Evolution of Currency: From Historical Shifts and Global Economic Impact

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Abstract

The evolution of currency from barter systems to gold coins is a long journey in economic history, evolving from the simplest trading mechanism to complex financial systems. The paper points out the critical developments that took place in the shaping of international finance, focusing on the role of gold and the subsequent rise of the U.S. dollar as a global reserve currency. In the aftermath of World War II, there was an attempt to strengthen international institutions, such as the United Nations and the International Monetary Fund, and to establish the Bretton Woods system to anchor world currencies to the U.S. dollar, itself anchored to gold. The Bretton Woods system collapsed in the early 1970s after a quite successful beginning, giving way to floating exchange rates. The research explores the strategic role of the United States dollar since the end of World War II. It explains how the dollar became a global currency due to a sudden burst of trust in the U.S. economic system and its use as a requisite in international transactions. Moreover, gold coins and the gold standard also worked to help international trade and finance remain stable until the disruptions of World War I and the changes that followed in the global economic environment. It follows the historical development of the currency and reveals the foundational aspects on whose basis modern financial systems were laid, together with the lasting effects gold and the U.S. dollar had on international economic activity.

Keywords: Barter System, Gold Standard, Reserve Currency, World War, Pound Sterling, Bretton Woods, Dollar Dominance

Methodologies

The methodology adopted by the paper for the literature review is based on integrating a diverse range of scholarly sources, from journals to government publications and economic reports. Case studies and examples are taken to evaluate such dynamics of the currency, the impact of the US dollar during the world wars, and the role played by the USD in international trade and finance. Furthermore, drawing from historical analysis and empirical studies when presenting evidence for the arguments that are made, this all-inclusive approach allows for a holistic view of the subject material.

Introduction

The phenomenon of why the US dollar has been tagged as a global currency is complex, having its roots in a number of historical, economic, and geopolitical factors. In other words, though there are many superpowers, like Russia and China, the US dollar has a special status within the global economy. Therefore, this paper will explore the drivers of the dominance of the US dollar and its implications for global trade and geopolitics.

Trade started, historically, through the barter system that was inconvenient for big transactions because the goods were perishable. Precious metals proved to be a big development as a medium of exchange, followed by the fashioning of coins. However, the problem of transporting heavy metals presented logistical issues and therefore paper currency came into being. China was the first country to systematize a banking system whereby paper notes could be exchanged for gold, a system taken back to Europe by Marco Polo. This system developed further as countries began to back their currencies with gold to create the gold standard. By then, the UK had amassed huge resources and productive capacity, and its currency, the pound sterling, had become the world's leading currency.

The World Wars marked a turning point. Heavily in debt and depleted of gold reserves, the UK began to see its pound sterling falter. The US had capitalized on neutrality and industrial might, amassing gold by supplying arms and goods. By the end of World War II, the US held the bulk of global gold reserves. In 1944, the supremacy of the US dollar was underscored with the Bretton Woods Conference. The agreement pegged other currencies to the US dollar, itself backed by gold, thereby making the dollar an anchor for world trade. That fact was reiterated with the creation of the World Bank and the International Monetary Fund, both of whom provided loans in US dollars and wove the currency even deeper into the world's financial order. The US leveraged its technology and security assistance to oil-rich nations like Saudi Arabia to ensure that the sale of oil is in dollars, which further entrenched the dollar's grip upon the world economy. Once more, this strengthened the hold of the dollar hegemony within the international trading system and financial community in general as the petrodollar system.

The United States dollar has long been the chief underpinning of the international system, serving as both major reserve currency and major standard in international trade and finance. Recently, however, with diversification in foreign reserves and claims, though at a very slow pace, other currencies like the euro, Chinese yuan, or renminbi have added strength to its weakening foundation. The dollar forms the anchor currency for the management of the world's economy, estimated at USD 105 trillion annually, and world trade, estimated at USD 25 trillion annually. To ensure that the global economic system works seamlessly, an approximate sum of USD 6.8 trillion is in circulation globally, which forms 58 percent of foreign exchange holdings.

The US dollar has won the distinction of becoming the global currency because of historical precedence, strategic economic policies, and geopolitical maneuvers. Understanding this evolution is further realization in understanding the dynamics of contemporary global trade and international relations. This paper proposes to explore those aspects in simple terms, in an attempt at a comprehensive understanding of why the US dollar remains the world's prime currency.

Evolution of Currency: From Barter System to Gold coins

Transition from Barter

The barter system is an ancient way of getting goods and services without using any form of monetary transaction, and it is much older than modern currency and was the only way that people of the earliest human societies carried out trade activities. In a barter system, individuals or communities directly traded items they had in excess for goods they needed. For instance, a blacksmith may have exchanged some of the tools that he made for a proportion of a farmer's crop in exchange for the tools he got. The barter system development occurred in the absence of a system that uses currency. One of its weaknesses came down to the fact that it was not a proper system of Trade among entities. They were faced with the difficulty of not having a standard way of specifying the value of the goods they

