

THE INTERNATIONAL CURRENCY CRISIS

(Part II)*

Dr. Waguñh Shidy

III. The Third Stage : the Smithsonian Compromise

1.—The Search for a compromise :

The Autumn of 1971 witnessed intensive negotiations within the Group of Ten and Common Market members. Several Summit meetings were also held in Washington D.C. and the Azores to find a solution for the most pressing problem facing the international monetary system.

The European countries plus Japan gradually recognized that the starting point was a realistic parity realignment coupled with the abolition of the import surcharge. The exchange rate should be made more flexible but within the principle of fixed exchange rates.

For this purpose both the U.K. and Germany held the view that the I.M.F. should recognize a new set of "pivotal" rates of exchange between the dollar and other currencies. Countries would be expected to support the dollar value of their currencies within 3 per cent of the pivotal rate.

By Mid-September 1971, the six finance ministers of the E.E.C. were able to reach a common position to be presented at the Group of Ten meeting in London and later to the annual meeting of the I.M.F. at the end of that month. This included the devaluation of the dollar against gold, widening the margin

(*) Part I of this study dealt with the anatomy of the international currency crisis of 1971, its causes and impact on the international trading and financial system. This part deals with the different stages of the crisis from the end of September 1971 to March 1973. It deals specifically with efforts to reach a compromise solution to the problem during the few months at the end of 1971, the Smithsonian Agreement, the floating of the Pound Sterling on June 23, 1972, and the second devaluation of the dollar on February 12, 1973.

of fluctuations around par, expanding the role of special drawing rights and the phasing out of the reserve role of the dollar.

This was an important achievement in reconciling the views of the Six, since France was insisting in the past on the principle of increasing the price of gold and Germany was reluctant to make too blunt an appeal for a dollar devaluation. However, when these proposals were put forward at the Group of Ten ministerial meeting in London, little progress was achieved. Instead they agreed on the following points :

First, "that the U.S. was in a fundamental disequilibrium in its trade and payments, requiring permanent radical remedies."

Second, that a "substantial adjustment is required... of the present payments imbalance in the world... and that measures to bring about this adjustment should be taken on a wide front and should include an appropriate realignment of currencies"⁽¹⁾.

The U.S. secretary of the Treasury Mr. J. Connally, was dismayed at the stand of the European countries. He was hoping to receive some help from them in the difficult moment in return for the U.S.A.'s help after the Second World War, instead of "ganging up against him". He refused therefore to modify his stand to increase the dollar price of gold «by one lot».⁽²⁾

Recognizing the difficulties of holding its views further and the need to solve the crisis, the U.S. modified its stand. Thus, Mr. Connally declared a few days before the November 30th meeting of the Group of Ten that "there is nothing sacred, we will talk about anything"⁽³⁾. In fact, Congressman Henry Reuss introduced, a few days after this statement, a bill to Congress giving the President discretionary power to raise the

(1) Communiqué of the Group of Ten, London, 8.p. 16. 1971.

(2) Reported by Peter Jay, Economics Editor, The Times, 8.p. 17, 1971.

(3) Statement at the New York Economic Club, before mid-November 1971.

official price of gold by up to 10 per cent, i.e. devaluing the dollar.

Although this bill was not officially presented by the U.S. government, however it reflected along with the statement of the U.S. Secretary of the Treasury the general mood about a possible compromise by the U.S. Thus, instead of solving all the financial and trade problems as one package, the U.S. re-arranged its priorities into two phases. The first, would include the revaluation of the strong currencies against the dollar. In turn, the U.S. would drop the 10 per cent surcharge. The second, would deal with long-term issues like U.S. trade with E.E.C., cost-sharing of the defence expenditure in Europe and the overhauling of the international monetary system.

The first proposition was accepted in principle by most European countries with the exception of the U.K., France and Italy which were against major revaluation in their currencies. As of Japan, it was clear that the U.S. requested a revaluation of at least 17 to 18 per cent. The Japanese government, in order to preserve its competitive position, resisted such a high percentage of revaluation.

The O.E.C.D. which played a key role in studying the problem, changed its previous position and regarded the American request for "11 per cent revaluation" as a reasonable contribution to bridge the American deficit.

From there on, the attention was centered on the distribution of the realignment between the European countries specially Germany and France. The parity between the D.M. and the Franc is important given the importance of trade between the two countries. While the D.M. was allowed to float, the value of the commercial Franc did not change. Thus, french exports held a competitive edge within the community and with the outside world. Thanks to the two-tier system and other restrictive measures.⁽¹⁾

(1) The French government established the two-tier system on August 20th, 1971. Furthermore it announced on December 3, 1971, new exchange control on non-resident deposits to halt further increase in the price of the financial Franc. Non-resident were given therefore, seven days to sell their holdings of Francs for other currencies.

