

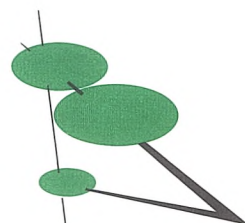
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# Monthly Review

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June 1972

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**Editor: William Burke**

# Devaluation of the Dollar

## I. Smithsonian: End of an Era

The year 1971 marked the end of an era in the evolution of the international-payments system. For nearly four decades, the U.S. Treasury had undertaken to exchange gold and dollars for foreign official entities at the ratio of \$35 per ounce of gold, plus or minus a service charge of  $\frac{1}{4}$  of one percent. With the advent of the International Monetary Fund at the end of World War II, this arrangement served to meet the U.S. obligation under the IMF articles of agreement to maintain the value of the dollar within the prescribed limits for spot transactions of plus or minus one percent of parity.

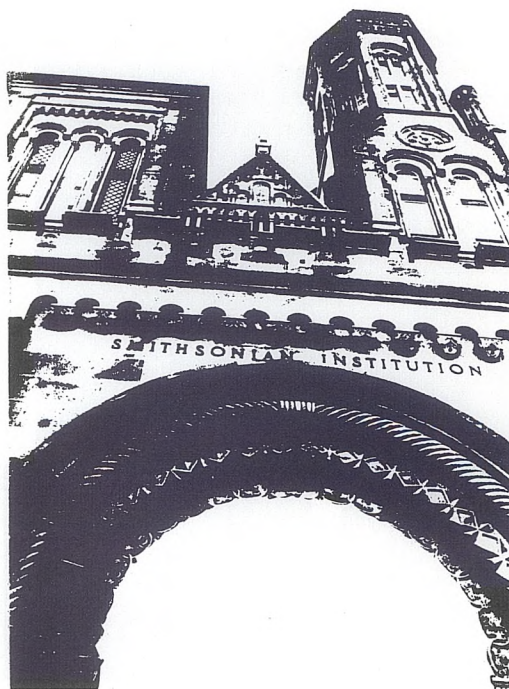
Whereas other countries maintained the value of their currencies within the prescribed limits by purchasing or selling dollars in exchange for their own currencies in their exchange markets, the U.S. maintained the convertibility of the system by exchanging gold and dollars upon request by foreign official entities. Convertibility of the dollar into gold for official holders thus became the centerpiece of the gold-exchange standard under the Bretton Woods system. Now, however, it is doubtful that gold will ever be restored to the unique monetary position it previously held.

### Landmark: August 15, 1971

On August 15, in the midst of the most severe and extensive international financial crisis in four decades, the U.S. role in this system was radically altered with the suspension of dollar convertibility not only into gold but into any other reserve asset as well.

This action was part of the Administration's new program directed toward stimulating the U.S. economy, increasing productivity, and overcoming persistent cost-push inflation in the presence of an unacceptably high level of unemployment.

The Administration's major moves included the imposition of a 10-percent surcharge on dutiable imports along with the suspension of reserve-asset convertibility of the dollar. These steps were taken not only to improve the U.S. balance of payments but also to encourage other countries to





change their respective exchange rates for the dollar — something the U.S. could not do directly — and to encourage them to assume a larger share of mutual-defense outlays and relax restrictive practices against U.S. goods. In addition, tax benefits for capital investment were restricted to expenditures for domestically produced goods.

With the suspension of dollar convertibility several countries moved to limit dollar inflows, which in a number of instances had become of unmanageable proportions. Most major foreign countries permitted their currencies to float and, as anticipated, the dollar declined on exchange markets in terms of major foreign currencies. In several cases the float was controlled by foreign official interventions, which restricted the competitive impact on export- and import-competing industries but at the same time required the absorption of additional dollars by the intervening institutions. Some countries attempted to deal with this problem by imposing restrictions on inflows of funds, while others adopted dual exchange rates, maintaining previously existing parities for trade while requiring other transactions to be conducted at higher floating rates.

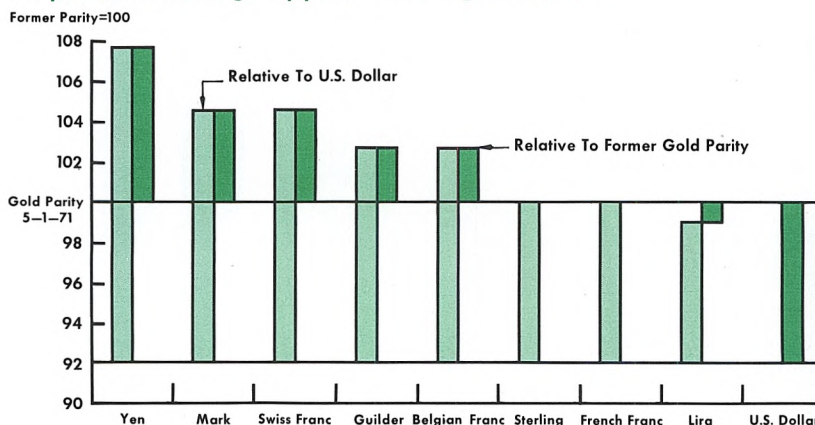
The exchange rates that developed in

these circumstances were not freely determined market rates, and appeared to fall considerably short of the adjustments deemed necessary to correct the mounting U.S. balance-of-payments deficit. Exchange restrictions, including trade restraints or subsidies, were increasing rapidly, thus creating uncertainty here and abroad concerning the conditions under which future trade and payments would be conducted. In particular, many observers became fearful that, if allowed to continue, the adverse effects of this uncertainty on business in the U.S. and in other major countries might precipitate a recession in world economic activity, encourage the proliferation of restraints on international trade and payments, lead to an expansion of regional discrimination, and increase political tensions among countries long accustomed to harmonious relations.

### Smithsonian agreement

Recognition of the dangers implicit in the situation led last autumn to intensive international discussions on an appropriate structure of exchange rates for the major trading nations. These efforts culminated in the Smithsonian Agreement of December 18, whereby the members of the Group of Ten

### New set of rates represents 12-percent average appreciation against dollar





major industrial countries agreed on a set of exchange rates which represented — relative to their May 1, 1971 parities — a trade-weighted average appreciation of major foreign currencies against the dollar of a little more than 12 percent.

The agreement set new “central rates” for these major currencies, resulting in upward revaluations of 16.88 percent for the Japanese yen, 13.58 percent for the German mark, and 11.57 percent each for the Dutch guilder and the Belgian franc. The U.K. and France, by leaving unchanged the gold parities for their currencies, thus revalued by 8.57 percent against the dollar, but Italy, by lowering slightly the gold parity of the lira, revalued by about 7.48 percent. Switzerland wound up with a 13.43-percent revaluation against the dollar (including its May revaluation), but Canada permitted its dollar to remain floating, as it had since June 1970.

