

# THE INTERNATIONAL CURRENCY CRISIS

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## Part I

### A.—Preface

The foundation of the present international financial system was laid down during the Bretton Woods Conference in 1944. From then to 1959 the system was not rightly tested because most European currencies were not fully convertible. Thus, the system was not actually tested except later.

Paradoxically, the forces that were responsible for the strength of some European currencies, have started to work against the strength of the dollar by the end of the fifties.

Financial experts like Professor Robert Triffin thus predicted the breakdown of the present international monetary system, and even pronounced its death since 1959.<sup>(1)</sup>

A major change in the system was experienced in the sixties. The Pound Sterling was devaluated along with the French franc, etc. . . The creation of the special Drawing Rights by the I.M.F. and lately the return to a two-tier gold system. The present crisis can also be considered as another stage in the breakdown of the system although it is far-reaching in its implications.

The International flow of capital, especially dollars from the United States and the Euro-dollar market to Western Europe, started at the end of 1970 and the first months of 1971. The month of April, 1971, however, witnessed a record volume of daily flow of dollars reaching almost 1 billion dollars on a single day in Frankfurt and almost 250 million dollars in Switzerland.

By the end of April, the flow of dollars declined only to reach monumental volumes at the beginning of May 1971. The

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1) Neither Gold nor the Dollar, Robert Triffin, in the International Monetary System, U.S. Chamber of Commerce, page 2.

amount of inflow posed a very complicated problem both for the Central Bank in Western Europe and the U.S. financial authorities, and later led to a questioning of the international status of the dollar.

On May 5, 1971, the Central Banks of some European countries were pressed, in their support operations, to add almost 2.5 billion dollars to their reserves. Of this amount, the German financial authorities provided 600 million, the Dutch authorities 240 million, the Belgian authorities almost 100 million.

Had it not been for the withdrawal of support operations at noon by central banks, the amounts could have been larger. Most important banks in Europe suspended operations from Wednesday, May 5 to the following Monday, May 10, 1971.

During this short period several meetings took place to find a solution for this very pressing problem. In addition, the Finance Ministers of the European Economic Community met to agree about measures to be taken to stop the inflow of dollars. As will be discussed later, the European countries were unable to reach a unified stand. Thus every country took unilateral action which was disclosed on the evening of May 9, 1971, to enable the financial market to reopen on Monday, May 10.

West Germany and the Netherlands decided to float their currencies, Switzerland and Austria decided to revalue their currencies by 7 and 2.65 percent respectively, while France was faithful to its own request for an increase in the price of gold.

The second phase of the problem came as a result of the gloomy picture of the U.S. economy. In particular the staggering estimates of the imbalance in the U.S. balance of international payments brought about President Nixon's program to rescue the dollar decided to stop the outflow of funds and reduce, if not totally eliminate, the deficit within few years.

President Nixon announced on August 15, 1971, his program to deal with the real causes of the problem instead of its symptoms. The program is an inter-related attack on both foreign as well as the domestic causes of the problem.

On the international front the President announced the following measures :

- 1 — The temporary suspension of full convertibility of dollars into gold or other reserve assets for Government and Central Banks
- 2 — The imposition of a temporary surcharge on imports to the United States, generally at a rate of 10 percent.
- 3 — A ten percent reduction in the foreign economic aid—  
On the domestic front, the President announced :
  - 1 — A ninety-days freeze on all prices and wages.
  - 2 — Creation of a Cost of Living Council to effect a transition from the temporary freeze to continued price and wage stability.
  - 3 — Recommendation that Congress erect an accelerated tax credit on investment at the rate of 10 percent for one year, to be followed by a permanent credit at the rate of 5 percent.
  - 4 — Recommendation that Congress repeal the 7 percent excise tax on automobiles.

Most experts were surprised by this program. Although no one questioned the right or even the duty of any country, including the U.S., to solve its own economic problems, however the actions went for a field from the required remedies! The U.S. attitude from the beginning of the crisis was lay tax.

The Nixon's program affected both the international financial as well as the international trading system. On the financial aspect it meant closing the gold window by stopping the convertibility of dollars into gold. The trade aspects of the measure, especially the 10 percent surcharge, were considered completely unusual steps taken against the interest of most Western countries. It actually meant a de facto devaluation of the dollar. In addition it reminded different countries of the old days of trade restrictions and trade war.

This autumn, every country tried to look after its self-interest. Thus each country took whatever measure to protect its financial and trade interests it thought necessary. They moved within international organizations like the General Agreement on Tariffs and Trade (G.A.T.T.), the International Monetary Fund (I.M.F.) and the Bank for International Settle-

ments (B.I.S.), plus regional organizations like the O.E.C.D. and the E.E.C. to reduce the seriousness of the actions and to find the proper solution for this most pressing problem for the World economy.

