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History and Chronology of Changes of the World Monetary System

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Abstract: The world monetary system has undergone changes based on the needs and economic demands of the time. The state of panic is a situation of desperation which is the main cause of changes in the world monetary system. Questions arise here: What are the panic situations causing these changes and whether the global economic crisis today is the panic situation that permits the world to change to gold system? Hence, the purpose of this study is to analyze the history of the development of world monetary system and to identify the chronological chain of currency changes as well as to detect the panic situations that are causing changes in the system. This is a qualitative study going by the strategic approach of historical studies and library research. The results revealed that the chronological changes in the monetary system occurred intermittently between gold and paper money system (float) due to several situations referred to as panic situations. The panic situations identified were the war, the world recession and the problem of excessive inflation and deflation. Therefore, it is not possible if a panic situation occurs in dealing with global economic crisis today prompting for a switch in the currency system today to return to gold standard system.

Key words: Monetary system, gold standard, monetary history, paper money, gold money, Malaysia

INTRODUCTION

The world monetary system has undergone several changes according to the needs and development of time. The world monetary system began with bimetallic systems (570 BC). Bimetallic system is a system based on metallic currency either using gold, silver, copper or bronze. Furthermore, the world had practiced a system of goldsmiths (1640-1800) when business between men was growing and the metallic coins in circulation were in abundance. After that the currency system switched to the classical gold standard system (1821-1914) when several nations had agreed in consensus to implement a fixed exchange rate system based on the value of gold. However, after World War I, the world had witnessed the use of paper floating exchange system between the year, 1915 until 1925 and the gold standard made its comeback after that from the year, 1925 until 1931. However, once again the currency was floated during the World War II and the great depression between the years, 1931 until 1944. Subsequently, starting in 1944 until 1971 over a period of 27 years, there was an episode where a fixed exchange system based on the value of gold known as the Bretton Woods System was used. The Bretton Woods System ended in 1971 and was replaced by a floating paper currency still practiced until today.

The development of the world currency system had demonstrated an evolution of changes in the monetary system based on the needs of particular eras which had also witnessed the greed of mankind in their pursuits of power and worldly gains. Since, the Prophet's S.A.W. (Peace Be On Him) time until the fall of the Ottoman Turks government in 1924, the currency system was based on physical gold and silver. During this period, the monetary system was stable, just and harmonious (Wan Mahmmod, 1983).

After that the world adopted the gold standard systems (Gold standard and Bretton Woods) that lasted nearly 100 years before it was revoked by President Richard Nixon in 1971 and which after that led to the advent of the floating currency system (paper money or fiat money without gold backup). During the period of gold-based system whether in physical gold currency as well as value backup, economic and monetary system then were more stable compared to the floating currency system (Bordo, 1992). A floating system is a system

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where the currency is not backed up by a valuable commodity. Thus, the system is unstable and is easily exploited by currency speculators. Speculation activities and usury system could easily creep into the floating currency system causing various crises in the economy (Yaacob, 2009).

This situation shows that the world monetary system has undergone several changes based on the needs and situation of the economy at that time. The economists called it a situation of desperation or the need that requires a change in monetary system, the state of panic situation (Yaacob, 2011). Thus, questions arise here: What is the panic situation? And whether the global economic crisis today is the panic situation and the monetary system will change to gold system? Therefore, this study aims to analyze the history of the development of world monetary system starting with the bimetallic system (570 BC) until today in order to identify the chronological changes in the world currency system. This study will also identify other panic situations that have become the root to those changes.

THE HISTORY OF WORLD MONETARY SYSTEM DEVELOPMENT

Bimetallic System (570 BC-early 7th century): Bimetallic system is a currency system of silver and gold coins. According to Nurfarizan (2010), the use of gold coins as currency can be detected beginning 570-546 BC during the reign of King Croesus of the Kingdom of Lidya. This coin was made of a metal called electrum which contained a mixture of gold and silver most commonly found in the rivers of Lidya. This currency was called stater of round shape coin and was rather rough. On the front part was a picture of an animal entailed by a straight horizontal line (Husin, 1967). Influence of the Lidyan government's currency had continued until after the invasion of the Persians. The existence of these currency units indicates civilisation of the Lidyans in the aspects of intellects and economic development.