Pending formal certification by the International Monetary Fund, these new central rates were not designated as official parities but rather as fixed rates which each country has agreed for the time being to defend operationally as if they were official parities. The Smithsonian Agreement also provided for the enlargement of intervention limits from 1.00 percent to 2.25 percent on either side of the central rates. A number of other countries in subsequent actions also raised the value of their currencies against the dollar. Developing countries generally retained their pre-August 15 dollar-exchange rates.

Associated with the Smithsonian currency adjustments were a group of trade agreements designed to reduce foreign discrimination against U.S. products. Negotiations which were in progress at the time of the Smithsonian accord were subsequently completed with Japan and the European Economic Community. (As of this spring, however, negotiations with our principal trading partner, Canada, remained unfinished.)

Comprehensive multilateral trade negotiations are being planned for next year to deal with such fundamental problems as the elimination or relaxation of nontariff trade barriers, liberalization of agricultural trade, and the possible elimination of all tariffs on industrial goods among developed countries.

Once agreement was reached on a satisfactory pattern of central exchange rates, the U.S. removed the 10-percent import surcharge and the discriminatory “Buy American” feature of the investment tax credit. To obtain agreement on currency adjustments, however, the U.S. was obliged to agree to a devaluation of the dollar in terms of gold. The extent of the devaluation was established at 7.89 percent and represents an 8.57 percent increase in the official price of gold from \$35 to \$38 per ounce. Formally, dollar devaluation was completed in early May, after the President signed the Par Value Modification Act and Congress appropriated \$1.6 billion to fulfill its “maintenance of value” obligations, which call for increases in U.S. subscriptions to the IMF and other international financial institutions proportionate to the gold-price increase.

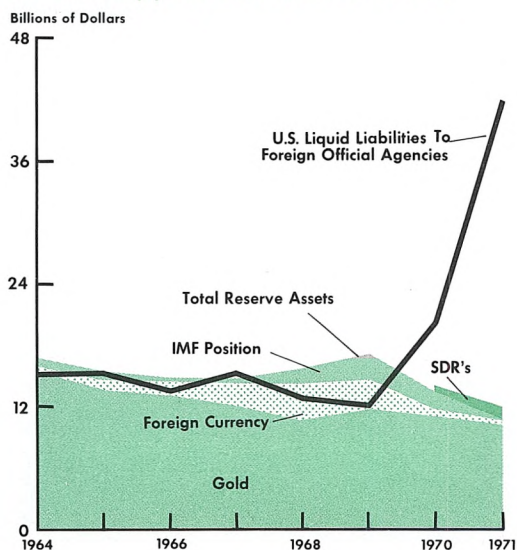
The net result of the various currency adjustments was to raise the gold value of the Japanese yen, German mark, Swiss franc, Netherlands guilder, and Belgian franc by smaller percentages than the reduction in the gold value of the dollar. (The yen appreciation, however, was almost as large as the dollar depreciation). Sterling and the French franc remained unchanged in gold content, while the Swedish krona and Italian lira were each reduced in content by about one percent. The gold content of the dollar was therefore changed more than that of any other Group-of-10 currency, and this contributed to the bulk of the change in exchange rates between the dollar and other G-10 currencies.

## Implications

Most observers expect that the Smithsonian Agreement will substantially improve the U.S. balance of payments, despite the continued weakness of the trade balance during early 1972. Foreign currencies that have been revalued are now more expensive in terms of dollars, and this ultimately should have a dampening effect on the physical volume of U.S. imports. Moreover, with the dollar cheaper in terms of these currencies, U.S. exports can be quoted at lower prices in those markets and compete more effectively in third countries. The new exchange rates will make foreign travel in this country less expensive while raising the cost of American travel abroad.

The outlook for long-term foreign investment in the U.S. is less clear. Investments will be cheaper in foreign-currency terms but earnings will be in depreciated dollars. However, strong economic expansion here should help to stimulate such inflows, as is evidenced by the recent increase of interest by Japanese, German and other foreign investors in American production facilities.

## Liabilities to foreign agencies far outstripped U.S. reserve assets



Nevertheless, these balance-of-payments benefits may not be fully apparent for perhaps two years and possibly longer. But short-term capital inflows may occur much sooner if short-term interest rates decline abroad and rise further here. Increased confidence in the durability of the new structure of exchange rates would encourage a reflow of the very large volume of funds which left the U.S. last year. This reflow is expected to be helped by the recent formal action devaluing the dollar. The ultimate outcome of the Smithsonian Agreement, however, will depend on the performance of the U.S. relative to other industrial countries in restraining increases in costs and prices.

## Sharing the "burden"

The relevance of a dollar devaluation in terms of gold to a viable structure of exchange rates between the dollar and other currencies is at best obscure, particularly in view of the U.S. suspension of official monetary transactions in gold. This nation's agreement to devalue the dollar evidently was reached at the insistence of other members of the Group of Ten, who regarded such a move as an indispensable condition for revaluing their currencies to the extent required to meet U.S. balance-of-payments objectives.

The case for dollar devaluation was based on the view that the U.S. should share the "burden" of adjustment with other countries, and that as a matter of principle the dollar should be devalued just as other currencies are when inflation at home reduces the international value of a currency. Because parity changes have come to be regarded as evidences of policy failure, sharing the "burden" appeared to mean sharing the "onus" of adjustment.

The dollar price of gold has no necessary relationship to the exchange value of the dollar in terms of other currencies. In the period since August 15, when dollar con-



vertibility into gold was suspended, a number of exchange rates remained unchanged vis-a-vis the dollar, while others (prior to the Smithsonian accord) were allowed to appreciate in controlled floats. Yet the official price of gold — and the gold value of the dollar—remained unchanged. In narrow economic terms, the Smithsonian currency adjustments could equally well have been made without a change in the dollar price of gold. Aside from the expectational impact or the speculative effect on the free-market price for gold, it made no real difference whether the U.S. was not buying or selling monetary gold at \$35 per ounce or whether it was not buying or selling it at \$38 per ounce (or any other price).

As for the burden of adjustment, the relevant economic considerations relate to the impact of exchange-rate changes on the principal dimensions of economic activity — namely output, employment, and consumption. A country whose currency depreciates relative to other currencies, as the dollar has done recently with respect to other major currencies such as the mark and the yen, tends to make its exports cheaper in foreign-currency terms while causing its imports to become more expensive in terms of domestic currency.

To the extent that such relative price changes induce an expansion of output in export industries and an increase in the production of import substitutes, there will be structural changes associated with the reallocation of resources between these sectors and other sectors of the economy. If elasticities of supply are low, larger price changes will be necessary to bring about the reallocation of resources than if supply elasticities are high. The shorter the period allowed for adjustment, the greater the degree of dislocation is likely to be. The country whose currency had depreciated would experience economic expansion; the country whose currency had appreciated would tend to experience re-

duced demand for exports and capital losses on foreign-currency assets.

