THE MANAGEMENT OF FLOATING EXCHANGE RATES.
The Case of the D-Mark/Dollar Rate, 1973-1983

by

Hans Berend Feddersen

Thesis submitted for assessment with a view to obtaining the Degree of Doctor of the European University Institute.

Florence, September 1986
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INTRODUCTION

In early 1973 the international monetary system underwent a significant change with regard to the role of exchange rates. Adjustable parities were abandoned as main organizing principle, and the exchange rates between the US dollar, the Japanese yen, and the European currencies were allowed to float. However, this increase in exchange rate flexibility between the major currencies of the Western World has not resembled the free float described in economic textbooks. Governments and central banks have not left exchange rate determination to market forces entirely. They have intervened in the economic processes of exchange markets at various times and in various ways. This management of floating exchange rates is the subject of the present study.

Exchange rate management has been much discussed in recent years. In particular, the way in which monetary authorities have stimulated the large depreciation of the US dollar in 1985/86 has attracted widespread interest. As on earlier occasions in the 1970s and 1980s, attention has concentrated on the exchange rates between the dollar and the Japanese yen and between the dollar and the German mark. Throughout the floating era these have been the most important exchange rates. It is now conventional wisdom among international economists that the United States, Germany, and Japan should collaborate closely in the management of the floating rate regime in order to achieve more stability and sensible levels for the yen/dollar rate and the D-mark/dollar rate. This is recommended as an important element in an international strategy to improve the performance of the world economy.1

This proposition corresponds to the so-called "key currency" scheme put forward by the Harvard-economist John H. Williams at the time of the Bretton Woods conference.2 It was largely disregarded then, but in contrast to the

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official British and American plans for a postwar monetary system, the "key currency" scheme was based on the realistic assumption that the world did not exist of a large number of equal countries and currencies, but that there were some "truly international currencies whose behavior dominates and determines what happens to all the others." In this sense, the dollar, the D-mark, and the yen qualify as the present-day key currencies. Similar to the conventional wisdom of the mid-1980s, Professor Williams advocated more than forty years ago that the leading countries should collaborate closely in order to stabilize their currencies with reference to each other. This was seen to be the essential condition for attaining monetary and economic stability throughout the world. On the basis of "proper economic health" within the key countries and a high degree of exchange stability between their currencies, John Williams expected that "the problem of maintaining exchange stability for the other countries, and a reasonable state of economic well-being within them, would probably not present major difficulties."

Judged against the standard of the "key currency" scheme, the record of international exchange rate cooperation has been mixed since the transition to floating rates in 1973. There have been periods of intense cooperation between the United States, Germany, and Japan, most recently in connection with the so-called Plaza meeting of the Group of Five in September 1985. At other times, exchange rate cooperation has been virtually absent between the key currency countries, for instance during the Reagan administration’s first term of office. This varied experience raises the question whether there is hope for the fulfillment of the proposition of the "key currency" scheme in the years to come. This question has hardly been touched upon by the current proponents of closer exchange rate cooperation. Although history is an imperfect guide to the future, it is the only one available. The rationale of the present study is therefore that it should be helpful to analyze exchange rate management in the period of widespread floating since 1973 in order to establish an empirical foundation for anticipating developments in this area in the next five or ten years.

The analysis will focus on the exchange rate between the American and the German currency in the 1973-1983 period. The DM/dollar rate has a particular significance from a European viewpoint. Since the collapse of pegged dollar rates in the early 1970s, the European countries have tried to maintain some kind of exchange rate stability among themselves. Formal symmetry notwithstanding, the D-mark has been at the center of the European exchange rate arrangements, first the so-called "currency snake" and since 1979 the European Monetary
System (EMS). Apart from intra-European exchange rate adjustments, the dollar rates of the non-DM currencies participating in the exchange rate mechanisms have largely moved in conjunction with the DM/dollar rate. This means that the competitiveness of the European economies in world trade is crucially dependent on the level of the DM/dollar rate. Expressed in national European currencies, the price of oil and raw materials varies with the DM/dollar rate. Furthermore, exchange rate stability within the EMS tends to be affected by fluctuations in the DM/dollar rate.

The study will not try to answer questions about the way the DM/dollar market works and about how the DM/dollar rate has been determined. The issues which will be examined concern only the intervention of authority for political purposes in the economic processes of the DM/dollar market under floating: how and why has the DM/dollar rate been managed? As mentioned above, the answers to these questions are not only of historical interest. They also help to understand present and to anticipate future activity with regard to the management of the DM/dollar rate. Considering the similarities between Germany and Japan as the two secondary key currency countries in an international monetary system in which the United States is the dominant player, the findings of this study are also likely to throw some light on the management of the yen/dollar rate which has been a matter of considerable diplomatic exchange between the United States and Japan on and off since the early 1970s.

The Object of Analysis

Most empirical studies of exchange rate policies have had a national focus since they primarily have asked questions about the behaviour of the monetary authorities in a particular country. In contrast, the subject of the present study is defined on the basis of the DM/dollar rate as a target of policy. The DM/dollar exchange rate management is defined as all official actions which

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3 After the move to floating exchange rates in 1973 many new models of exchange rate determination have been developed. Their predictive power, however, has been weak (see Richard A. Meese and Kenneth Rogoff, "Empirical Exchange Rate Models of the Seventies - Do They Fit Out of Sample?" Journal of International Economics, vol.14, February 1983). The state of the art at present seems to be a kind of eclecticism which at best allows ex post explanations of exchange rate behaviour. Factors like interest rates, inflation, and current balances are considered important for exchange rate determination, but in an unpredictable way. Stanley W. Black has demonstrated that each of these factors "played some role at different times, but none uniformly over the entire (1973–82) period." (Changing Causes of Exchange Rate Fluctuations, Brookings Discussion Paper in International Economics, no.12, Washington, January 1984, p.25).
are intended to influence the DM/dollar rate. This perspective broadens the scope of the study, because the DM/dollar rate has been the target of both US and German exchange rate policies (and to a minor extent even of other countries' policies).

The DM/dollar exchange rate management in the 1973-83 period fell into two parts. On the one side there were exchange rate measures which were directly aimed at the DM/dollar market. They included among other things foreign exchange operations and domestic monetary operations. Such actions, which will be called market-oriented exchange rate policy, have practically only been taken by the governments and central banks of Germany and the United States. The market-oriented management of the DM/dollar rate corresponds with the conventional meaning of exchange rate policy and exchange-rate oriented policy.

The other part of DM/dollar exchange rate management took place on the political level, primarily between US and German authorities. In addition to their own market-oriented measures both sides have managed the DM/dollar rate indirectly by exerting influence on the market-oriented policies of the other side. Such actions will be called diplomatic exchange rate policy and exchange rate diplomacy when considered as interaction. Diplomatic exchange rate measures have been an intrinsic part of the management of the DM/dollar rate in the 1973-83 period. They included, for instance, US demands for more intensive German efforts to arrest the fall in the DM/dollar rate in 1979, and German complaints about the lack of American interest in mitigating exchange rate fluctuations in the early 1980s.

Other countries have also participated in DM/dollar exchange rate diplomacy to a certain extent. Switzerland, for instance, joined the United States and Germany in several agreements about concerted exchange market interventions in the mid-1970s. Furthermore, Germany has often had support from other European countries in attempts to influence US policy towards the DM/dollar rate. However, it seems fair to say that third countries only played a peripheral role in the management of the DM/dollar rate. The present study focuses on US and German exchange rate policies with regard to the DM/dollar rate, and the role of third countries is put to the sidelines of the analysis.

4 There is no conceptual difference between "exchange rate policy" and "exchange rate management" in this study. The choice of term is mainly a question of grammar. In active tenses one can say "Authority X makes exchange rate policy" or, alternatively, "Authority X manages the exchange rate". In the passive voice with "exchange rate" in the place of the subject only "to manage" can be used: "The exchange rate is managed by Authority X". Instead of "The management of the DM/dollar rate" this thesis could just as well have been called "Exchange rate policies with regard to the DM/dollar rate."
The governments and central banks of the United States and Germany have been the institutions which have formulated and implemented US and German policies regarding the DM/dollar rate. Naturally, they have been influenced by various domestic political interests in the policymaking process. The present study does not examine this sub-national dimension of exchange rate policy. Influences emanating from the domestic political systems are regarded as aggregated and transformed by the governments and central banks into national exchange rate policies. Hence, the management of the DM/dollar rate is seen as behaviour of the governments and central banks of the United States and Germany. These policymaking authorities will be the units of analysis.

Diagrammatically, the management of the DM/dollar rate can be put as follows:

- **US authorities** through diplomatic efforts to influence exchange rate policies.
- These policies are then reflected in the **DM/dollar market**.
- **German authorities** also play a role by setting their own policies, which affect the market.

As far as the US authorities were concerned, the DM/dollar rate was the main target of exchange rate policy in the period under review. US policymakers may have been just as interested in the yen/dollar rate, but their exchange rate measures focused primarily on the DM/dollar rate. This was particularly the case for exchange market interventions of which 90 per cent was carried out in the DM/dollar market. With regard to the German authorities, the management of the floating DM/dollar rate was one side in a dual exchange rate policy. The other side was represented by the management of intra-European exchange rates in the context of the "currency snake" and the European Monetary System.
The Determinants of Exchange Rate Management

The behaviour of US and German authorities regarding the DM/dollar rate in the 1973-83 period will be analyzed on the basis of a proposition saying that any policymaker's management of floating exchange rates is determined by four sets of variables:

1. the policymaker's motivation
2. the exchange market situation
3. the policymaker's assessment of the costs and benefits of available exchange rate measures
4. diplomatic exchange rate measures of other states

This proposition has been derived from abstract considerations about the situation of a single policymaker in charge of conducting a state's exchange rate policy. It is assumed that influences from the domestic political system are fully represented in the policymaker's goals and assessments.

1) The policymaker's motivation. Every attempt by the policymaker to influence the exchange rate must be based on a notion of the desired effects provided his behaviour is rational. His goal in terms of the exchange rate can be called an exchange rate preference, i.e. a preferred state or development of the exchange rate. In the case of the DM/dollar rate the exchange rate preference could for instance be a particular rate like 2.60 DM/$, or an appreciation of the dollar against the DM, or the absence of short-term fluctuations.

The achievement of exchange rate preferences will not be the fundamental reason of exchange rate management. The policymaker will be motivated by goals beyond the exchange market. Such goals will be called the ultimate objectives of exchange rate policy. For instance, the policymaker may believe that an appreciation of the home currency will help to achieve domestic price stability. If the policymaker tries to strengthen his currency in order to reduce domestic inflation this will be called the ultimate objective of his exchange rate policy, whereas the appreciation only will be his intermediate target. As the example indicates, the link in policymaking between ultimate objective and exchange rate preference is the policymaker's perception of how the exchange rate development affects some "objective variables". These are typically indicators for the performance of the domestic economy like the inflation rate, the real growth of GNP, unemployment, and the current and trade account balances. They may also include "non-economic" variables like national prestige or freedom of action.

5 For the sake of simplicity the policymaker's target will be called "the exchange rate" although the target very well could be several exchange rates or an effective exchange rate index.
Exchange rate preferences are not static. They may change in response to a shift in the policymaker's priorities with regard to ultimate objectives. This may be caused by a change in the economic situation or in the domestic political context. Exchange rate preferences may also be affected by a changed perception about the transmission mechanisms between the exchange rate and the objective variables. This may be caused by new insights or the coming to power of new officials with different policy beliefs.

An exchange rate preference can be held more or less strongly depending on the circumstances. When an ultimate objective has a high priority and the policymaker sees a close connection between the exchange rate and the objective variable, he will tend to have a strong exchange rate preference. In other cases an exchange rate preference may get close to indifference, when the ultimate objectives are not seen to be endangered by the exchange rate development, or when the link between the exchange rate and the objective variable is perceived to be weak.

2) The exchange market situation. Although exchange rate preferences and their underlying objectives will be the motivating force behind all exchange rate management, the actual state and development of the exchange rate will be equally important in the making of exchange rate policies. It is evident that the policymaker will not try to influence the exchange rate when there is no difference between the actual and his preferred rate. Furthermore, it is reasonable to expect that his inclination to manage the exchange rate will vary with the divergence between the actual exchange rate and his exchange rate preference. In other words, the dynamic of exchange rate management is provided by the difference between the actual and the preferred exchange rate and not by the exchange rate preference alone.

3) The policymaker's assessment of the costs and benefits of available exchange rate measures. Naturally, the policymaker will abstain from an active exchange rate policy when he believes that he cannot influence the exchange rate, i.e. when he considers all available measures as ineffective. He will also remain passive when he regards the costs of the various courses of action as higher than the potential benefits. Generally it can be said, that the policymaker's choice of exchange rate measures will depend on a cost-benefit assessment of the existing alternatives.

6 Of course such an objective is not "ultimate" in the strict sense. There will always be motives and reasons on a deeper level. A reduction in the inflation rate may, for instance, be sought in order to maintain political stability or to win the next election.
The perceived costs and benefits of a specific exchange rate measure, whether it is market-oriented or diplomatic, may vary with changing circumstances. The balance between costs and benefits may change when the role of policymaker shifts from one set of officials to another with different policy beliefs and experiences. The side-effects of exchange rate measures may be adverse to the policymaker's interest in other areas at one moment, but not at another. For instance, a domestic monetary expansion caused by exchange market interventions may run counter to the policymaker's money supply target when money growth already is faster than desired. However, when money growth is slower than projected it will not be considered as a cost of the exchange rate measure.

4) **Diplomatic exchange rate measures of other states.** Due to the nature of exchange rates as relative prices between national currencies, the market-oriented exchange rate policy of one state affects the exchange rate interests of other states. Just as the policymaker considered here may try to influence the market-oriented exchange rate policies of other states, he may himself be exposed to diplomatic exchange rate measures of other states which may affect his own exchange rate policy.

The management of floating exchange rates easily becomes an international political issue where the behaviour of the various national policymakers is guided by their exchange rate preferences which can be considered as their national interests in this area. As in other areas of international relations, the character of exchange rate diplomacy depends on the compatibility of national interests. Compatible exchange rate preferences will be conducive to international cooperation in exchange rate management, although the participants may disagree on the methods of management and the distribution of costs. Incompatible exchange rate preferences, on the other hand, will not provide a basis for cooperation. Instead it will lead to outright conflict in exchange rate diplomacy, if the policymakers take exchange rate measures in accordance with their national preferences.

However, the processes and outcomes of exchange rate diplomacy do not only depend on the relationship between exchange rate preferences. The issue of exchange rate management may be linked to other issue areas in international relations (e.g., trade and defence) and such linkages will provide states with different capabilities to withstand and to exert influence in exchange rate diplomacy. It can be expected that the overall balance of power among states will be reflected in exchange rate diplomacy.
In general, the proposition about the determinants of exchange rate management implies that exchange rate measures can be fully explained by reference to factors which can be grouped into one or the other of the four analytical categories. In the following empirical analysis this hypothesis will guide the search for the explanatory factors behind the DM/dollar exchange rate management.

The Plan of the Study

The management of the DM/dollar rate in the 1973-83 period took place on the basis of a US-German consensus on the question of fixed versus floating rates. Both sides agreed throughout the ten-year period that a floating DM/dollar rate was preferable to any other exchange rate arrangement under the given circumstances. The background for this consensus will be examined in Part B. Direct interventions by the US and German authorities has been the most heavily used instrument in the management of the floating DM/dollar rate. For presentational reasons this aspect of the subject has been singled out for a descriptive survey in Part C. The main analysis of the DM/dollar exchange rate management is to be found in Parts D, E, and F. Part D covers the mid-1970s, i.e. the period from the onset of floating in March 1973 to the autumn of 1977. These four and a half years saw a relatively light management of the DM/dollar rate and the analysis will centre on three episodes with a particularly interesting exchange rate diplomacy. Part E covers the late 1970s, i.e. the period from the autumn of 1977 to the winter of 1979/80, which was characterized by a generally weak dollar and intensive efforts by the US and German authorities to contain the fall in the DM/dollar rate. Part F examines the DM/dollar exchange rate management in the early 1980s, i.e. until the spring of 1983. In contrast to the late 1970s this period was characterized by a strong dollar and a weak DM. The management of the DM/dollar rate became one-sidedly German as the US authorities adopted a passive stance. Finally, in Part G, previous findings are summarized, differences in US and German policies regarding the DM/dollar rate are explained with fundamental asymmetries between the two countries, and the prospects for international exchange rate stabilization are assessed.

7 This corresponds to the "overall power structure explanation" of international regime change in Robert O. Keohane & Joseph S. Nye, Power and Interdependence. World Politics in Transition, Boston, 1977, pp.42-49
Part B

THE DEVELOPMENT OF THE US-GERMAN CONSENSUS ON EXCHANGE RATE FLEXIBILITY

The management of the DM/dollar rate in the 1973-83 period was based on a consensus between the US and the German authorities regarding the question of floating versus pegged exchange rates. This consensus evolved from the international monetary crises of the early 1970s. Since then, the floating of the DM/dollar rate has been an unchanged datum in the making of US and German exchange rate policies. The present part of the study attempts to explain the nature of the US-German accord on exchange rate flexibility by pointing out the sources for the changes in official policy beliefs during the last years with a pegged DM/dollar rate.

The conversion of US and German policymakers to floating became manifest in their reactions to the gradual breakdown of the Bretton Woods system. Generally there were two types of official reactions to the threatening collapse of the system. On the one side, there were ad hoc measures to the pressure of events. Some of them were taken unilaterally and others in multilateral fora like the Group of Ten's Smithsonian Agreement in December 1971. On the other side, there was a more fundamental reaction against the old system and a readiness to consider the possibility of a completely new world monetary order, with a new charter to replace Bretton Woods. This tendency was soon to be institutionalized in the reform discussions of the Committee of Twenty under the aegis of the IMF.

Ultimately, both the ad hoc measures of the years 1971-73 and the negotiations about a 'grand design' for a new international monetary order were failures. The former could not for any significant length of time prevent the collapse of the par value system, and the latter could not produce a new system instead. March 1973, when the fixed parities were abandoned and widespread floating began, turned out to be the start of a new and unplanned exchange rate regime.

In contrast to a few years earlier, when they were strongly committed to fixed rates, German and American policymakers expressed contentment with the increased exchange rate flexibility in March 1973, although it was presented as a temporary solution at that time. But as the reform negotiations from 1973 to 1975 should show, both countries were not willing to return to
fixed rates thereafter. Floating was legalized and it has not been called into question by Germany or the United States in the period under review. In the first place, both sides have had serious doubts about the viability of pegged rates between the major currencies in view of diverging growth and inflation performances, oil price shocks and the rapid rise in exchange market turnover. Secondly, the political price of any attempt to maintain a formally pegged DM/dollar rate was simply regarded as too high by US and German policymakers.

With the focus on American and German attitudes towards exchange rate flexibility, the following chapter B.1. covers the ad hoc measures in the last phase of the Bretton Woods system, while chapter B.2. treats the negotiations about the reform of the international monetary system. The analysis will show that Germany favoured increased exchange rate flexibility earlier than the United States and that floating had different main functions in overall economic policy in the two countries. In the United States floating was primarily regarded as a balance-of-payments adjustment mechanism, while in Germany a floating DM/dollar rate primarily meant a protection of the external flank in the fight against inflation.

B.1. The Change from a Pegged to a Floating DM/Dollar Rate

The currency crises of the early 1970s provided the context for the development of the consensus between the United States and Germany on the desirability of a floating DM/dollar. From this series of events the present chapter attempts to point out the main reasons for the change in US and German preferences concerning the exchange rate system. Furthermore, a short review is made of the US-German interactions with regard to the exchange rate issue in this transitional phase. These interactions are the immediate historical background for the bilateral exchange rate diplomacy under the floating DM/dollar rate from March 1973 onwards.
B.1.1. The Emergence of a Dual German Exchange Rate Policy

German government officials and central bankers expressed relief and satisfaction in March 1973 when the pegged DM/dollar parity was abandoned and the DM was embarked on a joint float with the other member currencies of the "snake". In the preceding weeks huge speculative capital inflows had undermined German economic policy. But when the Bundesbank was exempted from the obligation to keep the DM/dollar rate within its fluctuation margin, control over the domestic money supply was regained. The main obstacle to a forceful anti-inflationary monetary policy had been removed.

Speculative capital flows had been a trademark of the last years of the Bretton Woods system. When the currency markets anticipated imminent changes in the DM/dollar parity in this period, billions of dollars could flood the Bundesbank's foreign exchange trading desk within hours and make it virtually impossible to uphold a pegged rate. If very strict exchange controls should be avoided, revaluation or gradual appreciation were the only response to the market pressures.

Germany had first succumbed to speculative market forces in September 1969, when the DM was allowed to float for one month before it was repegged at a higher level. This short float, however, was only considered as a bridging operation under suspended political authority after general elections until a new government could decide on an outright revaluation. But it was a successful experiment and it contributed to make floating more acceptable to policymakers. In this way the 1969-float of the DM prepared the ground for the DM-float in 1971.

A speculative inflow of 2 billion dollars in two and a half days in early May 1971 forced the German monetary authorities to unpeg the DM again. The DM appreciated in the following months, while Germany was insulated from further inflows of foreign funds. That gave the Bundesbank an increased freedom of action in monetary policy after having been constrained by exchange

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1 "It demonstrated that the markets could be entrusted with deciding exchange rates without serious disruption of trade and international investment decisions; that other central banks could adjust to a floating currency and that 'dirty floating' (i.e. central bank intervention to blunt the sharp edges of market fluctuations) was a practicable halfway house." Susan Strange, International Monetary Relations, vol. 2 in International Economic Relations of the Western World 1959–1971, ed. by Andrew Shonfield, London, 1976, p.330
rate considerations in the preceding years. After more than seven months of floating the DM/dollar rate was repegged in December 1971 as part of the so-called Smithsonian Agreement among the members of the Group of Ten.

During the currency market's next attack on a pegged DM/dollar rate in early February 1973, the Bundesbank bought nearly 6 billion dollars to resist another revaluation of the mark, but it had finally to yield to the market forces again. The multilaterally agreed devaluation of the dollar in the wake of this currency crisis was only ten days old, when another deluge of speculative capital flows from dollar into mark began. On March 1 the Germans closed their exchange market after official purchases of $ 2.7 billion in a single day. After this experience the German authorities were not willing to defend a pegged DM/dollar parity for the time being.

But the apparent impossibility of sustaining any pegged DM/dollar rate was not the only reason for the conversion of German policymakers to floating. The capital inflow in early 1973 had swamped the German money supply at a time when rising inflationary forces called for a restrictive monetary policy. Consumer prices increased by about 6 per cent annually, the highest rate since the Korean war. A DM-float was seen as the only acceptable way to regain control over monetary policy and to prepare the ground for an effective stabilization policy, which by then had become the top-priority of German economic policy.

A contributing factor behind the German support for a floating DM/dollar rate in March 1973 was the agreement between Germany, France, the Benelux-countries, and Denmark to continue their exchange rate cooperation initiated in April 1972 (the so-called "snake") as a joint float of their currencies against the dollar. Germany would probably have floated the DM even without the other snake-countries following suit due to the above-mentioned reasons, but the continuation of European monetary cooperation made a floating DM/dollar rate much more acceptable.

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2 The Smithsonian Agreement in December 1971 had enlarged the fluctuation margins around fixed dollar parities. That conflicted with the EC-countries' aspiration to move towards monetary union internally. Therefore they agreed in April 1972 to keep fluctuations of intra-EC exchange rates within narrower limits (2.25 per cent). This arrangement came to be known as the "snake". Until the dollar-parities were abandoned in March 1973, the "snake" meandered in the so-called "tunnel" which was the wider fluctuation band around the dollar-parities established with the Smithsonian agreement.
Germany had made three unsuccessful attempts to assemble a joint European float (May 1971, August 1971, February 1973). France especially did not favour floating rates against the dollar and prevented the proposals from being realized. After the currency turmoil in February 1973 France finally accepted a joint float in March 1973. Amongst the EC-member countries, Britain, Ireland, and Italy decided to float individually.

There seemed to be two reasons behind the reiterated German attempts to assemble a joint float of the EC-currencies against the dollar in the early 1970s. One obvious and openly declared motive was that floating rates among EC-currencies complicated the operations of the Community (especially the Common Agricultural Policy) and were incompatible with the plans for Economic and Monetary Union within the EC.

The other reason was not put forward in public because it concerned the competitiveness of German goods and services - an interest that easily could conflict with the corresponding interests of Germany's EC-partners. Given the different strengths of the EC-currencies in the early 1970s, an isolated DM-float would tend to appreciate the DM against most of the other EC-currencies. With the DM as the main European target of speculative capital flows, the appreciation would often be larger than warranted by the differences in economic performances within the EC. A joint float, however, could prevent that German price competitiveness vis-à-vis other snake-members deteriorated as a by-product of a DM-appreciation against the dollar. Furthermore, the almost inevitable delay of parity changes in an adjustable peg system like the snake would even tend to give a competitive advantage to Germany against snake-countries with weaker currencies like France. 3

3 It could be argued that the German support for the snake reflected a continuation of the "dynamic undervaluation strategy" which characterized German exchange rate policy in the 1960s according to William P. Wadbrook's study (West German Balance-of-Payments Policy, New York, 1972). Wadbrook argues very convincingly that Germany perpetuated the undervaluation of the DM in the Bretton Woods system by avoiding real adjustment. The revaluations of 1961 and 1969, for instance, are regarded as partial price-level realignments, recouping only part of Germany's competitive advantage accumulated during the periods preceding the revaluations. Vis-à-vis the dollar and other non-snake currencies Germany certainly abandoned the dynamic undervaluation strategy in the early 1970s when the inflationary costs of this policy became too high. Whether or when German exchange rate policy within the snake and the EMS has aimed at DM-undervaluation in the same way as German policy in 1960s could be the subject of another study.
That the Germans wanted stable rates within the EC for reasons of competitiveness became evident during the multilateral exchange rate negotiations in the autumn of 1971. Germany tried to reduce the DM's appreciation against other European currencies by favouring a substantial dollar devaluation without offsetting devaluations of the French franc, pound sterling, and the lira. When the United States itself proposed such a realignment after earlier refusals to devalue the dollar, and when the resistance of France, Britain, and Italy was overcome, an arrangement in accordance with the German strategy could be agreed upon. The Smithsonian Agreement of December 1971 reduced the DM's appreciation against the other European currencies considerably compared to the preceding months.

The currency crisis of 1971 showed the beginning of a split in German exchange rate policy. On the one side Germany developed a preference for an increased flexibility of the DM/dollar rate. This strategy manifested itself in the temporary float of the DM from May to December 1971 and in the approval of widened fluctuation margins around the repegged DM/dollar rate at the Smithsonian Agreement. On the other side Germany repeatedly tried to get EC currencies moving together against the dollar. The establishment of the snake in April 1972 was the next step in this direction.

The dualism in German exchange rate policy became fully apparent in March 1973 when the snake-currencies began to float together against the dollar. Since then, the managed float of the DM/dollar rate and the adjustable peg system of the snake (and subsequently the European Monetary System) have represented the two directions of German exchange rate policy.

In summary, the transition to a floating DM/dollar rate was acclaimed in Germany because massive speculation had made the support of a pegged rate impossible under the circumstances of early 1973, and because the rising inflation required a reorientation of German monetary policy from an exchange rate target to domestic price stability. The two reasons were interrelated in the sense that speculative capital inflows aggravated the domestic inflation. The establishment of a dual exchange rate policy made it possible for Germany to

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4 Bundesbank President Karl Klasen explained the German strategy in a speech on November 1, 1971: "Auf eine Dollarabwertung solle nicht verzichtet werden. Mit ihr wäre am ehesten zu erreichen, dass die zu hohen Paritätssänderungen vermieden würden, die die DM gegenüber dritten Währungen jetzt leider erreicht hat; denn um die Abwertungsrate des Dollars ermassigt sich der Aufwertungssatz der DM gegenüber den nichtamerikanischen Währungen." FAZ, 2 November 1971
maintain the advantages of the adjustable peg within an area where the potential benefits of such a system were considerable (European integration, competitiveness of German goods and services), while the DM was free to float against the dollar where it was most needed.

B.1.2. The American Conversion to Floating

During the dollar crisis in February 1973 the United States asked Japan, Germany, France, Britain, and Italy to accept a second devaluation of the dollar or to let their currencies appreciate in a free float. Japan chose a float, while the Europeans agreed to effect a dollar devaluation of 10 per cent. When the new parities came under speculative attack in the exchange markets shortly afterwards, the United States endorsed the decision of the European countries to let their currencies float against the dollar. In retrospect, the positive American attitude towards floating in early 1973 represented the decisive step in the gradual conversion of US exchange rate policy from adherence to fixed exchange rates to a pro-floating stance. Even though floating was widely regarded as a temporary measure at that time, the United States was never afterwards willing to return to fixed parities.

The American conversion to floating was closely related to the deteriorating US balance of payments position in the early 1970s. In the summer of 1971 it became clear that the United States would have a yearly trade deficit in 1971 for the first time since 1893. Then, after two and a half years with a passive exchange rate policy, the Nixon administration decided in August 1971 that the negative trend in the balance of payments should be reversed by exchange rate adjustments. The suspension of the dollar’s gold convertibility and the introduction of a 10 per cent import surcharge – announced by President Nixon on August 15 – aimed at a revaluation of other currencies against the dollar. These adjustments should bring about a $13 billion improvement in the US trade and current accounts.

The measures of August 15, 1971, more or less forced US trading partners to let their currencies float vis-à-vis the dollar. However, the measures did not imply a predisposition for floating rates on the part of key US decision-

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makers at that time. The forced float and the surcharge were only used to achieve a major currency realignment to suit US interests. According to dominant thinking in Washington there was no other way to get the dollar devalued against the yen and the European currencies. The events in 1971 showed that the United States was prepared to live with floating rates if necessary to achieve a changed valuation of the dollar. But the adjustable peg system remained the frame of reference for US exchange rate policy until 1973. The Smithsonian Agreement in December 1971 reestablished fixed parities with a 8.57 per cent devaluation of the dollar.

The American hope that the Smithsonian realignment would result in a rather fast improvement of the US balance of payments were frustrated. Quite to the contrary, the trade and current account deficits increased considerably in 1972, and in early 1973 there were no clear indications that an improvement was in the offing. The dominant opinion in Washington regarded the dollar as still overvalued, and when the dollar came under pressure in the currency markets in January 1973 a need for new exchange rate adjustments was perceived.

In secret negotiations in February 1973 with Japan and the major EC-countries, the United States succeeded in bringing about a second devaluation of the dollar and a float of the yen. The Secretary of the Treasury, George P. Shultz, left no doubt about the US intention with this currency agreement:

"These changes are intended to supplement and work in the same direction as the changes accomplished in the Smithsonian Agreement of December 1971. They take into account recent developments and are designed to speed improvement in our trade and payments position."

When it became clear in March 1973 that the new par values were not sustainable either, the United States endorsed the float of the European currencies as a logical consequence of the earlier American proposal to float, and in view of the obvious impossibility to defend pegged rates against the dollar under the circumstances of early 1973.

6 ibid. p.291
7 ibid. pp.311, 312
8 NYT 14 February 1973
9 There is some evidence that George Shultz deliberately furthered the collapse of the exchange rate agreement of February 1973. In his announcement of the second dollar devaluation he refused to give a general pledge to support the dollar and stressed that the United States had undertaken no obligations to intervene in the exchange markets. (NYT 14 February 1973). Furthermore, a New York Times article of February 16, 1973, reported that Mr Shultz had indicated that the administration was seeking a further dollar depreciation by an unspecified amount.
The US initiatives in August 1971 and in February 1973 aimed at a downward adjustment of the dollar's exchange value for balance-of-payments reasons. Apart from the marked difference in style between the almost brutal unilaterality of the measures in 1971 and the secret multilateral negotiations in February 1973, there was also a difference with regard to how the downward adjustment of the dollar should be accomplished. The 1971-measures aimed at a realignment of pegged rates and floating was regarded as a temporary device during the realignment negotiations. In 1973, the US position implied indifference with regard to the method of exchange rate adjustment. 'Outright dollar devaluation and floating were proposed as equally good alternatives. This apparent indifference covered over an internal disagreement among the top economic policymakers in Washington.' 10 Some, like the Treasury Secretary George Shultz, tended to favour floating, whereas others, the Chairman of the Federal Reserve Arthur Burns for example, preferred an outright dollar devaluation. 11 Instead of deciding between these two positions, the choice was passed on to the other countries.

In general, the "ideological floaters" were gaining ground in Washington in the early 1970s at the expense of the fixed-rate proponents. When the exchange markets finally forced governments and central banks to abandon pegged dollar rates, the supporters of floating had won the tactical advantage of a fait accompli. This advantage turned out to be decisive in the following years when US exchange rate policy gradually adopted an unequivocal and clear-cut pro-floating attitude, as the next chapter will show. But in the months after March 1973 the United States still remained formally committed to the reestablishment of a fixed exchange rate system. For the more ardent proponents of floating in the Nixon-administration the commitment was probably pure lip service. Yet even though the method of exchange rate adjustment was disputed in Washington, there was now a broad consensus about the objective - the need to improve the US balance of payments with a downward adjustment of the dollar rate.

10 Odell, op.cit. pp.311, 313
11 Odell has pointed out that "these substantive differences help explain why the US government failed to advocate a floating regime before 1973." ibid. p.311
B.1.3. US-German Exchange Rate Diplomacy in the Transition Period

In the two preceding sections it has been shown how Germany and the United States both developed a preference for increased exchange rate flexibility in the context of rising payments imbalances and inflation rates and the speculative movement of large funds across the exchanges. Yet US and German exchange rate policies did not change in a completely parallel way and, more important, not for the same reasons. For Germany increased exchange rate flexibility was primarily a question of controlling inflation. For the United States the improvement of the trade account was the main reason. As long as the priorities were distributed in this way, the danger was small that US and German authorities would manage the DM/dollar rate at cross-purposes. But the management of the floating DM/dollar rate will be analyzed in Parts C - F. The present section focuses on the US-German relations in the transitional phase before the final abandonment of a pegged DM/dollar rate as the direct historical background of the management of the floating DM/dollar rate.

In the 1960s "German docility and compliance with American wishes" was the characteristic feature of the US-German monetary relationship. Germany's growing economic strength was never used to defy the Americans outright. This stemmed from "Germany's perceived need for and dependance on the nuclear protection of the United States and on the presence of American and other NATO forces committed to its conventional defence."\(^{12}\)

Although German security continued to depend on American protection, US-German exchange rate diplomacy in the period of managed floating from 1973 onwards was different from the 1960s, as will be shown later. Though acknowledging the basic asymmetry in the world monetary system, Germany was then prepared to defend her own interests in exchange rate matters vis-à-vis the United States. A first indication of a more independent German stance was the resistance to US pressure for a DM-revaluation in November 1968.\(^ {13}\)

In the first two and a half years of the Nixon-administration (from early 1969 to mid-1971) there were three instances of disagreement between

\(^{12}\) Strange, op.cit. p.46

\(^ {13}\) This resistance, however, was made easier for the Germans by the fact that they had to deal with a lame-duck administration in Washington. ibid. p.325
the United States and Germany on exchange rate policy. They reflect the fact that Germany adopted a positive attitude towards increased exchange rate flexibility earlier than the United States. The dominant view in Washington in this period was that increased exchange rate flexibility and dollar devaluation were unnecessary and possibly harmful. In May 1969, Germany proposed a general realignment of currencies including a dollar devaluation which was rejected by the Americans. The short DM-float in the autumn of 1969 was only grudgingly accepted by the United States, and when Germany let the DM float in May 1971 the move was criticized by the United States as destabilizing for the international monetary system as a whole.

The US-German relations during the dollar crisis in 1971 showed that an outright exchange rate conflict between the United States and Germany could occur under floating. From early May onwards the Germans had let the DM float freely upwards against the dollar. This free float permitted the Bundesbank to pursue a monetary policy unimpeded by movements in monetary reserves. By mid-September, when the DM already had appreciated almost 9 per cent against the dollar, the United States officially demanded a 15 per cent DM-revaluation minimum as one condition for the lifting of the US import surcharge. Until then, the Germans had been the least hostile among the Europeans in their reactions to the Nixon-administration’s measures of August 15, 1971. German criticism had been sparse, and Finance Minister Schiller had even expressed understanding for the American policy and tried to tone down a joint EC-statement on the issue in early September.

But against the US demand for a 15 per cent DM-revaluation minimum, the Germans reacted vehemently. They rejected the demand as completely unrealistic and proposed instead a maximum revaluation rate of 8 per cent. Furthermore, they started to intervene in the DM/dollar market to keep the DM-appreciation below 10 per cent. German criticisms of US policy increased and at the

14 Odell, op.cit. pp.183-199
15 Strange, op.cit. p.327
16 ibid. p.330
17 Odell, op.cit. p.198
18 DB, Monthly Report, December 1971, p.37
19 FAZ 20 September 1971
20 FAZ 15 September 1971
21 FAZ 22 September 1971; NYT 2 October 1971
22 NYT 22 September 1971
IMF Annual Meeting at the end of September Finance Minister Schiller made a vague threat about possible changes in Germany's international monetary policy.\(^3\)

The Germans regarded the American demand as very unjustified in view of the fact that the DM had been the only currency which had been permitted to float freely, which for the Germans implied a "just" valuation of their currency. A DM-revaluation above the market valuation would imply an over-valued currency with a serious loss of German competitiveness. Because the United States was also seeking to improve competitiveness for its exports, the disagreement was a typical case of an outright exchange rate conflict, i.e. it was based on incompatible national exchange rate preferences.

In October, the atmosphere calmed down with conciliatory statements from both sides.\(^4\) The two countries had a common interest in revaluations of the British, French, and Italian currencies which actually put them on the same side in the final phase of the currency negotiations in the autumn of 1971. However, the incident shows that the era of almost unqualified German docility and compliance with American wishes in monetary affairs was coming to an end in the early 1970s.

When the Americans initiated secret multilateral negotiations on a new currency agreement in February 1973, they encountered much less opposition to the proposed dollar devaluation than they had in 1971.\(^5\) Agreement on a 10 per cent devaluation was reached swiftly once the Europeans had decided that they preferred a realignment of par values to floating.\(^6\)

But the new par values succumbed to speculative market forces after only 18 days on March 1, 1973. Floating of all the major currencies against the dollar became unavoidable. Under the pressure of market forces it had become a sheer necessity, acknowledged even by the French who in principle did not favour floating rates. The constellation of preferences concerning exchange rate systems had little significance for the adoption of floating rates in March 1973. But the US-German consensus on exchange rate flexibility was nevertheless a reality at that time. It had emerged gradually up to March 1973, but it was first confirmed and manifest during the negotiations about a reform of the international monetary system in the ensuing period, which is the subject of the following chapter.

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23 FAZ 28 September 1971
24 FAZ 15 and 18 October 1971; FT 15 and 18 October 1971
B.2. The Negotiations about International Monetary Reform

Although the German and American policymakers expressed satisfaction with the transition to floating in March 1973, they nevertheless called it a temporary solution to the monetary disorder. Negotiations about a comprehensive reform of the international monetary system had started the year before and they were widely expected to provide rules for a revised adjustable peg system in the following year. But the reform negotiations failed and the provisional arrangement of March 1973 came to persist. Floating was even legalized in the mini-reform of the IMF-charter in Jamaica in January 1976.

The following account of the German and American positions in the reform negotiations and of their official statements about the exchange rate system will reveal that the US-German consensus on the desirability of the float became firmly established in the first years after the transition. Furthermore, it will be shown that the Americans and Germans continued to have different motives for their advocacy of floating. The Americans were emphasizing the balance-of-payments effects of exchange rate changes, while the Germans primarily focused on the anti-inflationary function of a floating DM/dollar rate within the context of German stabilization policy.

B.2.1. The Committee of Twenty, 1972-74

In July 1972 the IMF set up a "Committee of the Board of Governors of the Fund on Reform of the International Monetary System and Related Issues" which came to be known as the Committee of Twenty (C-20). The deputies of the C-20 began substantive work in November of the same year.

The most important development in 1972 was the presentation of the United States' proposals for reform by the Treasury Secretary, George Shultz, in his address to the IMF Annual Meeting.27 Mr Shultz' proposals, which were

25 Odell, op.cit. p.316
26 ibid. pp.313ff
27 IMF Survey, 9 October 1972, p.70
elaborated later in a memorandum to the C-20, were based on a par value system with wider bands of permissible fluctuations than in the Bretton Woods system. He stressed the importance of the Special Drawing Rights, contemplating that the SDR would become the formal numeraire of the system.

Mr Shultz criticized the asymmetrical distribution of the adjustment burden in the Bretton Woods system.29

"Countries experiencing large deterioration in their reserve positions generally have had to devalue their currencies or take other measures to strengthen their balance of payments. Surplus countries with disproportionate reserve gains have, however, been under much less pressure to revalue their currencies upward or to take other policy actions with a similar balance of payments effect."

According to the American view, this asymmetry and the difficulties involved in achieving a dollar devaluation had led to the overvaluation of the dollar in the old system. The United States had virtually had to force her way to a dollar devaluation with trade sanctions in the autumn of 1971. A new system should provide symmetry in the balance-of-payments adjustment process in order to prevent an overvaluation of the dollar in the future.

The US Treasury Secretary proposed that a "surfeit of reserves" should indicate and force adjustment on the surplus side as losses of reserves already did it on the deficit side. The "objective indicator" of reserve changes should "note and locate the existence of an undesirable degree of balance-of-payments disequilibrium, and create a strong presumption that effective adjustment policies should be implemented."30 A rather high degree of automaticity was apparently desired, but the Americans kept this point rather vague.

The main opposition against the US proposal for a new adjustment process came from Europe, and not least from Germany. First of all, the EC-countries were opposed to the automaticity in the US proposal. A quasi-automatic adjustment process triggered off by variations in some statistical data was regarded as an unacceptable surrender of national sovereignty. According to the Europeans, an obligation to consult with the IMF would be a more appropriate

29 IMF Survey, 9 October 1972, p.70
30 loc.cit.
consequence of an observed disequilibrium. Secondly, the EC suggested several indicators instead of just the reserve indicator. Changes in the basic balance and price indices were put forward as other criteria.

The currency crises of early 1973 and the transition to widespread floating did not stop the reform discussions. But as the world economy was hit by an inflationary surge and the first oil price shock in 1973, and while the C-20 negotiations did not come closer to an agreement, the unplanned managed float represented to many countries an increasingly acceptable alternative to a negotiated system based on "stable but adjustable par values".

In the summer of 1973 the top economic policymakers in the United States and Germany were apparently still devoted to a negotiated agreement on world monetary reform. Secretary Shultz spoke of floating as a useful bridge before the introduction of a reformed system.31 Vice President Emminger of the Bundesbank called floating a useful technique in special situations, but said that stable, though adjustable exchange rates were desirable.32

At the IMF Annual Meeting in Nairobi in September 1973 the C-20's First Outline of Reform was released which set out all the main reform issues. But agreement was not in sight. The quadrupling of oil prices by the OPEC cartel in late 1973 turned the attention of economic policymakers away from the reform plans to the more immediate problems of recycling petro-dollars and related questions. Furthermore, most countries were quite content with the flexibility of the managed float system in order to cope with the international economic imbalances in the wake of the oil-price shock.

The US strategy for the reform negotiations changed from the time of the Nairobi meeting to January 1974, when the C-20 held a meeting in Rome. The proposal from 1972 was practically abandoned by the Treasury. Instead it was now seeking acceptance of floating exchange rates as legal under agreed rules. Apart from the European unwillingness to bend towards the US plan, there were quite a few good reasons for the Americans to give up a large-scale reform on the basis of an adjustable-peg system.

The main reason for the Americans to seek reform with a symmetrical, quasi-automatic adjustment process had been the desire to prevent competitive undervaluations of other currencies leaving the dollar in an overvalued position with negative effects for the US balance of payments. But the currency

31 FT 7 June 1973  
32 AP no.66/1973, 11 September 1973
crises in early 1973 had demonstrated that direct interventions had become ineffective in the defence of a pegged exchange rate, if the exchange market was convinced that this rate was out of line. The power of the market would force the authorities to adjust. A complicated scheme for political procedures in the case of significant reserve changes (a corollary of massive direct interventions to defend a pegged rate) was therefore unnecessary. The exchange market would have forced adjustment more effectively and swiftly than any political authority.

Another reason for the Treasury to abandon its own proposal was that any reformed system based on par-values would have required some kind of dollar convertibility into US reserves. A pure dollar standard, like the one in force between the Smithsonian Agreement and March 1973, was not acceptable to the Europeans as part of a negotiated system. Considering the relative modest US reserves\textsuperscript{33} dollar convertibility would always impose a certain balance-of-payments discipline on the United States, even within the most flexible adjustable peg system. In 1972 the United States was apparently willing to accept some kind of dollar convertibility into gold or SDR in return for an adjustment process guaranteeing against an overvaluation of the dollar. But with floating rates and market forces taking care of the adjustment side, there was no incentive for the United States to reintroduce dollar convertibility and, thereby, to subject herself to an external constraint in economic policymaking.

In addition, the drastic increase of inflation rates worldwide and the oil-price increases were such shocks to the world economy in 1973 that a very high degree of exchange rate flexibility was seen as necessary to cope with the resulting imbalances. Stable exchange rates were regarded as unrealistic in the foreseeable future at the end of 1973.

Unrelated to the events of 1973 the United States had a further good reason to favour more flexible rates (but not necessarily floating rates). The relatively small foreign sector in the US economy provides US policy with little leverage over the balance of payments via domestic demand policy, but significant leverage via the exchange rate. And according to standard economic theory, an exchange rate change is the most cost-effective among the adjustment

\textsuperscript{33} At the end of 1973 US reserve assets (gold, SDRs, and foreign exchange) amounted to $14.4 billion of which $11.7 billion was held in gold (valued at the official gold price of $42.2 per troy ounce). Germany had $33.4 billion in official reserves at the end of 1973 of which $5.2 billion was held in gold.
options for a large and relatively closed economy. Certainly, the US plan for a reformed adjustable peg system envisaged that a country facing a balance-of-payments disequilibrium should have substantial discretion in determining the composition of adjustment policies. The United States would therefore have been free to opt for an exchange rate change whenever an imbalance in the balance of payments occurred. But historical experience with adjustable peg systems show that revaluations and devaluations are highly politicized issues and, hence, often avoided or postponed by governments if they have the choice and can use another adjustment method or can finance the external imbalance. Within a floating system the United States could circumvent the political obstacles to exchange rate changes.

A final point which may have influenced the change in the American strategy was the rather positive experience with floating exchange rates in 1973. The leading US Treasury officials expressed satisfaction with the working of widespread floating. Despite the fears of business circles international trade and investment was not seen to have been seriously impaired.34

At the Rome-meeting of the C-20 in January 1974 there was a widespread realization that insurmountable obstacles to agreement would make further negotiations on a large-scale reform a futile exercise. It was agreed to abandon all further work on a 'Grand Design'. Instead the following months were used to work out guidelines for the management of floating rates and proposals for concrete "immediate steps" which were much more limited in scope than the originally planned reform.

The "Guidelines for Floating Rates" and the proposed immediate steps were issued in the C-20's final report (Outline of Reform) prepared for its last meeting in Washington in June 1974. The establishment of an Interim Committee as a new IMF-forum at ministerial level was among the proposed measures; it proved to be uncontroversial and could be acted upon already in 1974. The C-20 proposed also to regularize the floating of exchange rates by amending the IMF's Articles of Agreement. Under the old rules, floating was illegal. This point proved to be very controversial and the issue was first taken up for serious negotiations in 1975.

34 Secretary Shultz, quoted in IHT 7 June 1973, and Under Secretary Volcker, quoted in JC 27 May 1973. Arthur Burns, the Chairman of the Federal Reserve, kept his reservations about floating rates. But the Treasury was responsible for the C-20 negotiations on the American side.
The official German attitude to the failure of the C-20 negotiations could hardly be called regret. During the worldwide inflationary surge in 1973 German policymakers appreciated the floating DM/dollar rate as a shield against imported inflation. In fact, it was considered as an indispensable protection of the external flank in the pursuit of domestic price stabilization.\textsuperscript{35} This was clearly the decisive motive for the continued German support of floating exchange rates. It also explains the luke-warm German support in the C-20 for a monetary reform on the basis of an adjustable peg system. But also the rather positive experience with floating rates in 1973 and 1974 has probably contributed to the German stance. According to Bundesbank Vice President Emminger, floating was working better than expected without hampering the expansion of world trade in 1973. It was not seen as an ideal system, but as the only alternative at the time.\textsuperscript{36}

B.2.2. The Mini-Reform Negotiations in 1975

After a one-year break the question of the exchange rate regime was taken up again within the IMF-framework in 1975. The Interim Committee met in Paris in June 1975 to negotiate a change in the IMF-articles necessitated by the de-facto transition to widespread floating in 1973. The other issues on the negotiating table were the future role of gold and an increase of the IMF-quotas. While these two issues could be settled quite swiftly during the summer months of 1975, the question of the exchange rate system turned out to be intractable. The main contenders were the pro-floating Americans and the French, who favoured a fixed exchange rate system. It required a summit meeting of the leading industrial nations (to be held in Rambouillet near Paris in November 1975) before a solution to this problem could be found. The agreement was formally adopted by the Interim Committee on Jamaica in January 1976 and later ratified by the IMF members. The negotiations about this partial reform of the international monetary system showed that the US-German consensus on the desirability of a floating DM/dollar rate had been firmly established by 1975.


