Financial Perspective

International Monetary System

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

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

Features that IMS should possess

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

Characteristics of good International Monetary System

On the improvement and reform of international monetary system, I would like to make three points.

First, what is a good international monetary system? If we want to make reforms and improvements to the international monetary system, they must promote the characteristics that such a system should have. I suggest the following seven characteristics of a good international monetary system:

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1) It should promote development, which means that the system can facilitate trade and investment.

2) It should provide correct incentives for those who work hard, so their efforts can pay-off. This means, whether the country is big or small, and regardless of its region or religious makeup, et cetera, it should provide the right incentives.

3) It should be able to do the adjustment when the balance of payment is imbalanced. International history suggests that countries compete for different reasons, some based on mercantilism (and a positive balance of trade) others to make their money cheap. The system should be able to provide a mechanism to adjust each of these kinds of imbalances.

4) It should be able to provide a safety net so that during a crisis it can provide the necessary liquidity to deal with the crisis.

5) It should have an accurate representation of the world and reflect the world economic fundamentals.

6) It should be stable and resilient against all kinds of shocks—economic, political and otherwise.

7) It should contribute to maintain the stability of exchange rates and effective regional arrangements.

Evolution of International Monetary System

- Bimetallism (Before 1875)
- Classic Gold Standard (1875 – 1914)
- Interwar Period (1915 – 1944)
- Bretton Woods Agreement (1945 – 1972)
- Smithsonian Agreement (1971)
- International Monetary System (1973 to present)

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CLASSIC GOLD STANDARDS (1875- 1914)

- Countries had to establish the rate at which its currency could be converted to the weight of the gold.
- Participants – Germany, France, UK, USA.
- Example: $ 20.67/ounce, Pounds 4.247 / ounce.
- Exchange rate between any two currencies was determined by their gold content.
- Gold was used as storage of wealth and as a medium of exchange.
- Central banks were restricted not to issue more currency than gold reserves.

INTERWAR PERIOD (1915 – 1944)

- Described as a period of de-globalization.
- Countries had abandoned the gold standard, the international trade and capital flows shrank and started printing money to pay for war related expenses.
- After the war, high rates of inflation and a large amount of outstanding money.
- A return to the old gold standard was attempted.

BRETTON WOODS AGREEMENT (1945-1972)

- Named after the year 1944 meeting of 44 nations at Bretton Woods, New Hampshire initiated by John Maynard Keynes and Harry Dexter White.
- The goal was exchange rate stability without the gold standard.
- The result was the creation of the IMF and the World Bank.

Objective

- Freedom for governments to pursue domestic polices
- Promoting employment
- Stabilize exchange rates
- Provide capital for reconstruction from the war

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Features of Bretton Woods System

- Key difference was that the dollar was the only currency that was convertible into gold.
- Exchangeable rates could be readjusted at certain times under certain conditions.
- Each country was allowed to have a 1% band around which their currency was allowed to fluctuate around the fixed rate.
- The IMF was created with the specific goal of being the multilateral body that monitored the implementation of the Bretton Woods agreement.

SMITHSONIAN AGREEMENT (1971)

- Attempt to save Bretton Woods system, 10 major countries met at the Smithsonian Institute , Washington in December 1971.
- Conditions
  - Price of gold was raised to $38 per ounce
  - Countries revalued its currency against US dollars up to 10%
  - Exchange rate band was expanded to 2.25 %
- Devaluation of dollar did not stabilize the situation. Existed less than 2 Yrs

EXCHANGE RATE SYSTEM AFTER 1973

- The Board of Governors of the IMF appointed committee initiated an exchange rate system that could be acceptable to the member countries.
- Systems are classified based on flexibility in the exchange rates
  1. Fixed exchange rate (rate with fixed parity)
  2. Flexible exchange rate (involves market forces to determine the rate)

Functions Performed by the Global Financial System and the Financial Markets

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- **Savings function.**

The global system of financial markets and institutions provides a conduit for the public's savings.

- **Wealth function.**

The financial instruments sold in the money and capital markets provide an excellent way to store wealth.

- **Liquidity function.**

Financial markets provide liquidity for savers who hold financial instruments but are in need of money.

- **Credit function.**

Global financial markets furnish credit to finance consumption and investment spending.

- **Payments function.**

The global financial system provides a mechanism for making payments for goods and services.

- **Risk protection function**.

The financial markets around the world offer businesses, consumers, and governments protection against life, health, property, and income risks.

- **Policy function**.

The financial markets are a channel through which governments may attempt to stabilize the economy and avoid inflation.

Financial Markets

Financial markets refer broadly to any marketplace where the trading of securities occurs, including the stock market, bond market, forex market, and derivatives market, among others. Financial markets are vital to the smooth operation of capitalist economies.

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Financial markets play a vital role in facilitating the smooth operation of capitalist economies by allocating resources and creating liquidity for businesses and entrepreneurs. The markets make it easy for buyers and sellers to trade their financial holdings. Financial markets create securities products that provide a return for those who have excess funds (Investors/lenders) and make these funds available to those who need additional money (borrowers).

The stock market is just one type of financial market. Financial markets are made by buying and selling numerous types of financial instruments including equities, bonds, currencies, and derivatives. Financial markets rely heavily on informational transparency to ensure that the markets set prices that are efficient and appropriate. The market prices of securities may not be indicative of their intrinsic value because of macroeconomic forces like taxes.