In addition to the burden of adjustment represented by the reallocation of resources, there is the burden involved in correcting external deficits on goods-and-services account. Such deficits represent a net absorption of foreign goods and services, with surplus countries being compensated by accumulations of international assets or claims on the deficit country. The correction of such imbalances requires that compensation be made in real goods and services rather than in financial claims, and this would call for a deficit country to share its real output with surplus countries.

Neither of these burdens has anything to do with the dollar price of gold. The burden arising from structural shifts which are associated with changes in relative prices induced by currency adjustments is a function of *exchange rates*, which technically can be altered vis-a-vis the dollar without altering the gold content of the dollar. Moreover, the burden associated with eliminating a deficit on goods-and-services account is not relevant to the present problem, inasmuch as the U.S. has not recorded an annual deficit on such a basis since 1895—not even last year.

### Financial considerations

If there was a rational explanation for the foreign insistence on U.S. burden sharing, it evidently was not concerned with the “real” international economy. Rather, it could have reflected the political costs of changing parity, as well as purely financial considerations associated with the domestic-currency valuation of foreign holdings of reserve assets, which are almost entirely gold and dollars.

If the dollar were not devalued in terms of gold and the entire adjustment were made by appreciating other currencies in terms of the dollar and of gold, the *domestic currency* value of both the gold and dollar reserves of those countries would have to be written



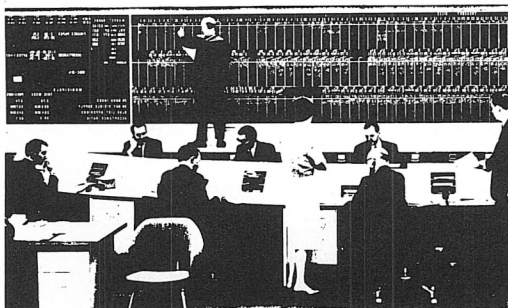
## FEDERAL RESERVE BANK OF SAN FRANCISCO

down, in each instance by the full amount of the currency change. The *dollar* value of those reserves, however, would remain unchanged. On the other hand, if the entire adjustment were made by devaluing the dollar in terms of gold, with other currencies retaining their former gold values, the *domestic currency* value of gold reserves in countries other than the U.S. would not be affected and reserve losses in domestic currency would be confined to holdings of dollars. However, gold reserves, and gold-denominated international assets such as gold positions and Special Drawing Rights in the IMF, would appreciate in value in terms of *dollars*, thus serving to offset losses on dollar reserves.

Minimizing the *appreciation* of other currencies in terms of gold while maximizing the *depreciation* of the dollar in terms of gold thus tends to limit the amount by which the domestic-currency value of foreign gold reserves has to be written down. It also provides a domestic-currency offset to the write-

down of dollar reserves, due to the rise in the dollar value of gold and gold-denominated assets. Hence, the larger the proportion of gold-valued assets relative to dollars in a country's monetary reserves, the smaller would be its total write-down of reserves if the currency adjustment could be shifted as much as possible to the dollar. This helps to account for the relatively small currency appreciations in terms of gold made by those countries which traditionally hold a large proportion of their reserves in gold.

Whatever weight such balance-sheet considerations may have had in strengthening foreign insistence that the U.S. participate actively in effecting exchange-rate adjustment, they were consistent with the policy stance required in other countries to gain public acceptance of such adjustments. Nationalistic voter psychology abroad would not condone allowing the dollar to remain unchanged while other currencies made the entire adjustment.



## II. Background of the Crisis

The decisive action of August 15 climaxed a long series of currency crises which had been occurring with increasing frequency and severity over a period of a decade or more. It also served as a summons to the international financial community to undertake the reforms required to achieve, and particularly to maintain, a reasonable approximation to long-term balance-of-payments equilibrium.

Since the formal restoration of current-account convertibility for major foreign currencies at the end of 1958, a number of significant changes had occurred in the world economy. The early post-World War II situation, wherein the U.S. acted virtually as the sole supplier of much of the goods sorely needed by the non-Communist world, had given way to a situation of increased foreign competition based upon the highly successful combination of foreign initiative and American reconstruction policies. As the economic resurgence abroad gained momentum, U.S. foreign-investment outflows increased apace—but these outflows, together with major continuing outlays for the common defense of the non-Communist world and for economic aid to developing countries, resulted in persistent U.S. balance-of-payments deficits.

In the decade of the 1950s these deficits were welcomed abroad, partly for their contribution to transactions balances and partly for their aid in rebuilding foreign official reserves—an essential pre-condition for restoring currency convertibility and bringing about greater freedom in international transactions. Yet as U.S. deficits continued to supply dollars to the rest of the world, the foreign official demand for dollars moderated, so that by the beginning of the 1960s, dollar supplies showed signs of exceeding official demands.

In the burgeoning world economy of the past decade, a new demand for dollars developed in the private sector. This took the form of a demand for transactions balances needed to fuel the rapidly expanding world economy—a demand which included the newly emerged and fast-growing Euro-dollar market. As the decade progressed, however, the dollars generated by large and persistent U.S. balance-of-payments deficits increasingly exceeded the volume which foreign official holders were willing to absorb.

### Unwanted dollars

Large and volatile movements of short-term capital, responding to interest-rate differentials, alternately swelled and depleted foreign official dollar reserves. Meanwhile, concern over the ability of the financial system to withstand such flows without a devaluation of the dollar (or appreciation of other currencies vis-a-vis the dollar) encouraged heavy speculative flows, and these in turn imposed further strains on the system. As foreign dollar holdings mounted and U.S. gold reserves declined, tension increased in the exchange markets, and foreign observers became increasingly concerned over the stability of the dollar in terms of gold and of other currencies.

Foreign concern over the ability of the U.S. to maintain gold convertibility surfaced in 1960 with an attack on the dollar on the London gold market. The problem was solved for a while by the formation of the “Gold Pool”—the U.S. plus seven European countries—which succeeded in stabilizing gold prices on the London market through sales and purchases of gold for the account of the participating central banks.

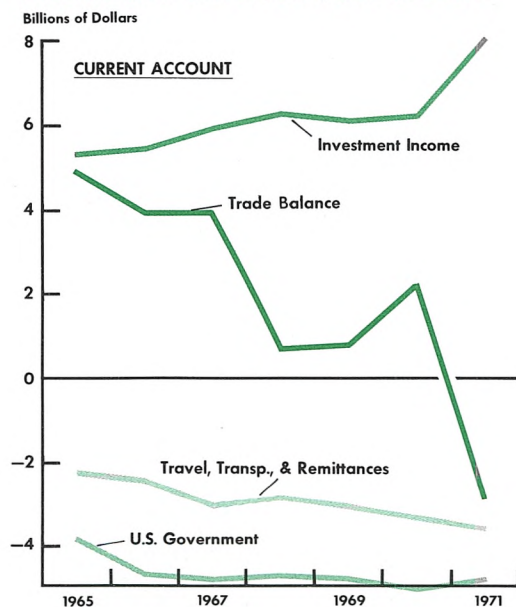
For a time this arrangement served to discourage speculation against the dollar. So



