CHAPTER 1

A Brief History of Financial Systems and the Birth of Money

Most of us know very little about our financial system and its history. Even though I had worked in the banking and finance industry for close to two decades, I knew very little about the financial system's history until I started doing my research. I was surprised to learn that our current financial system is only about 43 years old. I knew that the world had been using paper currencies for hundreds of years and that, before this, coins were used, mainly gold and silver. However, the circumstances for the shift from coin to paper as well as the shift to fiat currency were all new to me.

What I came to realize was that our financial system moves in cycles much like an economy does. It goes through periods of growth and expansion and then decline. There have always been crises in financial systems. No financial system has ever been perfect and free of flaws. Crises can be sparked by many factors—wars, speculation (bubbles), runaway government borrowing and spending, and government mismanagement of the economy or its currency.

To understand where we are and where we are heading, we must first understand where we have been, beginning with the history of money and financial systems. Literally hundreds of books have been written on early currencies and financial systems. This topic alone deserves time to explain in detail. However, to keep focused on the topic of this book, I will attempt to summarize the evolution of currencies and financial systems in this chapter.

EARLY FINANCIAL SYSTEMS AND CURRENCIES

Financial systems existed long before gold and silver were used as a medium of exchange. One of the earliest forms of money was cattle and other animals, which were used as a medium of exchange and a store of value as early as 9000 BCE.[1] Animals were used as payment under Roman law, whereby fines were paid in oxen and sheep.[2] Sacks of grain, salt, and even seashells have been used as a form of currency for trade at one point in time.[3] Thus, trade, taxation, and payment of fines existed before metal coins and money as we know them today were used.

There is even some research supporting the idea that debt and credit existed before coins and other money came into existence.[4] According to David Graber's research and his book, *Debt: The First 5,000 Years,* the first recorded credit and debt systems developed more than 5,000 years ago as means of accounting. Credit and debt existed in the Sumerian civilization around 3500 BCE. In this system of credit, farmers would often become so indebted that their children would be forced into slavery as a means to repay the debt. These debt slaves were periodically released by kings, who canceled all debts and granted them amnesty under what came to be known as the Law of Jubilee in ancient Israel. One of the conclusions of this research was that indebtedness throughout history often led to unrest, insurrections, and revolts.

Though barter was also used throughout ancient societies, it was never a complete system or means of account, as other social factors came into play. Social currencies (i.e., interaction among the community and mutual expectations and responsibilities among individuals) completed early financial systems. Social bonds were also created through gifts, marriages, and general sociability. This type of economy stood in contrast to the moral foundations of exchange, based on formal equality, reciprocity, and hierarchy. This system established the customs in a society, which also led to the development of caste systems (the "haves" and the "have nots").[5]

One of the first written codes of law mentioning money and debt was the Code of Hammurabi, enacted by the Babylonian king Hammurabi, who ruled from 1792 BCE to 1750 BCE.[6] The code consisted of 282 laws dealing with a wide range of matters, from trade to family relationships. Nearly half of the code dealt with laws for contracts, the establishment of wages, interest rates on debt, inheritance, and property rights.[7]

The first mention of the use of money within the Bible is in the book of Genesis,[8] which refers to the criteria of the circumcision of a bought slave. There are other early references to money going back as far as the twentieth century BCE, such as Abraham's reference to the purchase of the Cave of the Patriarchs.[9]

An example of an ancient currency is the shekel. It was an ancient unit of account used in Mesopotamia around 3000 BCE[10] to define both a specific weight of barley and equivalent amounts of materials such as silver, bronze, and copper.

The use of coins later developed primarily as a means to pay soldiers in ever-expanding empires around the world. The rise of great empires in

China, India, and the Mediterranean was marked by extreme violence as these empires grew and required more and more resources to pay for their expansion. In this way, coins developed to pay soldiers in far-off lands as well as to enforce the payment of taxes by the state's subjects to subsidize its growing armies. Around 1000 BCE, money in the shape of small knives and spades made of bronze were in use in China. The first manufactured coins appeared in India, China, and cities around the Aegean Sea between 700 and 500 BCE.[11]

GOLD AND SILVER

Throughout history, gold and silver have been the most common form of money. In many languages, such as Spanish, French, and Italian, the word for silver is still directly related to the word for money. Although gold and silver were commonly used to mint coins, other metals were used, such as iron and copper.

