currency clause or without other countries wanting to convert their dollar reserves into gold.

Under the **Bretton Woods** Agreement each government pledged to maintain a fixed or pegged exchange rate for its currency vis-a-vis the dollar or gold. The fixed exchange rates were maintained by official intervention in the foreign exchange markets by purchases and sales of dollars by foreign central banks against their own currencies. The IMF stood ready to provide the necessary foreign exchange to member nation defending the currencies from temporary factors. Any dollars acquired by the monetary authorities in the process of such intervention could then be exchanged for gold at the U.S. Treasury at a fixed price of $ 35 per ounce.

The functioning of the fixed exchange rates imposed a degree of discipline on the economic policies of nation participating in the system. For example, a country with expansionary monetary policies leading to a higher rate of inflation than that experienced by its partners would find that its goods have become expensive. As a result exports would reduce and the imports would increase. Thus the country would experience a balance of payments deficit. The effect of this deficit would be an increase in that country's currency in the foreign exchange markets there by depressing the exchange value of that currency. The central bank of the deficit country then had to intervene by buying with its reserves the excess supply of its own currency effectively reducing the domestic money supply and halting the inflationary pressures. Changes in the fixed rates as mentioned above were allowed only in the case of fundamental disequilibrium However, government perceiving the political costs of devaluation were reluctant to act in time. Thus financial crisis were created such as the French Franc Crisis of 1956-58 and problems of the British pound during 1964-68. Then the French and the British authorities had to devalue their currencies to correct the payment imbalances.

Americans were unwilling to sacrifice any of their major economic and political objectives as their economic supremacy waned and other countries, notably West Germany and Japan became economically powerful with surpluses in their balance of payments. As the rate of growth of economy accelerated in the 1960s and unemployment levels fell, the U.S. current account surpluses decreased. At the same time, the U.S. military expenditure abroad (particularly because of the Vietnam War) and investment increased. Thus the U.S. balance of payments produced large deficits. These deficits had averaged $ 1.1 billion per year from 1949 to 1959. During 1960-65, these deficits averaged $ 2 billion per year. In 1970, the U.S. overall balance of payments deficit stood at $ 9.8 billions. The result was a sharp deterioration in the ratio for U.S. reserves to its liquid liabilities; from 2.70 in 1950 to 0.92 in 1960 and 0.31 in 1970. Thus the dollar became vulnerable to speculative attacks, as doubts increased around the world about the country's ability to maintain its currency fixed to gold at the existing parity of $ 35 to one ounce of pure gold.

In 1971, the matters came to a head when President Nixon, as a preparation to the 1972 election, sought to expand U.S. domestic demand generating inflationary forces. Speculation against the dollar mounted. The free market gold price increased sharply. This led several countries to demand conversion of their surplus dollars into gold at the official price of $ 35 per ounce. The USA with $ 10 billion in gold reserves versus liabilities or $ 50 billion in other countries' reserves, decided to suspend convertibility in August 1971 and the US dollar was set free to float.

Because of the anxiety about the international monetary system, a conference of finance ministers was held in December 1971 at the Smithsonian Institute in Washington. The Smithsonian Agreement increased the fixed exchange band spread to 4.5 per cent, thus allowing central banks more room before intervention became necessary. Dollar was formally devalued against gold.

This dollar based international monetary system continue to function further for about an year, when in 1973 another devaluation of the dollar became necessary because of continuing payments deficits. In mid-March 1973, the Bretton Woods system finally collapsed when fourteen major industrial countries abandoned the fixed exchange rates and allowed their currencies to float against the dollar.

At this point, we may briefly mention the three major weaknesses of the Bretton Woods system. The first weakness was that the system did not provide for a systematic means by which world reserves could grow with world trade and the world economy. The world reserves increased partially because of the increased production of gold, but mainly as a result of deficits in the U.S. balance of payments. To the extent that the other currencies held dollars rather than purchase gold from the United States, total gross world reserves increased as a result of the U.S. deficits. Thus the United States took on one major role of a world central bank, fulfilling a function left unspecified in the Bretton Woods Agreement, i.e. the creation of international money. The U.S. balance of payments were necessary to increase international liquidity. But as U.S. liabilities to foreign central banks grew, the confidence in the convertibility of dollars into gold wavered. This problem is called Triffin dilemma, after Robert Triffin (1960) pointed out the difficulty of the existing monetary arrangements.

The second weakness of the Bretton Woods System concerned the balance-of-payments adjustment process. As individual countries faced balance-of-payments deficits, the international community provided credits and advice through the Fund. Exchange rate adjustment was a rare event in industrial countries and when they occurred, they were large and adhoc in response to speculative attacks.