\textsuperscript{36} \textbf{The Times} 31 October 1973; \textbf{Time Magazine} 10 June 1974
The US Treasury had been reluctant to express its wholehearted support of floating rates as long as the C-20 negotiations went on. But in 1975 US policy became unequivocally pro-floating. In March the Secretary of the Treasury, William Simon, declared to a Congress committee that he would aim at a legalization of floating in the IMF-negotiations.37 In a later testimony to Congress Mr Simon praised the virtues and rejected all the criticisms of floating rates.38 According to Mr Simon's statement, floating had made the world economy less chaotic in the preceding years than it would have been with fixed rates. Inflation had been the cause and not the consequence of floating which, on the contrary, could protect a country against imported inflation. Floating had not impaired world trade, but prevented protectionism during the energy crisis and the world recession of 1974/75. Referring directly to the special US interests in a floating dollar, Mr Simon said that the United States preferred to have the dollar's exchange rates and the structure of the US balance of payments determined by market forces than by the balance-of-payments objectives of other countries. He regarded the dissatisfaction of some other countries with the floating dollar rate as an expression of their now frustrated desire to maintain an undervalued currency within a fixed exchange rate system. In general, the relationship between the dollar's exchange rates and the competitiveness of American goods and services formed the leitmotif of the testimony.

In his speech to the IMF Annual Meeting on September 2, 1975, the Treasury Secretary made the US position very clear:

"US policy is to have our own exchange rate determined essentially by market forces, and not by arbitrary official actions. We do not propose to object if foreign countries elect to establish fixed exchange rates among themselves - the essence of a voluntary system is to permit a free choice - so long as our own desire for essential freedom of the dollar exchange rate is respected."

He continued to say that any agreement on amendment of the exchange rate provisions in the IMF articles should guarantee a "clear and unencumbered right to float".

France was the main adversary of the United States during the monetary negotiations of 1975, both with regard to gold and to exchange rates. According

37 FT 25 March 1975.
38 AP no.50/1975, 29 July 1975
39 AP no.62/1975, 9 September 1975
to the French view, floating was an anomaly and an amendment of the IMF-articles should maintain fixed rates as the standard. Unable to assemble a common European position on this issue, France had to stand up against the United States almost on her own in the IMF-negotiations.

The German view was clearly on the American side in this dispute. The French proposal to establish intervention zones around a pre-determined dollar rate was totally unacceptable to the Germans. The German satisfaction with a floating DM/dollar rate was expressed by the Bundesbank in an Annual Report published in April 1973:

"In retrospect it can be seen that the suspension of mandatory support of the US dollar and the floating of the Deutsche Mark in March 1973 were not only inevitable under the prevailing circumstances, but also proved effective in the subsequent period as a flanking measure and as a shield to domestic stabilisation policy. Without flexible exchange rates vis-à-vis the US dollar and other major currencies German monetary policy would hardly have had a chance in the following turbulent years to protect its efforts to achieve domestic stability against disturbances created by interest-rate-induced and speculative capital inflows and against the general inflation marasmus in the world economy. The appreciation of the Deutsche Mark following the decision to float dampened the effects both of the soaring raw material and oil prices of 1973-74 and of the inflationary demand pull from abroad on the German economy."

In general, the German-French difference of opinion with regard to the flexibility of the dollar rate corresponded to their different approaches to European monetary integration at that time. According to the German "economist" view the harmonization of general economic policies was a precondition for successful monetary union with fixed exchange rates within the European Community. Coordination of fiscal and monetary policies on a non-inflationary course should come first, monetary unification afterwards. The French "monetarist" stance regarded the establishment of a "parity-grid" among EC-currencies as the first step. The discipline of fixed rates would then lead to a coordination of general economic policies in a second phase.

With floating as an accomplished fact and realizing that the United States would not agree to any pegging of the dollar rate, the Germans remained discreetly on the sidelines of the French-American dispute. However, not being

40 DB, Annual Report 1974, p.35
willing to back the EC-partner on the substance of the issue, the German Chancellor Helmut Schmidt supported the French President Giscard d’Estaing in persuading US President Ford to participate in a summit meeting of the main OECD-countries to settle the dispute.\textsuperscript{42} A conference of the heads of state and government of France, Germany, Japan, Britain, Italy, and the United States was held in Rambouillet in November 1975. It should turn out to be the first of the now institutionalized annual economic summit meetings of the seven major industrialized countries.\textsuperscript{43}

In the weeks before the summit the French position had softened considerably. The emphasis on fixed exchange rates had been replaced with "stable rates" allowing for "exchange rate viscosity"\textsuperscript{44} implying that France would give up her insistence that any amended IMF charter should provide for the eventual re-establishment of a fixed exchange rate system. That paved the way for an American-French accord at Rambouillet on the amendment of the IMF Articles of Agreement.

Subsequently the Interim Committee agreed on the new exchange rate article at its meeting in Jamaica in January 1976. The amendment provided that a reintroduction of a fixed exchange rate system would require an 85 per cent affirmative vote in the IMF, which would give the United States an effective veto.

The negotiations in 1975 on the so-called mini-reform of the international monetary system had settled decisively for the US scenario.\textsuperscript{45} The American negotiators were in a very strong bargaining position due to the fact that floating was an established reality and that the United States was willing to live with the illegality of floating if no acceptable agreement could be found.\textsuperscript{46} Furthermore, the oil crisis of 1973/74 had led to a general shift in power among the major industrialized countries.\textsuperscript{47} The US position had been strengthened at the expense of – amongst others – France, which suffered from a severe

\textsuperscript{42} Rainer Hellmann, Dollar, Gold und Schlange, Baden-Baden, 1976, p.109
\textsuperscript{43} From 1976 onwards Canada participated in these meetings.
\textsuperscript{45} This was not only the case for the exchange rate amendment, but also with regard to the future role of gold. Tew, \textit{op.cit.} p.205
\textsuperscript{46} William Simon had declared in July 1975 that no agreement would be better than a bad one for the United States. \textit{NZZ} 22 July 1975
oil-induced payments deficit. The legalization of floating in Jamaica was the logical result of the constellation of interests and the distribution of power in 1975.

The statements made and the positions taken by the American and German monetary authorities under the negotiations in 1975 show clearly that both countries were quite content with floating under the existing circumstances. They were not willing to commit themselves in any way to a return to a fixed exchange rate system. Their consensus on the preferred type of exchange rate system was evident. But the German satisfaction with floating was primarily based on its role in stabilization policy, whereas the Americans primarily praised floating as a flexible balance-of-payments adjustment mechanism.
Part C

DIRECT INTERVENTIONS IN THE DM/DOLLAR MARKET 1973-1983

The present part is a survey on the use of direct interventions in the DM/dollar market in the first ten years of widespread floating (March 1973 - March 1983). There are two reasons why intervention policy is singled out for this special presentation from the whole complex of DM/dollar exchange rate management. Firstly, it is practical to describe the institutional framework and the technical-economic procedures of DM/dollar interventions as general background for the main analysis in the following parts. Secondly, it may be helpful to the reader to have the characteristics of US and German intervention policies described in outline for the whole 1973-1983 period, before Parts D, E, and F treat the intervention operations as part of the broader subject of DM/dollar exchange rate management in three subperiods.

The "Main Chart" in the Appendix provides a graphical illustration of the DM/dollar exchange rate development and the intervention activity in the DM/dollar market. It shows how the size of US and German interventions varied over the 1973-83 period. The discussion of the characteristics of US and German interventions in the following two chapters will shed further light on this chart.

C.1. US Intervention Policy

C.1.1. The Institutional Framework

Constitutionally speaking, the US Treasury Department as part of the Executive Branch holds primacy in the making of US international monetary policy, while the Federal Reserve System is guaranteed independence in domestic monetary policy. But with regard to US interventions in foreign exchange markets the reality is a delicate and complex partnership between the two institutions.¹ Based on an unwritten sense of teamwork the Treasury and the

Federal Reserve have sought consensus on general market intervention policy and specific currency interventions. Without going into the details of the policymaking procedures it can be generally stated that the Federal Reserve had an important say in the conduct of US intervention policy due to its role as financier and daily operator, but that the Treasury retained ultimate control with a de facto veto power over all interventions. Because the Treasury in general was less inclined to intervene than the Federal Reserve, this veto power was crucial for the making of US intervention policy in the 1973-1983 period.

The Treasury's influence on US intervention policy has contributed to a certain volatility on the American side of the DM/dollar exchange rate management, because every new administration is apt to reconsider the proper role of interventions in US exchange rate policy when it takes office. Different beliefs and perceptions of top economic policymakers have therefore been a source of change in US intervention policy as the transition of power from the Carter to the Reagan administration showed so vividly in early 1981.

With regard to the implementation of US intervention policy the Federal Reserve Bank of New York (FRBNY) acts as an agent for the Treasury and the Federal Reserve. In that respect the New York Fed is solely a service organization for the two Washington-based institutions. The foreign exchange trading desk of the FRBNY is under close guidance from Washington and has only a very limited discretionary power in the conduct of interventions. All "significant" amounts of intervention have to be cleared with both the Treasury and the Federal Reserve.

The American intervention operations were largely confined to the New York foreign exchange market. On a few occasions in 1979 and 1980 the US authorities conducted additional DM/dollar interventions in the overnight markets of the Far East. In 1980 they also intervened in Frankfurt by using the Bundesbank as an agent. All interventions have been spot transactions

2 ibid. p.41
3 ibid. pp.39,43; see also Charles A. Coombs, The Arena of International Finance, New York, 1976, p.72
4 John S. Odell has demonstrated that the policy beliefs, perceptions, and priorities of individual US monetary officials have been an important source of change in US international monetary policy in the 1960s and early 1970s. US International Monetary Policy. Markets, Power, and Ideas as Sources of Change, Princeton, N.J., 1982
5 Cohen, op.cit. pp.50ff
and more than 90 per cent have been made in the DM/dollar market. Most of the remaining interventions have been in Swiss francs and these have always been carried out in the same direction as the DM-interventions. From 1973 to 1977 the Americans intervened on a very small scale in French and Belgian francs and Dutch guilder.\(^7\) Likewise, there were a few instances of modest US interventions in the yen/dollar market between 1978 and 1982.

The concentration on the DM in US intervention policy is explained with the dominant role of the DM among European currencies. Influencing the DM/dollar rate was seen as the most efficient intervention method by the US policymakers, because the dollar's rate vis-à-vis the other European currencies (perhaps with the exception of the British pound) moved in conjunction with the DM/dollar rate. Interventions in the DM/dollar market were even seen to have an effect on the yen/dollar rate.\(^8\) Furthermore, interventions in other European currencies seemed to involve various technical problems for the Federal Reserve.\(^9\)

The US Treasury and Federal Reserve are probably the most forthcoming financial authorities of any of the major countries in reporting (with a lag) their exchange market interventions.\(^10\) The New York Fed submits quarterly and semi-annual reports on its foreign exchange operations, which are published in its *Quarterly Review* and in the *Federal Reserve Bulletin*. These reports provide the exact amounts of US interventions, describe their exchange market context, and indicate the official reasons for the US intervention activity.

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7 Interventions in French francs were shortly resumed in the summer of 1980.
8 This rationale for the DM-focus of US interventions has been given by various officials in the US Treasury and the Federal Reserve in interviews with the author.
10 Thomas D. Willett, "The Fall and Rise of the Dollar", *Testimony before the Subcommittee on International Economics of the Joint Economic Committee (US Congress)*, American Enterprise Institute, reprint no.96 (April 1979), p.10
C.1.2. The Financing of Interventions

When widespread floating began in 1973 the US monetary authorities owned almost no foreign exchange reserves. Under the previous dollar-gold exchange standard the dollar had been pegged to gold, and all other currencies had in practice been pegged to the dollar. Because the United States was not supposed to maintain the dollar's value in terms of any other national currency, there had been no need for foreign exchange in US official reserves which mainly consisted of $11.7 billion worth of gold in 1973.\textsuperscript{11} This lack of foreign exchange (apart from modest working balances) obliged the US authorities to rely on borrowed funds when they started to support the floating dollar by selling foreign currencies in the exchange market from mid-1973 onwards.

The Federal Reserve's so-called "swap arrangements" with the German Bundesbank provided 52 per cent of the funds which the US authorities used for dollar-supporting interventions in the DM/dollar market in the period under review. Swap arrangements (or swap lines) between the Federal Reserve and other central banks are bilateral and reciprocal short-term credit lines. Under such an arrangement loans can be swapped at the request of either central bank. For example, if the Federal Reserve needs DMs for its exchange market operations, it can borrow the needed amount from the Bundesbank in return for an equivalent sum of dollars. The transaction is reversed three months later, but the swap can also be rolled over for another three-month period by mutual consent.

These credit facilities had been devised by the Americans early in 1962. The first swap arrangement was a $50 mio. credit line between the Federal Reserve and the Banque de France. One year later all the major European central banks were linked up with the Federal Reserve in this way. The limits of the various swap lines were increased several times in the 1960s. By 1965 they had been built up to a total of $2.8 billion.

In the 1960s the swap line between the Federal Reserve and the Bank of England was the largest and the most heavily used with Britain as the persistent borrower. The dollars, which the Bank of England obtained in this way, were used for supporting sterling in the exchange market. The United States, on the other hand, used the swap lines with the Continental European central

\textsuperscript{11} Valued at the then official gold price of $42.2 per troy ounce. In addition, the US Treasury held Special Drawing Rights ($2.2 billion) and the US reserve position in the IMF ($0.6 billion).
banks to protect the American gold reserves. When the dollar was under downward pressure, the European central banks often accumulated unwanted dollar reserves in the process of maintaining the dollar parities of their currencies. The American authorities tried to avoid the conversion of such dollar holdings into US gold in various ways, inter alia by guaranteeing the exchange value of the unwanted dollars through swap transactions with the European central banks.12

When President Nixon abolished the dollar’s gold-convertibility on August 15, 1971, he also suspended the use of the swap arrangements. Apart from a short interlude with US swap-financed interventions in July 1972, the credit facilities were first reactivated in July 1973, when the United States started to support the floating dollar with exchange market interventions. At the same time the total value of the Federal Reserve’s swap lines with fourteen central banks and the BIS was increased from $11.7 billion to $18 billion. During the dollar crisis in 1978 the Federal Reserve’s swap lines with the central banks of Germany, Japan, and Switzerland were boosted with a total amount of $9.6 billion. Together with some minor increases of other swap lines between 1973 and 1982, this resulted in total swap facilities of $30.4 billion in early 1983. The table on the following page shows, how this sum was divided between the various central banks.

When the swap arrangements were reactivated in July 1973, their provisions were changed in such a way that the exchange rate risk on US drawings was shared evenly with the foreign central banks on which the drawings were being made. The interest rates paid on swap drawings continued to be based on the current rates for US Treasury bills. These rules were valid until 1981 when US swap drawings had ceased.13

12 For instance, when the Netherlands Bank had acquired dollars in the exchange market it could in principle convert these dollars into gold at the US Treasury which would protect the value of the Dutch reserve gain against a dollar devaluation. However, under the swap-rules in the 1960s a swap transaction with the Federal Reserve functioned as a 3-month forward contract and covered therefore the open dollar position of the Netherlands Bank in this period. Afterwards the swap could either be rolled over for another 3-month period or be exchanged for longer-term ‘Roosa’-bonds (see footnote 29 on p.2-52). Alternatively, the Federal Reserve could redeem the Dutch dollar assets with guilder borrowed from the IMF or purchased directly in the exchange market (provided the downward pressure on the dollar had receded in the meantime). Gerald H. Anderson, "Federal Reserve Swaps", Federal Reserve Bank of Cleveland's Economic Commentary, 9 February 1976

13 FRB March 1981, pp.211f. Under procedures beginning in 1981 the Federal Reserve, like its counterparts in the swap arrangements, takes the full exchange risk on its swap drawings. The rate of interest is based on the creditor country’s Treasury bill rate or the nearest equivalent market rate.
Federal Reserve reciprocal currency arrangements

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<tr>
<td>Austrian National Bank</td>
<td>1,500</td>
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<tr>
<td>National Bank of Belgium</td>
<td>3,000</td>
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<tr>
<td>Bank of Canada</td>
<td>300</td>
<td>300</td>
<td>300</td>
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<tr>
<td>National Bank of Denmark</td>
<td>1,500</td>
<td>1,550</td>
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<tr>
<td>Bank of England</td>
<td>3,000</td>
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<td>Bank of France</td>
<td>2,000</td>
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<tr>
<td>German Federal Bank</td>
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<td>Bank of Italy</td>
<td>3,000</td>
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<tr>
<td>Bank of Japan</td>
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<tr>
<td>Bank of Mexico</td>
<td>700</td>
<td>700</td>
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</tr>
<tr>
<td>Regular facility</td>
<td>9</td>
<td>325</td>
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<tr>
<td>Special facility</td>
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<td>250</td>
<td>250</td>
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<tr>
<td>Bank for International Settlements</td>
<td>300</td>
<td>300</td>
<td>300</td>
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<tr>
<td>Bank of Sweden</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
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<tr>
<td>Swiss National Bank</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Other authorized European currencies</td>
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</tr>
<tr>
<td>Total</td>
<td>20,100</td>
<td>225</td>
<td>20,425</td>
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Source: FRB March 1983, p.141

While the US authorities had used the swap facilities to protect their gold reserves under the dollar-gold convertibility of the 1960s, they used them to acquire short-term funds for dollar-supporting interventions in the 1973-1980 period. Because US intervention activity was concentrated in the DM/dollar market, the swap line between the Federal Reserve and the Bundesbank was by far the most heavily used of the 15 reciprocal currency arrangements. The Federal Reserve was always the initiating party in the period under review, and it drew and repaid a total of $15.5 billion equivalent of DMs. The maximum outstanding debt on this swap line was $4.6 billion at the end of 1978. US swap drawings in Swiss francs - the second most important intervention currency of the United States - amounted to less than one tenth of DM-drawings. The other swap lines were only used scarcely or not at all. By the end of 1980 the Federal Reserve had repaid its last swap debt to the Bundesbank and it has not made swap drawings since.

A separate swap arrangement between the US Treasury and the Bundesbank was established in January 1978. The total size of this facility has never been published, but the maximum outstanding debt has been $1 billion. The Treasury used its swap line only in 1978, when it drew a total amount of $2.5 billion, which had been completely repaid by the end of April 1979. That means, that 8 per cent of all US DM-sales in the exchange market has been financed with drawings on the Treasury's swap line.

Hence, Federal Reserve or Treasury swaps with the Bundesbank were used for 60 per cent of all US dollar-supporting interventions in the DM/dollar market.
The remaining 40 per cent ($11.6 billion) were financed directly out of US foreign exchange reserves. Before November 1978 these holdings were only modest working balances, but then the US Treasury started to accumulate more substantial amounts of foreign exchange. It converted $3 billion of its reserve position in the IMF and $1.4 billion of its SDR-holdings into DMs and yen in late 1978. In addition, the US foreign exchange reserves were temporarily increased with medium-term loans in DMs and Swiss francs: between December 1978 and January 1980 DM-denominated Treasury securities were sold in the German capital market for a total value of $5.2 billion. Similarly, the Treasury acquired $1.2 billion of Swiss francs by floating Swiss franc-denominated securities on the Swiss capital market. These securities, which became known as Carter-bonds, had maturities between 2½ and 4 years and had been completely redeemed by mid-1983. Then, the US foreign exchange reserves amounted to $10 billion.

The build-up of US foreign exchange reserves to $10 billion as well as the repayment of swap loans and the redemption of Carter-bonds was partly financed through market purchases of DMs and other currencies. But the largest part of the foreign exchange needed for these purposes was acquired off-market from so-called "correspondents",14 These were typically other central banks (not least the Bundesbank) or, for instance, an international organization like the World Bank. Swap drawings and Carter-bonds served therefore only as short- and medium-term bridging operations in the financing of the US intervention activity. Ultimately, the American dollar-supporting interventions were not financed with loans, but with purchases of DMs and other foreign exchange for dollars.

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14 The amounts of foreign exchange purchased by the FRBNY has not always been split up exactly between on- and off-market transactions in its reports on foreign exchange operations. The proportion has often only been indicated verbally with expressions like "purchases largely from correspondents" or "a small amount was purchased in the market, the rest from correspondents." A conservative estimate would suggest that not more than $10 billion equivalent of DMs was purchased in the DM/dollar market out of total DM-purchases equivalent of $29.3 billion between mid-1973 and early 1981.
C.1.3. The Changing American Approach to Exchange Market Interventions

The present section outlines the American operations in the DM/dollar market in the 1973-1983 period. The targets, size, and characteristics of US interventions are described, whereas background, ultimate objectives, and some particular episodes are analyzed in following chapters. Because there have been distinct changes in the American approach to exchange market interventions in July 1973, in October/November 1978, and in early 1981, the presentation is divided into subsections.

C.1.3.1. The Limited Intervention Policy, July 1973 - October 1978

During the first four months of generalized floating in 1973, the US monetary authorities did not intervene in the exchange markets at all. In July 1973, after a dramatic fall in the dollar's value against the European currencies, the United States began to support the dollar in the exchange market and declared that "active (US) intervention will take place in the future at whatever times and in whatever amounts are appropriate for maintaining orderly market conditions." This target was in accordance with the loosely defined ground rule for interventions which had been determined at the meeting of the Group of Ten and the European Community in Paris on 16 March 1973, when ministers and central bank governors "agreed in principle that official intervention in the exchange market may be useful at appropriate times to facilitate the maintenance of orderly conditions."

After July 1973 US officials gradually switched to the expression "countering disorderly market conditions" when they explained US intervention policy. Although the difference between the expressions may appear to be only one of nuance, the new wording more accurately reflected the American policy. The experiences with widespread floating in 1973/74 had shown all too clearly, that interventions could not ensure orderly market conditions. Therefore the new wording did not promise the attainment of this goal, but only that orderly exchange market conditions would be pursued.

16 NYT 17 March 1973
In November 1975, at the Rambouillet summit conference, President Ford signed a declaration obliging the US. monetary authorities "to counter disorderly market conditions, or erratic fluctuations in exchange rates." The Secretary of the Treasury stressed that this formula did not signify any essential change in US intervention policy. He regarded erratic exchange rate fluctuations as identical with disorderly market conditions.

In April 1978, pursuant to the notification provisions of the amended IMF articles of agreement, the United States notified the IMF that "exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the (US) authorities will intervene when necessary to counter disorderly conditions in the exchange markets."

The definition of disorderly markets was left open and subject to interpretation by the authorities. No serious attempt to define disorderly market conditions with any precision was made in the early years of floating. Monetary officials in the United States and elsewhere often said that they could not define a disorderly market, but they knew it when they saw it. Although it has never been possible to devise a common, comprehensive operational definition of "disorderly markets", the US Treasury started in 1978 to identify the phenomenon with substantial widening of bid-asked spreads, large intra-day exchange rate movements, and "thin" or highly uncertain trading.

17 IMF Survey, 1975, no.4, p.350
18 Treasury Secretary William Simon as quoted in JC, 20 November 1975
19 "In our view, the terms "erratic" and "disorderly", while not precisely defined or precisely definable in advance, are synonymous, in the sense that they are both meant to describe a situation in which the markets are not functioning properly. Put another way, it is in our view likely that erratic fluctuations would be characterized by disorderly market conditions."

20 ERP 1982, p.190
21 In 1973 US Treasury Secretary George Shultz characterized disorderly market conditions loosely as "very drastic fluctuations without coherence", ITT, 7 June 1973
22 See for instance the remarks by C. Fred Bergsten, Assistant Secretary for Monetary Affairs in the US Treasury, as quoted in Hb, 13 March 1978
US intervention policy was limited to short-term conditions and to one side of the market in the 1973-78 period. Interventions should only "brake an excessively sharp decline of the dollar on any single day." They should not moderate exchange rate movements over extended periods and they were never geared to counter disorderly market conditions when the dollar was under upward pressure. It is fair to characterize US policy until late 1978 as one in which intervention was the exception, and not the rule.

Until December 1977 the size of US interventions was very modest. The FRB NY sold only $3.4 billion equivalent of DMs in this period, which implies an average of $3 mio. per trading day. In the following eleven months, until late October 1978, the daily average of US dollar-supporting interventions was six times as high with total DM-sales amounting to $4.1 billion. This perceptible increase in US intervention activity did not change the principles of US intervention policy, but signified only a more forceful stance in the countering of disorderly market conditions.

Until November 1978 the US monetary authorities purchased $6 billion equivalent of DMs - about one third in the market and two thirds from correspondents. The only purpose of these purchases was to acquire DMs to repay swap loans and to replenish the Federal Reserve's and the Treasury's working balances after a period with dollar-supporting DM-sales in the exchange market. The market purchases were made as discreetly as possible so as not to reinforce or reignite downward pressures on the dollar. Because the DM-purchases were not intended to influence the DM/dollar rate, the US policymakers did not regard them as exchange market interventions in the narrow sense of the term.

23 Coombs, op.cit. p.234

24 In the reports on "Treasury and Federal Reserve Foreign Exchange Operations" the market purchases of DMs were typically described in the following ways:

- "....the System took the opportunity of a strengthening dollar to acquire currencies to repay debt." (FRB September 1975, p.356)
- "....with the dollar gradually gaining greater buoyancy, the Federal Reserve continued its program of acquiring marks to repay debt whenever market conditions permitted." (FRB September 1975, p.359)
- "At other times the Trading Desk was able to purchase modest amounts of marks for System balances mostly from correspondents but also in the market when trading was quiet." (FRB March 1977, p.205)
This distinction between interventions in a narrow and a broad sense reflected the widely held belief among US officials involved in intervention policy, that the way in which interventions were made was decisive for their effects. Given the enormous volume of dollar-denominated funds in the world, the limited US interventions were at best seen to affect market psychology by sending a signal of official concern and determination to the private market participants. Discreet market purchases of foreign currency under quiet exchange market conditions and, in particular, in off-market transactions were not seen to bring about such effects.

C.1.3.2. **Large-Scale Interventions, October 1978 - February 1981**

During the dollar's dramatic decline in October 1978 the United States initiated a new intervention policy, which was considerably more active. It lasted until shortly after the Carter administration left office in early 1981. Compared with the preceding years, both the scope and the size of US interventions was increased significantly.

The intervention strategy was broadened from the limited target of influencing short-term market conditions to include the attempt to influence the level of the DM/dollar rate over longer periods. Official statements in this period avoided mention of the policy to intervene only in disorderly market situations. Now it was said that interventions would be used to restore market stability and to correct exchange rate movements which clearly exceeded changes warranted by underlying factors. This was especially the rationale of US interventions at the outset of the new approach in the autumn of 1978. Subsequently the US authorities typically sold DMs in order to moderate downward movements in the DM/dollar rate in periods up to several months. This practice is usually called a "leaning-against-the-wind" strategy.  

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25 This distinction between interventions in a broad and a narrow sense was clearly made by senior FRBNY-officials at a press conference in June 1977, when they explained the Bank's foreign exchange operations. *LHT* 3 June 1977

26 "Leaning against the wind" means that the direction of intervention is determined by the current development of the exchange rate: a currency is bought when its price is falling and sold when its price is rising. The term was first used in connection with the Canadian float 1952-1960. For a discussion of the strategy see: Wilfred Ethier & Arthur I. Bloomfield, *Managing the Managed Float*, Princeton Essays in International Finance, no.112, October 1975; Raymond F. Mikesell & Henry N. Goldstein,
In the summer of 1979 it was supplemented with the attempt to prevent the dollar from falling below a certain psychological benchmark vis-à-vis the DM.

Paul Wonnacott has had access to daily figures on US interventions in the DM/dollar market between October 1977 and March 1980. Using regression analysis on these data and on the day-to-day changes in the DM/dollar rate, he has found that "there was an unmistakable tendency for the US authorities to lean against the wind". 27

The more ambitious US intervention objectives were pursued with massive sales of DM. Between late October 1978 and February 1981 the US intervention authorities sold $22 billion equivalent of DMs which represented three quarters of all American DM-sales in the ten-year period under review. The interventions were distributed unevenly (see the Main Chart), but they averaged $37 mio. per trading day.

Although truly large-scale interventions only were made on the dollar-supporting side of the market, the US authorities also modified their policy with regard to DM-purchases. Under the limited intervention policy from 1973 to 1978 the American DM-purchases had not been intended to influence the DM/dollar rate, not even even when they were made in the exchange market. Similarly, the main purpose of US DM-purchases between 1978 and 1981 (which totalled $23.2 billion) was to cover outstanding DM-liabilities. This was especially true for the off-market acquisitions of DMs which continued to constitute about two thirds of total DM-purchases by the American authorities. The novelty was, that the market purchases of DMs now partly were made with the intention to maintain orderly trading conditions and to counter strong upward pressure on the dollar. This was a clear departure from the previous abstention from attempts to influence the DM/dollar rate when the dollar was appreciating. Although US intervention policy therefore ceased to be completely one-sided in 1979 and 1980, a strong bias in favour of dollar-supporting interventions persisted nevertheless.

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C.1.3.3. The Minimal Intervention Approach, February 1981 - March 1983

Shortly after the Reagan administration had assumed office in early 1981 it stopped the practice with regular, large-scale interventions. Instead a minimal intervention approach was adopted under which US interventions became extremely rare. Officially the US authorities maintained that they adhered to the principle of using interventions to counter disorderly markets as called for under Article IV of the IMF Articles of Agreement. But unlike the Carter administration, the Reagan administration refused to define or characterize disorderly market conditions in advance.

Between late February 1981 and the end of March 1983 the United States only intervened in the DM/dollar market on five days. On one occasion in March 1981 $74.4 mio. equivalent of DMs was sold and on four occasions in 1982 a total of $66 mio. equivalent of DMs was purchased. Simultaneous with the DM-purchases in 1982, the US authorities also purchased $66 mio. equivalent of yen. No other US interventions were carried out until the end of March 1983.

C.1.4. The Impact of Dollar Interventions on US Monetary Conditions

An exchange market intervention can be either sterilised or unsterilised. Abstractly a sterilised intervention can be defined as "a change in the monetary authorities' net foreign currency assets which is offset by a corresponding change in their net domestic currency assets, so that their monetary liabilities (or, specifically, the monetary base) remain unchanged. If, on the other hand, the change in the authorities' net foreign currency assets is accompanied by a corresponding change in their monetary liabilities (so that, for instance, a reduction in foreign currency reserves would result in a reduction in the monetary base), the intervention is said to be unsterilised."

Because exchange market intervention is only one of several factors that influence the monetary base, it can be difficult to assess in an empirical analysis whether interventions in a particular period have been sterilised or not. When monetary authorities pursue growth targets for monetary aggregates, the monetary effects of intervention can be considered in some sense as having been neutralised as long as monetary targets are being met. When monetary

28 Jürgensen-report, op.cit. p.6
objectives are not met, it is a matter of judgment whether it is intervention or other factors (or both) that must be considered to have contributed to the outcome. 29

In the case of the United States, the operating procedures of monetary policy have ensured that interventions were sterilised in a quasi-automatic way in the period under review. This holds true no matter who carried out the dollar intervention, whether it was the Federal Reserve, the Bundesbank, or another central bank. Consider, for example, a dollar-supporting intervention (either by the Bundesbank or a swap-financed intervention by the Federal Reserve). The official dollar purchases drain US bank reserves of dollars and decrease thereby the US monetary base. As a corollary, the Bundesbank’s dollar reserves increase. This increase is immediately invested in US Treasury securities. The dollar-proceeds of the Treasury’s sale of securities to the Bundesbank are credited to the Treasury’s account at the Federal Reserve Bank of New York. The increase on that account is essentially the counterpart of the initial intervention-induced reduction of the monetary base. (If the dollar-supporting intervention had been financed with the Treasury’s working balances of DM, the Treasury’s dollar account at the FRBNY would have increased without the Bundesbank being involved.) “An increase in the Treasury’s balance is one of the factors that the management of the domestic Trading Desk takes into consideration in determining day-to-day open market operations. Other things equal, the domestic Trading Desk will react to an increase in the Treasury’s balance as a signal to provide reserves to the banking system to achieve the objectives specified under the directive of the Federal Open Market Committee (FOMC)” 30 In this, as in other conceivable cases of dollar interventions, undesirable liquidity effects in the United States are routinely sterilised by the Federal Reserve.

29 ibid. pp.6f
C.2. **German Intervention Policy**

C.2.1. **The Institutional Framework**

Chapter B.1. has described how Germany developed a dual exchange rate policy in the early 1970s. The division into a dollar-oriented and a European exchange rate policy became fully apparent in March 1973, when the DM began to float jointly with other European currencies against the dollar. German exchange market interventions reflected this dualism throughout the period under review. On the one side, Germany intervened in other European currencies in the context of the European narrow margins arrangement (the "snake") and the European Monetary System (EMS), which replaced the "snake" in 1979. On the other side, Germany intervened in the DM/dollar market, where the exchange rate was not pegged. The two types of intervention followed different rules.

Under German law the Frankfurt-based central bank (Deutsche Bank) is in charge of exchange market interventions. The Federal Government has the competence to fix a par value for the DM against another unit of account. If the DM is pegged against another currency, the Bundesbank is obliged to support the pegged exchange rate with interventions, if necessary. Since March 1973 the government has only used its right to determine fixed (but adjustable) DM-parities in the context of the snake and the EMS (in cooperation with the exchange rate authorities of the other European countries involved).

Interventions in the DM/dollar market, however, are optional for the Bundesbank. In this area – as in the conduct of domestic monetary policy – the Bundesbank is independent of instructions from the government. There has been close consultation and cooperation with the government in the past (especially with the Ministry of Finance\(^{31}\)), but the Bundesbank has been the primary policymaker.

The financing of interventions in the DM/dollar market posed no problems in the period under review. The Bundesbank could simply draw from and add to its sizable dollar reserves. They constituted the main part of the German foreign exchange reserves and were primarily held in US Treasury bills.

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In 1973 these dollar assets amounted to $25 billion and they increased by $15 billion net during the following ten years.

Interventions were predominantly carried out in Frankfurt. They were primarily spot transactions, but occasionally the Bundesbank intervened in the forward DM/dollar market. Since 1980 the Bundesbank has sold considerable amounts of dollars on a forward basis. \(^{32}\) Such transactions were preferred when the Bundesbank wanted to influence the spot exchange rate, but at the same time wanted to postpone the liquidity effects of an intervention. \(^{33}\)

The Bundesbank's publications provide only imperfect evidence of German interventions in the DM/dollar market. The released data indicate net changes in the Bundesbank's stock of foreign assets and liabilities (the "net foreign position")\(^{34}\) during periods of various lengths (from two weeks to six and a half months). Unlike the figures on US foreign exchange operations, the German statistics do not provide flow data about gross amounts of foreign currencies purchased and sold in the exchange market within specific periods. However, the Bundesbank tends to choose the periods in its statistics in such a way that each period represents a phase in which interventions mainly or exclusively were made in one direction (i.e., either DM-sales or DM-purchases). The data "loss", which appears when interventions in opposite directions cancel each other out, may therefore be limited. It must nevertheless be kept in mind that the data tend to underestimate the actual intervention activity in the DM/dollar market. The following table presents a summary of the published data on German foreign exchange operations in the 1973-83 period. \(^{35}\)


\(^{33}\) The Bundesbank maintains that forward interventions have some effect on the spot rate, because the Bundesbank's private partner bank in the transaction usually covers its forward purchase of dollars by borrowing dollars for a corresponding period. Then, the private bank sells the proceeds of the dollar loan in the spot market against DMs, which has the same exchange rate effect as a spot intervention by the Bundesbank. The private bank's liquidity position remains unchanged until the forward transaction is due. ibid., pp.266f

\(^{34}\) The Bundesbank's net foreign position comprises gold holdings, the IMF reserve position, SDR's, foreign exchange and other foreign assets minus foreign liabilities.

\(^{35}\) The complete set of available data is presented in the Appendix.
Changes in the Bundesbank's Net Foreign Position
April 1973 - March 1983 in bill. DM (excluding changes due to valuation adjustments)

<table>
<thead>
<tr>
<th>Periods</th>
<th>Changes in the Net Foreign Position Total</th>
<th>Caused by interventions in the DM/dollar market</th>
<th>Caused by other foreign exchange movements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>+ 6.5</td>
<td>- 7.5</td>
<td>+ 6.5</td>
</tr>
<tr>
<td>(April-Dec.)</td>
<td></td>
<td>- 1.4</td>
<td>- 0.6</td>
</tr>
<tr>
<td>1974</td>
<td>- 1.9</td>
<td>- 0.6</td>
<td>+ 0.1</td>
</tr>
<tr>
<td>1975</td>
<td>- 2.1</td>
<td>+ 11.5</td>
<td>- 5.0</td>
</tr>
<tr>
<td>1976</td>
<td>+ 8.8</td>
<td>+ 11.5</td>
<td>- 2.1</td>
</tr>
<tr>
<td>1977</td>
<td>+ 10.5</td>
<td>+ 11.3</td>
<td>- 2.1</td>
</tr>
<tr>
<td>1978</td>
<td>+ 20.5</td>
<td>+ 24.2</td>
<td>- 11.9</td>
</tr>
<tr>
<td>1979</td>
<td>- 5.2</td>
<td>+ 7.4</td>
<td>- 20.7</td>
</tr>
<tr>
<td>1980</td>
<td>- 27.1</td>
<td>- 18.3</td>
<td>+ 1.7</td>
</tr>
<tr>
<td>1981</td>
<td>- 2.2</td>
<td>- 21.6</td>
<td>+ 4.2</td>
</tr>
<tr>
<td>1982</td>
<td>+ 3.2</td>
<td>- 6.6</td>
<td>+ 6.2</td>
</tr>
<tr>
<td>1983</td>
<td>+ 9.9</td>
<td>+ 0.4</td>
<td>+ 4.8</td>
</tr>
<tr>
<td>(Jan.-March)</td>
<td>+ 20.9</td>
<td>- 10.4</td>
<td>+ 47.8</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- 16.6</td>
</tr>
</tbody>
</table>

Source: Deutsche Bundesbank, Annual Reports 1973 - 1982

The table distinguishes between interventions in the DM/dollar market, interventions within the context of the "snake"/EMS, and other foreign exchange transactions. The three categories do not only reflect the Bundesbank's own foreign exchange operations. DM-operations by foreign monetary authorities can affect the Bundesbank's net foreign position as well. For instance, Federal Reserve drawings on the swap line with the Bundesbank increase the Bundesbank's net foreign position because such a swap loan is matched by an equivalent increase in German dollar reserves. Vice versa, the net foreign position is decreased by a swap repayment. Similarly, changes in the Federal Reserve's and the US Treasury's DM-balances can affect the Bundesbank's net foreign position, because these balances typically are placed with the German central bank. In its statistics the Bundesbank has chosen to classify DM-interventions by the US authorities together with its own interventions in the DM/dollar market and not as "other reserve movements".36
If one wants to determine the Bundesbank's own interventions in the DM/dollar market, it helps to compare the Bundesbank data with the figures in the Federal Reserve's reports on US foreign exchange operations. However, an exact division of the data into German and American interventions in the DM/dollar market is impossible, because the time periods in the two sets of statistics do not always correspond with each other. Only when the periods match, the Bundesbank data can be purified for US interventions. When the German and American interventions in such periods are compared, one must still take into account that the Bundesbank's figures are net whereas the US figures are gross.37

It can be argued that the Bundesbank data on the combined US-German interventions in the DM/dollar market often have been a better expression of the Bundesbank's intervention policy than "purified" figures, which only reflect the Bundesbank's own interventions. The Bundesbank does not control the size of US intervention, but by adjusting its own interventions to the level of US interventions it can determine the total amount of DM/dollar interventions. For instance, as chapter E.2.1. will show, the Bundesbank scaled down its intervention support for the dollar in the winter of 1977/78 in response to the increase in US interventions. As long as US interventions in New York did not exceed a level, which the Bundesbank regarded as appropriate, it had control over the total amount of DM/dollar interventions. This seems especially to have been the case before 1978 and after 1980 due to the low level of US interventions in these periods. In any case, an analysis of the Bundesbank's intervention policy in the DM/dollar market must consider the statistical problems involved and the Bundesbank's reactions to changes in the size of US interventions.38

36 Even the FRBNY's purchases of DMs from correspondents were classified as "changes in the Bundesbank's net foreign position due to interventions in the DM/dollar market" provided the funds were used to repay swap debt. DB, Annual Report, 1979, p.53

37 These remarks apply also to the graphical illustration of "Changes in the Bundesbank's Net Foreign Position due to Interventions in the DM/Dollar Market" on the Main Chart in the Appendix. The columns, which represent these changes are divided into a German and a US part. The division is an estimate, partly because of the above-mentioned mismatch of time-periods and partly because of the conversion of US intervention figures from dollar into DM. (The conversion has been carried out on the basis of the average DM/dollar rate in the period concerned, but the Bundesbank's statistics may be based on a different exchange rate, e.g. the rate at the end of the year.)

38 Econometrical analyses of the Bundesbank's intervention policy in the early and mid-seventies ignored these complications, but at that time US interventions were also much smaller than in the late 1970s. See
C.2.2. The Bundesbank's Approach to Interventions in the DM/Dollar Market

Already at the outset of widespread floating in 1973 the Bundesbank did not believe that interventions should (or could) counter fundamental market trends. If anything, the Bundesbank's scepticism in this respect seems to have grown in the latter half of the 1973-83 period. In 1983 the Bundesbank's Annual Report stated that the experience since 1973 had shown that (sterilised) interventions alone cannot effectively influence an exchange rate over the medium and long run. Interventions without support from general monetary policy are not believed to have much effect on exchange rate movements which are caused by interest-rate induced capital movements or one-sided market expectations. With regard to short-term market conditions, however, the Bundesbank has consistently regarded direct interventions as a useful instrument to prevent, or at least to blunt, exchange rate fluctuations which do not serve any purposes.

As mentioned in the previous section, the Bundesbank data do not allow an exact determination of the size of German interventions. What can be said is, that in 23 periods between April 1973 and March 1983 the Bundesbank recorded net reserve gains totalling DM 76.3 billion due to interventions in the DM/dollar market. A good half of this can be attributed to DM-interventions by the US authorities and 83 per cent was gained between October 1977 and the end of 1979.

In 26 periods the Bundesbank recorded net reserve losses totalling DM 86.7 billion due to interventions in the DM/dollar market. About two fifths of these reserve losses can be attributed to DM-operations by the American


39 DB, Annual Report 1982, p.77
40 DB, Annual Report 1980, p.60; DB, Annual Report 1981, pp.73f
41 In those 23 periods in which the Bundesbank recorded net reserve gains due to interventions in the DM/dollar market, DM-interventions by the FRBNY (as defined by the Bundesbank) increased the Bundesbank's dollar reserves by an estimated DM 41.2 billion net.
authorities and 62 per cent was lost between the beginning of 1980 and the end of March 1983.

The average size of the Bundesbank's own interventions in the DM/dollar market in the 1973-83 period can be calculated to be about DM 33 mio. per trading day. Due to the aforementioned data "loss" the Bundesbank's actual intervention activity must have been somewhat higher.

The Bundesbank's intervention strategy for the DM/dollar market contained two parts. On the one side, the Bundesbank focused on market conditions on a single day or over a few days and attempted to counter disorder and to dampen hectic fluctuations in the rate. Disorderly conditions in the DM/dollar market were sometimes defined as meaning a jump in the exchange rate by more than one per cent per day. On the other side, the Bundesbank regularly tried to smooth exchange rate fluctuations over the medium term: "We (the Bundesbank) have deliberately tried to smooth out what we considered temporary (or "erratic") movements, by sometimes intervening in the same direction over several months." This is the "leaning-against-the-wind" strategy, which also was a feature of US intervention policy between 1978 and 1981. The two distinct aspects of the German intervention strategy were already clearly expressed in the Bundesbank's Annual Report for the Year 1974:

"In its intervention policy the Bundesbank's guiding principle is that interventions should be made only for the purpose of maintaining "orderly market conditions", and that fundamental trends in the market should not (and cannot) be counteracted. However, interventions have not only served to maintain orderly market conditions and avoid hectic exchange rate fluctuations from day to day. Rather, the attempt has been made to moderate excessive fluctuations in the Deutsche Mark vis-à-vis the US dollar over extended periods of time."

The Bundesbank limited the use of the "leaning-against-the-wind" strategy to temporary or "erratic" movements of the DM/dollar rate which were

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42 In those 26 periods in which the Bundesbank recorded net reserve losses due to interventions in the DM/dollar market, DM-interventions by the FRBNY (as defined by the Bundesbank) decreased the Bundesbank's reserves by an estimated DM 37.7 billion net.


44 Quote from a speech by Dr Emminger, Vice President of the Deutsche Bundesbank, at the World Banking Conference in London, 10 December 1975, AP no.86/1975, 19 December 1975. For a similar statement see also DB, Annual Report 1975, p.50.

45 DB, Annual Report 1974, p.60
defined as those that cannot be explained by basic economic trends in the countries concerned.\footnote{46} Usually it is impossible to distinguish ex-ante between temporary exchange rate fluctuations and fundamental longer-run shifts in the exchange rate. The Bundesbank had to "feel its way" by trial and error.\footnote{47} It often acted on the presumption that exchange rate movements should be partially resisted until it could be determined better whether they represented a longer-run shift or a temporary and possibly self-reversing change.\footnote{48}

Although the Bundesbank's basic approach to interventions in the DM/dollar market was relatively stable throughout the 1973-83 period, the intensity of the Bundesbank's smoothing operations varied with the perceived implications of DM/dollar exchange rate movements for the Bundesbank's policy objectives. When price stability, an appropriate level of economic activity, or intra-European exchange rate stability was seen to be endangered by movements in the DM/dollar rate, the Bundesbank tended to intervene more forcefully. At other times the Bundesbank has clearly refrained from "leaning against the wind", especially when it regarded the DM/dollar rate as misaligned and the rate moved in the right direction according to this judgment. Occasionally the Bundesbank's activity in the DM/dollar market depended also on the intervention behaviour of other countries, especially the United States.\footnote{49} It has already been mentioned above that the Bundesbank for instance reduced its intervention activity in response to an increase in US interventions in the winter of 1977/78.

The available intervention data suggest that the Bundesbank made regular use of the "leaning-against-the-wind" strategy, but a true test of the strategy is impossible. The following table and the Main Chart show that increases in the German reserves due to interventions in the DM/dollar market tended to coincide with periods of dollar depreciation. Vice versa, reserve losses tended to coincide with dollar appreciations. This pattern remains when the data are "purified" for interventions by the FRENZY and only reflect the Bundesbank's own interventions. It must be kept in mind, however, that

\footnote{46} Emminger, \textit{op.cit.} (footnote 44). Hence, with regard to the expression "erratic fluctuations" the German interpretation differed from the view of the US Treasury (cf. p.C-9).

\footnote{47} \textit{ibid.}

\footnote{48} \textit{ibid.}; Gleske, \textit{op.cit.} p.266; Jurgensen-report, \textit{op.cit.} p.11

\footnote{49} This was confirmed by Leonhard Gleske, Bundesbank Director in charge of foreign exchange operations, in a speech at a conference in Frankfurt on 14/15 May 1982.

| Change in the Bundesbank's Net Foreign Position due to Interventions in the DM/Dollar Market | Movement in the DM/Dollar Rate |
| --- | --- | --- |
|  | Dollar-Depreciation | Dollar-Appreciation | Unchanged |
| Increase (Net Dollar Purchase) | 17 (17) | 1 (1) | 5 (5) |
| Decrease (Net Dollar Sale) | 3 (3) | 18 (17) | 5 (3) |
| Unchanged | 1 (1) | 0 (1) | 1 (3) |

*The numbers in brackets show the results when the German data on "changes in the Bundesbank's net foreign position due to interventions in the DM/dollar market" are purified for interventions by the FRBNY.*

*Defined on the basis of a comparison between the average DM/dollar rate in the first and the last week of the respective period. The DM/dollar rate is seen to have remained unchanged when the change has not exceeded 0.02 DM/$.

The periods are rather arbitrarily chosen by the Bundesbank, and that the DM/dollar rate never moved steadily in one direction during the relatively long periods. 50 Asymmetric "leaning-against-the-wind" interventions within such periods can lead to that the net figures suggest an aggressive intervention policy (or a "leaning with the wind"). 51 For instance, the Bundesbank made net dollar sales in April/May 1973, when there was a net decline of the dollar against the DM. Comments by the Bundesbank in its weekly reports suggest that it was selling a substantial amount of dollars during the slight rise in the DM/dollar rate in April, while it was only buying a relatively small amount of dollars during the dollar depreciation in May.

