Federal Reserve Bank of San Francisco

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Business & Financial Letter

Gnomes of Frankfurt

The Smithsonian monetary agreement broke down this past week, as the legendary gnomes of Zurich shifted their activities to Frankfurt, Tokyo and other financial centers. The final crisis began just about three weeks ago. The growing weakness of the Italian lira triggered a flight to the Swiss franc and then to the German deutschemark and the Japanese yen, and this eventually led to a massive flight from the U.S. dollar. Multinational corporations, banks and speculators all flooded the German market with dollars, forcing the German central bank to purchase about $6 billion in exchange for marks within about a week's time, to keep the mark from rising above its ceiling of 3.15 to the dollar. Finally, when the pressures became irresistible, the Administration announced plans for a 10-percent dollar devaluation to add to the 8.57-percent devaluation of December 1971.

Plans for '73

The Administration plan, as announced by Treasury Secretary Shultz, actually includes three separate elements. Congress will be asked to accomplish the desired devaluation by changing the official price of gold to $42.22 an ounce from its present $38. (The price was $35 an ounce before the 1971 devaluation.) Congress also will be asked to provide for authority to negotiate lower tariff and nontariff barriers to trade while providing new safeguards against import disruption to domestic markets.

As a third part of the package, the Administration plans to phase out, no later than the end of 1974, such decade-old controls as the interest-equalization tax and curbs on foreign direct investment.

Following the American move, the German cabinet approved a shift in the mark's central rate from 3.22 to 2.90 marks per dollar, and the Japanese government announced the floating of the yen. (According to a German official, the dollar devaluation and the expected upward shift of the yen could amount to a weighted-average 2-percent upward valuation of the deutschemark against all world currencies.) Meanwhile, Italy announced a float of its official lira, along with a continued float of its financial lira. At midweek, the French maintained their two-tier system, and the Swiss, British and Canadians all continued to float their respective currencies.

Troubles in '72

All was not quite well even before the onset of the recent crisis. The dollar was under downward pressure and, conversely, most other currencies were under upward pressure several times during 1972—early in the year, when uncertainties were widespread about the new monetary arrangements, and again during the summer, when a loss of confidence in the established value of the British pound raised questions about the whole new

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structure of exchange rates. However, the dollar strengthened relative to most other currencies during the spring and again during the fall months.

The British pound came under considerable downward pressure around midyear, when fears about the U.K.'s considerable inflation problem and its prolonged labor troubles raised doubts about the viability of the British exchange rate established at the Smithsonian. The British authorities tried to prevent the pound from dropping below the Smithsonian floor, but lost a substantial amount of foreign exchange in doing so, and eventually allowed the pound to float downward in response to market pressures. By year-end, the pound's value was 10 percent below the earlier-established central rate.

The Japanese yen, in contrast, was under considerable upward pressure after midyear, reflecting the large surplus in the nation's balance of payments. Throughout late 1972, the Japanese authorities were forced to purchase large amounts of dollars to keep the value of the yen from rising above the Smithsonian ceiling. At the same time, forward yen rates remained substantially above the Smithsonian ceiling, as a consequence of the market uncertainty over the existing yen parity.

Why the crisis?

The new financial storm blew up quite suddenly, and the experts will be arguing for years about the causes of the crisis. One possible explanation could be the tentative nature of the Smithsonian agreement. In the short term, the Smithsonian participants agreed on a realignment of exchange rates among the various currencies to relieve the existing disequilibrium in international payments. For the long run, they agreed to enter into multilateral negotiations on the reform of the international economic system. Yet the discussions of this type held over the past year simply have been overtaken by events.

Another possible explanation of the crisis is the widespread belief in world money markets that the U.S. inflation might get out of hand once again. This ignores the fact that the controls mechanism remains in place under Phase III to combat inflationary pressures.