Unfortunately, collective actions take time; thus different countries relied on unilateral action to countervail the American measures as we will see later.

The final stage of the crisis witnessed the different efforts by the group of ten and various summit meetings between the European leaders and President Nixon, during which the U.S. government declared its willingness to make a compromise by devaluing the dollar, coupled with an increase in the price of gold from 35 to 38 dollars an ounce, and the abolition of the 10 percent surcharge. Most European countries, in turn, agreed to revalue their currencies and to negotiate trade problems with the U.S. Thus an important and far-reaching step was taken to solve the monetary crisis of 1971. The ramifications of this agreement go way beyond regular parity realignment to affect the status of dollar and even the future of the international monetary system.

#### B.—The real reasons behind the crisis :

It is difficult if not impossible to pin-point one specific reason as the real cause behind the currency crisis of 1971. In fact, it was the culmination of different but interrelated factors that brought the crisis to a head. The following factors are the most important;

- 1 — the continued imbalance in the U.S. balance of international payments which prevailed for several years,
- 2 — the nature and the effect of the Euro-dollar market which entails a vast pool of liquid and unregulated resources,
- 3 — and finally, the difference in kind between the economic problem facing the United States and most European countries and other international monetary problems, and with it the complexity of the fiscal and monetary policies required to deal with it (especially the interest rates).

## 1 — The U.S. Balance of International Payments

The U.S. balance of international payments was and still is a great cause for the trouble in the International Monetary System. Beginning with the fifties the U.S. balance of payments has been in deficit, irrespective of the definition used.

From 1949 to the beginning of 1971 the deficit exceeded 42,000 million dollars.<sup>(1)</sup> Out of this enormous amount only 13,000 million was covered from the U.S. reserves. The rest was financed by accumulating dollar assets abroad. The U.S. was practically the only country able to keep such a disequilibrium for so long a period because of the role of the dollar as the official international currency.

In the early years of the period, the deficits were seen as part of a process of achieving a more adequate distribution of world reserves, thus enabling the European countries to establish convertibility. "U.S. reserves were high and the convertibility of the dollar into gold was out questioned".<sup>(2)</sup>

When the European countries plus Japan reacquired their competitive strength in relation to the U.S., they accumulated surpluses and started to convert their dollar holdings to gold from the U.S. gold reserves. Furthermore, in contrast with the preceding period, the U.S. deficit in these years was financed in major parts by a drawing down of reserve assets.

However, with passage of time, it was evident that this situation could not last forever. The U.S. gold reserves have been reduced from 24,000 million dollars, since the war, to about 10,000 million in 1971, while its short-term indebtedness skyrocketed from 7,000 million to almost 48,000 million in the summer of 1971. Furthermore, the surplus countries in Europe became more and more impatient. On one hand, they knew that the U.S. cannot meet its obligations, and on the other it is continuously exporting inflation to their domestic economies.

1) On Liquidity basis, Dr. E.E. Aschinger, Economic Advisor to the Swiss Bank Corp. Prospects, Sept. 1971

2) Developments in the International Monetary System, Frank Southard Jr. I.M.F., November 15, 1971.

Perhaps the last stroke came as a result of the forecast of the Department of Commerce about the worsening of the merchandise trade balance, which was considered by a distinguished bank as the most striking development.

Traditionally the U.S. trade balance was in surplus. The range varied between more than 4 billions to two billions a year. A trade surplus with foreign countries meant a reduction in the overall deficit of the balance of international payment. However, for the first time since 1893 the Commerce Department estimated a deficit in the trade balance of about 2.1 billion dollars which would wipe the 1970 surplus.

In fact U.S. total reserve assets dropped to about 12 billion dollars in August 1971, making it the lowest decline in U.S. history. At this level, U.S. reserves were lower than 1937, its reserves stood at 12.31 billions, all of which were in gold.

## 2 — The role of the Euro-dollar market

The difference in economic policies between the U.S. on the one hand and most European countries on the other, plus the interest rate differential, opened the door wide open for one of the most efficient and most competitive financial markets to act, i.e. the Euro-dollar market.

By definition, the Euro-dollar market is 'the market in U.S. dollars held on deposit with banks outside the U.S.'<sup>1)</sup> Although these are also markets for European currencies outside the countries in which these currencies are considered legal tender, like the Euro-mark in London and Euro-sterling in Continental Markets, nevertheless, the size of the Euro-dollar market has increased from a few billions in the early sixties to 25 billions in 1968 and approximately 50 billions by 1971.