The third weakness was the failure of the system to cope with large disequilibrating capital flows. Interest rates differentials could induce sizeable movements of capital. These could not be controlled without controlling all international transactions thus creating disequilibrating forces.

1.6 FLOATING EXCHANGE RATES : 1971 ONWARDS

In 1973, the world officially turned to floating rates. There were several attempts to bring order in the exchange rates practices. The second amendment in April 1978 following discussions in Rambouillet in France (1975) and Jamaica (1976) provided for the reforms in the international monetary system. As a result, members got a great deal of freedom in the choice of an exchange rate policy. Members may peg, float or manage their currencies to whatever degree they feel as consistent with their own domestic economic policies. The second amendment restricted the role of gold in the international monetary system. The official price of gold was abolished. It was decided that Special Drawing Rights (SDR) should become the primary reserve asset of the international monetary system. The IMF abolished the requirement that members make some payments in gold.

From 1971 onwards, the international monetary system had to go through difficult times. because of some external events such as the oil crisis of 1973-74. Some affected countries experienced balance of payments difficulties. The oil producing and exporting countries and some other countries like Japan and some European countries ended up with balance of payments surpluses which were recycled to debtor countries (thus creating conditions for the debt crisis to follow in 1980s.)

1.6.1 Assessment of Floating Rate System

The impact of floating rates in practice has been to increase uncertainty and misalignment ("overshooting") in foreign exchange markets. Overshooting implies that exchange rates move significantly beyond the equilibrium level. Markets for financial assets, including foreign exchange, react more quickly than markets for goods to financial disturbance or policy changes. Foreign exchange markets tend to be more volatile than other markets. Thus real exchange rate volatility has increased, not decreased since floating began.

Three variables determine the exchange rates; difference in price performance and in interest rates, movement of current account balances, and the expectations about future exchange rates engendered by these variables: There is a growing recognition of the importance of current account balances in influencing exchange rates.

Given this recognition a number of economists have called for a return to fixed exchange rates. They suggest to restrict more tightly the types of monetary and other policies governments can pursue and put a premium on avoidance of current account imbalances. It is argued that this should make expectations less volatile and reduce fluctuations in the real exchange rate.

The present state regarding the exchange rate practices of IMF members includes various alternatives from pegging to floating.

Pegged exchange rates are managed on a day-to-day basis through official intervention in foreign exchange markets. Some countries are pegging their currencies to a group of currencies.

Floating exchange rates are managed less closely. Generally, nations with developed financial markets prefer to float their currencies. However, they do manage their currencies informally or rely on a co-operative exchange rate agreement such as the European Monetary System. Some countries 'lean against the wind' by official interventions to smooth short-term fluctuations in exchange rates. Some countries use target rates or objective indicators to provide signals for a devaluation or a revaluation of their currencies. Table 1.1 shows practice in countries pegging or floating their currencies, as of march, 1995.

Table 1.1 : Exchange rate pegging around the world, 31st March 1995

Sl.No.	Practice	No. of currencies
1.	Currencies pegged to :	
	US dollar	23
	French franc	14
	SDR	3
	Other currency basket	28
2.	Flexibility limited vis-a-vis a single currency	4
3.	Co-operative arrangements	10
4.	Adjusted according to a set of indicators	3
5.	Managed float	35
6.	Independent float	59
	Total	**179**

1.6.2 Special Drawing Rights

In view of the limitations of the dollar (or any other currency), or gold as the international reserve asset, from the later half 1960s, the negotiations over new reserve asset continued. In 1969, the Special Drawing Rights (SDRs) were created The SDRs were allocated to individual member countries by the IMF in proportion to their quotas-rather like a bonus issue of shares in a company. A country holding SDRs may use them to acquire foreign currency by transferring them to another country in exchange for foreign currency.

The value of the SDR is calculated by using a currency basket, which includes currencies of members having the largest exports of goods and services during 1980-84. These include the US dollar, the Deutsch mark, the Japanese yen, the French franc and the pound sterling. The dollar value of the SDR is computed daily by using the average of the buying and selling at mid day on the London foreign exchange markets. In addition to financing outright purchases of foreign currencies, members can now use SDRs in forward and swap transactions and they can donate SDRs or make SDR denominated loans to other members.

Check Your Progress A

1 What do you understand by International Monetary System?

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2 What is Gold Standard and Gold Exchange Standard?

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3 When and Where I.M.F. and the World Bank were set up?

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4 Point out the weaknesses of the Bretton Woods Agreement.

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5 How is the value of SDR calculated?

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1.7 WORLD TRADE AND REGIONALISM

During the 1930s the chaos in world markets, as mentioned earlier, led to an increased use of discriminatory trade policies and de facto formation of trading blocs usually centred around dominant countries, like England, France, Germany. Japan, etc. The first post-war II attempts at regionalism started with the establishment of the European Economic Community (EEC) and European Free Trade Area (EFTA). In 1980s, United States took lead in the formation of the North American Free Trade Area (NAFTA).