exchanged but also the problem of having both sides to want for the goods the other was ready to give. Money has come a long way since the barter system. One of the first forms of money was the so-called commodity, a thing that had its own value, such as salt, cattle, or precious metals, and these were used as a medium that allowed exchange. For example, salt used to be the currency in ancient Rome, while cowrie shells continued to be the currency in many parts of the world. The goods were valuable because they were essential in everyday life and thus, tended to be accepted as a means of exchange. It is because of commodity money that a standardization of transactions occurred, and there was a better flow of business due to currency being in one medium. The introduction of currency marked the real transition from a bartering to a monetary economy. The use of currency eased trade by offering a medium of exchange and a standard measure of value. In this way, more complex and efficient economic systems could grow out of these basics and help in the rise of civilization and the spread of trading networks.
Specific examples may be provided for the early forms of currency; for instance, cowrie shells have been used in most African, Asian, and Pacific Island countries, mainly based on their shape and scarcity. They were used, in trade, for many hundreds of years. Also, precious metals like gold and silver served as currency in most of the ancient civilizations, such as Greeks, Romans, and Egyptians. Apart from being very durable, these metals were mainly valued because they were very rare and inherently valuable. In some ancient societies, cattle were used for the purpose of currency. The number of cattle one owned measured a person's wealth and was used for trading purposes or even as an exchange medium for goods and services. In the 17th and 18th centuries, representative money was in the form of bank and state-issued promissory notes. These notes could be exchanged for a certain amount of gold or silver.

Emergence of Gold Coins

The history of gold as an international medium of exchange is well footed on its perpetual value and exclusive properties that have contributed much to its role within the economic systems of the world since time immemorial. From being a currency and a standard, the function of gold has been central to shaping global trade and financial systems, down to a hedge for inflation. There are a number of factors that have contributed to the emergence and significance of gold coins as a universal medium of exchange, all of which combine to establish its timeless relevance. Gold coins have very rich history and date from the 6th century BC in Lydia, one of the ancient greater regions of present times Turkey. The first universally admitted form of gold coins was Croeseid minted by King Croesus of Lydia, which marked a milestone in the history of currency. The use of gold coins quickly spread through other civilizations, such as Greece, Rome, and China, where they became one of the major substitutes in trading and commerce. It would be adopted for minting coins across various cultures and regions because gold has some ideal aspects—durability, divisibility, and intrinsic value—making it fit perfectly for this field. Gold is considered an intrinsically valued metal and was so widely adopted that it has served as a form of currency for more than thousands of years. From ancient civilizations, including Egypt, Mesopotamia, and Rome, through the modern age, gold coins have been accepted everywhere for trading and commerce, thus remaining a symbol of wealth and power. Because central banks even nowadays keep huge reserves of gold to protect their economies from uncertainties, it becomes evident that gold has long remained stable and recognized as a currency. Gold coins did very fast systematization of the economic systems, for they established a value unit responsible for helping Trade and Economic Growth become easier. On the other hand, gold coins helped in stabilizing economies through the provision of a reliable, standardly accepted form of currency that did reduce uncertainties associated with the barter system or commodity-based exchange. Further, another factor that favored the expansion of world commerce was that gold coins were widely accepted and contributed to the creation of complex financial systems like banking, lending, and long-distance trade. The Byzantine Empire struck the Gold Solidus, a coin famous for its consistent purity that helped it survive as a stable currency for more than seven centuries. The Gold Dinar, first introduced by the Islamic Caliphates, became universally accepted in the Middle East, North Africa, and parts of Europe, helping to expand Islamic trade networks. Minting of gold coins by individuals and the government during the 19th century California Gold Rush outlined the nature of the economy in today's American West and helped achieve standardization.

Shift to Paper Cuurency

This change, from gold coins to paper money, is one of the major developments that have marked the history of money where intrinsic value is translated into representative value. It was gradual, with varied economic, practical, and technological causes. Paper money first came into being with the development of the first merchants in China during the Tang period of 618-907 AD. Merchants first started to issue paper which represented the intrinsic value of heavy copper coins which they did not wish to carry in their pockets. By the 11th century, government of the Song Dynasty came up with the first generally circulating "jiaozi." These early forms of paper money were still commodity-backed and circulated with coins. The jiaozi notes were first issued by private merchants and later by the government, facilitating trade by reducing the need to transport bulky metal coins over long distances.

Paper money would start being adopted later in Europe. The first banknotes issued in Europe were in 1661 by Stockholms Banco in Sweden. These were printed to replace alternative heavy, rather cumbersome copper plates that were being used in place of money payment. This experiment was soon aborted when the bank collapsed in 1664 due to a lack of coins to exchange for the notes. Despite this failure, the concept of paper money had been planted in Europe, and others began experimenting with issuing different notes in banks and other institutions. The changeover to paper currency in Europe was closely associated with the development of banking. Goldsmiths, during the 17th century in London, started the practice of issuing receipts for gold deposits, which soon began to circulate as money. The receipts evolved to the modern banknote, and the goldsmiths became some of the first bankers. Firstly, the receipts were simple slips for deposits, but they gradually standardized and started to be accepted in commerce generally. This practice developed the modern system of banking where banknotes had something to stand for, and it was not simply the promise of redemption in gold.

More importantly, the establishment of central banks introduced standardization and control of paper money. The Bank of England, established in 1694, received the exclusive privilege for issuing banknotes in England. It was expected of the bank to stabilize the currency by offering a stable method of exchange. The original notes of the Bank of England were thus backed by gold, in that they could be exchanged for a certain amount of gold when presented. This system, called the gold standard, supported establishing confidence in the new paper currency. The development of paper money in the United States was characterized by the creation of the First Bank of the United States in 1791 and the Second Bank of the United States in 1816. In fact, until the establishment of the Federal Reserve in 1913, there was no statutory provision for any central authority with the authority to issue national banknotes. Previously, most state and private banks issued their own notes; the monetary system was, therefore,

