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Reserve currency Throughout history, precious metals such as gold and silver have been used for trade, sometimes in the form of bullion , and from early history the coins of various issuers â€" generally kingdoms and empires â€" have been traded. The earliest known records of pre-coinage use of precious metals for monetary exchange are from Mesopotamia and Egypt, dating from the third millennium BC. At that time, forms of money were also developed in Lydia in Asia Minor , from where its use spread to nearby Greek cities and later to many other places. For example, scholars have tentatively suggested that the Roman king Servius Tullius created a primitive monetary system in the early history of Rome. Tullius reigned in the sixth century BC - several centuries before Rome is believed to have developed a formal coinage system. But by about the 4th century BC coins were widely used in Greek cities. They were generally supported by the city state authorities, who endeavoured to ensure they retained their values regardless of fluctuations in the availability of whatever base or precious metals they were made from. Coins were in use in India from about BC; initially they played a greater role in religion than in trade, but by the 2nd century[ clarification needed ] they had become central to commercial transactions. Monetary systems that were developed in India were so successful that they spread through parts of Asia well into the Middle Ages. In Venice and the other Italian city states of the early Middle Ages, money changers would often have to struggle to perform calculations involving six or more currencies. This partly led to Fibonacci writing his Liber Abaci which popularised the use of Indo-Arabic numerals , which displaced the more difficult Roman numerals then in use by western merchants. When a given nation or empire has achieved regional hegemony , its currency has been a basis for international trade, and hence for a de facto monetary system. This was succeeded by Roman currency of the Roman Empire , such as the denarius , then the Gold Dinar of the Ottoman Empire, and later â€" from the 16th to 20th centuries, during the Age of Imperialism â€" by the currency of European colonial powers: With the growth of American power, the US dollar became the basis for the international monetary system, formalised in the Bretton Woods agreement that established the postâ€"World War II monetary order, with fixed exchange rates of other currencies to the dollar, and convertibility of the dollar into gold. The Bretton Woods system broke down, culminating in the Nixon shock of , ending convertibility; but the US dollar has remained the de facto basis of the world monetary system, though no longer de jure[ dubious â€" discuss ], with various European currencies and the Japanese yen also being prominent in foreign exchange markets. Since the formation of the Euro , the Euro has also gained use as a reserve currency and a medium of transactions, though the dollar has remained the most important currency. A dominant currency may be used directly or indirectly by other nations: Until the 19th century, the global monetary system was loosely linked at best, with Europe, the Americas, India and China among others having largely separate economies, and hence monetary systems were regional. European colonization of the Americas , starting with the Spanish empire, led to the integration of American and European economies and monetary systems, and European colonization of Asia led to the dominance of European currencies, notably the British pound sterling in the 19th century, succeeded by the US dollar in the 20th century. Some, such as Michael Hudson , foresee the decline of a single base for the global monetary system, and the emergence instead of regional trade blocs ; he cites the emergence of the Euro as an example. See also Global financial systems , world-systems approach and polarity in international relations. It was in the later half of the 19th century that a monetary system with close to universal global participation emerged, based on the gold standard. History of modern global monetary orders[ edit ] The pre WWI financial order: From the to the outbreak of World War I in , the world benefited from a well-integrated financial order, sometimes known as the "first age of globalisation". In the absence of shared membership of a union, transactions were facilitated by widespread participation in the gold standard , by both independent nations and their colonies. In contrast to the Bretton Woods system, the preâ€”World War I financial order was not created at a single high level conference; rather it evolved organically in a series of discrete steps. The Gilded Age , a time of especially rapid development in North America, falls into this period. Between the World Wars: The years between the world wars have been described as a period of "de-globalisation", as both international trade and capital flows shrank compared to the period before World War I. During World War I, countries had abandoned the gold standard. Except for the United States, they later returned to it only briefly. By the early s, the prevailing order was essentially a fragmented system of floating exchange rates. To protect their reserves of gold, countries would sometimes need to raise interest rates and generally follow a deflationary policy. The greatest need for this could arise in a downturn, just when leaders would have preferred to lower rates to encourage growth. Economist Nicholas Davenport [9] had even argued that the wish to return