The earliest known records of gold and silver being used for monetary exchange date back as far as the third millennium BCE, when gold, specifically, was used in Mesopotamia and ancient Egypt.[12] The first gold coins were minted in Lydia (modern-day Turkey) during the Grecian age around the year 700 BCE.[13] By the fourth century BCE, coins had become widely used in Greek cities. The coins were supported by the city-state authorities (the issuing authorities), who strived to ensure they retained their value regardless of fluctuations in the availability of whatever base precious metals they were made from.

Once well-established in Greece, the use of coins spread slowly westward throughout Europe and eastward to India. By the second century BCE, coin usage in India 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. During the fourteenth century, much of Europe had converted from use of silver in currency to minting of gold.[14]

Metal-based coins had the advantage of carrying their value within the coins themselves. One disadvantage, however, was that they could be manipulated. The clipping of coins was a fairly frequent practice. The clippings were then traded and recycled. Governments, over time, also had the habit of diluting the precious metal content in coins, such as blending copper with gold or copper with silver. This, of course, caused inflation and, in some cases, loss of faith in the issuing authority. Governments did so because they were short on precious metals and had bills to pay.

A bigger problem was the use of coins made of different metals—copper, gold, and silver in Europe. Gold coins, for example, were valued more than silver coins, and silver coins were valued more than copper coins. In England in the 1670s and 1680s, the gold-based guinea coin began to rise against the English silver-based crown. The huge amounts of gold coming into Europe from discoveries in the New World shifted trade away from silver and into gold. In Asia, the situation was the opposite: Gold was leaving for Europe in favor of silver. Some prominent Europeans such as Isaac Newton, Master of the Royal Mint, were uneasy about these movements, as they created instability and made it difficult to value one metal over another.[15]

Soon thereafter, national banks were set up to bring stability to the system by guaranteeing to change money into gold at a promised rate. This, however, did not come without its own challenges. The Bank of England came close to a major financial crisis in the 1730s when customers demanded their money be changed into gold at a moment of crisis. The crisis was avoided only when London's merchants saved the national bank with financial guarantees.[16]

What's important to note about this period is that money evolved from being a unit of weight to being a unit of value. A distinction could be made between its *commodity value* (i.e., its weight in gold) and its *specie value* (its value in the market).[17]

PAPER MONEY, PROMISSORY NOTES (*SUKUK*), AND BILLS OF EXCHANGE

Once money became a unit of value, it no longer needed to be held in commodity form. Paper money began to appear in China in the seventh century, under the Tang Dynasty.[18] The development of banknotes (paper currency) was rooted in merchants' desire to avoid the weight and bulk of transporting coins to settle large commercial transactions. They developed a system whereby they would issue credit notes, which were for a limited duration and at a discount to the promised amount. This new paper currency did not replace coins until later, in the Song Dynasty, in the eleventh century. The banknotes were used alongside the coins until the central government noticed the economic advantages of printing banknotes and holding a monopoly right over their issuance.

It was not until the thirteenth century that paper money reached Europe through the accounts of travelers, such as Marco Polo.[19] In medieval Italy and Flanders, money traders started using promissory notes due to the high risk and impracticality of transporting large sums of money over long distances. These notes are considered to be the predecessor of the regular banknotes we know today. In 1661, the first European banknotes were issued by Stockholms Banco, later known as the Bank of Sweden.[20]

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At the same time banknotes started to appear in China, another form of paper currency began to appear in the Islamic world, the *sakk,* more commonly known as the promissory note. These notes were seen during the rise of the Islamic Umayyad Caliphate from the year 661 to 750 CE.[21, 22] Each note individually was called a *sakk,* and in the plural, *sukuk,* which is cognate with the European root *cheque*. A *sakk* meant any document representing a contract or conveyance of rights, obligations, or monies done in conformity with the Shariah.[23] *Sukuk* were used extensively during the medieval period in Islamic society for the transfer of financial obligations originating from trade and other commercial activities. The essence of *sukuk,* in the modern Islamic perspective, lies in the concept of asset monetization, also known as securitization. *Sukuk* are discussed in detail in Part II.