These vast financial resources have been traditionally free to move to European countries, U.S.A. and other interested countries in the world. They have been used by banks, business corporations, Central Banks and even individuals. Until the beginning of June 1971 the resources of the Euro-dollar mar-

1) Euro-dollar Banking M.E.L., First National City Bank, July 1971 pp. 11 to 15.

ket have been used freely. The governing criteria for their use has been the competitiveness of their rates. In several instances its role has been called "the tyranny of the Euro-dollar market" because it was and still is, to a lesser extent, a source of instability to the international financial system.

During 1969 most of the demand for Euro-dollars came from the United States because of the tight credit conditions. In that year alone 15 billion dollars were borrowed by U.S. Banks. When U.S. banks were able to obtain funds in the domestic market at a relatively cheap rate, their borrowing from the Euro-dollar market declined to 7.7 billions in 1970 and to only 2.3 billions in June 23, 1971.

In fact the tide has been reversed and most of the U.S. banks started to borrow from the domestic market to repay the relatively high interest Euro-dollar borrowing.

At the same time the business communities in some European countries, especially West Germany, have considered the Euro-dollar market as the right way out of the tight credit conditions in their domestic market.

The strong demand for Euro-dollars by the industrial and commercial firms in West Germany coupled with the huge repayments of previously borrowed funds by U.S. banks and firms resulted in a massive flow of dollars to Germany. Moreover, the financial dealers have learned from their experience that it is safe to transfer their funds to Marks. The past experience of upvaluing the Mark twice confirmed this psychological feeling.

Furthermore, central banks used to deposit funds with the Euro-dollar market for years. However, most of the Euro-dollar supplies came from individuals and the business community. During the 12 months previous to the crisis this pattern was altered. Banks, especially central Banks became the main suppliers of Euro-dollars. At the end of the first quarter of 1971 more than 9 billion dollars (of the outstanding amount) were placed by Central Banks. Also due to the rise in the dollar reserves of most West European central banks and the inability of the U.S. money market to offer competitive returns, more funds were placed with the Euro-dollar market. In fact, by

the end of the first quarter of 1971 more than a billion dollars were placed by central banks. Thus they became the main supplier of funds in 1970. This is in sharp contrast to the previous pattern in which individuals and the business community were the main sources of funds.

### 3 — The difference in the nature of the economic problem

The difference in the nature of the economic problem between the U.S. and most European countries (especially the disparities in the business cycles) gave rise to differences in interest rates and the degree of tightness in the money market. Thus while the U.S. was trying to foster expansion in the economy as a part of its policy to invigorate a depressed economy with a high rate of unemployment, most European countries were trying to dampen inflation by making money dearer in their markets.

The large difference in interest rates between the American money market, the Euro-dollar market, and the European money markets resulted in massive accumulation of dollars by foreign Central Banks. Interest rates were reduced several times during 1970 and 1971 to reach half of its levels in a period of 12 months.<sup>(1)</sup> The Treasury Department reduced interest rates on its bills from 8 per cent in December 1969, to 3.5 per cent in April 1971. Furthermore, the Federal Reserve discount rate was reduced five times since November 13, 1970.<sup>(2)</sup>

At the same time, the prevailing interest rate in European money markets was around 6 to 7 per cent in March 1971. In their attempt to dampen inflation most European countries tried to reduce the interest rates by 0.5 to 1 per cent at the end of March and the beginning of April, 1971, to limit financial expansion.

From March to December 3, 1970 the West German government reduced the interest rate three times from 7.5 per cent to 6 per cent. In April, 1971, the rate was reduced again to 5 per cent. However, the interest rate in Europe was still higher than the prevailing rate in the U.S.

1) The Times, April 2, 1971.

2) International Herald Tribune, April 1971.

American banks and corporations made use of interest rate differentials by rapidly borrowing funds from their ample domestic market to repay their high cost Euro-dollar borrowings. As a result the Euro-dollar rates were sharply reduced.

Foreign borrowers were encouraged, therefore, to obtain funds in the Euro-dollar market rather than the local money markets because of the reduced interest in the latter. Used internally, these funds were presented to Central Banks for conversion into local currencies thus increasing the dollar holdings of European Central Banks.

### C.—The anatomy of the problem.

The world monetary system has witnessed a second flow of dollars to several European countries, especially West Germany. The flow has started in the early months of 1971. The month of April however, witnessed a record volume of almost one billion dollars on a single day in Frankfurt and almost 250 million in Switzerland.