It was natural therefore, for the Germans to refuse any realignment which would involve a greater revaluation of the D.M. against the Franc. This problem was not solved until the West German Chancellor Willy Brandt met the French President in Paris on December 4, 1971. They both agreed to adopt a coordinated stand within the group of ten and during their coming bilateral meetings with President Nixon.

Thus, the road was paved for an official agreement between the U.S. and its major partners. Few days after the Canadian, British, French and German summit meetings with President Nixon in Washington D.C. and the Azores, the Smithsonian Agreement was announced.

2 — The Smithsonian Agreement; a stopgap solution :

After several months of negotiations between the major European countries and Japan on one hand, and the United States on the other, the Smithsonian Agreement was reached in an attempt to solve the international currency problem. In declaring the decisions reached by the group of ten, their communiqué talked about "new and lasting equilibrium in the international economy." Before we can analyse the agreement it is useful to summarize the main decisions reached.

- An increase in the official price of gold from 35 dollars to 38 dollars an ounce, thus devaluing the dollar by 8.57 per cent.
- The immediate removal of the 10 per cent surcharge imposed by the U.S. in August 1971.
- In exchange the eight European countries plus Japan and Canada agreed to effect the following parity changes

Belgian franc	+ 11.57
French franc	+ 8.57
Italian Lira	+ 7.48
German mark	+ 13.58
Netherlands florin	+ 11.57
Swedish krona	7.49
Swiss franc	+ 13.9
British pound	+ 8.57
Japanese Yen	+ 16.88
Canadian dollar	(floating)

In the meantime, both sides agreed to widen the permitted margin of fluctuations around par from 1 per cent to 2 1/4 per cent on either side of the parity.

The communiqué also reflected the agreement reached by the group of ten that "discussion should be promptly undertaken, particularly in the framework of the I.M.F. to consider reform of the international monetary system over the longer term. It was agreed that attention should be directed to the appropriate monetary means and division of responsibilities for defending stable exchange rates and for insuring a proper degree of convertibility of the system; to the proper role of gold, of reserve currencies, and of special drawing rights in the operation of the system; to the appropriate volume of liquidity; ... and to other measures dealing with movements of liquid capital."

Thus for the first time in four decades the American Government officially agreed to devalue the dollar. In fact it reached a bigger depreciation than any other currency. The percentage of depreciation was particularly big against the yen and the weaker European currencies like the pound, French franc and the Italian Lira, as is clear from the following table :

Percentage upvaluation against the dollar⁽¹⁾

	Col. 1 New Parity	Col. 2 Since May 1	Col. 3 Since August 13	Col. 4 Since Dec. 17
Yen	308	+ 16.9	+ 15.9	+ 1.9
Sterling	2.6057	+ 8.6	+ 7.8	+ 3.0
French francs	5.1157	+ 8.6	+ 7.8	+ 7.8
Lira	581.5	+ 7.5	+ 6.2	+ 3.3
Swiss francs	3.84	+ 13.9	+ 5.9	+ 1.0
D. marks	3.223	+ 13.6	+ 5.1	+ 1.1

(1) The Economist, London, December 25, 1971.

The increase in the official price of gold was admitting a *facto* situation by legalizing it into a *de jure* situation. In any case it was and still is the price at which the U.S. refuses to sell gold. For this reason, the stumbling block towards reaching a solution to the problem was not the official price of gold as much as the realignment of the new parities between the Americans and the rest of the Group of Ten. This was actually an exercise in brinkmanship and political manoeuvre. The parity changes were supposed to bridge the 9 billion dollars deficit in the U.S. balance of international payments which meant an average currency revaluation of 11 per cent. However, the parity changes reached at the Smithsonian meeting did not achieve the desired effect as we shall see later.

In fact, the Americans had a bigger depreciation than most experts expected or even thought possible when the critical point was reached in August 1971. Let us only recall the statement of the Under Secretary of the Treasury that the devaluation of the dollar was "like a balloon that has been burst long time ago". In the meantime the American Government removed the 10 per cent surcharge which represented a turnback from its liberal trade policy, although the full impact of the surcharge was not completely felt yet.