Europe during the Middle Ages witnessed a lot of financial innovations, not only with the development of banknotes but also with the development of trade bills of exchange. Their development was directly the result of the rapidly increasing trade throughout the region. A thriving trade business is heavily dependent on credit for expansion. Bills of exchange worked by allowing the buyer to receive the goods in return for the buyer delivering to the seller a bill of exchange, which constituted the buyer's promise to make payment at a specified date in the future. The seller could then present the bill to a merchant banker and redeem it in money at a discount to its value before it actually became due. The seller would get paid sooner and remove the risk of repaying in return for accepting a lower price against the bill's value. This transferred the risk to the merchant banker, who would accept the bill and make a profit in return for taking on the repayment risk.

As you can imagine, merchant bankers would need to ensure that the buyer is reputable and that the bill was endorsed by a credible guarantor. This evolved into a regional credit system whereby a bill of exchange could be issued in one town and redeemed in another town through a network of merchant bankers. In England, bills of exchange became an important form of credit and money during the late eighteenth century up to the early part of the nineteenth century before banknotes, checks, and credit lines were widely available.[24]

Another innovation during this period came from England in the twelfth century. The English monarchy introduced a notched piece of wood known as a *tally stick* to record the various amounts of taxes to be payable to the crown. The reason for using tallies was mainly because paper was rare and costly at that time. However, tallies were so popular that they continued to be used until the early nineteenth century, even after paper forms of money had become prevalent.

Initially, tallies were simply used as a form of receipt to the taxpayer indicating that the dues had been paid. As tallies became successful for collecting taxes, the revenue department found new uses for them and began issuing tallies to denote a promise by the tax assessee to make future tax payments at specified times during the year. Each tally consisted of a matching pair: One stick was given to the assessee, representing the amount of taxes to be paid by which date, and the other was held by the revenue department, representing the amount of taxes to be collected by which date.

It was soon discovered that these tallies could also be used to create money. When the government was short on money it would use tally receipts, which represented future tax payments due, as a form of payment to its own creditors. These creditors would be able to collect the tax revenue directly from the assessees or use the same tally to pay their own taxes to the government. This led to the development of a thriving market for trading tallies, which would be traded at a discount reflecting the length of time remaining until the tax was due for payment. The longer the time remaining on the tally, the larger the discount. Thus, the tallies became an accepted medium of exchange for some types of transactions and an accepted medium for storage of value. Once the market for tallies took off, the government realized that it could issue tallies that were not backed by any specific assessment of taxes. By doing so, the government was able to create new money that was backed by public trust and confidence in the monarchy rather than by specific revenue receipts.[25]

GOLDSMITH DEPOSITS AND THE ESTABLISHMENT OF BANKS

As trade flourished in Europe, merchants grew to be very wealthy, and many of them amassed huge hoards of gold. The safest place to store this wealth at the time was to entrust it to the Royal Mint. However, in 1640, King Charles I of England seized the private gold stored in the mint, calling it a loan, which was to be paid back over time.[26] This caused merchants to remove their gold from the mints and place it instead with goldsmiths. Goldsmiths in England had been craftsmen, bullion merchants, money changers, and money lenders since the sixteenth century, but did not actively get involved in gold storage until this event. They also possessed private vaults.

Merchants began storing their gold in goldsmiths' vaults for a fee. In exchange for each deposit of precious metals—namely, gold and silver—the goldsmiths issued receipts certifying the quantity and purity of the metal they held in trust. These receipts could not be assigned to another party. Only the original depositor could collect the stored precious metals. With all the precious metals stored in vaults sitting idle, goldsmiths soon began lending out the metals on behalf of depositors and issuing promissory notes for money deposited. These deposits were treated as loans from the depositor to the goldsmith. The depositors allowed the goldsmith to use the money for any purpose, including advances to his customers. Goldsmiths did not charge a fee for accepting these deposits and, in many cases, paid interest on them. This was the beginning of the fractional reserve banking system, as these promissory notes were payable on demand and the loans to the goldsmith's customers were repayable over a longer time period. Gold deposits were relatively stable, often remaining in the goldsmith's vault for years, so there was little risk of default so long as the goldsmith maintained public trust and was financially sound.