Whereas in the year, 406 BC, the Greek government began to mint metallic currency of gold and silver coins and the currencies were used by the communities of Marcedonian and Babylon. This continued until the reign of Alexander the Great in the 4th century BC. The staple currency was known as the drachma made of silver. In addition, Husin (1967) also identified five types of other currencies were made according to the price level and were all made by hand. However, starting in the 3rd century BC, the Greek government had been using silver coins in a mass while gold coins were no longer minted (Abidin, 2002). In the 2nd century BC, the Romans introduced their own currency coins. The currency was originally made of bronze then was replaced by silver currency known as the denarius. In the year 46 BC, the denarius gold coin was minted in Rome during the reign of Caesar. Starting from then on, the Roman currency was of denarius gold coins, silver and bronze (Abidin, 2002). In 395 AD, the Roman Empire was divided into two, the Western Rome which was based in Rome and the Eastern Rome in Constantinople. Later in 476 AD, the Western Romans government suffered a decline and this had opened a window of opportunity to the development of Eastern Rome known as the Byzantine Empire based in Constantinople.

Following this, the Byzantine Empire emerged as a renowned and powerful empire of political and economic aspects. After that the solidus gold coins introduced by the Emperor of Constantinople became the official government currency across Europe and several other regions. This currency however was popularly known as denarius among the Roman community. The greatness and prowess of the Byzantine government during that time had helped in promoting the widespread of the denarius gold currency to several surrounding regions through regional trade activities (Del Mar, 1968; Nurfarizan, 2010).

The Persian government began to mint their own currency in the year, 546 BC when their territory was controlled by the government of Lydia. The currency minted was square in shape before it was later changed to round. The gold coins minted by the Persians were known as daric and silver coins called siglos. However, after the time of Alaxender The Great, the Babylonian Greek influence had encouraged the Persian community to mint silver currency known as the drachm. The drachm continued to be used even though Persia was dominated by the Sassanid Empire and the currency was also used in Egypt, Syria, North Africa, Iran, Iraq and the surrounding area (Nurfarizan, 2010). Therefore, the gold dinar used by the Arabs of Makkah and Medina in the 6 and 7th century AD were the gold and silver coins issued and used in the territories of the Byzantine and Sassanid Empire. According to the Islamic history, the Prophet S.A.W (Peace Be On Him) did not even try to mint a new currency for the use of the Islamic nations, on the contrary he acknowledged the use of the existing currency without any changes. This had continued until the time of Caliph Abu Bakr R.A. and in part of Caliph ᶜUmar al-Khattab R.A. time. However, Caliph ᶜUmar R.A. was reported to have minted silver coins (dirham) according to the Sassanid's mold. ᶜUmar al-Khattab R.A. had also introduced a set of standard measurement by weighing which was also known as the Standard of

Caliph ᶜUmar al-Khattab R.A. These standards specified 10 dirham as equivalent to 7 dinars. Each dinar must have a weight of 4.25 g of gold and each dirham of 3 g of silver (Abidin, 2002). In 76 H ᶜAbd al-Malik ibn Marwan issued the 1st Islamic dinar in history. This gold dinar money no longer had the picture of the Roman Emperor instead was inscripted with the Quranic verses. The use of gold and silver coins as the Muslims currency continued until the end of the ᶜOttoman government in Turkey. After that the dinars and dirhams continue to be used in business transactions, savings and also zakat payments (Hosein, 2008).

Goldsmiths system (1640-1800): The study conducted by Bernstein (1965) and Lewis (2007) showed that the goldsmiths system began around the 7th century AD during when the volume of trade and payments increased significantly in Europe. The use of metallic money (gold and silver) had created difficulties in large-value transactions due to the high cost in transportation as well as storage and the risk of loss. Therefore, the merchants began to deposit their coins into private firms, especially the goldsmiths. The system was based on the redemption of gold for paper money issued by the goldsmiths. A jeweller would issue a receipt or note called goldsmiths notes to represent the gold being deposited under his safe keepings.

According to Gee (1936), the goldsmiths' notes were a group money representative. If the notes were pegged to the full content of coins and the notes issued not exceeding the value of the coins then it became a full content money representative. For example, if someone kept an ounce of gold, he would get a receipt for the value of an ounce of gold. Lewis (2007) asserted that the goldsmiths notes were of papers pledged 100% to gold. At that time, the merchants were confident on the goldsmiths that it became a medium of exchange or money that eventually there was no need to surrender the notes to reclaim their gold. Unclaimed deposits were used as collateral to issue new notes. The new notes or money is loaned to borrowers by charging them interests (Bernstein, 1965). Subsequent to this, according to Lewis (2007) and Tahir (2009), the goldsmith system or gold storage firms eventually evolved from storing gold nuggets to private banking and leading to subsequent creation of a banking system, we see today.