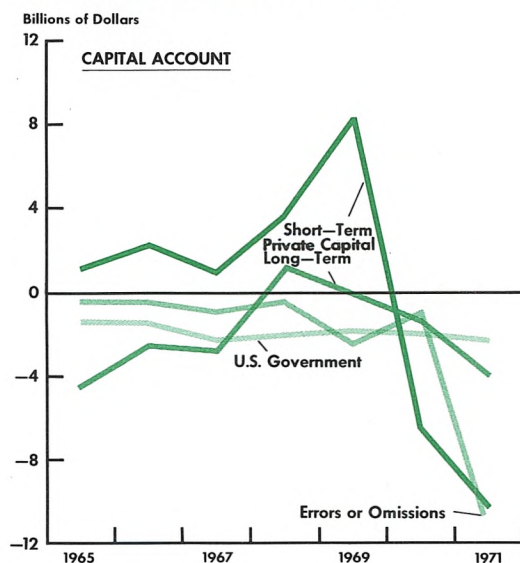
# FEDERAL RESERVE BANK OF SAN FRANCISCO

long as the available dollar resources of speculators continued to be dwarfed by the massive gold reserves of the Gold Pool, speculation was discouraged and the price of gold

## 1971 marked by rise in investment income and deficit on trade account



... but primarily by remarkable outflows of short-term funds

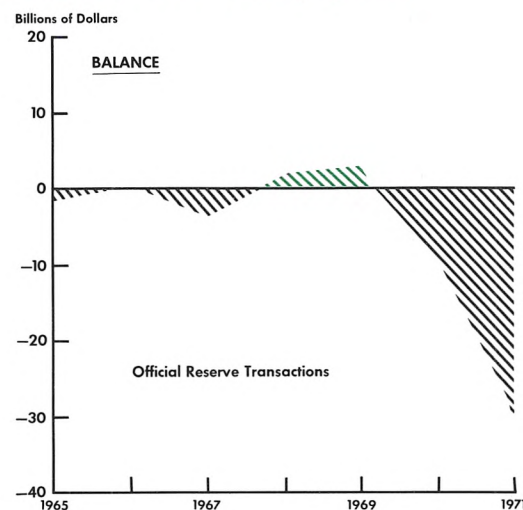


could be stabilized at the official rate of \$35 per ounce. However, continued large U.S. balance-of-payments deficits undermined this arrangement, since they consistently oversupplied the world with dollars at a time when monetary gold reserves were growing at a relatively sluggish rate.

Soon after the formation of the Gold Pool, the Federal Reserve System established a currency-swap network with a number of foreign central banks for the purpose of offsetting large reversible balance-of-payments flows. The network, consisting of reciprocal lines of credit, was set up to provide temporary supplies of foreign currencies to the U.S. and dollars to other participants. In this way foreign reserves could be bolstered by drawings on the Federal Reserve, and dollar flows into foreign-exchange markets could be absorbed by the use of Federal Reserve drawings against foreign central banks, which shielded the U.S. gold stock from an additional potential demand.

Despite these efforts, however, it became increasingly clear as the decade progressed that the world faced a serious payments dilemma. On the one hand, there was a long-

... causing dramatic deterioration in nation's balance of payments





term need for larger monetary reserves to keep pace with the larger payments swings anticipated with the growth of world trade and capital flows. Yet on the other hand, world gold production was inadequate and unreliable for this purpose. If U.S. payments deficits were to be eliminated, the principal source of world reserve growth—dollar accretions to foreign reserves—would disappear. But if the deficits were to persist, confidence in the dollar would continue to weaken with the increase in U.S. liquid liabilities to foreigners, especially in view of the inadequacy of the reserves needed to maintain gold convertibility at the prevailing price of \$35 per ounce.

### Demise of Gold Pool

To meet this problem, the International Monetary Fund developed a new international-reserve asset as a supplement to existing reserve assets. Known as “Special Drawing Rights” (SDRs), this reserve asset can be created (or destroyed) in accordance with world reserve needs, which previously had depended for satisfaction on the vagaries of gold discoveries and extractive technology as well as the balance-of-payments deficits of reserve-currency countries.

Yet even as the IMF was approving the long-range SDR plan for reserve growth (1967), short-term gold speculation became superimposed on a rising industrial demand, which under the Gold Pool price-stabilizing arrangement was supplied in part from the monetary reserves of Pool members. Convinced that the Pool would not be able to continue holding the \$35 price against their onslaught, speculators intensified their efforts, until finally (March 1968) the Gold Pool was disbanded.

In its place a two-tier gold system was established. On the official tier, purchases and sales of existing gold holdings were restricted to monetary authorities who, as part of the arrangement, also agreed not to buy

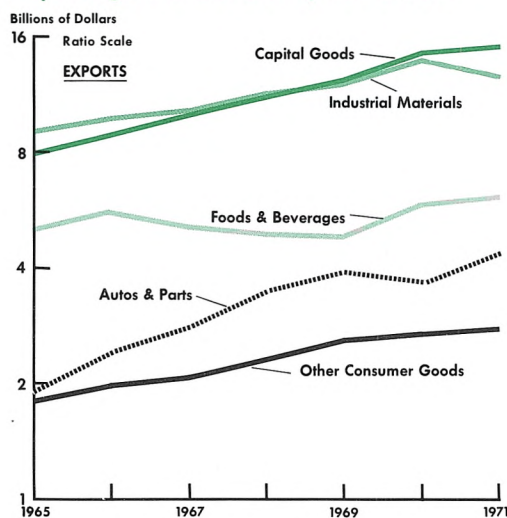
newly mined gold and not to sell gold to private entities. The other tier was a free-market reserve for private transactions of all kinds, in which the price was determined by market forces of supply and demand. This arrangement, in effect, distinguished between the monetary and private uses of gold. In so doing, it also indicated official recognition of the continued declining importance of gold as a monetary metal and of the potential and developing role of SDRs as a reserve asset. This period of the late '60s was also marked by a series of major currency crises, which resulted in the devaluation of the British pound in 1967 and of the French franc in 1969, as well as the upward revaluation of the German mark in 1969.

Unable itself to change the exchange rate of the dollar against other currencies, the U.S. attempted over the years to deal with its deficit in other ways. Successive Administrations tried by various means to increase U.S. exports and to obtain a larger and more appropriate sharing of mutual-defense outlays abroad, particularly by surplus countries. Expenditures for economic aid to less-developed countries were tied to purchases in the U.S. Surges in capital outflows brought into being the Interest Equalization Tax (1963) and the Voluntary Foreign Credit Restraint Program (1965). Also instituted was a voluntary program of restraint over direct investment abroad (1965), which was later made mandatory (1968). Despite these efforts, the U.S. balance-of-payments position showed only temporary improvement; indeed, as the decade of the '60s came to an end, the payments position weakened in line with the worsening inflation.