There has been a conflicting evidence about the effectiveness of such blocs. They can be a force for growth if they adopt expansionary policies and they can isolate the region from deflationary pressure which may come from the international trading system.

The 1994 GATT (General Agreement on Tariff and Trade)– the signing of the Uruguay round- ended seven years of negotiations and created the new World Trade Organisation (WTO) to promote international trade.

The WTO has come up during the last five years to a remarkable extent with common agreements by the member countries to free the international trade by reducing or completely eliminating tariff barriers as well as doing away with certain non-tariff barriers such as quotas.

In these two aspects the WTO has succeeded to a certain extent primarily out of the desire of the developed countries to find markets and the multinational corporations to increase their sales and financial clout. During the last two decades, developing countries, once wedded to socialist controls have been increasingly opening up their economies by liberalising imports and trying to step up exports to supplement their inadequate domestic savings by earning foreign exchange.

A time-table has been agreed upon by the member countries to reduce the tariffs to the agreed levels. The possible penalty of being expelled from the WTO as well as the danger of the tap for foreign loans being closed by the affluent developed countries as well as international financial institutions have been largely responsible for less developed countries falling into line.

But if the latest Seattle conference of WTO in the U.S.A. is any guide, the progress of the WTO is likely to be in a bumpy and zigzag ride.

As far as finding markets for their manufactured products, financial services and knowledge products of information and entertainment industries are concerned, the developed countries of the West and Japan have been beneficiaries of the arrangements hammered out in various WTO agreements.

However, there has been a sea-change in the patterns of production and trade during the last decades. The capital has become internationally mobile and with free convertibility of currencies can be moved from one country to another at the click of a button.

The international capital is keen to move to low wage developing countries like India, China and South Asian countries, having adequate brain power. Multinational enterprises prefer to set production facilities abroad in developing countries. This has, however, led to reduction in job opportunities in the developed countries. In U.S.A. the problem is quite acute. The U.S.A. has experienced a prolonged period of economic growth, when paradoxically the employment level has not kept pace with the growth rate or even stagnated. With increasing levels of consumption made possible by increased inflow of dollars from abroad, the Americans, who are in a position to do so have been spending while a large mass of population dependent on employment are being pushed into a new 'under-class'. With such dilemmas inherent in the global trade and financial situation the WTO has to reconcile many a contradictory interests.

With tariff barriers going down and quota restrictions removed, the developed countries are seen to depend on ecological laws and humanitarian practices such as prevention of child labour to restrict the exports from developing countries, while the developing countries feel threatened by the proposed labour standards and intellectual property rights legislation. In Seattle, the American president, Clinton, was seen openly supporting the claims of the organised labour and other N.G.Os for labour standards. This resulted in the break-down of negotiations at Seattle, though the optimists believe that at the next Geneva conference, compromises will be hammered on many troublesome issues.

There is reason to believe that optimists may well be right as the penalties not making the WTO a going entity are too horrible to think of. With the U.N.

sponsored initiatives in Kosova and East Timor, it is now certain that the concept of national sovereignty as known in the past has been in retreat and the intervention by multinational agencies, such as IMF, World Bank, U.N. or WTO has gained legitimacy albeit backed by the mighty military power of the U.S.

Despite such bouts of pessimism, freer trade and WTO hold the future. Ricardo, the nineteenth century economist would be vindicated in 21st century.

1.8 EUROPEAN MONETARY SYSTEM

The European Monetary System (EMS) was created by the countries in the European Union (EU) to establish a zone of exchange rate stability and with a view to encourage trade and growth, so that integration of economic policies in the EU would be speeded up.

The main feature of the EMS is the operation of its exchange rate. The European Currency Unit (ECU) is the basket of fixed amounts of EU currencies. Thus ECU represents a weighted average of market exchange rates of EU currencies with weights being the proportions of fixed amounts of currencies in the basket. If economic fundamentals changed, the weights could be changed by official action. The value of the currency of a particular country and its weight would fluctuate thus with market exchange rates.

The ECU is a numeric of the Exchange Rate Mechanism. It is also used for settlements between central banks within the EU. It is also a unit of account for official EU business and is used frequently as a currency of denomination in the international credit and bond markets. Some EU countries also issue domestic treasury bills in ECUs.