50 The division into 51 periods of variable length does not only reflect turning points in the development of the DM/dollar rate, but sometimes the date of a realignment in the snake or the EMS, or the end of the year or a reporting period.

51 Aggressive interventions were defined by the 1974 IMF guidelines for the management of floating exchange rates as they stated that a "(IMF) member should not normally act aggressively with respect to the exchange value of its currency (i.e. should not so act as to depress that value when it is falling, or to enhance that value when it is rising)." IMF Annual Report 1974, pp.112-116.
C.2.3. Exchange Market Interventions and German Monetary Policy

Under the fixed exchange rate system the Bundesbank neutralized the liquidity effect of foreign exchange operations to a very large extent through offsetting changes in the domestic component of the monetary base. During the dollar crises in the early 1970s obligatory interventions in the DM/dollar market became so large, that the Bundesbank could not sterilise them to the extent which it deemed appropriate. This came to an end with the transition to a floating DM/dollar rate in March 1973:

"The end of mandatory intervention heralded a completely new chapter for German domestic monetary policy. From then on, the external flank of stabilization policy was largely protected, control of the domestic money supply reverted to the Bundesbank, and speculative currency crises lost their sting."53

Since December 1974 the Bundesbank has regularly announced a monetary target for the following year every December. The target is stated in terms of central bank money as defined by the Bundesbank.

<table>
<thead>
<tr>
<th>Growth in German Central Bank Money: Targets and Outcomes 1975 - 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in per cent)</td>
</tr>
<tr>
<td>end 1974 - end 1975</td>
</tr>
<tr>
<td>average 1975 - 1976</td>
</tr>
<tr>
<td>- 1976 - 1977</td>
</tr>
<tr>
<td>- 1977 - 1978</td>
</tr>
<tr>
<td>1978 IV - 1979 IV</td>
</tr>
<tr>
<td>1979 IV - 1980 IV</td>
</tr>
<tr>
<td>1980 IV - 1981 IV</td>
</tr>
<tr>
<td>1981 IV - 1982 IV</td>
</tr>
<tr>
<td>1982 IV - 1983 IV</td>
</tr>
</tbody>
</table>

Source: Deutsche Bundesbank, Annual Reports


Unlike in the United States, the procedures of monetary policymaking in Germany did not ensure that interventions were sterilised automatically. Especially in 1977/78 massive DM/dollar interventions contributed to the monetary overshooting. But it would be wrong to assume that deviations from the monetary target happened because the Bundesbank was unable to sterilise the liquidity effects of foreign exchange operations. In 1978, for instance, the Bundesbank deliberately decided to accept a temporary overshooting of the original monetary target a few months after it had been set. In spite of mandatory interventions within the currency snake and the EMS and optional interventions in the DM/dollar market, which sometimes reached massive proportions, the Bundesbank's control over monetary conditions in Germany was never decisively undermined by currency inflows after the transition to a floating DM/dollar rate in March 1973.

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54 The stock of central bank money exceeded its growth target due to strong increases in the Bundesbank's foreign reserves in 6 quarters in the years 1975-1978. In four of these quarters (1975 I, 1977 IV, 1978 I, 1978 IV) interventions in the DM/dollar market were clearly the main source of monetary expansion. In these periods the Bundesbank's domestic monetary operations did not offset the liquidity-increasing effects of dollar-supporting interventions sufficiently to keep the growth of central bank money at the target rate. In another 7 quarters in 1975 - 1978, however, the monetary target was overshot even though the Bundesbank's net foreign position remained unchanged or even declined. Harmen Lehment, op.cit., pp.26-32.

In Part B it was shown how the United States and Germany came to share a preference for a floating DM/dollar rate in the first half of the 1970s. Floating benefitted the US balance of payments and German stabilization policy. The development of the floating DM/dollar rate was of secondary importance compared with the fact that the exchange rate was not pegged anymore.

Yet both sides took an interest in the movements of the DM/dollar rate after the onset of floating in March 1973. In the first four and a half years up to October 1977 the DM/dollar rate fluctuated in the range between 2.25 and 2.85 (see the Main Chart). Differences between the actual exchange rate and policymakers' preferences led to an active management of the DM/dollar rate during most of this period. In general, however, the management remained fairly light. Direct interventions were only used modestly compared with the late 1970s. Monetary policy was only marginally influenced by exchange rate considerations. Other market-oriented exchange rate measures were changes in the restrictions for international capital movements and official announcements intended to influence the exchange market.

US-German exchange rate diplomacy contained elements of cooperation as well as of conflict in the period between spring 1973 and autumn 1977 (which will be called the mid-1970s) The monetary authorities of both countries adhered to the principle that the exchange rate level should reflect the underlying economic conditions (the "fundamentals"). In most cases they agreed when the DM/dollar rate was out of line with the "fundamentals" in one or the other direction. On three occasions, when they considered the dollar as undervalued against the DM, they decided to coordinate their interventions in order to support the dollar (July 1973, May 1974, February 1975). But in the winter of 1973/74, when they considered the DM as undervalued against the dollar, they disagreed sharply over the responsibility to intervene in the DM/dollar market.

Another conflict in US-German exchange rate diplomacy occurred in the summer of 1977, when US and German exchange rate preferences for once were incompatible after the transition to floating. US policymakers wanted to see a fall in the DM/dollar rate, whereas the Germans wanted to avoid this. The situation was defused when the US Treasury Secretary stopped to promote his
exchange rate preference by "talking the dollar down", but the episode damaged US-German exchange rate cooperation and the general relationship between the two countries for some time.

The analysis of DM/dollar exchange rate management in the mid-1970s centers upon three episodes with a particularly interesting exchange rate diplomacy. Chapter D.1. covers the beginning of US interventions in the DM/dollar market during the period of extreme dollar weakness in the summer of 1973. Chapter D.2. focuses on the exchange rate diplomacy in the winter of 1973/74, when the United States and Germany partly cooperated and partly conflicted in their policy response to a strong dollar. Chapter D.4. analyzes the episode in the summer of 1977 when W. Michael Blumenthal, the US Secretary of the Treasury, "talked the dollar down". Chapter D.3. does not look at a particular episode, but covers the three-year period between spring 1974 and spring 1977, when the DM/dollar exchange rate management was free of noticeable conflicts.

D.1. The "Third Devaluation of the Dollar" and the Beginning of US Interventions in the Summer of 1973

As mentioned in chapter C.1.3.1. the US authorities started to intervene with relatively modest amounts in the DM/dollar market in July 1973 after a few months of non-intervention. The question whether the United States should intervene in a floating rate regime had been discussed on an international level since pegged exchange rates between the dollar and the currencies of the European "snake" were abandoned in March 1973. This chapter investigates the background for the adoption of the limited intervention approach by the US authorities.

On Sunday, March 4, 1973, the nine members of the EC decided to keep their foreign exchange markets closed for two weeks after an enormous speculative dollar inflow during the preceding week. In search for an appropriate response to the latest dollar crisis they took the initiative for a joint meeting with the United States by inviting the non-EC members of the Group of Ten to attend a conference of finance ministers and central bank governors in Paris on March 9. Anticipating that the Europeans would cease pegging their currencies against the dollar, the question was now raised in Washington whether or not the United States should refrain from exchange market interventions under a floating rate regime. The opinion among US policymakers was
Arthur Burns, the Chairman of the Federal Reserve, who in principle was opposed to floating, but accepted it as unavoidable under the circumstances, favoured limited market interventions. On the other side, George Shultz, the Secretary of the Treasury, was ideologically inclined to floating. He argued for a clean float and succeeded in winning President Nixon's support for this approach.

At the Paris-meeting on March 9, the EC ministers blamed the United States for the currency crisis. They called on the Americans to intervene in support of the dollar, using their own reserves or foreign borrowings; to tighten domestic credit and restrict capital outflows toward the same end; and to take several other measures. The French, in particular, were concerned about the prospects for a further depreciation of the dollar against the snake-currencies which would imply a continued loss of French and European competitiveness vis-à-vis the United States. They reportedly urged that the Common Market retaliate against the protectionist effect of any further decline in the value of the dollar by imposing a surcharge on US goods. But the US delegation declined to make a pledge to intervene or to take any other economic measures to support the dollar. Thus, the meeting produced only an insubstantial communiqué, and the fourteen states agreed to meet again one week later in order to take the decisions necessary to re-open the exchange markets.

Before that meeting, the six EC-countries participating in the snake-arrangement decided to let their currencies float jointly against the dollar. Britain and Ireland would float together separately from the others, and Italy would float alone.

The second conference of the fourteen nations in Paris on March 16 witnessed a continued American refusal to make binding commitments to intervene in the exchange market. The US delegation accepted only an extremely loose ground rule under which floating exchange rates could be managed. The communiqué stated the compromise formula on exchange rate management as follows:

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2 ibid. p.322
3 See the NYT, 10 March 1973, for the text of the communiqué.
4 Odell, op.cit. p.323
5 AP no.23/1973, 21 March 1973
"They (the ministers and central bank governors of the fourteen nations) agreed in principle that official intervention in exchange markets may be useful at appropriate times to facilitate the maintenance of orderly conditions, keeping in mind also the desirability of encouraging reflows of speculative movements of funds. Each nation stated that it will be prepared to intervene at its initiative in its own market, when necessary and desirable, acting in a flexible manner in the light of market conditions and in close consultation with the authorities of the nation whose currency may be bought or sold."

After the general framework for the new exchange rate regime had been put in place, the exchange markets were re-opened on March 19, 1973.

In the German view, the Paris agreement indicated that the United States would take an interest in an orderly exchange rate system and, particularly, in the dollar's exchange value. Otmar Emminger spoke about the United States' "benign interest" in the dollar's exchange rate in contrast to the so-called "benign neglect" of the US balance of payments in the 1969-71 period. At the same time, he expressed the hope that the Americans would prove their alleged interest with own interventions, even if these had to be financed by European central banks (i.e. with swap-loans).⁶

In the first two months with a floating DM/dollar rate the exchange market remained calm. In the first weeks after the re-opening of the exchange market the dollar even appreciated slightly against the DM allowing the Bundesbank to sell part of the dollar reserves accumulated in the previous months. The US monetary authorities, on the other side, did not see any reason even to consider exchange market interventions under these conditions.

From mid-May onwards the dollar came under rapidly increasing downward pressure against the DM and other European currencies. Within eight weeks the DM/dollar rate fell from a level above 2.80 DM/$ to below 2.30 DM/$. US policymakers regarded this development as the result of a speculative market fever intensified by the progressive tightening of German monetary and fiscal policies; by worsening US inflation; by forecasts of vastly higher US energy imports; and by political uncertainty about the possible ramifications of the Watergate affair.⁷ According to the US Treasury, the "irrational" exchange market behaviour led to an undervalued dollar vis-à-vis the European currencies.⁸ The official statements expressed dissatisfaction

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⁶ Interview with Dr Emminger, Die Weltwoche (Zurich), 28 March 1973
⁷ FRB September 1973, p.623; FT 7 June 1973
with the undervaluation of the dollar referring to the negative consequences for domestic inflation and for international confidence in the main reserve and transaction currency.  

However, the US authorities also recognized that the dollar depreciation improved US competitiveness in world markets and helped to correct the trade balance deficit. At any rate, they did not take any measures to support the dollar during its downward slide in May and June. In early June Treasury Secretary Shultz stressed that market conditions did not warrant US interventions as long as the downdrift of the dollar was orderly. The United States was not obliged to intervene, but interventions were not ruled out in other circumstances, it was said.  

At the same time the French President Georges Pompidou and his Finance Minister Giscard d'Estaing strongly urged the United States to intervene in the exchange market to stop what they called the "third devaluation of the dollar". The Germans did not join the French in this demand in June. Bundesbank Vice President Emminger even recommended to the Americans to abstain from dollar-supporting interventions for the time being. This can be explained with the Bundesbank's efforts to regain price stability. With an economy running at full capacity and a large and still growing current account surplus the DM-appreciation helped to contain the inflationary pressures in the German economy. In contrast to the French, the Germans were not concerned about a loss of competitiveness under these circumstances. The Bundesbank itself smoothed the dollar's fall only with very modest DM-sales. With the futile interventions against speculative market forces in early 1973 fresh in their memory, Bundesbank officials were not inclined to intervene massively in support of the dollar. Their efforts to tighten bank liquidity after the huge capital inflow earlier in the year would be counteracted by renewed dollar purchases whether these were made by the Bundesbank or by the Federal Reserve. 

Even without substantial interventions in the DM/dollar market the Bundesbank's credit tightening was difficult enough at that time due to obligatory 

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9 FAZ 29 June 1973; NZZ 30 June 1973
10 IHT 7 June 1973
11 Le Monde 8 June 1973; VVD 26 June 1973
12 FAZ 7 and 8 June 1973; Le Monde 7 and 8 June
13 FAZ and Le Monde 7 June 1973

European University Institute
DOI: 10.2870/52840
interventions within the European currency snake to counter upward pressure on the DM. On June 29 the German government revalued the DM by 5.5 per cent against the other snake-currencies after the Bundesbank had had to absorb foreign currencies worth DM 4 billion in the previous twelve days to keep the DM within the snake's 2.25 per cent fluctuation margin.  

The German recommendation to the Americans to abstain from dollar-supporting interventions in June 1973 also stemmed from the assessment that the "third devaluation of the dollar" was a resumption of the dollar's confidence crisis and represented a continued liquidation of a "dollar overhang". Central bank intervention to counter the dollar's weakness - it was assumed - would be more effective if one waited until the dollar became "oversold" and the market atmosphere could be turned more easily. 

In early July the DM/dollar rate fell below 2.40 and approached quickly the 2.30 level in hectic exchange market trading. At this time the Bundesbank apparently became convinced that interventions would be helpful to calm the market. The Bundesbank director in charge of foreign exchange operations, Johannes Tüngeler, publicly recommended on July 7 that the United States should itself intervene in support of the dollar.  

The Under Secretary for Monetary Affairs at the US Treasury, Paul Volcker, admitted that European monetary authorities had demanded US interventions in the first week of July. He regarded, however, the exchange rate development as mainly a European problem because the dollar had remained stable against the Japanese yen and the Canadian dollar.  

On the weekend of July 7/8 the BIS-group of central bank governors met in Basle to discuss the currency crisis. At this meeting the European members successfully challenged the US attitude that the dollar depreciation was a European problem. On German initiative the central bank governors of the snake-countries and the United States decided to intervene in cooperation to maintain orderly exchange market conditions. The price for US participation appeared to be European concessions with regard to the swap agreements.

15 VWD 19 June 1973
16 Hb 9 July 1973
17 VWD 7 July 1973
18 FAZ 9 July 1973
19 NZZ 10 July 1973
20 DB, Annual Report 1973, p.46
The official communiqué at the end of the meeting was very brief. It only recalled the Paris formula about intervention policy (see above p. D-4); said that this approach remained appropriate; and noted that the necessary technical arrangements now were in place to implement it.\textsuperscript{21} But already on July 9 the Federal Reserve in agreement with the US Treasury approved the initiation of US interventions. On the following day the first dollar-supporting interventions by the Federal Reserve were carried out.\textsuperscript{22} One week later the Treasury and the Federal Reserve issued a joint statement on US intervention policy saying that active US intervention would take place in the future at whatever times and in whatever amounts were appropriate for maintaining orderly market conditions.\textsuperscript{23}

The Europeans, on the other hand, accepted a 50 per cent increase in the Federal Reserve's swap lines at the Basle-meeting. This was accompanied by a new arrangement to share exchange risks on swap drawings. Before, the exchange risk had fallen entirely on the debitor central bank, which meant that the United States suffered losses when the dollar depreciated between a swap drawing and its repayment. The new agreement provided for both creditor and debitor to share a reserve loss equally.\textsuperscript{24} According to insider information leaked to the press, the new formula had been adopted after strong US requests.\textsuperscript{25}

The coordinated interventions of central banks after the Basle-meeting on July 7/8 easily achieved a turn-around in the exchange market. According to Bundesbank Vice President Emminger, the dollar had become so oversold in the previous weeks that dollar purchases of $50 million were sufficient to reverse the dollar depreciation.\textsuperscript{26}

In general, in the months after the transition to a floating DM/dollar rate in March 1973, Germany was preoccupied with its stabilization policy, while the United States was concerned about its trade balance deficit. A slow, steady appreciation of the DM against the dollar would probably not have worried any of them. Even when the dollar depreciation accelerated in June with

\textsuperscript{21} For the text of the communiqué see \textit{AP} no. 51/1973, 11 July 1973
\textsuperscript{22} \textit{FRB}, September 1973, pp. 623f
\textsuperscript{23} \textit{FRB} September 1973, p. 624. See also p. C-8 above.
\textsuperscript{24} \textit{FT} 23 July 1973; \textit{FRB} March 1981, p. 211
\textsuperscript{25} \textit{VWD} and \textit{SZ} 11 July 1973
\textsuperscript{26} Interview with Dr Emminger, May 1983.
the DM/dollar rate falling by 9.4 per cent during the month, both sides were reluctant to counter the development with exchange market interventions, but for different reasons. The US Treasury was fundamentally skeptical about the usefulness of US interventions although it maintained a rather pragmatic attitude on this question. The Bundesbank, on the other hand, was primarily worried about the expansionary monetary effect implied by massive dollar-supporting interventions, whether they were carried out by the Bundesbank itself or by the Federal Reserve. However, neither side wanted to see the dollar depreciation get out of hand. When the exchange market became increasingly disorderly in early July with the DM/dollar rate falling by 5.2 per cent within one week, the Germans were the first to become convinced that an active US intervention policy was desirable. At that time there seemed to be tactical disagreement with the Americans about intervention policy which, however, was swiftly overcome when central bank governors met at Basle on July 7/8. In return for European concessions with regard to the size and the terms of Federal Reserve swaps, the United States started to support the dollar.

D.2. The Dollar's Recovery during the Oil Crisis in the Winter of 1973/74

In the six months following the Basle-meeting in July 1973 the dollar appreciated by 25 per cent against the DM. Just as the dollar weakness in the summer of 1973 the dollar strength in the winter of 1973/74 was accompanied by a relatively intensive exchange rate management, especially on the diplomatic level. US and German policymakers agreed that the dollar's recovery went too far, but they disagreed on which side should intervene in the DM/dollar market to counter the dollar's rise. The present chapter analyzes the background for this conflict in the management of the DM/dollar rate.

The dollar's "third devaluation" had been halted at the 2.30 DM/$ level in July 1973. In the following months the DM/dollar rate fluctuated narrowly around 2.40 under relatively quiet exchange market conditions. Consistent with his statements in June, US Secretary of the Treasury Shultz regarded the dollar as still somewhat undervalued at that level.27 Late in October, however, the calm in the DM/dollar market was dramatically broken when the US

27 FAZ 10 September 1973
trade figures showed a turnaround from a longstanding deficit to an unexpec-
tedly large surplus. In early November the oil crisis in the wake of the Arab-
Israeli October-war reinforced the dollar-strengthening due to the widely
held belief that the United States would be less vulnerable to the energy
crisis in the long run than other countries. But both the Bundesbank and the
Federal Reserve regarded the reversal in the US balance of payments as the
decisive factor for the comeback of the dollar.28

From late October to end-November the dollar strengthened against the
DM from 2.40 DM/$ to well above 2.60 DM/$. German and US policymakers did not
regard this rise as exaggerated on the background of the even larger fall
earlier in the year, but they started to become concerned about a continuation
of the trend. At a meeting of the so-called Group of Five29 in late November,
American as well as German policymakers expressed the view that the DM/dollar
rate at that time was about right.30 But any appreciation of the dollar be-
yond 2.67 DM/$31 was seen as undesirable by both sides and this attitude was
well publicized.32

This identity of US and German exchange rate preferences was based on
the same ultimate objectives which had made both countries prefer increased
exchange rate flexibility in the pre-floating era. The United States, on the
one hand, did not want a continued dollar appreciation because it would neu-
tralize the improvement in competitiveness gained by the dollar devaluations
in December 1971 and February 1973. The Germans, on the other hand, were not
interested in seeing the effects of their stabilization policy weakened by
higher import prices due to a continued rise in the DM/dollar rate. Further-
more, the German economy was still running at full capacity and an increased
external demand for German goods due to a DM-depreciation would only fuel
domestic inflationary pressures. Once again, the American perception of the

28 DB, Annual Report 1973, pp.44f; FRB March 1974, p.191
29 The Group of Five (G-5) comprised the finance ministers of the five main
OECD-countries (USA, Japan, Germany, France, Britain). Since April 1973,
when the group met for the first time, it has been an important forum for
international monetary negotiations, partly replacing the older Group of
Ten (G-10).
30 BZ 30 November 1973; Stuttgarter Zeitung 28 November 1973
31 2.67 DM/$ was the nominal parity between the DM and the dollar based on
their official SDR-value after the dollar devaluation in February 1973
and the DM-revaluation within the snake in June 1973.
32 FT 1 December 1973; WWD 21 December 1973
exchange rate as primarily a mechanism for balance-of-payments adjustment contrasted with the German emphasis on the domestic effects of exchange rate changes.

After the G-5 meeting in November 1973 the exchange market had been given the firm impression that the United States and Germany had decided to treat the 2.67 DM/$ - mark as a line of resistance which would be defended with Bundesbank sales of dollars. The Bundesbank's intervention in the DM/dollar market had been rather substantial in the last quarter of 1973, but its support for the DM was not increased when the rate exceeded 2.70 DM/$ in January 1974. Operators in the market then formed the opinion that the German monetary authorities did not intend to stabilize the rate on any specific level. This belief was reinforced by official and semi-official statements saying that the DM/dollar rate essentially was an issue for the market and questioning the usefulness of interventions in the existing situation.

The German reluctance to step up its already significant interventions during the extraordinary buoyancy of the dollar in January 1974 was also related to the situation in the European currency snake. After a temporary weakness in the last months of 1973, the DM had regained its strength vis-à-vis the other snake currencies, especially the French franc. In this situation the DM-supporting dollar sales of the Bundesbank tended to aggravate intrasnake tensions and obliged the Banque de France to increase its franc-supporting dollar sales. Running down the foreign exchange reserves was unpopular with the French government during the height of the first oil crisis. The French reserves were regarded as more precious than ever in view of the expected oil-induced balance-of-payments deficits.

Furthermore, the European dollar sales tended to curb the depreciation of all snake currencies vis-à-vis the dollar. France, however, was not at all opposed to see the franc weakened against the dollar for competitive reasons. These considerations contributed to the German reluctance to intensify dollar interventions in January 1974, but it could not prevent the French with-

33 FAZ 8 January 1974
34 FAZ 5 January 1974; FT 8 January 1974
35 Rainer Hellmann, Dollar, Gold und Schlange, Baden-Baden, 1976, p.64
36 FAZ 11 January 1974
drawal from the snake on January 21. President Pompidou decided that the protection of the French exchange reserves had priority over the French commitment to pegged exchange rates.

Another reason for the German reluctance was given by Finance Minister Helmut Schmidt saying openly that Germany had to regard its dollar reserves in a new light after the oil crisis. In future Germany, like France, might need the reserves to cover balance-of-payments deficits generated by higher prices of oil and other raw materials. 38

As the Main Chart shows, DM-purchases by the US authorities remained very modest in the winter of 1973/74. However, the US Treasury took other more radical measures to stem the rise of the dollar. First and foremost, the longstanding controls on capital outflows from the United States were completely removed on January 29. The United States had wanted to lift the restrictions for a long time because they hurt US business, reduced the efficiency of the international financial system, and prevented New York City from recovering its former position as the center of the world financial community. 39 But the US balance of payments deficit and the dollar weakness had been obstacles to a liberalization until the winter of 1973/74. Removing the capital outflow restrictions then brought the further advantage of a depreciating effect on the dollar rate.

The American elimination of capital controls had been coordinated with an extensive easing of the German barriers against capital inflows. The minimum reserve requirements for the foreign liabilities of domestic banks were lowered together with the cash-deposit ("Bar-depot") ratio which applied to certain borrowing from non-residents. Other restrictions on foreign borrowing and on sales of securities to non-residents were substantially liberalized. These measures were announced on January 30 and went into effect on February 1. They were mainly motivated by a desire to counter the dollar depreciation. 40

Another market-oriented exchange rate measure of the US administration in January 1974 was the attempt by Treasury Secretary Shulttz to talk the dollar

38 Bulletin of the Federal Government, Bonn, 24 January 1974, no.9, p.79; JC 23 January 1974. This change of view with regard to the German dollar reserves was confirmed by Bundesbank President Karl Klasen in an interview with Die Zeit 1 March 1974.
40 SZ 31 January 1974
down in public. At a time when the exchange markets focused on European and Japanese dependance on OPEC-oil, George Shultz emphasized the exchange rate implications of the fact that the United States would import more oil than any other country in the following years. Furthermore, he said that the strength of the US economy had been overestimated by the market.41

On the diplomatic level, the United States tried to counter the dollar's rise by urging countries with high dollar reserves to make heavy dollar sales in the exchange markets. Already at the G-5 meeting in November 1973, George Shultz made it clear to his colleagues, and especially to the German Finance Minister Helmut Schmidt, that the United States expected forceful interventions if the dollar should rise above the 2.67 DM/$ threshold.42 This expectation was later repeated by Federal Reserve Chairman Burns, who also pointed to the Japanese dollar sales of $6 billion net since February 1973 as an example worthy of imitation.43

When the dollar actually rose above the 2.67 DM/$ level to as high as 2.88 DM/$ in January 1974 without the Bundesbank increasing its dollar sales, Mr Shultz became openly critical of German intervention policy. He said that he expected the Germans to be in the forefront with regard to diminishing the so-called dollar-overhang which had caused so many European complaints only half a year earlier.44 Being aware of the changed view on official dollar reserves after the oil-price shock, he ironically added that "they (the Germans and others) are hanging on to dollars for dear life."45

The American pressure on Germany to step up dollar sales in the market was rejected. Helmut Schmidt excluded German "manipulations of the dollar rate" and suggested instead that the US administration should intervene on its own behalf to influence the dollar rate. The Bonn government and the Bundesbank would then be prepared to support this policy with their own appropriately commensurate effort.46 Meanwhile Bundesbank President Klasen emphasized that the responsibility for keeping the value of the dollar from

41 Hb 23 January 1974; FAZ 23 January 1974
42 Stuttgarter Zeitung 28 November 1973; FT 1 December 1973
43 WWD 5 December 1973
44 Hb 23 January 1974
45 WP 18 February 1974
climbing too high rested primarily and overwhelmingly with the US monetary authorities. "After all, the dollar is the American currency and the United States must bear the major burden of supporting its rate", said Dr Klasen.47

But German willingness to cooperate was also stressed in the statements, and according to the Washington Post, Dr Klasen suggested in discussions with US officials that both sides should intervene equally on a dollar-to-dollar basis.48 This proposal was refused, which was not surprising considering the fact that the German dollar sales in January 1974 were about four times as high as the US dollar sales. At that time the United States was not willing to change its intervention principle that purchases of foreign currencies should be limited to the covering of swap debt and the replenishment of modest working balances.49 DM-purchases by US authorities in order to weaken the dollar would lead to the accumulation of US foreign exchange reserves. That was still considered infra dig by US policymakers. They did not want to renounce the longstanding privilege of the United States of not having to own foreign exchange reserves.

A political solution to the US-German dispute about intervention policy was rendered superfluous by the exchange market development. In February the market sentiment shifted decisively against the dollar. At the end of the month the DM/dollar rate had fallen back to 2.67 which was regarded as an acceptable level by US and German policymakers. They saw the new exchange rate trend as the combined result of a swing in interest rate differentials; the deregulation of international capital movements; and a turn to a more negative evaluation among exchange market operators about the prospects for further improvement in the US trade balance (possibly stimulated by George Shultz’ above-mentioned remarks about US oil imports).

In general, the dollar’s strength in the winter of 1973/74 was countered by a relatively intensive exchange rate management. Just as during the dollar weakness in the summer of 1973, US and German policymakers agreed that the DM/dollar rate had moved to an excessive level. With regard to market-oriented policy measures they cooperated on deregulating international capital movements, but they disagreed on how to distribute the burden of DM-supporting interventions. On the one side, this conflict was based on the American unwillingness.

47 JC 23 January 1974
48 WP 18 February 1974
49 This principle was confirmed by George Shultz on January 22, 1974.
FAZ 23 January 1974
to purchase foreign currencies in excess of what was needed to repay swap
debt and to replenish modest working balances. On the other side, it was due
to the particular situation in the winter of 1973/74 with problems in the Eu-
ropean currency snake and widespread concern in oil-importing countries about
oil-price induced current account deficits. This situation made the German
authorities reluctant to spend their dollar reserves to depress the value of
the dollar in spite of energetic American pressure to that effect.

D.3. **Three Years of Non-Controversial Exchange Rate**
Management. Spring 1974 - Spring 1977

Between the winter of 1973/74 and the summer of 1977 the management of
the DM/dollar rate was free from US-German conflicts. There were some pro-
nounced shifts in the level of the DM/dollar rate (see the Main Chart), but
its management was very light. That was in distinct contrast to the persistent
and large-scale management of other important floating exchange rates at the
same time (for instance, the yen/dollar rate and the dollar/sterling rate).

The light and non-controversial character of DM/dollar exchange rate
management in the 1974-77 period reflected the fact that neither the US nor
the German policymakers regarded the exchange rate development as a serious
threat to their major economic objectives. The DM/dollar rate did not return
to the high level of January 1974 when Washington had been concerned that the
US economy would lose the improvement in international competitiveness gained
by the devaluations in 1971 and 1973. The fact that the US current account had
returned to surplus in 1973 and remained in the black until 1977 contributed
to a rather indifferent attitude towards the dollar's external value among
US policymakers.

On the German side, the inflation rate was lowered from a maximum of 11
per cent in late 1973 to 4 per cent in the spring of 1977. The authorities
regarded the transition to a floating DM/dollar rate as the key to this suc-
cessful stabilization policy, because it protected the external flank of the
German economy against uncontrollable capital inflows. Compared to this, the
actual development in the DM/dollar market was only a secondary question for
German policymakers. The level of the DM/dollar rate, which fluctuated between
2.65 and 2.30, was never seen to endanger their stabilization efforts seriously
in the 1974-77 period.
Although the DM/dollar rate did not give rise to serious concern, it was not allowed to float completely free. The table on the following page summarizes the exchange rate measures of the US and German monetary authorities in the 1974-77 period. Each of the five subperiods is characterized by a dominant movement of the DM/dollar rate and their sequence shows alternating periods of DM-appreciation (dollar depreciation) and DM-depreciation (dollar appreciation). The table also lists the principal reasons for these exchange rate movements as perceived by the policymakers in the United States and Germany.50

The size of exchange market interventions was very modest. This can be illustrated by the fact that the US and German dollar purchases between February 1974 and June 1977 were smaller than German dollar purchases on the last day of the pegged DM/dollar rate.51 The Bundesbank pursued its two-part strategy for the DM/dollar market (described in chapter C.2.2.). On the one side it countered disorderly market conditions over the short term and on the other side it "leaned against the wind" by smoothing medium-term exchange rate movements. The US authorities followed the principles of the limited intervention approach adopted in July 1973, (described in chapter C.1.3.1.). Only during a period of dollar weakness in early 1975 they supplemented the countering of disorderly market conditions with more substantial dollar purchases to resist an exchange rate movement that - according to their view - had gone beyond the levels justified by the fundamental economic conditions. At this time the US authorities tried to influence the exchange rate level of the dollar; normally the limited intervention approach only aimed at smoothing the very short-term fluctuations. The more ambitious character of US intervention policy on this occasion was particularly evident in March when the Federal Reserve continued to support the dollar after the DM/dollar rate had started to rise. The Fed explained its "aggressive" intervention behaviour52 in the following way:53

"The dollar's rise was highly tentative at first, and the Federal Reserve continued to intervene in German marks and Swiss francs to prevent a backsliding in rates that threatened to undermine a more solid recovery."

50 The policymakers' perceptions about the causes of these medium to long-run shifts in the DM/dollar rate are stated in the Bundesbank's Annual Reports and the Federal Reserve's semi-annual reports on foreign exchange operations (published in FRB).

51 On March 1, 1973, the Bundesbank purchased $2.7 billion in the market.

52 For the definition of aggressive interventions see footnote 51 on p.C-22.

53 FRB September 1975, p.554.
<table>
<thead>
<tr>
<th>Period</th>
<th>Development of the DM/dollar rate</th>
<th>Principal reasons (policymakers' perceptions)</th>
<th>Exchange rate measures</th>
</tr>
</thead>
</table>
- Watergate-affair  
- expected negative effects of oil-price increase on US trade account; continuing German trade surplus  
- accelerating US inflation | US: $-purch. 375, $-sales 4  
German: $-purch. 280, $-sales –  | - announcement of intervention agreement (Basle, May 1974) |
| June 1974 – September 74 | DM-depreciation: 2.40 DM/$ - 2.67 DM/$ | - interest rate differential*  
- improving US balance-of-payments position; stagnant German surpluses | German: $-purch. 900  
US: $-purch. 130, $-sales 269 (381) | - German "Bar-depot" lifted (Sept. 1974) |
| October 1974 – March 1975 | DM-appreciation: 2.67 DM/$ - 2.28 DM/$ | - interest rate differential*  
- expectations that US recession will lead to further falls in US interest rates | US: $-purch. 1,030, $-sales 83 (185) | - Schmidt-statement (November 1974)  
- London-agreement on intervention policy (February 1, 1975) |
| April 1975 – September 75 | DM-depreciation: 2.28 DM/$ - 2.67 DM/$ | - interest rate differential*  
- US trade account shifts into surplus | German: $-purch. 860  
US: $-purch. 189, $-sales 510 (961) | - German liberalization of capital import restrictions (September 1975) |
- worsening of US balance of payments (late 1976, 1977)  
- inflation differential | US: $-purch. 1,280, $-sales 233 (562)  
German: $-purch. 150 | -  |

* The chart on p.D-22 compares the DM/dollar interest rate differential with the DM/dollar exchange rate  
* The numbers in brackets include the off-market dollar sales (i.e. DM-purchases from correspondents)
The reason for this attempt to raise the level of the DM/dollar rate seemed to be a concern at the Federal Reserve about the inflationary impact of a weak dollar.54

The Bundesbank supplemented its medium-term smoothing of the DM/dollar rate on two occasions by changes in German capital import restrictions. When the DM was depreciating against the dollar in September 1974 and in September 1975 the German government lowered its barriers against capital imports. It had imposed or tightened these restrictions in the early 1970s in order to moderate inflationary capital inflows. Now, as the dollar crisis was over, the German authorities gradually liberalized the restrictions. As mentioned in chapter D.2., the first deregulation took place during the dollar strength in January 1974, when it was the main German contribution to bring the DM/dollar rate down. The next step was taken during the upward trend in the DM/dollar rate in September 1974. This time the Bonn government repealed the cash-deposit requirement ("Bar-depot") which applied to certain borrowing from nonresidents. The measure was partly explained with a desire to bring about a revaluation effect on the DM which should dampen import prices.55

One year later, when the DM/dollar rate again was on an upward trend, the German government liberalized still further its restrictions on capital imports. Most importantly, the ban on interest payments on nonresident deposits was lifted. Thereafter only a few types of capital inflow remained restricted. Also in this case the deregulation seemed to be timed with a view to braking the DM-depreciation against the dollar.

Monetary policy played only a minor role in the management of the floating DM/dollar rate until the summer of 1977. Such tools as open-market operations, discount rate rate policy, and changes in minimum reserve requirements were primarily oriented towards domestic monetary targets in both the United States and Germany. The Bundesbank has not revealed exactly when and to what extent exchange rate considerations had an impact on its monetary policy.

54 This interpretation of the early 1975–episode is confirmed by the Jurgen- sen Committee's report (Report of the Working Group on Exchange Market Intervention, March 1983, p.15). See also Paul Lewis' article in FT 28 April 1975. The Federal Reserve took the initiative to this more active spell in US intervention policy. The Treasury was apparently sceptical about the benefits of the increased intervention activity, JC 26 February 1975, FAZ 3 March 1975.

However, the nature of this impact is indicated by Otmar Emminger in the following statement which refers to the first years of managed floating: 56

"Flexible exchange rates have by no means made interest-rate policy fully autonomous ...... In contrast to former times, interest-sensitive capital movements now affect the exchange rate rather than monetary reserves. The desire to avoid unnecessary distortions of the exchange rate by temporary interest-rate differentials has therefore on occasion become one of the factors determining interest-rate policy."

Although interest rate policy had occasionally been affected by exchange rate considerations, the most important part of the Bundesbank's monetary policy in these years, viz. liquidity policy, was independent of exchange rate considerations. The Bundesbank determined and pursued the growth target for the supply of central bank money independent of the state of the DM/dollar rate. The same can be said of the Bundesbank's liquidity policy from March 1973 to the first announcement of a quantitative money supply target in December 1974.

In the United States, the monthly instructions for the Federal Reserve's open-market operations regularly alluded to the balance-of-payments situation as a factor to be taken into account. 57 It is, however, generally acknowledged that US monetary policy was only marginally influenced by exchange rate considerations in the 1973-77 period. 58 Furthermore, these considerations seemed only to be effective when the dollar was weak. There are indications that the Federal Reserve kept US monetary conditions relatively tight in the spring of 1974 and again in early 1975 in order not to weaken still further the already depressed value of the dollar. 59 The reason seemed to be perceived inflationary effects of an excessive dollar depreciation.

One policy development shall be mentioned, even though its effect was probably more psychological than substantial. During the period of dollar weakness in May 1974, the US, German, and Swiss representatives attending the monthly meeting of central bank governors in Basle reached agreement on a concerted

57 Henry C. Wallich, Governor of the Federal Reserve Board, in the FAZ 29 November 1975.
58 See for example Emminger, op.cit., p.41. The point has been confirmed in interviews with present and former Federal Reserve officials.
59 FT 6 May 1974; NZZ 15/16 March 1975.

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plan of intervention to counter excessive speculation against the dollar.\textsuperscript{60} The details of the plan were not revealed; only the fact that agreement had been reached was announced to the press. This display of central bank unity and determination was sufficient to achieve the desired turnaround of market sentiment. In all likelihood the central bank governors had calculated how the market would react to the announcement of such an agreement.

In November 1974 there was another official statement which very probably was made with the intention to influence the DM/dollar rate. The German Chancellor Helmut Schmidt told foreign journalists that the German government would welcome a continued appreciation of the DM because of its anti-inflationary effect.\textsuperscript{61} The DM was immediately bid up by almost 2 per cent against the dollar.\textsuperscript{62} Because the statement was made during a period with a clear upward trend of the DM against the dollar, it qualifies as an "aggressive" talking-up of the DM just as market sales of dollars at that time would have been called an aggressive intervention if they had been carried out. The statement as such does not prove that an exchange rate effect was intended. But as a former finance minister with direct experience of the powerful exchange rate effects of well-timed official statements on exchange rate issues, it is highly probable that Helmut Schmidt expected the self-fulfilment of his declared preference.\textsuperscript{63}

At other times too in the 1974-77 period US and German officials expressed opinions about the reasonableness of the exchange rate level and expectations or preferences about the future exchange rate development. But these statements were generally not aggressive in the above-mentioned sense, nor did they have the significant impacts on exchange market trading as the announcement of the intervention agreement in May 1974 or as Helmut Schmidt's talking-up of the DM in November of the same year.

Besides the agreement in May 1974, the United States, Germany, and Switzerland concluded another tripartite currency agreement in the 1974-77 period. Central bank governors from the three countries met in London on February 1, 1975,

\textsuperscript{60} FRB September 1974, p.637
\textsuperscript{61} Die Welt, 15 November 1974; SZ 16/17 November 1974
\textsuperscript{62} FRB March 1975, p.137
\textsuperscript{63} The Chancellor's remark was not in accordance with Bundesbank-policy. In the speculative trading following the statement, the Bundesbank intervened in cooperation with the Federal Reserve to stem the DM-appreciation, just as the Bundesbank's interventions in general were "leaning against the wind" during the DM-appreciation from October 1974 onwards.

European University Institute
DOI: 10.2870/52840
to discuss a joint approach to exchange market interventions. The background was a 14 per cent fall in the DM/dollar rate from 2.67 in September 1974 to 2.30 in late January 1975. The US representatives, Arthur Burns and Charles Coombs, were somewhat concerned about the inflationary consequences for the US economy. They proposed more forceful interventions on a coordinated basis in order to arrest the dollar's decline.64 The other participants concurred, but on German insistence an upper limit for the size of interventions was determined.65 The outcome of the meeting was reflected in relative large dollar-supporting interventions in February 1975.66

The intervention agreement of February 1, 1975, was an ad hoc measure to counter the dollar's weakness in early 1975. One year later, when the dollar had recovered to the 2.60 DM/$ level, the president of the Swiss central bank proposed that the tripartite agreement be reactivated.67 But the US authorities were only interested in coordinated interventions when the dollar was weak. This was in accordance with the one-sided character of their limited intervention approach which continued a defensive tradition in US foreign exchange operations. In the 1960s the rationale of US foreign exchange operations had been to protect the US gold reserves from being depleted under the dollar/gold convertibility of the Bretton Woods system. Now they should limit a downward slide in the dollar's external value under disorderly exchange market conditions.

The one-sidedness of US intervention policy was never emphasized and hardly ever alluded to in public statements by US officials. This may partly have been a deliberate down-playing of a feature in US exchange rate policy that might have given rise to foreign criticisms. But it also reflected an underlying attitude which regarded it as obvious and hardly worth mentioning that the United States should not support other currencies beside the dollar.

65 Interview with Dr Emminger, May 1983. He and Dr Klasen participated on the German side. Fritz Leutwiler, President of the Swiss National Bank, was the Swiss representative. He had taken the initiative to the meeting.
66 According to Dr Emminger, the dollar-supporting interventions did not reach the pre-determined limit before the dollar started to recover. Because of the initial secrecy about the meeting and the substantial content of the agreement, it seems unlikely that the central bank governors - primarily or at all - intended to create an announcement effect.
67 FT 19 March 1976
Apart from the two special intervention agreements of May 1974 and February 1975 US-German exchange rate cooperation was apparently limited to routine procedures, especially in connection with the Federal Reserve's swap drawings at the Bundesbank. On the whole, the 1974-77 period was characterized by light and non-controversial management of the DM/dollar rate. Neither the United States nor Germany had balance-of-payments problems, while inflation was relatively high in both countries. Consequently, the DM/dollar rate was primarily considered in terms of domestic inflation performances. The level or the movements of the DM/dollar rate did not give rise to serious concern in that respect, but on balance German and US exchange rate measures had a bias towards supporting the respective national currency against depreciation.

D.4. Mr Blumenthal's "Open-Mouth Policy" in the Summer of 1977

In the summer of 1977 the management of the DM/dollar rate became a contentious issue in US-German relations. The background was a drastic deterioration of the US current account. As in the early 1970s, US policymakers developed a preference for a dollar depreciation as a mechanism to improve the American balance-of-payments situation. The way in which the new US Secretary of the Treasury, W. Michael Blumenthal, tried to pursue this preference gave rise to conflict in US-German exchange rate diplomacy.

The exchange market context of this episode in DM/dollar exchange rate management was as follows: The dollar had been on a downward trend since mid-1976. Within 12 months the DM/dollar rate had fallen slowly and orderly by 9 per cent to a level of 2.35 in June 1977. Then, the dollar depreciation gathered pace and in the second half of 1977 the DM/dollar rate slid by 11 per cent to a level of 2.10. In the preceding years US and German policymakers had viewed the development of the DM/dollar rate as primarily determined by the interest rate differential. However, changes in relative interest rate levels could not be made responsible for the dollar's decline in 1977. The dollar depreciation happened in spite of a widening of the interest rate gap in favour of dollar investments as the chart on the following page shows. Neither was the difference between the US inflation rate of 6.5 per cent and the German inflation rate of 3.7 per cent seen as a major reason for the

68 See p. D-16 above.
International interest rate differential and exchange rate of the U.S. dollar

Monthly averages

<table>
<thead>
<tr>
<th>Difference between interest rates for 3-month funds 1)</th>
<th>In favour of investments in U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ 4</td>
<td>+ 3</td>
</tr>
<tr>
<td>+ 2</td>
<td>+ 1</td>
</tr>
<tr>
<td>+ 1</td>
<td>0</td>
</tr>
<tr>
<td>0</td>
<td>- 1</td>
</tr>
<tr>
<td>- 1</td>
<td>In favour of investments in Deutsche Mark</td>
</tr>
</tbody>
</table>

Exchange rate of the U.S. dollar in Frankfurt

1) 3-month certificates of deposit of New York banks against 3-month interbank funds in Frankfurt

* DB, Annual Report 1977, p.54

Dollar depreciation. The decisive factor was perceived to be the deteriorating US current account as compared with a stable surplus of $18 billion in 1975 and $4 billion in 1976 to a deficit of $14 billion in 1977. The trade balance showed even a $40 billion swing into the red within two years. At the same time the German balance-of-payments position remained virtually unchanged with annual current account surpluses of almost DM 10 billion in 1975, 1976, and 1977.

As the size of these imbalances became apparent during the summer of 1977, operators in the exchange market became increasingly apprehensive about the

69 The US Council of Economic Advisers stated in its Annual Report for 1977: "Although Germany and Switzerland had somewhat lower inflation than the United States, only a small fraction of the appreciation of these currencies could be attributed to actual differences in inflation rates. Moreover, developments during the year did not warrant a shift in expectations of future inflation large enough to account for a substantial part of the movement in exchange rates." ERP 1978, p.120
prospects for the dollar. Confidence in the dollar waned, as dealers became fearful that the exchange rate would ultimately emerge as the means of achieving adjustment. Speculative dollar outflows were stimulated by the US Treasury Secretary W. Michael Blumenthal, who made a number of comments on the exchange rate situation in the summer and autumn of 1977. It was admitted on the American side that the media furore about these remarks contributed to the dollar's weakness. 70

Mr Blumenthal's remarks were dubbed the "talking down" of the dollar, or the "open-mouth policy" by those who regarded it as a deliberate attempt to lead the market. It created discontent and suspicion in Germany and friction in the relationship with the United States in the summer of 1977. Whether the remarks actually represented a conscious and therefore aggressive exchange rate policy, or just were rash comments with unintended consequences by an official with limited experience in international monetary matters will be discussed in this chapter together with the consequences for US-German exchange rate diplomacy.

D.4.1. US Demands for the Surplus Countries to Adjust

Mr Blumenthal's most controversial remarks were made in June and July. But already in the preceding months it had become apparent that exchange rate relationships had regained a more prominent place in the economic thinking of US policymakers. The role of exchange rate changes as a balance-of-payments adjustment mechanism was again emphasized as in the early 1970s.

It became evident that the US policymakers had developed a preference for a depreciation of the dollar vis-à-vis the currencies of countries with a current account surplus (Germany, Japan, the Netherlands, and Switzerland). This preference was clearly based on the desire to improve US competitiveness and the deteriorating current account. The surplus countries were repeatedly urged not to resist a market-determined appreciation of their currencies. For instance, speaking as chairman of the Federal Reserve in April 1977, Arthur Burns argued that "those non-OPEC countries that are experiencing significant and persistent current account surpluses must understand that they too have adjustment obligations .... (S)uch countries should not actively

70 FRB September 1977, pp.793-798, passim.
resist tendencies toward appreciation in the value of their currencies in foreign exchange markets."\textsuperscript{71}

Such recommendations were combined with the demand that surplus countries should reflate their economies faster and that they should reverse their current account surpluses into deficits. With the support of the OECD the Carter administration justified this policy with the so-called "locomotive theory". The United States was seen as part of an interdependent world with US prosperity depending on world prosperity and vice versa. A global approach to economic recovery was advocated. The United States, Japan, and Germany as the "three great engines" of the world economy had a special role in this context. They should be the locomotives pulling the world economy on the right track from 'stagflation' to sustained and non-inflationary growth through expansionary demand management.

This message was first conveyed to the Germans officially by Vice President Mondale when he came to Bonn in early February 1977 shortly after President Carter's inauguration. The US demand for German reflation was then repeated publicly and privately at innumerable international gatherings and in speeches by US officials. The Americans were supported by Britain and other countries and by the secretariats of the IMF and the OECD in their attack on the management of the German economy. At the London summit of May 1977 Chancellor Schmidt gave way to these demands and promised 5 per cent real growth of the German economy in 1977. In the previous year the German growth rate had been 5.5 per cent and economic activity had continued to rise strongly in the first quarter of 1977. In this context Mr Schmidt apparently felt that he risked very little by promising 5 per cent growth for 1977 as a whole.