### Unique position

In the course of this experience, it had become apparent that the U.S. was in some significant sense different from other countries. In particular, its size set it apart from every other country of the non-Communist

## U.S. exports rose strongly for capital goods but slowly for others

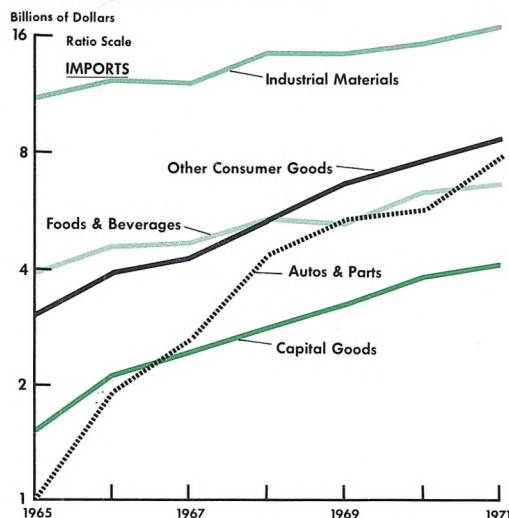


world, since it accounts for nearly half of total GNP and almost a seventh of total world trade. Thus, domestic policies sufficiently restrictive to end the U.S. payments deficit implied grave consequences for other countries who were much more dependent on the U.S. economy than the U.S. economy was upon theirs.

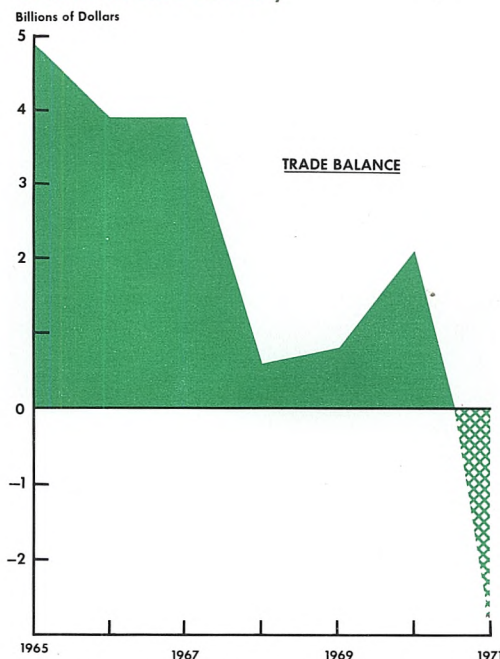
Nor would such policies have been appropriate for the U.S. economy itself. Given the small size of the foreign-trade account in the U.S. GNP, restrictive monetary and fiscal policies (in the absence of relatively greater inflation here than abroad) were particularly unacceptable options for dealing with the U.S. payments deficit. So long as other countries wished to run surpluses, there was little the U.S. could do to overcome its deficit short of precipitating world-wide recession.

The alternative adjustment mechanism available to other countries — devaluation against other currencies — was not available to the U.S., inasmuch as the dollar served as the de facto standard to which foreign currencies were generally pegged. Official monetary institutions of other countries maintained the international value of their

## ... while imports soared in almost every category



## ... leading to first trade deficit in this century



currencies by trading those currencies for dollars in their exchange markets at rates which they themselves determined, generally in accordance with IMF regulations. The



U.S., under the Bretton Woods Agreement, assumed a passive role in the maintenance of exchange rates within the established margins. The U.S., with its unlimited dollar resources, could have intervened unilaterally in foreign-exchange markets to drive up the value of foreign currencies in terms of dollars, but this action might well have driven the other countries involved into defensive restrictive actions which could have destroyed the basis for international currency stability established at Bretton Woods. Devaluation for the U.S. was thus a matter of changing the dollar price of gold, rather than changing the rates at which currencies exchanged for one another in the exchange markets.

Changing the dollar price of gold by U.S. unilateral action offered little assurance in and of itself that exchange rates more favorable to the U.S. would be adopted. In view of the reluctance of surplus countries to forego their surpluses, and particularly to risk competitive disadvantage vis-a-vis third countries in unilaterally revaluing their currencies, it is very doubtful that a rise in the U.S. price of gold would have elicited more than token voluntary revaluations vis-a-vis the dollar.

### **Towards the brink**

This was the setting as the climactic year 1971 approached. The payments system likely would not have broken down if it had had to contend only with a continuation of moderate-sized U.S. deficits. Indeed, with the gold and currency crises of the late '60s behind it, the system seemed for a while to have achieved a state of relative stability. Two new conditions emerged, however, which together threatened to jeopardize this stability. First, industrial countries faced with rapidly rising prices sought to fight inflation by resorting to stringent but uncoordinated monetary policies, which precipitated wide swings in short-term capital movements in internation-

al markets. Second, the underlying U.S. balance-of-payments position on merchandise account began to deteriorate badly during the late '60s because of the accelerating inflation in this country.

The weakening trend in the underlying U.S. payments position was concealed for awhile, particularly in 1969, by large inflows of short-term capital from abroad. These inflows reflected interest-rate incentives arising not only from this country's tight monetary policy but also from the disparity in phasing of the business cycle on the two sides of the Atlantic. Much of this capital inflow came about because of borrowings of U.S. banks from their foreign branches to meet rising domestic demands for credit, at a time when their deposits here were running off as market rates rose above Regulation Q interest-rate ceilings. Foreigners meanwhile were induced to shift out of assets in their own currencies into Euro-dollar deposits as branches of U.S. banks bid for such funds, and this contributed to upward pressure on interest rates abroad and caused foreign central-bank reserves to decline.

During 1970, U.S. monetary policy shifted from severe restraint toward moderate ease as excess demand was brought under control, but European monetary policy generally shifted toward restraint because of intensifying economic activity and accelerating wage costs. Consequently, short-term interest rates in the U.S. fell relative to those in Europe. As funds here became cheaper than in the Euro-dollar market, U.S. banks began to repay earlier borrowings from their branches abroad.

European borrowers, including governmental entities as well as private corporate borrowers, found the cost and availability of funds in the Euro-dollar market more attractive than in their domestic money markets, and thus were able to avoid the impact of domestic credit stringency. The ensuing reflow of funds from U.S. banks to their for-



foreign branches thus reflected a strong demand for funds in Europe, where credit conditions remained tight, as well as a tapering off of demand in the U.S., where an easier monetary policy was emerging.

The resultant inflow of dollars into foreign official reserves showed up in a large U.S. official-settlement deficit, whose financing was aided by the geographic distribution of foreign-reserve gains. For the most part, these gains were realized by countries whose reserves had been depleted by the previous year's capital flows to the U.S., or by those who were building up reserves in anticipation of scheduled debt repayments to the U.S. or to the IMF.