As of the upward revaluation of other currencies, it was part of the deal. They agreed to revalue their currencies if the Americans devalued by more than 5 per cent. As it turned out their effective rate of revaluation was more than 9 per cent from August 13, 1971. However, the relative position of each currency was different after the revaluation from their previous position.

The yen was officially revalued by 18.88 per cent. At this rate it was revalued by 15.9 per cent from August 13, 1971, making it the highest revalued currency. However, in comparison with the going rate on December 17, 1971, it was revalued by 1.9 per cent only. The Americans pressed for the relatively higher percentage of depreciation for the dollar against the yen to insure an end to the ever rising trade surplus with them. To their surprise later on Japan continued to achieve a trade surplus and accumulate more reserves, which brought about another crisis at the beginning of 1973. as will be seen later on.

The second highest revalued currency was the D.M. It was revalued by 13.58 per cent. In fact the D.M. had been revalued twice before in 1961 by 5 per cent and in 1969 by 9.3 per cent before it was allowed to float on May 10, 1971. However, it was upvalued against the dollar by 5.1 per cent only from August 13, 1971. At this rate it was relatively depreciated against the yen, French franc and even the pound Sterling. That is why the Economist rightly declared that the D.M. had "come out of the realignment too cheaply."⁽¹⁾ For this reason it was felt at that time that Germany might start another export-led boom to get over their mini-recession.

As to the pound sterling it was revalued by 8.57 per cent to preserve its competitive position against other currencies since May 1, 1971. However, at this rate the position of sterling was not envied by other currencies. By this revaluation it was relatively upvalued by 2.1 per cent against the Swiss franc and by 2.7 per cent against the D.M., while at the same time other countries like Australia had devalued their currency against the pound by 2 per cent and South Africa by 12.3 per cent. Thus the pound became one of the overvalued currencies at a time when the U.K. needed a push to improve its external accounting position. As it turned out, the fall of the pound below the "floor" during the summer of 1972 came as one of the results of this realignment. In the meantime the Dutch and the Belgians moved together by revaluing by 11.57 per cent due to their close trade relations.

(1) The Economist, London, December 25, 1971, p. 66.

What happened to the different currencies⁽¹⁾

Fund members chose one of six different options :

A — to float.

B — to keep their gold parities,

C — to devalue against gold and the dollar,

D — to devalue upwards.

E — to appreciate in terms of the dollar but by less than the gold parity, and

F — the dollar area which devalued in terms of gold in the exact percentage like the U.S. dollar.

A. Canada Korea Lebanon Philippines Paraguay
Ecuador

B. Britain France Spain Ethiopia Somalia Iraq
Libya Kuwait Saudi Arabia Yemen

Sterling associates : Australia New Zealand Ireland Cyprus
Malaysia Singapore Hong Kong Nigeria Sierra Leone
The Gambia Jamaica Barbados Trinidad and Tobago
Malawi

Franc Zone and associates : Algeria Tunisia Morocco
Madagascar Republic Dehomey Ivory Coast Mauritania
Niger Senegal Togo Upper Volta Chad Mali
Cameroon Gabon Congo Guinea Central African Republic.

C. Israel Yugoslavia Ghana Burma South Africa
Rhodesia Lesotho Swaziland Botswana.

D. Germany Japan Austria Belgium Luxembourg
Netherlands Malta Venezuela

E. Italy Norway Sweden Denmark Finland India
Turkey Portugal

F. Argentina Bolivia Brazil Chile Guyana Mexico
Panama Nicaragua Uruguay Costa Rica Peru
El Salvador Haiti Honduras Dominican Republic Greece
Taiwan Thailand Vietnam Korea Nepal Iran
Ceylon Kenya Tanzania Uganda Zambia

(1) From the Dollar Crisis, by Susan Strange, Foreign Affairs, January 1972, p. 212.

The reason behind the whole exercise was to return the international financial system from widely floating rates to fixed exchange rates. The unprecedented movements of funds in 1971 resulted in frequent central banks interventions in the market to prevent the value of their currencies from appreciating against the dollar. The intervention of the central banks did not accommodate the market or stop the muddle in the major currencies mainly due to the limited ability of these banks and the limited margin of fluctuations permitted under the rules of the I.M.F.

To overcome this problem the Smithsonian Agreement allowed currencies to fluctuate by 2.25 per cent on either side of parity, or by a range of 4.5 per cent. This was a step forward, since governments and central banks do not have to peg the exchange rate as frequently as they did before. Furthermore, the business community could plan for the future with some degree of certainty.

To insure more flexibility in the system, different governments can inform the I.M.F. about their par value or their central rate. Unlike the par value the Articles of Agreement of the IMF do not require the approval of the central rate.