With regard to balance-of-payments adjustment, US Treasury Secretary Blumenthal called upon Japan, Germany, the Netherlands, and Switzerland to change their current account surpluses into deficits.\textsuperscript{72} The US current account had moved into deficit in the second half of 1976 and now the United States

\textsuperscript{71} Arthur F. Burns, "The Need for Order in International Finance", \textit{Federal Reserve System press release}, 12 April 1977, p.17

The demand for a free upward float of the strong currencies was supported by J. Witteveen, the managing director of the IMF, on several occasions. In a speech on May 12 he said for example: "Beyond the maintenance of adequate growth rates, therefore, countries in strong payments position will have to permit adjustment through an appreciation of their currencies and through increased flows of long-term capital exports and development aid." H. Johannes Witteveen, "The World Economic Situation", \textit{IMF press release}, 12 May 1977, p.8

\textsuperscript{72} At the International Monetary Conference in Tokyo in May 1977. \textit{FAZ} 27 May 1977.
demanded that the remaining surplus countries within the OECD also should accept current account deficits in the process of domestic demand stimulation. The Americans argued that the burden of the oil-price induced balance-of-payments deficits had been carried by the countries with weaker economies in the first years after the oil-price shock of 1973/74. Germany and other surplus countries had a responsibility to help the weaker economies by accepting current account deficits, at least as long as the OPEC-countries generated surpluses.

The various demands directed towards the surplus countries were the topic of a contentious OECD Ministerial Meeting in Paris in June 1977. The quests for reflation, balance-of-payments adjustment and appreciation were combined in one key sentence in the communiqué:

"Member countries in a strong external position will provide for a sustained expansion of domestic demand compatible with further reduction of inflation; they are ready to see a weakening in their current account positions and an appreciation of their currencies in response to underlying market forces."

The Germans pointed out that this formulation was fully in accordance with actual German policy. The economy was reflated within non-inflationary limits and the exchange rate and the current account were allowed to reflect the fundamental market forces. But they regarded it as irrelevant to press these issues further in communiqués and official statements. There was a widespread feeling in Germany in 1977 that the more or less explicit accusations of irresponsibility were an unfair reward for virtuous economic management. Having maintained price stability, when all around were losing theirs, and a rate of growth beyond the grasp of economies with levels of inflation incomparably higher than their own, the Germans found themselves an object of envy and criticism rather than approval.73

Especially Mr Blumenthal's demand for a direct reversal of current account surpluses to deficits caused irritation and resentment in Germany. It was pointed out that the current account position was not a fully controllable variable, but depended on the economic policies and performances of the trading partners and on the size and direction of capital movements. It was said that a German current account deficit probably would lead to a DM-depreciation contrary to the US demand for a DM-appreciation. Finally, it was mentioned that the US current account deficit was not worthy of imitation. It had mainly come about

through increased oil imports and imports from Japan and not contributed much
to ease the burden of the other deficit countries. 74

The strained relations between the United States and Germany in the area
of international economic policy in 1977 suffered also from the negative atmo-
spheric repercussions of disagreements on East-West policy (President Carter's
human rights campaign) and the export of nuclear technology (the German-Brazi-
lian deal). In addition, there was a serious problem in personal relations be-
tween President Carter and Chancellor Schmidt which tended to permeate and
sour the whole fabric of bilateral relations between Bonn and Washington. In
this context Mr Blumenthal's "open-mouth policy" in June and July reinforced
the German distrust in the way the Carter administration conducted US foreign
and economic policy.

D 4.2. The "Talking Down" of the Dollar

At the OECD-meeting in Paris on June 24, when the DM/dollar rate was at
2.35, Mr Blumenthal gave a press briefing at which he urged the surplus coun-
tries Japan, Germany, Switzerland, and the Netherlands not to interfere with
exchange rate determination and to play their appropriate role in the process
of exchange rate adjustment. 75 This remark, in conjunction with the above-
mentioned communiqué of the meeting, was interpreted by many exchange market
participants as implying that Mr Blumenthal wanted the dollar to depreciate
and was attempting to lead the market. That sparked off a fall in the DM/dollar
rate in the last days of June, a movement which gathered force once market pro-
fessionals were free of their quarter-end positioning requirements in early
July. 76

During July the DM/dollar rate fell to 2.25 apparently stimulated by Mr
Blumenthal's public statements. In an interview with a German financial daily,
the Handelsblatt, on July 7 the Treasury Secretary said that the DM and the
yen ought to appreciate in order to reflect the strong surplus positions

74 Dr Emminger in Manager Magazin (Hamburg), July 1977; Manfred Lahnstein
(State Secretary in the Ministry of Finance) in HB 1/2 July 1977
75 Michael Blumenthal, Remarks at the Ministerial Meeting of the OECD,
US Mission to the OECD, 24 June 1977, pp.3-8
76 FRB September 1977, p.797
of Germany and Japan. Two weeks later, on July 21, Mr Blumenthal continued his "open-mouth policy" in an interview with the Washington Post:

"I would like to see a free floating - apart from smoothing out ragged movements - and allow the exchange rate between the dollar and the yen and the dollar and the Deutschemark to settle down where it does in that context. Whether or not that point has been reached, time will tell, and I would be quite happy to live with whatever the result is."

If Mr Blumenthal's three statements on the exchange rate situation were not made inadvertently, they must be characterized as an aggressive exchange rate policy because they strengthened an existing exchange rate trend. Mr Blumenthal himself has denied any intention to talk the dollar down. But even if he had acted wilfully he would have denied it, because aggressive exchange rate policy - and especially the aggravation of a depreciation of the policy-maker's own currency - is generally considered an offence against the written

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77 Hb 8/9 July 1977

Hb: Aus Ihrer Rede könnte man den Vorwurf herauslesen, dass die Bundesrepublik durch "schmutziges Floaten" die notwendige Wechselkursanpassung verhindert?

Blumenthal: Ich wollte nicht sagen, dass die Bundesrepublik schmutzig gefloatet hat. Die Tatsachenfeststellung, dass wir die Wechselkurse der wichtigen Überschussländer Bundesrepublik und Japan nach oben anpassen lassen müssen, so dass sie die wirklichen Angebots- und Nachfrageverhältnisse, also die starke Überschussposition reflektieren, war nicht als Kritik auf ein bestimmtes Land gerichtet. Die Anpassung im Dollar-Yen Verhältnis, wir sehen dies in letzter Zeit am Devisenmarkt, findet bereits statt.

Hb: Entspricht also die jüngste Dollarschwäche den amerikanischen Anpassungsvorstellungen oder haben die jüngsten Abschläge beim Dollarkurs bereits zu Stützungsinterventionen geführt?


Operators in the currency markets paid a good deal of attention to these remarks. See for example JC 11 July 1977.

78 WP and IHT 22 July 1977

79 In talks with German officials in August 1977, according to Interview with Dr Emminger (May 1983), and at a press conference in Paris on August 7, 1977 (FAZ 8 August 1977). In early 1979 Mr Blumenthal said in an interview "I never said that I wanted the dollar to decline", Fortune Magazine, 29 January 1979.
and unwritten norms of international monetary policy. An admittance may have raised a storm of worldwide protests about US "beggar-thy-neighbour" policy and a protectionist wave in trade and exchange rate policies.

It has been said that "there is no evidence whatsoever that a deliberate, conscious effort was ever initiated to accelerate or accentuate artificially a dollar depreciation". Certainly, Mr Blumenthal had a relatively limited experience in international monetary affairs and it is conceivable that his statements at the OECD-conference were only intended to put additional pressure on Japan and Germany and that it was not a conscious attempt to lead the market. But after having experienced the OECD-incident's depressing effect on the dollar, it is highly unlikely that the Treasury Secretary made the aforementioned interview remarks in July without anticipating their effects on the dollar. Although conclusive proof of Mr Blumenthal's "malevolence" cannot be established, probability points clearly in that direction.

US intervention policy did not run counter to the attempt to talk the dollar down. Certainly the Federal Reserve sold $94.7 million equivalent of DMs between July 8 and July 26, but these interventions were clearly part of the normal policy of "countering disorderly markets." They should only dampen the very short-term fluctuations of the DM/dollar rate, while Mr Blumenthal's "open-mouth policy" was intended to reduce the level of that rate. Unlike early 1975 when the DM/dollar rate also had fallen below 2.30, the US interventions were not stepped up to support the level of the exchange rate in the summer of 1977.

80 The non-binding IMF-guidelines for the management of floating exchange rates from 1974 stated for instance that a "(IMF) member should not normally act aggressively with respect to the exchange value of its currency (i.e. should not so act as to depress that value when it is falling, or to enhance that value when it is rising)." IMF Annual Report 1974, pp.112ff


82 "In 1977, neither the US Treasury secretary nor his chief financial deputy, the undersecretary for monetary affairs, had come into his job with first-hand professional background in either the banking or financial markets community. Secretary Michael Blumenthal and Undersecretary Anthony Solomon had earned graduate degrees in economics, both had experience in the business sector, and both had held high-level trade positions in the Kennedy-Johnson administrations. But neither had dealt with the sensitivities and idiosyncrasies of the foreign exchange community." ibid. p.19

83 FRB September 1977, p.798

84 See page D-15 above.
A few days after Mr Blumenthal's remarks to the Washington Post, Federal Reserve Chairman Arthur Burns tried to calm the furor which the interview had created. Prompted in part by several days of sharp drops in the stock market and partly by advance knowledge that the US trade deficit had jumped to a record $2.8 billion in June, Dr Burns told a Congressional committee on July 26 that the United States had "the responsibility to protect the integrity of its currency for international as well as domestic reasons" and that Mr Blumenthal had been interpreted wrongly by the press. This statement prompted an immediate stabilization of the dollar in the currency markets, but the Federal Reserve Chairman received a public reprimand from Mr Blumenthal. A Treasury spokesman said that the Secretary of the Treasury alone determined the guidelines of US exchange rate policy and that the Federal Reserve merely had to implement this policy.

Both Dr Burns and the Treasury tried to play down the dispute immediately afterwards by declaring complete agreement on the substance of US exchange rate policy and, in particular, on their will to maintain the value of the dollar. And indeed, the tenor of a speech which Mr Blumenthal held on July 28 in Louisville, Kentucky, was quite different from his previous statements:

"A strong dollar is of major importance not only to the United States but also to the rest of the world .... The way to assure the strength of our currency, and the only way to assure a strong dollar, both at home and in international money markets, is by following sensible economic policies, by keeping inflation under control and introducing an effective program for conserving energy and by improving the vitality and efficiency of our economy. The Carter administration is following this approach."

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85 *THT* 28 July 1977; *Guardian* 3 August 1977
86 *THT* 28 July 1977; *VWD* 28 July 1977; *NZZ* 29 July 1977

Later Dr Burns said in an interview "I remember I was testifying before a Congressional committee, and I emphasized the importance of a stable dollar on international markets. I was asked if that was not inconsistent with Treasury policy. I kept a straight face and said it wasn't. Blumenthal was furious." Martin Mayer, *The Fate of the Dollar*, New York, 1980, p.263

The row between Mr Blumenthal and Dr Burns can be taken as a piece of circumstantial evidence against Mr Blumenthal's claim that he had not talked the dollar down on purpose.

87 *THT* 28 July 1977. Arthur Burns said in a second Congressional testimony on July 29 that his divergence with the Treasury had merely been in rhetoric and not on substance. *FT* 30 July 1977
88 *THT* 29 July 1977; *WB* 29 July 1977
This speech represents a complete volte-face compared with Mr Blumen-thal's previous statements on the dollar. A clearly stated preference for a dollar depreciation had been replaced with a preference for a "strong dollar". It is unlikely that the Treasury Secretary genuinely had changed his mind about the desirability of a dollar depreciation within a few days. It is more plausible that the mounting criticism of the "talking down" of the dollar had forced him to abandon that policy and to adopt the traditional role of the responsible finance minister making protective statements in defence of the national currency.

D.4.3. The German Reaction to the "Open-Mouth Policy"

After the recession of 1974/75 the German economy experienced a cyclical upturn which had brought about a 5.5 per cent growth rate in 1976. But in the second and third quarter of 1977 the economy stagnated temporarily, partly because of a slowing down of growth rates in other countries. Consequently the German economic policymakers became worried in the summer of 1977 that the promised 5 per cent growth of the economy could not be attained for the year as a whole. In this context the dollar depreciation and the DM's real appreciation were especially deplored because of the resulting loss of German competitiveness in the international markets for goods and services. 89 The fall in the DM/dollar rate in July was clearly at odds with the exchange rate preference of the German policymakers and they repeatedly stated that the dollar was undervalued. 90

The exchange rate development was countered with three types of market-oriented measures. Firstly, the Bundesbank resumed interventions in early July when the exchange markets became dominated by speculative trading in the wake of Mr Blumenthal's remarks at the OECD-meeting. Before that incident, the DM/dollar rate had been remarkably stable and the Bundesbank had not intervened at all in the second quarter of 1977. During July, however, the dollar purchases averaged more than DM 50 million a day, the heaviest dollar-supporting interventions by the Bundesbank since the advent of floating rates.

89 Especially Finance Minister Hans Apel voiced concern about the export industry's difficulties in face of the DM-appreciation. RZ 15 July 1977; VWD 28 July 1977
Secondly, in order to arrest the "turbulent and erratic" dollar depreciation the Bundesbank lowered its Lombard rate from 4.5 per cent to 4 per cent on July 14.91 It was hoped that a widening of the interest rate gap in favour of the dollar would reduce the flow from dollar holdings into DM. Although exchange rate considerations had influenced the Bundesbank's interest rate policy occasionally in the previous years, it was the first time since the breakdown of the Bretton Woods system that the discount or the Lombard rate were changed outright for exchange rate reasons. However, it was stressed that the measure did not run counter to domestic economic needs, because economic activity threatened to stagnate anyway and the growth of central bank money was still in line with the target rate of 8 per cent.92

Finally, the reiterated statements by German policymakers in July about the dollar's undervaluation can also be regarded as a market-oriented measure as far as the statements were intended to counter the dollar-depressing effects of Mr Blumenthal's "open-mouth policy".

In the bilateral perspective the situation in the summer of 1977 represented an outright conflict between German and American exchange rate preferences and policies. The American preference for a dollar depreciation was clearly at odds with the German desire to avoid a fall in the DM/dollar rate, and while Mr Blumenthal's "open-mouth policy" promoted the American exchange rate preference the Germans countered the dollar depreciation with the above-mentioned measures. The situation contained the ingredients of a classical competitive-depreciation scenario.

However, this constellation of preferences and policies did not erupt into a very serious or long-lasting bilateral crisis, partly because the German government's diplomatic reaction to the "open-mouth policy" was rather cautious, and partly because the "talking down" of the dollar was abandoned

91 According to Dr Emminger at the press conference following the central bank council's meeting on July 14, BZ, 15 July 1977.
92 The Bundesbank's easing of monetary conditions revealed how difficult it was to satisfy the US demands that Germany on the one hand should relax more forcefully and, on the other hand, not resist an appreciation of the DM. Monetary measures like the reduction of the Lombard rate, fulfilled the former demand, but conflicted with the latter.
93 The German policymakers regarded the American exchange rate preference as being opposite to their own: "...it had to be assumed that the US authorities considered this deterioration in the exchange rate of the dollar to be a useful means of reducing the US trade and current account deficits", DB, Annual Report 1977, pp.44f
swiftly after the last and most controversial incident (the Washington Post interview):

Although the German policymakers seemed to regard Mr Blumenthal's statements to the press as a planned attempt to weaken the dollar, they did not accuse him publicly in that way. 94 It was only regretted that "incautious remarks" had contributed to the dollar's weakness. 95 The Bonn government was apparently anxious to avoid a deterioration of the relations with Washington by taking the conflict over the exchange rate into the public. In contrast, Henri Simonet, the Belgian foreign minister and chairman of the EC Council of Ministers at that time, said openly that the United States had shifted from "benign neglect" to "aggressive neglect" and that it was a deliberate policy. 96 The German press was also very harsh in its criticism of Mr Blumenthal's behaviour.

Helmut Schmidt may have complained about Mr Blumenthal's statements when he was in Washington in mid-July, but at the end of the visit the German Chancellor and President Carter declared "absolute agreement". Mr Schmidt denied that the Americans had asked him to do more than to attain the promised 5 per cent real growth on that occasion. According to the German weekly Der Spiegel, Mr Blumenthal had told the German Chancellor that there would be no new American demands as long as Germany achieved 5 per cent real growth and did not resist a DM-appreciation in response to basic market forces. 97

After the third incident of "open-mouth policy" on July 21, Bonn's patience with Mr Blumenthal seemed to have worn thin. Again according to Der Spiegel, Helmut Schmidt asked Federal Reserve Chairman Arthur Burns if he could stop the Treasury Secretary. 98 Whether this unconventional contact between a head of government and a foreign central bank chief actually took place or not, Dr Burns intervened and put an end to the talking down of the dollar as described in the preceding section.

94 Bundesbank President Emminger leaned to the view that Mr Blumenthal's statements were a deliberate attempt to talk the dollar down: "Manches deutet darauf hin, dass Blumenthal im Juni/Juli 1977 bewusst den Dollar nach unten redete," Interview with Dr Emminger (May 1983). Bundesbank Director Leonhard Gleske shared this perception when he mentioned the "talking down of the dollar" at a conference in Frankfurt on 14/15 May 82.

95 Finance Minister Apel after the interview in the Washington Post.

96 IHT 28 July 1977

97 Der Spiegel no.32/1977, 1 August 1977

98 loc.cit.
Hans Apel, the German Finance Minister, reacted to the Washington Post article by telling the press that he would have to talk very seriously with his American counterpart at a forthcoming conference of finance ministers in Paris on August 6/7. Actually, the two finance ministers made a public demonstration of unanimity at the end of their meeting in Paris. A confrontation was apparently avoided, probably helped by the fact that the dollar had recovered noticeably after Dr Burns had made his dollar-supporting statement in Congress. Mr Blumenthal denied to have talked the dollar down deliberately on this occasion and he could refer to his Louisville-speech where he had expressed his preference for and belief in a strong dollar.

The conflict between the US and German exchange rate policies in July 1977 had a damaging effect on the daily coordination of intervention policies. The cooperation between the American and German monetary authorities remained on a low level in the remaining part of the year. Furthermore, the "open-mouth policy" increased the German policymakers' (especially Helmut Schmidt's) distrust in the Carter administration's handling of international economic policy. In this way, the episode contributed to the creation of the European Monetary System in 1978.


After the "open-mouth policy" had been stopped and the exchange market had been reassured by Dr Burns' statement and Mr Blumenthal's Louisville-speech at the end of July, the dollar recovered somewhat and remained above the 2.30 DM/$ level from mid-August until the end of September under calm and orderly exchange market conditions. But then the dollar depreciation resumed and continued throughout the remaining part of 1977.

99 Hb 25 July 1977
100 FAZ 8 August 1977
101 Hb 25 July 1977
102 According to Professor Norbert Kloten, a member of the German central bank council, the US monetary authorities declined more or less to cooperate with the German authorities on exchange rate policy in the autumn and winter of 1977. Norbert Kloten, "Das Europäische Währungssystem", Europa-Archiv no.4/1980, p.112
103 "The EMS emerged, in other words, against the background of the German chancellor's diminishing confidence in American leadership in general and not simply in the monetary sphere." Ludlow, op.cit. p.69
According to market observers, the renewed dollar depreciation was stimulated when Michael Blumenthal talked about rather bleak prospects for the US trade balance at the IMF Annual Meeting at the end of September. But while the Treasury Secretary was not criticized for these remarks, another incident in mid-October revived the earlier allegations of "open-mouth policy". A press briefing by Mr Blumenthal on October 13 resulted in a news story that quoted him as saying that the appreciations of the yen and of the mark as of that date were "relatively small".

The Treasury Department issued a denial both of this report and of an Associated Press report carried in newspapers on October 15, quoting the Treasury Secretary as saying that he felt the yen and mark were undervalued against the dollar. The denial stated that the press reports did not reflect the secretary's view on the subject. It has been demonstrated by Stephen D. Cohen that Mr Blumenthal had been grossly misquoted in that case. His remark about exchange rates had been taken out of context and were apparently given a different meaning from that he intended. There seems to be no reason to suspect a deliberate attempt to talk the dollar down in October 1977, although the actual exchange rate effects resembled the effects of the "open-mouth policy" in June/July 1977.

In a speech in Houston on October 19 Mr Blumenthal tried to mitigate the depressing effects on the dollar which the press reports had created. He declared that a strong and stable dollar was essential both to the United States and to the world at large. Furthermore, he maintained that a dollar depreciation would not erase the US trade deficit, which instead should be reduced by an effective energy program.

From the official German side no accusations about "open-mouth policy" were made, but the press resumed the earlier criticisms of the US Treasury Secretary. When Mr Blumenthal was in Germany in early November, he tried to calm the resentment against his exchange rate policy. He restated the US interest in a strong dollar and said that he had learned self-restraint with regard to comments on the exchange rate situation.

104 Guardian 10 October 1977; FRB March 1978, p.165
105 Cohen, op.cit. p.21; Die Welt 15 October 1977
106 Cohen, ibid.
107 loc.cit.
108 WB 20 October 1977; IHT 20 October 1977
109 NZT 3 November 1977
While the "open-mouth policy" had disappeared as a controversial issue in US-German relations in the autumn of 1977, the same could not be said about the reflation of the German economy. It had become clear by then that the German growth rate for 1977 would remain far below the 5 per cent target which Chancellor Schmidt had promised to attain at the London summit in May. During Mr. Blumenthal's visit in Bonn there had been -- in diplomatic parlance -- "a very open exchange of views,"110 on the subject. This dispute continued in the following winter and it remained linked to the exchange rate issue. But unlike the reflation issue, US-German relations with regard to exchange rate management underwent a change in the winter of 1977/78 as Part E will show.

110 Hb 4 November 1977
From October 1977 to the end of 1979 the dollar depreciated by 26 percent against the DM from 2.30 DM/$ to 1.70 DM/$. The dollar’s weakness was especially pronounced in the winter of 1977/78 and in the second half of 1978 and 1979. In between these phases the dollar had two spells of modest recovery against the DM and other currencies. In early 1980 the US currency started to gain ground in the DM/dollar market on a more enduring basis.

The period of dollar weakness in the late 1970s was characterized by a much more intensive management of the DM/dollar rate than the preceding 4½ years as the exchange rate gained a political importance in the United States and in Germany which was unprecedented since the last phase of the Bretton Woods system. The American and German authorities tried to contain the fall in the DM/dollar rate with a variety of measures, but their commitment to this task developed in opposite directions between late 1977 and the autumn of 1979. On the German side the efforts to arrest the fall in the DM/dollar rate decreased considerably as the initial worries about the dollar weakness waned into equanimity. The Americans, on the other hand, increased their dollar support considerably during the same period as their attitude towards the dollar weakness changed from indifference to strong concern. The opposite tendencies in US and German exchange rate policies are analyzed in the respective national perspectives in the first two chapters of this part.

On the basis of the two partial analyses of DM/dollar exchange rate management the exchange rate diplomacy between the United States and Germany is examined in chapter E.3. The main argument is that the opposite developments in the American and German attitudes towards the dollar weakness in the late 1970s changed the constellation in the bilateral management of the DM/dollar rate fundamentally. In November/December 1977 the German policymakers tried to persuade their American colleagues to be less complacent about the dollar depreciation and to support their own currency more vigorously, but these efforts were of little avail. In the next year and a half the balance of power shifted gradually in Germany’s favour as the United States developed a strong preference for arresting the dollar’s fall, but remained reluctant to pursue domestic economic policies in accordance with this preference. The Americans tried to minimize unpopular internal adjustment measures by
involving Germany (and to a much lesser extent Japan and Switzerland) in the
defence of the dollar. The American interest in foreign help for the ailing
dollar provided the Germans with a certain leverage on US policies which
they used in the preparation of the dollar rescue package of 1 November 1978.
In the following year Germany’s concern about the falling DM/dollar rate had
abated and American demands for stronger German efforts to bolster the dollar
were refused. Consequently an adjustment of US policies became unavoidable.
On 6 October 1979 the Federal Reserve announced a number of measures which
ended the inconsistency between the US preference for a stronger dollar and
the conduct of domestic monetary policy.

Each of the chapters in this part is divided into three sections corres-
ponding to the three phases of dollar weakness in the late 1970s. This divi-
sion is appropriate because the most significant changes in the political-
economic context of the DM/dollar exchange rate management happened between
the various bouts of dollar weakness.

E.1. US Exchange Rate Policy in the Face of the Dollar Crisis

Since the advent of widespread floating in 1973 the United States had
often been criticized for supporting the dollar insufficiently when the US
currency was falling in the exchange markets. In the summer of 1977 the US
Treasury Secretary was even accused of actively engineering a dollar depre-
ciation. Such criticism died down in 1978 and 1979 as the US authorities
became increasingly concerned about the dollar’s weakness and gradually step-
ped up their efforts to strengthen the dollar. The present chapter examines
how and why US exchange rate policy departed so significantly from the ini-
difference and passivity which prevailed in the initial stage of the dollar
weakness.

In the winter of 1977/78 US policymakers started to pay more attention
to the negative effects of the dollar weakness on domestic price stability,
the international price of oil, the dollar’s international standing, and
global economic recovery. Reluctantly they increased their support for the
dollar avoiding any fundamental changes in US exchange rate policy.

In the autumn of 1978 US policymakers also started to worry about the
implications of the rapidly depreciating dollar for the position of the
United States in the international political system. A comprehensive rescue package for the dollar was announced on November 1. This program changed some long-standing principles of US exchange rate policy and initiated a period with massive American interventions in support of the dollar.

In 1979 the issues of inflation and dollar depreciation became more intertwined as the view gained ground among American policymakers that the dollar's external weakness not only stimulated domestic inflation, but also - and even primarily - was a symptom of it. In accordance with this perception, the Federal Reserve decided to combat inflation, dollar depreciation, and their mutually reinforcing relationship with a drastic revision of US monetary policy. This comprised monetary restrictions and a fundamental change in the operating techniques of US monetary policy. The measures, which were announced on 6 October 1979, are generally seen to have been crucial for the dollar's recovery in the early 1980s.

It was a characteristic trait of US exchange rate policy in the late 1970s that each successive effort to curb the dollar's decline included a larger domestic dimension, i.e. measures which addressed the domestic roots of the dollar weakness. This trend reflected a gradual shift in the perceptions of US policymakers regarding the causes of the dollar crisis. In the winter of 1977/78 they did not believe (or did not admit) that the dollar depreciation had domestic origins. Almost two years later - in October 1979 - Washington's exchange rate policy became based on the view that US monetary expansion and US inflation was the basic cause of the dollar's external weakness.

E.1.1. The Emergence of an American Concern about the Dollar Weakness in the Winter of 1977/78

From late September 1977 to March 1978 the dollar depreciated by 14 per cent against the German mark. At first the US policymakers were not seriously concerned, but as the negative consequences for a number of their political-economic objectives became apparent they paid more attention to the exchange rate development. The emerging concern resulted in various attempts to arrest the dollar's decline, although the US authorities remained reluctant to commit themselves too deeply in exchange rate management in this phase of the dollar's weakness.
When the DM/dollar rate started to fall in the autumn of 1977 the US policymakers did not consider the dollar depreciation to be out of line with the underlying economic and financial conditions. Certainly, Treasury Secretary Blumenthal and other US officials rarely omitted an opportunity to declare the Administration's interest and belief in a strong dollar. But the context of these statements suggests that they were made to pacify those who had criticized Mr Blumenthal for his "open-mouth policy" in the summer of 1977 and to erase the impression that the Carter administration still wanted the dollar to depreciate. But the statements in the autumn of 1977 did not reflect a preference for a strengthening of the dollar.

In December 1977, when the DM/dollar rate had fallen by 9 per cent and approached 2.10 DM/$ in hectic foreign exchange trading, the top policymakers in Washington abandoned their nonchalant attitude towards the dollar's external value. It was now said that the dollar had depreciated by more than the fundamental conditions warranted. The reason for the emerging concern about the dollar weakness seemed to be the negative consequences which Federal Reserve Governor Henry C. Wallich enumerated in a speech in late December and which also were recognized by other policymakers in Washington.

Firstly, it was perceived that the dollar depreciation contributed to domestic inflation which was running at an underlying rate of 6 to 6½ per cent at that time. The new Federal Reserve Chairman G. William Miller explained in a Congressional testimony in March 1978, that the dollar's depreciation had added 0.75 percentage point to the US inflation rate since September 1977. In general the Carter administration showed a new interest in fighting inflation in 1978, probably because it wanted to make progress on this front before the approaching mid-term elections. Traditionally changes in the dollar rate had almost exclusively been discussed in terms of price competitiveness in the United States. But the dollar depreciation of 1971-73 and inflation rates around 10 per cent in the following years had made policymakers and

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1 President Carter in a statement on December 21, WB 22 December 1977
2 IHT 29 December 1977. The full text is reprinted in Finanz und Wirtschaft (Zürich) 11 January 1978.
3 IHT 16 March 1978
4 A historical parallel in American politics to such pre-election concern about inflation was President Nixon's "New Economic Policy" in 1971. The wage and price controls of this program lowered inflation temporarily in 1972 which helped to bring about Richard Nixon's landslide victory against Senator McGovern.
informed public opinion more aware of a link between the dollar's external value and the level of domestic prices and wages. This relationship was furthermore seen to be strengthened by a significant increase in the openness of the US economy during the 1970s.

Secondly, it was realized in the United States that the OPEC-countries might raise the dollar-denominated oil price in compensation for a continued depreciation of the dollar. At an angry meeting of OPEC ministers in December 1977 the "moderate" countries led by Saudi Arabia had warded off demands for an oil price increase of up to 15 per cent from the more hawkish members. The meeting's communiqué expressed "great concern" about the loss of the OPEC-countries' purchasing power as a result of inflation and the depreciation of the dollar against other major currencies. The Saudi oil minister, Sheik Yamani, said that the main reason for the continuing price freeze was an oil surplus of 2 million barrels a day and that once this surplus had been absorbed oil prices would be rising. According to a published report, President Carter received a direct warning from the Saudi Arabian King Khalid during a state visit in Riyadh in early January 1978 that oil prices would be increased if the United States did not prevent the dollar from depreciating further. Even though Washington denied that such a threat had been made, the President was clearly made aware of Saudi concern over the dwindling value of the dollar, and it had apparently made a strong impact on him. Immediately afterwards, on January 4th, the US monetary authorities initiated a new currency swap arrangement with the German Bundesbank.

Thirdly, it was believed that an excessive dollar depreciation weakened investors' confidence in the dollar as a suitable store of value. Such a lack of confidence was apt to stimulate a flight out of dollar into other currencies and cause instability and disruption in the international monetary system. It was feared that as a result the financing of the US current account deficit

5 FT 22 December 1977
6 JC 4 January 1978
7 "It is rumoured that the US attitude (on the dollar) was finally modified only after King Khalid of Saudi Arabia had told President Carter during a state visit that Saudi Arabia could not hold the price of oil if the United States could not hold the price of the dollar." Tom de Vries, "In Search of an Exchange Rate Policy for the Dollar", Banca Nazionale del Lavoro Quarterly Review, no.125, June 1978, p.155. See also Newsweek 16 January 1978; Martin Mayer, The Fate of the Dollar, New York, 1980, p.274; and Robert Solomon, The International Monetary System 1945-1981, New York, 1982, p.346.
would become increasingly difficult. In the fourth quarter of 1977 that defici-
ty was running at an annual rate of $28 billion and the dollar's depreciation
was first expected to improve the current account after a lag of 1 or 2 years. 8
In addition, the dollar's instability reduced its usefulness as a transaction
currency in international trade, and it was rumoured that OPEC was considering
using a basket of currencies (like the SDR) instead of the dollar for the de-
nomination of the oil price. The US policymakers were aware of the national
and systemic disadvantages which would follow if the dollar's attractiveness
in its various international roles was seriously and abruptly reduced in the
process of depreciation. 9

Finally, the Germans had often argued in 1977 that an excessive depre-
ciation of the dollar would slow down economic recovery in Germany and else-
where. In late December 1977 indications became apparent that US policymakers
accepted this reasoning. 10 It was mentioned as one of the factors behind the
US interest in a strong dollar not only by Governor Wallich but also by Fede-
ral Reserve Chairman Burns. 11 In accordance with the "locomotive theory",
economic growth abroad was very much desired by the United States, not at
least because of the expected increase in demand for US goods and services.

The emerging American concern about the dollar's weakness was reflected
in a number of exchange rate political measures in the winter of 1977/78.
The first reaction of the US authorities was an intensification of their
direct interventions in the DM/dollar market. The US Treasury acknowledged
that the dollar rate was moving erratically, 12 and said that US interventions
would be on a larger scale at times of "hectic movements" in the exchange
markets. 13 The American DM-sales totalled $545 million in December (an ave-
rage of $26 million per business day) which was higher than in any one-month
period before in the era of floating exchange rates. But this increase did

8 ERP 1978, p.110
9 Wallich, op.cit.
10 The US editor of the Financial Times detected "signs in recent weeks that
the US has become more receptive to the West German argument that the Fe-
deral Republic's ability to stimulate its economy this year was being
circumscribed by the strength of the D-mark against the dollar."
FT 5 January 1978
11 Wallich, op.cit.; Dr Burns as quoted in IHT 31 January 1978
12 Treasury Undersecretary Anthony Solomon in an interview, IHT 10/11 Decem-
ber 1977
13 FT 16 December 1977
not signify a departure from the basic stance of US intervention policy. It was rather a reaction in proportion to the acknowledged increase in market disorder. US interventions were still restricted to smoothing erratic fluctuations of the DM/dollar rate on a day-to-day basis when the dollar was weak.

The mounting official concern about the disorderly nature of the foreign exchange markets prompted also a high-level strategy review meeting in December 1977. The initiation by the administration of public statements of concern and determination to address the exchange rate problem was the main result of the meeting. On December 21 the White House released a lengthy pronouncement on US balance-of-payments and exchange rate policies. It was an attempt to weather the dollar crisis by using the announcement effect of a presidential statement, but avoiding substantial changes in US exchange rate policy.

In the statement President Carter noted the emergence in 1977 of a large deficit in the US trade and payments position. He said that the deficit had "contributed to some disorder in the exchange markets and rapid movements in exchange rates .... While some exchange rate adjustment has been understandable in light of economic developments in Germany, Japan, and the United States, recent exchange market disorders are not justified." He acknowledged "a responsibility to protect the integrity of the dollar" and announced a number of minor administrative steps to reduce US dependence on foreign oil and to expand US exports. When fully implemented, these measures were expected to improve the US balance of payments with "several hundred million dollars" (compared with current account deficits of $14 billion in both 1977 and 1978). Furthermore the statement repeated the standard formula of US intervention policy:

"In the discharge of our responsibilities, we will, in close consultation with our friends abroad, intervene to the extent necessary to counter disorderly conditions in the exchange markets."

In short, President Carter reaffirmed what already had been said by Treasury and Federal Reserve officials. The Administration was apparently hoping that the display of concern at the highest level of government would be sufficient to restore confidence in the dollar, stabilize the exchange market and silence

15 WB 22 December 1977
16 US officials conceded that none of these measures could possibly be working before the start of 1979 at the earliest. FT 22 December 1977
the foreign critics of US benign neglect. The use of announcement effects was continued in January 1978 in President Carter's State of the Union Message and in the Economic Report of the President.

The currency markets, however, were not impressed by this "talking up" of the dollar and in the week after Christmas the dollar continued its descent. This development was aggravated by the announcement that President Carter had removed Arthur Burns from the chairmanship of the Federal Reserve and replaced him with G. William Miller, a largely unknown businessman. Dr. Burns had become a symbol of stability and anti-inflationary commitment and the manner and timing of the change increased the international financial community's distrust of the Carter administration's economic policies.

Realizing that the statement of December 21 had failed to achieve the desired impact, the US monetary authorities decided to take other steps. In early January 1978 they took the initiative to establish a new currency swap arrangement between the US Treasury Department's Exchange Stabilization Fund and the German Bundesbank. On January 4th the Treasury and the Federal Reserve issued the following joint statement:

"The Exchange Stabilization Fund of the United States Treasury will henceforth be utilized actively together with the 20 billion US$ swap network operated by the Federal Reserve System. A swap agreement has just been reached by the Treasury with the Deutsche Bundesbank and is already in force. Joint intervention by the Treasury, the Federal Reserve, and foreign central banks is designed to check speculation and re-establish order in the foreign exchange markets."

This new credit line of unstipulated magnitude was in addition to the existing $2 billion Federal Reserve swap line with the Bundesbank. It was designed to dramatize official determination to restore and maintain an orderly DM/dollar rate. The Treasury's financial participation in the swap network should

17 The initiative to this agreement was taken by the American side according to Bundesbank President Emminger (VVD 6 January 1978; FAZ 7 January 1978) and Anthony Solomon, Under Secretary for Monetary Affairs at the US Treasury (Martin Mayer, op. cit., p.276). Mr Solomon placed the initiative more specifically on Dr Burns. See also DB, Annual Report 1977, p.46
18 WB 5 January 1978
19 The total size of this swap line has never been disclosed. However, the maximum outstanding debt on this swap line has never exceeded $1 billion. Bundesbank President Emminger said, when asked about the size of the arrangement, that there was an understanding with the Americans about the appropriate size of the credit line, but that it did not represent an absolute limit. Der Spiegel, 9 January 1978
demonstrate that the Carter administration itself, and not only the Federal Reserve, was backing the dollar-supporting interventions. 20

The announcement rephrased the stated target of US interventions from "countering disorderly market conditions" to "checking speculation and re-establishing order in the foreign exchange markets." However, the old wording was reinstated in official Treasury statements a few weeks later. 21 It seems as if the formulation in the January 4 statement only had been chosen to underline the determination of the US authorities. That could not have been achieved with the worn-out and rather diffident formula about "countering disorderly exchange market conditions."

Actual US intervention activity confirmed that the January 4 announcement did not imply a departure from the basic principles of US intervention policy. Certainly, on the day when the announcement was released, "the Federal Reserve's foreign exchange trading desk shifted to a more open and forceful approach to the market than it had used in the previous months." 22 For seven trading days the US DM-sales averaged $109 million. But even on one of those days no DM-sales were made at all because "the exchange market came into better balance." 23 When the DM/dollar rate stabilized briefly in mid-January, the US interventions were stopped completely for a week. In response to new downward pressure on the dollar, interventions were stepped up again in February and March to a daily average of $29 million, i.e. roughly the same level as in December 1977. All the US DM-sales in the first quarter of 1978 were financed by equal drawings on the Federal Reserve's and the Treasury's respective swap lines with the Bundesbank.

In general, the size of US interventions was increased perceptibly during the dollar crisis in the winter of 1977/78. In the four months from December 1977 to March 1978 US DM-sales amounted to $2.6 billion (compared with total DM-sales of $3.3 billion from July 1973 to November 1977). The 'light intervention' stance had been replaced with a somewhat more determined approach. But the other aspects of US intervention policy had not changed. US interventions continued to be financed with swap loans from the Bundesbank and they remained one-sidedly oriented towards dollar support. They were still carried

21 PT 3 February 1978; WB 7 February 1978
22 FRB, March 1978, p.164
23 ibid. p.167
out on a day-to-day basis with the limited target of countering short-term erratic fluctuations and disorderly market conditions. No attempts were made to moderate exchange rate movements over extended periods by "leaning against the wind."\textsuperscript{24}

In addition to the intensification of interventions and the attempts to talk the dollar up, domestic monetary policy played a role in US exchange rate policy in the winter of 1977/78. On January 6 the Federal Reserve decided to increase the US discount rate from 6 per cent to 6.5 per cent in view of "the recent disorder in foreign exchange markets (which) constitutes a threat to orderly expansion of the domestic and international economy."\textsuperscript{25}

The stated motive seemed to imply that concern for the dollar's international strength had transformed policy priorities away from the domestic economic situation. However, the real motives for the monetary tightening were a mixture of external and internal considerations at the Federal Reserve. For Arthur Burns, the outgoing Federal Reserve Chairman and initiator of the discount rate increase\textsuperscript{26}, the measure was primarily intended to support the dollar in the exchange market, although he did not perceive a dilemma between the exchange rate target and the domestic economic needs. Inflation was his overriding concern and that called for monetary restraint on both fronts.\textsuperscript{27}

According to an interview conducted by Stephen D. Cohen with an official involved in the release of the announcement about the discount rate increase "tightening of monetary policy complemented both internal and external economic needs. The externally oriented motivation was chosen specifically to preempt any repetition of the traditional criticism by a Democratic White House of Federal Reserve efforts to increase interest rates."\textsuperscript{28} That means, by

\textsuperscript{24} Treasury Undersecretary Anthony Solomon confirmed the long-standing principles of US intervention policy in a Congressional testimony on February 6, 1978. \textit{WB} 7 February 1978

\textsuperscript{25} Statement by the Federal Reserve Board, Washington, 6 January 1978

On January 9, when the discount rate increase became effective, the Federal Reserve boosted its interest rate target on federal funds from 6.5 per cent to 6.75 per cent. This promotion of firmer conditions in the US money market reinforced the psychological impact of the discount rate increase. \textit{FT} 11 January 1978

\textsuperscript{26} The monetary tightening was disputed within the Federal Reserve and was not backed up by the Treasury. \textit{FT} 11 January 1978 and 12 January 1978; Interview with Dr Emminger, May 1983.

\textsuperscript{27} Interview with Dr Emminger, May 1983

\textsuperscript{28} Cohen, \textit{op.cit.} pp.23f: not-for-attrition interview with former Federal Reserve Board official, February 1979.
justifying the discount rate rise with exchange market disorder the Federal Reserve hoped to avoid being criticized for an excessive preoccupation with price stability in its monetary policy at the expense of further economic growth.

Certainly, the monetary measures in January 1978 did not signify a re-orientation of US monetary policy towards an exchange rate target. If the domestic economic situation had not called for a monetary tightening, the dollar's weakness in the exchange market would hardly have been sufficient to spark off an interest rate increase at that time. But in contrast to the previous years, exchange rate considerations had played more than only a marginal role in the decision-making.

In spite of the various support actions for the dollar in December and January the exchange market trend was not reversed. The DM/dollar rate fell from a level of 2.10 at the turn of the year to just below 2.00 on March 1. At that point the German and American authorities were already engaged in intensive consultations about a new bilateral initiative to support the dollar. On March 13, US Treasury Secretary Blumenthal and the German Finance Minister Hans Matthöfer issued a joint statement. It reaffirmed the Rambouillet-formula on intervention policy once more by declaring that "forceful action will be taken to counter disorderly conditions in the exchange markets." To reassure the markets that ample resources would be available to finance US intervention, the swap line between the Federal Reserve and the Bundesbank was doubled to $4 billion. Moreover, the US Treasury announced that it was prepared to sell 600 million in special drawing rights (SDRs) to Germany and, if necessary, to draw on its reserve position at the IMF to acquire foreign exchange that might be needed for intervention. The United States also indicated its commitment to conserve energy, to develop new sources of supply, and to press for Congressional approval of an energy program.

The statement of March 13 failed to strengthen the dollar in the exchange market. The announced measures were less far-reaching than anticipated by most market operators, who had been aware for some time that a new dollar support

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29 In interviews with the author, Federal Reserve officials said that exchange rate considerations did not play a decisive role in US monetary policy before November 1978.

30 Besides exchange rate policy the March 13 statement covered the issue of German counter-recessionary measures. The bilateral diplomacy behind the US-German agreement is discussed in chapter E.3.1.

31 WB 14 March 1978
package was in the offing. The reluctance of the US authorities to commit themselves too deeply in exchange rate management was almost sensed between the lines of the statement. Certainly, the resources available for US interventions were boosted, but that medicine had already been prescribed in January without a lasting effect on the dollar's value. Even an increased dosage was not sufficient to turn the market in March. The declaratory parts of the statement could not impress either. The dollar remained on a level only slightly above 2.00 DM/$ in the following weeks.

In general, the more active American exchange rate policy from December 1977 to March 1978 reflected the emerging concern among US policymakers about the negative consequences of the dollar depreciation for domestic inflation, oil prices, the dollar's international standing, and global economic recovery. However, they avoided any drastic change in US exchange rate policy in this phase of the dollar weakness. The most substantial measure was the perceptible increase in swap-financed DM-sales, but the limited target of "countering disorderly market conditions" was maintained. In spite of the official motivation, the monetary tightening in early January seemed primarily to have been domestically oriented. The remaining measures were mainly attempts to arrest the dollar's decline with public expressions of concern and determination to counter market disorder.

E.1.2. The Dollar-Rescue Package of 1 November 1978

The autumn of 1978 saw the second phase of the dollar's weakness in the late 1970s. The fall in the DM/dollar rate was about the same size as in the winter of 1977/78, but it occurred under more chaotic exchange market conditions. Especially in October, the exchange rate movements of the dollar got completely out of hand. In panic-stricken currency trading the dollar's value fell to DM 1.70, which prompted the US authorities to announce a comprehensive "rescue package" on 1 November. The measures included the use of monetary policy for exchange rate purposes in conflict with domestic economic goals, the acquisition of foreign exchange reserves, and more ambitious exchange market interventions.

32 The main part of the dollar's depreciation happened between early August and late October. In that period the DM/dollar rate fell by 17 per cent from 2.05 to 1.70 (see the Main Chart).
Among the reasons which had activated US exchange rate policy in the winter of 1977/78, the concern about the inflationary effects of the dollar's weakness gained a special prominence under the circumstances of 1978. The United States was entering the fourth year of expansion after the recession of 1974/75. Output and employment continued to rise, although more slowly. Production began to reach full capacity, and productivity growth dropped significantly. Under these conditions inflation accelerated. The consumer price index increased 9 per cent over the four quarters of 1978, compared to 6.6 per cent in 1977.34

Already in the spring the Carter administration started to pay more attention to improving price stability in response to the worsening inflation figures and probably also with an eye to the Democratic Party's chances in that year's mid-term elections. In April President Carter announced an anti-inflationary program. Business and labour were presented with "guidelines", federal pay rises were cut, and a tax reduction plan was trimmed and delayed. At the same time the Federal Reserve shifted to what it called "a less accommodative stance" in domestic money markets. However, neither the Administration nor the Federal Reserve was willing to make a significant departure from the expansionary course of economic policy in 1978. At the peak of the longest recovery in the postwar era the federal budget showed a $50 billion annual deficit and real interest rates were negative since nominal interest rates remained below the inflation rate.37

According to the Federal Reserve, the anti-inflationary measures in April and the slight rise in interest rates contributed to the temporary strengthening of the dollar in the spring of 1978.38 The DM/dollar rate climbed back to a maximum of 2.13 in mid-May after having touched the psychological benchmark of 2.00 DM/$ in March. The American authorities appeared to be content

33 Economic growth slowed from 5% per cent over the four quarters of 1977 to 4.25 during 1978. The increase in employment fell from 3.9 million jobs in 1977 to 3.3 million in 1978. ERP 1979, pp.25f
34 ERP 1980, p.27
35 ERP 1979, pp.46f, 77-85
36 FRB, September 1978, p.721
37 While the consumer price index rose by 9 per cent during 1978, the average money market rate was 7.93 per cent and Treasury bonds yielded 8.49 per cent on average. IMF, International Financial Statistics Yearbook, 1980, p.52
38 FRB, September 1978, p.721
with this development and they used the opportunity to purchase DMs to liquidate outstanding swap debt with the Bundesbank.

On 19 April the Treasury announced that it would resume the sale of gold from US reserves after a break of almost three years. A total of 1.8 million ounces should be sold from the stock of 275 million ounces in a series of six monthly auctions starting in May. Just as with the sale of 1.25 million ounces in 1975, the gold sales in 1978 were supposed to be a step towards the demonetisation of gold, but were also widely interpreted as a symbolic gesture by the Carter administration to show its determination to act in favour of the dollar's international strength. That interpretation was confirmed in August and November 1978 when the US Treasury explicitly presented increases of the gold sales as dollar-supporting measures.

The dollar's recovery in the spring of 1978 did not endure for long. In late May, when new data and forecasts pointed to a widening of the US current account deficit and to an acceleration of the inflation rate, the balance of market forces tipped against the dollar once more. The DM/dollar rate started to fall slowly from the level of 2.10 and reached 2.05 at the end of July. The trading in the DM/dollar market remained relatively orderly in that period and the Federal Reserve's dollar-supporting interventions were very small. However, in the same period the dollar depreciated by 13 per cent against the yen (with the US authorities abstaining from interventions in the yen/dollar market as usual). Federal Reserve Chairman Miller regarded this as "a breakout of the yen rather than a decline of the dollar" and ascribed it to the high and rising Japanese current account surplus. In 1978 that surplus amounted to $16.5 billion compared with Germany's surplus of $9 billion. The general impression among observers was that the US policymakers quietly approved of the yen's real appreciation in the summer of 1978 because it reduced the competitiveness of Japanese products on the American market. But that did not mean that they held the same attitude with regard to the DM and other European currencies as the developments in August 1978 should prove.

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40 FRB, September 1978, p.722

41 For example by Anthony Harris of the Financial Times (21 April 1978) and by the Washington-correspondent of the Neue Zürcher Zeitung (22 April 1978).