To some extent, however, the large influx of dollars undermined the anti-inflationary policies of foreign central banks. This situation was aggravated by the actions of several central banks in shifting dollar reserves from the U.S. to the higher-yielding Euro-dollar market. Such transfers resulted in the creation of dollar reserves additional to those originating in the U.S. balance-of-payments deficit. Indeed, by making more funds available to European borrowers, they tended to weaken further the effectiveness of tight monetary policies in Europe.

### Countermeasures

Monetary policymakers here and abroad thereupon took steps in early 1971 to moderate the spread in short-term rates. The Federal Reserve System raised the marginal reserve requirement on Euro-dollar borrowings, first adopted in 1969, from 10 percent to 20 percent. This represented an additional cost of future Euro-dollar borrowings should banks reduce their reserve-free base by excessive Euro-dollar repayments. In open-market operations the System concentrated, where practicable, on purchasing coupon issues rather than Treasury bills, in order to moderate downward pressure on short-term interest rates within the limits imposed by

the prevailing stance of monetary policy. In addition, Export-Import Bank and Treasury securities were sold to foreign branches of U.S. banks for the purpose of absorbing funds that might otherwise have accrued to foreign central banks.

European central banks, in response to domestic as well as external needs, meanwhile reduced their discount rates (April), and thereby helped to narrow the differential in interest rates. With interest rates here and abroad converging, and outflows from U.S. banks to Europe temporarily receding, it seemed that flows of capital from here to Europe had crested and that more stable conditions were in prospect. Improvement was also expected from arrangements then being made to halt further Euro-dollar creation by foreign central banks and to redirect recycled dollars from Europe to the U.S.

Before these measures could become fully effective, however, participants in the world's financial markets began to express serious concern over the U.S. payments situation and the stability of the dollar. The U.S. trade surplus, which in earlier years had served as a substantial offset for outflows on other balance-of-payments accounts, fell drastically in the fourth quarter of 1970 and continued weak in the first quarter of 1971. Moreover, the early-1971 outflows of short-term funds in response to widening interest-rate spreads drove the dollar down to its lower intervention point against most European currencies.

With foreign dollar reserves continuing to rise, it appeared to market participants that an even larger U.S. deficit than that of 1970 was developing, and bringing a dollar crisis in its wake. Their belief that these flows were approaching unmanageable proportions, and that the prevailing structure of exchange rates might be jeopardized, led to the emergence of speculative forces which were later to intensify and overwhelm the payments system.

The German mark was particularly attractive to speculators. Tight money policies in Germany had maintained interest rates relatively higher there than in alternative money markets, and the freedom of German corporations to borrow outside Germany enabled such borrowers to pull funds into Germany. In addition, the German trade surplus continued to show strength. The resulting increase in reserves in a period of credit restraint confronted Germany with difficult policy choices: to accept further inflation, to impose exchange controls, or to change the exchange rate of the mark either by floating or by revaluing the mark parity.

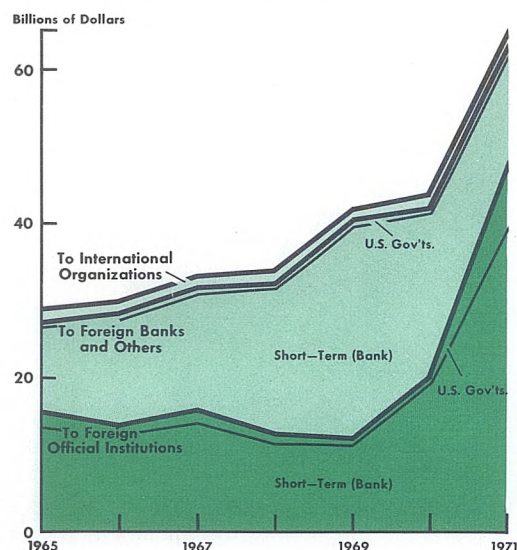
### Final months

Against this background, the recommendation of a change in the exchange rate by five German economic-research institutes — and the reported implied approval of the recommendation by certain German officials—generated a huge wave of speculation that the mark and other currencies would be revalued. The German Federal Bank absorbed \$1 billion in the first hour of trading on May 5, on top of an inflow of similar magnitude on May 3 and 4, and at that point withdrew from the market. Several other European central banks quickly followed the German move and withdrew from their own exchange markets.

Following a meeting of European Common Market officials on May 8-9 in Brussels, the mark and the Dutch guilder were allowed to fluctuate beyond their previously maintained limits. Switzerland and Austria revalued their currencies by 7.07 percent and 5.05 percent, respectively. Belgium adapted its dual exchange-rate system to the new situation by effecting a further separation of its financial and official franc markets, with the latter still subject to the previous intervention limits. The French franc and Italian lira were left unchanged.

These moves had the effect of relaxing the

### U.S. liquid liabilities soared as short-term funds flowed out



high state of tension that had developed in the exchange markets, and for a short time they actually resulted in a limited reversal of speculative flows. Soon thereafter, however, it became evident that substantial elements of instability still remained in the system. The U.S. domestic economy seemed unable to solve the twin problems of inflation and stagnation, and the U.S. trade balance, which had continued to show a small surplus in the first quarter of 1971, shifted into deficit in April and later months. As additional balance-of-payments data became available, market observers concluded that the payments deficit for the year as a whole could far exceed any U.S. deficit on record. Meanwhile, the upward floating mark and guilder became a highly visible indicator of the dollar's weakening position in foreign-exchange markets, and served as a guide to further speculation.

This situation gave rise to a second and much more severe crisis as an avalanche of funds moved across the exchanges. Demand for the currencies of other industrial coun-



# FEDERAL RESERVE BANK OF SAN FRANCISCO

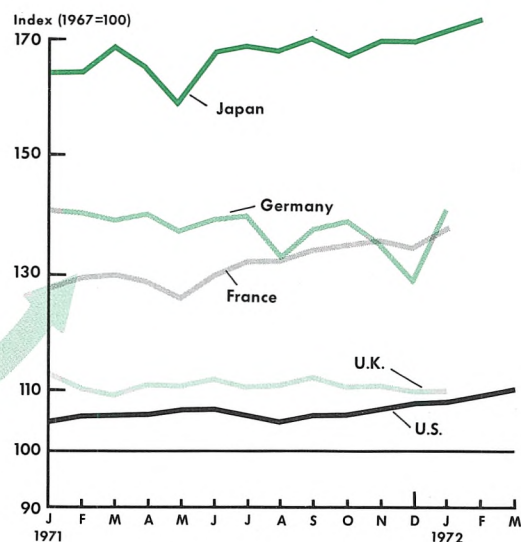
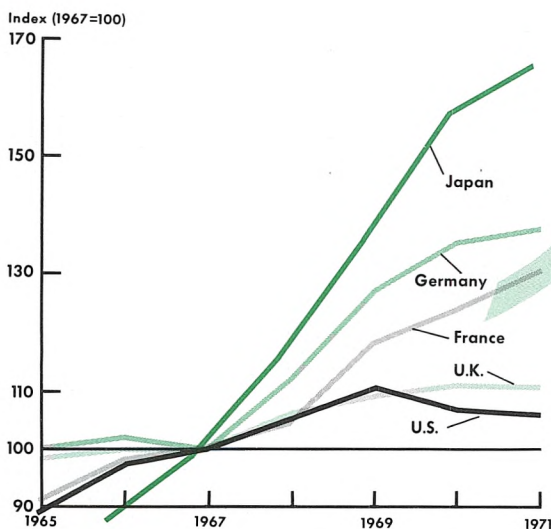
tries ran high, and foreign official reserves rose at an accelerating rate. After rising by more than \$10 billion in the January-June period, U.S. liquid liabilities to foreign official entities jumped almost \$7 billion more in July and the first two weeks of August. During the first half of 1971 U.S. reserve assets declined by nearly \$1 billion, and they dropped about \$1.5 billion more within the succeeding six-week period.