Britain to the gold standard "sprang from a sadistic desire by the Bankers to inflict pain on the British working class. In contrast to Great Britain in the previous era, capital exports from the US were not countercyclical. As the Great Depression intensified in , financial institutions were hit hard along with trade; in alone, US banks collapsed. According to economist John Maynard Keynes , another factor contributing to the turbulent economic performance of this era was the insistence of French premier Clemenceau that Germany pay war reparations at too high a level, which Keynes described in his book The Economic Consequences of the Peace. The Bretton Woods Era: The objective was to create an order that combined the benefits of an integrated and relatively liberal international system with the freedom for governments to pursue domestic policies aimed at promoting full employment and social wellbeing. The plan involved nations agreeing to a system of fixed but adjustable[ clarification needed ] exchange rates so that the currencies were pegged against the dollar, with the dollar itself convertible into gold. So in effect this was a gold â€” dollar exchange standard. There were a number of improvements on the old gold standard. A key part of their function was to replace private finance as a more reliable source of lending for investment projects in developing states. At the time the soon to be defeated powers of Germany and Japan were envisaged as states soon to be in need of such development, and there was a desire from both the US and Britain not to see the defeated powers saddled with punitive sanctions that would inflict lasting pain on future generations. A system of capital controls was introduced to protect countries from the damaging effects of capital flight and to allow countries to pursue independent macro economic policies [12] while still welcoming flows intended for productive investment. Keynes had argued against the dollar having such a central role in the monetary system, and suggested an international currency called bancor be used instead, but he was overruled by the Americans. Towards the end of the Bretton Woods era, the central role of the dollar became a problem as international demand eventually forced the US to run a persistent trade deficit, which undermined confidence in the dollar. This, together with the emergence of a parallel market for gold in which the price soared above the official US mandated price, led to speculators running down the US gold reserves. Even when convertibility was restricted to nations only, some, notably France, [13] continued building up hoards of gold at the expense of the US. Eventually these pressures caused President Nixon to end all convertibility into gold on 15 August This event marked the effective end of the Bretton Woods system; attempts were made to find other mechanisms to preserve the fixed exchange rates over the next few years, but they were not successful, resulting in a system of floating exchange rates. The current era has seen huge and turbulent flows of capital between nations. An alternative name for the post Bretton Woods system is the Washington Consensus. While the name was coined in , the associated economic system came into effect years earlier: Generally the industrial nations experienced much slower growth and higher unemployment than in the previous era, and according to Professor Gordon Fletcher in retrospect the s and 60s when the Bretton Woods system was operating came to be seen as a golden age. On the positive side, at least until investors have frequently achieved very high rates of return, with salaries and bonuses in the financial sector reaching record levels. The "Revived Bretton Woods system" identified in [ edit ] International monetary systems over two centuries [16] Date.

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After the abandonment of gold standard and chaotic international monetary conditions during the inter-war period, the need was being felt to evolve a more efficient and effective world monetary system. In , the representatives of 44 countries met at Bretton Woods, New Hampshire in the United States for creating the framework of the international monetary system. The conference at Bretton Woods outlined certain principles as the guidelines for operating the world monetary system. Only in the event of a fundamental disequilibrium in the BOP would a country be expected to change its exchange rates. Thus Bretton Woods meet sought to combine certain features of the old gold standard with a greater degree of flexibility and some measure of control over international liquidity. The expectation and objective at the Bretton Woods was to create a new system that would avoid the undesirable aspects of the old system while retaining its best features. The things that were to be avoided included rigidity of exchange rates and associated deflationary adjustment mechanism of the gold standard, the instability of the freely floating exchange rates, conflicts of national economic policies, competitive exchange depreciation and the repressive and distorting techniques of exchange controls. The features, on the other hand, that were to be retained included stability of gold standard, easy adjustment mechanism, market freedom of floating rates, the discretionary control over market forces of the flexible rate system and the selective use of controls. In order to accomplish these objectives, new practices and institutions had to be devised. It was a compromise between the British plan put forward by Keynes and the American counter-plan put forward by