42 IHT 1 August 1978
In early August the dollar came under more general downward pressure and the DM/dollar rate plunged by 5 per cent within two weeks to 1.95. Now the US authorities admitted that there was a dollar problem and their concerns about the negative consequences of an excessive depreciation reappeared. On 16 August the White House issued a statement in which President Carter expressed his "deep concern" over what he labelled the "sharp decline in the dollar and disorderly market conditions" and he asked the Secretary of the Treasury and the Federal Reserve Chairman to seek ways to stem the decline. The statement noted that the exchange rate situation could "threaten progress towards dealing with our inflation" which was running at an annual rate of 10 per cent at that time. Federal Reserve Chairman Miller added that if the United States did not act "there will be tremendous pressure for OPEC to think of a solution, either through increased prices or through a shift to another form of payment." However, President Carter's initiative on 16 August was also a reaction to the state of affairs in US-German exchange rate diplomacy which will be discussed in chapter E.3.2.

After the presidential statement the DM/dollar rate stabilized temporarily at the 2.00 DM/$ level while the Federal Reserve and the Treasury followed up on the announcement with a number of concrete measures. They had already intensified their intervention activity somewhat in early August and their dollar purchases in the DM/dollar market averaged $27 million per business day during the month. More importantly, the Federal Reserve increased the discount rate with half a percentage point to 7.75 per cent on 18 August. The Administration gave its full support to this measure which main target seemed to be the exchange rate, although the official motivation mentioned both internal and external considerations: "The action was taken in view of recent disorderly conditions in foreign exchange markets as well as the continuing serious domestic inflationary problems." The discount rate increase was accompanied by a similar increase in the federal funds rate.

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43 There was no official confirmation of this view; the US policymakers had become more careful with statements about the exchange rate situation after the "talking-down-the-dollar" incidents in 1977: "To some extent (the US administration) has been so fearful of being misinterpreted that it has believed that silence on currency matters is the best course to pursue." Frank Vogl in The Times, 9 August 1978.
44 See the remarks by Treasury Secretary Blumenthal in IHT 18 August 1978.
45 FRB, March 1979, p.204; IHT 17 August 1978
46 In an interview with the Journal of Commerce, 21 August 1978.
47 IHT 19/20 August 1978
In addition to raising interest rates the Federal Reserve tried "to improve the international position of the dollar" by eliminating the reserve requirements on American banks' Eurodollar borrowings. This measure aimed to give US banks an incentive to repatriate dollars from their foreign branches. It was expected to strengthen the dollar by increasing the demand in Euro-markets for dollar-denominated assets. The Treasury for its part announced that it would increase the amount of gold sold at its monthly auctions from 300,000 to 750,000 ounces during four months starting in November 1978. It also said that it was considering to draw substantial amounts of foreign currency from the IMF for intervention purposes.

However, these defence measures failed to hold the DM/dollar rate for more than a few weeks. In September the dollar's downward trend resumed and was not interrupted when the discount rate was hiked another 1/4 percentage point to 8 per cent on 22 September. US interest rates continued to lag behind the rising level of inflation. Federal Reserve Chairman Miller had shown that he was unwilling to make monetary policy the spearhead against inflation. In July he had denounced a further rise of interest rates and voiced the fear that higher rates would drive the economy into a recession. The widespread impression, that the top policymakers in Washington did not fear inflation and dollar depreciation as much as a new recession, was amplified when Charles Schultze, the chairman of the Council of Economic Advisers, unequivocally rejected an OECD-recommendation that the United States should accept a decline in economic growth in order to fight inflation and strengthen the dollar. On this background, the dollar-supporting measures in August and September appeared as half-hearted and as "drops in the ocean" in the words of the Financial Times.

In early October the DM/dollar rate passed the 1.90-mark and massive amounts of hot money continued to flow out of dollars and into DMs, yen and

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48 IHT 18 August 1978
49 IHT 30 August 1978; FRB, March 1979, p.204
50 The Times 26 August 1978
51 FT 26 August 1978
52 According to the Federal Reserve this discount rate increase was made "in recognition of recent increases in other short-term interest rates" and "to strengthen the dollar." IHT 23/24 September 1978
53 IHT 21 August 1978
54 In a testimony before the Senate Budget Committee, NZZ 23 July 1978.
55 FT, editorial on 25 August 1978
Swiss francs. US interventions averaged only $17 million per trading day from the beginning of September until late October, but on 13 October the Federal Reserve decided to raise the discount rate another 1/2 percentage point to 8 1/2 per cent and Congress passed the long-awaited energy bill. There was no perceptible impact on the currency markets. The Carter administration’s energy program had been discussed for 18 months and it had been strongly watered down in the process. However, the government never tired of pointing out that its implementation would be a crucial step towards improving the trade balance and strengthening the dollar, but apparently this opinion was not generally held among currency dealers.

On 24 October, when the DM/dollar rate had plunged to 1.80, President Carter announced a new anti-inflation program which mainly consisted of voluntary wage and price guidelines and a pledge to reduce public spending in the 1980-budget, still a year away from coming into effect. Any restriction which might look as though it would increase unemployment and curb economic growth was avoided. The Administration hoped to keep real economic growth at 3 to 3 1/2 per cent in the following year. With regard to monetary policy the President said only that it would be "responsible". International economic policy was not mentioned at all.

The exchange market reacted with a dramatic increase in dollar offers. The US currency depreciated by up to 2 per cent per day against the stronger currencies in the last week of October. A soaring gold price and a sharp decline in stock prices added to the tense and almost panic-stricken atmosphere in financial markets. Apparently, the private sectors in the United States and abroad had little confidence that President Carter’s anti-inflation program had sufficient teeth to dampen the inflationary pressures within the US economy. On 31 October the DM/dollar rate was pushed to a record low of 1.70. Within one month it had fallen by 12 per cent. Against the yen and the Swiss franc the dollar had lost 7 and 6 per cent, respectively.

The US authorities regarded the exchange market behaviour in October as an instance of market failure. The dollar’s decline was termed "excessive" and the market was blamed for not reflecting the fundamental economic factors, especially the improving US trade balance. According to the Council of

56 "...the dollar's decline in the fall of 1978 was an instance of a malfunctioning of exchange markets." ERP 1979, p.156
57 Statement by President Carter on 1 November 1978, AP no.84/1978, 3 November 1978.
Economic Advisers, the dollar depreciation in the autumn of 1978 could "for some part ... be accounted for by the acceleration and persistence of inflation in the United States", but "by the end of October ... there was considerable evidence that the primary reason for the dollar's fall was the uncertainty in foreign exchange markets..... Market participants ... were highly uncertain about the future course of US macroeconomic policy, and this uncertainty encouraged shifts out of dollars because it made the dollar a riskier, and hence less attractive, asset." In contrast to the winter of 1977/78 it was now admitted in Washington that the dollar weakness also had domestic origins.

After the disappointing effects of the President's anti-inflation speech had become apparent, the American policymakers decided that they could not tolerate a further decline of the dollar. In the words of Treasury Undersecretary Solomon "the point had come when Adam Smith had to be curbed." Treasury Secretary Blumenthal summarized the considerations of the US policymakers in a Congressional testimony:  

"The consequences of a continued deterioration of the dollar were grim. The precipitous decline of the dollar threatened to erode our anti-inflationary effort. Foreign official and private portfolio managers were already showing signs of selling off US securities and would have been encouraged to sell more of their outstanding dollar holdings for assets denominated in other currencies. The OPEC countries would have been pressured to substantially raise oil prices to recoup excessive dollar losses. The world economy - indeed, the whole world financial system - would have been impaired - and with it, the economy of the United States. The leadership of this nation in world affairs, political as well as economic, would have been severely damaged."

It is difficult to evaluate the relative importance of the various concerns mentioned by Mr Blumenthal on the basis of the available evidence. Most observers incline to the opinion that the inflationary cost of the dollar depreciation was the weightiest consideration when President Carter decided to launch a major rescue package for the dollar on November 1, 1978.  

58 ERP 1979, p.154  
59 NPR (radio) interview, reprinted in WB 27 November 1978  
60 On 14 December 1978, reprinted in WB 15 December 1978  
61 Cf the following three statements by American analysts of US exchange rate policy:

"The inflationary cost of further dollar depreciation allegedly was the factor that convinced the president to approve the new actions." Stephen D. Cohen, op.cit. p.29
But for the first time US policymakers had also started to worry about the negative effects of the dollar crisis on national security and on US influence on world affairs in general. Such concerns have allegedly been raised in the National Security Council prior to the November 1 rescue package.

The concern about a new round of oil price increases has also played an important role in the thinking of US policymakers. Apart from official statements on motives there are three pieces of circumstantial evidence. Firstly, President Carter had already been impressed when Saudi Arabian King Khalid had hinted at the link between the value of the dollar and the price of oil in the winter of 1977/78 (see p. E-5 above). Secondly, during the dollar's bout of weakness in August 1978 Mr Blumenthal and Mr Solomon (i.e. the Treasury undersecretary dealing with monetary affairs) had secretly conferred with the Saudi Arabian finance minister. It was widely believed that the meeting, which was arranged at Saudi request, had been instrumental in the subsequent assertions of confidence in the dollar given in a newspaper interview with Saudi Crown Prince Fahd, published a few days later. Prince Fahd said that Saudi oil would continue to be priced in dollars, not a basket of currencies, and promised further moderation on the pricing front. In return for this helping hand it seems likely that Mr Blumenthal had extended a promise regarding the dollar's exchange value. Thirdly, a visit of the US Treasury Secretary to the major oil-producing countries was scheduled for November 1978. Oil prices would certainly be a subject on this trip and Mr Blumenthal's negotiating ability would have been severely impaired if the dollar was still on its way down and there was not any evidence that Washington was prepared to deal seriously with it.

Apparently President Carter was also influenced by more or less overt criticism of his economic policies which was voiced by foreign governments.

"Two considerations were decisive in carrying President Carter: reports that other heads of government were criticizing him and forecasts that continued depreciation of the dollar would undermine his anti-inflation program." R. Solomon, *op. cit.* p.349

Miles Kahler regards the inflationary effect of a depreciating dollar as a "factor of critical importance in the President's decision" and says: "A second concern was the response of OPEC: with their oil revenues diminished by a depreciating dollar, it was feared that the oil-producing states would push for another round of price increases, ratcheting-up inflation still further." Miles Kahler, "America's Foreign Economic Policy: Is the Old-Time Religion Good Enough?" *International Affairs, Summer 1980*, p.462

62 Treasury officials confirmed on 25 August that the meeting had taken place in Florida on 19/20 August. *FT* 26 August 1978
in the autumn of 1978.63 (For obvious reasons this was not mentioned by Mr Blumenthal in his Congressional testimony on the November 1 package.) At the Western economic summit meeting in Bonn in July 1978 the US President had promised to pursue exchange rate stability among other things, partly in return for German concessions regarding growth-stimulating measures (see chapter E.3.2. below). On this background he could ill afford to ignore the complaints of other heads of government when the dollar moved towards a value of DM 1.70 and $ 175 in late October.

Finally, US policymakers were concerned about the negative effects of the dollar weakness on international trade and finance and on the dollar’s long-term standing in the international monetary system. These considerations had already played a role in US exchange rate policy in the winter of 1977/78 and there can be no doubt about that they also figured in the US Treasury’s thinking in the autumn of 1978.

Following President Carter’s ill-fated announcement of his new anti-inflation program on 24 October the US monetary authorities intensified their dollar-supporting interventions drastically. In the last four trading days of October they sold $ 977 million equivalent of DMs. In the meantime Washington’s top economic policymakers prepared a package of emergency measures for the dollar in utmost secrecy. The major issue was how to apportion the package between a tightening of monetary policy and the mobilization of funds for exchange market intervention.64 As chapter E.3.2. will show, the German side had an important say on this matter. The agreed proposals were approved by President Carter on 28 October. After the necessary arrangements had been made with key officials of Germany, Japan, Switzerland, and the IMF, the President announced the dollar-rescue program on 1 November.

The package contained two parts. The first was a tightening of monetary policy consisting of a full 1 percentage point increase in the discount rate to 9½ per cent and the establishment of a 2 per cent supplementary reserve requirement on large time deposits. The second part contained the establishment of credit facilities totalling $30 billion in DM, yen, and Swiss franc to be available for a "program of forceful exchange market intervention in coordination with foreign central banks to correct recent excessive exchange rate movements." In addition, the Treasury would increase its gold sales to at least 1.5 million ounces monthly beginning in December.

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63 R. Solomon, op.cit. p.349 (see footnote 60); David P. Calleo, The Imperious Economy, Cambridge (Mass.), 1982, p.145

64 R. Solomon, op.cit. p.349
The $30 billion worth of intervention funds was to be assembled from four different sources:

- the drawing of $3 billion equivalent of DM and yen from the US reserve position at the IMF
- the sale of a total of $2 billion of Special Drawing Rights (SDRs) for DMs, yen, and Swiss francs
- an increase of the Federal Reserve’s swap lines with the central banks of Germany, Japan, and Switzerland by $7.6 billion to a total value of $15 billion (the swap line with the Bundesbank was increased from $4 billion to $6 billion)
- the issuance by the US Treasury of foreign currency denominated securities up to $10 billion in the German and Swiss capital markets

President Carter's surprise announcement on November 1 brought an immediate rise of the dollar. Within three trading days the DM/dollar rate jumped back from 1.70 to 1.90 - a 12 per cent appreciation. The new measures were widely heralded as a turning point in US exchange rate policy and as a clear dissociation from the attitude and the policy of benign neglect. However, the US policymakers had already ceased to be indifferent with regard to the dollar weakness in the winter of 1977/78. The novelty in the autumn of 1978 was rather that their concern had reached a point where they also were prepared to make substantial changes in US exchange rate policy, whereas the earlier dollar-supporting measures had been more declaratory and symbolic. More specifically, the November-package introduced three significant innovations in US exchange rate policy. They concerned the ranking of exchange rate concerns relative to other considerations, the acquisition of foreign exchange reserves, and the intervention strategy. With regard to the first point, the monetary measures in the package in the package meant that exchange rate concerns were allowed to modify the course of domestic monetary policy to a much more significantly degree than previously. Some of the earlier discount rate increases in 1978 had been triggered off by bouts of dollar weakness, but they had also been considered as more or less appropriate from a domestic point of view. This time, the increase of the discount rate to the historical record of 9½ per cent was a bitter pill to swallow in domestic terms. It was politically unpopular, and if it had not been for the dollar crisis, the move would certainly not have been made so shortly after the discount rate rise of 13 October and President Carter's anti-inflation program of 24 October and only one week before the Congressional elections.

The second innovation in US exchange rate policy in November 1978 were new ways to acquire the foreign exchange needed for large-scale interventions.
As on previous occasions, the Federal Reserve's swap facilities were increased, but this time with a more impressive amount ($7.6 billion). More importantly, the US authorities committed themselves to build up their own foreign exchange reserves by drawing on their IMF reserve position and by converting SDRs. They had already agreed to this in principle in March 1978, but subsequently refrained from it. This time the announcement was swiftly followed up by action.\footnote{The IMF drawings in DM and yen amounted to $2 billion and $1 billion, respectively, and were made on November 6 and 9. The conversion of SDRs into DMs and yen had a total value of $1.4 billion ($800 million in DM) and were made on November 24. \textit{WB} 14 December 1978} Another new way to acquire foreign exchange was the introduction of foreign currency denominated securities (which came to be called Carter-bonds or, more correctly, Carter-notes). The idea of letting the Treasury issue such securities had first been discussed in the preceding winter, but it had been explicitly rejected by the Treasury then, apparently because of the exchange rate risk involved.\footnote{See chapter E.3.1. on this point.} The shift in the Treasury's attitude was generally regarded as a convincing sign that the US authorities now were strongly determined to defend the dollar's international value. The advantage of Carter-note issues in comparison with swap loans was the longer time span to maturity. Carter-notes should first be redeemed after 2 1/2-4 years against 3 months for swap loans (although these could be rolled over for another 3-month period). Thereby the US intervention operations could be conducted unrestrained from the necessity to reverse transactions after a few months.\footnote{The first tranche of DM-denominated securities amounted to $1.6 billion and was floated in the German capital market on December 15. A second tranche ($1.35 billion) was issued in February 1979. (The only issue of Swiss franc denominated Carter-notes took also place in the first quarter of 1979 and amounted to $1.2 billion.)}

A third innovation concerned US intervention policy. The November 1 program announced "forceful exchange market interventions ... to correct recent excessive exchange rate movements." This indicated a change in both size and target of US interventions. Until late October the American intervention support for the dollar had been relatively modest. It remained even below the level reached in the winter of 1977/78. The disastrous exchange rate effect of President Carter's anti-inflation speech on 24 October brought about a drastic increase in the size of US interventions. In the last four trading days of October the US authorities purchased almost $1 billion in the DM/dollar market. This significant intensification of dollar-supporting interventions...
was confirmed by the November 1 statement ("forceful exchange market interventions") and by the subsequent practice. In November and December the American DM-sales amounted to $5.7 billion.

With regard to the target of interventions, the November 1 announcement indicated a significant departure from the long-standing strategy of "countering disorderly market conditions." The announcement's phrase, that interventions should "correct recent excessive exchange rate movements" (understood as the excessive decline of the dollar), implied that interventions should influence the level of the exchange rate. Furthermore, the wording indicated an offensive strategy because the target-level was different from the existing level.

In practice, the US authorities behaved in accordance with their declaration. The announcement on November 1 had itself succeeded in breaking the bandwagon effect in the exchange market which had brought the dollar down to DM 1.70. In the following days the dollar rebounded strongly as "many market professionals moved quickly to dump their long mark positions" and as the Federal Reserve intervened in support of the dollar in a "highly visible and forceful" manner. Within three trading days the dollar appreciated to DM 1.90. Strictly speaking, this behaviour represented an instance of aggressive interventions. By enhancing the upward movement of the dollar the US monetary authorities were "leaning with the wind" in contrast to the normal and accepted practice of "leaning against the wind". The action can, however, also be interpreted as a belated reaction to the previous decline of the dollar and thus to the "wind" that had been blowing strongly for some time.

Treasury Secretary Blumenthal explained the American intervention policy in the following way:

"The shift in intervention practices announced on November 1 was aimed at correcting a particular situation. Our objective is to restore order

68 This corresponds to DM-sales of $139 million on average per trading day in the two-month period. In fact, interventions were only carried out on 26 of 41 trading days, which means that the US authorities purchased $220 million on average on days when they were active in the DM/dollar market. More than one third (38.1%) of these intervention sales was financed with resources acquired from the conversion of SDRs, from IMF-drawings, and from the floating of Carter-notes in the German capital market; the rest was borrowed on the swap lines with the Bundesbank.

FRB, March 1979, p.206

69 FRB, March 1979, p.205

70 Congressional testimony on 14 December 1978, WB 15 December 1978
and a climate in the exchange markets in which rates can respond to the economic fundamentals, in this case to the improved outlook for the fundamentals that underpin the dollar's value. We are not attempting to peg exchange rates or establish targets or push the dollar beyond levels which reflect the fundamental economic and financial realities."

Apparently the US policymakers considered a DM/dollar rate around 1.90 to be in accordance with the fundamental economic and financial realities. In early December 1978, when the DM/dollar rate was at 1.92, Federal Reserve Chairman Miller said that the dollar was in an appropriate zone, and that it would be premature for the dollar to become much stronger, but also that it would be "inappropriate and unacceptable" if the dollar became weaker.71 This statement corresponds with the fact that the US interventions lost their offensive thrust when the dollar had recovered to the level of 1.90 DM/$ in early November. Thereafter the Federal Reserve seemed rather to defend the achieved correction of the exchange rate level than to push up the level any further. Especially in December, when the dollar came under strong downward pressure once more, the US interventions were clearly defensive "leaning-against-the-wind" interventions.72 The DM/dollar rate receded to a level of 1.85 DM/$ at the turn of the year, before the market calmed in early 1979. The dollar-supporting interventions were reduced from a daily average of $133 million in December to $25 million in the first six weeks of 1979 and came to a complete standstill as the dollar's second phase of weakness ended. But the new willingness of the US authorities to sell large amounts of foreign currency in dollar-defending "leaning-against-the-wind" operations should be confirmed during the dollar's third phase of weakness in 1979.

In general, the November 1 program was the largest and most important step in the gradual activation of US exchange rate policy in the late 1970s. In terms of the earlier mentioned trend in the American rescue operations for the dollar to a larger role of domestic measures at the expense of interventions and the mobilization of intervention funds, the November 1 program was about halfway between the measures in the winter of 1977/78 and the revision of US monetary policy in October 1979. The inclusion of monetary tightening in the program reflected the emerging perception among US policymakers

71 NZZ 7 December 1978; FT 22 December 1978

72 "To moderate this advance (of the DM against the dollar) the US and German authorities again intervened forcefully throughout December." FRB, March 1979, p.206
in the autumn of 1978 that the erosion of the dollar's internal value contributed to the decrease in the dollar's external value. The motives of US policymakers were the negative effects of the dollar weakness on US inflation, the price of oil, US security interests, international trade and finance, and the dollar's standing in the international monetary system. In addition, foreign pressure contributed to the adoption of the "November measures".

E. 1.3. The Redirection of US Monetary Policy on 6 October 1979

US exchange rate policy in 1979 was characterized by the fact that the issues of inflation and dollar depreciation had become inextricably linked. The dollar entered its third phase of weakness against the DM in June 1979, while US inflation continued to increase at double-digit annual rates. Massive interventions and several interest rate increases were not able to arrest the dollar's decline. The prospects for the dollar improved first in the aftermath of a drastic revision of US monetary policy announced on 6 October. The initiative was based on the belief that domestic inflation was the basic cause of the weak dollar and that firm control with the growth of monetary aggregates was needed to curb inflation and to strengthen the dollar in the process. This section examines the background for the shift in US exchange rate policy to a reliance on the concept of controlling domestic inflation in order to strengthen the dollar externally.

Following the political upheavals in Iran, which temporarily cut off oil exports from that country, there emerged a shortfall in world oil supplies early in 1979. The ensuing second oil price shock left also its mark on exchange rates. Among the major currencies, sterling was strengthened most due to the British North Sea oil, whereas the yen was the main loser of the oil crisis in 1979 due to Japan's high dependence on energy imports. With regard to the dollar, the Federal Reserve attributed its 3.5 per cent rise against the DM from the level of 1.85 DM/$ in January to 1.92 DM/$ in late May partly to the oil shock.73 The United States was generally seen on the basis of past experience to be better able to cope with oil price and supply problems than most other oil-importing countries. Furthermore, the price increases for oil generated additional demand for dollars in the exchange market to pay for the higher oil bills. Other factors which were seen to be responsible for the

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73 FRB, September 1979, pp.721,725
dollar’s slight recovery in the first half of 1979 were the improvement in the US current account and some expectation early in the year of a moderation of inflationary pressures. The moderate strengthening of the dollar against the DM and other European currencies "delighted" US monetary officials. 74 On the other hand, the 10 per cent depreciation of the yen against the dollar in the first five months of 1979 was described by Federal Reserve Chairman Miller as "too strong". 75

The US authorities used the stabilization of the dollar to acquire DMs for the repayment of their outstanding swap commitments. By the end of April these debts to the Bundesbank, which had amounted to the equivalent of $5.4 billion in January, were completely repaid. Afterwards the US authorities continued to purchase DMs in order to replenish the reserves, which had been acquired under the various parts of the November 1 program (IMF-drawings, SDR-sales, Carter-notes), and which had been reduced by the dollar-supporting interventions in late 1978.

Most of the DMs were purchased from official correspondents of the Federal Reserve in off-market transactions, but when the bidding for dollars was particularly strong, the Federal Reserve also acquired some DMs in the exchange market in the process of "maintaining orderly trading conditions." 76 This was a new practice. Hitherto the US authorities had only purchased DMs in the market in order to be able to repay swap debt or to replenish working balances. They had always tried to minimize the impact of these operations on the exchange rate. 1979 saw the first instances of US interventions with the explicit aim of maintaining orderly market conditions when the dollar was appreciating. This novelty in US exchange rate policy passed largely unnoticed, but it was nevertheless significant. It meant that the more active intervention approach, which the US authorities had adopted in 1978, was not limited to the dollar-supporting side of the exchange market. How far the Americans would carry the new practice of managing a rising DM/dollar rate

74 Referring to February, March, and April 1979, Alan R. Holmes, the Executive Vice President in charge of the foreign exchange function at the Federal Reserve Bank of New York, said, "what we've seen over this three-month period ... is almost the exact reversal of what was happening in the last half of 1978; we are rather delighted to see it happen". HFT 6 June 1979.

75 NZ 26 May 1979

76 FRB, March 1979, p.207; FRB, September 1979, pp.722,725
with interventions remained, however, to be seen. It was not certain in 1979 whether they would continue the practice when DM-purchases did not serve the additional purpose of replenishing US foreign exchange reserves to the level foreseen by the November 1 program.

The relative-stability in the DM/dollar market lasted until mid-June when the dollar suddenly came on offer. Within one month the dollar depreciated by 6 per cent to 1.80 DM/$ and during the remainder of the year the DM/dollar rate fell by another 5.5 per cent to 1.70 DM/$. This weakness of the US currency was not reflected in the yen/dollar rate. The Japanese currency lost 8 per cent against the dollar during the second half of 1979. The US policymakers deplored the depreciation of the yen and the ensuing improvement in Japan's competitiveness. Federal Reserve Chairman Miller tried even to talk the Japanese currency up, but with little success. However, the main focus of the Americans was directed to the falling DM/dollar rate.

According to Treasury Secretary Blumenthal, the narrowing of the interest rate differential between the United States and Germany was the main factor behind the resumption of the dollar's weakness against the DM in June 1979. German monetary conditions had been tightened, whereas US interest rates had eased somewhat in the second quarter. Furthermore, there was a growing belief that the American economy was heading for recession which gave rise to expectations that US rates would decline more significantly in the future. Actually, the fears of an impending recession made the Federal Reserve reluctant to tighten monetary policy in the summer of 1979. Federal Reserve Governor Wallich said in August that monetary policy had been loosened rather than tightened and he emphasized that real interest rates still were negative.

However, the US authorities did not hesitate to engage in massive dollar-supporting interventions as soon as the market turned against the dollar in mid-June. As described earlier, the operating procedures of the Federal Reserve's open market operations ensured that dollar purchases in the exchange market did not result in an unwanted upward pressure on domestic interest rates.

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77 The Wall Street Journal of 24 July 1979 quotes Mr Miller for having said at a press conference that "he believed the dollar would be 'better off near 200 than nearer 220' yen", because he felt that the yen was "too low" at that time (relative to the dollar).

78 FT and THT 21 June 1979

79 FRB, September 1979, p.726

80 NZZ 4 September 1979
Actually the foreign exchange trading desk at the New York Bank felt that its heavy dollar-supporting interventions in June were countered by falling money market rates. The American DM-sales totalled $9.5 billion between mid-June and early October against $8.0 billion during the dollar weakness in the second half of 1978. The daily average was $118 million, i.e. approximately the same as in the two months after the announcement of the November program ($135 million). The largest part of the interventions was now financed out of the Treasury's and the Federal Reserve's own reserves (i.e. the reserves acquired through IMF-drawings, SDR-sales, and the issuance of Carter-notes); the part which was financed with swap loans from the Bundesbank had been reduced to 42.4 per cent from 61.9 per cent in November/December 1978.

Just as in late 1978, US interventions "leaned against the wind" in the DM/dollar market over an extended period in the summer of 1979. But this time there was the additional element that the US authorities also wanted to defend a floor level for the dollar. They tried to prevent the DM/dollar from falling below the psychological benchmark of 1.80. According to a former Federal Reserve official who was involved in the intervention activity at that time, the foreign exchange traders at the Federal Reserve Bank of New York had been told to keep the DM/dollar rate above that rate. As it became increasingly costly to hold this line of resistance in September, the American intervention operations were scaled back from one day to the next. The DM/dollar rate dropped immediately to 1.77 and to 1.74 in the following week. Treasury Secretary Solomon admitted that a "judgment" had been made to let the dollar decline, but he denied of course that there had been any particular significance in the 1.80 DM/$ rate.

The American attempts to contain the downward pressure on the DM/dollar rate must primarily be seen in the context of the worsening inflation situation.

81 Interview with James T. McGroarty on 30 June 1983. Mr McGroarty was working with the Federal Reserve Bank of New York in 1979 and is now Vice President of the Discount Corporation of New York.
82 ibid.; The Washington Post (21 September 1979) cited "high-standing Administration officials" for having said that the Administration had decided to withdraw the support level for the dollar from 1.80 DM/$ to 1.75 DM/$. There is, however, no supporting evidence that a new line of resistance was established after the abandonment of the 1.80 DM/$ rate on September 20. On the contrary, the DM/dollar rate fell below 1.75 DM/$ in the following week without a renewed intensification of US interventions.
83 FRB, March 1980, p.194; NZZ 22/23 September 1979
84 Reuter Money Report 20 September 1979; WSJ 25 September 1979
On the one side, it was generally acknowledged that each 1 percentage drop in the dollar's effective exchange rate would lead to an extra 0.15 percentage increase in prices\(^\text{85}\) and the most widely watched price index had already advanced to the range of 13 to 14 per cent increase at an annual rate by the third quarter of 1977. The inflationary effects of further dollar depreciation were unequivocally the dominating consideration behind the American dollar support in 1979. On the other side, inflation was now also seen as the major cause of the dollar weakness. The Council of Economic Advisers, for instance, stated that the "downward pressure on the dollar in the second half of 1979 primarily reflected the market's assessment of the strength of continued inflationary pressure in the United States."\(^\text{86}\) The view had gained ground as the US current account deficit vanished in the course of the year and therefore could not be blamed for the dollar's weakness anymore. The perceived interrelationship between the internal and external erosion of the dollar's value made C. Fred Bergsten, Assistant Secretary at the Treasury, say that the United States had entered a vicious circle of inflation and dollar depreciation.\(^\text{88}\)

<table>
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<th>Year</th>
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<th>Current Account Balance</th>
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<td>1978 I</td>
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<td>- 6.173</td>
</tr>
<tr>
<td>II</td>
<td>- 8.295</td>
<td>- 4.102</td>
</tr>
<tr>
<td>III</td>
<td>- 7.508</td>
<td>- 3.166</td>
</tr>
<tr>
<td>IV</td>
<td>- 6.815</td>
<td>- 820</td>
</tr>
<tr>
<td>1979 I</td>
<td>- 5.114</td>
<td>1.408</td>
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<tr>
<td>II</td>
<td>- 8.070</td>
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<tr>
<td>IV</td>
<td>- 9.225</td>
<td>- 1.802</td>
</tr>
</tbody>
</table>

\(^{85}\) This relationship had been put forward by the Council of Economic Advisers in its 1979 Annual Report (ERP 1979, p.43) and it was repeated by the Treasury in the summer of 1979, VWD 24 July 1979

\(^{86}\) ERP 1980, p.174

\(^{87}\) ERP 1981, Table B-99

European University Institute
DOI: 10.2870/52840
The worsening inflation situation and especially the declining DM/dollar rate made the Federal Reserve permit money market rates to rise somewhat in the third quarter in spite of the recession fears. The process was accompanied by a rise in the discount rate in three steps from 9.5 per cent in July to 11 per cent in late September. These measures did not change the basically expansionary course of US monetary policy. Interest rates still lagged far behind the increases in the inflation rate. Nevertheless, higher interest rates were badly received in Congress and other circles as the fears of an impending recession became more widespread.89

The last of the three discount rate increases, which was announced on 19 September, did nothing to alleviate the downward pressure on the dollar, as it had been hoped. On the contrary, the fact that the Board of Governors approved the measure by a publicly announced split vote of 4 to 3 deepened the market's concern about the US resolve to combat inflation, according to the Federal Reserve Bulletin.90 It was on the following day that the US authorities gave up to intervene in defence of the 1.80 DM/$ line of resistance in the exchange market. The opposition to a tightening of US monetary policy came from those policymakers who - according to former Federal Reserve Chairman Arthur Burns - adhered to a "gradualist" approach in anti-inflationary policy and who believed "that a return to price stability could be delayed for four to five years to make a deflationary crunch more palatable."91 On the other side there was the view held by the new Federal Reserve Chairman Paul A. Volcker, that price stability ought to have the highest priority and that inflation had to be reduced "quickly" (the "shock therapy" approach to price stabilization).92 He did not perceive any real trade-off between inflation and unemployment, because failure to deal with inflation and inflationary expectations would ultimately produce more unemployment. According to Mr Volcker, inflation had been caused by an excessive growth of the money supply with the dollar's international weakness being a major symptom of the malaise. If the

89 For instance, the influential New York Times considered US interest rates to be higher than warranted by the domestic economic situation (editorial on 3 August 1979).
90 FRB, March 1980, p.194
91 In a speech at the 1979 Annual Meeting of the IMF in Belgrade, IHT 1 October 1979
92 Mr Volcker had moved to his new assignment from the presidency of the New York Federal Reserve Bank in connection with a major cabinet reshuffle in July 1979 in which the previous Federal Reserve Chairman, G. William Miller, succeeded Michael Blumenthal as Secretary of the Treasury.
United States dealt with inflation at home, the external dollar problem would automatically be resolved.\(^93\)

In the two weeks following the ill-fated discount rate increase of September 19, a massive amount of funds was shifted into DM from the dollar. The DM/dollar rate approached the levels reached just before the dollar-rescue package of 1 November 1978. In addition, all commodity markets were hit by a speculative fever as asset holders shifted from "paper" currencies into tangible assets—particularly into gold. In this context preparations were made at the Federal Reserve for a major revision of US monetary policy. On October 6 the Federal Reserve introduced a package of radical new measures to restrict monetary growth which was widely heralded as a revolution in American economic policy.\(^94\) Federal Reserve Chairman Volcker—as the principal architect of the package—had managed to get the support of all members of the Federal Open Market Committee. As chapter E.3.3. will show, the US-German exchange rate diplomacy played a significant role for the adoption of the package.

The package included a 1 percentage point increase in the discount rate to 12 per cent and the imposition of an 8 per cent marginal reserve requirement on increases in so-called "managed liabilities". But the monetary tightening itself was less important than the change in the procedures for implementing monetary policy. Explicit targets for the growth of money had been a central feature of US monetary policy since 1976, but the operational guide from day to day in conducting open market operations had continued to be the federal funds rate—the US interbank rate. Now the Federal Reserve announced that it would focus on the provision of bank reserves in order to improve its observance of the established targets for monetary growth. This change to a quantitative guide for open market operations implied that short-term interest rates would be allowed to fluctuate more freely in response to shifts in demand for money and reserves.

The October 6 package signalled a reorientation of US monetary policy from an expansionary to a restrictive course. It had been precipitated by the dollar's external problems, but its thrust was primarily aimed at curbing domestic inflation. As long as the dollar continued to be considered weak

\(^93\) Mr Volcker made these hard-line statements at the press conference following his appointment and in the confirmation hearing before the Senate Banking Committee on 30 July 1979. NZZ 27 July 1979; IHT 1 August 1979; M. Mayer, op. cit. p.304

\(^94\) Calleo, op.cit. p.146; FT, editorial on 8 October 1979.
Internationally, exchange rate considerations would be an additional reason to pursue this course. Unlike the November 1 package, the October 6 measures contained virtually no international component. This reflected Mr Volcker's basic perception of the relationship between inflation and dollar depreciation. Testifying before a Congressional committee a few weeks later, he explained: "...I do not anticipate, in practice, any sharp dichotomy between "foreign exchange" and "money supply" oriented monetary policy strategies. The fact is that, for the foreseeable future, a policy looking toward attaining and maintaining a noninflationary growth in money at home would appear broadly compatible with our concern about the international position of the dollar. I do not, in any event, view our domestic and international problems as distinct and separable. Recent experience has shown - all too clearly - that weakness in the value of the dollar internationally is symptomatic of basic problems here at home." (the underline is mine)

Interest rates in the US and Eurodollar markets moved up sharply in the days following the new monetary measures. In the DM/dollar market the rate climbed back to 1.80 DM/$ without official interventions. However, the dollar's recovery was fragile and in November and December the US currency weakened again. According to the Federal Reserve, a number of political-economic developments were interpreted negatively for the dollar by exchange market participants - especially the crisis in US-Iranian relations after the seizure of the American Teheran embassy by Iranian militants and the Soviet invasion of Afghanistan. US interventions in the DM/dollar market were resumed after mid-November, but the dollar-supporting operations were relatively modest compared with the summer months ($22 million on average per trading day from mid-November to end-December). At the turn of the year the DM/dollar rate fell shortly to the all time low of 1.6996 DM/$ before the dollar started to recover.

In general, the October 6 package implied a new shift in US exchange rate policy. In the preceding months the US authorities had continued the policy initiated in the autumn of 1978, i.e. massive dollar-supporting interventions and interest rate increases which were partly seen to be in conflict with domestic economic needs by US policymakers. The failure of this policy to arrest the dollar's decline contributed to the adoption of a new approach to dollar stabilization with the revision of US monetary policy on 6 October 1979. Afterwards the role of interventions was toned down and US exchange rate

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95 Congressional testimony on 13 November 1979, reprinted in WB 26 November 1979
policy came essentially to rely on the concept of controlling domestic inflation with monetary discipline. This approach reduced US exchange rate policy to a part in a broader strategy to regain price stability.

There was an element of continuity in the October-package as far as it completed the trend towards a larger domestic dimension in each successive effort to bolster the dollar since the winter of 1977/78. This time no international support measures were added to the domestic measures.

E.2. The German Reactions to the Fall in the DM/Dollar Rate

The purpose of this chapter is to identify and explain the German policymaker's attitudes and actions towards the dollar weakness in the late 1970s as the second pillar on which next chapter's analysis of the bilateral management of the DM/dollar rate will be founded. It will be shown how the German attitude changed from serious concern over the falling DM/dollar rate in the winter of 1977/78 to a more relaxed stance in the autumn of 1978 and especially in 1979, and how the intensity of the German support measures for the dollar declined correspondingly.

This will primarily be explained with three developments. Firstly, the rise in the US inflation rate in 1978 and 1979 widened the inflationary gap between the United States and Germany which justified a certain fall in the DM/dollar rate in the German view. Secondly, the Bundesbank mitigated the growth-dampening effect of the DM-appreciation in 1978 by adjusting its monetary policy. Thirdly, changing economic prospects for the German economy in the winter of 1978/79 shifted the emphasis of Bundesbank-policy from growth-stimulation to price-stabilization which made the anti-inflationary effects of a weak dollar relatively more attractive.

At various places in this chapter there will be alluded to the role of the new European Monetary System in Germany's exchange rate policy vis-à-vis the dollar. But the significance of the EMS-creation in 1978 for the management of the DM/dollar rate will primarily be discussed in chapter 3 in the context of US-German exchange rate diplomacy.
E.2.1. Massive Dollar-Support in the Winter of 1977/78

Already in July 1977 Bundesbank President Emminger had complained about the "unrealistically" low dollar rate of 2.27-2.28 DM/$. Naturally, this attitude became more pronounced among German policymakers when the DM/dollar rate approached the psychological benchmark of 2 DM/$ in the winter of 1977/78. By December 1977 the "dollar crisis" had become the main problem for the Bonn government and the Bundesbank. There were three main reasons for the German concern about the exchange rate situation.

Firstly, the dollar depreciation was perceived to be extremely detrimental to the domestic economic recovery the solidity of which was still very much in question at that time. On numerous occasions in the winter of 1977/78 Bundesbank and government officials voiced concern about the hindering influence of the dollar weakness on the domestic upswing. The 13 per cent fall in the DM/dollar rate from 2.30 in October 1977 to 2.00 in March 1978 was accompanied by a 4 per cent rise in the DM's real external value. This deterioration in Germany's international price competitiveness was seen to be a strong impediment to an export-led recovery.

In addition to the effect on competitiveness, the dollar weakness was made responsible for an observed rise in German direct investments abroad. The falling DM/dollar rate increased production costs and narrowed profit margins in Germany relative to countries in the dollar area and made it increasingly attractive for German firms to place new investments overseas. The German policymakers assumed that the rise in foreign direct investments happened at the expense of domestic investment activity thereby damaging the recovery prospects for the German economy additionally.

Secondly, the DM-appreciation vis-à-vis the dollar hindered the smooth functioning of the European currency snake. From October 1977 to mid-January

1 AP no.44/1977, 15 July 1977
2 The German policymakers' concern about the falling DM/dollar rate found a pronounced expression in the Bundesbank's Monthly Report for December 1977.
3 See for instance the remarks by Count Lambsdorff, the Economics Minister, in SZ (5 December 1977), and by Bundesbank President Emminger in AP no.83/1977 (9 December 1977) and in BZ (31 December 1977).
4 See the comments on this point by Dr Emminger in AP no.83/1977 (9 December 1977) and in BZ (31 December 1977), and by Bundesbank Vice President Pöhl in AP no.11/1978 (31 January 1978).
1978 there were strong tensions within the snake due to the weakness of the dollar, which tended to push up the DM against the other snake currencies.\(^5\) Besides the DM, the snake consisted only of the Benelux currencies and the Danish and Norwegian kroner at that time, but the maintenance of the European exchange rate arrangement was nevertheless referred to as an especially important economic and political objective under the turbulent exchange market conditions in the winter of 1977/78.\(^6\) The strains within the snake remained within manageable limits and the member countries avoided a realignment of parities with relatively heavy supporting interventions and a tightening of monetary policy in Belgium.

Thirdly, the dollar depreciation was perceived as a threat to the efficient and smooth working of the international economic system which depended on a reasonably stable dollat as the main key currency. A persistent aura of distrust around the dollar was seen to disturb the flow of goods and capital across borders.\(^7\) The Germans were especially concerned about the oil-price uncertainty. It was feared that OPEC would respond to the dollar erosion with a significant increase in the dollar price of oil which could upset the whole international economy as in 1973/74.\(^8\) As the second oil price shock in 1979 showed, the fear was not unfounded.

The concern about these negative consequences of the falling DM/dollar rate prompted the Bundesbank to engage in heavy exchange rate management. As the primary counter-measure it stepped up its dollar-supporting interventions to a level which was without precedence since the final phase of the Bretton

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5 DB, Annual Report 1977, p.45
6 For instance by Dr Emminger, AP no.83/1977, 9 December 1977
7 Dr Emminger voiced this "systemic" concern repeatedly:

"Wenn wir uns für einen "starken" Dollar einsetzen, dann nicht nur wegen unserer legitimen Handelsinteressen, sondern noch mehr wegen der zentralen Rolle, die der Dollar im Währungssystem spielt. Der Dollar ist nicht einfach irgendeine Währung, er ist die wichtigste Währung der Welt. Ein Dollar, der ständig von Misstrauen umgeben ist, könnte einen äußerst störenden Einfluss auf die Handels- und insbesondere Kapitalströme ausüben, ganz abgesehen davon, dass sich ein fortwährendes Abrutschen des Dollars möglicherweise auf die Ölpreise auswirken könnte." AP no.79/1977, 22 November 1977

"Der Dollar ist nicht eine Währung wie jede andere .... Wenn hier einmal das Vertrauen völlig zusammenbräche und auch nur vorübergehend panikartige Zustände entstünden, so könnten enorme Beträge ins Rutschen kommen, was zu gefährlichen Kursübersetzungen und unangenehm Abwehr-Reaktionen - Protektionismus, Devisenimportkontrollen etc. - führen könnte." AP no.28/1978, 6 April 1978

8 See for instance Count Lambsdorff's remark in SZ 5 December 1977.
Woods system. The German dollar purchases from October to December 1977 amounted to DM 7.4 billion which was more than the Bundesbank's dollar-supporting interventions in the preceding 4½ years as a whole. The Bundesbank bought dollars for DM 120 million on average per business day in that quarter.

The German policymakers did not believe that direct interventions could arrest the downward trend of the DM/dollar rate completely, but Bundesbank President Emminger explained that the heavy interventions ought to keep the excessive decline of the dollar under some control in addition to the smoothing of erratic fluctuations from day to day. The considerable increase in the size of German interventions indicated a much more forceful "leaning-against-the-wind" policy than in the previous years. Less intervention in the DM/dollar market would probably also have required larger interventions in support of the agreed exchange rates within the currency snake.

In the first quarter of 1978 the Bundesbank more than halved its dollar-supporting interventions to DM 3.6 billion. However, this fall must be seen in relation to the substantial increase in the swap-financed interventions by the American authorities mentioned in the preceding chapter. Due to its role as the financier of the US interventions, the Bundesbank was always informed about the American intervention plans and could control the total amount of official DM-sales in the DM/dollar market by adjusting its own interventions. In the first quarter of 1978 the Bundesbank took the increase in the US interventions into account in such a way that the total amount of US and German dollar-supporting interventions only fell from DM 9.3 billion in the previous quarter to DM 7.9 billion. The American share of these amounts increased from 20 per cent to 55 per cent.

In addition to the massive direct interventions, the Bundesbank supported the dollar by reducing the discount and Lombard rates with half a percentage point each to 3 per cent and 3½ per cent respectively on 15 December 1977. The measure was explicitly motivated by exchange rate considerations, although the Bundesbank maintained that it was also justified by the feebleness of the domestic economic recovery. Just as the cut in the Lombard rate in July 1977,

9 AP no.83/1977, 9 December 1977
10 Leonhard Gleske, the Bundesbank Director in charge of foreign exchange operations, admitted during a lecture at the European University Institute in Florence on 4 May 1981 that the Bundesbank occasionally had intervened in the DM/dollar market in order to stabilize intra-European exchange rates.
the interest rate lowering in December should reduce the downward pressure on the DM/dollar rate by making DM-investments less attractive relative to dollar holdings. By widening the interest rate differential between DM and dollar assets it was hoped that capital flows from dollar into DM at least were reduced, if not reversed. The Bundesbank preferred that the US current account deficit should be financed with private capital imports rather than by an accumulation of dollar reserves at the Bundesbank and other central banks, as it had been the case in 1977.

Together with the interest rate cuts, the Bundesbank announced on December 15 the first tightening of German capital import restrictions since the dollar crisis in the summer of 1973. In order to discourage capital inflows, minimum reserve requirements on foreign deposits were increased and the existing ban on nonresident purchases of German bonds was extended to include securities with maturities of up to four years against two years before.

The extent of the Bundesbank’s exchange rate measures in the winter of 1977/78 revealed a strong determination to slow down the fall in the DM/dollar rate. The change from the relatively light exchange rate management of the previous years reflected not only the large size of the exchange rate movement, but also the seriousness with which the German authorities regarded its negative effects on German economic recovery, on European exchange rate stability, and on the international economic system in general.

E.2.2. Interventions and the Two-Dimensional Monetary Strategy in 1978

During the second phase of the dollar weakness from the summer to the end of 1978 the Bundesbank tried again to limit the fall in the DM/dollar rate. The support for the dollar continued to be founded on concerns about the domestic recovery, the currency snake, and the international economic system in general. But the Bundesbank also started to draw attention to another negative aspect of the dollar crisis in 1978: the DM was coming to be used increasingly as an international reserve currency and the trend was seen to be stimulated by the DM's strength vis-à-vis the dollar.

Many central banks, especially in developing countries and in smaller industrialized countries, were diversifying their foreign exchange holdings in the 1970s by investing a larger share in DM-assets at the expense of assets...
denominated in dollar or sterling, the traditional reserve currencies. The DM's average share in the exchange reserves of foreign monetary authorities was estimated at over 11 per cent at the end of 1978. With that, the DM was the second most important currency in the portfolios of central banks after the dollar whose share was around 80 per cent.

The Bundesbank regarded the DM's growing importance as a "substitute" reserve currency as undesirable. The diversification of foreign exchange reserves tended to press the DM/dollar rate even further down and the reserve currency role was seen as an "excessively heavy burden" for the DM. The German money and capital markets had a limited capacity and could not easily absorb the changing flows of foreign money which were seen as the unavoidable by-product of being a reserve currency country. It was apparently feared that the domestic economy would have to be managed more in accordance with the changing international demand for DM-assets. The British experience in the 1950s and 1960s had shown how the status of reserve currency country could become a severe constraint in the management of the domestic economy.

The Bundesbank warned also against the increased use of the DM as a reserve currency, because it would strengthen the development towards a multiple reserve currency system. Such a system was regarded as a "highly unstable structure, exposed to the risks of constant exchange rate unrest and uncontrolled development of international liquidity."

