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A study on Currency Values and Monetary System

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Abstract

Ever since we were young we were told that money is hard to come by and we should work hard to earn that money. This statement holds true for most of us but when you think about it you might wonder as to why money is being termed as measurement for our success and mostly ponder upon the question as to why we use money as a medium of exchange. Does the money that we currently use have a value of its own? Or is it just a piece of paper with an inventive value that we are told to believe as its intrinsic value. The study aims to understand about the different currency's and monetary systems and on the emergence of cryptocurrency.

Keywords:

The Gold Standard, Bretton woods system, Fiat money, Quantitative Easing, Cryptocurrency

Introduction

The term money can be defined by its functions. As stated by the IMF, money can be distinguished by its three fundamental functions: a store of value, meaning it can be stored and used later without its value being depreciated, Unit of account, meaning it is being used to value goods and services, And lastly as a medium of exchange, which can be used to exchange in return for goods and services. These three fundamental functions of money have remained constant since centuries. But the method and policies we use to value our money has changed over the decades.

In the early days of the human civilization people were evolving, inventing and discovering things around them. In a community not every individual had an expertise or time to produce goods to satisfy his everyday needs. This problem was solved by the term today known as The Barter System. People exchanged goods and services for other goods and services directly without the need of a medium of exchange. This concept seemed beneficial only to people in a small community and until the needs of a person were limited. The factors which made the system inefficient were transferability and divisibility. Ergo this system didn't hold good due to certain events which made people exchange goods on a larger scale.

Because of the various incriminating disadvantages of the barter system, people decided to evolve and exchange their goods in such a way that it countered the disadvantages of the barter system and that's when commodity money was created. Commodity money was valued based on the commodity it's made off so for example, a block of gold would be worth different than a block of silver. This type of money solved the problem of transferability due to its versatility with being mobile, it could be carried around by people and exchanged in the market for goods. Another problem it overcame was divisibility, in the barter system, if one person wanted to exchange meat for milk, the right amount would be near impossible to calculate, this problem was solved by commodity money because it had its own value in the market and people knew exactly how much to trade and how to trade properly without such issues.

When commodity money was originally introduced, many commodities were involved and in various countries there were various standards set in the market for each recognizable currency. Over time, people stopped using plenty of the commodities because of various factors like storage, capacity, time etc.. And it all boiled down to two commodities, silver and gold. And gold generally had greater value than silver because of its flexibility is use in terms of it being used more in jewelry and that it had and has a unique color of its own.

Slowly, the commodity money boiled down to gold and silver and for obvious reasons, gold was what was set as a standard. The reason gold standard was created was because many European countries wanted a standard when it came to trading in the world market and so, the gold standard was adopted by the European countries by the 1870s and many other countries followed suit after. Gold was then traded in as a standard currency and was used the most in the market, goldsmiths would make gold coins which in turn would be used by citizens in the market for purchase. These goldsmiths then would go on to create banks to store people's gold, these banks were made because of fear of robbery of the gold from people. So goldsmiths were old age bankers, then they evolved by handing out receipts as loan and have gold as collateral.

Then came the demise of the gold standard. So how did that happen? Well, the gold standard was abandoned because it limited central banks from printing out more currency when the economy needed it, it also limited governments from running deficits when countries needed them because gold was a rare metal and was very limited in physical form because it was what created value to currencies. So when countries started abandoning the gold standard, it led to the great depression.

This lead to various countries wanting a spine to value their currency, that's when the Bretton woods system was established, one thing that differentiated the gold standard and the Bretton woods system was devaluation, with gold, there was no devaluation, but with the Bretton woods system, there was. But when the US decided that its currency was not accepted to be converted to gold, it ended the Bretton woods system and created a system we know today, the fiat money.

Key difference between every other currency valuation system in history and the fiat money system was that this system had and has no intrinsic value. Currency is now valued based off of the economy, and its demand in the foreign exchange market.

Fiat money has since been in use up until now and possibly in the future. How would currency be valued at present had it not been for the demise of the gold standard? And what does the future hold when it comes to valuation of currency? Will we keep the system we have now or will cryptocurrency take over the world?

Review of Literature

In this article, the writer talks about the Gold Standard. The Gold Standard is a monetary system where a currency of a country is linked to the gold at a fixed rate. The period 1880 to 1914 was when the majority of the countries followed this system and was known as the classic gold standard period. A few traits of the gold standard were: the stability of the prices due to the fixed price for gold and a mechanism which self-adjusted the balance of payments between countries known as the price-specie flow. The systems decline was attributed to many factors such as: the short term monetary shocks which affected the domestic money supply and price levels, the increase in interest rates by some economies and the cost of producing and maintaining the gold. (D Bordo, n.d.)