Gold standard system (1821-1914): According to Hawtrey (1947), Marcuzzo and Rosseli (1986) and Meissner (2005), the gold standard system was a monetary system in which the standard economic unit of account was a fixed mass of gold allowing freedom of exchange and trade in gold. Classical gold standard era began in 1880 until 1914. For Wanniski (1995), the gold standard system was: A government guarantee to borrowers, if they were to borrow an ounce of gold today, it would be repaid with an ounce of gold a year after 10 or 30 years later. This is a golden handshake between the government and the public.

In a fixed gold standard system, each country used the same currency, i.e., gold and owned several types of full gold standards such as the gold coinage standard and the gold bullion standard. The government would make gold coins at an official standard and allocated a portion as seigniorage to finance the cost of minting coins. Gold was used in local transactions as well as internationally. Therefore, the limited amount of gold in circulation would constrict the development of trade and economic growth. Furthermore, the problem of deficit or surplus in the balance of payments would disrupt the flow of gold and thus, causing fluctuations in import and export prices (Yen, 1989).

The gold flows can be disrupted every time there was a war. This situation can be seen during the US Civil War in the years of 1861-1865 when the United States failed to give full commitment to the gold standard system but instead had printed a lot of paper money to finance the war. This gold standard system returned to its function in 1879 when the United States felt that the gold policy was being undignified by overprinting of paper money over the prescribed limit. The situation became more complicated when at the end of 1870s; Germany made his claim on gold from the United States causing the price of gold to soar. To resolve the rising price of gold, the United States began to mint silver in mass causing the price of silver to plummet.

During the state of panic after the United States Civil War in 1893, many people converted their currencies into gold and the US gold reserves declined tremendously. In March, 1900 the Congress passed the Gold Standard Act, in which this Act allowed money to be redeemed in gold. Gold reserves of US$150 million were created and bonds were sold to maintain the gold reserve. However, this was changed when the Federal Reserve Act was enforced, dividing the nations into 12 reserve areas in which each area owned a Federal Reserve Bank (Ruggiero, 2002). The period of classical gold standard was short-lived when the system collapsed in 1914 due to the World War I and the gold price at that time was US$20.67 ounce^{-1}. While Brown (1978) and Yen (1989) felt that the classical gold standard could not be sustained due to a diminishing increase in gold reserves (as a result of mining) hampering the growth of the international trade development which was otherwise growing progressively. However, this era has seen a harmonious and stable progression of world currencies for >25 years (Bernstein, 1965) and was often referred to as the heyday of the gold standard system or the golden era (Wan Mahmmod, 1983) due to its ability in stabilizing price, improving growth and development of world commerce and trade. Goldenweiser (1951) also acknowledged that during the war time and post-war, the gold reserves in gold standard should be expanded even though other gold functions were neglected. This is because gold must be employed as international reserves to secure confidence and trust from the people on the robustness of the world monetary system. Thus, not surprisingly if today's intellectuals look at the golden era as the nostalgic golden age of the foreign exchange.

Floating paper currency exchange system (1915-1925 and 1931-1945): According to Bordo (1993), the classical gold standard era ended when the world experienced the shock of World War I. Fiat money was once again used due to the need to finance World War I. During this period, all nations who went to war printed a lot of money causing insufficient gold in the reserves to back up the money. Hence, fiat money was used until World War I ended and this went on over a period of 14 years. Under the gold exchange system of fiat currency, all countries needed to hold both gold and dollar or pound sterling as a reserve except the United States and United Kingdom. Both countries needed only to have gold as a reserve. Furthermore, many countries were bound by the sterilization policy preventing the outflow of domestic currency as a consequence to the flow of gold out of the countries (Bordo, 1999). Thus in this period, the market value of gold had become uncertain due to the introduction and adoption of a currency system which was not fully independent of the value of gold.

This situation occurred since the formation of central banks in the respective countries. The mechanism was changed and the government was allowed to exchange gold with dollar value. Problems began to arise when people wished to change to silver currency in exchange for gold and in 1918 Pittman Act limited the minting of silver currency and gave permission to the government to remove silver currency from circulation. Interest in the form of silver currency and cheaper money was once again used during the depression. At this time, the government did not only mint silver currency but also printed paper money that can be redeemed in silver. In 1933, President Franklin Roosevelt had raised the price of gold from US\$20.67-35.00 ounce^{-1}. After that he made the exchange illegal to the people of the United States against its own gold. The Federation had raised the liquidity in the banking system and the President feared that the Americans would not want to exchange cheaper money with gold. As the result, the United States abolished the gold standard system under his own directive even though gold was technically the underlying dollar at that time (Ruggiero, 2002).