The promissory notes developed into an assignable instrument, which could circulate as a safe and convenient form of money backed by the goldsmith's promise to pay. Goldsmiths were able to advance loans, issue promissory notes, and offer checking accounts allowing depositors to draw down their balances held by issuing checks.[27] This is how the London goldsmiths became the issuers of money and credit, and went on to give birth to the banking system.

This led to the establishment of banks, which issued paper notes called *banknotes*. These notes circulated in the same way that government-issued currency circulates today. In essence, each bank would have the ability to issue its own currency. This practice continued until 1694, when England decided to monopolize the right to issue banknotes and established the Bank of England (central bank).

In the United States, this practice continued through the nineteenth century until the Federal Reserve Bank was established in 1913. At one time there were more than 5,000 different types of banknotes issued by various commercial banks in the United States, some reputable and some not so reputable. The notes issued by the largest, most creditworthy banks were widely accepted. The banknotes of the smaller and less reputable banks circulated locally. Farther from home banknotes were accepted only at a discounted rate, if they were accepted at all. The proliferation of types of money went hand in hand with a multiplication in the number of financial institutions.

These banknotes were a form of representative money, which could be converted into gold or silver by application at the bank. Since banks issued notes far in excess of the gold and silver they kept on deposit, sudden loss of public confidence in a bank could cause mass redemption of banknotes and result in bankruptcy.

The use of banknotes issued by private commercial banks as legal tender has gradually been replaced by the issuance of banknotes authorized and controlled by national governments. Until recently, these government-authorized currencies were forms of representative money, since they were partially backed by gold or silver and were theoretically convertible into gold or silver. This has since changed, as convertibility and linking currency to any tangible asset was dropped in favor of being backed by simply the trust in the issuing authority and its creditworthiness, otherwise known as *fiat currency*.

It is important to understand why nations switched from representative money to fiat money, as this is where the story begins to explain why we are in a financial mess today.

FINANCIAL GLOBALIZATION AND THE GOLD STANDARD (1821–1913)

Before financial globalization there were regional powers, which dominated trade; hence, their currencies were most commonly used and accepted. Before the Roman Empire reached its height of power, the Persian Empire was the dominant force and its currency, the *daric*, was the most widely used currency. This was succeeded by the Roman currency, the *denarius*, and then the gold *dinar* of the Islamic empire. During the age of Imperialism (sixteenth to twentieth centuries), the currencies of European colonial powers dominated foreign trade, beginning with the Spanish dollar, followed by the Dutch guilder, then the French franc, and ending with the British pound in the late nineteenth century. With Europe in ruins following World War I, the U.S. dollar became the dominant trading currency and is the basis for the current international monetary system.

Until the nineteenth century, the global monetary system was not very well integrated. The system was regional in focus, with colonial powers wielding influence over their former colonies in Africa, Asia, the Middle East, and South America. The influence of the former Spanish empire led to the integration of American and European economies and monetary systems. European influence in Asia led to the dominance of European currencies, most notably the British pound.

In the eighteenth century, much of the world was on a bimetallic standard, meaning more than one precious metal was legal tender. The main metals used were gold and silver, and copper to some extent. This created problems, as mentioned earlier. During the Napoleonic Wars (1803 to 1815), the United Kingdom suffered a silver shortage and was forced drop this standard and go on a fiat standard. The main change to this system began in 1821 when the United Kingdom returned to a convertibility system and established the classical gold standard.[28] This new system allowed banknotes to be redeemed for gold bullion at the Bank of England. The redemption rate was set at 4.24 pounds for one ounce of gold. So anyone holding pounds at the time could go to the Bank of England and redeem their pounds for gold at this fixed rate. The main objective of this was to bring trust and stability to the system. Over the next decades, more and more countries embraced this new standard and dropped silver. By 1880, most of the countries around the world were on some form of gold standard.[29]

With currencies stabilized, world trade began to grow at a faster pace than it had in prior decades. World leaders began to promote free trade, which led to a huge expansion in communications, railway transportation, and transatlantic shipping. This period also witnessed record levels of migration.