By the end of April the flow of dollars was reduced only to reach monumental levels at the beginning of May. The level of inflow reached 2.5 billion dollars during the early hours of May 5, 1971. Thus the central banks of several European countries were pressed, in their support operations, to add almost 2.5 billion dollars to their reserves. Of these the German financial authorities alone absorbed almost 1 billion, the Swiss financial authorities 600 million, the Dutch authorities 240 million and the Belgian authorities almost 100 million dollars.

Central banks were forced therefore to abandon their support operations for the dollar and close their doors until May 10, 1971. During the few days from May 5 to May 9, 1971, numerous contacts and serious efforts were made in an attempt to find the right solution to this problem.

The right solution to this impasse was by no means easy to find. First there was a difference in views between the financial authorities in the various countries; second, there was a sharp difference in views between the main partners to the problem, viz. the U.S. and the European countries, and between the European countries themselves, especially in the case of Germany

and France. There was also a difference of opinion as to the proposed action of member countries in the Common Market and just what was in the best interest of the Market as a whole.

In this kind of situation, however, it was very difficult, if not impossible, to reach a common stand supported by rational economic reasoning. Thus, each country tried to protect its self-interest given the prevailing international forces and pressures.

The U.S. financial authorities took a very passive view of the crisis. The U.S. Treasury Department declared that the monetary unrest need not bring about any parity changes or any shift in policy. In fact some officials declared that there was little that the U.S. could do to solve the problem.

Furthermore, the possibility of increasing the price of gold, which has been raised several times during the sixties, was quickly dismissed by U.S. officials as an old balloon which has been burst long ago.<sup>(1)</sup> Thus they passed the problem onto the European countries, especially West Germany, by their «wait-and-see» attitude.

In fact, they ascribed to the problem the wrong cause. They viewed it as a result of the differential in interest rates, which could be solved when the U.S. economy enters into an expansionary phase. Through further growth and expansion the increase in domestic demand for funds would iron out the difference in interest rates.

#### D—The Case for Germany

The ability of the German Central Bank to pursue an effective domestic monetary policy was greatly weakened by the huge inflow of short term funds into Germany, mainly from the U.S. and the Euro-dollar market. In 1970 about 8 billion dollars were transferred. In the first four months of 1971 an additional 3 billion dollars were absorbed. During the three days of May 3-5 about 2 billion dollars were transferred, thus bringing the total to more than 11 billions in less than a year and a half.

(1) Statement by Paul Volcker, U.S. Under Secretary of the Treasury reported in the Financial Times, May 6, 1971.

Thus, to stem the flow of dollars into West Germany and to brake the country's mounting inflation which was estimated to reach 4.5 per cent during 1971 <sup>(1)</sup>, four of West Germany's five principal economic institutes <sup>(2)</sup> recommended the free «floating» of the Deutsche Mark for an indefinite period. The fifth — the Economic Institute of West Berlin — called for outright revaluation possibly preceded by an interim period of floating.

The report of the five institutes believed there were three major causes for the global upswing in inflation : (a) a sharpening of the fight to narrow the gap between the income groups, (b) increased demands by trade Unions to insure that employees obtain real income rises, and (c) a willingness by employers to pay higher wages and then offset the higher cost through raising prices.

Although these institutes are independent foundations, their ideas have been known to influence governmental policy. In the crisis of October they were among the advocates of the course of action the government followed <sup>(3)</sup>.

The report of the five institutes, on the one hand inspiring government policy, on the other inspiring the enthusiasm of speculators who pressed the Deutsche Mark in foreign exchange markets, the publication of this annual joint report of the West German economic research institutes resulted in another outbreak of speculation. The Bundesbank was obliged to buy over \$ 1,000 m. at the official floor price of DM 3.630 in a massive supporting operation. An unprecedented record was set early in May 5, 1971 with the exchange of another \$ 1,000 m. in West Germany. This forced the Central Bank, backed by the government, to abandon support operations. Similar pressures in Switzerland, Holland, Belgium and Austria forced their central banks to follow likewise.

In view of the heavy speculation and the mounting domestic inflation, the West German government was faced with a num-

(1) Coupled with a low rate of growth of real GNP of 3.5%, a rise in industrial unit production costs of 8%, and a rise in wages of 11% in the second half of this year.

(2) In Kiel, Hamburg, Munich and Essen.

(3) The Mark was briefly floated and then appreciated by 2.5%.

ber of alternative policy choices : a) Immediately revaluing the Deutsche Mark, b) Allowing the currency to float on its own accord in order to find a more realistic value in terms of the dollar, and c) Imposing severe foreign exchange controls.<sup>(1)</sup> The choice of policy had been complicated by a lack of agreement as to what should be done to curb inflation. Another complicating factor was the inability of West Germany to convince France of the need for a concerted move in the direction of greater exchange flexibility. This was at the same time that Germany was inhibited from acting unilaterally by the EEC policy of closer monetary integration.