This belief also ignores the harder fact that the U.S. price performance has been somewhat better than that of most of its trading partners during the last several years; even Germany has done no better than the U.S. in this regard, with an 8-percent increase in wholesale prices over the past two years.

More obviously, the world's money managers have remained disturbed about the size of the U.S. balance-of-payments deficit, even though it has improved from $29.8 billion in 1971 to $11.6 billion in the first three quarters of 1972, on an official-settlements basis. But

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the improvement has come about entirely in the capital account, largely as a result of the sharp reduction over 1971 in speculative outflows of capital. In 1972, unlike 1971, Americans and foreigners alike found good opportunities in the U.S. money and capital markets. But the merchandise-trade account, despite the purported benefits of devaluation, went from a $2.7-billion deficit to a $7.0-billion deficit, as the rapid U.S. expansion attracted imports and the relatively sluggish economies of our major trading partners limited the growth of U.S. exports.

With the dollar inconvertible into reserve assets, virtually the entire U.S. deficit on an official settlements basis was financed last year by inreased dollar holdings of foreign central banks. Thus, U.S. liabilities to official foreign institutions, at $61 billion in late 1972, were up $10 billion in one year's time and up $36 billion in two years' time.

Permanent solutions?
This week's shock treatment should give the world's markets some temporary stability, but a more permanent solution to the monetary tangle must still be accomplished. The foundations for such a settlement were laid by Sec'y. Shultz' September speech to the IMS.

The U.S. reform program primarily emphasizes the creation of an even-handed mechanism for adjusting payments imbalances—one that would set up broadly symmetrical rules for surplus as well as deficit countries to follow in acting to restore payments equilibrium. One simple approach would be to gain general acceptance of the idea that disproportionate changes in a nation's reserves, in either direction, would indicate the need for measures to eliminate the payments imbalance. This approach would allow considerable diversity in the choice of instruments—for bringing about adjustment—for example, by permitting increased flexibility in exchange rates as well as reducing exchange controls and impediments to trade.

The U.S. reform program also envisages the expansion of special drawing rights to meet long-term world liquidity needs, and the elimination of certain barriers which reduce their present usefulness as a reserve asset. International official reserves totalled $152 billion in late 1972, but SDRs accounted for only about 6 percent of that total.

The U.S. program contemplates a gradual diminution of the role played by gold in the international monetary system; gold's proportion of total reserves dropped from 50 to 26 percent over the past three years, but primarily because of the massive buildup of dollars in official reserve holdings. Holdings of foreign-currency reserves, which are neither banned nor encouraged under the U.S. plan, probably would become a smaller proportion of the world's total reserve assets than they are today.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/31/73	Change from 1/24/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments*	69,200	+607	+7,879	+12.85
Loans adjusted—total*	50,619	+334	+7,470	+17.31
Commercial and industrial	17,837	+ 82	+2,101	+13.35
Real estate	15,189	+ 37	+2,429	+19.04
Consumer instalment	7,754	+ 21	+1,265	+19.49
U.S. Government securities	7,327	+193	+ 456	+ 6.64
Other securities	11,254	+ 80	— 47	— 0.42
Deposits (less cash items)—total*	66,929	+122	+6,643	+11.02
Demand deposits adjusted	20,314	— 51	+1,478	+ 7.85
U.S. Government deposits	1,224	+115	+ 388	+46.41
Time deposits—total*	44,099	— 46	+4,540	+11.48
Savings	18,101	— 69	+ 330	+ 1.86
Other time I.P.C.	17,323	+ 85	+2,967	+20.67
State and political subdivisions	6,373	— 66	+ 718	+12.70
(Large negotiable CD's)	6,937	+ 10	+1,868	+36.85

	Weekly Averages of Daily Figures Week ended 1/31/73	Week ended 1/24/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	— 1	0	5
Borrowings	248	96	2
Net free (+) / Net borrowed (—)	—249	— 96	+ 3
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+230	+366	+370
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	— 4	— 81	+276

*Includes items not shown separately.

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