Once the globalization wave started to take hold, protectionism began to rise, beginning in Germany in 1879. German Chancellor Otto von Bismarck introduced tariffs on agricultural and manufacturing goods, making Germany the first country to institute protectionist trade policies. France and the United States followed shortly with their own protectionist policies. Despite these measures, global trade continued to flourish, leading to an increase in foreign investment and capital flows.

As a result of the rise in capital flows between Europe and the Americas, new financial centers developed. Before 1870, London and Paris were the main financial centers. However, Berlin and New York soon began to compete on par with London and Paris. Other financial centers grew in importance as well, such as Amsterdam, Brussels, Geneva, and Zurich. London remained the leading international financial center in the four decades leading up to World War I.[30]

At the end of this period, another major event occurred. The U.S. Congress passed the Federal Reserve Act on December 23, 1913, giving rise to the Federal Reserve System, which acts as the country's central bank. The authority of the Federal Reserve System is derived from statutes enacted by the U.S. Congress and is subject to congressional oversight. There is, however, some controversy surrounding the establishment of this system, as it removed the right of Congress to issue and control the currency, as stated in Article 1, Section 8, of the U.S. Constitution.[31]

The Federal Reserve Bank (the Fed), contrary to popular belief, is not a government entity. It is independent from the government and owned by member banks. The specific shareholding of the bank is not disclosed, but the bank's website states that more than one-third of U.S. commercial banks are members.[32] Member banks receive an annual statutory dividend of 6 percent of their capital investment in the Fed, and the U.S. government receives the remaining profits.[33]

The main objective of the Fed was to become the sole lender of last resort and to resolve the inelasticity of the money supply in times of crisis. However, this liberated banks from the need to maintain their own reserves, and they began taking on greater risks. The system that was set up to safeguard the country from financial crises actually made the economy more prone to crises, as we shall see in the following chapters.

THE TWO WORLD WARS AND THE GREAT DEPRESSION (1914–1945)

On June 28, 1914, Austrian Archduke Franz Ferdinand was assassinated while on a visit to the Bosnian capital, Sarajevo. This event led to Austria's invasion of Serbia one month later. Germany sided with its Austro-Hungarian ally, and Russia sided with its allies in the Balkans. Soon, Belgium, Luxembourg, and France were invaded by Germany, and the United Kingdom declared war, sparking the first world war of the century.[34]

Over the next four years, there would be 16 million deaths and 20 million wounded, making it among the deadliest conflicts in human history.[35] Economically speaking, Europe was in shambles, with the exception of four allies—Britain, Canada, Italy, and the United States, which saw their gross domestic product (GDP) increase during the war. The decline in the GDP in Austria, France, Russia, and the Ottoman Empire reached 30 to 40 percent. In Germany, the GDP declined by 27 percent.[36]

In addition to the cost of war, high inflation and food shortages can be blamed for sparking the Russian Revolution in 1917. The tsar was overthrown, and a civil war began, bringing the Communist Party to power. The Union of Soviet Socialist Republics (U.S.S.R.) was established in 1922.

The war officially ended in November 1918, but the Treaty of Versailles was not signed until six months later, in June 1919. The treaty forced Germany to disarm and imposed harsh reparations to pay for war damages. Notable economist of the time John Maynard Keynes voiced his concerns about excessive reparations, saying it was too hard a punishment and counterproductive.[37] Most of Germany's reparations payments were funded by loans from U.S. banks. Between 1919 and 1932, Germany paid out 19 billion gold marks in reparations and received 27 billion gold marks in loans from New York bankers and others. These loans were later paid back by West Germany after World War II.[38]

During the war, countries enacted trade embargoes on gold exports, leading many countries to abandon gold redemptions, thus dropping the gold standard altogether. This allowed their currency exchange rates to float freely. After the war, some countries deliberately weakened their currencies, hoping to boost exports and help their economies. In the 1920s, Austria, Hungary, Germany, Russia, and Poland began experiencing hyperinflation. Seeing the negative effects of this, the United States tried to persuade countries to go back to the gold standard and was fairly successful. By 1927, many countries had returned to the gold standard,[39] but this wouldn't last long, as the world was again headed toward protectionist policies, which eventually made their way to the United States.