The alternative of imposing statutory limitations on capital movements — though contrary to prominent German economic thinking — was known to have been under consideration.

Floating the Mark meant that the Bundesbank would withdraw its commitment to keep the mark pegged to its present parity of between 3.63 and 3.69 to the dollar. It would be left to float in foreign exchange markets until it reached whatever parity becomes established by supply and demand. At first this would mean an even greater inflow of dollars because of speculative desires to cash in on its expected rise in value. As the dollars enter in greater amounts and the floating rate rises, however, the exchange value of the dollars would decrease thus making it no longer profitable for speculators to sell dollars for marks thus, halting the dollar inflow.

#### E.—A unilateral action

Due to the lack of the European countries to reach a unified stand, specially within the E.E.C., with respect to the dollar, each country tried to advocate and later to adopt different policies consistent with its own conception of national self-interest.

The German government had decided to let the Mark float for an indefinite period beginning May 10, 1971. The Swiss government revalued the Franc upwards by 7 percent, while

(1) A large dollar inflow leads to an increase in cash in circulation within Germany thus fueling its rate of inflation. German industrialists, however, contest of a free floating or re-valuation of the Deutsche Mark because of the harmful effects on exports.

Austria revalued the shilling by 5.65 percent. The Netherlands decided also to float the guilder. In fact both Germany and the Netherlands pushed the European countries to float their currencies, particularly the Belgian Franc. The Netherlands definitely preferred the latter course because of their close trade relations with Belgium. The French government, however, did not alter its previous position in requesting a change in the price of gold to benefit from its gold reserves.

The decision of the different countries to revalue or to float their currencies, did have wide repercussions within each country, within the European Economic Community and on the international financial markets.

The business community in Austria believed that the rate of revaluation of the shilling was too high. They preferred a rise of 3 percent because of the effect on foreign trade. Austria exports about one third of its production, a substantial part of these exports go to North-America and Yugoslavia. It was feared that the higher export prices would affect the timber exports. Thus the government tried to overcome this problem by granting an export tax rebate to reduce the export tariffs and duties<sup>(1)</sup>.

The situation in Switzerland was slightly different but basically the same. Some industries feared the long-term effect of the revaluation on the domestic economy. Some industries were bound, given the effect of higher export prices, to lose their foreign markets, specially those operating within extremely slim profit margins<sup>(2)</sup>.

Concern for the floating of the D.M. and the guilder was expressed by the Vice-President of the Common Market's Executive Commission. He based his concern on the fact that if the member's currencies were allowed to float for too long, this would undermine not only the monetary union, but also the organization itself whose very existence presupposes fixed and stable exchange rates<sup>(3)</sup>.

(1) The Times, London, May 11, 1971.

(2) The Times, London, May 28, 1971.

(3) Speech by M. Raymond Barre at the European Parliament, Luxembourg, May 19, 1971.

On its first day of trading, the D.M. floated as high as 4.5 per cent above its former parity but closed at 3.5 per cent higher. The guilder moved in concert with the D.M., but its rise was modest. On the first day it rose by 3 per cent but ended the day with only 2.5 per cent higher than its parity.

In the following days both the D.M. and the guilder floated downwards. The Mark floated at around 2.5 per cent, while the guilder went down to 2 per cent. However, on May 21, the Mark floated upward again to its highest level since May 10, 1971, recording a rise in its parity of about 4.5 per cent to the dollar.

At that time, no one knew exactly the limits within which the German government would allow the Mark to float. However, it was widely believed that an upper limit close to 5 per cent was the maximum beyond which the Bundesbank would intervene to prevent further appreciation against the dollar.

In fact, the Bundesbank did not intervene in the market right after the decision to float, although it held vast amounts of dollars (about 16 billions). However, the bank intervened later to insure the following objectives :

First : To discourage foreign holdings from coming to Germany. For this reason the bank ordered credit institutions to pay no interest on foreign holdings. In addition foreigners were not allowed to purchase any more interest bearing Treasury or money market notes. As an exception foreigners may hold cash in West Germany after receiving permission. This regulation however, did not apply to deposits exceeding 50 thousand D.M.

Second : To insure that the D.M. would float within reasonable but undeclared limits to other currencies, especially the E.E.C. currencies, so as to minimize the effect of floating on the internal financing of the Community.

However, weeks after the German government decided to float, several issues were still unsettled. Questions like how

(1) The Times, London, May 11, 1971.

long the Bundesbank would take to divest itself of its vast dollar holdings; how long the authorities would allow the D.M. to float; and, what measures would be adopted to ensure economic stability.