1.8.1 The Exchange Rate Mechanism

The EMS, to achieve stability through co-ordinated exchange rate management depended on the Exchange Rates Mechanism. The Exchange Rate Mechanism (ERM) is a system of flexible exchange rates. The participant countries in the exchange rate mechanism would keep the value of their currencies within margins of 2¼ per cent on either side of the central rates against the other countries in the ERM. The British sterling, the Spanish peseta joining later on were allowed margins of 6 per cent upwards or downwards. If these ceilings or floors were likely to be breached, the ERM countries had to intervene in the foreign exchange markets. Thus if the sterling fell to its floor within the system, the Bank of England would be required to buy pounds and/or sell other currencies to maintain the value of sterling against the exchange rates of other European countries. Other countries would also intervene, on behalf of the weak currency, to prop it. The country whose currency was under pressure, could also raise its short-term interest rates to make it more attractive to investors. If both the interventions in the foreign exchange market as well the interest rate adjustment failed, to prevent the currency from going outside its floor or the ceiling, the central rates would be realigned to relieve the tensions. Initially there were realignments, but from 1987 to the massive tension in 1992, there were none. It was argued that the failure of other currencies in the ERM to realign in response to the increasing strength of the Deutche mark brought the system to the verge of the breakdown.

1.8.2 European Monetary Union

The linking of currencies together by the countries in ERM is along a broad spectrum. At one end, there is very little linkage with little sacrifice of the independence of the country's monetary policy. On the other end of the spectrum, the independence is given up altogether. In 1989, a committee headed by Jacques Delors recommended three stages in which countries can achieve the goal of monetary union by moving from one end of the spectrum to another. The ultimate goal was to replace national currencies by a single EU currency managed by a sole central bank operating on behalf of all EU members.

Leaders of the EU countries met at Maastricht in Netherlands on 10th December 1991. The treaty of Rome was amended to provide for calling of the stage two of the Delors plan on Ist January 1994 and starting the stage three not later than Ist January 1999. Certain steps to harmonise social policies within the EU (such as workplace safety, consumer protection) were taken. Steps were also taken towards centralising foreign and defence policy decisions. Certain criteria were laid down for individual countries before moving to the stage three, regarding interest rates, budget deficits (below 3 per cent of the GNP), national debt (not to exceed 60% of the GNP. etc.)

Despite this agreement at Maastricht, many European nations viewed the treaty with scepticism. There was a doubt whether it was wise to give up control over national economic polities. The Maastricht Treaty would not come into force unless all EU countries ratified it. In June 1992, the Danish voters rejected it. This rejection raised legal problems about the Maastricht accord, because it required unanimous approval of EU countries. With expectations about the French refusal to ratify the Maastricht Treaty, speculative attacks started on week currencies which were expected to devalue. The Finish markka and the Swedish krona were first to be attached by currency speculators. They were not yet members of the ERM, but had pegged their currencies to the ECU. Markka depreciated steeply against the ECU. The Swedish Central Bank, the Riksbank allowed interest rates on call loans to reach 500 per cent per annum. Thus speculation in krona died down.

However speculation against the British pound and the Italian Lira continued. By Friday, 11th September 1992, the Bundesbank, the German Central Bank, had spend $ 16 billion in supporting the lira by buying the lira. However it was reluctant to do anything more. Next week, Italy devalued its currency by 7 per cent against the ECU. The foreign exchange market speculators expected that similar attacks on other ERM currencies might succeed. In addition, certain remarks by the Bundesbank president regarding the necessity of currency realignment sparked off a speculative attack on the pound and the lira. On 16th September 1992, a day known as the Black Wednesday now, the pound was allowed to float after the Bank of England lost several billion dollars in unsuccessfully defending it. Italy took the lira out of the ERM rather than lose more reserves. Spanish peseta was devalued and the Spain reimposed exchange controls. The French franc also came under attack when speculators started selling francs, which would have breached the floor of the ERM band, but for the massive intervention by the Bank of France and the Bundesbank in addition to a sharp rise in interest rates. After this turbulent week, French voters narrowly ratified the Maastricht Treaty on 20th September and EMU got another chance.

1.8.3 German Unification

The tensions which led to the possibility of the collapse of the EMS were mainly due to the economic disturbance caused by the reunification of the East and West Germany. East German wages moved upwards as the result of the parity everywhere in the country. The result was the high unemployment and fall in output in East Germany. The West Germany had to transfer above 5 per cent of its income to the East to renovate the capital stock and the support the unemployed workers. The heavy borrowing by the German Government increased fiscal deficit and created inflationary pressures. The pent-up demand of East Germans for goods and services further stocked the inflation. The Bundesbank, the Central Bank of Germany, tightened monetary controls and raised the interest rates steeply.