With all the emphasis on going back to the system of fixed exchange rates according to the Bretton Woods principles, there were still some unresolved problems. The convertibility of the dollar into gold or S.D.R. especially when several European central banks were holding vast amounts of dollars from their support operations, has been one of the major problems. The implicit acceptance of the Bretton Woods system was based on the ability of the leading currencies specially the dollar to be converted into gold. In fact the system was based for a long period on a dollar standard.

On the question of the convertibility of the dollar the communiqué spoke only about "insuring a proper degree of convertibility of the system" without specifying the ways and means of insuring this goal. Thus, the American authorities had no obligation to convert the huge amounts of overseas-held dollars into gold, S.D.R. or other foreign currencies. In fact the Ame-

rican government have never attempted to maintain a fixed rate against other currencies. In a system based on a dollar standard it was up to foreign governments to fix and maintain fixed exchange rates against the dollar to avoid revaluing their currencies. With the huge accumulation of dollars during their support operations, most European countries plus Japan were left with the unpleasant choice of holding devalued dollars, or selling them on the market at a loss.

This problem had another dimension relating to the proper function of the IMF and in particular to absorption of the big British debt repayment which was due in June 1972. During sterling's difficulties near the end of the 1960's, the British Government had borrowed about 1,000 million dollars. This amount had increased due to the dollar devaluation to about 1,078 million dollars, which the Bank of England wanted to repay in June 1972. However, according to the IMF practices the repaying country has to hand over acceptable currencies to the Fund. At the time, the dollar could not be considered as such because of the huge holdings of other countries. It was thought therefore that a U.S. drawing of usable currencies would help, as these currencies could then be exchanged with Britain for dollars; thus the U.K. would be able to repay.⁽¹⁾

The U.S. attitude on the convertibility of the dollar was therefore, subject to several attacks and criticisms even by American financial experts. In a paper published in N.Y. Mr. Edward Bernstein the former Research Director at the I.M.F. criticized the U.S. reluctance to begin negotiations or even to restore a measure of convertibility to the dollar. He even went further to point out that this is a violation of the Smithsonian Agreement which spoke about "defending stable exchange rates and ensuring a proper degree of convertibility in the system."⁽²⁾

In short the Smithsonian Agreement was a stopgap solution by the "rich-man's club" to a difficult and thorny problem.

(1) Samuel Britton, *Financial Times*, London, Feb. 10, 1972.

(2) Muel Roland and Co., *Quarterly Review*, N.Y., 1972, reported in the *Financial Times* February 8, 1972.

The solution, although partial, did not pass the first practical test a few months later. For this reason Susan Strange was right when she called it a truce than a peace treaty.⁽¹⁾

However, the Common Market countries later agreed to give some trade concessions to the Americans as part of the package deal. This included a reduction of tariffs on the following items.

- On oranges from 15 to 4 per cent during the peak of the U.S. export season (June to September) for the next two seasons.
- On grapefruit from 6 to 4 per cent for the next two seasons.
- In addition the Community agreed to stockpile 1.5 million tons of surplus grain from its 1971-72 harvest, compared with a U.S. request to stockpile 3.4 million tons in both farm years.⁽²⁾

The idea behind the quick trade concessions given by the Community in early February 1972 to the U.S. was to present the dollar devaluation bill to Congress along with the trade concessions from the Community to avoid being defeated or loaded down with Christmas tree amendments by Congress. For the same reason the thorny issues of trade policy between the E.E.C. and the United States were postponed to a new round of long-term negotiations to be held in 1973.

In the meantime, the E.E.C. Commission wanted to limit fluctuations between any two currencies within the Community to 2 per cent instead of the 4.5 against the dollar for each one of them. In presenting this proposal to the Foreign Ministers of the Community Mr. Raymond Barre reminded the delegates that "the realignment so far had not led to any reflux of capital to the U.S." as was expected before.⁽³⁾ He feared that further speculative pressure against the European currencies might take place if the U.S. continued its credit and budgetary policies. The only

(1) *The Dollar Crisis*, Foreign Affairs, N.Y., January 1972, p. 209.

(2) *Financial Times*, February 1, 1972.

(3) Speech by M. Raymond Barre on February 1, 1972, reported in the *Financial Times*, February 2, 1972.

way for the Community currencies to have an advantage over the dollar would be through narrowing the margin of fluctuations to 2 per cent only. This policy was particularly desirable for a well functioning common agricultural policy.