On the question of the time period, the Finance Minister declared that the final aim was to return the currency to its D.M. 3.66 parity against the dollar when the floating period ends. Thus there was no specific time period known to the public. However, it was reported that the Minister of Economics favored a long period of floating to strengthen the Mark, to cool the inflation, and at the same time to allow the Central Bank to sell some of its dollar holdings.

The Deutsche Mark came out of the crisis stronger than ever before. In fact, it is now considered to be at the same level as the other reserve currencies. This development left its mark on the future of the international monetary system.

## II. The Second Stage

### A.—Reaching the Critical Point

Traditionally the U.S. trade balance has been in surplus, with the range varying in recent years between 2 billion to 4 billion dollars a year. The trade surplus allowed for a reduction in the overall deficit of the U.S. balance of international payments. However, for the first time since 1897, the U.S. Department of Commerce estimated a deficit in the 1971 trade balance of about 2.1 billion dollars.

At the same time, the reserves of the Group of Ten increased by 4 billion dollars during the second quarter of 1971, with nearly half of this amount being accumulated by one country, namely Japan<sup>(1)</sup>. In fact, the reserves of West Germany, which had risen by 6 billions over the year 1970, rose by a further 3 billions in the first quarter of 1971 and by yet another 2 billions in the first few days of May to reach 18.8 billions, nearly twice

(1) Excluding the U.S., but including Switzerland, World Financial Markets, Morgan guarantee Trust Company, N.Y., July 20, 1971.

as much as the U.S. reserves<sup>(1)</sup>. Thus, the forecast of the U.S. Department of Commerce, represented the last straw in a gloomy situation.

Other economic indicators gave a gloomy picture. The consumer price index was increasing, the rate of unemployment reached nearly 7 percent, the forecast of a balance of payments deficit of 11.3 billion dollars and a decline in the U.S. gold reserves to 10 billion dollars.

The orthodox solution to the U.S. deficit problem could have been achieved through restrictive monetary and budgetary policies and a reduction in money expenditures on goods and services. The deflation of demand would lead to a decrease in the rate of employment of both men and machines. However, no country in modern times is willing to achieve equilibrium through a slack in its economy.

In fact, the U.S. for years, expanded domestic demand to encourage growth and full employment, although it had a balance of payment deficit. However, given the degree of pressure that was building against the dollar in foreign exchange markets, it was inevitable that a major action would have to be taken by the American Government.

President Nixon, therefore, announced on August 15, 1971 his programme mentioned above to deal with domestic economic ills and the international position of the dollar. In the domestic arena, the programme included a 90 days freeze of all prices and wages, the creation of a cost of living council and a recommendation of a 15% tax credit on investment.

On the international front the President announced the temporary suspension of full convertibility of dollars into gold or other reserve assets, the imposition of a temporary surcharge on imports into the U.S. generally at a rate of 10%, and a ten per cent reduction in foreign economic aid<sup>(2)</sup>.

The administration hoped that through the programme it would check inflation, give the economy incentives, and thus

(1) *The Currency Crisis*, The Banker, Volume 121, June 1971, page 553.

(2) Speech by the U.S. Deputy Under-Secretary of State to the G.A.T.T. Council, Geneva, August 21, 1971.

decrease the rate of unemployment. The programme would, in addition, help reduce the deficit in the balance of international payments, thus defending the international position of the dollar.

The Administration response, however, could have been different from the one actually decided on, and it could have been limited strictly in international matters. But as it was expressed by a leading American bank, 'The President seized upon the situation as an opportunity to do much more... and he did so in a manner clearly calculated to maximize the psychological dividends'<sup>(1)</sup>.

Emphasis will be given in the following pages to the effects of these actions on international trade, as well as their far-reaching implications on the international financial system<sup>(2)</sup>.

### B.—The Effects on International Trade

Washington created the crisis in the first place, by its delay in acting at the right time. Even when it moved as late as August 1971 it took far-reaching steps.

The target of American policy was to offset the 13 billions a year deficit at the expense of everyone including its Western allies and the developing countries. To begin with, this figure was disputed. According to the I.M.F. and the O.E.C.D. the deficit was estimated at 10 billion dollars, of which a great part has been used over the past period to finance the war in Vietnam and American investments abroad.

In order to bridge this gap in its payments balance, the American government relied on drastic measures by imposing a 10% surcharge on imports from abroad, adopting a protectionist policy and reducing its aid to developing countries.

This inward-looking mood had brought back old memories of protectionist policies and trade restrictions adopted before the 1930s. Several writers were, in fact, speaking of the prevailing mood of protection in American foreign economic policy.