Together with the aforementioned reasons, the aversion against the DM's reserve currency role helps to understand the German concern about the fall in the DM/dollar rate and the attempts to limit it. However, during most of

12 "For the D-Mark the role of reserve currency with its consequential large money flows into and out of our currency would be too big and too burdensome; it would create great problems for our domestic monetary management and would distort the D-Mark's exchange rate even more." Dr Emminger in a speech in Munich on June 3rd, 1978 (AP no.43/1978, 6 June 1978).
13 DB, Monthly Report, November 1979, p.32
14 See Susan Strange, Sterling and British Policy, London, 1971
The late Sir Andrew Shonfield explained the German dislike of a reserve currency role for the DM in a blunt, but incisive remark: "They have seen the British do it, and the Americans do it, and it's not fun. It is all right if you happen to have an empire to cope with, but even then, it is a doubtful game." Statement reprinted in Wilfrid Kohl & Giorgio Basevi (eds.), West Germany: A European and Global Power, Lexington (Mass.), 1980, p.207
15 DB, Monthly Report, November 1979, p.33
the summer of 1978, when the dollar depreciated in a slow and orderly fashion against the DM, the Bundesbank did not intervene in the DM/dollar market over extended periods. Only when the dollar depreciation became "erratic" were dollars purchased in order to dampen the movement. For instance, the Bundesbank moderated the sudden dollar fall from 2.05 to 1.95 DM/$ during the first two weeks of August. This policy reflected the Bundesbank's belief that interventions not should be used to counter movements in a floating exchange rate which reflected underlying fundamental conditions such as inflation differentials. Given the fact that the German inflation rate declined to below 3 per cent in 1978, whereas US inflation increased towards a two-digit rate, the Bundesbank regarded a moderate fall in the DM/dollar rate as justified.  

When the dollar depreciation accelerated in September and October 1978, the functioning of the European currency snake was adversely affected again. As usually, the dollar weakness strengthened the DM against the other snake currencies. The Bundesbank and the other participating central banks had to intervene with progressively larger amounts to maintain the margin of 2.25 per cent between their currencies. On October 15, the snake countries submitted to the market pressure and realigned the exchange rates among their currencies. The desire to avoid this realignment had probably been one of the reasons for the Bundesbank's dollar-supporting interventions in the DM/dollar market in the weeks up to October 15.

When the DM/dollar rate fell towards 1.70 in late October, the Bundesbank "leaned against the wind" with substantial dollar purchases. Together with the American authorities the Bundesbank purchased dollars for about DM 3 billion in the second half of October. The German policymakers regarded

16 Interview with Bundesbank President Emminger in The Banker, September 1978
17 Another factor, which was even more important for the strains within the currency snake in the autumn of 1978, were the negotiations among the EC-countries over a new European monetary system to replace the currency snake. In the early autumn these negotiations had become the subject of extensive press and market commentary and many operators in the currency markets came to expect that, before the new system could be introduced, a substantial revaluation of the DM against the other snake currencies would be necessary.
18 The DM was revalued by 2 per cent against the Benelux-currencies and by 4 per cent against the Danish and Norwegian kroner. The snake interventions in the preceding 3 ½ months had augmented the Bundesbank's foreign exchange reserves with DM 10.1 billion. In contrast, the combined US-German interventions in the DM/dollar market in the same period expanded the German reserves only with DM 1.8 billion.
19 See footnote no. 10 on page E-35
the dollar’s dramatic decline as excessive and without foundation in economic realities. After the dollar rescue program of November 1, the Bundesbank continued to support the dollar with DM 2.3 billion until the end of the year.

The Bundesbank’s dollar-supporting interventions in the second half of 1978 totalled DM 6.3 billion against DM 11 billion in the six-month period from October 1977 to March 1978. The lower level of German interventions was accompanied by the significant rise in US intervention activity described in the preceding chapter. The Bundesbank’s share of total US-German interventions decreased from 80 per cent in the last quarter of 1977 to 18 per cent in the last two months of 1978.

The lower volume of German interventions in the autumn of 1978 as compared with the winter of 1978 does not in itself reflect a changed attitude towards the dollar weakness, because it simply may have been a reaction to the increase in US intervention activity. But public statements and the Bundesbank’s reports show that the German policymakers were less worried about the exchange rate development in the autumn of 1978 than in the winter of 1977/78 as far as the supposed dampening effect on domestic economic activity was concerned. This seemed partly to be due to the development in the DM’s real external value, which was the most crucial variable for the Bundesbank when it assessed the impact of exchange rate developments on domestic economic activity. During the dollar weakness in the winter of 1977/78 the DM had appreciated by 4 per cent in real terms against a weighted average of foreign currencies. Most of this rise had been neutralized when nominal exchange rates stabilized in the second quarter of 1978 while the inflationary gap between Germany and its trading partners persisted. The DM’s appreciation against the dollar and most other currencies in the second half of 1978 was only just

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20 This figure was mentioned by Dr Emminger at a press conference in Berlin on 2 November 1978 (DB, Presse- und Informationsstelle). US and German interventions cannot be separated exactly for this period, but the US side was carrying out more than half of the combined DM-sales.


23 From 1977 to 1978 the annual average of the consumer price index increased with 2.7% in Germany, 3.6% in Japan, 7.7% in the United States, and 9% in the EC less Germany. DB, Annual Report 1979, p.11
sufficient to bring the DM's real external value back to the level of March 1978 by the end of the year. In other words, Germany's international price competitiveness as measured by the DM's real external value did not decrease between the end of the dollar weakness in the winter of 1977/78 and the end of the dollar weakness in the second half of 1978. The DM was regarded as overvalued in March 1978 and that was seen to have an adverse impact on domestic economic activity. But the fact that the exchange rate development after March 1978 did not lead to an additional worsening of Germany's competitive position appears to have contributed to the Bundesbank's more relaxed attitude.

Another reason may have been that the German economic performance was rather good in 1978. The hitherto slow recovery gained speed in the second half of the year and employment was rising for the first time since 1973. Inflation declined to a rate below 3 per cent and the current account of the balance of payments showed a comfortable surplus of DM 17.5 billion against DM 10 billion in 1977. Furthermore, the negotiations about establishing a European Monetary System in the autumn of 1978 may have diverted the attention.
of German policymakers somewhat from the dollar weakness and reinforced the
trend to a more relaxed attitude towards the falling DM/dollar rate.\textsuperscript{24}

In spite of the development in the DM's real external value the Bundes-
bank believed that the exchange rate movements in the autumn of 1979 exerted
a dampening effect on domestic economic activity. This is clearly shown by
a passage in its 1978 Annual Report which refers to the DM's appreciation at
the beginning of 1978 as well as in the autumn of that year:\textsuperscript{25}

"In order to slow down this upward movement, which far exceeded the
price and cost differential between Germany and other countries, and
at the same time to mitigate the dampening effect of an excessive
appreciation on domestic activity, the Bundesbank took considerable
amounts of foreign currency out of the market."

The countering of the dampening effects was not limited to direct inter-
ventions, but included also monetary policy. But whereas the interventions
were intended to reduce the DM-appreciation as the cause of the dampening of
domestic activity, monetary policy was designed to neutralize the remaining
effect which nevertheless occurred. Because monetary policy was considered
to be an effective counterweight to the DM-appreciation in that respect, it
seems to have contributed to the more relaxed German attitude towards the
DM-appreciation in the autumn of 1978 as compared with the winter of 1977/78.
But contrary to a widespread belief, the following discussion of the Bundes-
bank's so-called two-dimensional monetary strategy will show, that German
monetary policy was not directed toward managing the exchange rate in 1978.

For each of the years 1977 and 1978 the Bundesbank had announced an 8
per cent growth target for the stock of central bank money (stated in terms
of the annual average as against the annual average of the previous year).
The actual growth rates turned out to be 9 per cent in 1977 and 11.4 per cent
in 1978. The monetary expansion was fed by the massive interventions in sup-
port of the dollar, which added DM 35.4 billion net to the German foreign ex-
change reserves during the two years. Interventions within the European cur-
rency snake and other foreign exchange operations reduced the reserves with
DM 4.8 billion net, so that the Bundesbank's net foreign position between the
beginning of 1977 and the end of 1978 increased with DM 30.6 billion. The
following table shows the extent to which this increase contributed to the
deviations between the actual and the planned growth of central bank money

\textsuperscript{24} See chapter E.3.2. on this point.
\textsuperscript{25} DB, Annual Report 1978, p.1

<table>
<thead>
<tr>
<th>Year</th>
<th>Quarter</th>
<th>Increase in Central Bank Money against Previous Quarter (seasonally adjusted, annual rate)</th>
<th>Change in the Net Foreign Position against Previous Quarter as Percentage of Central Bank Money (seasonally adjusted, annual rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>I</td>
<td>8.0</td>
<td>+ 2.0</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>8.2</td>
<td>- 4.6</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>11.5</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>10.6</td>
<td>+ 35.2</td>
</tr>
<tr>
<td>1978</td>
<td>I</td>
<td>13.1</td>
<td>+ 13.9</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>9.4</td>
<td>- 12.0</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>10.7</td>
<td>+ 18.1</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>13.0</td>
<td>+ 36.4</td>
</tr>
</tbody>
</table>

Excluding changes due to valuation adjustments and new allocations of SDR

If central bank money would have shown a regular quarterly increase by 7.6 per cent (annual rate) in 1977, the average stock of central bank money would have been 8 per cent higher in 1977 than in the preceding year and the announced growth target would have been realized. The corresponding figure for the required quarterly increase in 1978 is 6.1 per cent. The first column of the table shows therefore, that in every quarter of 1977 and 1978 the growth rate of central bank money was higher than the growth rate that would have implied a regular quarterly increase consistent with the annual growth target of 8 per cent. The figures in the second column show the hypothetical percentage change in central bank money that would have occurred if the domestic component of central bank money had remained unchanged. A comparison between the two columns shows that the Bundesbank sterilized the expansionary liquidity effects of interventions partly in four quarters (1977 IV, 1978 I, 1978 III, 1978 IV).

26 Source: Harmen Lehmen, Devisenmarktinterventionen bei flexiblen Wechselkursen, Tübingen, 1980, p.230
27 ibid. p.229
but not sufficiently to prevent a monetary "overshooting". In the other four quarters, when interventions and other foreign exchange operations did not increase the stock of central bank money (or only insignificantly as in 1977 I), liquidity creation was nevertheless faster than stipulated by the announced target rate, because the Bundesbank boosted the domestic component of central bank money.

Although the monetary expansion in the winter of 1977/78 and in the second half of 1978 stemmed from the massive exchange market interventions, it cannot be said that the interventions led to an involuntary expansion of the money supply. The Bundesbank was able to sterilize unwanted amounts of intervention-induced liquidity by offsetting changes in the domestic component of central bank money. According to the Bundesbank's own statements, the monetary expansion was controlled and was not allowed to become excessive.28 The monetary overshooting was deliberately accepted as a temporary departure from the medium-term target of monetary policy. If the Bundesbank should have desired to redirect the growth of central bank money towards the target rate, but was constrained by the currency inflow, it would have had a chance to dampen the monetary expansion in the second quarter of 1978, when there was a currency outflow. However, the Bundesbank continued the monetary overshooting in that quarter by a substantial reduction in minimum reserve requirements and other measures which expanded the domestic component of central bank money.

When the Bundesbank announced the monetary target for 1978 in December 1977, it had apparently hoped that the rate of monetary expansion could be reduced significantly in the course of 1978. The 13.1 per cent increase (annual rate) in central bank money in the first quarter frustrated this hope and in April the Bundesbank explained why it was tolerating the monetary overshooting deliberately.29 First, the economic upturn had remained moderate and there had been no indications of a strong increase in general demand. A powerful expansion of the money supply was seen to support domestic activity. Second, the DM's appreciation in the winter of 1977/78 had a dampening effect on economic activity and inflation.30 Thereby it provided a counterweight

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28 For instance, after the massive currency inflows in October 1978 Bundesbank President Emminger said that domestic liquidity was under control and that there was no need for liquidity-absorbing measures for the time being. DB, Presse- und Informationsstelle, Bundesbank press conference in Berlin on 2 November 1978.

29 Dr Emminger in an article in FAZ (4 April 1978) and the Bundesbank's Annual Report 1977, pp.20-24
against the loosening effects of the monetary expansion. Bundesbank President Emminger called the flexible exchange rate the second dimension of German monetary policy at that time with the Bundesbank steering a middle course between the expansionary effects of the liquidity increase and the price-dampening and deflationary effects of the DM-appreciation.\(^{31}\) In June the Bundesbank formally abandoned the 8 per cent target for the growth of central bank money in 1978.\(^{32}\)

The two-dimensional policy was also seen to be working satisfactorily in the autumn of 1978 when the DM's nominal and real appreciation against the dollar and other currencies continued after the temporary reversal in the second quarter. However, towards the end of the year the Bundesbank regarded the monetary expansion with growing anxiety. In November Bundesbank President Emminger said that the Bundesbank was watching the strong monetary expansion very carefully and that it would not hesitate to neutralize excessive liquidity.\(^{33}\) Finally, in mid-December, the Bundesbank signalled that it would return to a more restrictive monetary policy in 1979. A monetary target was set according to which central bank money should expand within a range of 6-9 per cent between the fourth quarter of 1978 and the fourth quarter of 1979. Compared with the actual monetary expansion in 1978, the new target implied a substantial tightening. At the same time the Bundesbank announced a reduction in rediscount quotas from 1 January 1979 as a first dampening measure.

The Bundesbank's change of course in the winter of 1978/79 had a domestic as well as an exchange rate background.\(^{34}\) The recovery of the German economy

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30 Besides the dampening effect of the real DM-appreciation on both prices and economic activity, the DM's nominal appreciation against the dollar had a special price-dampening effect: it reduced the DM-price for dollar-denominated import commodities like oil and most raw materials at least as long as the dollar price of these commodities did not rise, and that happened first in early 1979.

31 The two-dimensional monetary strategy is also discussed in Dr Emminger's essay "Internationale Währungsentwicklung und Stabilitätspolitik" in Werner Ehrlicher & Rudolf Richter (eds.), Probleme der Währungspolitik, Berlin, 1981, pp.21-23.

32 DB, Monthly Report, June 1978, p.18

33 In a speech in Frankfurt on 10 November 1978, AP no.87/1978, 15 November 1978.

had gained speed in the second half of 1978 and was seen to have become self-sustaining by the end of the year when the real growth rate was about 4 per cent on an annual basis. This increased the inflationary dangers of a fast monetary expansion also because the Bundesbank expected that the "stability import" associated with the DM-appreciation in 1977/78 would cease, partly because of the impending introduction of the European Monetary System. The exchange rate mechanism of the EMS would peg the currencies of two of Germany's most important trading partners, France and Italy, to the DM. That would tend to reduce the protection against external inflationary impulses which floating rates provided for Germany.

In 1979, when the inflationary forces turned out to be stronger than expected (the second oil price shock), the Bundesbank was criticized by some observers for having tightened monetary policy too late. Dr Emminger conceded that, with the benefit of hindsight, it would have been better to have tightened monetary policy in the autumn of 1978 rather than to wait until December. Primarily he justified the timing with the exchange rate situation. He said that a monetary tightening at the height of the dollar crisis in the autumn of 1978 would have been outright provocative by aggravating the crisis and it would not have been in accordance with Germany's responsibilities for the international monetary system. Dr Emminger compared the situation in 1978 with the conflicts between the exchange rate target and domestic monetary considerations during the Bretton Woods era, although he was careful only to talk about a potential or latent conflict between the internal and external goals of monetary policy in 1978, and not about an actual dilemma. Basically his message was, that even if the Bundesbank should have wanted to tighten monetary policy before December 1978 it would have been prevented by the dollar crisis.

36 In a speech in Munich on 16 May 1979, AP no.33/1979, 17 May 1979. As another but less important obstacle Dr Emminger mentioned that the domestic political support for a monetary tightening would have been even weaker in the autumn of 1978 than it turned out to be in the winter of 1978/79.
37 In a speech in Basle on 10 April 1979, AP no.26/1979, 12 April 1979.
38 The Bundesbank's Annual Report 1978 (published in April 1979) described the situation as follows (p.1):

"When assessing monetary developments in 1978 it must be borne in mind that the Bundesbank's room for maneuver in the monetary field was greatly constricted at times by external developments. Both at the beginning
However, there is no evidence that the Bundesbank actually wanted to tighten monetary policy for domestic reasons before December 1978, but felt constrained by the exchange rate situation. Throughout the autumn of 1978 the Bundesbank regarded the expansionary forces of the growth in the money supply as adequately counterpoised by the dampening impact of the exchange rate development. Therefore it cannot be said - as it is often believed - that the general course of German monetary policy was directed toward the exchange rate in 1978. The exchange rate development was only one factor which the Bundesbank took into account in its attempt to stimulate economic activity without endangering price stability.

In general, the dollar-support which the German authorities provided unilaterally in the autumn of 1978 was clearly on a lower level than in the preceding winter. It was limited to direct interventions which were 40 per cent lower than in the first phase of the dollar weakness. The reduced German support for the dollar was partly a response to the increased American activity, but it was also a reflection of the German policymakers' more relaxed attitude towards the falling DM/dollar rate as far as the dampening effects on the German economy were concerned. This change of view has been explained with the less alarming development in the DM's real effective exchange rate, the strengthening of the economic upturn in Germany, and the compensating effects of the domestic monetary expansion. It has been demonstrated that the Bundesbank's monetary policy was not used as an exchange rate instrument, but that it only was adjusted to serve domestic economic objectives in the context of an appreciating DM.

of the year and in the autumn new monetary unrest associated with the temporary weakness of the US dollar, and to some extent also with tensions in the European narrower margins arrangements (the "snake") resulted in a rapid appreciation of the Deutsche mark in international foreign exchange markets. In order to slow down this upward movement, which far exceeded the price and cost differential between Germany and other countries, and at the same time to mitigate the dampening effect of an excessive appreciation on domestic activity, the Bundesbank took considerable amounts of foreign currency out of the market.... In these circumstances, the Bundesbank was forced to adhere to a relatively easy domestic monetary policy. Both factors - the massive inflows of funds from abroad and the stance of domestic monetary policy - led to an expansion of the money stock in Germany that greatly overshot the Bundesbank's original monetary growth target for 1978."

From this passage (and from the rest of the report) it can only be inferred that the exchange rate situation restricted the freedom of action of monetary policy, but not that it resulted in an actual dilemma between external and internal goals.


DOI: 10.2870/52840
E.2.3. *Equanimity about the Dollar Weakness in 1979*

During the third and last phase of dollar weakness from June to December 1979 the German policymakers did not become alarmed and showed less concern about the falling DM/dollar rate than during the first two phases in 1977/78. The fact that the movements in the DM/dollar rate were more orderly than in the previous two years seems to have been a reason behind this change of attitude. The sudden re-emergence of the dollar weakness in June 1979 was seen to destabilize the international monetary system, but unlike October 1978 no overhanging danger was perceived that international confidence in the dollar should collapse completely with severe consequences for the whole international economic system.

However, the dollar depreciation was still seen to lead to an undesirable increase in the DM’s role as an international reserve currency and to disturb the smooth functioning of the European narrower margins arrangements, now in the form of the EMS. The former of these consequences was an unspectacular, gliding development, whereas the latter effect became manifest in the summer of 1979 when the new European Monetary System experienced the first strong pressures against the agreed exchange rates. As often happened in the old currency snake during such periods, the DM was at the upper end of the parity band and massive interventions were carried out in order to prevent a break in the fluctuation limits. The dollar’s weakness tended to strengthen the DM more than the other EMS-currencies and increased thereby the strains within the system which basically reflected the different inflation rates between member countries. In September it was decided to realign EMS-rates after interventions in support of the old rates had increased the German foreign exchange reserves with DM 8.8 billion.

In addition to these negative aspects, the dollar’s weakness in 1979 was also seen to have a positive side. As described in chapter E.2.2., the Bundesbank’s description of exchange rate movements in 1979 in its *Annual Report 1979*, pp.50-52

Bundesbank President Emminger in a speech in Munich on 26 June 1979, reprinted in Otmar Emminger, *Verteidigung der DM* op.cit. p.250


In the EMS-realignment of 23 September 1979 the DM was revalued by 5 per cent against the Danish kroner and by 2 per cent against the other EMS-currencies.

European University Institute
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bank had announced a reorientation of monetary policy to a more restrictive course in December 1978 in anticipation of increased inflationary pressures from the domestic upswing and a discontinuation of the price-dampening exchange rate development. Until then the expansionary effect of the rapid growth in the money supply had been seen to be counterpoised by the dampening effect of the DM-appreciation (the two-dimensional strategy). The Bundesbank’s change of course was initially criticized by Finance Minister Matthöfer for coming too early in the recovery, but this complaint disappeared when the Iranian revolution in early 1979 sparked off the first of several oil price increases in that year which gave a strong cost push to the German economy. Under these circumstances the containment of inflationary forces became an increasingly important objective of German economic policy and in that regard the fall in the DM/dollar rate from June onwards was seen as helpful.

By contrast, the development in the DM/dollar market had not helped to counter German inflation in the spring of 1979. Early in the year the downward pressures on the dollar had eased off and the DM/dollar rate stabilized on the 1.85 level. Then a reflux of funds into dollar from March to early June propelled the rate to a maximum of 1.92 DM/$. The nominal DM-depreciation against the dollar contributed to the 2 per cent fall in the DM’s real external value in the first half of 1979, not least because the movements in the DM/dollar rate influence the DM’s value against many other currencies.

The Bundesbank regarded the rise in the DM/dollar rate as being due to short-term factors. It was termed unjustified in view of the much higher and still rising inflation rate in the United States. It led to an undesirable increase in the DM-prices of oil and raw materials on top of the higher dollar prices for these commodities. The domestic inflationary consequences of the DM-depreciation explain why the Bundesbank countered the exchange rate movement with substantial "leaning-against-the-wind" interventions between mid-March and mid-June. In the last half of this period the Bundesbank’s interventions averaged about DM 70 million per trading day. Furthermore the Bundesbank raised the discount and Lombard rates with a whole percentage point to 4 and 5 per cent respectively in late March. According to Bundesbank President Emminger this measure should on the one hand dampen the domestic credit expansion and on the other hand support the DM by narrowing the differential between

44 VWD 31 January 1979
45 FT 13 June 1979
46 DB, Monthly Report, June 1979, p.39; FAZ 28 April 1979

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German and foreign interest rates. Thereby it suited both the domestic needs and the Bundesbank's exchange rate preference.47

By mid-June 1979 the slight upward trend in the DM/dollar rate came to a halt and the rate tumbled 6 per cent to 1.80 DM/$ within one month. During the remaining part of the year the dollar continued to be weak against the DM and other European currencies with the DM/dollar rate reaching a minimum of 1.70 in early January 1980 before the dollar started to recover.48 The Bundesbank regarded the high and rising US inflation rate as the fundamental cause of the dollar's weakness in 1979.49 The 8 per cent fall in the DM/dollar rate during 1979 as a whole corresponded roughly to the inflation differential between the United States and Germany. The consumer price index increased by 13 per cent in the United States during 1979 against 5½ per cent in Germany.

The re-emergence of a downward trend in the DM/dollar rate in June 1979 was a welcome development from the point of view of containing inflationary forces. It helped to neutralize most of the DM's real depreciation at the source, so that the DM's real external value only showed an insignificant fall during 1979 as a whole. That was in accordance with the Bundesbank's stated preference to avoid an "inflation import" through a real DM-depreciation.50 In addition, the falling DM/dollar rate compensated partly for the preceding rises in the dollar price of oil and raw materials. (It was, however, generally believed in 1979 that a continued dollar depreciation would provoke further oil price increases by OPEC.)

The German preference for a nominal appreciation of the DM to compensate for the existing inflation differentials became also manifest in the first realignment of exchange rates within the EMS in September 1979. The initiative for a DM-revaluation came from the Germans and they were prepared to revalue the DM by more than the other member countries could accept.51 In October 1978, on the contrary, the initiative for a realignment of snake currencies seemed to have come from the Belgians while the Germans had opposed a suggestion for a

47 AP no.33/1979, 17 May 1979
48 The dollar's weakness against the European currencies was not reflected in the dollar/yen relationship as mentioned in chapter E.1.3. The yen depreciated by 23 per cent against the dollar in 1979.
49 DB, Annual Report 1979, p.53
50 Dr Emminger in a speech in Munich on 26 June 1979, AP no.45/1979, 27 June 1979.
51 Dr Emminger in a speech in Kassel on 15 October 1979, reprinted in Emminger, (Verteidigung der DM) op.cit. p.104
higher DM-revaluation. This change in the German negotiating position reflects the shift in the priorities of German economic policy: from wanting to stimulate domestic economic activity in 1978 it shifted to price stabilization in 1979. This shows that changes in German attitudes towards the dollar weakness were accompanied by similar changes in German preferences with regard to intra-European exchange rates.

The high priority which the Bundesbank placed on price stabilization in 1979 also explains why exchange rate considerations were not allowed to soften the increasingly restrictive course of German monetary policy in the second half of the year. At the end of June, when the DM/dollar rate had started to decline, the Bundesbank signalled its intention to keep the growth of central bank money in 1979 at the lower end of the previously announced target range of 6-9 per cent. That implied a significant tightening of monetary conditions in the remainder of the year, because the growth rate of central bank money had been at the upper end of the target range during the first six months. In spite of substantial capital inflow in the third quarter due to the large intervention sales of DM in the DM/dollar market (mostly by the Americans) and within the EMS, the Bundesbank was able to keep domestic monetary expansion at such a low rate in the second half of 1979 that central bank money only grew with 6.3 per cent from the last quarter of 1978 to the last quarter of 1979.

With regard to the interest rate side of monetary policy, Bundesbank President Emminger declared in late June that the exchange rate situation should not be allowed to hinder a policy oriented to price stability. Two weeks later, on July 12, when there still was strong downward pressure on the DM/dollar rate, the Bundesbank actually increased the discount rate from 4 to 5 per cent and the Lombard rate from 5\(\frac{1}{2}\) to 6 per cent. The rising German interest rate level, at a time when US rates tended to fall, was generally seen to stimulate the downward trend in the DM/dollar rate. The determined tightening of monetary policy in the summer and autumn of 1979 left no doubt about the Bundesbank's unwillingness to sacrifice its domestic stabilization efforts for the sake of the dollar.

The creation of the EMS may indirectly have influenced the Bundesbank's exchange rate policy vis-à-vis the dollar in 1979. As mentioned in the preceding

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52 FAZ 13 October 1978
53 AP no.45/1979, 27 June 1979
section, the impending introduction of the EMS was one consideration behind the Bundesbank's reorientation of monetary policy towards a more restrictive course in the winter of 1978/79. The replacement of the currency snake with the EMS increased significantly the part of Germany's foreign trade which was settled under fixed exchange rate conditions. That would reduce the inflation-dampening effect of a general DM-appreciation as Bundesbank President Emminger explained.\footnote{54} It was not said explicitly, but it is plausible to assume in consideration of the Bundesbank's general skepticism towards the EMS's capability to enhance price stability, that the pegging of the DM/French franc and the DM/lira rate was perceived as an increased danger for Germany to experience an importation of inflation. France and Italy were both main trading partners of Germany and had a higher propensity to inflate.\footnote{55} Just as the introduction of the EMS had been a consideration behind the announcement of a monetary re-orientation in the winter of 1978/79, it is likely that the increased fear to import inflation made the Bundesbank less prone to moderate the tightening of German monetary policy for the sake of the dollar in the summer and autumn of 1979.

Officially the monetary tightening was solely directed at the domestic front. Although the German current account had turned into deficit in 1979, the financing of the deficit did not become a consideration of monetary policy before 1980.\footnote{56} But the Bundesbank was not averse to the DM-appreciating effect of higher German interest rates. It did not openly say that the DM's appreciation against the dollar or any other particular currency was desirable, but it welcomed the slight rise in the DM's real external value in the second half of 1979.\footnote{57} With Germany's relatively low inflation rate this attitude implied that the rise in the DM's nominal value against the dollar and other currencies also must have been regarded as desirable. Hence, it can at least be said that the Bundesbank regarded a further strengthening of the DM as a helpful price-dampening side effect of a primarily domestically-oriented monetary tightening. There was clearly no dilemma in the Bundesbank's monetary policy between domestic and exchange rate considerations in 1979.

\footnote{54}{\textit{EZ} 15 December 1978}
\footnote{55}{The consumer price index increased with 10.8 per cent in France and with 14.8 per cent in Italy from 1978 to 1979 against a 4.1 per cent increase in Germany. DB, \textit{Annual Report 1979}, p.11}
\footnote{iibid.}{p.40}
\footnote{57}{Dr Emminger in an interview, \textit{IHT} 10/11 November 1979}
The fact that the Bundesbank supported the dollar in the exchange market with quite substantial "leaning-against-the-wind" interventions from June onwards seems at first to contradict what has been said about the Bundesbank's exchange rate preference and monetary policy. Between mid-June and 6 October (when the changes in US monetary policy eased the downward pressure on the dollar) the Bundesbank purchased dollars for about DM 4 billion in the DM/dollar market or about DM 50 million per business day. However, that was less than one fourth of the size of US interventions during the same period and clearly below the level of German interventions in the winter of 1977/78 and in the autumn of 1978. According to Bundesbank President Emminger, the Bundesbank refrained as much as possible from dollar-supporting interventions in the summer and autumn of 1979.  

The German interventions were not inconsistent with the preference for a moderate fall in the DM/dollar rate, if they only should counter disorderly market conditions and brake a decline in the DM/dollar rate in excess of what the Bundesbank considered to be reasonable in view of existing inflation differentials. If that has been the case, the Bundesbank's intervention policy would not only have been in accordance with the Bundesbank's general philosophy about the role of interventions in the management of floating exchange rates, but it would also have been considered as a successful policy, because the Bundesbank expressed its satisfaction with the rise in the DM's real external value in the second half of 1979. In other words, it seems likely that interventions served as the brake pedal used to prevent the fall in the DM/dollar rate from exceeding the desired speed. Furthermore, the Bundesbank's DM/dollar interventions up to the EMS-realignment of September 23 may partly have been aimed at maintaining EMS-rates within the agreed intervention margins. Less intervention support for the dollar would probably have required even more German support for the weak EMS-member currencies.

In general, the German policymakers tended to view the dollar weakness with relative equanimity in 1979. Especially in a national and short-term perspective the advantage of the price-dampening effect outweighed the negative consequences. This was a significant change compared with the German attitude in the autumn of 1978 and especially in the winter of 1977/78. Then, the growth-dampening aspect of the falling DM/dollar rate had been relatively more important and had added to the concerns about European exchange rate.

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58 Emminger in Ehrlicher & Richter, op.cit. p.19
59 See footnote 10 on p. E-35.
stability, the DM's increasing reserve role and the general destabilization of the international economic system. Besides the shift in the priorities of German economic policy, the German attitude towards the dollar was based on the rising inflation rate in the United States. Considering the widening inflation differential a certain fall in the DM/dollar rate was necessary to prevent an import of inflation via the exchange rate. However, it cannot be said that the German authorities were indifferent to a fall in the DM/dollar rate if only it was in accordance with the inflation differential. A weak dollar was regarded as a major destabilizing factor in the international economic system also without changes in real exchange rates. More than in the market-oriented exchange rate policy this view was reflected in Germany's exchange rate diplomacy towards the United States.

E.3. The Dollar Crisis in Bilateral Perspective

The two preceding chapters have analyzed the exchange rate policies of the United States and Germany in the late 1970s in the respective national perspectives. Chapter E.1. analyzed the growing commitment of the US authorities to arrest the dollar's depreciation between late 1977 and the autumn of 1979 and chapter E.2. explained why German exchange rate policy developed in the opposite direction. The present chapter examines the management of the DM/dollar rate in this period from a bilateral perspective, i.e. as an issue in US-German relations.

The different trends in US and German exchange rate policies were responsible for a significant transition in US-German exchange rate diplomacy. In the winter of 1977/78 the German policymakers had been dissatisfied with the American passivity towards the dollar's decline and pressed for a more active policy. But in 1979 the roles were reversed: the Americans were now demanding stronger German efforts to bolster the dollar. Autumn 1978 was a crossover point for the opposite tendencies: there was a similar degree of concern about the dollar weakness in both countries and a relatively cooperative exchange rate diplomacy. However, the US-German interactions with regard to the management of the DM/dollar rate were also affected by other issues between the two countries, most notably the controversy about German reflation.
(the locomotive discussion) and the creation of the European Monetary System. The following three sections will show how the balance of power in US-German exchange rate diplomacy shifted in Germany's favour between late 1977 and autumn 1979 in response to changes in economic conditions, policymakers' perceptions and goals, and the state of affairs on related issues.

E.3.1. Discord over Dollar Weakness and German Reflation in the Winter of 1977/78

In November/December 1977 - before President Carter acknowledged the responsibility of the United States "to protect the integrity of the dollar" on December 21 - there were growing complaints by the German government and the Bundesbank about American indifference and passivity towards the dollar weakness. In the German view, the currency disorder in the winter of 1977/78 was primarily a dollar crisis caused by the US current account deficit which, in turn, was seen to stem from the increase in US oil imports and a mounting trade deficit with Japan. The DM-strength was only regarded as the mirror image of the dollar weakness.¹

This perception provided the rationale and justification for German monetary diplomacy vis-à-vis the United States. The tenor of German policy was that the US monetary authorities ought to acknowledge their responsibility for countering the currency disorder. Unlike July 1977 there was no outright conflict between the US and German exchange rate preferences and policies. It was acknowledged in Germany that Mr Blumenthal and his associates had proclaimed a US interest in a strong dollar on several occasions since late July. It was rather the American passivity in face of the dollar crisis which was the controversial issue in the management of the DM/dollar rate in November/December 1977. The Germans regarded it as just and fair that the United States should carry part of the burden of restoring exchange rate stability, and they tried to convince the Americans about the need and desirability of an active US exchange rate policy.

¹ See for instance the speech by Bundesbank President Emminger in Bonn on 8 December 1977, AP no.83/1977, 9 December 1977. In contrast to the DM's 8.3% appreciation against the dollar since January 1977, Dr Emminger regarded the yen's 21% appreciation against the dollar in the same period as justified in view of Japan's growing current account surplus ($10.9 billion in 1977 against $4.3 billion for Germany).
Public speeches and comments by German officials show that they had three types of policy changes in mind when they argued in favour of US measures to stabilize the dollar. The recommendations covered US intervention, monetary, and energy policy. With regard to intervention, the Germans advocated a far more forceful approach. In the German view, the Americans were making a fetish of the Rambouillet formula about limiting interventions to counter disorderly markets and were using it as an excuse for inaction.  

In a speech in New York in mid-November, Dr Emminger said that an improved coordination of intervention policies between the most important countries would be desirable. Furthermore, he argued for a flexible interpretation of the rule that interventions should be made only to smooth temporary fluctuations in view of the dollar's position in the monetary system. The implicit criticism of the narrow US understanding of the Rambouillet formula was discreet, but obvious. When the US authorities intensified their interventions in December, Dr Emminger welcomed this.

But interventions were not a sufficient remedy for the US current account deficit which was regarded as the direct cause of the dollar's troubles. For the long-run correction of this deficit German policymakers recommended that US oil imports should be reduced by means of an appropriate energy program including, for instance, higher energy prices in the United States. Meanwhile the US current account deficit had to be financed either by increasing capital inflows into the United States or with dollar purchases by foreign central banks. In 1977 the US current account deficit of $14 billion had been accompanied by a net outflow of private capital. The overall payments deficit of $28 billion had been financed through increases in the dollar reserves of foreign central banks. Especially the purchases of $16 billion by the Bank of England between January and October 1977 contributed significantly to the financing of the US external deficit. When the British authorities abruptly discontinued the build-up of foreign exchange reserves in October in face of a dangerous expansion of the domestic money supply, the Bundesbank stepped in as the main financier of the US deficit.

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2 JC 15 December 1977
3 AP no.79/1977, 22 November 1977
4 FT 16 December 1977
5 For example by Count Lambsdorff, the Economics Minister (SZ 5 December 1977) and by Mr Föhl, Bundesbank Vice President (VWD 30 November 1977).
But since November 1977 the leading Bundesbank officials repeatedly emphasized that the global accumulation of official dollar reserves could not be expected to continue in 1978. The Bundesbank's own dollar purchases should only be understood as a short-run bridging action, it was said. If the dollar was to be prevented from further drastic falls, the US capital account had to be turned into surplus to ensure overall US payments equilibrium. However - as Bundesbank President Emminger explained - private US net capital imports required an appropriate interest rate differential favouring the dollar, tight US monetary policy, and foreign confidence in long-term US stabilization policy. The call for a US policy favourable to capital imports was actually a request that the United States should finance its own current account deficit by tightening monetary policy.

The German demand for an active US exchange rate policy was supported by other European countries, most notably by Switzerland whose currency had appreciated even more than the DM against the dollar. The Swiss central bank president, Fritz Leutwiler, criticized the United States for "sheer neglect" and even "malign neglect" of the dollar's international value. But all the evidence goes to show that the dispute about the right policy response to the dollar crisis was primarily an American-German controversy, even though this was blurred somewhat by the long-standing tendency of the German authorities to downplay differences of opinion with the United States for the sake of the military alliance and to discuss such matters in multilateral fora (like the G-10, the G-5, and the OECD) where the linkage between military and monetary issues was less likely to be made.

The US monetary authorities were not very receptive to foreign proposals about changes in their economic policy. According to Professor Norbert Kloten, a member of the German central bank council, the United States declined German offers of monetary cooperation for months in the autumn and winter of 1977. In this the Treasury was more adamant than the Federal Reserve. For a long

7 For instance Dr Emminger in his speech in New York in mid-November, AP no.79/1977, 22 November 1977.
9 LHT 7 December 1977
time the Americans played down the size of the dollar’s depreciation by referring to the less dramatic fall in the trade-weighted index of the dollar’s international value rather than to the changes in the bilateral exchange rates vis-à-vis the DM, the yen, and the Swiss franc.\(^{11}\) The German suggestion that the United States ought to take the balance-of-payments situation and the dollar rate into account in the conduct of monetary policy was rejected by the Americans. They countered such recommendations by arguing that the falling DM/dollar rate was caused by the different timing of the business cycle in the United States and Germany (the so-called “business cycle gap”). While the Germans argued that the falling DM/dollar rate worsened the prospects for sustained economic growth in Germany and elsewhere, the Americans maintained that increased German growth was a precondition for a more balanced DM/dollar rate.\(^{12}\) According to the American view, Germany should increase the counter-recessionary efforts not only for the sake of worldwide economic recovery (the locomotive theory), but also because it would tend to reduce the current account imbalances and, hence, increase exchange rate stability. The crux of this dispute was that the Americans wanted a domestically-generated growth of the German economy, while the German policymakers primarily had an export-led growth in mind.

Bundesbank President Emminger denied that the “business cycle gap” had had much impact on the DM/dollar rate, and anyway, he argued, if it were to be narrowed, it would be better to strengthen anti-inflationary efforts in the United States rather than to run further inflationary risks in Germany. The German government had already stimulated the domestic economy substantially in 1977 and a budget deficit of 4.5 per cent of GNP was expected for 1978. Dr Emminger complained about the lack of appreciation on the American side about these reflationary efforts.\(^{13}\)

The conflict about US exchange rate policy culminated in December 1977 in connection with multilateral meetings of finance ministers and central bank leaders. A Group-of-Five meeting in Paris on December 3/4 ended in deadlock with Treasury Secretary Blumenthal refusing even to consider further American actions to support the exchange value of the dollar.\(^{14}\) A meeting of central-

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11 \textit{NZZ} 13 December 1977
12 See for instance the remarks by Richard N. Cooper, Under Secretary of State for Economic Affairs, as quoted by the \textit{FAZ} 23 December 1977.
14 \textit{FT} 9 December; \textit{NYT} 10 December 1977; \textit{NZZ} 13 December 1977. The Treasury’s position was reaffirmed by Undersecretary Solomon in an interview shortly after the Paris-meeting, \textit{IHT} 10/11 December 1977.
bank governors in Basle on December 11/12 was equally unproductive with the participants separating in sharp disagreement according to the Financial Times.  

Shortly afterwards, US policymakers at last began to become apprehensive about the dollar depreciation as described in chapter E.1.1. The first clear sign was President Carter's statement on US balance-of-payments and exchange rate policies on December 21. The German arguments about the negative effects of the dollar depreciation on global economic recovery may have contributed somewhat to the new American preference for a strengthening of the dollar, but there is no evidence that Washington's dollar-supporting initiatives in December and January were the result of German pressure. The OPEC threat to raise the price of oil seemed to have made much more impact on the US government than the complaints about US benign neglect from Germany and other countries.

In official statements the German authorities welcomed the American exchange rate measures as helpful to the stabilization of the currency markets and as a remarkable departure from the attitude of benign neglect. But the German policymakers were also virtually obliged to praise the American measures in official comments, even though they may have considered them insufficient. Anything else but full support would have undermined their psychological effect on the exchange market. Hence, the American measures silenced all open criticism of US exchange rate policy by foreign monetary officials for a while.

By this means the United States gained a diplomatic advantage in the bilateral relationship with Germany. In late 1977 the German demand for US dollar support had been counterbalanced by the American demand for more German reflation. Now the balance tipped in favour of the United States and it became more difficult for the Germans to respond to the demand for more economic stimulation with a counterclaim in the area of exchange rate policy. The Americans used their new political leverage and the Germans felt an increased pressure for growth-stimulating action in early 1978.  

However, the German Chancellor Helmut Schmidt made it clear in the course of the annual statement of government policy to the Bundestag on January 19

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15 **FT** 14 December 1977

16 Bundesbank Vice President Pöhl, for example, spoke about a remarkable change in the US attitude towards the dollar problem away from "benign neglect", AP no.11/1978, 31 January 1978.

17 According to Dr Emminger, AP no.12/1978, 3 February 1978. The American pressure on Germany was not only supported by the IMF and the OECD, but also by Germany’s EC-partners, especially Britain, see Peter Ludlow, **The Making of the European Monetary System**, London, 1982, pp.75f.
that the German government did not plan to follow the American call to raise steam in the German economy: "We cannot follow every foreign giver of advice who sees our budget deficit as too small and who recommends even bigger deficits." 18 Yet the Americans continued to exert pressure on Bonn and when the German complaints about insufficient American efforts to strengthen the dollar resumed, they seemed partly to be a tactical manoeuvre to divert attention from the reflation issue. The bilateral tensions increased markedly in February 1978 when the visits of the German Economics Minister, Count Lambsdorff, to Washington and of US Treasury Secretary Blumenthal to Bonn not only failed to reconcile the opposing positions, but also made the rifts more generally visible. 19 According to unconfirmed newspaper reports, Mr Blumenthal had threatened to stop all substantial interventions if the Germans did not become more cooperative with regard to the reflation issue. 20 On the other hand, a high German government official close to the Chancellor informed the press that Helmut Schmidt and Michael Blumenthal had agreed to end their lingering public argument about economic policy. The understanding meant that the US government would stop suggesting that the projected German growth rate of 3½ per cent for 1978 was insufficient to help the world economy and that, as such, it represented a shirking of Germany’s responsibilities as a global economic force. In turn, the German government promised to "stop talking about the weakness of the dollar" as a cause of instability in international trade. 21

In fact, the tone of US-German relations was more conciliatory after Mr Blumenthal’s talks in Bonn. Bundesbank Vice President Pöhl, for instance, said that much of the criticism directed against US exchange rate policy was exaggerated. With their "active intervention policy" and the "exclusively exchange-rate oriented discount rate increase" in January, the US monetary authorities had proved their interest in a stable dollar, according to Mr Pöhl. 22

In late February the DM/dollar rate approached the psychologically important benchmark of 2.00 DM/$. This development worried the policymakers in Germany as well as in the United States and made them consider new measures to

20 NZZ 21 February 1978
21 IHT 24 February 1978
22 AP no.17/1978, 27 February 1978
bolster the dollar. It provided also the opportunity to combine the exchange rate issue with the reflation issue in a bilateral agreement between the United States and Germany. In cooperation with their respective central banks, Anthony Solomon of the US Treasury and his opposite number in the German Finance Ministry, Manfred Lahnstein, prepared an agreement which was presented on March 13 as a joint US-German statement.23 The exchange rate measures, which were announced in this statement, have been described in chapter E.1.1. But the agreement contained also a reaffirmation of the German government’s commitment to support economic recovery at home. A key sentence of the statement reads as follows: “Economic developments during the first quarter of 1978 will be particularly important in determining the future course of economic policies in the Federal Republic of Germany and elsewhere”.24 A Treasury official said that this sentence meant that the Germans would take a new look at their economic policies – designed to achieve a real growth rate of 3½ per cent in 1978 – around early May.25 Transitory factors, including industrial disputes, had affected the most recent statistics about German output and the German government had apparently insisted that it could not contemplate new stimulatory measures until a clearer picture of the state of the economy was available. In effect the reflation issue was postponed until the economic summit meeting in Bonn four months later.

Basically the statement of March 13 reflected a political quid pro quo between the United States and Germany covering the interlinked issues of dollar support and the stimulation of the German economy. While Bonn promised to reconsider its attitude towards additional reflationary measures in the coming months, Washington agreed in principle to use its own resources (i.e. SDR-reserves and the IMF reserve position) for intervention purposes and not only borrowed funds. (In practice, however, the US monetary authorities continued to rely on swap loans for their dollar-supporting interventions and refrained from drawings on their own resources until November 1978.)

One proposal, which the US Treasury refused to consider in the negotiations prior to the agreement of March 13, was the issuance of Treasury securities denominated in foreign currency.26 The proposal was first realized with the dollar-rescue package in November 1978 which introduced the so-called Carter notes. The idea had first been suggested by Federal Reserve Chairman Arthur Burns

23 FAZ 11 March and 13 March 1978
24 WB 14 March 1978
25 IHT 14 March 1978
26 IHT 24 February 1978; Hb 13 March 1978
during the preparation of the January 4 - package when it had been rejected by the Treasury. 27 It envisaged that the US Treasury should issue, for instance, DM-denominated securities with four years to maturity and sell them to investors in Germany. The proceeds of the sale could then be used for dollar-supporting interventions in the DM/dollar market. The Treasury's most important objection to the sale of US securities in foreign denominations lay in the risk it would have to take of incurring substantial losses if the market price of the dollar should continue to fall. 28 In contrast to the existing swap agreements, the exchange rate risk would not have been shared with the Bundesbank (and the Federal Reserve), but fall on the Treasury alone.

Dr Burns' proposal has possibly been inspired by the Treasury's issue of the so-called 'Roosa-bonds' in the early 1960s and by Britain's Basle Agreement in 1968. 29 The Roosa-bonds were the first indication that the times had gone where the United States had scorned to offer anyone guarantees on their dollar holdings. "For any country with the status of international banker to stoop to reassuring particular holders as to the value of their holding in terms of some other monetary asset once seemed infra dig." 30 As mentioned before, the US authorities used swap transactions with European central banks as another way to guarantee the exchange value of unwanted dollar holdings in the 1960s. At that time, however, only foreign monetary authorities were partly covered against exchange rate losses in case of a dollar devaluation. Dr Burns' proposal suggested that the dollar's position as reserve- and investment currency had been weakened even more by 1978 as the exchange rate guarantee now was proposed to be extended to private creditors of the United States. However,

27 "I worked out a plan with my staff," Burns says, "and told them to work it out with the Treasury staff. The Treasury staff refused to look at it - they had instructions from Blumenthal not even to talk about it. Emminger sent people here to discuss the proposal with the Treasury; Blumenthal wouldn't agree to see them unless it was understood that the sale of US paper in foreign denominations would not be brought up at the meeting." Martin Mayer, The Fate of the Dollar, New York, 1980, p.275

28 ibid. p.276

29 Roosa-bonds were non-marketable bonds issued by the US Treasury to foreign monetary authorities for two years and denominated in the currency of the holding country. It ensured the holder against an exchange rate loss in case of a dollar devaluation. Similarly, in the 1968 Basle Agreement Britain provided the countries within the sterling-area a guarantee against exchange rate losses on their reserves in case of a sterling devaluation.

in the winter of 1977/78 the US Treasury still considered it unnecessary to
degrade US monetary power in this way.

The Germans, on the other side, had supported the idea. The sale of
DM-denominated securities by the US Treasury would be an official US capital
import and reduce the need to finance the US current account deficit by accu-
mulating dollars in the foreign exchange reserves of the Bundesbank and other
central banks. Compared with swap loans, the scheme had the advantage that the
liquidity-increasing effect of American DM-sales on the German money supply
automatically would be counterbalanced by the liquidity-decreasing effect of
the bond sales in the German capital market. In spite of their support for
official US capital imports, German policymakers refrained from advocating
Dr Burns’ proposal with much insistence. Knowing that the US Treasury’s oppo-
sition could not be overcome at that time, a public campaign on this issue
would only have worsened the relationship with Washington and have negatively
affected market sentiment towards the dollar.

E.3.2. The Co-operative Exchange Rate Management in the Autumn of 1978

The US-German compromise, which was manifested in the agreement of 13
March 1978, was only a truce in a continuing double conflict over US support
for the dollar and German stimulation of domestic demand. However, the tempo-
rary recovery of the dollar in the following months helped to prevent that
this transatlantic row flared up again. When strong downward pressure on the
dollar resumed in August the reflaction issue had been settled and the atti-
dudes towards the dollar weakness had been modified in both countries. Due to
the changed circumstances Germany’s position had strengthened vis-à-vis the
United States which left its mark on the dollar-rescue package of 1 November.
Although the dollar weakness as such was more dramatic than in the winter of
1977/78 the bilateral exchange rate management became more harmonious and co-
operative in the autumn of 1978.