This created a problem for ERM partners of Germany. Should they tighten their own monetary policies to maintain the ERM rates? Or should they devalue their currencies against the mark to stimulate demand for their products? The ERM countries allowed their interest rates to rise to avoid devaluation. Already, the slow down of economic activity in the USA had resulted in the real depreciation of the dollar. Thus the world demand moved away from the European goods towards American goods. However the defence of the EMS exchange rates vis-a-vis dollar deepened the European recession. One solution to the problem would have been for Germany to lower its lending rates, but the Bundesbank, an independent central bank whose prime duty is to monitor the domestic monitor policy refused to do so for fear of inflation at home.

Thus currency upheavals continued through 1992 and 1993. There were repeated speculative attacks on weak ERM currencies. However the Bundesbank remained inflexible. Some critics say that the Bundesbank wanted to claim for the central bank status in the EMS, and thus deliberately tried to weaken the claims of London or Paris.

On 31st May 1995, the European Commission prepared a blueprint for achieving the shift to a single currency. The transition towards the adoption of the ECU as the new currency of legal tender (to be called Euro) was to be achieved in three stages.

Stage I : One year's period to participating countries to lock their exchange rates.

Stage II : Fixing of parities by the European Central Bank and beginning of the operation of a single monetary policy.

Stage III : The final change over to the new currency with passing out of participating countries' own national currency and the ECU becoming the sole tender. The beginning of 1999 saw the introduction of Euro as limit of account. By 2001 EMU would introduce Euro-bank notes and coins.

1.8.4 The Prospect

The ERM is now operating, with wide bands of currency movement for participating countries (mainly plus or minus 15 per cent). Thus breaking up of exchange rates of the ERM members is virtually non existent. The German and the Dutch exchange rates (the strong currencies among them) remain in a movement towards a common European currency. With Austria joining in, a common European currency would materialise with its possible adoption by other European countries. Britain, because of its cultural problems and the goals of its political elite would possibly remain outside in the first wave towards common currency. But it is hoped that it would eventually join the European mainstream not to be left behind losing the advantages of the European Monetary Union.

1.9 INTERNATIONAL FINANCIAL SYSTEM AND DEVELOPING COUNTRIES

Taking a broader view of Post-World War II years, it can be said that since 1980s there has been a general easing of restrictions in the international trade and finance policies. Firstly, residents can borrow freely in international financial markets and non-residents invest in domestic financial markets. Secondly, residents transfer capital and hold financial assets abroad. Non-residents issue liabilities and borrow in domestic financial markets. Thirdly, domestic transactions, such as bank deposits and lending are allowed in foreign currencies.

Even though official restrictions and regulations try to decide the degree of this financial openness, these are seldom implemented because financial institutions are underdeveloped, many financial transactions take place in informal 'curb' markets, and a number of specific factors, (such as, high earnings from tourism and remittances, the so-called invisible exports, the presence of multinational corporations, the proximity to hard currency areas in the case of Latin American countries) can facilitate financial transfers.

The first wave of liberalisation in developed countries allowed the private sector to borrow abroad. In most countries such as Philippines, Brazil, Chile, South East Asian countries, there was a massive build-up of foreign exchange liabilities by private corporations leading to the subsequent debt crisis and payment difficulties. The entry of foreign banks and the access of non-residents to national equity markets has been encouraged in the context of privatisation programmes. In highly indebted developing countries this has generated opportunities for speculation and windfall profits for a handful of operators in creditors and debtor nations. The effect of foreign currency deposits has increased the importance of foreign currency in domestic monetary system encouraging currency substitution and dollarisation of the economy.

It can be safely said that financial openness and internationalisation of finance has allocated resources internationally and led to faster economic growth of a number of countries. Rapid dissemination of information, increased ease of market access and a great reduction in transaction costs have equalised returns on various assets denominated in the same currency. However, returns on assets denominated in different currencies are not equalised (as indicated by the differentials between forward exchange rates and future spot rates). Thus the evidence so far strongly suggests that speculation is predominant in the determination of exchange rates. This destabilises the whole system.

Increased financial openness and dismantling barriers to capital flows have strengthened the links between financial markets around the world, but has weakened the degree of political autonomy of individual countries. Political autonomy refers to the ability of national policy makers to control national policy goals by using the monetary and fiscal policy instruments available. The loss of political autonomy is greatest in the case of less developed countries with high financial openness.

It should as well be said that the loss of autonomy does not always undermine national policy goals. In a financially open economy, fiscal stimulae tend to leak abroad thus attracting capital inflows. The ability to attract capital through financial policies can avoid taking deflationary actions such as tightening monetary policies, at times of serious external payments difficulties. However, there is a great deal of uncertainly as to the final outcome. The response of international financial markets cannot be correctly predicted. The realisation is growing that this uncertainty and the loss of control over the national economies cannot be overcome by the uncoordinated actions of individual countries. These problems can be tackled only by the collective action involving management of international money and finance.