In this article, the writer explains about the circumstances which led to complete abolition of the gold standard. During the classical gold standard period, since the exchange rate was fixed the production of gold backed money was limited, this led to the sluggish growth in the economies and due to the hoarding of gold. Later came a reformed version of the gold standard which too failed to survive as a consequence of the Great Depression which led to unemployment, trade restrictions and political failures. (Mark Harrison, 2013)

The article is about the Bretton Woods system. The Bretton Woods system was formed to overcome the problems of the earlier system i.e. the Gold Standard. This system was established to bring in economic stability and to ease the money supply to fund for the damage caused by the WW2. Since the US had majority of the world's gold reserve, the dollar was backed by gold at the rate of $35 per ounce. Thus the US dollar was used as the worlds reserve currency for international transactions. The reason for the fall of this system was due to the great inflation which was caused by the balance of payment deficit of the US, this shock effected the other economies and resulted in suspension of this system in 1971. (Bordo, 2017)

This article explains about the shift in exchange rate after the fall of the Bretton Woods system. The Bretton Woods system followed a fixed exchange rate system where a country's currency was pegged to another country's currency. Later on many economies adopted floating exchange rate system where the currency of that country is determined by principles of supply and demand. By 1996 this system was predominated in majority of the countries. The reason for the shift was due to autonomy of the monetary policies and the ability to maintain the inflation. (Caramazza & Aziz, 1998)

The writer explains the much talked about phrase "do banks create money out of thin air". The recent stimulus package by the central banks have raised this question. This is caused by the monetary policy called Quantitative Easing, where the central bank injects money into the economy to advance the economic activity by lowering interest rates. Before this was created as the writer explains, money was created based on the value created or work done. But quantitative easing has transformed this by using money to create value. (O, 2020)

Money is valued not only complementary to physical labour and demand but also by psychological satisfaction. Value of money in various households depends of financial constraints. Labour provides credit and that credit is used for the purchase of valued goods. The greater the demand for a currency, the greater its value. (Value of money, Ray Linder, 2000)

Fiat money is valued by demand and supply and stability by the issuing government. The concept of fiat money gives governments greater control over the intrinsic value of currencies because they control their respective currency's value. Fiat money is convertible and irredeemable, it's value could be deemed worthless if it's demand is very low or if there was a case of hyperinflation. Money has always been adversely a subsidy of demand, for example, the reason currency help value when the gold standard was around was because of not only gold reserves but demand for gold. (Fiat money, James Chen, 2020)

Cryptocurrency and blockchain is a possible future in the banking sector with increasing number of challenger banks or app banks. As said by Anne Boden "blockchain is easily the most revolutionary money change on the horizon and may make a huge difference across the fintech sector". It is easier to start a new bank than to fix an old one. The future of cryptocurrency and app banks lies in the adverse use of technology by ordinary citizens in. (The future of banking, Darryn Pollock, 2019)

If the gold standard were to be brought back, the government would have difficulty in determining the value of gold to begin with. If gold were to be valued at a fixed rate with the US dollar, there would either be a problem of there being a higher amount of interest rate to make the dollar more attractive or issues with the US trading partners. Also if two countries' currencies are valued at different rates but have the same gold reserves, then there would be a problem of either inflating or deflating one of the currencies. (What would happen if we returned to the gold standard, Christopher Beam, 2010)

Although gold standard was abolished in 1971, it is still a huge beneficiary to a currency's value. Few economists even believe that the gold standard should be brought back so as to stabilize currency fluctuations and also lessen printing of currency by the government. Gold is a huge pillar when it comes to hedging against inflation, reason being gold billions have inherent value and a limited supply. Also, gold is a huge contributor of balance of payments, when a country endures net exports, it's currency value greatly appreciates. (How gold affects currencies, Kalen Smith, 2019)

Research Methodology

The data for this research was collected through secondary sources. The qualitative data is used for this research as the research being a descriptive study. The sources for the study are collected based on the needs for the study. The sources include journals, findings from past researchers, the official data are collected from the websites of the government organizations and government institutions, articles, abstracts from books and research papers. The research covers studies from the US, UK and India. The study was conducted in Bangalore, Karnataka, India.