In the course of the year American perceptions of the currency crisis
moved closer to the view which the Germans already had held in the winter of
1977/78 about the perceived causes of the dollar weakness and the prime respon-

31 FAZ 27 February 1978; Frankfurter Rundschau 2 March 1978; Interview with
Dr Emminger, May 1983.
sibility of the United States for strengthening the dollar. Furthermore, there was growing agreement in principle with the other German contention - i.e. that the fundamental economic conditions for the dollar could be improved by an effective US energy program and by more determined anti-inflationary policies in the United States. Although the Germans were not impressed by the American attempts in that direction (the energy program of 13 October and the anti-inflation program of 24 October) they abstained largely from criticism - at least in public. The dollar rescue package of 1 November was an American initiative and unequivocally welcomed by the Germans, who especially appreciated the tightening of monetary conditions in the United States. They had made their co-operation on the mobilization of intervention funds conditional on substantial internal adjustment measures in the United States. The co-ordination of intervention operations in the DM/dollar market functioned apparently without friction in this second phase of dollar weakness.

There were three reasons for this significant shift to a non-contentious exchange rate management during 1978. First there was a changed perception among US policymakers about the causes and effects of the dollar depreciation discussed extensively in chapter E.1.2. Unlike in the winter of 1977/78, they accepted by and large the exchange rate development in the autumn of 1978 as a crisis of the dollar. Compared with the first phase of the dollar weakness they were much more concerned about the negative effects of further dollar depreciation on US inflation, the price of oil, US security interests, international trade and finance, and the dollar’s standing in the international monetary system. Hence, they were more prone to become engaged in substantial dollar-supporting measures, giving less occasion to German criticism and pressure.

Secondly, the German attitude towards the dollar weakness was more relaxed as far as the negative effects on German economic activity were concerned. In explaining the less apprehensive view among German policymakers the analysis in chapter E.2.2. has primarily pointed to the Bundesbank’s two-dimensional monetary strategy, the improved growth-performance of the German economy, and the widening inflation gap between the United States and Germany, which justified a certain fall in the DM/dollar rate according to the German view. There were continued worries in Germany about the implications for intra-European exchange rate stability, the DM’s reserve currency role, and the international economic system in general. But all things considered, the German concern about the negative effects of the dollar weakness had diminished compared with the winter of 1977/78, providing less incitement to urge the United States to step up its dollar support effort.
This convergence of US and German attitudes towards the dollar weakness was essential for the non-contentious exchange rate diplomacy in the autumn of 1978. But there was yet another reason why the earlier conflict over the management of the DM/dollar rate was not revived. The crucial event here was the seven-nation economic summit meeting in Bonn in July 1978. On that occasion the 18-month old controversy about German reflation was ended with Chancellor Schmidt’s concession to cut German taxes with an amount equal to 1 per cent of GNP. In addition to this concrete result there was an intensive exchange of more or less vague promises with regard to international trade, exchange rates, anti-inflationary policy, growth targets, and energy policies.

An important precondition for the multilateral package deal at the Bonn-summit was the American benevolence towards the plan for a new European monetary system. In conjunction with French President Valéry Giscard d’Estaing, the German Chancellor had proposed a scheme for closer European monetary integration at the European Council meeting in Copenhagen in April 1978. Mr Schmidt’s personal efforts turned out to be the key contribution to the creation of the European Monetary System (EMS) which could be launched in early 1979, after less than a year of preparation.

The basic idea behind the EMS was to reduce exchange rate fluctuations within the European Community. The currencies of the four largest EC-countries (Germany, France, Britain, and Italy) were floating against each other and the dollar weakness in the winter of 1977/78 had caused movements between them which were not seen to be justified by relative economic performances. Furthermore, the dollar weakness had created tensions within the currency snake, which was essentially a DM-bloc consisting only of the Benelux-currencies and the Danish and Norwegian kroner besides the DM in early 1978. The EMS-plan envisaged a "zone of monetary stability" in Europe which should be insulated from the exchange rate volatility spread by the dollar. The EMS should replace the currency snake with a similar exchange rate mechanism (an adjustable peg system), but comprising all EC-currencies and with improved procedures for the defence of pegged rates. A supra-national currency unit (the ECU) should be created as a weighted average of all EC-currencies. The ECU should serve as a unit of account and as a means of payment between EC central banks with potentially wider uses. Furthermore it was planned to pool a part of the member countries’ gold and dollar reserves and to establish a European Monetary Fund at a later stage with

31 Ludlow, op.cit., pp.121f
32 Ludlow, passim
central bank responsibilities on a European level. The EMS would provide the institutional basis for subsequent steps toward a true European monetary union with a common monetary policy and a common currency.

Helmut Schmidt's initiative was a way to get European integration going again after years of standstill. It was prompted by the dollar crisis in the winter of 1977/78 and by his concern about the quality of American leadership in general and US exchange rate policy in particular. "It was an act of self-defence in case, as in his worst moments Mr Schmidt must have feared, the American president possessed neither the skill nor the capacity to deal with the fundamental problems underlying the weakness of the dollar." Although Mr Schmidt asserted repeatedly that the EMS was not directed against the United States, the long-term perspective was no doubt to create checks-and-balances in the world monetary order with the aim of confronting the United States with another roughly comparable monetary area with a currency capable of rivaling the dollar in its international roles.

The EMS-initiative reflected the realization that it was futile to attempt to change US economic policies by complaining and lecturing. It may have been feared that further attempts of that sort could damage German interests in more vital military questions. In the absence of German power to influence US behaviour significantly, the only alternative was to minimize the negative consequences through adjustment. Whereas the Bundesbank adjusted its monetary policy to the falling DM/dollar rate by adopting the two-dimensional strategy, the government initiated a response on the European level.

The Carter administration's attitude towards the EMS was formulated at a very early stage and the American endorsement of the plan was already signalled to the Europeans in early June, that was one month before the European Council decided on the basic principles of the new system at its meeting in Bremen. There had been some sceptical voices in the US Treasury, but "the administration gave its blessing to the scheme before they knew what was in it, for the a priori reason that the American government had always been in favour of European unity and that, as the monetary proposal was a step towards this goal, it ought to be approved and supported." The evidence of American benevolence helped

33 ibid. p.117
34 ibid. p.129
35 See, for instance, Hb 26 April 1978.
36 Ludlow, op.cit. pp.118-121
the on-going EMS-negotiations because it reduced the British reservations, which partly had been motivated with the damage that the new system might inflict on the dollar. More importantly, the positive American attitude paved the way for what was called "Schmidt's grand design for the economic summit".  
"Had the advice of certain elements in the United States' Treasury prevailed, it is extremely doubtful that Mr Schmidt would have been prepared to make (his concession on growth) and it is quite certain that the Bonn meeting itself would have been thoroughly disagreeable."  

When the German Chancellor indicated in early June that he felt he had American support for his EMS-plan, the outline of a package deal for the Bonn-summit on 16/17 July was emerging. In the agreement of 13 March the German government had promised to reconsider the course of its economic policies as soon as the economic development in the first quarter of 1978 could be properly assessed. By early summer the available statistics made it appear unlikely that Germany would achieve the target of 3.5 per cent real growth in 1978. Under these circumstances Mr Schmidt could hardly avoid to yield to the pressure from the United States, assisted by Britain and other countries, to give an additional fiscal boost to the German economy. Apparently the Americans were asking for a stimulus equivalent to 1 per cent of the German GNP. The US demand was especially hard to resist because the downward pressure on the dollar remained modest in June and July after the 6 per cent rise in the DM/dollar rate in the preceding two months. Complaints about the dollar weakness

37 ibid. p.118. The reluctance of Treasury officials to give the Europeans a blank cheque regarding the details of the planned system was apparently based on a concern that a common European currency would be able to rival the dollar as the pivot of the international monetary system. Furthermore, they wanted reassurance that a new EMS:
- would not result in a closed currency block and restrictions on capital movements;
- would not result in a systematic overvaluation of the dollar with regard to the European currencies;
- would not provide a new lease of life for gold;
- would not attempt to resume the Bretton Woods system or impose exchange rates so rigid as to prevent fundamental adjustments worldwide;
- would have neither a low growth nor an inflationary bias;
- would not be a threat to the IMF.

ibid. p.119

39 Ludlow, op.cit. p.122
40 FT 9 June 1978. Actually the 3.5 per cent growth target was exactly attained due to the strong recovery in the second half of the year.
41 loc.cit.
and US exchange rate policy could therefore not be used as effectively as in the winter of 1977/78 to ward off the US demands for German reflation.

Helmut Schmidt was determined to sell the inevitable concession on growth as expensively as possible. First of all, he wanted acceptance of the EMS from those EC-countries which still were hesitating, notably Britain. This was achieved at the European Council meeting in Bremen on 6/7 July. But the stakes for which Mr Schmidt was playing were higher still. "He wanted not just the EMS, but a public commitment by the American administration in the most augst setting possible that it really would deliver on the economic policies that it had promised, but failed to implement, for so long." 42 Although the EMS initiative was born in anger and frustration as an act of self-defence in face of the dollar crisis, Mr Schmidt seemed to adopt the view as the Bonn-summit approached, that "a durable EMS required a healthy dollar: it could only in the short-run be a substitute for a weak one." 43 Mr Schmidt wanted therefore serious efforts by the American administration to tackle the problems of their economy. In particular, he wanted a cut-back in US oil-imports, because he believed the American energy deficit to be at the root of the dollar's difficulty. 44

In effect, the German strategy for the Bonn-summit was largely fulfilled. On the one side, Mr Schmidt promised stimulatory measures "up to 1 per cent of gross national product". Within two weeks the German government had decided on tax cuts and spending measures which would increase the German budget deficit with DM 13 billion annually, i.e. roughly 1 per cent of GNP, from the beginning of 1979. On the other side, President Carter promised to cut US oil imports and to raise domestic energy prices to world levels by 1980. The communiqué also confirmed American goodwill as far as the EMS was concerned. Japan would aim at 7 per cent real growth in 1978 and try to reduce its trade surplus. Furthermore, the participants promised to resist protectionist pressures with regard to international trade and to pursue anti-inflationary policies and greater exchange rate stability.

With the concession on demand stimulation (which came to be widely regretted in Germany in the years to follow because of its effect on inflation and on the budget) Mr Schmidt achieved a major political victory. After the Bonn-summit he was in "a position of incomparably greater strength and authority.

42 Ludlow, op.cit. p.129
43 loc.cit.
44 Samuel Brittan in FT 20 July 1978.
... Through his concessions on growth and still more through the speedy implementation of them, Mr. Schmidt wrested for his country a moral advantage that it had not possessed at any other stage of the world recession." 45 On the one side, the fulfillment of the German Chancellor's 'grand design' advanced the realization of the Franco-German EMS-plan. On the other side, it had a number of implications for the management of the DM/dollar rate which help to explain the absence of conflict in US-German exchange rate diplomacy in the autumn of 1978.

First, Germany's 'moral advantage' after the Bonn-summit seems to have fostered a sense of obligation on the American side to live up to President Carter's pledge to pursue exchange rate stability when the dollar crisis erupted in the autumn of 1978. The swift American reaction to the dollar's fall in August - only one month after the summit - seems partly to have been made in respect for the summit communiqué. President Carter's promises at the summit also help to explain the adoption of the "November measures" as mentioned in chapter E.1.2. According to Robert Solomon, President Carter gave his final go-ahead to the dollar-rescue program partly because of reports that other heads of government were criticizing him. 46

Second, in the winter of 1977/78 the-German complaints about US exchange rate policy had partly been a tactical manoeuvre to divert attention from the American demands for German measures to stimulate the domestic economy. Obviously this motive vanished with the German concession at the Bonn-summit, which by this way reduced the German policymakers' incentive to criticize US exchange rate policy.

Third, the progress with regard to the EMS, which was made possible by the success of Mr Schmidt's strategy in the summer of 1978, may indirectly have helped to prevent a revival of US-German conflict about the management of the DM/dollar rate in the autumn of 1978. On the one hand, the expectation that the new European Monetary System would soon be put into effect may have strengthened the tendency toward more active US support for the dollar:

"...the possibility cannot be ruled out that the political move towards closer European integration and thus towards more influence in international monetary affairs 'helped' the US government and central bank to embark upon a policy to regain stability of the dollar." 47

45 Ludlow, op.cit. p.132
On the other hand, the EMS-negotiations and the prospect for a swift implementa-
tion of the plan may have diverted the attention of German policymakers
somewhat from the dollar crisis and reinforced the trend to a more relaxed
attitude towards the falling DM/dollar rate, which has been described in chap-
ter E.2.2. Certainly, it was widely believed that the ultimate success of
the EMS also depended on a reasonably stable dollar, but the inclusion of the
French franc, the Italian lira, and possibly the British pound, would in any
case tend to reduce the DM's effective appreciation if the dollar should con-
tinue to depreciate after the start of the EMS.

As a result of all these influences the German policymakers' criticism
of US exchange rate policy was very subdued during the dollar's second phase
of weakness. Only Count Lambsdorff, the Economics Minister, made some strong-
worded remarks about the dollar problem at a press conference in Tokyo in late
August. 48 He stressed that Germany had met the commitments it made during the
Bonn-summit "to the full" and reminded the US administration of its pledges
with regard to energy and anti-inflationary policies. But this was an isolated
incident; there was no systematic German campaign to prod the United States
to act faster or more determined on the dollar problem in the months after the
Bonn-summit. On the contrary, the German government welcomed the American
dollar-supporting measures in August 49 and at a G-10 meeting in early Sep-
tember, chaired by Bundesbank Vice President Föhl, the participants were said
to be confident that the measures taken by the Carter administration were suf-
cient to protect the dollar against possible new speculative pressures. 50
In October, when the dollar was under particularly strong pressure, the German
policymakers did not criticize the United States in public, although the energy
program of 13 October and President Carter's anti-inflation speech on 24 Octo-
ber impressed them as little as the exchange market. With regard to the anti-
inflationary measures the German government spokesman merely noted that they
were "a step in the right direction." 51

48 Count Lambsdorff urged the American administration "to push through an en-
ergy conservation program" and "to take energetic steps against inflation,
which at the rate of 8% ... has now reached serious proportions." He refer-
ted to the special obligations of the United States as the reserve currency
country and said that "with an inflationary reserve currency you will de-
stroy any monetary system." IHT 1 September 1978
49 FT 18 August 1978
50 IHT 9/10 September 1978
51 FT 2 November 1978. See also the slightly disparaging remarks about the
US programs made by Bundesbank President Emminger at a press conference
on 2 November 1978, DB, Presse- und Informationsstelle.
The fact that the Germans largely abstained from using their 'moral advantage' after the Bonn-summit to put pressure on the United States, preserved the improved atmosphere between Bonn and Washington which had developed in the summer of 1978. Actually the same conditions which prevented a new outburst of the previous dispute about an appropriate American dollar policy facilitated US-German co-operation on the issue. Count Lambsdorff, at the aforementioned occasion in Tokyo, stressed that "it will be up to us not only to remind the Americans of their special task, but also to try to help them with it."52

US-German co-operation on the management of the DM/dollar rate in the autumn of 1978 centered upon the dollar-rescue package of November 1. The package, which has been analyzed in chapter E.1.2., was primarily an American exchange rate measure, although Germany, Japan, and Switzerland participated in the mobilization of funds for US interventions. Already at the IMF's Annual Meeting in late September the Americans started to sound out the possibilities for a multilateral rescue operation.53 US-German consultations were intensified in the last week of October.54 According to Bundesbank President Emminger, there had been no need to tell the Americans that the exchange rate development could not be allowed to continue unchecked after the disastrous effects of President Carter's anti-inflation speech on 24 October.55 But the Bundesbank was only interested in joint action provided it was underpinned by energetic internal measures in the United States, for instance a tightening of monetary policy.56

It has been mentioned in chapter E.1.2. that the major issue among Washington's top economic policymakers up to November 1 was the very question how to apportion the rescue package for the dollar between a tightening of monetary policy and the mobilization of funds for exchange market intervention. Because the Bundesbank's participation was indispensable for the mobilization of intervention funds, the Bundesbank's demand must have carried considerable weight on the American decision to raise the discount rate with a full percentage point and to introduce a supplementary minimum reserve requirement.

52 IHT 1 September 1978
53 NZZ 9 November 1978; Los Angeles Times 2 November 1978
55 loc.cit.
In the winter of 1977/78 the mobilization of US intervention funds had been a bilateral affair between the United States and Germany. In connection with the November 1 program it would have been impossible for the Americans to assemble the equivalent of $30 billion in available intervention resources with German help alone. Besides the DM, the yen and the Swiss franc had been the currencies which had appreciated most against the dollar in 1978. Swiss participation in international agreements to support the dollar had precedents in May 1974 and in February 1975, when the central banks of the United States, Germany, and Switzerland agreed on co-ordinating their intervention operations. Furthermore the Swiss had helped to support the British pound in the 1960s. Japan's participation added to the credibility of the American claim to be determined to strengthen the dollar. 57 A few months earlier US policymakers had appeared to approve of the falling yen/dollar rate, but now it was signalled that the dollar's depreciation had gone too far even against the yen. However, US intervention policy continued to concentrate on the DM/dollar rate after November 1. The new intervention resources in yen and Swiss franc were only used to a minor extent.

On the German side the dollar-rescue package was welcomed as a fundamental turning-point in US exchange rate policy. For a long time the American interest in the dollar had not been as pronounced as the German policymakers would have liked it to be. 58 Bundesbank President Emminger hailed the November 1 program as a definitive departure from the attitude of benign neglect in US exchange rate policy. He said that for the first time the United States had fully recognized and accepted the requirements of the situation and assumed responsibility for the dollar's external value and for the financing of the US balance-of-payments deficit. Especially the tightening of US monetary policy was appreciated. This measure was seen to address the evil's root with regard to the dollar weakness. 59

57 The American acceptance of Japan as a partner in international exchange rate co-operation may also be interpreted as a manifestation of the tri-lateral philosophy for the management of international affairs which was in vogue during the Carter presidency.

58 Finance Minister Matthöfer in an interview with Die Welt 3 November 1978

59 In a speech in Frankfurt on 10 November 1978, AP no.87/1978 (15 November 1978). Similar remarks were made by Bundesbank Vice President Pöhl at a conference in Zurich on 28 November 1978 , NZZ 29 November 1978. Economics Minister Count Lambsdorff emphasized also the anti-inflationary aspect of the program, i.e. the monetary tightening, Stuttgarter Zeitung 5 December 1978.
In accordance with their attitude in early 1978, the German policymakers were also content that the Americans had agreed on issuing Treasury securities denominated in foreign currency. When the so-called Carter notes would be floated in the German capital market they would represent an official US capital import. They would reduce the need to finance the US current account deficit through accumulation of dollar assets at the Bundesbank and other central banks. This latter form of financing had long been criticized as inflationary by the Germans.

The Bundesbank was less enthusiastic about the increase from $4 to $6 billion of the swap line with the Federal Reserve. Dr Emminger stressed that the liquidity effects of swap-financed US interventions complicated the conduct of German monetary policy. However, in return for the extension of the swap line the Bundesbank had obtained a tightening of US monetary conditions, and Dr Emminger stressed that the Bundesbank's approval of this measure had been facilitated by the fact that the dollar package otherwise was regarded as a positive turn in US exchange rate policy. He belittled the swap-line extension by saying that it did not belong to the core of the program and expressed the hope that it would not be used at all. This wish was not fulfilled. 60 62 per cent of the $5.7 billion worth of American DM-sales in November and December 1978 was still financed with swap loans. The remaining part was financed out of the new American reserves acquired through the issuance of Carter notes, IMF-drawings, and the conversion of SDRs. At the end of the year the Federal Reserve's outstanding swap debt to the Bundesbank amounted to $4.6 billion.

In the German view the November 1 program implied that the United States had started to behave like a normal deficit country. 61 It was stressed that the United States now would contribute to the financing of its current account deficit not only by raising domestic interest rates, but also by issuing Treasury notes denominated in foreign currency. 62 In general the German policymakers seemed to approve of the dollar-rescue package as a move towards more symmetry in the management of the DM/dollar rate.

61 Bundesbank Vice President Pöhl in Zurich on 28 November 1978, NZZ 29 November 1978.
E.3.3. The Conflict about Monetary Policy in 1979

US-German exchange rate diplomacy during the dollar's third phase of weakness in 1979 was almost a mirror-image of the first phase in the winter of 1977/78. Then, the Germans had demanded from the reluctant Americans that they should increase their efforts to arrest the dollar depreciation. In 1979 the roles had been reversed with the Americans demanding a higher German contribution to the support of the dollar. The background to this change in the bilateral management of the DM/dollar rate has been examined in chapters E.1. and E.2. The partial analyses showed that the American and German attitudes towards the dollar weakness developed in opposite directions during the late 1970s. Autumn 1978 can be seen as the crossover point where the intensity of concern about the dollar weakness was similar in both countries, which contributed to a relatively harmonious exchange rate management. In 1979 the US policymakers' concern increased further, whereas the German attitude became more relaxed. This divergence led to a revival of conflict in US-German exchange rate diplomacy in the summer and early autumn of 1979 before the Americans opted for a unilateral solution to the dollar crisis with the monetary measures of October 6.

On the American side the concern about the inflationary effects of the dollar depreciation had become even more pronounced in 1979 as US inflation was increasing at double-digit annual rates. The authorities continued the policy adopted with the dollar-rescue package of 1 November 1978, i.e. massive interventions and interest rate increases. However, the monetary tightening in the summer of 1979 was modest and hesitating as there was a widespread fear of an impending recession. With US monetary policy in a perceived dilemma between the need to sustain economic growth and the need to counter the dollar depreciation, the American policymakers developed a strong interest in the conduct of German monetary policy. The focus was on the interest rate differential between the United States and Germany which depended just as much on German as on US monetary policy.

The German attitude towards the dollar weakness in 1979 has been described as equanimity in chapter E.2.3. Considering the large inflation differential between the United States and Germany, the German policymakers saw both positive and negative effects of the falling DM/dollar rate. On the debit side there were the familiar effects on European exchange rate stability, international trade and capital movements, and the DM's reserve currency role.
On the credit side the falling DM/dollar rate helped to prevent an import of inflation via the exchange rate. This consequence had gained much more importance in 1979 with the build-up of domestic inflationary pressures and the second oil price shock. Of course, the best of both worlds in the German view would be a stabilization of the DM/dollar rate achieved through a lowering of the US inflation rate. Pending such a development, German exchange rate policy was limited to direct interventions in order to smooth and brake the fall in the DM/dollar rate. Monetary policy was geared to contain the inflationary pressures and not used as an instrument of exchange rate policy.

As soon as the dollar's third phase of weakness began in June 1979, the question of interest rates and monetary policies became the dominant issue in the bilateral management of the DM/dollar rate. US Treasury Secretary Blumenthal blamed the new bout of dollar weakness on the narrowing of interest rate differentials.63 Whereas interest rates were rising in Germany, there had been a slight downward movement in US rates. Mr Blumenthal said that there would be no further narrowing of interest rates citing a "good program" of central bank co-operation.64 This remark gave rise to rumours that there had been a kind of "gentlemen's agreement" between the United States and Germany on monetary policy. The existence of such an agreement was promptly denied by Bundesbank President Emminger. He stressed that the modest narrowing of the interest rate differential could not be the main factor behind the dollar's renewed weakness.65 The Bundesbank had just decided to aim for a very low increase of the domestic money supply in the second half of 1979 and Dr Emminger declared that the exchange rate situation should not be allowed to prevent a policy oriented towards domestic price stability.66 Throughout the dollar's third phase of weakness the Bundesbank did not waver in its determination to pursue a tight monetary course in spite of the falling DM/dollar rate.

On July 12 the Bundesbank raised its discount and Lombard rates to 5 and 6 per cent, respectively. The US policymakers were clearly worried about this trend to rising interest rates in Germany and its exchange rate implications.67 The DM/dollar rate was 6 per cent down from its level in early June and

63 FT, IHT, and WSJ 21 June 1979
64 IHT 21 June 1979
65 SZ 23/24 June 1979
66 AP no.45/1979, 27 June 1979. See also p.E-51 above.
67 See for instance the remarks by the Under Secretary of State for Economic Affairs, Richard N. Cooper, in Brussels on July 13, VWD 16 July 1979.
approached the psychological benchmark of 1.80. In addition to massive DM-sales in the exchange market the Federal Reserve supported the dollar by increasing its discount rate on July 20 to 10 per cent and by firming money market rates as well. The American policymakers found themselves compelled to follow the German lead in interest rate policy as they feared that the dollar would weaken further against the DM if the interest rate differential between the two countries was allowed to narrow. In two further steps the US discount rate was increased to 11 per cent in August and September.

The American disenchantment with the restrictive German monetary policy was brought home to German policymakers on various occasions. Under Secretary of State Richard N. Cooper, for instance, warned against the dangers of a European-American interest rate competition when he was in Brussels in mid-July for consultations with EC-officials. Under Secretary of the Treasury Anthony Solomon made complaining remarks about German monetary policy at a monetary seminar in Austria in late August. But the criticism of administration officials remained relatively restrained and the newly-appointed Federal Reserve Chairman Paul A. Volcker commented on the German monetary policy only by saying that it was "explicable" under the given circumstances. The most outspoken critic of the Bundesbank was Congressman Henry S. Reuss, Chairman of the House Banking Committee. On several occasions he complained about Germany's "super-restrictive" monetary policy, which forced the Federal Reserve to raise US interest rates to "astronomical heights", far above what was required to fight domestic inflation. Some observers in Washington believed that Congressman Reuss' criticism was made at the request of the Carter administration as a way of putting indirect pressure on the Bundesbank without causing a diplomatic row.

In any case, there was a general suspicion in Washington that Germany and other European countries wanted to alleviate their own inflation and oil price

68 In March 1980 the German Finance Minister Hans Matthöfer admitted that the German interest rate policy had been criticized by the Americans in 1979, Finanz und Wirtschaft. 29 March 1980. Dr Emminger confirmed the American dissatisfaction with the German support for the dollar in 1979, Interview with Dr Emminger, May 1983.
69 VWD 16 July 1979
70 FAZ 1 September 1979
71 NZZ 4 September 1979
72 FAZ 1 September 1979; Wirtschaftswoche 17 September 1979
73 Wirtschaftswoche 17 September 1979
problems with the help of a weak dollar. Instead of directly criticizing the Europeans, the view was sometimes pronounced as a warning against competitive appreciations by monetary means as a new form of "beggar-thy-neighbour" policy. An editorial in the New York Times on 3 August 1979 expressed the American dissatisfaction with the German monetary policy more bluntly, by warning the "Europeans" to be cautious about raising interest rates if the United States should continue defending the dollar more vigorously than warranted by its own economic needs.\footnote{This comment was based on a misconception about the relative interests in a stabilization of the DM/dollar rate. Given the serious concern of the American policymakers about the dollar weakness and the relative equanimity on the German side, Washington was not in a position to threaten to withdraw its support for the dollar.}

Bundesbank President Emminger rejected the American criticism of German monetary policy.\footnote{Bundesbank President Emminger rejected the American criticism of German monetary policy. He said that it was not excessively restrictive, but rather too loose to contain the domestic inflationary pressures especially emanating from the construction sector. He denied that changes in the interest rate differential had contributed to the dollar's weakness. The real problem was the high US inflation rate. He maintained that US interest rates were too low considering the double-digit inflation rate; real interest rates were around zero and even negative for long-term funds. A stabilization of the dollar's external value required a lowering of the domestic inflation rate in the United States.}

Also with regard to intervention in the DM/dollar market the transatlantic co-operation was troubled. The use of different operating techniques at the New York Fed and at the Bundesbank had caused a lack of effective co-ordination and led to "complaints" from the American side.\footnote{Also with regard to intervention in the DM/dollar market the transatlantic co-operation was troubled. The use of different operating techniques at the New York Fed and at the Bundesbank had caused a lack of effective co-ordination and led to "complaints" from the American side. More important, the American policymakers seemed also to criticize the size of the Bundesbank's dollar-supporting interventions as insufficient.}

\footnote{More important, the American policymakers seemed also to criticize the size of the Bundesbank's dollar-supporting interventions as insufficient. Between mid-June and early October the Federal Reserve sold the DM-equivalent of $9.5 billion in the exchange market.}

\footnote{Between mid-June and early October the Federal Reserve sold the DM-equivalent of $9.5 billion in the exchange market.}

\footnote{Remarks by Treasury Undersecretary Anthony Solomon, \textit{FT} 3 October 1979, and interview with Dr Emminger, \textit{SZ} 6/7 October 1979.}

\footnote{In an interview with \textit{Finanz und Wirtschaft}, 29 September 1979, and in a speech in Munich on 28 September 1979, \textit{VWD} 29 September 1979.}

\footnote{Interview with Dr Emminger, May 1983}
market of which 58 per cent was financed out of US-owned resources (i.e. DMs acquired through the issuance of Carter notes, the conversion of SDKs and IMF drawings) while the rest was financed with swap loans from the Bundesbank. The Bundesbank itself had only sold the DM-equivalent of $2.2 billion in the DM/dollar market in the same period. Prior to the "judgment" of the US and German intervention authorities on 20 September to let the dollar fall below the 1.80 DM/$ line of resistance, which had been held against increasing market pressure for more than two months, the Bundesbank had been most in favour of reducing interventions and accepting a lower DM/dollar rate. Because it was determined to keep the growth of the domestic money supply at a very low level in the second half of 1979, the Bundesbank had not only to sterilize the liquidity effects of its own interventions, but also those of the American interventions and those carried out within the framework of the EMS as far as they were not neutralized by other foreign exchange movements (see Table 2 in the Appendix). Between mid-June and early October the various types of foreign exchange operations added no less than DM 18 billion to the German reserves and required substantial liquidity-absorbing operations by the Bundesbank. Under these circumstances it was obviously interested in limiting the capital inflows induced by massive interventions in the DM/dollar market to defend a particular rate. In accordance with its generally relaxed attitude towards the DM/dollar rate in 1979 the Bundesbank was not especially worried about a DM/dollar rate below 1.80.

The US-German differences about the management of the DM/dollar rate were discussed at a high-level meeting in Hamburg on 29 September. On their way to the Annual Meeting of the IMF in Belgrade, Treasury Secretary Miller and Federal Reserve Chairman Volcker stopped there and held a four-hour meeting with Chancellor Schmidt, Finance Minister Matthes and Bundesbank President Emminger. The meeting had been arranged more than a month before, but the deterioration of the dollar's situation in late September enhanced its importance. Also on this occasion the American complaints about insufficient German efforts to stabilize the DM/dollar rate were to no avail. In the autumn of 1979 it could no longer be denied that the dollar weakness had been of the United States' own making. Furthermore, the US policymakers had a stronger interest in arresting the dollar's fall than their German counterparts. Under these circum-

78 Anthony Solomon as quoted by the WSJ, 25 September 1979.
79 NZZ, 22/23 September 1979
80 DB, Annual Report 1979, pp.22,53
stances the Americans had little leverage to bring about an increased German dollar support. In Hamburg they "found themselves essentially receiving instructions rather than negotiating a compromise."\(^{81}\) The Germans pressed for a more restrictive US monetary policy.\(^{82}\) Their position was that the dollar problem was one for the United States to solve in the only way it could be solved, by suppressing demand in the American economy until prices began stabilizing. The Germans clearly refused to participate in a dollar support program in the style of the November 1 package of 1978, i.e. to help mobilizing additional DM-funds for the US intervention authorities.\(^{83}\) The Americans had not as yet decided on the monetary measures subsequently announced on October 6, but the plans were discussed in Hamburg.\(^{84}\) According to Manfred Lahnsteinn from the German Finance Ministry, the two sides were able to clear up some misunderstandings on interest rate policies at the meeting.\(^{85}\)

In terms of co-operative agreements to counter the dollar weakness the Hamburg-meeting was not productive. A previously scheduled press conference was cancelled, though Undersecretary Solomon met with the press more casually and told them that it is always darkest just before the dawn.\(^{86}\) The communiqué remained on a fairly high level of abstraction. Both sides maintained that the dollar was undervalued and that its decline reflected occasionally irrational market forces. They planned to intervene quickly and vigorously in the exchange market to combat "unwarranted as well as erratic" exchange rate movements. Both countries considered fighting inflation to be their first priority, and William Miller and Paul Volcker promised that single-digit inflation and a current account surplus would be reached by the United States "in coming months" through fiscal restraint and tight control of the money supply. Speaking for the Bundesbank, Dr Emminger stated that German monetary policy would continue to take full account of international as well as domestic requirements.

The bilateral US-German consultations continued at the IMF's Annual Meeting in Belgrade in the first week of October. During these talks the afore-

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81 M. Mayer, op.cit. p.324
82 Interview with Dr Emminger, May 1983; Finance Minister Matthöfer in Finanz und Wirtschaft, 29 March 1980
83 Manfred Lahnstein, State Secretary at the German Finance Ministry, as quoted in JC 30 October 1979.
84 ibid. and Mr Matthöfer in Hb 10 October 1979
85 JC 30 October 1979
86 M. Mayer, op.cit. pp.324f
mentioned differences with regard to intervention techniques were settled, but there was still no agreement on a new international rescue operation for the dollar.

Mr Volcker returned to Washington from the IMF-meeting earlier than planned in order to remove the remaining obstacles to the major revision of US monetary policy which was announced a few days later, on 6 October 1979. After the Hamburg-meeting the US policymakers had decided to refrain from incorporating an international component in a new rescue package for the dollar and to rely completely on domestic monetary restraint to counter both domestic inflation and dollar weakness. The October 6 measures, which have been described in chapter E.1.3., ended the inconsistency between the American policymakers' preference for a stronger dollar and their expansionary monetary policy. The previous increases in US interest rates had lagged behind the rising inflation rate and had not changed the basically loose monetary policy which served domestic growth and employment goals. Between the emergence of an American concern about the dollar weakness in the winter of 1977/78 and the October 6 measures the US authorities had tried to circumvent the conflict between their exchange rate preference and their domestic goals by substituting exchange rate diplomacy and massive interventions for internal adjustment measures conducive to dollar stability. They had relied on the German interest in arresting the fall in the DM/dollar rate and used the willingness of the German authorities to co-operate by involving them in dollar-supporting operations, in particular the mobilization of intervention funds. However, with the receding German concern about the dollar weakness this strategy was gradually undermined. In the autumn of 1978 Bundesbank President Emminger had already asked a price for German co-operation in procuring intervention funds by demanding a tightening of US monetary policy. In September 1979 the Germans refused to participate in a new dollar rescue operation à la 1 November 1978 and they were also unwilling to sacrifice their anti-inflationary stance in monetary policy for the sake of the dollar.

Considering the deteriorating situation for the dollar in the exchange market in late September 1979, when massive interventions and a US discount rate rise had failed to keep the DM/dollar rate above 1.80, the German position suggests that the Americans were virtually forced by the market to resort to significant internal adjustment measures. However, it would be an oversimplification to treat the American side as an entity in this case. As chapter E.1.3.

87 FT 3 October 1979; SZ 6/7 October 1979; FT 26 October 1979
has shown, Federal Reserve Chairman Volcker had advocated a re-orientation of US monetary policy since his appointment in July, but in September he still found it hard to find support on the Federal Reserve Board for even a one-half-point rise in the discount rate. The German position at the Hamburg-meeting (possibly in conjunction with a threat to resign\textsuperscript{88}) must have helped him to win unanimous support from the other Federal Reserve governors for the much more deep-cutting measures of October 6 - and to persuade the White House to welcome the move.

Obviously the German reaction to the October 6 measures was positive as there had been demands for a tightening of US monetary policy from that side since the winter of 1977/78. The full significance of the "Volcker-revolution" for US-German exchange rate diplomacy became first apparent in the following years when the dollar recovered against the DM. But already in the final months of 1979 it could be sensed that it represented a step from bilateralism towards unilaterality in the management of the DM/dollar rate. The role of intervention was toned down in US exchange rate policy which came essentially to rely on the concept of stabilizing the dollar's external value by bringing down inflation through monetary discipline. This shift in US exchange rate policy reduced not only the American concern about the conduct of German monetary policy, but made the United States also less dependent on borrowing DMs for dollar-supporting interventions.

\textsuperscript{88} M. Mayer, \textit{op.cit.} p.325
THE DOLLAR'S RECOVERY IN THE EARLY 1980s

The 1980s have hitherto seen an extremely strong dollar in the foreign exchange markets where the DM/dollar rate has risen to as high as 3.47 DM/$ in February 1985. The present study of DM/dollar exchange rate management goes only as far as spring 1983 when the dollar still had not gone beyond 2.60 DM/$. But already in this period (which will be called the early 1980s) the dollar's rise was quite spectacular. Between January 1980 and August 1981 the DM/dollar rate soared by 50 per cent from 1.70 to 2.56. Thereafter the DM/dollar rate fluctuated in the range between 2.20 and 2.60.

US and German policymakers explained the dollar's strength against the DM in largely identical ways. First of all, they stressed the importance of the interest rate differential, which had favoured the dollar over the DM to varying degrees since the summer of 1980. Secondly, the German current account was in large deficit in 1980 and 1981, whereas the US current account showed a small surplus in these years. Thirdly, the dollar's rise was seen to reflect an increased demand for US assets (rather than for US goods) as international investors regained confidence in the economy and in the political leadership of the United States. The watershed in this respect was the election of Ronald Reagan to the US presidency in November 1980. Finally, certain political and economic events were seen to have driven up the dollar's value against the DM and other currencies at least temporarily. The crisis in Poland in 1981 and Mexico's debt problems in 1982 were examples of such events.

The dollar's recovery was accompanied by distinctive changes in the management of the DM/dollar rate as compared with the late 1970s. US policymakers became rather complacent about the dollar's exchange rate. The conduct of US monetary policy ceased to be influenced by exchange rate considerations and the Reagan administration practically abstained from exchange market interventions. On the German side, however, the soaring DM/dollar rate caused considerable concern and gave rise to countermeasures. The DM was not only supported by direct interventions and official capital imports, but the Bundesbank also felt obliged to pursue a monetary course, which was tighter than it considered appropriate in view of the domestic recession.

These changes in attitudes and policies towards the DM/dollar rate completely altered US-German exchange rate diplomacy. In the late 1970s the
Americans had been in the weaker position relying on German support to bolster the sagging dollar. With the dollar's recovery the balance of power shifted in favour of the United States. Now the Federal Reserve was again the pace setter in monetary policy with the Bundesbank adjusting its own policy to changes in US interest rates in order to support a relatively weak DM. The high level of US interest rates, their volatility, and the passive American intervention policy gave rise to German complaints, but US policymakers were immune to such criticism. DM/dollar exchange rate diplomacy was at a deadlock in the early 1980s.

Like Part E, the present part is subdivided into three chapters. The first two focus on US and German exchange rate policies in the respective national perspectives, whereas the third chapter examines the exchange rate diplomacy.

F.1. The Return to US Benign Neglect

As the dollar strengthened in the early 1980s the US authorities abandoned the previous years' active stance in the management of the DM/dollar rate. The return to a passive exchange rate policy was a two-step process. Exchange rate considerations ceased already to exert any significant influence on the conduct of US monetary policy when the downward pressure on the dollar eased off in the wake of the Federal Reserve's measures of October 6, 1979. US intervention policy, however, continued to adhere to the active approach adopted during the dollar crisis in late 1978. First when the Reagan administration assumed office in early 1981 a minimal intervention approach was adopted.

With regard to monetary policy, the October 6 measures gave the Federal Reserve stricter control over the money stock and provided the basis for a policy of slowing monetary growth in order to reduce inflation. However, up to the presidential election in November 1980 US economic policy remained in a state of great confusion and the Federal Reserve did not (or could not) pursue its new restrictive course consistently.1 According to Professor Martin Feldstein, President Carter forced the Federal Reserve to abandon its new monetary policy in early 1980.2 The money supply expanded very unevenly in 1980 and

2 The Economist, 18 May 1985, p.21
interest rates were extremely volatile. On the background of relatively stable interest rates in Germany the interest rate differential between dollar and DM funds fluctuated correspondingly. As the following chart illustrates, the DM/dollar rate was almost perfectly correlated with the DM/dollar interest rate differential in 1980.

![Interest rate differential between the Deutsche Mark and the dollar, and exchange rates](image)

![Interest rate differential chart](image)

### Source:

However, even when US interest rates were low in the summer and the dollar receded to 1.73 DM/$ in the exchange market, the Federal Reserve's ensuing

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3 The prime rate rose first to 20 per cent in April, then it fell back by 10 percentage points within two months, before it rebounded to 21.5 per cent in the second half of 1980.
tightening of monetary conditions was a reaction to the rapidly growing money supply and not based on exchange rate considerations. Similarly, the dollar's relatively high value against the DM and other currencies in the spring and late in the year did not have any bearing on the Federal Reserve's monetary policy.

When the Federal Reserve tightened the reins on monetary growth in the autumn of 1980 and interest rates soared again, President Carter attacked the Federal Reserve for its "overreaction".4 First when Ronald Reagan succeeded Jimmy Carter in the White House, the Federal Reserve received the necessary backing for a consistent anti-inflationary policy.

"President Reagan brought to the White House not only vehement opposition to inflation but also the conviction that inflation could only be controlled by limiting the growth of money. He therefore supported Mr Volcker's return to a policy of slowing monetary growth despite the fact that it plunged the economy into a severe recession in 1981 and 1982. And even as the 1982 congressional elections approached with the unemployment rate at 10.5% and rising, the president's campaign slogan was "Stay the course".5

The US inflation rate declined from 12 per cent in 1980 to 4 per cent in 1982. Much of this success was attributed to the 33 per cent rise in the dollar's effective exchange rate in the same period, and much of this appreciation was in turn attributed to tight US monetary conditions. Nevertheless, the exchange rate effects of US monetary policy were only an unintentional by-product of a domestically oriented strategy. With regard to the inflation rate these effects were benign, but it was also realized in Washington that the dollar's strength damaged the international competitiveness of the US economy.6 When the trade deficit started to increase significantly in the third quarter of 1982, it was widely blamed on the dollar's appreciation.7 But this negative consequence of the dollar's rise did not worry the US authorities to such an extent that they modified their monetary policy for exchange rate reasons, let alone fiscal policy.

With regard to intervention policy the change to a passive stance occurred in early 1981. The preceding year was a transition phase in which the US

4 Calleo, op.cit. p.149; NewswEEK 13 October 1980, pp.50-53
5 Prof. Martin Feldstein in The Economist, 18 May 1985, pp.21f
6 ERP 1983, pp.66f
7 loc.cit.; Martin Feldstein as cited in IHT 9/10 April 1983; FRB, March 1983, p.142
authorities continued to adhere to the active intervention approach adopted during the dollar crisis in 1978 under the changed circumstances of an appreciating dollar. Only when the dollar came under bursts of heavy selling pressure between April and June 1980, did the Federal Reserve Bank of New York sell a large amount of DMs ($3.3 billion) to counter disorderly market conditions and to moderate the fall in the DM/dollar rate (i.e. "leaning-against-the-wind" interventions). Apart from that period, the New York Fed was almost exclusively purchasing DMs in the 12 months up to the change in US intervention policy (see the Main Chart). The largest part of the DM-purchases was still made in off-market transactions with correspondents, but even the market purchases surpassed total (market) sales of DM.8

Until the autumn of 1980 the main purpose of all DM-purchases was to liquidate the Federal Reserve’s remaining swap debt and to cover the Treasury’s medium-term DM-obligations (Carter notes), which were due for repayment in 1981-83. Just as in the spring of 1979, market purchases of DMs had occasionally the additional objective to counter disorderly market conditions.

When the outstanding DM-liabilities had been covered in the autumn of 1980 the DM-purchases continued, but now mainly in the market. The stated motive was the attempt to settle volatile market conditions and to counter the strong one-way pressures building up in favour of the dollar.9 At a press conference in March 1981 the spokesman of the New York Fed said that the DM-purchases in the winter of 1980/81 neither had been a systematic effort to support the DM nor part of a program for the acquisition of foreign exchange reserves. They were said to have been purely pragmatic responses to exchange market conditions on a day-to-day basis.10 However, it was known that the New York Fed had a preference for accumulating a war-chest of foreign exchange reserves to be at its disposal for possible dollar-supporting interventions in the future. It regarded the dependence on swap loans and other borrowed intervention funds as a constraint in its foreign exchange operations.11 This institutional interest in acquiring US-owned DM-reserves seems to have been at least a strong additional motive for the DM-purchases in the winter of 1980/81.12

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8 Between January 1980 and February 1981 total DM-purchases amounted to $14.8 billion and total DM-sales to $4.4 billion.
9 FRB, March 1981, pp.214f
10 FT 5 March 1981; NZH 7 March 1981
11 This was confirmed in interviews with officials at the Federal Reserve Bank of New York (Steven V.O. Clarke, Gretchen Greene, and Jeffrey R. Shafer) on June 27, 1983.
The Council of Economic Advisers regarded the interventions primarily under this aspect when it said that "this was the first time, at least in recent history, that the United States had embarked on a deliberate policy of acquiring substantial foreign exchange reserves."  

As mentioned above, the active period in US intervention policy ended in late February 1981, shortly after the Reagan administration had assumed office. The DM-purchases were stopped without public announcement, but informed observers had realized by then, that the new administration intended to let exchange rates fluctuate without much intervention. In April and early May Treasury Secretary Donald T. Regan and his undersecretary for monetary affairs, Beryl Sprinkel, announced the new "minimal" intervention approach with great fanfare in public speeches and statements. It was made clear that the new approach was based on the Reagan administration's overall economic philosophy which called for as little interference as possible with free market forces. Interventions were regarded as inefficient and costly, and even as counterproductive to the smooth functioning of exchange markets. They were seen to increase uncertainty and to hinder the development of "deep" markets. Accordingly, the previous accumulation of foreign exchange reserves was viewed as unnecessary and studies about their possible liquidation were announced.

Interventions were not ruled out completely, however. Formally the United States adhered to the provisions under Article IV of the IMF articles of agreement and pursued a policy of countering disorderly market conditions. Unlike the Carter administration, the Treasury now refused to characterize disorderly

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12 Apparently the New York Fed had unusually large room for manoeuvre in its foreign exchange operations in the winter of 1980/81. The Carter administration was in its lame-duck period and Anthony Solomon had succeeded Paul Volcker as president of the New York Fed, while his former position as undersecretary for monetary affairs at the US Treasury remained vacant.

13 ERP 1982, p. 173

14 WP 27 February 1981


16 "Significant and frequent intervention by governments assumes that a relative few officials know better where exchange rates should (or shouldn't) be than a large number of decision makers in the market, and that public funds should be put at risk on the basis of that assumption." Statement by the Undersecretary of the US Treasury, Beryl Sprinkel, before the Joint Economic Committee of the US Congress in Hearings on International Economic Policy, May 4, 1981.
market conditions in advance. It was emphasized that the United States would only intervene under exceptional and severe circumstances or in times of emergency and crisis. A practical example was given with the sale of $74.4 mio. equivalent of DMs following the assassination attempt on President Reagan on 30 March 1981. According to Treasury Secretary Regan, US interventions were contemplated on other disquieting occasions, all of a political character, in 1981 - as after the Polish military crackdown, the assassination of Egyptian President Anwar Sadat, and the announcement of French President Mitterand’s nationalization program.

In 1982, the United States intervened on June 14 by purchasing DMs as well as yen, allegedly in an attempt to restore orderly trading conditions after a realignment of EMS exchange rates. Furthermore, "the US authorities intervened on one day in early August and on three days in early October when the dollar was bid up sharply to higher levels in unsettled markets." Total US interventions in 1982 amounted only to the purchase of $132 mio. equivalent of foreign exchange which was split equally between DMs and yen. Between early October 1982 and the end of March 1983 no US interventions took place.

In practice, the American intervention policy between February 1981 and March 1983 was not much different from complete abstention from direct interventions. The minimal intervention approach reflected not only the Reagan administration’s disbelief in the usefulness of interventions and its ideological predisposition to a "clean" float, but also the same complacent attitude towards the rising dollar which already had made the Federal Reserve disregard the exchange rate consequences of its monetary policy since the beginning of the dollar's recovery. The negative effects of the high dollar rate on the US economy did not become sufficiently strong in the early 1980s for US policymakers to start worrying and to consider an active exchange rate policy.

(In 1985, however, the US authorities returned to an active exchange rate policy for competitive reasons, using both monetary measures and exchange market interventions to bring down the dollar's exchange rate against the yen and the European currencies.)

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17 When Beryl Sprinkel was asked to define the minimal approach more precisely, he replied that "by 'minimal' I mean each day when I come into my office I expect the market will take care of the exchange rate, not the Federal Reserve or the Treasury". Ibid.

18 Newsweek 7 June 1982

19 This action is discussed further in chapter F.3. on p.F-23.

20 FRB, March 1983, p.142
F.2. The Bundesbank's Defensive Reaction to the Rising DM/Dollar Rate

Whereas the US authorities kept themselves aloof from exchange rate management in the early 1980s, the DM/dollar rate played a prominent role in German economic policymaking. The Bundesbank countered the rise in the DM/dollar rate with dollar sales in the exchange market and high interest rates. Direct interventions in the DM/dollar market were substantial, but monetary policy emerged as the Bundesbank's primary instrument in the protection of the DM's external value. Exchange rate considerations played a more important role in German monetary policy than ever before since the transition to floating.