IV. The Fourth Stage : The Sterling Floats

To start with, the Smithsonian rate of the pound sterling was set at a relatively higher rate than other currencies. It was difficult therefore to sustain this rate for a long period. Furthermore, the overall balance of payments surplus was reduced from 933 million pounds in the first quarter of 1971 to only 57 million in the corresponding period of 1972.⁽¹⁾ In fact, the merchandise trade balance recorded a deficit of 118 million pounds in the first quarter of 1972 after a surplus of 74 million pounds during the same period of 1971. These adverse developments can be explained by the industrial disputes, coal miner's strike, lost output and declining export competitiveness due to wage inflation. Wage costs per unit of output increased by 27 per cent from mid-1967 to the fourth quarter of 1971. This fact reflected on British export prices which registered an increase of 26 per cent from mid-1970 to the first quarter of 1972.⁽²⁾ Moreover, the British Government and the business community wanted to enter the European community with a favourable rate for the pound.

The rate of sterling continued to drop against the European currencies (except the Italian Lira) and even the dollar. To keep the rate between sterling and the E.E.C. currencies within the allowed narrow margin of 2 1/4 per cent, instead of the 4 per cent permitted under the Smithsonian Agreement, European Central Banks spent over 2.6 million dollars in supporting sterling, most of it on Wednesday and Thursday, 21 and 23 June, 1972. In the meantime the Bank of England gave direct support especially after the European banks closed their doors. Nevertheless, holdings of sterling continued to fall, and the rate drop-

(1) Excluding £124 million S.D.R. allocation, World Financial Markets, Morgan Guarantee Trust Company N.Y., June 23, 1972, p. 2.

(2) The Economist, July 1, 1972, p. 88.

ped. On Thursday evening the pressure was so strong that the closing rate dropped to 2.485 dollars on Wednesday June 21, 1972 and to 2.575 on Thursday, June 22, 1972 against the old Smithsonian rate of 2.805 dollars to the pound. At this rate the pound had devalued against the dollar by 4.5 per cent and 3 per cent respectively below the old Smithsonian rate.

To remedy this situation the British Government decided on the morning of Friday June 23, 1972 to allow the pound to float. Thus, the London foreign exchange market was closed on Friday June 23, 1972 and on Monday June 28, 1972. In declaring this decision the Chancellor of the Exchequer emphasized both the temporary nature of this measure and the immediate application of exchange controls on transactions by U.K. residents with residents of the Overseas sterling Area (O.S.A.) except the Irish Republic.

Bank of England approval was thus required for new direct investment in O.S.A. countries on the borrowing of U.K. companies for their operations in the U.K. if they are controlled by O.S.A. residents, and a maximum limit of 20,000 pounds per family was imposed on emigrants to O.S.A. countries.⁽¹⁾

What has happened in manufacturing Since last time⁽²⁾

% Increase	Export Price in U.S. dollars		Hourly earnings		Wage costs per unit of output
	Mid-1967 to Mid-1970	Mid-1970 1st qtr 1972	Mid-1967 to 1st qtr 1972	Mid-1967 to 1st qtr 1972	Mid-1967 to 4th qtr 1971
	% (1)	% (2)	% (3)	% (4)	% (5)
Britain	0	28	28	58	27
Germany	12	16	30	53	21
Japan	12	9	29	101	23
Italy	10	12	23	62	32
United States	13	4	18	31	13
France	5	9	14	64	18

(1) Economic Progress report, U.K. Treasury, London, 30 August, 1972.

(2) The Economist, London, July 1, 1972.

Following the British decision, there was a division in the views between some E.E.C. members as to the proper course of action to be taken for their own currencies. While both the Dutch and the Belgians wanted the Six's snake tunnel to float against both sterling and the dollar, the Germans and the French wanted to maintain the Smithsonian fixed parities and the application of the narrow exchange margins agreed upon by the E.E.C. members. Both of them were motivated by the desire to keep their exports lead through a stable and relatively undervalued currency, while protecting their imports either through the cheap commercial French franc or the undervalued D.M. They convinced Belgium and the Netherlands, therefore, to maintain the existing rules and a communique was issued to that effect stating that the finance ministers of the E.E.C. agreed to "maintain the margins and parities agreed in the Smithsonian Agreement and the European Economic Community's narrow system of exchange margins."⁽¹⁾ The Japanese and the Americans were pleased with this decision, but for different reasons. As for Japan it was impossible to keep the fixed parity of the yen while the major European currencies were floating. The U.S. would have benefitted from such a float, but it did not want a further deterioration of the dollar immediately before the presidential election.