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chaotic and often unreliable. In 1913, Congress had passed the Federal Reserve Act to provide for a more stable and uniform currency, with Federal Reserve Notes as the standard form of paper money.
The maintenance of the gold standard helped in enabling the international acceptance of paper money. By the 19th century most major economies were using the gold standard, so their currencies were pegged to an amount of gold. This creates the needed stability in the exchange rate, which in turn helps in international trade. For instance, at some historical point in time, one British pound sterling was defined in terms of a given amount of gold, and that became the standard means of settling international debts and trade balances. The gold standard stability gave confidence in paper currency and encouraged its wider use. Various acts and restrictions contributed to the development of the paper money. For instance, the British Bank Charter Act of 1844 forbade any but the Bank of England from issuing banknotes to control and centralize the money supply. The same was achieved in the United States with the two National Banking Acts of 1863 and 1864, which established a system of nationally chartered banks and noted issuing a uniform banknote backed by government securities. That was done with a view to effect a stable and uniform currency system for reducing the problems that had been brought about by the earlier system of state and private banknotes.
What had really started implicitly as a shift from gold coins to paper currency was, however, a gradual process, influenced by economic, practical, and technological factors. From the early experiments in China to the establishment of a central bank, together with the gold standard, the evolution of paper money marked a sea change in the history of monetary systems. In the early 20th century, paper currency took center stage and turned out to be the greatest or most dominant form of money available, shaping the stage for further developments in the monetary systems of the modern world.

Currency Standardization for facilitating trade

It is undisputed that currency standardization greatly reduces transaction costs, exchange rate risks, and ensures economic stability. Standardization of currency, to a great extent, facilitates trade by eliminating uncertainty about exchange rate fluctuations. According to Rose and Engel, in their study in 2002, "currency unions, such as the Eurozone, have been tremendously successful in their goal of increasing trade among member states by removing exchange rate uncertainty and lowering transaction costs. Moreover, it makes cross-border transactions easier, as in the case of the European Union—it provides a common currency and relieves one from the agony of having to exchange currencies for many nations simultaneously. That, in addition, allows price transparency and enhances the efficiency of trade. For example, the European Central Bank argues that the adoption of the euro has greatly facilitated trade and investment in the Euro area, promoting higher economic integration and growth.
In addition, standardization of currency helps to increase economic growth by ensuring price stability, improved markets, and attraction of FDI. A stable and standardized currency regime whereby reduces inflationary pressures increases confidences among investors and assures long-term economic stability. The following case of Hong Kong with its currency board system, pegged to the US dollar, gives a clear pointer on how standardization of currency has broadly helped in promoting economic growth. The HKMA stresses that the currency peg has helped keep price stability and supported economic growth, together with attracting FDI inflows. Moreover, it is a fact that the currency standardization does provide an environment conducive to capital mobility and investment inflows simply by reducing the uncertainty pertaining to the foreign exchange rate fluctuations. According to Frankel and Rose (2002), the currency unions and fixed exchange rate regimes have positive effects on FDI inflows since such setups offer a

stable and predictable environment to the investors, and this in turn, creates the preconditions for economic growth.

Despite its advantages, currency standardization also comes with several problems and issues, mainly regarding asymmetric shocks and economic differences between countries. The Eurozone experience in the wake of the global financial crisis brought with it the realization that currency standardization could not do anything against asymmetric economic shocks. It is actually the divergence in economic performance among member countries that pressed home calls for fiscal integration or coordination to supplement the efforts of currency standardization. Finally, according to Beetsma and Giuliodori, the ex-post effects of asymmetric shocks, in 2011, may need to be reduced by greater fiscal integration within a currency union. On the other hand, decisions about a common currency or fixed exchange rate systems consider an array of elements which include economic convergence, monetary policy coordination, and institutions. The case of the West African Economic and Monetary Union illustrates the different issues contributed by heterogeneity in a primarily economic setup in relation to standardization. From this experience, institutional capacity building, policy coordination, and economic convergence come out as critical pillars in setting up a viable regime of currency standardization.

Sterling to Dollar: Shifting Dynamics of Global Financial Power

19th Century Prosperity of the Pound

The British pound became the main international currency during the 19th century due to its industrial strength and undisputed leadership in world trade of Britain. Britain was the first country to gain the advantages of the Industrial Revolution and therefore exported large portions of its industrial production on the rest of the world and imported vast quantities of raw materials and foodstuffs. By 1860, Britain accounted for more than 30% of world exports, but somewhat fell during the decade of 1890 while remaining above 20%. Moreover, Britain exported services like shipping and insurance; it invested on a huge scale abroad, earning almost £4 billion of net overseas assets by 1913.

It was quite convenient that the use of sterling was pretty common for trade and investment, as countries conducting external transactions in pounds held sterling reserves in London. Sterling reserves also provided interest-earning investment, thereby becoming more attractive against higher risks compared to gold.

Example, consider two shopkeepers, one of whom saves his money in gold coins, and the other in pound notes, which are redeemable in gold. The shopkeeper who holds pound notes will gain some advantages, such as interest, but there are many dangers involved. If something goes wrong with his bank, it may prove difficult for him to exchange his notes for gold without loss. While the shopkeeper who keeps gold coins does not receive interest, he has the advantage and peace of mind that comes from knowing the value of his gold is stable and under his personal control. At its peak before 1914, the gold standard, also known as the gold-sterling exchange standard, was when currencies were convertible into gold, impacting the money supply and, consequently, economic activity.

