Finally, we discuss the implications of all this material for international business. We will see how the exchange rate policy adopted by a government can have an important impact on the outlook for business operations in a given country. We also look at how the policies adopted by the IMF can have an impact on the economic outlook for a country and, accordingly, on the costs and benefits of doing business in that country.

The Gold Standard

The gold standard had its origin in the use of gold coins as a medium of exchange, unit of account, and store of value—a practice that dates to ancient times. When international trade was limited in volume, payment for goods purchased from another country was typically made in gold or silver. However, as the volume of international trade expanded in the wake of the Industrial Revolution, a more convenient means of financing international trade was needed. Shipping large quantities of gold and silver around the world to finance international trade seemed impractical. The solution adopted was to arrange for payment in paper currency and for governments to agree to convert the paper currency into gold on demand at a fixed rate.

MECHANICS OF THE GOLD STANDARD

Pegging currencies to gold and guaranteeing convertibility is known as the **gold standard**. By 1880, most of the world's major trading nations, including Great Britain, Germany, Japan, and the United States, had adopted the gold standard. Given a common gold standard, the value of any currency in units of any other currency (the exchange rate) was easy to determine.

For example, under the gold standard, one U.S. dollar was defined as equivalent to 23.22 grains of "fine" (pure) gold. Thus, one could, in theory, demand that the U.S. government convert that one dollar into 23.22 grains of gold. Because there are 480 grains in an ounce, one ounce of gold cost $20.67 (480/23.22). The amount of a currency needed to purchase one ounce of gold was referred to as the **gold par value**. The British pound was valued at 113 grains of fine gold. In other words, one ounce of gold cost £4.25 (480/113). From the gold par values of pounds and dollars, we can calculate what the exchange rate was for converting pounds into dollars; it was £1 = $4.87 (i.e., $20.67/£4.25).

STRENGTH OF THE GOLD STANDARD

The great strength claimed for the gold standard was that it contained a powerful mechanism for achieving balance-of-trade equilibrium by all countries.[2] A country is said to be in **balance-of-trade equilibrium** when the income its residents earn from exports is equal to the money its residents pay to other countries for imports (the current account of its balance of payments is in balance). Suppose there are only two countries in the world, Japan and the United States. Imagine Japan's trade balance is in surplus because it exports more to the United States than it imports from the United States. Japanese exporters are paid in U.S. dollars, which they exchange for Japanese yen at a Japanese bank. The Japanese bank submits the dollars to the U.S. government and demands payment of gold in return. (This is a simplification of what would occur, but it will make our point.)

Under the gold standard, when Japan has a trade surplus, there is a net flow of gold from the United States to Japan. These gold flows automatically reduce the U.S. money supply and swell Japan's money supply. As we saw in Chapter 10, there is a close connection between money supply growth and price inflation. An increase in money supply will raise prices in Japan, while a decrease in the U.S. money supply will push U.S. prices downward. The rise in the price of Japanese goods will decrease demand for these goods, while the fall in the price of U.S. goods will increase demand for these goods. Thus, Japan will start to buy more from the United States, and the United States will buy less from Japan, until a balance-of-trade equilibrium is achieved.

This adjustment mechanism seems so simple and attractive that even today, 80 years after the final collapse of the gold standard, some people believe the world should return to a gold standard.

THE PERIOD BETWEEN THE WARS: 1918–1939

The gold standard worked reasonably well from the 1870s until the start of World War I in 1914, when it was abandoned. During the war, several governments financed part of their massive military expenditures by printing money. This resulted in inflation, and by the war's end in 1918, price levels were higher everywhere. The United States returned to the gold standard in 1919, Great Britain in 1925, and France in 1928.

Great Britain returned to the gold standard by pegging the pound to gold at the prewar gold parity level of £4.25 per ounce, despite substantial inflation between 1914 and 1925. This priced British goods out of foreign markets, which pushed the country into a deep depression. When foreign holders of pounds lost confidence in Great Britain's commitment to maintaining its currency's value, they began converting their holdings of pounds into gold. The British government saw that it could not satisfy the demand for gold without seriously depleting its gold reserves, so it suspended convertibility in 1931.

The United States followed suit and left the gold standard in 1933 but returned to it in 1934, raising the dollar price of gold from $20.67 per ounce to $35 per ounce. Because more dollars were needed to buy an ounce of gold than before, the implication was that the dollar was worth less. This effectively amounted to a devaluation of the dollar relative to other currencies. Thus, before the devaluation, the pound/dollar exchange rate was £1 = $4.87, but after the devaluation it was £1 = $8.24. By reducing the price of U.S. exports and increasing the price of imports, the government was trying to create employment in the United States by boosting output (the U.S. government was basically using the exchange rate as an instrument of trade policy—something it now accuses China of doing). However, a number of other countries adopted a similar tactic, and in the cycle of competitive devaluations that soon emerged, no country could win.