The Stock Market Crash of 1929 and the onset of the Great Depression raised protectionist fears in the United States, leading President Herbert Hoover to sign the Smoot–Hawley Tariff Act in 1930. The act raised import tariffs on thousands of goods. U.S. trading partners responded by introducing tariffs on U.S. goods.[40] Exports from the United States dropped 60 percent from 1930 to 1933.[41] Worldwide international trade virtually ground to a halt. The international ramifications of the Smoot–Hawley Act—the spread of trade policies and the rise of economic nationalism—are credited by economists with prolonging the Great Depression.[42]

The Great Depression brought about bank runs in Austria, Germany, and the United States, which put pressure on gold reserves in the United Kingdom to such a degree that the gold standard became unsustainable. Germany became the first country to formally abandon the post–World War I gold standard in July 1931. In September 1931, the United Kingdom allowed the pound to float freely. By the end of 1931, several other countries, including Austria, Canada, Japan, and Sweden, abandoned gold.[43]

Some historians believe that the effects of the Great Depression, which lasted nearly a decade, were also the result of high interest rates and a contraction of the money supply.[44] The Fed could not increase the money supply without more gold, putting pressure on the ability of the United States to maintain its gold standard. In 1934, Congress passed the Gold Reserve Act, nationalizing all gold by ordering the Fed to turn over its supply to the U.S. Treasury. In return, the banks received gold certificates to be used as reserves against deposits and Federal Reserve notes. The act also authorized the president to devalue the dollar gold redemption rate from \$20.67 per ounce to \$35 per ounce, effectively devaluing the dollar by more than 40 percent.

The Allied Powers thought to avoid history repeating itself and saw financial cooperation as a way to encourage mutual cooperation among the countries affected by the war. In 1930, during the early days of the Great Depression, the Bank for International Settlements (BIS) was established. The main purposes of the BIS were to manage Germany's reparations payments imposed by the Treaty of Versailles as well as to function as a bank for central banks around the world. Countries can hold a portion of their reserves as deposits with the BIS. The BIS also operates as a trustee and facilitator of financial settlements between countries.[45]

These efforts, however, did not stop the rise of nationalism, which was further fueled by the economic depression and protectionist trade policies. The crippling effects of the Treaty of Versailles on the German economy gave way to the rise of Hitler in the 1930s. In 1939, another world war was started, which would last six years and claim 61 million lives.[46]

THE BRETTON WOODS AGREEMENT (1945–1971)

In the aftermath of World War II, world powers again looked for ways to prevent future conflicts and bring about peace, stability, and prosperity. There were three major developments during this period: the birth of the United Nations, establishment of the Marshall Plan, and the negotiation of the Bretton Woods Agreement.

The United Nations (UN) was born on October 24, 1945, as an intergovernmental organization established to promote international cooperation, replacing the League of Nations, which had been deemed ineffective.

In 1948, the United States launched the Marshall Plan. The initiative was aimed at helping Europe rebuild after the war in order to prevent the spread of Soviet communism. The plan was in operation for four years, beginning in April 1948. Other objectives of the plan included removing trade barriers, modernizing industry, and making Europe prosperous again.[47]

In 1944, delegates from the soon-to-be-created United Nations held a conference at a hotel in Bretton Woods, New Hampshire, called the United Nations Monetary and Financial Conference, which is now commonly referred to as the Bretton Woods Conference. With the effects of the Great Depression and two world wars still fresh in their minds, delegates devised a new system that would relieve them of the challenges of maintaining a gold standard while also reducing currency volatility and instability.

Delegates at Bretton Woods favored pegged exchange rates for their flexibility over the previous fixed exchange rates. This arrangement would come to be known as the Bretton Woods System. Under this system, countries would peg their exchange rates to the U.S. dollar and the U.S. dollar would be convertible to gold at $35 per ounce.[48] Countries pegging their currencies to the U.S. dollar would allow their exchange rates to fluctuate within a 1 percent band of the agreed-upon exchange rate. To achieve this, central banks would buy or sell their currency against the dollar to maintain the peg.[49]

This effectively made the U.S. dollar, rather than gold, the world's reserve currency. The U.S. dollar would still be redeemable for gold; however, other countries would no longer be required to hold large gold reserves or ship gold back and forth to adjust any payment imbalances, since the dollar would now serve that purpose. A country wishing to receive gold would first need to convert its currency to U.S. dollars and then present them to the Fed for gold.