A large part of the gold standard's impact on money supply and economic activity was its relating a nation's currency to the gold reserves. It encouraged direct control of the money supply since nations could only print money with values corresponding to their gold holdings. This structure set an economic environment that, in theory, balanced underpinning or depressing economic activities through controlling influences on deflationary and inflationary forces so that trade and investment remained steady and sound. This postulates that international trade balances were managed through gold flows:

surplus countries accumulated gold reserves, which expanded the money supply, but in cases when countries had a deficit, reserves would become depleted, thereby monetary control needed to be tighter. In words, the gold standard generated economic growth, trading dynamics, and overall stability due to regulation of monetary supply and international transactions. However, World War I caused a disruption in the system and introduced a shock to the British economy and, hence, the pound's value.

British Economy in the aftermath of World War 1

World War I was not finished by Christmas 1914 but was an extended, hard, and costly dash. Britain's military deaths accounted for 715,000; over twice that were wounded, and 3.6% of its human capital lost. The war led to a loss of between 10% of home capital and 24% of foreign capital, given that Britain used over 25% of its domestic product in financing the war between 1915 to 1918. The economic shock waves continued to be felt through the 1920s and beyond, and new issues arose out of the complexities of postwar reconstruction and changing parameters in the world economy.

The poor productivity performance in Britain pushed its unemployment levels higher, squeezed its real earnings, and called for big budget surpluses to support its fiscal stability. Before the war, Britain was the significant capital exporter. It had 27% of the world's manufactured exports, and trade was covering 54% of its GDP. World War I brought the liberal order of the economy in the late 19th century to an instant halt because, by causing an increase in protectionism. Prior to the war, most of the nations accepted free trade policies and the idea of open markets in the economy, which brought long-term economic growth and stability. But the war shook this foundation:

For instance, during the World War I, countries like Germany imposed numerous trade barriers and heavy protectionist tariffs to protect domestic industries and conserve the resources for the war. Such protectionism aimed at insulating local economies from external competition and assurance that entities critical for conduction of wars were not lacking. In fact, it was the requirements of the war economies that forced a decision whereby nationalistic interests had to take priority over cooperation within the global economic system, which increased the protectionist stance and a sharp 12-percentage point drop in its trade ratio, indicative of serious declines in both imports and exports linked to wartime disruptions. This contraction seriously hurt investment and total factor productivity (TFP). Factors flow for investment dropped and became uncertain due to the transfer of resources from commercial activities to the needs of war that seriously hurt British industries. The investment started to evaporate due to the disaster uncertainty as factors were pulled away from commercial uses and into war uses. Furthermore, the decrease in international trade retarded the technological process and effective resource use, hence depressing total factor productivity. This economic growth slowdown associated with the war proved that, indeed, Britain went through a difficult time regarding normalization and economic restructuring after the war. During the war, countries like Japan and the United States replaced Britain in international markets. The effect was the continued erosion of Britain's advantages in a whole range of industries, from cotton textiles to international lending, permanently reducing their market share. High inflation came with a lot of borrowing during the war and greatly increased the national debt. By 1920, the GDP deflator had risen to 270.8 from 1913 = 100, while national debt had increased to £7.8 billion, equivalent to 1.3 times GDP from £0.62 billion, equivalent to 0.25 times GDP in 1913. This enormous jump in the ratio of debt to GDP negatively affected economic growth operating through interest rates, taxes, investment, and TFP.

Table 1 Labour productivity in the United States (UK = 100)

	Agriculture	Industry	Services	GDP	Real GDP/person
1909/11	103.2	193.2	107.4	117.7	107.8
1929	109.7	222.7	121.2	139.4	125.3

Note: real GDP/person comparison is for 1913.

Sources: Maddison (2010) and Broadberry (2006).

Rise of Dollar and Decline of the British Pound: Economic Shift Post World War I

It was during World War I that the US dollar had emerged as an international currency when the US evolved from a borrower to a lender. At the same time, the United States was also serving as the Allies' supplier of weapons and goods. The United States offered colossal loans and investments to its allies and rendered itself as a great international creditor. Consequently, foreign nations started holding enormous reserves of dollars, thereby increasing the usage of their currency in world trade and as reserve currency.

During the First World War, European countries faced very difficult economic challenges and expenses due to the war effort. As a measure to finance war expenditures and ensure stability in their economies, many European countries-imposed controls on foreign exchange transactions. This would imply that they restricted or regulated the purchase and sale of their currencies in the international markets to conserve holdings in dollars and prevent their currencies from depreciating too much.

In addition, throughout the war, it was increasingly difficult for European countries to maintain their adherence to the gold standard. The gold standard would have countries change their money into gold at a fixed rate so that through the use of gold, there is stability in international trade and finance. But looking at the costs of the war, and financial flexibility needed, many European countries decided to abandon the gold standard on a temporary basis. This gave them the room to print and issue government securities in financing their wars without much worrying about a constant value in regard to gold exchange.

By contrast, the United States kept convertibility during this period—that is, its currency remained convertible into gold at a fixed rate. This decision attested more to the strong relative position of the United States economy at that time: it had significant gold reserves and not such an urgent necessity to use inflationary measures to finance expenditure on the war.

These several approaches to foreign exchange control and gold management pertained, hence, to the economic context of various European nations and the United States, including wartime pressures and strategies for managing financial stability within the demands of total war. True to this hypothesis, Europe had a huge demand for U.S. goods following the War, which was supplied by heavy dollar reserves. The U.S. was untouched by wartime devastation and in a position and willing to meet this demand. Much of the financial history of the interwar period revolves around the gold standard and efforts to restore and maintain the convertibility of individual currencies into gold. This was crucial to the development of the two reserve currencies.

Early in 1919, when Great Britain's foreign reserves became exhausted, the British, stopped supporting sterling at its wartime level and allowed it to fluctuate in terms of gold; all other important European currencies followed this same policy.