At the same time several European countries like Germany, Switzerland plus Japan embarked on applying exchange controls to avoid foreign inflow of funds especially the dollar at its unattractive rate. Italy also applied exchange controls, but for a different reason, that is to prevent a further outflow of funds due to the weaker position of the Lira.

Thus, by July 1, 1972 there were more exchange controls in most industrial countries than at any time since the beginning of the sixties. This fact let the Economist to declare that "unless worldwide exchange controls are far more effective than before ... this may still lead to a general floating"⁽²⁾.

(1) Statement of the E.E.C. finance ministers, Luxembourg, Monday, June 28, 1972.

(2) The Economist, London, July 1, 1972, p. 90

V. The Fifth Stage : The second Devaluation of the Dollar.

At the beginning of 1973 the economic scene in the U.S. looked encouraging. Sales, production, employment, incomes and profits were rising in 1972 while the rate of inflation slowed; the balance of trade was the only uncertain indicator. This was in sharp contrast to the recession of 1969-70. In fact, between the third quarter of 1971 and the same quarter of 1972, real gross national product rose by 7.2 per cent against 4.6 per cent between the fourth quarter of 1970 and the third quarter of 1971⁽¹⁾.

However, the international monetary scene became erratic within a very short period of time, when the Italian Government decided to introduce a two-tier exchange system effective from January 22, 1973. This step was motivated by the government's fear of an outflow of arbitrage money plus the usual speculative outflow of capital due to the rising interest rates all over Europe. Italy chose this approach rather than devaluing the Lira because of its handsome current balance of payments surplus — 1.3 billion dollars — which as a proportion of G.N.P. is higher than Japan's, while the level of its reserves could not sustain additional outflow⁽²⁾. In the meantime, it pushed aside any rise in interest rate to restimulate economic growth.

Thus it joined the "floating club" of other E.E.C. members like France, Belgium, and Holland which allowed their currencies to float for capital transactions. If we add Britain and Ireland which are floating for both capital and current transactions, then we could say that with the exception of Germany the major countries in Europe joined this club.

Following the Italian decision, the international currency market was shaken when the Swiss National Bank, under the impact of large inflows of foreign exchange, especially dollars, ceased to intervene in the exchange market to support the dollar price after its rate dropped. From the last few days in January

(1) Monthly Economic Letter, First National City Bank, N.Y. January 1973, p. 2.

(2) The Economist, January 27, 1973, p. 71.

the rate sank visibly on most foreign currency exchanges. Against this background, the Swiss Government decided to float the franc.

The sharp upward float of the Swiss franc triggered off speculation that other strong currencies could be candidates for floating. The foot-loose hot money acted quickly to convert dollars to D.M., yen, guilder and other strong currencies. Speculators thus tried to have the best of both worlds, to opt out of their holdings, to avoid any loss and at the same time to share in the forthcoming float or revaluation of the strong currencies.

The news coming out of the U.S. about the increase in the trade deficit from 2.7 billion in 1971 to 6.4 billion dollars in 1972, the alarmist stories in the U.S. about the energy crisis and its impact on the balance of trade in the future, the unconvertibility into gold, and the advancing phenomenon of inflation were added reasons for pessimism.

Against this background, the situation developed very quickly. Despite the restrictions imposed in most countries on capital transfers, huge amounts of funds were transferred mainly to Germany and later to Japan. The Bundesbank had thus to accept a large amount of dollars at the lower intervention point of 3.15 D.M. to the dollar. Monetary authorities in other countries found themselves in the same boat. However, the dollar purchases were on a smaller scale there than in Germany.

To counteract this massive inflow of dollars and to protect its own self-interest, the Federal Government adopted further restrictions on capital movements from February 5, 1973 and requested Parliament to amend the Cash Deposit Act permitting the ratio of cash deposit to be raised from 50 per cent to a maximum of 100 per cent⁽¹⁾.

However, the different statements coming from the U.S. about possible devaluation of the dollar intensified the inflow to Germany and Japan. The Bank of Tokyo had to accept more

(1) Monthly Report, Deutsche Bundesbank, Vol. 25, No. 2, February 1973 p. 7.

than 650 million dollars at the floor rate of 301.10 yen to the dollar in the few days preceding February 9, 1973⁽¹⁾. In fact, the dollar reached its floor limit in practically all major exchanges on February 8, 1973. The barriers erected in Germany and the different programmes to control the inflow in Japan proved ineffective. Thus, the major currency exchanges were closed from Monday, February 12, to Wednesday, February 14, 1973.