According to Bordo, this process was an attempt to restore the positive features of classical gold standard system (fixed gold standard system) while giving a better role for the domestic stability policy. This created a conflict between strengthening the laws and the wisdom in establishing a currency system. It was also a period of trial to reduce gold reserves by imposing restriction on its usage by the central bank and also to encourage the use of foreign exchange as an alternative. However, the period had witnessed various teething complications that took place and among them were the use of dual reserve currency (pounds and dollars), the absence of leadership with hegemonic power (influence on other nations), the letdown in getting cooperation from major countries (England, France and the United States) and there was no willingness from the two big countries, i.e., the United States and France to adhere to the law of gold exchange standard. Instead, they practiced deflationary pressures to stabilize the world through a continuous cut on the balance of payments surplus.

Other problems also surfaced in the gold exchange system, particularly the nation's distrust on paper money that was not fully backed up by gold causing the readoption of a fixed gold standard system in 1926. However, this system only lasted for 5 years (1926-1931) because when the Great Depression took place, most world nations tried to redeem their money particularly from the United States and England with gold. Unfortunately at that time, there was insufficient of gold held in reserve due to over printing of money accompanied by the pressure of World War II (1939-1945). Consequently, the currency system was switched back to fiat money system in order to avoid from bankruptcy beginning the year, 1931 until 1944.

Bretton Woods System (1944-1971): The Bretton Woods System began in 1944 when representatives of 44 non-communist countries across the world held a conference to reform the international monetary system. As a result of the conference, the Bretton Woods System was created and implemented beginning from 1944 until 1971, i.e., for 27 years. That period was known as the Bretton Woods era. The Bretton Woods convention had also led to the establishment of three major institutions, the International Monetary Fund (IMF), International Bank of Reconstruction and Development (IBRD) and General Agreement on Tariffs And Trade (GATT). The

IMF tried to institute a new foreign exchange rate to replace the gold-based system. Therefore, all members of the IMF declared gold value against their currency. Then, the relative gold value between countries was accounted for as the exchange rate of the respective countries. Each country also agreed to intervene in the foreign exchange market in order to maintain his country's exchange rate in the free market to either be revalued or devalued against their respective currency (Othman, 1993).

In principle, the Bretton Woods System still retained gold as the base currency value and the fixed exchange rate. Under this system, a country set the value of its currency in gold or in US dollar at a rate which was referred to as par value. The set value of gold was at US\$35 ounce^{-1} of gold, i.e., the base value of a currency. US dollar could easily be converted to gold on demand. If a nation who had set its currency against US dollar wanted to own gold, the country would change its currency to US dollar first. The parity value of each respective country's currency was expressed either directly in gold or indirectly in the form of US dollar by weight and purity of gold beginning July 1, 1944. The exchange was set at 0.888671 g of pure gold. The fund required for each member country to self-determine their parity, if they wanted to convert these values, they must get prior approval. In addition if there were changes in their parity values, they must ensure that the holding value of the fund was stable against the old (gold) parity of its currency (Yen, 1989).

Meanwhile according to Ware (2001), each currency was allowed to vary in accordance to the exchange rate at the level of 1% of the respective parity value. A reform of the Bretton Woods System was that besides gold, the member countries were also allowed to hold other currencies acceptable by the international community as a medium of exchange and reserve. The US dollar currency had gained trusts due to the country's (the United States) commitment and promise to buy and sell gold at any time demanded which was sealed through declaration and treaty. Therefore, the position of US dollar was becoming increasingly important in the international monetary system.

In 1971, President Richard Nixon of the United States had broken ties with gold and US dollar with the defeat of the United States in the Vietnam War. The United States had printed US dollar in large quantities to finance the war in excess of the gold reserves held.

Thus, this system had also failed to establish a mechanism to harmonise the economic balance. Full cooperation between the member countries no longer existed due to their selfish attitude. The Bretton Woods System was completely revoked in 1973 after the Smithsonian's meeting, signed in 1972 and replaced by the floating exchange system (fiat money).