Only the dollar remained convertible into gold at a fixed price throughout the 1920's. The war ruined the absolute supremacy of the pound, and with the increased collectability as well as strength of the dollar, New York was partially taking over the role of London. In the 1920's, the British pound was facing a lot of problems due to various reasons.

In 1925, The United Kingdom returned to the gold standard, and the pound was once again linked at its pre-war gold value in a move that overvalued the currency. This overvaluation damaged British exports and made imports cheaper, putting additional pressure on the economy. Also, in 1926, France firmly linked its franc to gold at an undervalued rate, improving its economy further and putting more pressure on the pound from a competitive point of view. Pressure on the pound was added by the big gold reserves maintained by France and their continuous policy of converting sterling balances into gold, further depreciating the pound. More importantly, the shift in economic power after World War I saw the rise of the United States and an comparatively enervated Britain, which altered the character of international finances and further put a threat upon the British economy.

Rise of U.S. Financial Power and the Impact of World War II: 1930s Developments

In 1934, the U.S. revalued gold again at $35 an ounce, doubling its gold holdings and drawing funds from Europe, which people and institutions feared devaluation of their currencies. By 1940, U.S. gold reserves reached $22 billion, nearly 75 percent of world reserves, enhancing the dollar's status international trade.

Unique to the Second World War were the differential impacts to the pound and dollar. The Britain's financial position deteriorated since the country was selling it foreign investments and gold leading to big sterling liabilities that over reeked its gold reserves, Moreover Nazis tried to flood Europe with fake British banknotes, MI5 files show, which further deteriorated value of British Pound and lost trust of other nations in the currency On the other side, the United States served as the Allies' supplier of weapons and other goods the U.S. financial position remained intact with increased gold reserves and foreign-owned dollar assets balanced out by long-term investment abroad --. By the war's end, US gold holdings stood three times higher than dollar assets owned by foreigners. The amazing rise of the volume of gold held, and especially long-term trends in liquid dollar claims owned by foreigners dominated the whole scene and were indicative in their own way of growing American economic muscle. Long-term trends were dominated by the remarkable rise in the volume of gold held and liquid dollar claims owned by foreigners, both indicative in their way of growing American economic muscle.

Table 1.
U.S. and U.K. International Asset Position, End of Year, 1913-1965 [1]

(Values expresed in billions of U.S. dollars)

	1930	1920	1930	1940	1945	1950	1960	1965
U.S Gold holdings	1.3	2.5	4.3	22	20.1	22.8	17.8	14.1
As percentage of the world	27	34	39	73	63	68	47	34
U.K Gold holdings	0.2	0.8	2.3	3.9	6.8	7.1	17.3	24.1
As percentage of the world	4	11	8	9	5	9	7	7

Sources: IMF, International Financial Statistics; Bureau of the Census, Historical Statistics of the United States; U.S. Department of Commerce, U.S. Balance of Payments Statistical Supplements. Excludes gold holdings of international institutions; sterling assets are converted to dollars at current exchange rates

Long-term trends were dominated by the remarkable rise in the volume of gold held and liquid dollar claims owned by foreigners, both indicative in their way of growing American economic muscle.

- The rise in gold holdings in the U.K. and foreign-owned liquid sterling assets increased but not dramatic compared to that of the U.S.
- Whereas the United States could be classified, as of 1913, a net debtor, by 1965 it emerged as a major net creditor.
- The series reflects the shift of world economic dominance from U.K. to the U.S. over the period.

The overwhelming effects of World War II were felt on the world economy. The result was massive destruction of infrastructures, industries, and productive capacity for the greater part of Europe, Asia, and other areas directly hit by the war. Huge human and economic losses were registered, resulting in populations being displaced and trade and investment flows disrupted. Confronted with these challenges, countries started mobilizing resources for the war effort and increased government spending, thereby industrially concentrating production to sustain the military effort, which structurally made relevant changes in labor markets. On top of that, the War amplified technological development, especially in matters like aviation, communications, or medicine, that would later on help sustain post-war economic growth. This remapped the geopolitical landscape, as well, insofar as the decline of the colonial empires went hand in hand with the rise to prominence of new world powers, especially the United States and the Soviet Union. The aftermath of World War II required huge efforts in reconstruction, paved the way for international institutional formation like the United Nations and the IMF, and laid foundations for an economic order to emerge under the Bretton Woods system—thereby setting the course of world economics.

The Bretton Woods System: Establishing Dollar as the Anchor of Global Finance

This is in the year 1944, delegates from 44 Allied countries used to meet at Bretton Wood, New Hampshire, to develop a system that deals with foreign exchange not to harm any nation. The delegation thus, develops or reaches to a conclusion that the world's currencies were not going to be linked with gold but with the pegging of the U.S dollar.

The 1944 Bretton Woods system established a framework whereby all member countries adopted the fixing of their relevant currency's exchange rate against the US dollar. This US dollar was in turn pegged to gold at the time. Each country is then obliged to keep the value of its currency stable within a narrow band vis-à-vis the US dollar. For example, it can establish its currency at 4 units per US dollar. The US dollar had a guaranteed amount of $35 per ounce of gold. The currencies were therefore indirectly guaranteed with gold, thereby giving the idea of indirect gold backing of the currency that people would exchange. The aim was to bring stability to international trade and finance by avoiding garments devaluation and therefore promote economic cooperation. The adjustment was controlled through interventions and policies put in place by the International Monetary Fund, that oversaw interventions but also provided support to the concerned member nation that had problems in its balance of payments. Though very successful at its start, the Bretton Woods System also faced many challenging situations and collapsed in the early 1970s, which called for floating exchange rates to be used in global finance.