1.9.1 The Asian Currency Crisis (1997)

Various reasons are advanced for the Asian currency crisis, such as going too fast or liberalising too much. The one factor common to all countries was the financial panic that spilled across national boundaries. The problem started in Thailand, which had a fixed exchange rate against the dollar. So had Malaysia. So when the dollar strengthened after 1995, this pulled up the Thai baht and Malaysian ringitt also adversely affecting their export competitiveness. Thailand's current account deficit jumped to 8 per cent of the GDP (gross domestic product). This created incentives for banks and finance companies to borrow dollars at low interest rates abroad and re-lend the money locally at high interest rates. Thus Thailand and Malaysia used dollars to finance a domestic boom, which took the bank credit to 150 per cent of GDP. If export-oriented industries had been financed by dollars, that would have led to the real growth in GDP. However, the flood of dollars was channalised by foreign bankers into real estate creating a property boom. Properties were held as collateral against foreign exchange loans.

When the property bubble burst, prices crashed. The collateral was insufficient to recover the loans. In the meantime, Thailand used up its bulk of the foreign exchange reserves to prop up the exchange rate. It proved unsuccessful and the baht floated, losing its value in dollars.

The IMF package could not reverse the trend. The history shows that in Thailand, Indonesia and Korea the currency plunge actually worsened after the IMF packages. Suddenly the confidence in the Asian miracle was replaced by blind panic, which spread from Thailand, Malaysia, Philippines and Indonesia. Japan was also affected.

Indonesia had only a modest trade deficit and modest lending boom. But the financial system was extremely weak. Loans were dictated by connections, or name-lending rather than sound appraisal and follow-up practices. The relatives of President Suharto, who had been continuously ruling for the last three decades were major beneficiaries of the so called (much praised by Americans and Europeans) "Asian value" or "quanxi" system where people depend on informal networks, friendly contacts, family values of obedience to the head of family, relative absence of formal contracts and less reliance on legal enforcement machinery etc. Foreign lenders thought that any loan to a Suharto relative had the Government guarantee. Peregrine, a Hong Kong based merchant banking company, loaned $ 270 million to a company simply because one of the owners was a Suharto. Peregrine busted later on.

In Korea, the "chaebol" system was considered mainly responsible for the South Korean miracle. Businessmen had little money of their own, so the government directed enormous amount of bank credit to favoured "chaebols" (business conglomerates) to enable them to build empires. The debt equity ratios were at times one thousand to one. Such highly leveraged business houses were extremely vulnerable to adverse economic conditions.

Indian analysts have patted our own backs in not having the fixed exchange rate against the dollar, keeping the current account deficit down, (1.5 per cent of GDP as against 8 per cent in Thailand), not allowing banks and finance companies to borrow in dollars and re-lending in local currencies, recording all foreign debt, especially short-term debt, having properly audited accounts for companies, not having too high debt-equity ratios for companies, etc. However, with all the restrictions India has not managed to grow as fast as South Asian countries. India shows a per capita income of $ 320 as compared to $ 3000 in Thailand and $ 10,000 for Korea. It appears that the quality of corporate governance and management of financial institution and banks in India needs to be improved much further. Financial markets need to be effectively administered. Till then we need capital controls thus inhabiting the flow of foreign direct investment.

1.10 REGIONAL FINANCIAL INSTITUTIONS

Development Banks may operate at national, regional or international level. They not only provide finance but also help in project development. The world bank and International Finance Corporation (IFC) operate at international level. During seventies and eighties a tendency was noticed among countries to concentrate on regional cooperation. During this period many development banks were set up at regional level.

1) **Asian Development Bank :** A multinational development finance institution was founded in 1966 by 31 member governments to promote the social and economic progress of Asian and Pacific region. The Bank gives special attention to the needs of the smaller or less-development countries and priority to regional, subregional and national projects and programmes. The Bank's principal functions are (i) to extend loans and equity investments for the economic and social development of its developing member countries, (ii) to provide technical assistance for the preparation and execution of development projects and programmes and for advisory services (iii) to promote and facilitate investment of public and private capital for development purposes and (iv) to respond requests for assistance in co-ordinating development policies and plans of its developing member countries. The two largest shareholders of the Bank as on 31st December 1997, were Japan and United States, each accounting for 16 per cent of total subscribed capital. Forty-one regional members accounted for 63 per cent of total shareholdings, while 16 non-regional members contributed 37 per cent of total. The Bank's operations cover a wide spectrum of activities and have been classified according to the sectors : (i) agriculture and natural resources, (ii) energy, (iii) industry and non-fuel minerals. (iv) finance, (v) transport and communication, (vi) social infrastructure and combination of some of the sectors (i) and (vi).