Dexter and White. While the former was for the creation of an international clearing union, the latter was for a less ambitious stabilisation fund. The IMF started functioning in March, with a membership of 30 countries. At present, its membership has gone upto  The IMF had two specific objectives of overseeing that the member countries followed a set of agreed rules of conduct in international trade and finance and of providing borrowing facilities for the member countries to tide over their BOP difficulties. Such borrowings were to be repaid within a period of three to four years. Each member country was assigned a quota on the basis of its economic importance and the volume of its international trade. The US quota was the largest in at 21 percent, followed by 7 percent each for the U. The member country on joining was to pay 25 percent of its quota in gold and remainder in its own currency. The member country could borrow 25 percent of its quota in one year upto a total of percent of its quota over a period of 5 years. The first 25 percent of its quota, called gold tranche, could be borrowed almost automatically without any restriction or condition. For further borrowing in the subsequent years, called credit tranche, the higher interest rates are charged and the IMF imposes more supervision and conditions to ensure that the deficit nation was taking appropriate measures to eliminate the BOP deficit. As regards repayments, these were to be made within a period of 3 to 5 years. Under the Bretton Woods System, the gold exchange standard was introduced. Other nations were required to fix the price of their currencies directly in terms of dollars and indirectly in terms of gold. The exchange rate could fluctuate within plus or minus 1 percent around the agreed par value. The member countries could intervene in the exchange markets to prevent the fluctuation beyond the permissible limit. With the allowed band of fluctuation, the rate of exchange was determined by the forces of demand and supply. It is clear that Bretton Woods System ushered in an adjustable peg system of exchange rate that combined the stability of fixed exchange system with greater flexibility than was allowed under the gold standard. The Bretton Woods System envisaged the removal of all restrictions on the full convertibility of the currencies of member countries into currencies of one another or into dollar. The member countries were expected not to impose additional trade restrictions. The existing trade restrictions were to be removed gradually through multilateral negotiations. The restrictions on the international liquid capital flows were, however, permitted to enable the member countries to protect their currencies against large destabilizing, international money flows. Since the IMF could provide assistance to the member countries only for tackling the temporary BOP deficit, the amounts obtained from it were to be repaid within a short period of 3 to 5 years. This provision was considered necessary so that the IMF funds should not get tied up for long periods. Subsequently, International Development Association IDA was established in to provide concessional development assistance to the poorer countries. Another affiliate of the World Bankâ€” International Finance Corporation was established in to stimulate private investments in the developing countries from the indigenous and foreign sources. During this period, there were conditions of relatively free trade, a rapid expansion in trade and capital mobility. There was very little inflation or unemployment in the major industrial countries. Breakdown of the Bretton Woods System: No doubt the system worked fairly well until the mid but the system had some in-built weaknesses and contradictions, under the pressure of which, it eventually broke down on 15th August The main factors that led to the collapse of this system were as follows: For the continued economic expansion, it was essential for the United States to maintain this deficit as it was the only way through which the growth of international reserves could be sustained in the absence of any other reserve asset including gold. In the event, the USA continued to run bigger and bigger deficits while its gold assets remained constant. Britain faced in a continuing BOP deficit and dwindling official reserves creating the expectations of devaluation of pound. The outflow of funds from England put pressure upon the pound sterling and led eventually to the devaluation of pound sterling in November A similar episode occurred in Such an expectation resulted in an almost embarrassing accumulation of reserves due to large scale inflow of foreign funds to that country. France particularly suffered a huge outflow of funds and to protect Franc, the French government imposed stringent exchange controls. But ultimately storm could be weathered only after there was upward readjustment of Mark and downward adjustment of Franc. It was argued that the Bretton Woods System gave rise to the seigniorage of the United States over other countries, since dollar became the international reserve currency that conferred some undue privilege upon the Americans. The question of seigniorage arose because the United States was the issuing country of dollar. As and when it required dollar, it could issue more dollars. On the other hand, another country that wanted to increase its holding of dollars could do so only by creating an export surplus i. The central bank of the United States could obtain a much higher rate of return for dollars from the foreigners than what it could obtain in the home country. The