Collapse of Bretton Woods and the Impact of the Nixon Shock on Global Financial Dynamics

All countries borrow money, and the US was keen to take advantage of this. The US had already wanted the US dollar to be the currency that dominated the financial world; it wanted for the US dollar to be the sole currency in circulation. There were many advantages to this, which will be touched on in detail as the paper progresses.

One wonders why the other countries accepted this situation. Couldn't they have developed their economy gradually and hoarded gold to build their respective nations? The problem was that most gold was produced in two places: South Africa and the Soviet Union. Both were not on good terms with the other European nations, hence the last thing European nations wanted was to depend on gold purchases from them. Due to the situation, they quietly accepted the US's terms of the loans offered.

Yes, it is true that the US did much to rebuild Europe after World War II, and this cultivated many good relationships that last to this day. Even if other countries wanted to walk away from US terms did not have many other alternatives. Example, Japan. It required grain from Sri Lanka, but payment in Japanese yen was just not feasible because no country would accept the yen. If Japan, on the other hand, offered US dollars, then clearly Sri Lanka would gladly accept them since it could exchange the dollars in the US for gold. And so it bred a sort of tacit agreement: begrudgingly, countries circulated the US dollar because they trusted it far more than each other's currencies.

Then and now, there existed a need pressured for the US dollar. As such, loans, trade, and many other transactions began taking place in dollars. The US was aware that for the dollar to continue being relevant, it must not share the same fate as the British pound sterling, which had lost its value. The US thus made another strategic move.

Back then, there were US and European companies extracting and trading oil worldwide. Basically, the technology for the discovery and extraction of oil is originally from US and European companies, while the Arab countries have the oil but are sadly lacking in both technology and market. The US offered assistance to Saudi Arabia on the issue of extracting oil in return for an agreement: Saudi Arabia will sell its oil only in US dollars. Saudi Arabia agreed because it needed US technology and security. Saudi Arabia had suffered from the security threats posed during the Second World War.

It meant any country that wanted oil had to have reserves in US dollars. Other oil-producing countries began doing what Saudi Arabia did and started selling oil only in dollars. The US further made sure it dollar supply would not be readily converted to gold by printing more currency than its gold reserves could support. It all depended on counting on the fact that all the countries would not convert their dollars into gold simultaneously.

The US had formed a gold pool with eight allied countries in order to keep the price of gold stable and block a mass conversion of dollars into gold. These eight countries had been manipulating the gold market in London in a bid to maintain the dollar's value. However, by 1967, most of these countries had left this pool because of the heavy losses that were being incurred, and the US plan was in total ruins. The pressure was such that the US was forcing the UK to close the London gold market to stop the manipulation of gold prices.

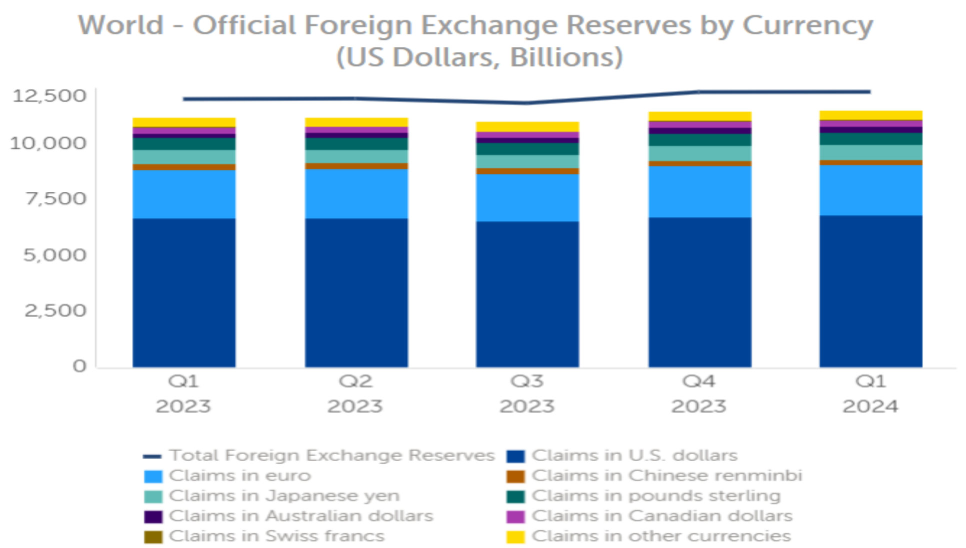
By 1971, US gold reserves had fallen to alarmingly low levels. As what is termed as the Nixon Shock, President Nixon suspended the convertibility of its dollar into gold. The whole world was shocked because world trade, debts, and oil transactions were conducted in dollars. There was no choice but to

continue using the dollar, even in its devalued form.
It reassured Saudi Arabia that its dollar earnings could be invested in the US, maintaining the value of its dollar reserves. In doing so, this would establish what today is called the petrodollar system, in which oil sales were to be transacted only in dollars, furthering its global dominancy.
When other nations moved to contest the dollar, as in the case of Iraq changing to euros, or Libya's initiative to institute a common African currency, they were invaded by military forces. Its plan to create an oil bourse using euros also incurred the wrath of the United States in the form of severe sanctions against Iran. There, in a nutshell, the dependence of the world on the US dollar is secured through a network of economic, political, and military instruments. Most challenging attempts of the dollar raise the ghosts of the antagonism of the United States whose influence was already great in world economic affairs. In fact, over several decades, the role performed by the U.S. dollar has literally been that of a backbone to the international system in serving as a major reserve currency and standard in international trade and finance. However, this foundation is now being questioned.