(1) The Morgan Guarantee Survey, Morgan Guarantee Trust Comp. N.Y., August, 1971.

(2) This part of the analysis was written before, for the Economic Bulletin, National Bank of Egypt, Vol. XXIV, No. 3, 1971.

No one would question the right and even the duty of any country, including the U.S.A., to overcome an imbalance in its balance of payments. As a leading world power and the champion of free trade since the 1930's however, the U.S. measures went further afield than the required remedies.

American officials had declared that the surcharge would not be lifted until several issues had been settled. High on the list were the reform of the Common Market's farm policy, the sharing of Nato costs and the foreign aid burden, the removal of non-tariff barriers which hamper American trade, and above all parity changes.

In a protectionist mood, the U.S. Senate passed on November 16, 1971 a resolution giving the President broad authority to declare a «balance of payments emergency» and to impose a surcharge of 15 percent instead of 10 percent. It also gave him power to impose quotas or total bans on any product imported in the U.S.

In fact the U.S. President went as far as invoking the Trading with the Enemy Act to limit textile imports from Japan on October 15th to the benefit of the large textile lobby of the South. Japan agreed to limit its exports of man-made textiles to the U.S. However, this action severe as it was, did not contribute much to the 10 billion dollars target. Rather it illustrates to what extent the Administration was willing to take severe measures to bring about such a shift in the dollar outflow.

The Administration's own studies also showed that if all existing quantitative import restrictions and discrimination by Western Europe, Japan and Canada regarding agricultural and industrial products were to be lifted, the benefit for American exports would be less than 500 million dollars a year<sup>(1)</sup>. The U.S. would, thus, still be left with 96% of the imbalance uncovered.

What was dangerous was the belief held in both Western Europe and especially in the U.S. that time is on their side. While the U.S. was overestimating its bargaining strength, the Western European countries were taking countervailing measures, until the pattern of conflict was fixed. Thus :

(1) Reported by International Herald Tribune, September 27, 1971.

- 1 — West Germany intervened in the exchange market at the end of September 1971 to hold the upward float of the mark. In fact most of America's trading partners have put a lid on the upvaluation of their currencies until Mr. Conally negotiates;
- 2 — Members of the Common Market and Japan were preparing to follow the Canadians in subsidizing their exports to overcome the surcharge barriers, and,
- 3 — Some countries, like Denmark, had taken counter-measures to restrict American imports to their markets.

### C.—The Financial Aspects of the Problem.

Theoretically, the U.S. dollar was convertible into gold. In actual practice, however, this general rule was subject to several limitations :

- 1 — By a limited convertibility of the two-tier gold price system which was declared in 1968;
- 2 — By more than a three to one ratio of the claims against the available gold stock in the U.S., and,
- 3 — Most important, by the pressures of all kind applied to foreign authorities when they demand gold. But pressure and persuasion do not always work, as evident during the era of General De Gaulle.

The full convertibility of the dollar has, thus, been turned in actual practice into a limited convertibility. This fact, simple as it was, was not acknowledged by the U.S. except quite lately.

Every time there was a currency crisis, different voices were raised to give advice ranging from a dollar devaluation to a re-evaluation by other countries. The U.S. authorities, however, were not willing to hear anything about a dollar devaluation, even during the present monetary crisis.

The only official body which acknowledged this fact was the Sub-Committee on International Exchange and Payments of the U.S. Congress. In a report issued in the summer of 1971, the Committee accepted the fact that the dollar is over-valued and should be revalued.

Furthermore, some American experts like Edward Bernstein called for a devaluation of 7 to 8 percent while the major Western European Countries should upvalue their currencies by a similar amount<sup>(1)</sup>.

#### D.—A de facto Devaluation.

The fact that U.S. Government assets have declined to only 10 billion dollars hanged like the sword of Damocles on the role of the dollar in any future monetary arrangements. The persisting imbalance in the U.S. balance of payments casted more than a doubt about the future of the dollar. Given these circumstances, it was natural from the American point of view to close the gold window and stop the convertibility of dollars into gold.

The world was shocked by this action and the European countries were astonished, not only by the closing of the gold window which, from their point of view, was an unnecessary step, but also by the severity of the measures taken to bridge the deficit of the balance of payments.

One trade aspect of three measures, namely the 10% surcharge, was a completely unusual step taken against their trade and economic interests. It meant in actual practice a de facto devaluation of the dollar.

Thus, the international monetary system has been radically altered. The days of the dollar based on gold have gone like those of the old gold standard. It was up to the world monetary authorities to choose between two different alternatives: the first, to keep the basic stretch within the existing system while giving temporary relief from the different symptoms; the second was to come to grips, with the basic problem and try to solve it through multilateral action.