existence of seigniorage was the cause of irritation among some of the countries including France. This factor, in the long run, undermined the Bretton Woods System. From the long run point of view, a serious weakness in the Bretton Woods System was the absence of an efficient balance of payments adjustment mechanism. No country can afford to have a persistent BOP deficit. The principal types of adjustment mechanism include adjustment through changes in relative incomes, through relative price changes, through the movements in exchange rates and through the imposition of direct controls over foreign transactions. The Bretton Woods System almost prohibited the use of direct controls. So the crucial issue was to determine whether the disequilibrium was temporary or fundamental. The operational difficulty had been the timely recognition of the presence of fundamental disequilibrium. There was a general tendency among the member countries of IMF to resist changing the par value of the currency. Devaluation was often opposed on the ground that it amounted to the acceptance of the failure of government policies and also on account of loss of national prestige. The upward revaluation was frequently opposed by the export industries of the surplus countries. The alternative adjustment mechanism through changes in prices and incomes was found to be in conflict with the domestic goals of full employment and price stability. The adjustment through quantitative controls was opposed on account of possible distortion of resource allocation and reduction in economic efficiency. In such circumstances the countries adopted wait-and-see policy rather than taking a decisive and speedy action for BOP adjustments. The undue delay led to an aggravation of maladjustment and deepening of the BOP crisis. A serious inbuilt contradiction in the system was exposed by Triffin as early as The latter alternative could only cause the crisis of confidence. The existence of this dilemma clearly showed that the system was inherently unstable and was destined to collapse. There was a general problem of symmetry between deficit and surplus countries or between the USA and the rest of the world. Although the Bretton Woods System intended that both deficit and surplus countries should share the burden of adjustment in payments imbalances, yet the brunt of adjustment fell practically entirely upon the deficit countries. While the surplus countries could continue to run surpluses so long as they were willing to accumulate reserves, the deficit countries could not run down their reserves indefinitely. This asymmetry between the deficit and surplus countries exposed a serious weakness in this system and became partly responsible for its eclipse. One of the predominant causes of the breakdown of the Bretton Woods System was the problem of liquidity. Any system of fixed or stable exchange rate could work efficiently only if there were sufficient international reserves. In either of the two cases, the United States reserves deteriorated. The rest of the world continued to have large demand for dollars for making the BOP adjustments among themselves as dollar was the key currency. Even for maintaining the exchange rates stable in terms of dollars, countries started keeping a large fraction of their international reserves in the form of dollar balances and the short term dollar securities. This problem of liquidity continued to become grave raising the worldwide expectation of the impending devaluation of dollar. But since other countries were tied to the dollar, that did not permit the United States to make readjustment of the exchange rate of dollar with other principal currencies. The anticipated changes in par values on account of heavy pressure upon dollar resulted in large scale speculative capital. It led to the speculative capital movements from the United States to other surplus countries such as Germany, Japan and Switzerland. These large scale capital movements were bound to have destabilising effect upon exchange rate as well as the BOP adjustments. An important factor to cause the collapse of the Bretton Woods System was the domestic inflation in the United States particularly after the escalation of Vietnam War from  Both Johnson and Nixon administrations were unwilling to finance the war efforts by increased taxes. Instead easy money policies were pursued. These policies intensified inflation in the United States and the balance of current account got weakened. The surplus countries of Europe feared the transmission of inflation to their own countries, when their balance of payments surpluses had been bringing about an increase in their money supplies. These countries, especially West Germany, attempted to counter inflation through the enforcement of strict monetary policies. The high interest rates further accentuated capital flow from the United States to the countries of Europe and Japan and precipitated in the fall of Bretton Woods System. All these developments eventually resulted in the United States declaring on August 15, the inconvertibility of dollar into gold. At the same time, it imposed a temporary 10 percent surcharge on imports and the Bretton Woods System broke down. The negotiations began almost immediately to bring about proper readjustments in the international monetary system. This meeting could hammer out an agreement called as Smithsonian Agreement. This implied the devaluation of dollar by about 9 percent. While the German mark was revalued by 17 percent and the Japanese yen was revalued by 14 percent.

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