Reduced Importance of Dollar over the years

The Backbone of Global Trade: U.S. Dollar's Dominance and Emerging Challenges

In fact, over several decades, the role performed by the U.S. dollar has literally been that of a backbone to the international system in serving as a major reserve currency and standard in international trade and finance. At the same time, however, it eroded recently through diversification processes across countries vis-à-vis foreign reserves and trading in other foreign currencies. The euro, Chinese yuan, and renminbi have marked out territory against the dollar supremacy in this evolution.
The global economy, valued at approximately USD 105 trillion annually, and virtually all international trade, worth roughly USD 25 trillion annually, are predominantly managed through the U.S. dollar. By pricing a significant portion of the global economy in dollars, traders worldwide benefit from stable value and convenient transactions. This system instills confidence that deals will be honored and paid, facilitating the seamless operation of international trade. facilitating the seamless operation of international trade. Currently, there are USD 6.8 trillion in circulation globally, held by banks, firms, governments, and individuals. This accounts for 58 percent of all foreign exchange holdings, ensuring that there are sufficient dollars available to maintain the functionality of the global economic system.



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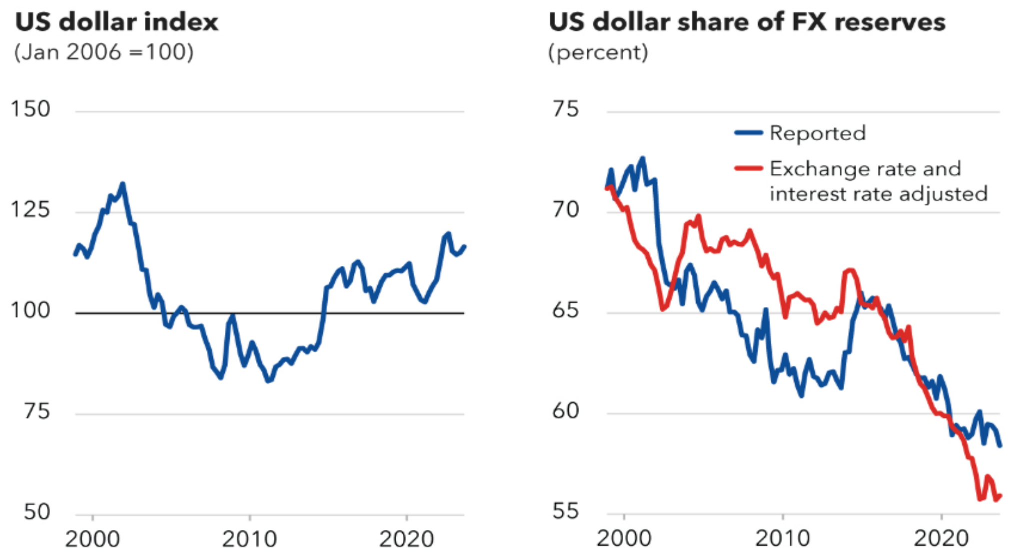
However, reliance on the U.S. dollar has notable disadvantages for many countries, particularly poorer nations and those at risk of geopolitical tensions with Washington. For less stable economies, the scarcity of dollars can make it prohibitively expensive to import goods and services, thereby hampering economic growth and development. Furthermore, dependence on the U.S. dollar grants Washington significant influence over these countries' domestic affairs, as U.S. monetary policy and sanctions can have profound impacts on their economies.

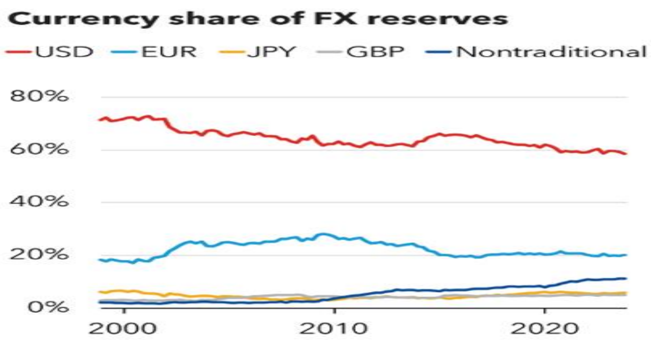
Trends in Global FX Reserves: Rise and Diversification beyond U.S. Dollar

The index reflects the strength of the US dollar relative to other currencies. The significant decline during the 2008 financial crisis indicates a period of weakness. Following this, there was a gradual recovery, which was then interrupted by a fall in value due to the COVID-19 pandemic in 2020, followed by a subsequent recovery and a smaller, gradual decline.

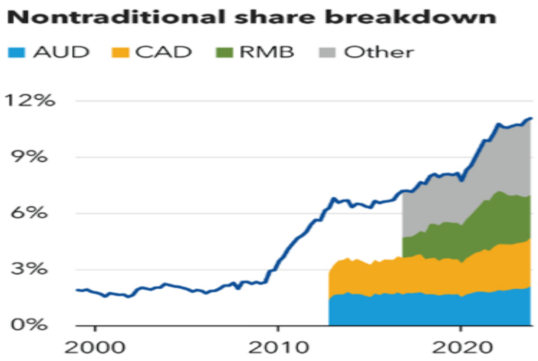


Source: Arslanalp, Eichengreen, and Simpson-Bell (2022, updated).
Note: Federal Reserve Board Trade-Weighted Dollar Index (Advanced Economy).

The declining trend in the share of US dollars in FX reserves indicates diversification by central banks into other currencies. The more pronounced decline in the adjusted share suggests that exchange rate and interest rate fluctuations have significantly impacted the attractiveness of holding US dollars. This diversification is driven by geopolitical considerations, changes in global trade patterns, and efforts by countries to reduce reliance on the US dollar.