From the beginning of speculation to the close of currency exchanges about 8,000 million dollars were absorbed by foreign central banks. Out of this total amount the Bundesbank alone took 6,000 million dollars — about 18.5 billion D.M. — at the lower intervention point. As the official report of the Bundesbank put it "no previous wave of speculation had resulted in funds flowing into Germany on such a scale⁽²⁾".

Unlike the previous crisis of 1971, the February crisis of 1973 was not a dollar-D.M. crisis, but a dollar-yen crisis. The fact that more dollars were sold in Germany than in Tokyo does not negate this analysis. There are two explanations for this paradox :

Firstly, the widespread belief that the West-German Government was more vulnerable to political pressure to re-value than the Japanese Government, and,

Secondly, the exchange control protection given to the yen was more effective than that given to the D.M.

The French franc was not affected by the 1973 crisis because of the strong protection of the franc by the two-tier system which was introduced in August 1971. Furthermore, there were several reports about the possibility of a change in government as a result of the March elections. The French franc did not attract therefore speculators as a strong currency in the immediate future that might bring a quick profit.

Let us now turn back to the reasons why the crisis of February 1973 was a dollar-yen crisis and not a dollar-D.M.

(1) Reported in the Daily Telegraph, London, February 9, 1973.

(2) Reported in the Times, London, Oct. 17, 1972.

The revaluation of the yen by 16 per cent at Smithsonian Agreement was supposed to bring equilibrium in Japan's external accounting. This desired result did not materialize, the trade balance registered a continued increase which reflected on an ever increasing reserves. However, the Japanese efforts were directed mainly at tightening foreign exchange controls to prevent the inflow of foreign funds rather than encourage the outflow. The Government, therefore, announced three programmes to defend the yen from May 1971 to the end of 1972. The first was the eight points programme announced in the summer of 1971 which ended with the Smithsonian Agreement. The second was the seven points programme of May, 1972, which was overshadowed by an ever increasing trade surplus and reserve accumulations. In September 1972 the statistics for the first half of the Japanese fiscal year (April to September) were announced showing an overall exports of 14,097 million dollars, or a gain of 15.9 per cent to the same period a year ago while exports to the industrially advanced countries increased by 22 per cent over the first half of fiscal 1971. In other words the overall export surplus for fiscal 1972 was expected to reach more than 9,000 million dollars. With a trade surplus in 1972 similar or even higher than the surplus of 8,500 million dollars in 1971, it meant further balance of payments surplus contributing to an increase in reserves to nearly 20 billion dollars by the end of 1972 instead of the 16.7 billion dollars reached at the end of March 1972.

With this kind of economic performance, not only the expected equilibrium was far from being reached, but also the government and the business community were under heavy pressure to formulate new liberal policies to encourage imports, slow down exports and liberalize foreign capital investments.

In fact, the powerful Japanese Federation of Economic Organizations — Keidanren — came out in favour of a foreign trade control ordinance for curtailing exports as the only way to slow down the pace of expansion in exports to the U.S. and Western Europe. Furthermore, it requested a cut in tariff rates by between 20 to 30 per cent, reduction in the number of items remaining subject to import restrictions, and expansion of import quotas.

The Tanaka Government thus embarked on studying ways and means to reduce this huge surplus which would ultimately

lead to another upvaluation of the yen. However, there was a division of views within the cabinet between the Ministry of Finance supported by the Bank of Tokyo on the one hand and the Ministry of International Trade and Industry (MITI) supported by the business community on the other. While the former proposed the imposition of an export tax to reduce the level of exports, the latter opposed such a measure which would be in effect a disguised upvaluation of the yen; instead it proposed liberalising imports and reducing exports to the developed countries. The views of the Ministry of Finance subsided. Thus the Cabinet announced on Friday, October 20, 1972, the third five points programme to defend the yen against revaluation or floating.

The programme included the following measures :

- 1 — To reduce tariffs on nearly three-quarters of Japan's tariffs by 20 per cent, while decreasing the quotas on several items to encourage imports,
- 2 — To limit the expansion of Japanese exports through administrative measures on items where exports have been rising at an annual rate of over 20 per cent,
- 3 — To promote the outflow of capital through private investment or through foreign economic aid to the developing countries,
- 4 — To liberalize the rules on foreign direct investment in Japan while tightening the rules on foreign speculation into the yen and,
- 5 — To increase spending at home on welfare projects through a supplementary budget.