Recourse to the \$11.7-billion reciprocal currency arrangements (swap network) between the Federal Reserve System and other central banks (plus the Bank for International Settlements) provided a temporary cushion for a limited amount of foreign-dollar accruals. At the beginning of 1971, Federal Reserve drawings outstanding totalled \$0.8 billion. Through June an additional \$1.2 billion was drawn but was more than offset by repayments of \$1.4 billion — but then, in the third quarter, Federal Reserve drawings rose nearly \$2.4 billion. An-

other stopgap was the increased sale of Government securities to foreign agencies. U.S. Treasury securities outstanding (foreign currency series) increased sharply during this period, rising from nearly \$1.4 billion on January 1 to approximately \$2 billion on September 30.

Such were the conditions that culminated in the President's action on August 15. The international payments system could not withstand the combined impact of a major long-term balance-of-payments disequilibrium (induced largely by inflation of the principal reserve and transactions currency), cyclical maladjustments between the U.S. and other industrial countries, and short-term capital flows generated by interest-rate differentials and outright speculation. Nor could the system, as an international and multi-lateral mechanism, withstand the resurgence of nationalism and regionalism in the form of growing preferential trading arrangements and discriminatory trade practices.

## Industrial-production indexes show out-of-phase behavior of various national economies





### III. Post-Smithsonian Developments

Announcement of the Smithsonian accord relieved international financial tensions that had developed during the fall months of 1971, and for the time being removed the threat of a degenerative drift toward greater restraints over international payments. The new exchange rates were widely accepted, some reflow of funds to the U.S. occurred, and market rates for major currencies hovered close to their new lower support levels.

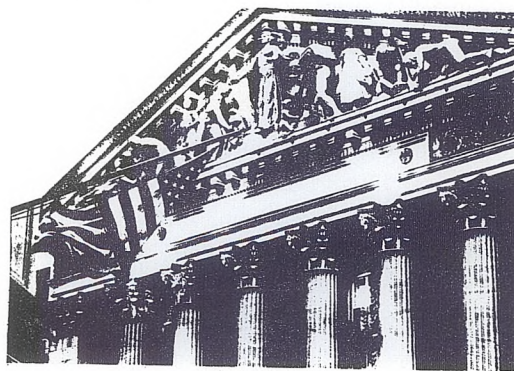
Early in the new year, however, initial confidence in the new structure of exchange rates began to give way to doubts that the rates could be maintained. Realization that some time more would be required before a substantial improvement could develop in the U.S. balance of payments suggested that with the dollar inconvertible into other reserve assets, foreign central banks faced the prospect of further large dollar accretions to their reserves — at least as long as they chose to maintain the new central exchange rates. Thus, in January-February 1972, U.S. liabilities to foreign central banks began to rise sharply again. Several waves of speculation forced the mark, the guilder, the Belgian franc and the yen close to or up against their upper intervention limits, as market participants contemplated the possibility that some foreign central banks might abandon their Smithsonian commitments and allow their currencies to float upward again.

#### Decisive intervention

This eventuality did not materialize. Decisive intervention by the central banks involved, who recognized that the U.S. balance-of-payments deficit could not be eliminated all at once, demonstrated their determination to uphold the Smithsonian Agreement. Moreover, Congressional action

early in March to raise the official dollar price of gold, further reduced the uncertainty previously prevailing in international financial markets. Interest-rate disparities between the U.S. and Europe began to narrow as foreign discount rates were reduced—first in Germany, Belgium and the Netherlands, and later in France and Italy—and as the U.S. Treasury-bill rate increased.

In addition, various measures were taken abroad to discourage the inflow of dollars. In an effort to control heavy foreign borrowing by German industrial firms—a major source of the continued strength of the mark—Germany imposed a 40-percent deposit requirement (retroactive to January 1) on certain corporate liabilities to non-residents. Among other actions taken, Japan reinstated controls over speculative purchases of yen, the Netherlands prohibited interest payments on non-resident guilder deposits and banned the acceptance of new deposits of this type from non-residents, and Belgium reimposed limits on the net external positions of Belgian and Luxembourgian commercial banks.



#### Unfinished: trade negotiations

The formal suspension of convertibility of the dollar last August 15 had as its ultimate objective the achievement of substantial

equilibrium in the U.S. balance of payments, as well as the establishment of conditions, practices and policies in international economic relations which would offer reasonable assurance that such equilibrium could be maintained in the future. The exchange-rate adjustments of December 18 were a first essential step toward this goal. Beyond this, however, lay a number of difficult issues which would have to be dealt with if the U.S. balance-of-payments problem were to be solved. At least a partial advance was achieved with respect to one of these issues when commitments were made by certain countries at the time of the Smithsonian Agreement to assume a somewhat larger share of the costs of the common defense.

An especially difficult problem area concerns the need to reduce barriers to trade, particularly with respect to agricultural products. If the recent currency adjustments are to make an enduring contribution to the elimination of chronic deficits in the U.S. payments position and of chronic surpluses abroad, both tariff and nontariff impediments to trade must be greatly liberalized if not abolished. Such impediments are largely rooted in the depressed conditions of the interwar period and the early post-World War period of reconstruction.

Tariff barriers have been under attack for many years with the U.S. playing a leading role, beginning with the reciprocal most-favored-nation tariff-cutting agreements of the mid-1930s. More recently, successive rounds of tariff negotiations under the General Agreement on Tariffs and Trade (GATT) have succeeded notably in reducing tariffs.

As tariff levels have receded, however, non-tariff barriers to trade have remained — and where progress has been made in reducing existing non-tariff barriers, some ground has been lost due to the emergence of new

barriers. Moreover, preferential trading agreements and discriminatory trade practices have developed in connection with the formation of regional trade groupings such as the European Economic Community. The prospect of additional nations joining these groups now lends some urgency to the long-standing need to replace such arrangements and practices with policies of nondiscrimination and openness.