The European countries plus Japan believed, as a matter of principle, that the U.S. should make a contribution first, and that the requested rate of re-evaluation is enormously high. Every country had, thus, embarked on a unilateral action to defend its economic interests. The result has been a general float

(1) Statement before the Congressional Committee U.S. Congress, Sept. 1, 1971.

for their currencies. In fact, Germany, the Netherlands, Belgium, Italy, Britain and the three Scandinavian countries had established free exchange markets for commercial transactions.

The British government let the pound float at the end of August 1971. To the surprise of several financial experts, the rate of fluctuation was not violent. As a result, the pound reached a de facto upvaluation of about 8 percent above its parity of 2.40 dollars.

The French financial authorities decided to float the franc against the dollar for capital transactions only, leaving trade transactions to the fixed parity. By holding to its official dollar parity the franc benefited more than 8 percent against the mark and 5 percent against the guilder compared to the previous rate in May 1971. France accepted to float for capital transactions, only because it was to its comparative advantage. Among the European countries, France was the least willing to foot the U.S. bill.

The Benelux countries, however, started an interesting experiment by keeping their currencies in fixed parities to each other, while allowing them to float against the dollar. Technically the joint float was based on a "private rate" which was the rate prevailing before the guilder floated in May 1971. As put by the Economist, the effect has been to drag the dollar and pull up the franc<sup>(1)</sup>.

### The I.M.F. and the Crisis

The International Monetary Fund (I.M.F.) is traditionally against freely floating exchange rates mainly because it is its function to police fixed rates. When the European countries floated their currencies and the U.S. closed the gold window in August 15, 1971, the I.M.F. was in a difficult situation.

To deal with this serious situation, the Managing Director of the Fund, Mr. Prime-Pall Schweitzer ruled out in August 1971 a rise in the official price of gold as insufficient step to restore

(1) The Economist, London, August 28, 1971.

a realistic parity between the dollar and other currencies. Furthermore, he called on the U.S. for a formal devaluation of the dollar against gold.

The fund started on calculations, the figures that news reported in September, 1971 reflected that the dollar should be devalued by 3 to 5 percent and other currencies should be revalued: the yen by 15.2 percent, the deutsche mark by 12.3 percent, the Canadian dollar by 11.3 percent and the Pound Sterling by 7.2 percent<sup>(1)</sup>.

The effect of this unconfirmed reports put pressure on the foreign exchange market. Thus the D.M. and Sterling climbed further. The climb in the D.M. was equivalent to a re-evaluation of 10 percent on its pre-float parity and in the case of Sterling a revaluation of 3.5 percent<sup>(2)</sup>.

The American decision of August 15, 1971 to suspend the convertibility between the dollar and gold created a serious clash between the U.S. government on one hand and the I.M.F. staff, and member countries on the other<sup>(3)</sup>.

Before August 15, 1971, debtor countries used to buy with their dollars other hard currencies from the U.S. to repay their debts to the Fund. However, because the U.S. was in a small net debtor position in the Fund, it resisted along with the Fund, accepting dollars in repayment of debts. Thus, if these countries were to use their dollar to buy other hard currencies like the D.M. or the guilder in the foreign exchange market this would put unwelcomed pressure on Germany or the Netherland to accumulate additional amounts of dollars.

To solve this technical problem, the I.M.F. thought during the interim period of August 15, to December 1971 of allowing debtor countries to buy usable currencies in amounts equal to new drawings of those currencies from the Fund by other countries to pay their debts.

(1) Reported by Kyodo news service of Japan on Sept. 23, 1971, as a proposal made by Mr. Schwabert at the recent Group of Ten meeting in London.

(2) The Times, Sept. 2, 1971.

(3) Edwin L. Dale Jr., I.H.T., November 23, 1971.

During the I.M.F. annual meeting in Washington D.C. a resolution was passed calling on the 118 member countries to collaborate in establishing satisfactory changes in currency values as promptly as possible. In particular, the resolution called for :

- A. "Establish a satisfactory structure of exchange rates, maintained within appropriate margins, for the currencies of members, together with the reduction of restrictive trade and exchange practices ; and
- B. Facilitate resumption of the orderly conduct of the operations of the fund."<sup>(1)</sup>

Thus, while the I.M.F. called for a satisfactory structure of exchange rates, in particular, it called on all members, especially the U.S., for a reduction of restrictive trade and exchange practices.

In the meantime, the financial experts proposed a change in the basic rules of the I.M.F. to change the margin of fluctuation from 1 percent to about 2 $\frac{1}{2}$  or 3 percent to cope with unforeseen circumstances.

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(1) Resolution adopted on October 1, 1971.