Analysis and Interpretation

The monetary system over the centuries has gone through a lot of change. From barter system to fiat money. From the review of literature, the advantages and disadvantages of each system can be understood. The disadvantages of barter system outweighed the advantages, some of the disadvantages of the barter system were: lack of double coincidence of wants, absence of a common measure of value, indivisibility of goods, difficulty in storing value. The system which later came into prominence was the Gold Standard, where the country's currency was backed by gold at a fixed rate. The gold standard went through a lot of policy changes and reforms from its beginning in 1820's till 1970, when it was completely abolished. Though the gold standard seemed like a perfect alternative monetary system compared to the previous systems, the system had many drawbacks: The cost of producing and maintaining gold were high, The money supply and price levels were affected by the monetary shocks in the economy, Hoarding of gold, and limited production of gold led to the sluggish growth of the economies during that period. Even the reformed versions of the gold standard failed due to political failures and trade restrictions during the Great Depression.

The next monetary system which became widely recognized and accepted is the Fiat money. This is the system which is in use by majority or all of the economies in the world. Unlike gold standard where the currency of the country was pegged to a commodity i.e. gold. The Fiat money is not backed by any commodity or anything physical in its form, this is a legal tender issued by the government decree. Decree here means an official order by the government which has the force of law. Fiat money started to dominate during the late 20th century when the U.S. President Richard Nixon announced that convertibility of dollar into gold or other reserve assets would be suspended. (The Editors of Encyclopaedia Britannica, 2019).

The Fiat money has no intrinsic value. The monetary system uses floating exchange rate system where the currency's value is determined by demand and supply of the currency. This system has brought in a lot speculations and a popular phrase which says "do banks create money out of thin air"(Romanchuk, 2019). The money is created and regulated by the central bank of the respective country. The process of creation of money is termed as "Open Market Operations". In this system the central bank buys or sells securities from the commercial bank. Securities usually bought and sold in the process are treasury notes and mortgage backed securities. The central banks print money to buy these securities (Amadeo, 2020).

Through this system a more unconventional method has evolved known as Quantitative Easing. This method is an expansion of the open market operations. Quantitative Easing is used to stimulate money supply into the economy at a rapid rate, specifically during recessionary times. The central banks buy long-term securities from the commercial banks and lends money to them. The supply of money into the economy stimulates the economy: It keeps the bond yields low which results in easy access of credit to the consumers and businesses, Due to the increase in money supply country's currency depreciates in value which attracts foreign investment and increases exports. The drawback which arises in this system is it causes inflation in the economy, which has led to many major crisis in the world. (Amadeo, 2020)

Are Cryptocurrency's the future?

According to an article by Darryn Pollock on crypto and block chain. Challenger banks have started to take over vastly and will potentially be the future of banking also that cryptocurrency and blockchain could possibly swarm the banking scene and soon may be used as legal tender given the amount of demand they have however, it is true that cryptocurrency are allowed only to a minimal, what that means is that for example; there can only be 21 million bitcoin in the world, after which there can be no more production and distribution of the cryptocurrency, the same applies to other cryptocurrency as well, this detail may stop the progress of cryptocurrency in its tracks knowing that these massive e-currencies are only available in limited amount and are extremely expensive given their demand and the world's population. (The future of cryptocurrency – Darryn Pollock)

A huge contributor to the enhancement of cryptocurrency as legal tender is simply the fact that cryptography protects its security making it nearly impossible to counterfeit, also the fact that the whole concept of cryptocurrency is built on a strong foundation of mathematics and logic making the human factor negligible. (The future of cryptocurrency as legal tender by finance tampi)

Conclusion

Throughout this endeavour, we have learned about the how money had been backed and valued and how over the years, it managed to be valued in many different ways. We had the barter system which lacked a lot of things, then the gold standard then fiat money.

What we have learned through all of this is just that the process of valuation of money is never going to remain the same, that is usually because of the fact that mankind keeps advancing. What could be concluded from all the above data is that the economy and the various factors that make it so amazing will in fact bring about another process by which money could be valued. As we know from existing data on valuation that banks are now slowly starting to accept cryptocurrency, this, in turn, will definitely bring about a rather seamless means of valuation money in the future and it could be related to cryptocurrency and blockchain.

What we think that in the future, although demand and supply will be a huge factor, money would be valued on the basis on blockchain. As we all know currently money is valued based on demand and supply, we just assume that the same process would apply except that there would be virtually no physical money to go around, we think that money would be stored in the cloud encrypted by various security systems. We assume money would be valued based on demand and supply of cryptocurrency, so what that means it that you could store your money on the cloud as any cryptocurrency you please and as the demand of that cryptocurrency fluctuates, your money's worth would as well.

Given the expeditious development of technology and the various known cryptocurrency, this theory doesn't seem too far-fetched.

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