A concerted attack upon non-tariff barriers, which presently are the most serious causes of trade dislocation, will be a very difficult assignment. Non-tariff barriers are prevalent everywhere, and range from normal quota restrictions (including “voluntary” export quotas) to automobile weight and horsepower limitations, patent requirements, packaging and labeling requirements, and health and safety standards of dubious merit. For such an array, legislative specification of negotiating limits and conditions will itself be a difficult and time-consuming task, quite apart from the task of achieving international agreement on “equivalent” concessions among restrictions of such diversity. Yet, in the interest of building a durable structure of international trade, the U.S. has begun to press for major changes in trade policy and the establishment of a Doctrine of Fairness in International Trade.

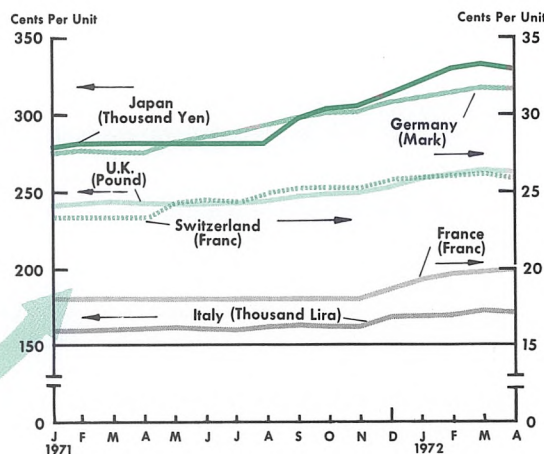
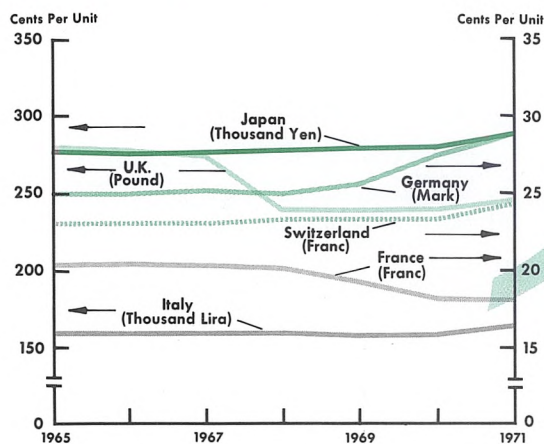
### Unfinished: payments arrangements

Another major problem area concerns the modification of the international monetary system. Matters of pressing consideration include:

- ▶ The role, relationship and nature of future reserve assets and the control of international liquidity with respect to: Special Drawing Rights; gold; other forms of assets (such as Currency Reserve Units within the IMF); and the status of the dollar.



## Exchange rates rose above new official levels in early '72 before central banks intervened



- Greater flexibility in making needed parity adjustments, including provision for temporary departures from par values, for surplus as well as deficit countries.
- The disposition of the current large overhang of foreign central-bank dollar reserves.
- The establishment of a suitable forum (including representation of developing countries) for restructuring the international monetary system.

Near the forefront of these issues is the question of restoring dollar convertibility. (Incidentally, the dollar is still convertible—fully convertible—for non-resident private holders, who may use their dollars to purchase anything they wish, including gold in the free market.) Restoration of official convertibility of the dollar into reserve assets, which is urgently being pressed by European central banks and by a few highly regarded economists in this country, is still some distance off. Convertibility into gold, even on a limited scale, would appear to be even more remote. Gold has been in the process of demonetization for a great many years; it has been phased out as a domestic mon-

etary metal virtually everywhere, and has been steadily reduced in importance as an international reserve asset.

The present situation, in providing the world with an exceptional opportunity to build a new monetary system, also invites recognition of the historical decline of the monetary role of gold. Restoration of dollar convertibility into gold, except in some limited form and then only as a transitional step, would run against the tide of history and invite a continuation of the instability that has long been associated with the use of gold for monetary purposes.

Restoration of convertibility in terms of some non-gold asset is a more realistic possibility. The key to whether and when the dollar can be made convertible is the degree of success that may be realized in righting the U.S. balance of payments. This in turn implies the establishment of equitable trading practices and the adoption of appropriate modifications in the international payments system.

If these reforms can be brought into being, the restoration of dollar convertibility into reserve assets can begin to proceed. Yet

## FEDERAL RESERVE BANK OF SAN FRANCISCO

the return of dollar convertibility, however important it may be to the stability and well-being of the system, is not a simple matter of declaring the dollar convertible. The enormous overhang of official dollar balances greatly exceeds U.S. reserve-asset holdings, and renders a return to convertibility impossible in present circumstances.

Since last December 18, the payments system has operated with a structure of fixed central-exchange rates in the absence of any form of dollar convertibility. While this arrangement has involved the willingness of other countries to accept further accretions of dollars as a temporary accommodation, it is not without more lasting significance. With the dollar convertible into reserve assets, countries receiving excessive dollar accretions to their reserves have a lever to use in applying pressure to the U.S. to curtail its balance-of-payments deficits. Aside from the fact that this leverage in the past merely resulted in the suspension of dollar convertibility—and can be expected to do so again if convertibility is established without the reforms needed to sustain it—the essence of the problem is clearly the malfunctioning of the adjustment process and the creation of an excessive volume of dollar reserves abroad through past U.S. inflationary policies.

### Basic problems

The payments system cannot be put on an enduring basis unless these problems of adjustment and inflation are solved. The restoration of dollar convertibility is not the answer—it is merely a by-product of the problem. When the preconditions of U.S. balance-of-payments equilibrium are restored domestically and internationally, and when satisfactory arrangements are made to fund or in some other manner handle the currently excessive foreign holdings of dollars, the dollar can again become convertible into reserve assets. In such a new environment, the dollar

may at times again become scarce, and the need for convertibility occasionally take the form of dollar *purchases* with reserve assets.

As a practical matter, some limited form of non-gold reserve-asset convertibility may have to be worked out to span the long adjustment and negotiating period ahead. Future bilateral surpluses of foreign countries with the U.S. might be financed by the use of U.S. reserve assets, or some proportion of such surpluses might be so financed. A variant of this might be partial asset settlement for foreign surpluses on certain accounts, such as those included in the “basic” balance concept.

The road ahead is a long one. The world’s trade and payments system will not be quickly or easily reformed. Basic issues of national policy are involved, and fundamental differences must be reconciled. Many questions of underlying philosophy are involved.

Will the European Economic Community’s progress toward monetary union result in a tighter, more inward-looking region, or will it become a liberalizing force in the world economy? Can the attitudes of those holding that controls are permanently necessary be reconciled with the views of others favoring a system comparatively free of trade and payment restraints? Can a system be devised that will accommodate in some satisfactory degree differences in national economic policies? Will surplus countries accept the loss of their surpluses or the running of deficits as the counterpart of the U.S. movement towards balance-of-payments equilibrium or surplus?

Only time will tell, of course, whether the present opportunity to achieve lasting reforms will be seized, and utilized to lay the groundwork for a strong and expanding world economy. Perhaps the greatest assurance of ultimate success is that all countries have a stake in the outcome.

*Ernest Olson*