Floating System (1971-now): The Bretton Woods System had worked well up until 1971 when the United States had experienced a deficit in the balance of payment due to over-excessive printing of dollars over gold reserves. The end of fixed exchange system represented the manifestation of the United States in checking the deficit of balance of payment from getting larger. The imbalance of claims against the available gold reserves of the United States had caused a large decline in gold reserves, i.e., from US\$18 billion in 1960 to US\$11 billion in 1970. This amount would be greater if it included all short-term claims owed and pending settlement by the United States. Thus, not surprisingly there was a growing number of countries doubting that the gold parity of the US dollar as prescribed at the beginning of the Bretton Woods System could be rescued (Mohidin, 1994).

On December 18, 1971, the major industrial countries of the group 10; namely Belgium, Canada, France, Germany, Italy, the United States, Japan, Netherlands, Sweden and the United Kingdom had agreed to sign a treaty called the Smithsonian Agreement to temporarily remedy the situation in the foreign exchange market. Through the treaty, the United States agreed to depreciate dollar on the condition that Germany, Japan and France agreed to increase the value of their respective currencies. The United States agreed to increase the value of gold from US\$35-38 ounce^{-1} which is equivalent to the decline of the US dollar by 7.9%. With the latest development, the US dollar clearly was not able to be the single reserve currency for the world even though dollar retaiend its status as an international currency. Therefore, the European countries such as Germany, Italy and France decided to float their respective currencies in the foreign currency exchange market (Mohidin, 1994).

In February of 1973, the devaluation had to be done once again by 10% but the economic situation remained unchanged and finally in March, 1973, the foreign exchange market had tobe closed for several weeks when the conditions went out of control. When it was reopened, the exchange rate as allowed to float and this inadvertently had ended the Bretton Woods System. Since the collapse of the Bretton Woods Agreement, the world monetary system was replaced by a floating currency system in which a country's currency was valued against another country's currency. This arrangement resulted inuncertainty of currency value fluctuations thus giving opportunity tocurrency speculatorsto make profitson thelossof other nations. Duncan (2003) in his book The Dollar Crisis, predicted the possibility of an economic crisis much worse than the great depression should the current currency system continued to be used. The floating exchange rate system was officially authorized through a treaty known as the Jamaican Treaty in 1976 around the same time gold no longer owned an official value. Gold was only sold and bought by the central banks at market price.

According to Wan Mahmmod (1983), a floating exchange rate system functioned under the circumstance where the monetary authority of a country (usually the central banks) was not held liable in keeping the exchange value within a specified limit or range. In other words, the exchange rate either rose or fell based on the factors of a currency supply and demand in the market. Just like commodities when there was an exceeding supply of currency in international financial markets then the value of the currency would fall. So, generally the floating exchange system would be easier to fluctuate than the system of fixed exchange rates due to uncertain supply and demand factors and without any intervention from the monetary authorities. Therefore starting in 1973 until today, the world has been adopting the use of the floating currency system.

Duncan (2003) pointed out that the instability and depreciation of paper currency occurred when US dollar lost 95% of its value since, 1913. Paper money would always diminish in value due to unlimited printing and issuance. This situation began to be felt in 1933 when the American people could not convert dollars into gold at a value of US$20 over an ounce of gold whereas these values were set by the United States themselves at that time.

The same incidence happened in 1971 when the communities outside the United States could not redeem their gold at the value of US$35 ounce^{-1} of gold. This had led the foreign central banks to rush in tandem to recover their gold by redeeming their gold holdings from the United States due to their loss of confidence in the United States ability of convertibility. This disorder had caused the President Richard Nixon to finally break the ties between dollar and gold.

CHANGES CHRONOLOGY OF THE MONETARY SYSTEM

In general, based on the history of world monetary system, there is a form of chronological cycle change in the currency system. The world monetary system is repeatedly experiencing changes according to the needs, time and insistence of circumstances. Basically, the gold-based currency system has been championing the eras for over a very long period of time , however the gold-based system would switch to a floating paper currency system in the event of a state of panic such as the period of war, world recession and the problem of excessive inflation and deflation.

However, history shows that gold system often comes back after the implementation of floating paper currency in order to preserve the currency value and stabilize the economic situation. The cycle change of world monetary system clarifies a few things.

The gold-based currency system is an ideal system which adheres to the theory and concept of currency. The value of currency backed up by gold has been able to maintain currency stability and reduce inflation and manipulation. The system has lasted for over a long period of time. The system's stability and harmony is proven by history through the existence of the classical gold standard era (1785-1914), the gold standard (1931-1944) and the Bretton Woods System (1944-1971). The system of paper money (fiat money) appears when there is a state of panic or various desperate situations of economic instability such as war and economic recession (great depression).