However, these measures were not well received by financial experts. They based their judgement on the inability of tariff reduction to increase the general level of imports mainly because more than 50 per cent of Japan's imports are raw materials which are not price sensitive. Furthermore, Japan did put forward two programmes before and neither was effective. They would have preferred instead an outright revaluation of the yen or at least an export surcharge of 10 per cent especially when the Japanese National Economic Research Institute declared before that Japan

could absorb a 6.2 per cent upvaluation of the yen and still enjoy 11 per cent growth rate in the next two financial years.

In anticipation for such a revaluation, the yen was quoted at about 280 to the dollar in forward transactions which meant an upvaluation of 10 per cent on the Smithsonian parity (301.10).

Despite the previous steps to liberalize imports and capital investments, and to lower imports tariffs, Japan recorded a surplus of more than 4 billion dollars in its foreign trade with the U.S. This trade deficit with Japan was considered from the American point of view the largest with any one single country, it constituted about two-thirds of their overall trade deficit in 1972.

Mr. William Eberle, President Nixon's special trade representative was thus sent to Tokyo, to request the Japanese government to revalue the yen by at least 10 per cent otherwise the U.S. may take actions against Japan like an import surcharge.

The Japanese attitude was very cool, they refused to offer any major trade concessions on two grounds. First, to make export and import even does not necessarily mean an equilibrium due to large deficit suffered by Japan with the U.S. in non-trade balance. Japan thus should continue to maintain a trade surplus of 2 billion dollars with the U.S.⁽¹⁾ Second, the Japanese Government requested more time for the 1971 adjustment in parities to be felt. Mr. K. Inamura, Deputy Minister of Finance for International Affairs expressed the official attitude by declaring that "the Smithsonian Agreement is only one year old and it takes time for the effects to be felt."⁽²⁾

Thus the Eberle's mission in Tokyo did not achieve its goals. He left to the major capitals in Europe to express the official American view that progress in trade, monetary, financial co-

(1) Yoshizane Iwasa, Chairman, Japan - U.S. Economic Council, The Japan Economic Review, Tokyo, January 18, 1973.

(2) Reported in the Financial Times, London, Feb. 9, 1973.

operation and defence cost-sharing negotiations was necessary on a coordinated basis between the U.S. and the European countries. The U.S. was still hoping then that the surplus countries would either agree to participate in another Smithsonian general revaluation agreement or to start a joint float.

The American policy therefore adopted the previous strategy of 1971, that if they do have a currency crisis they can remain resolute and leave the problem simmering, their other partners would have to take action before it explodes. Thus they could be relieved from taking a drastic action while passing the problem to the others.

This strategy however did not work out during this crisis. In fact the Japanese Government took the previous position of the Americans, they stood tight and resolute. The major industrial countries did not feel the need to change their exchange rates simply because they all adopted well in advance direct controls on capital account and at the same time they did not consider that their external position was one of significant surplus. Thus they refused to upvalue or let their currencies float. Japan felt then that even if the U.S. threat of imposing a surcharge on its exports were to materialise, it would leave its mark on the international trading system. It would try then to divert its exports to other countries especially Western and Eastern Europe. Furthermore, this situation might start a trade war between the major industrial countries in the world.

In the meantime the international support operations for the dollar in the six trading days ending Feb. 8, 1973 reached more than 8,000 million dollars. The dollar thus reached its floor limit in practically all major financial markets in the world by the end of the first week of Feb. 1973.

Discovering that its old strategy did not pay off, and convinced that the surplus countries, particularly Japan, are not going to take appropriate measures, the moment of decision could not be further delayed. A 10 per cent devaluation of the dollar was thus announced by the U.S. Secretary of the Treasury late Monday night Feb. 12, 1973. The magnitude of this devaluation exceeded the expectations of some observers. It came quicker

and by a bigger percentage than the 7.8 per cent first devaluation of December 1971.

Uncertain about the future stability of the dollar, the leading industrial countries representing the nine members of the E.E.C. reacted by announcing a "joint float". This float was based on linking their currencies to one another through fixed parities to allow them to move up or down in the market as a unit according to the forces of supply and demand.

By adopting floating rates, the whole structure of the Bretton Woods of international monetary-system based on stable and fixed exchange rates has been dethroned. It is the first time since 1946 that the forces of supply and demand are given major expression in determining the exchange rates. This helps to restore equilibriums in the balance of payments at the cost of greater uncertainty in world trade.

It is still to be seen whether the new practice would be widely adopted and to what extent it will be effective. The unilateral action by the leading industrial countries and the indecision of the Group of Twenty has cast its shadow on the future role of the I.M.F.