Another important development following the Bretton Woods Agreement was the creation of two new institutions: the International Monetary Fund (IMF) in 1947 and the International Bank for Reconstruction and Development (IBRD) in 1946, which later became the World Bank. The IMF was established to support the Bretton Woods monetary system with the mission of facilitating multilateral cooperation on international monetary issues, providing assistance to member states, and offering emergency lending to countries experiencing crises and help in restoring their balance of payments.[50]

Under the agreement, members were authorized and encouraged to employ capital controls as necessary to help manage payment imbalances and meet pegging targets, but were prohibited from relying on IMF financing to cover particularly short-term capital hemorrhages.

The IBRD was established to serve as a financial intermediary for channeling global capital toward long-term investment opportunities and postwar reconstruction projects.[51] The creation of these two organizations was a crucial milestone in the evolution of the international financial architecture, and some economists consider it the most significant achievement of multilateral cooperation following World War II.

POST–BRETTON WOODS—FIAT CURRENCIES (1971–TODAY)

Under the Bretton Woods system, international trade grew, but this success masked an underlying flaw in the system's design. There was no mechanism for increasing the supply of international reserves to support continued growth in trade. In the late 1950s and early 1960s[52] central banks worldwide needed more dollars to hold as reserves but were unable to expand their money supplies, as that meant exceeding their dollar reserves and threatening their exchange rate pegs. For the system to be successful, the United States needed to run dollar deficits. As a consequence, the value of the dollar began exceeding its gold backing.

During the early 1960s, investors could sell gold at a higher price in London than the stated rate of $35 per ounce in the United States, indicating that the dollar was overvalued. In 1960, Belgian-American economist Robert Triffin defined this problem, which came to be known as the Triffin dilemma, whereby a country's economic interests conflict with its international objectives as the custodian of the world's reserve currency.[53] This means that the United States couldn't provide the world with a reserve currency while at the same time doing what is best for the country's economy; it had to choose one policy to follow at the expense of the other.

France voiced concerns over the artificially low price of gold in 1968 and even called for a return to the former gold standard. Around this same time, excess dollars flowed into international markets as the United States expanded its money supply to accommodate the costs of its military campaign in the Vietnam War. Speculators began attacking the dollar to exploit this weakness.

In August 1971, President Richard Nixon suspended the exchange of dollars for gold. The suspension of convertibility effectively shifted the adjustment burdens of a devalued dollar to the rest of the world. Speculators moved on to attacking other currencies and began selling dollars in anticipation of these currencies being revalued against the dollar. Central banks were faced with choosing between inflating money supplies, imposing capital controls, or floating exchange rates.[54]

In response to these developments, the Group of 10 member countries, also known as the G-10, which represented the 10 largest economic powers of the IMF at the time, met in Washington in December 1971 to sign what is known as the Smithsonian Agreement. The agreement called for the dollar price of gold to be raised to $38 per ounce, effectively depreciating the dollar by a further 8.5 percent. In addition, the Bretton Woods System was modified to allow fluctuations within an expanded band of 2.25 percent instead of 1 percent. The agreement was not very effective and merely delayed the system's collapse. Market forces continued to put pressure on the dollar/gold price, which devalued the dollar by another 10 percent over the next two years. In February 1973, Japan and European Economic Community (EEC) members decided to let their currencies float freely in the market. Within a decade all industrialized nations had done so, creating the fiat system we have today.[55]

OTHER RELEVANT EVENTS IN OUR CURRENT MONETARY SYSTEM

There have been a few small adjustments to this system over the years, but it remains largely unchanged. Due to increasing volatility in foreign exchange markets under the new fiat system in the 1980s, two additional agreements were reached: the Plaza Accord in 1985 and the Louvre Accord in 1987. These accords created the managed float system by which central banks jointly intervene to resolve under- and overvaluations in the foreign exchange market to stabilize otherwise freely floating currencies.[56]

In the 1990s, foreign exchange markets were relatively calm. Volatility did not come back to the market until the dot-com bubble burst in 2000 and became even more volatile since the most recent financial crisis in 2008.