When these situations arise, the currency system is usually changed to a system of paper money. The state of panic situations that have been detected were the Napoleon War, the United States Civil War, World War I (1914), World War II (1939-1945), the Great Depression (1920s and 1930s), the Vietnam War (1965-1970) and the Global Economic Crisis (2009-2011).

The state of panic will often result in agreements between countries, changing monetary policies for a better system. Starting with the Bretton Woods Agreement, the Smithsonian Agreement and the Jamaican Treaty which all have resulted in the creation of a floating currency system in 1976. The reuse of gold-based currency system in the occurrence of a state of panic is to restore the economic stability. Thus, discussions and debates towards supporting the return of gold-based currency system should be encouraged and enhanced in order for us to find solutions to the predicaments we are about to face in the economy today and the fact that we are already in the panic state due to the global economic crises of 2008 that still continues until today (2011). Figure 1 shows the chronological chain of intervening changes in the monetary system of gold and paper money. The state of panic that is influencing the changes in the monetary system is also highlighted to explain the chronological chain.

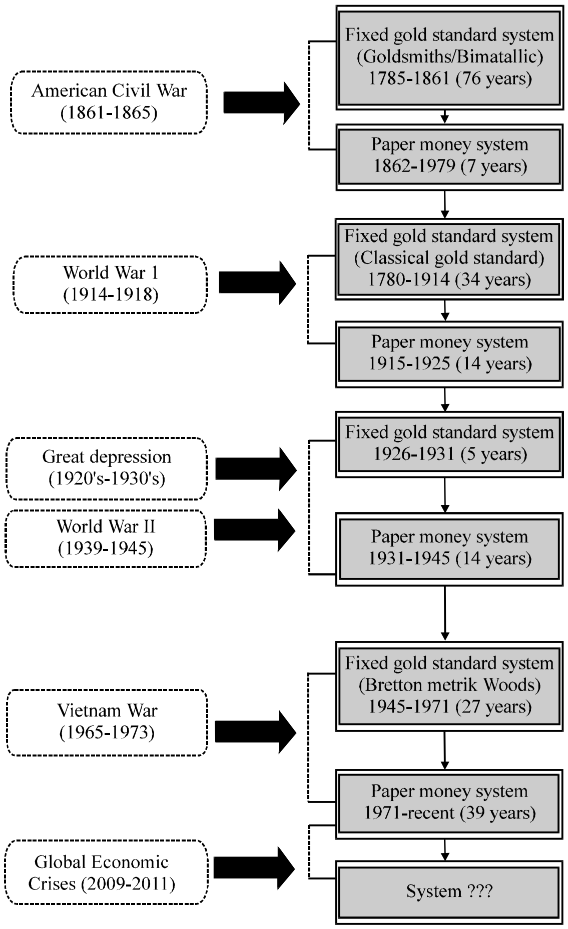

Fig. 1: Cycle change of the world monetary system

CONCLUSION

The history of the world monetary system starts with the bimetallic systems, goldsmiths, classical gold standard, floating paper money, the Bretton Woods system and ends with a floating currency system of today. Data analysis of the historical development of monetary systems finds that the currency system has undergone intervening changes between gold and paper money system. These changes occur due to the state of panic situations that have taken place. The situations panic detected in history are of war, world recession and problem of excessive inflation and deflation. The chain of chronological change in the currency system is unique and has become valuable lessons in spearheading today's monetary system. In lieu to this, a small number of experts in economies have classified that the global economy crises of today (2008-2011) is a situation panic and that it is not impossible if the world continues failing in addressing these global economic crises, eventually causing the currency system to switch to gold standard System. Accordingly, today the world's economic experts have been debating on advantages of the gold-based system and recommending the use of Bretton Woods II System. The proposal is seen as relevant when it receives many supports from other world nations in bringing back the gold-based currency system. These supports can be evidenced by looking at unrelenting efforts by the World Gold Council (WGC) organizing seminars on gold at international level starting in Paris (1999) followed by Paris (2000) then Berlin (2001). Such conferences have revealed views of the world national central banks and their responds in going back to gold backup currency system against the current currency system of today. Such conferences alike have produced resolutions that often time lead to the acknowledgement of gold-based currency system advantages and thus already are making impacts on the IMF.

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