2) **African Development Bank :** The African Development Bank (ADB) is a regional multilateral development bank, engaged in promoting the economic development and social progress of its Regional Member Countries (RMCs) in Africa. The Bank was established in 1964. It started functioning in 1966 with its Headquarters in Abidjan, Cote d'Ivoire. Its shareholders are the 53 countries in Africa as well as 24 countries in the Americas, Europe, and Asia. The Bank's principal functions are : (i) to make loans and equity investments for the economic and social advancement of the RMCs; (ii) to provide technical assistance for the preparation and execution development projects and programs; (iii) to promote investment of public and private capital for development purposes: and (iv) to respond to requests for assistance in according development

policies and plans of RMCs. In its operations, the Bank is also required to give special attention to national and multinational projects and programs which promote regional integration. The financial resources of the Bank consist of ordinary capital resources, comprising subscribed capital, reserves, funds raised through borrowings, and accumulated net income. The Bank's authorised capital amounted to US$ 23.29 billion at the end of 1996. The ADB's capital is subscribed such that RMCs hold two-third of total subscribed capital, and non-regional members hold one-third. The Bank has borrowed funds for its ordinary operations from the international money and capital markets. The Bank's callable capital backs its borrowings in the capital markets. The Bank's operations cover the major sectors, with particular emphasis on agriculture, public utilities, transport, industry, the social sectors of health and education, and concerns cutting across sectors, such as poverty reduction, environmental management, gender mainstreaming, and population activities. Most Bank financing is designed to support specific projects. However, the Bank also provides program, sector, and policy-based loans to enhance national economic management. The Bank also finances nonpublicly guaranteed private sector operations. The Bank actively pursues co-financing activities with bilateral and multilateral institutions.

3) **European Investment Bank :** The European Investment Bank (EIB) offers funds for certain public and private projects in European and other nations associated with the common market. It emphasizes loans to lesser-developed regions in Europe and to associated members in Africa.

4) **Inter-American Development Bank :** The Inter-American Development Bank (IADB) the oldest and largest regional multilateral development institution was established in December 1959 to help accelerate economic and social development in Latin America & the Caribbean. It is one of the key source of long term capital in Latin America. It lends to joint ventures, both minority and majority foreign owned.

5) **Atlantic Development Group for Latin America :** It an international private investment company dedicated to the development in Latin American.

6) **Arab Fund for Economic and Social development (AFESD) :** AFESD is restricted to Arab League countries. The AFESD is an Arab regional financial institution, having an independent juridical personality. Its objectives are to assist member countries in eliminating development constraints, increasing absorptive capacity and achieving higher rates of growth; and to foster economic integration and cooperation among member countires. Its function is to assist the economic and social development of Arab counties through; (1) financing economic and social development projects, with preference given to overall Arab development and to joint Arab projects; (2) financing private sector projects in member states by providing all forms of loans and guarantees to corporations and enterprises possessing juridical personality and participating in their equity capital, as well as providing other forms of financing and furnishing the requisite financial, technical and advisory services; (3) forming or participating in the equity capital of corporations possessing juridical personality for the implementation and financing of private sector projects in member states, (4) establishing and administering special funds whose purpose in compatible with that of the

Arab Fund, and whose resources are provided by the Fund or other sources; (5) encouraging the investment, directly or indirectly, of private and public capital in a manner conducive to the development of the Arab economy; and (6) providing expertise and technical assistance in the various spheres of economic development.

7) **European Bank for Reconstruction and Development :** EBRD was established in 1991. It exists to foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative in the countires of central and eastern Europe and the commonwealth of independent States (CIS) committed to and applying the principles of multiparty democracy, pluralism and market economics. It seeks to help in 27 counties of operation to implement structural and sectoral economic reforms, promoting competition, privatisation and entrepreneurship, taking into account the particular needs of countries at different stages of transition. Through its investments it promote private sector activity, the strengthening of financial institution and legal systems and development of the infrastructure needed to support the private sector. The Bank applies sound banking and investment principles in all of its operations. In fulfilling its role as a catalyst of change, the Bank encourages co-financing and foreign direct investment from public and private sectors helps to mobilise domestic capital and provide technical cooperation in relevant areas. It works in close cooperation with international financial institutions and other international and national organisations.

Check Your Progress B

1 What is WTO and GATT?

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2 Why EMS was created? What is its purpose?

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3 Which countries are members of EU?

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4 Which Asian countries faced currency crisis in 1997?