There is now increasing pressure on world leaders to find alternatives to the dollar-based fiat system, as the cracks are appearing ever more frequently.

Some suggested alternatives have been to go on a multicurrency system, which would consist of a basket of currencies, such as U.S. dollars, euros, and yen. Another alternative would be to use the IMF's special drawing rights (SDRs) to back currencies. Developed in 1969, SDRs are another type of reserve instrument that consist of a basket of 16 major currencies.[57] (I discuss SDRs in more detail in Chapter 11.) Other alternatives include moving away from the dollar to another reserve currency, such as the euro or Chinese yuan. Some politicians and economists in the United States have even suggested going back to the gold standard. No one knows for sure what the next system will look like, but one thing is for sure: The current system needs to change, and this will happen only once another crisis hits and breaks it beyond repair.

Now we can see how our current monetary system was born, in 1971. There have been a few modifications over the years, but in essence the system remains the same. The world is on a fiat system using currencies based on trust and faith in the issuing authorities. Though there are benefits to this system, the negatives tend to outweigh the positives. The primary advantage of this system is that money supply can expand (without limit) and contract more easily than on a gold standard. This gives central banks comfort in knowing they can try to balance out market forces. The primary drawback of such a system is that governments eventually abuse it, as solving their budgetary problems by turning on the money printing press is too tempting to forgo. History does not favor fiat currencies, as they have all disappeared, either by default or as a result of hyperinflation.

To see why the fiat currency system is not sustainable, we need to look at the reasons such a system leads to instability and recklessness among governments and financial institutions. In the following chapters we look at past financial crises and see what caused them. We then turn to our current situation to see if we can spot a new crisis forming.

SUMMARY

- Early financial systems existed before the invention of money, dating back as far as 9000 BCE, and were based on social interactions, customs, barter, mutual reciprocity, and hierarchy in the community.
- Some of the first forms of currency were animals, grains, salt, and seashells.
- Later, precious metals emerged and became the preferred medium of exchange as empires grew and the need to pay soldiers and collect taxes also grew.

- With the expansion of trade during the Middle Ages, the need for better and safer alternatives to transporting large quantities of metals led to the development of promissory notes (*sukuk*) and bills of exchange.
- Since precious metals were still the main store of value, the need for storage vaults to house these metals grew in line with the expansion in trade.
- Merchants and kings stored their wealth in royal mints until attempts at confiscation and abuse took place, which caused merchants to move their metals to private storage vaults at goldsmiths.
- Goldsmiths, in turn, started to find new and creative ways to make a profit out of the vast sums of wealth in their vaults and began making loans, taking deposits, and issuing promissory notes.
- As paper currency became more accepted, banks were launched off the backs of the success goldsmiths had in issuing notes. Banks issued their own notes, called banknotes, which is how our paper currency today came to be.
- Having seen the success of these banknotes and their ability to create money, governments monopolized the right to create money, and central banks were formed to handle this task, beginning with the Bank of England in 1694.
- Central banks sought to create stability in the financial system by making the paper notes redeemable for gold at a set price. In 1821, this formally became known as the gold standard.
- This system worked well until governments got into financial trouble or wars wrecked the economy, at which point governments dropped the redemption rights in order to print their way out of trouble. It never ended well, and governments switched back to the gold standard.
- The Great Depression put enormous pressure on countries to maintain currency stability and gold reserves, leading some to devalue their currencies against gold, as the United States did with the Gold Reserve Act.
- After World War II, the Bretton Woods Agreement was established, removing the requirement that other countries hold large gold reserves to support their currencies. Instead, the new system called for the U.S. dollar to become the reserve currency. The U.S. dollar, in turn, would remain redeemable for gold at a set price, thus maintaining a quasi–gold standard.
- Cracks began to appear in the Bretton Woods Agreement, and by 1971 the United States was forced to suspend the exchange of dollars for gold. Currencies are now backed by the faith in and credibility of the issuing authority, and are better known as fiat currencies.