The net result was the shattering of any remaining confidence in the system. With countries devaluing their currencies at will, one could no longer be certain how much gold a currency could buy. Instead of holding onto another country's currency, people often tried to change it into gold immediately, lest the country devalue its currency in the intervening period. This put pressure on the gold reserves of various countries, forcing them to suspend gold convertibility. By the start of World War II in 1939, the gold standard was dead.

LO11-2

The Bretton Woods System

In 1944, at the height of World War II, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system. With the collapse of the gold standard and the Great Depression of the 1930s fresh in their minds, these statesmen were determined to build an enduring economic order that would facilitate postwar economic growth. There was consensus that fixed exchange rates were desirable. In addition, the conference participants wanted to avoid the senseless competitive devaluations of the 1930s, and they recognized that the gold standard would not ensure this. The major problem with the gold standard as previously constituted was that no multinational institution could stop countries from engaging in competitive devaluations.

The agreement reached at Bretton Woods established two multinational institutions—the International Monetary Fund (IMF) and the World Bank. The task of the IMF would be to maintain order in the international monetary system and that of the World Bank would be to promote general economic development. The Bretton Woods agreement also called for a system of fixed exchange rates that would be policed by the IMF. Under the agreement, all countries were to fix the value of their currency in terms of gold but were not required to exchange their currencies for gold. Only the dollar remained convertible into gold—at a price of $35 per ounce. Each country decided what it wanted its exchange rate to be vis-à-vis

CHAPTER SUMMARY

This chapter explained the workings of the international monetary system and pointed out its implications for international business. The chapter made the following points:

1. The gold standard is a monetary standard that pegs currencies to gold and guarantees convertibility to gold. It was thought that the gold standard contained an automatic mechanism that contributed to the simultaneous achievement of a balance-of-payments equilibrium by all countries. The gold standard broke down during the 1930s as countries engaged in competitive devaluations.
2. The Bretton Woods system of fixed exchange rates was established in 1944. The U.S. dollar was the central currency of this system; the value of every other currency was pegged to its value. Significant exchange rate devaluations were allowed only with the permission of the IMF. The role of the IMF was to maintain order in the international monetary system (*a*) to avoid a repetition of the competitive devaluations of the 1930s and (*b*) to control price inflation by imposing monetary discipline on countries.
3. The fixed exchange rate system collapsed in 1973, primarily due to speculative pressure on the

dollar following a rise in U.S. inflation and a growing U.S. balance-of-trade deficit.

4. Since 1973, the world has operated with a floating exchange rate regime, and exchange rates have become more volatile and far less predictable. Volatile exchange rate movements have helped reopen the debate over the merits of fixed and floating systems.
5. The case for a floating exchange rate regime claims (*a*) such a system gives countries autonomy regarding their monetary policy and (*b*) floating exchange rates facilitate smooth adjustment of trade imbalances.
6. The case for a fixed exchange rate regime claims (*a*) the need to maintain a fixed exchange rate imposes monetary discipline on a country; (*b*) floating exchange rate regimes are vulnerable to speculative pressure; (*c*) the uncertainty that accompanies floating exchange rates dampens the growth of international trade and investment; and (*d*) far from correcting trade imbalances, depreciating a currency on the foreign exchange market tends to cause price inflation.
7. In today's international monetary system, some countries have adopted floating exchange rates; some have pegged their currency to another currency such as the U.S. dollar; and some have pegged their currency to a basket of other currencies, allowing their currency to fluctuate within a zone around the basket.
8. In the post–Bretton Woods era, the IMF has continued to play an important role in helping countries navigate their way through financial crises by lending significant capital to embattled governments and by requiring them to adopt certain macroeconomic policies.
9. An important debate is occurring over the appropriateness of IMF-mandated macroeconomic policies. Critics charge that the IMF often imposes inappropriate conditions on developing nations that are the recipients of its loans.
10. The current managed-float system of exchange rate determination has increased the importance of currency management in international businesses.
11. The volatility of exchange rates under the current managed-float system creates both opportunities and threats. One way of responding to this volatility is for companies to build strategic flexibility and limit their economic exposure by dispersing production to different locations around the globe by contracting out manufacturing (in the case of low-value-added manufacturing) and other means.