Some financial markets are small with little activity, and others, like the New York Stock Exchange (NYSE), trade trillions of dollars of securities daily. The equities (stock) market is a financial market that enables investors to buy and sell shares of publicly traded companies. The primary stock market is where new issues of stocks, called initial public offerings (IPOs), are sold. Any subsequent trading of stocks occurs in the secondary market, where investors buy and sell securities that they already own.

Classification of Financial Market

1. By Nature of Claim

- **Debt Market**: The market where fixed claims or debt instruments, such as debentures or bonds are bought and sold between investors.
- **Equity Market**: Equity market is a market wherein the investors deal in equity instruments. It is the market for residual claims.

By Maturity of Claim

- **Money Market**: The market where monetary assets such as commercial paper, certificate of deposits, treasury bills, etc. which mature within a year, are traded is called money market. It is the market for short-term funds. No such market exist physically; the transactions are performed over a virtual network, i.e. fax, internet or phone.

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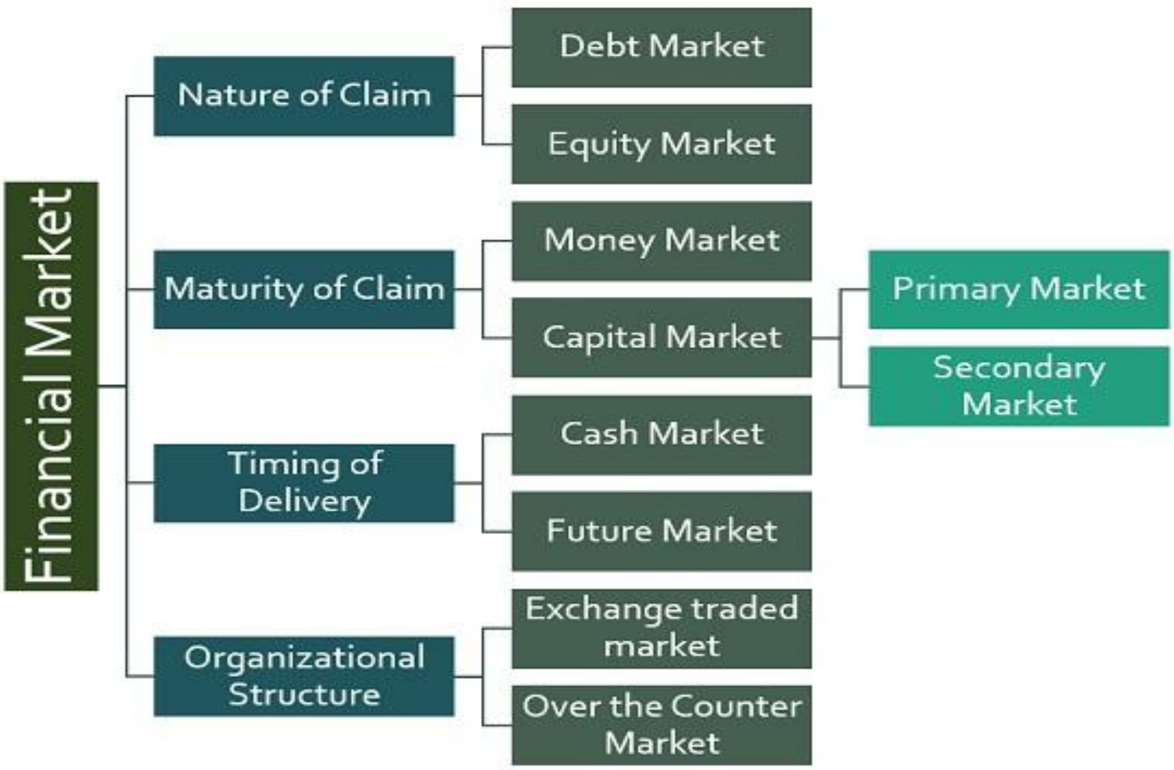
- **Capital Market**: The market where medium and long term financial assets are traded in the capital market. It is divided into two types:
  - **Primary Market**: A financial market, wherein the company listed on an exchange, for the first time, issues new security or already listed company brings the fresh issue.
  - **Secondary Market**: Alternately known as the Stock market, a secondary market is an organised marketplace, wherein already issued securities are traded between investors, such as individuals, merchant bankers, stockbrokers and mutual funds.



By Timing of Delivery

- **Cash Market**: The market where the transaction between buyers and sellers are settled in real-time.
- **Futures Market**: Futures market is one where the delivery or settlement of commodities takes place at a future specified date.

By Organizational Structure

- **Exchange-Traded Market**: A financial market, which has a centralized organization with the standardized procedure.
- **Over-the-Counter Market:** An OTC is characterized by a decentralized organization, having customized procedures.

Since last few years, the role of the financial market has taken a drastic change, due to a number of factors such as low cost of transactions, high liquidity, investor protection, transparency in pricing information, adequate legal procedures for settling disputes, etc.

Functions of the Markets

The role of financial markets in the success and strength of an economy cannot be underestimated. Here are four important functions of financial markets:

1. Puts savings into more productive use

As mentioned in the example above, a savings account that has money in it should not just let that money sit in the vault. Thus, financial markets like banks open it up to individuals and companies that need a home loan, student loan, or business loan.

2. Determines the price of securities

Investors aim to make profits from their securities. However, unlike goods and services whose price is determined by the law of supply and demand, prices of securities are determined by financial markets.

3. Makes financial assets liquid

Buyers and sellers can decide to trade their securities anytime. They can use financial markets to sell their securities or make investments as they desire.

4. Lowers the cost of transactions

In financial markets, various types of information regarding securities can be acquired without the need to spend.

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