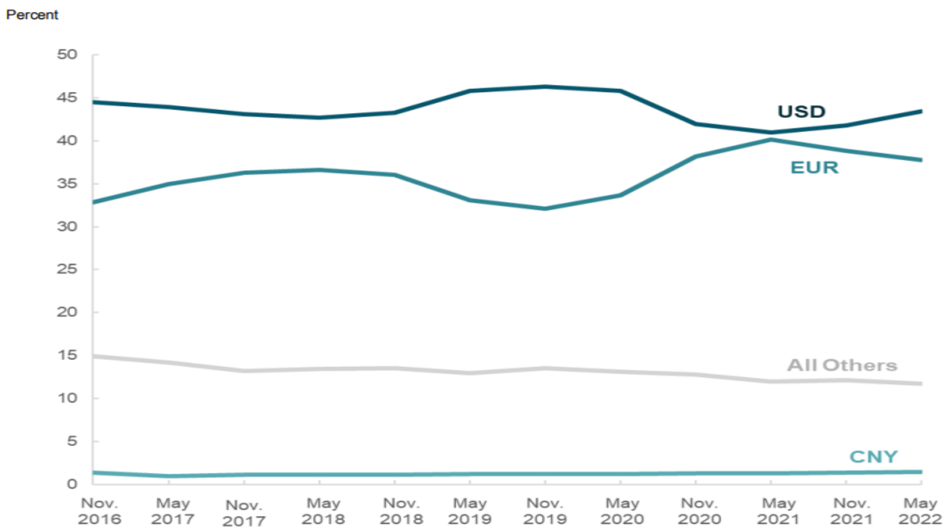
The steady decrease in the USD's share suggests that central banks are diversifying their reserves away from USD due to geopolitical considerations, economic policies, and risk management strategies. The EUR has seen periods of both stability and volatility. Its significant share points to its importance as a major reserve currency, although it has not consistently gained ground against the USD. The relatively stable shares of JPY and GBP indicate their enduring but minor roles in global FX reserves, offering stability but not significant growth in their shares. The increasing share of non-traditional currencies highlights a trend towards greater diversification in FX reserves, reflecting a broader acceptance of a multipolar currency world. The overall share of non-traditional currencies in FX reserves has grown from about 1% in 2000 to approximately 12% by 2023. This significant increase shows a clear trend



towards diversification among central banks, seeking to mitigate risks and reduce reliance on traditional major currencies. The RMB's entry into the FX reserves and its rapid growth reflect China's increasing role in the global economy and efforts to internationalize its currency. The inclusion of RMB indicates growing acceptance and confidence in China's financial system.

Dominance of U.S. Dollar in Global Trade and Finance: Analysis with Euro and Chinese Yuan

The meaningful position that the U.S. dollar occupies in world trade and finance is that of acting as the main reserve and exchange currency used in international transactions. That kind of extraordinary status is derived from a superposition of historical, economic, and geopolitical factors which have served to solidify the United States dollar as the world's primary reserve currency. This essentially means that the United States dollar is widely used in world trade, with some estimates suggesting that about 44 percent of international transactions occur annually in that particular currency.



Data source: SWIFT. Includes shares of all international transactions settled through SWIFT. Excludes transactions within the countries of the euro zone. USD = U.S. Dollar EUR = Euro CNY = Chinese Renminbi The category "All Others" comprises the Japanese yen, British pound, Canadian dollar, Australian dollar, and Swiss franc

The USD, although it has dropped and risen, remains by far the most used currency in international trade and financial transactions. Its share, therefore, is relatively stable—a fact which projects this currency at the very centre of world economic activity. The EUR has shown much more volatility than the USD. It was growing sharply until 2020 but then dropped drastically. The share of CNY remains negligible, indicating that despite the large role China has played in world trade, its currency has not gained the same level of international acceptance or usage as USD or EUR. The combined share of other currencies remains stable, suggesting that no other currency could make much headway into the dominance of USD and EUR in international transactions.

The international debt market, including a wide range of debt securities such as bonds, debentures, and loans, plays a crucial role in global finance by providing essential capital for governments, corporations, and financial institutions. As of 2023, the total debt outstanding in U.S. dollars stood at approximately $13 trillion, highlighting the pervasive influence of the dollar in this critical financial sector. The EUR holds a significant share, indicating the Eurozone's strong influence in international debt markets. The fluctuations post may be related to various economics crisis in Europe, such as the Eurozone debt crisis. The gradual increase in CNY- denominated debt securities signifies China's growing influence in global finance. China's debt trap policy is one of the reasons for the increase in debt amount.

Conclusion

Historically, gold coins and the gold standard had a considerable impact on the stabilization of international trade and finance. These efforts used to be effective up until the shock of World War I, following which it was sensed that there was a shift in the global economic scene due to which even these systems were disrupted. After World War II, there was a massive effort to rebuild, leading to the creation of international institutions like the United Nations and the IMF. These institutions laid the groundwork for the Bretton Woods system, which linked world currencies to the U.S. dollar, pegged to gold. This system aimed to stabilize international trade and finance. Although the Bretton Woods system initially brought stability, it faced challenges and eventually collapsed in the early 1970s. This collapse led to the adoption of floating exchange rates, fundamentally changing the way global currencies operated. The research paper also emphasizes the strategic importance of the U.S. dollar after World War II. It became the dominant global currency because countries trusted the U.S. economic system and relied on the dollar for international transactions.

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