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1.11 LET US SUM UP

The international monetary system consists of the institutions, laws, rules, instruments and procedures for payments made and received for international transactions. Before 1914, the international monetary system that operated was called Gold Standard System. Two major assets — gold and sterling were accepted in settlement of international debt under gold standard system. Central bank was obliged to give gold in exchange of its currency presented to it. In 1925, Gold Exchange Standard was adopted. Under this system, central banks of individual countries exchanged home currency for the currency of some other country on the gold standard rather than gold itself. Until the second world war most countries adopted fluctuating exchange rates, while others adopted strict exchange controls. In 1944, at Bretton Woods by an agreement among nations, IMF and the World Bank were set up. The former dealt with short term aspects of economic activity, whereas it was to look the problem of long-term development of international economy. Under this agreement, fixed exchange rate system was adopted and the US dollar became the measurement of new monetary order. But this also did not work. In 1973, the world officially again turned to floating rates.

Due to shortage of international liquidity because of pressure on U.S. Dollar, in 1969 a new international reserve asset, called SDR, by IMF was created. Its value is based on basket of five major currencies. In 1973, the Bretton Woods Era formally crumbled when fourteen nations decided to float their currencies. Now-a-days many countries have floated their currency. Some countries have fixed the value of their currency either to US dollar or Franc or against SDR.

In 1979 European Monetary System was created by European Union countries. The objectives of EMS were to establish a zone of exchange rate stability to encourage trade and growth and to integrate common economic policies within EU. The reunification of East and West Germany in 1990 created an economic disturbance that affected EMS. On 1.1.1999, eleven European countries of Economic and Monetary Union (EMU) took a historic step with the launch of a new currency - the Euro. These countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Portugal and Spain. Later U.K. also joined it. Some E.U. member countries have not joined EMU. The latest event of this century was Asian Currency crises. The currency crisis occurred in Thailand, Malaysia, Phillipines and Indonesia.

1.12 KEY WORDS

Adjustable peg (or fixed exchange rates) : An international monetary system under which exchange rates of different currencies are fixed / pegged but adjustable under some circumstances. The International Monetary Fund maintained such a system for almost two decades after World War II.

Balance of payment : The difference between a country's payments to foreigners, and its receipts from foreigners reflecting all of the international economic transactions of a country and its citizens during a particular time period.

Balance of trade : The portion of a country's overall balance of payments consisting of exports and imports. A balance of trade surplus, often referred to as a 'current account surplus' or a "favourable" balance of trade, exists when exports exceed imports. There is a balance of trade/current account deficit, when the reverse is true.

Balance of payments disequilibrium : A balance of payments surplus or deficit that cannot persist indefinitely.

Capital account : That part of the balance of payment consisting of the purchase and sale of assets. India typically invests less abroad than foreigners invest in India creating a surplus in India's capital account.

Crawling peg : A proposed foreign exchange system in which frequent and automatic small adjustments in the par value of a currency would occur as that currency's market value persistently presses against the "floor" or "ceiling" of allowable exchange rates. Mini devaluation.
Currency : Coins or paper money.

Deflation : A statistical adjustment of nominal values to express those values in terms of base year prices. Also a decline in the general price level (the opposite of an inflation).

Devaluation : An official reduction in the par value of a currency.

Exchange controls : Controls that limit the access of individuals and firms to foreign exchange markets.

Exports : Sale of domestically produced goods and services to the rest of the world.

Flexible or floating exchange rates : Foreign exchange rates that are determined in a free market by the interaction of supply and demand.

Gold Standard : An international monetary system in which each nation's currency is defined in terms of a fixed 'weight of gold with gold bullion used to clear international payments imbalances.

International Monetary Fund (IMF) : The international organisation that has administered the international monetary system since the Bretton Woods Conference in 1944.

WTO-World Trade Organisation : A new organisation that thus replaçed GATT (General Agreement of Trade and Tariffs), both an agreement and organisation, whose basic objective is to promote free multi-lateral trade from January 1955.

1.14 TERMINAL QUESTIONS/EXERCISES

1 Is a floating-rate system move inflationary than a fixed rate system? Explain.

2 Comment on the following statement : "A system of floating exchange rate fails when governments ignore the verdict of the exchange markets on their policies and resort to direct controls over trade and capital flows."

3 Has speculation failed to smooth exchange rate movements?

4 What were the basic weaknesses of the Bretton Woods System?

5 Suppose nations attempt to pursue independent monetary and fiscal policies, how will exchange rates behave?

6 What lessons can would you draw from the breakdown of the Bretton Woods System?

7 What lessons can economists draw from the exchange rate experiences of the European Monetary System?

8 In spite of official party between the Deutschmark and the Ostmark, the black market rate in early 1990 was about ten Ostmarks for one Deutschmark. What problems might have arisen in setting the exchange rate at one Ostmark for one DM for Germany.

9 What lessons India can draw from the South Asian Currency Crisis?

10 Do you think W.T.O. has succeeded in its achieving its objectives? Point out its achievements and failures.