The Bundesbank's efforts to limit the DM-depreciation took place in the context of a weak performance of the domestic economy. The current account had turned negative in mid-1979 for the first time in fourteen years. From a surplus of over DM 18 billion in 1978 it swung to a record deficit of nearly 30 billion in 1980. The inflation rate increased to 6 per cent after the boom in 1979 and the second oil price shock. The economy fell into recession in mid-1980 which resulted in zero growth in 1981 and a 2 per cent fall in real GNP in 1982. Unemployment increased to 6.7 per cent of the work force.

As described in chapter E.2., the Bundesbank had gradually tightened monetary policy in 1979 in order to contain the rising inflationary forces. In the first half of 1980 the trend to higher interest rates continued, but now it was primarily a response to Germany's worsening balance-of-payments situation. Not only was the current account in heavy deficit, but there was also a net outflow of private capital. The Bundesbank tried to contain the capital outflow by increasing discount and Lombard rates in two steps in February and April from 6 to 7.5 per cent and from 7 to 9.5 per cent respectively. Capital inflows were encouraged by broadening the range of securities available to foreign investors. In addition, the government adopted the unusual practice of official capital imports by placing DM-denominated debt instruments directly with foreign official institutions, primarily the Saudi Arabian Monetary Authority (SAMA). In 1980 Germany's official capital imports amounted to DM 23 billion.

In mid-1980, when US interest rates temporarily receded to the German level and the DM/dollar rate declined to a minimum of 1.73, the Bundesbank started cautiously to ease monetary conditions in view of the emerging recession. However, this attempt was abandoned as soon as US interest rates began to rise again and the DM weakened against the dollar as well as within the EMS.
in the second half of 1980. German interest rates firmed again and the Bundesbank intervened in support of the DM both in the DM/dollar market and within the EMS. These interventions tended not only to strengthen the DM in the exchange market, but they helped also to finance the German current account deficit.21

Some German economic research institutes and the trade unions criticized the Bundesbank's reaction to the downward pressure on the DM. They suggested that monetary policy should be geared towards the falling level of domestic economic activity (i.e. that it should be stimulative) and that a DM-depreciation should be accepted. They argued that Germany's relatively low inflation rate would lead to a reversal of the exchange rate trend after some time.

The Bundesbank rejected this recommendation.22 It acknowledged that the slowing down of economic growth seemed to call for an expansion of the money supply and lower interest rates. But it doubted that a de-coupling of German interest rates from high interest rates abroad would be possible apart from the very short run under the given circumstances. The risk of entering a vicious circle of depreciation and inflation was seen as too high. First when an improved international competitiveness of the German industry had corrected the current account deficit, monetary policy could be oriented more towards the need to stimulate economic activity. The DM's role as an international investment and reserve currency was also said to oblige the Bundesbank to avoid a large depreciation and to sustain confidence in the DM.

In early 1981 this confidence seemed to be seriously endangered. In the first seven weeks of the year the level of the DM/dollar rate jumped from 1.95 to 2.20 in spite of the purchase of DM 4.7 billion by the Bundesbank and the New York Fed in the DM/dollar market. Even within the EMS the DM had to be supported. The Bundesbank was concerned about the inflationary consequences of the DM-depreciation and feared that it would trigger an even larger capital outflow.23 It became convinced that it had to give a clear signal to the exchange markets regarding its determination to maintain the internal and

21 In 1980 as a whole the Bundesbank's reserve losses due to DM/dollar interventions (DM 18.3 billion) and EMS-interventions (DM 10.5 billion) financed the whole German current account deficit.

22 A comprehensive argumentation against the strategy proposed by the Bundesbank's domestic critics was delivered in speeches by Dr Leonhard Gleske, member of the Bundesbank's directorate, AP no.96/1980, 10 November 1980, and AP no.12/1981, 6 February 1981. See also the discussion on "How (not) to deal with the DM Weakness" in Hugo M. Kaufmann, Germany's International Monetary Policy and the European Monetary System, New York,1985, pp.97-100
external stability of the DM. On February 19 the banking sector's access to the Bundesbank's normal Lombard facility for short-term funds was suspended. Instead the Bundesbank established a special Lombard facility which provided credit at 12 per cent interest. This was 3 percentage points more than the previous Lombard rate and short-term interest rates increased correspondingly. This drastic measure moved the DM from the lower to the upper fluctuation margin within the EMS and temporarily arrested the DM's downward trend against the dollar.

Until the autumn of 1981 the tight course of German monetary policy remained unchanged. The stock of central bank money expanded at the lower limit of the 4-7 per cent target range and interest rates were at record levels. Although a loosening of monetary conditions was considered desirable on purely domestic grounds it was still ruled out by the Bundesbank as long as the balance-of-payments problems persisted and the DM was depreciating against the dollar. But on the other side the Bundesbank also refrained from an additional tightening of monetary policy after February 1981, even though US interest rates had increased and the DM/dollar rate had soared from 2.10 in mid-March to 2.56 in mid-August. But unlike early 1981 the DM was strong within the EMS, and the Bundesbank was now regarding the rising DM/dollar rate more as a manifestation of the dollar's regained strength and less as a weakness of the DM. 24 Furthermore, the Bundesbank's tight course had started to draw criticism, not only from Chancellor Schmidt and his Social Democratic Party, but also from France whose currency was under devaluation pressure within the EMS. 25 Instead of tightening monetary policy further, the Bundesbank countered the strong upward trend of the DM/dollar rate with massive "leaning-against-the-wind" interventions, which reduced the German foreign exchange reserves by DM 12.5 billion between February and August 1981.

Three measures, primarily supposed to ease the financing of Germany's current account deficit, tended also to reduce the downward pressure on the DM against the dollar. First, the remaining restrictions on capital imports were repealed together with the interest rate increase on 19 February. 26 Second,
restrictions on capital exports were ruled out as counterproductive and as incompatible with the DM's role as international investment and reserve currency, but the Bundesbank had concluded an informal gentlemen's agreement with the German banks which should limit speculative capital outflows. Under this arrangement the banks voluntarily curbed lending to non-residents which was mainly attributable to exchange rate factors. According to the Bundesbank this measure had helped to moderate slightly the strong demand for foreign currencies at the beginning of 1981. Third, the government continued with official capital imports, mainly from OPEC-countries. This recycling of petro-dollars amounted to DM 22 billion in 1981.

In late summer 1981 the external constraints on the conduct of German monetary policy started to become less severe. The strong upward trend of the DM/dollar rate ended and the signs of improvement in the German current account became stronger. After a realignment of EMS-rates in October, in which the DM was revalued against all other member currencies except the Dutch guilder, the Bundesbank began cautiously to relax monetary conditions.

In the following eighteen months the Bundesbank's room for manoeuvre increased further as Germany's balance-of-payments performance improved and the inflation rate declined. In 1982 the current account showed a surplus of DM 8 billion after three years of deficits. The DM remained relatively weak against the dollar, but the DM/dollar rate did not rise above the 2.60 benchmark to which it already had come close in August 1981. Within the EMS the DM was strong and had to be revalued twice. Under these conditions the Bundesbank felt free

27 The Bundesbank's rejection of formal restrictions on capital exports was explained as follows by Bundesbank President Pöhl:

"A great deal is being said about de-coupling from dollar interest rates. Some believe that this could be done through exchange and capital controls. I think nothing of such measures. For Germany, as the second largest reserve currency country, preventing capital outflows by means of administrative regulations so as to put pressure on the level of domestic interest rates would amount to a policy of hara-kiri. We would simply expose ourselves to the danger of the D-Mark being stigmatised as a mouse-trap currency. The foreign funds invested in Germany would drain out anyway through very varied channels (for example, shifts in the terms of payment) and no new foreign funds would come in. Therefore we maintained free capital markets and abstained from capital and exchange controls even when the D-Mark was under heavy pressure." AP no.47/1982 (25 May 1982).

The Bonn government was also opposed to restrictions on capital movements: (Finanznachrichten des Bundesministeriums der Finanzen, Bonn, 5 March 1982).

28 Professor Claus Köhler, member of the Bundesbank's directorate, in a speech in Hamburg on 13 May 1981, AP no.43/1981, 14 May 1981.
European University Institute

Growth of central bank money stock, 1981 - 1983

Movement of interest rates, 1981 - 1983

Source: DB, Annual Report 1982, p.34

European University Institute
DOI: 10.2870/52840
to reduce interest rates gradually and to accept a faster growth of the money supply in order to stimulate the sluggish economy (see the table on page F-12).

The Bundesbank's more relaxed attitude towards the high DM/dollar rate was also reflected in its intervention behaviour in the DM/dollar market: net dollar sales were scaled down from DM 21.6 billion in 1981 to DM 6.6 billion in 1982. When the DM/dollar rate fluctuated between 2.20 and 2.60 from August 1981 to late 1982 the Bundesbank practiced an asymmetrical "leaning-against-the-wind" policy. Upward movements in the DM/dollar rate were countered with dollar sales, but when the rate declined the Bundesbank did not intervene. A fall in the DM/dollar rate was regarded as justified by the fundamental economic conditions and as generally desirable for the domestic and the world economy. "Leaning against the wind" when the dollar depreciated would only have prolonged the "misalignment" of the DM/dollar rate.

In general it can be said, that the Bundesbank's strong defensive reaction against the rising DM/dollar rate in the early 1980s primarily was based on a concern for the inflationary consequences of an uncontrolled slide in the DM's external value. An additional reason was to preserve international confidence in the DM according to its role as an international investment and reserve currency. Thus, the Bundesbank was especially worried about the exchange market situation in 1980/81 when the rising DM/dollar rate was seen to reflect a generally weak DM. When the German current account improved and the DM strengthened against the other EMS-currencies, the Bundesbank countered rises in the DM/dollar rate less strongly.

29 As part of general realignments of EMS-rates on 14 June 1982 and on 21 March 1983.
F.3. Exchange Rate Diplomacy at Deadlock

With the rise in the DM/dollar rate in the early 1980s, the balance of power in US-German exchange rate diplomacy shifted significantly to the American side. The co-operative exchange rate management of the late 1970s, when the German authorities had had considerable influence on US exchange rate policy, disappeared. Bilateralism gave way to unilateralism and DM/dollar diplomacy was largely reduced to fruitless German complaints about those aspects of US economic policies which were seen to be adverse to the German exchange rate preferences. The new situation was based on three elements which have been discussed in the preceding chapters:

- the indifference and passivity of the US authorities towards the rise in the dollar's external value
- the concern of the German authorities about the rising DM/dollar rate and their attempts to contain this rise with a tight monetary policy, which was costly in terms of domestic economic activity
- the German perception that the domestically-oriented economic policies of the US authorities led to high dollar interest rates, which - in turn - were seen as the most important reason for the rise in the DM/dollar rate

Since 1981 the German criticism of US policies was often embedded in a common position of the EC-countries. This joint European pressure on the United States was occasionally supported by other countries (e.g. Japan) and the secretariats of international organisations (OECD, IMF, BIS). But it did not result in any significant changes in Washington's economic policies in the period under review. This chapter describes how the transatlantic exchange rate diplomacy in the early 1980s became locked in a stalemate between European complaints and American intransigence.

With regard to intervention policy US-German co-operation continued until early 1981 along the lines of the late 1970s. The US authorities carried out the largest part of DM/dollar interventions (see the Main Chart). DM-purchases dominated because the dollar strengthened in general. Actually the American accumulation of DMs in 1980 financed about half of Germany's DM 29 billion current account deficit in that year. The Bundesbank adjusted its intervention policy to the Federal Reserve's operations in the DM/dollar market. 30 There

30 Bundesbank director Gleske at a conference in Frankfurt on 14/15 May 1982.
is no evidence of any disagreement between the German and the American authorities about the size or the distribution of DM/dollar interventions in 1980.

In the summer of 1980 there was a particular instance of US-German intervention co-operation. The dollar suffered a temporary relapse and was supported with substantial DM-sales. However, the DM was relatively weak within the EMS and the interventions in the DM/dollar market tended to weaken the DM further against other European currencies. In these circumstances the US authorities supplemented their DM-intervention with sales of French francs so as to avoid aggravating the strains on the DM within the EMS.  

With regard to monetary policy German policymakers started cautiously to complain in 1980 about the Federal Reserve's disregard for the exchange rate effects of its new and more monetarist approach. When the Bundesbank began to tighten its monetary policy in response to increases in US interest rates in the first half of 1980, Bundesbank President PöhI warned about the dangers of an international interest rate war. But it was also said that it would be wrong to complain about the tightening of US monetary policy. After all the Germans sympathized basically with the Federal Reserve's efforts to reduce inflation and they had strongly advocated a tightening of US monetary policy half a year earlier. However, when US interest rates increased again in the autumn of 1980 after the temporary low in the summer, the German concerns became stronger. The Federal Reserve's renewed tightening of monetary conditions stymied the Bundesbank's plans to loosen the credit reins to counter the domestic inflations.

31 Quarterly Review of the FRBNY, Autumn 1980, p.33
32 FT 18 March 1980. The term "international interest rate war" has previously been used in connection with the widespread rise in short-term interest rates that took place during the 1960s, to reach a climax in the autumn of 1966 and again in the summer of 1969. Then, the monetary authorities of the United States, Britain, and Germany contributed significantly to the general trend towards higher interest rates when they tightened monetary policies to further internal or external equilibrium of their respective economies. Because much of their action was competitive, with one nation's interest rate increase forcing others into adopting a similar policy, it is appropriate to describe the course of events in the 1960s as "war" in the same way as the term is used in the area of international trade. See Eric Chalmers, The International Interest Rate War, London, 1972.

As Eric Chalmers had foreseen in 1972, the phenomenon of competitive interest rate increases was not limited to a fixed exchange rate regime. The German monetary tightening in the winter of 1977/78 can be seen as the beginning of a US-German "interest rate war". After Germany's early advantage, the United States launched a counter-offensive in October 1979 and held the upper hand in the early 1980s.

economic downturn. According to David Marsh of the Financial Times, Mr Pöhl used one of the monthly central bankers’ meetings in Basle in the autumn of 1980 "to complain that fluctuating US interest rates cause trouble for the DM."  

When the DM was on the brink of a serious confidence crisis in February 1981 the German government became openly critical about the high level of US interest rates. Finance Minister Matthöfer called for international efforts to reduce interest rates. His proposal appeared more as a protest against the high level of dollar interest rates than as a serious effort to get a practical initiative launched. In an interview with the French financial newspaper Les Échos, Chancellor Schmidt complained about, what he called, the destructively high level of US interest rates which was completely unacceptable in the longer run if the objective of full employment should be maintained.

During the spring of 1981 the economic strategy of the Reagan administration became fully apparent. The fiscal expansionism of "Reaganomics" was regarded with considerable scepticism by the Germans, not least because it was seen to prolong the period with high dollar interest rates. Their adverse impact on economic activity in Germany and other European countries was brought up by Finance Minister Matthöfer and Chancellor Schmidt in bilateral meetings with their American counterparts in May. Mr Matthöfer met US Secretary of the Treasury Donald T. Regan in Kronberg near Frankfurt in mid-May and Mr Schmidt went on an official visit to Washington one week later. The economic situation was the most important subject of Mr Schmidt’s talks with President Reagan. The German Chancellor was said to have stressed that his country was badly hurt by high US interest rates, but his complaints only led to Mr Reagan expressing his "keen appreciation" of Germany’s economic predicament.

The Bundesbank, on the other hand, refrained from public criticism of US monetary policy. When Bundesbank President Pöhl was in Washington in February 1981 to meet members of the new administration and to discuss monetary problems with Federal Reserve Chairman Volcker, he told the press that he had

34 FT 17 November 1980  
35 FT 13 February 1981  
36 Les Échos 25 February 1981  
37 FAZ 16 May 1981  
38 IHT 23/24 May 1981; Newsweek 8 June 1981  
39 The Bundesbank’s attitude towards US monetary policy was shared by Count Lambsdorff, the Minister of Economics.
no intention of urging lower US interest rates. 40 "I fully understand that as long as you have an inflationary problem, the central bank is obliged to pursue a restrictive policy." 41 In June Mr Pöhl explained his position as follows: 42

"I have not joined in the chorus of those criticizing high interest rates in the United States, for several reasons:

- first, it seems clear enough to me that the Federal Reserve is no longer pursuing an interest rate policy, but a target-oriented money supply policy, with interest rates largely left to market forces;
- second, high interest rates are an unavoidable part of the attempt to bring inflation down through adherence to a tight monetary policy, and
- third, it is in the interests of us all that inflation should come down as rapidly as possible in the United States."

Compared with the question of high and gyrating US interest rates the Reagan administration's adoption of a minimalist stance in intervention policy in early 1981 was only a secondary issue in US-German relations. But it strengthened the perception in Germany and elsewhere that the United States had embarked on a unilateral course in economic policy and paid little regard for the economic concerns of allied nations. Bundesbank President Pöhl had expressed a certain sympathy with the Reagan administration's intention to let exchange rates fluctuate more freely during his above-mentioned trip to Washington in late February. 44 But when the dogmatic character of the new US intervention policy became fully apparent in the course of 1981, both the Bundesbank and the German government grew more critical. The American abstention was seen to reduce the effectiveness of the Bundesbank's own interventions in the DM/dollar market because "close cooperation between central banks is at the root of success or failure of any effort that is made towards more stable exchange rates." 45 Another objection was that the high-profile and almost belligerent way in which the new policy was announced in April/May 1981 deprived the authorities of the crucial element of surprise in their dealings with the exchange markets.

In the summer of 1981 foreign complaints about US monetary and exchange rate policies became more widespread as the dollar soared to 2.56 DM/$.

40 WP 27 February 1981
41 JC 25 February 1981
44 WP 27 February 1981
The regular multilateral economic conferences were dominated by discussions about the high level and the fluctuations of US interest rates, the strong dollar, and the consequences for the world economy. It had become an extremely sensitive issue between the United States and the rest of the industrialized world. As in the 1960s and in the mid-1970s France was the most outspoken opponent of the American policies. French economic diplomacy was not restrained by dependence on American military protection, which in the case of Germany led to the aforementioned tendency to tone down monetary and exchange rate conflicts with the United States.

The series of complaints and critical statements started in mid-June at the OECD ministerial meeting and the annual meeting of the Bank for International Settlements. The BIS Annual Report, for instance, criticized the US policy mix of "severe monetary restraint not supported by appropriate government policies in other areas", leading to misalignment of exchange rates. Uneasy about the impact of fluctuating dollar interest rates on the world economy, the BIS also criticized the United States for its techniques of monetary policy "which deliberately assign interest rates the role of a mere residual."

Late in June, the heads of government of the European Community deplored the "devastating impact" of US monetary policy on the EC economy and expressed determination to press the United States to change it. On the basis of a report by the EC's monetary committee the EC-countries agreed on a common position for the seven-nation economic summit conference in Ottawa on July 20/21. On this occasion the European concern about the damaging effects of high and gyrating US interest rates was conveyed once more to the Americans. The minimal intervention approach was also criticized as the monetary committee's report had stated that "the US policy on exchange-rate intervention as recently outlined to Congress seems to go too far in limiting its use in disorderly market conditions."

But all these complaints were to no avail. In Ottawa, President Reagan and Treasury Secretary Regan rejected all requests for changes in domestic

46 For instance, M. Claude Cheysson, who had become foreign minister in France's new socialist government, launched a heavy attack on US economic policies at the OECD meeting in mid-June 1981, HTT 17 June 1981.
47 FT 16 June 1981
49 HTT 16 June and 8 July 1981; FAZ 20 July 1981; SZ 20 July 1981
50 WSJ 13 July 1981
policy for international reasons. A few days before the summit, Federal Reserve Chairman Volcker had furthermore declared that the Federal Reserve had no intention of relaxing its tight-money policies. 51

Professor Henry R. Nau maintains that the unilateral approach in US international economic policy during the Reagan administration's first term was based on policymakers' "domesticist" perspective in contrast to the "globalist" view underlying US international economic policy in the 1970s. 52 The "globalist" sees the world economy as a highly integrated and complex system with strongly interdependent national economies. International co-operation is required to cope with global economic problems and to make national policymaking effective. In the "domesticist" view, on the other hand, national economic policymaking must have priority over international co-operation because the world economy is only as good as the national economies that comprise it: "...domesticists play down direct, international political bargaining and institutions and advocate instead the use of vigorous national action, working indirectly through the international marketplace, to induce mutual adjustment of national policies toward low inflation, strong market incentives, and open borders." 53 According to Henry Nau, the Reagan administration's reluctance to seek international consensus on economic issues through diplomatic bargaining reflected the view that US power in the international marketplace remains much greater than its power at the bargaining table. 54

The diplomatic deadlock at the Ottawa-summit started a widespread debate in Europe about the possibility of "de-coupling" European monetary policies from high dollar interest rates. The French government and the EC Commission supported the idea of co-ordinated interest rate cuts possibly in connection with capital export restrictions. A fully-fledged proposal was never presented and it would also have been unfeasible because of German opposition to such measures. As described in chapter F.2., the Bundesbank preferred to avoid an

51 Newsweek 27 July 1981
53 ibid. p.16
54 ibid. p.22; On the interplay between the power of the US government in interstate relations on the one hand, and in the authority/market relationship on the other hand, see Susan Strange, "Still an Extraordinary Power: America's Role in a Global Monetary System" in Raymond E. Lombra & Willard E. Witte (eds.), Political Economy of International and Domestic Monetary Relations, Ames (Iowa), 1982, pp.73-93.
uncontrolled rise in the DM/dollar rate by adjusting its monetary policy to US interest rates. This strategy increased the room for manoeuvre in monetary policy only gradually, but without the inflationary risks of an immediate decoupling. Because of the DM's central position in the EMS most of the other member countries felt forced to follow the same course. In effect it can be said, that the French government led the fruitless rhetorical attack against US monetary and exchange rate policies in the early 1980s, but that the Bundesbank's silent adjustment to the American lead was decisive for Europe.

Up to the world economic summit meeting in Versailles in June 1982 the rift between the United States and the rest of the industrialized world deepened further. In February 1982, when the Federal Reserve tightened its monetary targets and the Reagan administration's projected budget deficits for 1983 became known, the EC-countries launched a new attack on the US economic strategy. The Council of Finance Ministers approved a new report by the monetary committee which again criticized the US authorities for their non-intervention policy, their techniques of monetary control, and especially for the growing budget deficit, which was boosted by the combination of the 1981 tax cuts and increased defence spending. These policies were said to lead to high and volatile interest rates and to a grossly overvalued dollar which caused severe damage to the economic recovery elsewhere. According to the EC-report, the United States did not live up to its responsibilities for the world economy.55 This message was conveyed personally to President Reagan by the Belgian Prime Minister Wilfried Martens, whose country held the presidency of the EC Council of Ministers, when he went to Washington in mid-February.56 One week later the German Chancellor and the French President used their regular semi-annual meeting to express discontent with US economic policies and they promised unspecified initiatives to counter the adverse effects on the European economies.57

Even Bundesbank President Pöhli became more outspoken in his criticism of US intervention and monetary policies at that time. In a speech in Hamburg he told his audience that he considered the complete abstention from exchange market interventions by the US monetary authorities as a problem. He would welcome it, if the United States would abandon this attitude of "benign neglect"

55 BZ 16 February 1982
56 FT 16 February 1982
57 BZ 1 March 1982; IHT 2 March 1982
and contribute more to the stabilization of exchange rates. However, Mr Pöhl stressed that monetary policy and not intervention policy was the main issue of the discussions with the US authorities. He said that it would be helpful, if the Americans could be persuaded to use other techniques in monetary policy in order to avoid erratic interest rate fluctuations which caused unnecessary shocks in the financial markets in the United States as well as in other countries.

In 1981 the US authorities had by and large ignored foreign complaints, but after the criticisms in February 1982 they apparently felt that a response was required. Undersecretary of the Treasury, Beryl Sprinkel, rejected the European calls for US interventions in the exchange market to which he contemptuously referred as "rigging" the market. With regard to monetary policy he said that "the impact of US interest rates on foreign economies has been greatly exaggerated." It was also argued that there was no automatic transmission from dollar interest rates to interest rates in currencies which were floating against the dollar. Furthermore, the Chairman of the Council of Economic Advisers, Murray L. Weidenbaum, maintained that "it seems fair to say that European budget deficits, more than US deficits, have been putting demands on the international pool of credit and on interest rates in recent years."

As far as concerned the European complaint that the Federal Reserve responded too sharply to deviations of weekly and monthly money growth figures from longer-term targets and caused unnecessary interest rate fluctuations in the process, the president of the New York Fed, Anthony Solomon, said:

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59 A few months later Mr Pöhl elaborated his criticism of the US minimal intervention approach: "Without the United States' active participation, dollar interventions appear to be less convincing, and their effects may therefore evaporate, because isolated interventions by individual central banks run the risk of fizzling out in the broadly-based foreign exchange markets. But it is less the high level of interest rates for dollar assets than the sharp fluctuations in them that have made it considerably more difficult for the European countries and Japan to closely coordinate their intervention policies and interlock them with national monetary policy." Speech at the International Forex Conference, London, May 22, 1982, AP no.47/1982, 25 May 1982.

60 IHT 2 March 1982

61 Interview with Federal Reserve Governor Henry C. Wallich in Der Bund (Switzerland), 12 May 1982

62 IHT 2 March 1982

63 JCT 29 March 1982
"We don't intend or seek to correct deviations in money growth from our long-term targets immediately. We have generally decided to make the corrections over time. However, in an atmosphere where the financial markets are so very sensitive to every new published monetary statistic, it is important to show that a mechanism is in place to start the adjustment without excessive delay. That's important to our credibility and for making sure that inflationary expectations don't deteriorate."

The European complaints never did make the US authorities consider changes in the basic thrust of their economic policies. There was simply no leverage behind the European pressure under the given circumstances. However, as the Versailles-summit approached, the US stance on the secondary issue of exchange market intervention appeared to become more flexible. At the annual ministerial meeting of the OECD in Paris in early May, Treasury Secretary Regan proposed that a neutral international body should prepare a study in order to determine the effectiveness of exchange market interventions. Mr Regan said that the US administration was willing to intervene in the exchange markets if such action was effective, but on past experience he did not believe it was.64

It soon became clear that the intervention study proposal was merely a tactical element in the American strategy for the Versailles-summit. The Reagan administration's top priority with regard to the summit was an agreement to limit the volume and to raise the price of Western export credits to the Soviet Union. The rationale for this was apparently that a tighter credit policy would reduce Western overexposure to Soviet indebtedness and economic leverage, and would make it more difficult for the Soviet Union to increase military spending to counter the Reagan administration's arms build-up.65 To gain European support for this plan, the Americans were willing to make two empty gestures. One was to accept "global negotiations" with the Third World on development issues. The other was to consider exchange market intervention in the framework of an international study group.

The conference itself took place in a more cordial atmosphere than the previous meeting in Ottawa. Certainly, there were complaints about high US interest rates by Chancellor Schmidt and others, but the French had largely suspended their aggressive tone towards the United States as they obviously wanted "their" summit to appear as a success. The participants achieved a modest compromise along the lines of the American strategy, i.e. a linkage between the

64 FT 10 May 1982
issues of economic relations with the Soviet Union, relations with the Third World, and "international monetary undertakings". With regard to the last-mentioned issue, the seven summit countries declared to be "ready, if necessary, to use intervention in exchange markets to counter disorderly conditions, as provided for under Article IV of the IMF articles of agreement." Furthermore, they commissioned a joint study of the effectiveness of official intervention under floating as Treasury Secretary Regan had proposed. The study was to be carried out by a working group consisting of international monetary experts from the finance ministries and central banks of the seven summit countries and from the EC. It became known as the Jurgensen-committee after its chairman, Philippe Jurgensen from the French Ministry of Economy and Finance.

A few days after the Versailles-summit the US Treasury demonstrated its willingness to live up to the communiqué's provision about interventions in case of disorderly markets. On June 14 - after 15 months of abstention from intervening - the US authorities purchased a relatively small amount of DMs and yen in the exchange markets following a realignment in the EMS (cf. page F-7 above). Contrary to normal practice, the interventions were announced by the Treasury immediately afterwards. According to Secretary Regan, they should smooth out erratic bounces in exchange rates and restore order in a disorderly market (which nobody else had noticed). Both Mr Regan and his undersecretary, Beryl Sprinkel, stressed that the intervention was "not a change in policy" because the United States had always stood ready in the event of disorderly conditions in the market.\textsuperscript{66}

The Reagan administration's apparent softening of its hard-line attitudes on interventions was only a tactical manoeuvre in its diplomacy towards its summit partners, who, according to Mr Regan, were "almost desperate for us to intervene in the market."\textsuperscript{67} There was no substantial change in US intervention policy in May/June 1982, but the political gestures helped President Reagan to extract a few limited concessions on East-West trade from the Europeans and it helped to fend off complaints about US benign neglect during the following year.

The Versailles-summit, however, did not generate any long-lasting improvement in the atmosphere between the United States and the European Community. The linkage between economic relations with the Soviet Union and international monetary issues proved to be a two-edged sword. In late June President Reagan

\textsuperscript{66} WSJ 15 June 1982
\textsuperscript{67} loc.cit.
decided to embargo sales by US firms and subsidiaries for the Soviet gas pipeline to Western Europe. Washington's European summit partners regarded that action as a breach of promises made by Mr Reagan at Versailles. Subsequently, at the European Council meeting in Brussels in early July, US economic policies were attacked harsher than before the Versailles summit. 68

However, transatlantic tensions with regard to monetary and exchange rate issues did ease somewhat in the second half of 1982. The IMF annual meeting and other international financial gatherings were dominated by the debate about the debt problems of Third World countries after the Mexican debt crisis in August. The Federal Reserve relaxed its monetary policy which led to declining dollar interest rates. The prime rate fell from 16 per cent in the summer of 1982 to 11 per cent in January 1983 and the Treasury bill rate declined even from 16 to 8 per cent in the same period. This helped to increase the room for manoeuvre in German monetary policy. DM interest rates moved downwards in accordance with the needs of the domestic economy. Although the DM/dollar rate rose to almost 2.60 in November 1982, the German policymakers' attitude towards the DM/dollar rate became much more relaxed in the course of 1982 as described in chapter F.2. The German complaints about US benign neglect subsided correspondingly.

Early in 1983 the Jurgensen-committee finished its report on exchange market interventions and on April 29, 1983, the finance ministers and central bank governors of the seven summit nations and the representative of the European Community met in Washington to review the policy implications of the working group's findings. They issued a statement which said: 69

"Under present circumstances, the role of intervention can only be limited. Intervention can be useful to counter disorderly market conditions and to reduce short-term volatility. Intervention may also on occasion express an attitude toward exchange markets. Intervention will normally be useful only when complementing and supporting other policies. We are agreed on the need for closer consultations on policies and market conditions; and, while retaining our freedom to operate independently, are willing to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful."

Basically this statement confirmed the existing free-for-all practice in intervention policy. Accordingly, US Treasury Secretary Regan declared that the

68 Newsweek 12 July 1982
agreement did not require the United States to change its intervention policy. The German Finance Minister Gerhard Stoltenberg said that the German position was not to achieve more frequent interventions, but to persuade the Americans to join the other countries in interventions when necessary. In his view there was a certain rapprochement of positions, because two years earlier there had been beliefs in Washington that all kinds of interventions were meaningless or doubtful. However, the Reagan administration's less dogmatic attitude toward exchange market intervention since the Versailles-summit in June 1982 was not followed up by a real departure from its passive exchange rate policy - at least not within the period under review (i.e. until the spring of 1983).

In general, the DM/dollar exchange rate diplomacy in the early 1980s was circumscribed by the American return to benign neglect, which put an end to the US-German bilateralism of the late 1970s. The management of the DM/dollar rate became a unilateral German affair. German complaints about the exchange rate effects of the domestically-oriented American policies did not make the US authorities depart from their passive exchange rate policy. Even though Germany joined forces with the other EC-countries, their combined protests remained unproductive. In a regained position of strength the United States was simply impervious to foreign criticism. The American ability to disregard the dollar's external value entirely over a number of years and to be immune against sharp criticism from its allies reflected the basic political-economic asymmetry in international monetary relations. However, the complaints in Germany and other European countries about "Reaganomics" and "benign neglect" also had a domestic political dimension: the United States served as a convenient scapegoat for recession and growing unemployment. In this sense the exchange rate diplomacy in the early 1980s fulfilled an important political function.
CONCLUSION

In the preceding parts the management of the DM/dollar rate in the 1973–83 period has been analyzed on the basis of the abstract proposition, put forward in the introduction, that exchange rate policy under floating is determined by the policymaker's motivation in terms of exchange rate preferences and ultimate exchange rate objectives; by the exchange market situation; by the policymaker's assessment of the costs and benefits of available exchange rate measures; and by possible diplomatic exchange rate measures of other states. The empirical analysis has shown that all four categories help to explain the management of the DM/dollar rate in the ten-year period under review. The dynamic behind the various market-oriented and diplomatic exchange rate measures was provided by tensions between the exchange rate development and the policy goals of US and German authorities. Assessments of the costs of exchange rate measures in relation to the potential benefits tended to restrain the use of market-oriented and diplomatic measures. At times, the behaviour of the US and German authorities was modified by the exchange rate diplomacy between the two states.

It is the purpose of this concluding chapter to summarize the findings of the preceding analysis about US and German management of the floating DM/dollar rate. It will be argued that most of the differences between the American and the German policies rested on three fundamental asymmetries between the United States and Germany: the different size and openness of the two economies; the different international roles of the dollar and the DM; and the American supremacy in the overall balance of power between the two countries. Based on the findings for the 1973–83 period, the final section provides an outlook for collective management of the DM/dollar rate.
The US Management of the DM/Dollar Rate

The various attempts by the US administration and the Federal Reserve to influence the DM/dollar rate in the first ten years of floating were motivated by the following six objectives:

- to further domestic price stability
- to improve the US trade account
- to further a stable and smoothly functioning international monetary and trade system
- to preserve the dollar's standing in the international monetary system
- to counter increases in the international price of oil
- to maintain the position of the United States in the international political system

Naturally, these objectives were not guiding US exchange rate policy simultaneously. The last three items on the list were exclusively related to the American dollar-supporting measures during the dollar crisis in the late 1970s. Equally, domestic price stability was a particularly important consideration in US exchange rate policy in that period. But some of the dollar-supporting measures in the mid-1970s have also been motivated by this goal. The trade account was the primary objective of US exchange rate measures in the winter of 1973/74 and in the summer of 1977. The desire to further a well-functioning international monetary and trade system was a standing reason behind US interventions to counter disorderly exchange market conditions between 1973 and 1981. During the dollar's weakness in the late 1970s this objective influenced all aspects of US exchange rate policy.

With regard to the content of US exchange rate policy, it can be said that the US authorities generally tried to manage the DM/dollar rate "on the cheap", i.e. by using measures which did not interfere with the thrust of their domestically-oriented economic policies. During most of the 1973-83 period US policymakers were not indifferent to the exchange market situation, but usually their goals in this respect were secondary to domestic economic considerations. Therefore they preferred exchange rate measures which incurred no or only low costs in terms of domestic economic objectives. These measures were sterilized exchange market interventions partly financed by the Bundesbank, public announcements, and attempts to influence the market-oriented measures of the German authorities. Monetary measures were only used for exchange rate purposes in 1978/79, when the concern of US policymakers about
the negative consequences of the dollar's weakness came close to their concern about the prospects for domestic economic activity and the consequent electoral prospects for the party in power.

Direct interventions in the DM/dollar market was the most heavily used instrument in the US management of the DM/dollar rate. As described in chapter C.1.3., the US intervention authorities followed a shifting course in the first ten years of floating. First they changed from passivity to limited interventions. In the late 1970s they supported the dollar with large-scale interventions. Finally, in the early 1980s, they returned to a non-interventionist stance (eventually abandoned only in September 1985 with the "Plaza Accord" of the Group of Five). The varying degree of tension between the exchange rate development and US policy goals explains much of this volatility. But the fact that the Treasury had the main say in US intervention policy was also a reason. Changes in the top positions at the Treasury contributed to a discontinuity in assessments of costs and benefits of exchange market interventions.1

US policymakers often used the announcement effect of public statements as another low-cost measure to influence the currency markets. Some of these statements were apparently off-hand remarks by top policymakers to the press about the prospects for the dollar or the appropriateness of certain exchange rates. George Shultz' remark about the damaging effects of the first oil price shock on the US trade account in the winter of 1973/74 was one example. Similarly, all the evidence goes to show that Michael Blumenthal tried to depress the value of the dollar with his press comments in the summer of 1977. On other occasions the US authorities consciously used the announcement effect of new exchange rate measures to influence the exchange market. The most remarkable example was President Carter's announcement of the dollar-rescue program on November 1, 1978. At other times the use of announcement effects was linked to the conclusion of international agreements on intervention cooperation.

In addition to the market-oriented exchange rate measures the US authorities tried on various occasions to influence the DM/dollar rate indirectly via the market-oriented policies of the German authorities. This aspect of US policy will be summarized in the subsequent section on DM/dollar exchange rate diplomacy.

1 This was especially evident in early 1981, when Donald T. Regan became Secretary of the Treasury and Beryl W. Sprinkel his Undersecretary for Monetary Affairs. Similarly, the change from Mr Regan to James Baker in February 1985 seems to have contributed to the subsequent intensification of US intervention activity. FT 31 October 1985
The German Management of the DM/Dollar Rate

On the German side the management of the DM/dollar rate was also based on six different objectives:

- to further domestic price stability
- to stimulate domestic economic activity
- to protect intra-European exchange rate stability
- to further a stable and smoothly functioning international monetary and trade system
- to maintain international confidence in the DM
- to limit the DM's role as an international reserve currency

Domestic price stability was a particularly important consideration during the DM's weakness in the early 1980s. In the mid-1970s this objective played a minor role. Concern about domestic economic activity influenced German exchange rate measures in 1977/78. Protecting stability within the European "currency snake" and the EMS was an important aspect of the German DM/dollar exchange rate management from 1977 to 1981. As on the American side, a stable and smoothly functioning world monetary and trade system was a regular consideration in German intervention policy. The desire to maintain international confidence in the DM emerged as an objective during the DM's weakness in the early 1980s, whereas the German support for the dollar in the late 1970s was partly determined by the wish to limit the DM's role as an international reserve currency.

The German authorities used five types of measures to further their exchange rate objectives in the course of the 1973-83 period: direct interventions, monetary policy, changes in capital import restrictions, public announcements, and diplomatic measures.²

German interventions in the DM/dollar market were a regular feature of the DM/dollar exchange rate management. As described in chapter C.2., the Bundesbank's approach remained by and large constant in the ten-year period. On the one hand it countered short-term fluctuations and disorderly market conditions. On the other hand it resisted movements in the DM/dollar rate over longer periods with "leaning-against-the-wind" interventions.

² In a certain sense the official German capital imports in the early 1980s can also be considered as an exchange rate measure, although they were primarily intended to help finance the current account deficit. The same holds true for the informal agreement between the Bundesbank and the German banks to limit speculative capital outflows, cf. p. F-11 above.
Unlike the US authorities the Bundesbank always kept an eye on the DM/dollar rate in the conduct of monetary policy. But from the onset of floating until the end of the 1970s monetary measures were only used to a limited degree for exchange rate purposes and not in outright conflict with domestic economic imperatives. In the early 1980s, however, the Bundesbank did not hesitate to counter the DM's weakness by tightening monetary conditions in spite of a domestic recession.

Changes in capital import restrictions were used relatively often by the German authorities in the management of the DM/dollar rate. When floating started in March 1973 Germany had considerable barriers against capital imports. Ten years later almost all of these restrictions had been repealed. The Bundesbank and the Bonn-government favoured deregulation as a way to achieve greater efficiency in financial intermediation, but the timing of the deregulation measures and occasional set-backs in the trend reflected the fact that the German authorities used changes in capital import restrictions as an instrument in the management of the DM/dollar rate. When the German policymakers wanted the DM to strengthen in the exchange market, they pushed deregulation forward (for instance in January and September 1974 and in 1980/81). On the other hand, when they were concerned about the DM's strength, as in December 1977, they were willing to tighten capital import restrictions again.

Compared with the American side, public announcements were used sparsely in the German management of the DM/dollar rate, possibly because verbal interventions by German policymakers received less attention in the exchange markets than US announcements. When they occurred, it was usually in conjunction with an international agreement on exchange rate management as in May 1974 or in March 1978. But with regard to diplomatic measures the German policymakers were as active as their US counterparts as the following section will recollect.

US-German Exchange Rate Diplomacy

The basis of all US-German interactions with regard to the management of the DM/dollar rate was a consensus on the desirability of floating. US and German policymakers did not see a return to a pegged DM/dollar rate as a feasible option considering the differences in economic performances, oil price shocks, and rapidly growing exchange markets. Furthermore, any attempt to uphold a formally pegged DM/dollar rate was expected to lead to unacceptable constraints on domestic economic policymaking in both countries.
Within the undisputed framework of a floating-rate regime the question was how to manage the floating DM/dollar rate. The empirical analysis in the preceding parts has shown that the character of the US-German exchange rate diplomacy at any given time primarily depended on the relationship between US and German exchange rate preferences. There was one episode (in the summer of 1977) when incompatibility of exchange rate preferences led to a short outright exchange rate conflict, i.e. a situation in which the two sides managed the DM/dollar rate at cross-purposes. But usually US and German exchange rate preferences were compatible and the nature of US-German interaction was primarily determined by the difference in their degrees of concern about the exchange market situation. The most concerned side, i.e. where the tension between the actual exchange rate and the exchange rate preference was the most intense, was in a weaker position in bargaining terms as it had more to lose from a continuation of the existing situation. The relative degrees of concern between US and German policymakers determined essentially the balance of power in DM/dollar exchange rate diplomacy.

The United States and Germany have alternated in the weak and strong positions. This was most clearly seen in the late 1970s and the early 1980s. In the winter of 1977/78 the Germans were more concerned about the falling DM/dollar rate than the Americans, but for the reasons spelled out in Part E this pattern had been completely reversed by the summer of 1979. In the early 1980s the rising DM/dollar rate made the German policymakers apprehensive, whereas it removed the American exchange rate worries.

Usually the initiatives in the DM/dollar exchange rate diplomacy came from the weaker-placed policymakers with the relatively higher degree of concern about the exchange rate development. They tended to be more active with regard to market-oriented measures and they wished that the other side would do more to counter the undesirable exchange rate development. They could argue that there was an unequal burden-sharing in exchange rate management. Occasionally they would also complain that the other side aggravated the exchange rate problem with policies directed at its domestic goals. Sometimes they tried to persuade the other side to participate in coordinated attempts to influence the exchange market - attempts which were usually believed to be more effective than unilateral measures.

Diplomatic measures by the US or the German authorities were far from always successful in achieving a change in the other side's market-oriented exchange rate measures. It depended on the willingness of the initiating
country to pay a price for the other side’s cooperation. Furthermore it presupposed a willingness among the authorities of the stronger-placed country to compromise on market-oriented policies. No side could impose its will on the other side in this area. Five instances have been identified when the DM/dollar exchange rate diplomacy resulted in quid-pro-quo agreements:

- In July 1973 the Germans initiated coordinated exchange market interventions with American participation to end a drastic fall in the DM/dollar rate. On that occasion the Americans achieved a change in the conditions for swap loans which they considered to be to their advantage.

- In March 1978 the US Treasury declared itself willing to use some of its own reserve holdings for the support of the dollar. In return, the Germans made a concession regarding the stimulation of their domestic economy and they agreed to double the swap line between the Bundesbank and the Federal Reserve.

- A similar deal was struck in connection with the Bonn summit in July 1978. The German willingness to take expansionary fiscal measures was partly counterbalanced by President Carter’s promise to work for greater exchange rate stability.

- In the autumn of 1978 the United States proposed an international rescue package for the dollar including a program of coordinated exchange market interventions and increased German credits to finance such interventions. Germany made its participation in the rescue operation conditional on a tightening of US monetary policy.

- At the Versailles summit in June 1982, Germany and her European partners achieved a small and mainly symbolic modification in the official US attitude on exchange market intervention. In return, the Europeans made a few limited concessions to the Americans on the issue of East-West trade.

In four cases diplomatic initiatives by the United States or Germany did not lead to changes in the market-oriented policies of the other side:

- In the winter of 1973/74 the United States failed to press Germany to counter the rise in the DM/dollar rate more forcefully with increased dollar sales.

- In late 1977 the German requests and proposals for American measures in support of the depreciating dollar were largely ineffective.

- In the summer and early autumn of 1979 the American demands that Germany should support the dollar with increased interventions and lower interest rates were rejected by the Germans.

- In the early 1980s the criticisms from Germany and others about the lack of US efforts to arrest the rise in the dollar’s value and to counter exchange market volatility were ignored or rejected by the Americans (with the exception of the above-mentioned deal at the Versailles summit in 1982).
US–German Asymmetries and their Effect on the DM/Dollar Exchange Rate Management

When economic policymaking in the United States and Germany is compared, it is fair to say that the DM/dollar rate was generally more important to the Germans than to the Americans in the first ten years of floating. The German policymakers were more sensitive to developments in the DM/dollar market than their American counterparts who tended to regard their policy objectives as less dependent on the exchange rate. It is possible to argue that US policymakers generally underrated the degree to which the US economy was affected by the dollar’s external value, and that German policymakers on the other hand tended to overstate the significance of the DM/dollar rate for prices and economic activity in Germany. However, it is undeniable that the size and structure of the US economy and the international roles of the dollar mitigated the consequences of exchange rate changes for the United States as compared with Germany.

Due to the enormous volumes and the continental nature of its internal markets the United States has an economy which is much more closed than the German economy. Measured by export value in relation to GNP, the United States and Germany had "economic openness ratios" of 5.5 per cent and 19.7 per cent, respectively, in 1973. In 1980 these ratios had increased to 9.4 per cent and 26.4 per cent; respectively.

The size of the US economy and the political stability and military strength of the United States has not only made the dollar the primary reserve and investment currency, but also the leading transaction medium and unit of account in international trade and finance. In 1983 the dollar accounted for 69 per cent of total identifiable world currency reserves against 12 per cent for the DM as the second most important reserve currency. About 50 per cent of world trade was factored in dollar in 1981 against 14 per cent for the DM. The DM is not a world trading currency in the true sense in that very little third country trade is settled in DM. In contrast, the dollar is for instance used as transaction currency and unit of account for international trade in raw materials and energy. Furthermore, the bulk of Euro-market dealings is denominated in dollars.

These structural asymmetries between the United States and Germany were reflected in the management of the DM/dollar rate, in particular in the use

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3 The DM’s 14 per cent share was largely due to the high proportion of Germany’s trade that is denominated in DM (87% for exports, 40% for imports).
of monetary policy. Because the exchange rate played a more limited role in the United States than in Germany, the Federal Reserve was less willing to use this instrument for exchange rate purposes than the Bundesbank. This comes out clearly when the US reaction to the dollar's weakness in the late 1970s is compared with the German reaction to the DM's weakness in the early 1980s. From late 1977 onwards US policymakers acknowledged that the dollar's external weakness called for a tightening of domestic monetary conditions. However, apart from some limited concessions to the exchange market situation, monetary policy continued for almost two years to be geared to the perceived need of the US economy for low interest rates. When US monetary policy finally was reoriented from an expansionary to a restrictive course in October 1979, the change was precipitated by the dollar's weakness in the exchange market, but the new measures were nevertheless primarily aimed at curbing domestic inflation. On the German side, in contrast, monetary policy was immediately tightened when the DM weakened in the DM/dollar market in 1980. In the following year German monetary policy was mainly oriented to the Bundesbank's exchange rate objectives although the sluggishness of the domestic economy called for a more expansionary stance.

The asymmetry between the large, relatively closed US economy and the medium-sized, relatively open German economy also helps to explain the fact that US policymakers put more emphasis on the DM/dollar rate as a balance-of-payments adjustment mechanism, whereas German policymakers tended more to view the DM/dollar rate in terms of domestic economic activity and price stability. Consequently, the trade account has been one of the US objectives in DM/dollar exchange rate management, whereas economic activity figures on the German list of exchange rate objectives.

Other differences between the above lists of US and German exchange rate objectives can be attributed to the asymmetry between the international roles of the dollar and the DM. The DM's role as nexus between the dollar and other European currencies via the mechanisms of the currency snake and the EMS meant that intra-European exchange rate stability became an objective of German DM/dollar exchange rate management. With regard to the dollar, the extensive use of the US currency was based on the position of the United States as the leading economic and political power in the Western world. But this position was also reinforced by the very fact that the dollar was the globally preferred monetary medium. Hence, the political and economic strength of the United States was affected negatively in the late 1970s when the dollar's extreme weakness in the exchange markets started to undermine its international roles. Considerations
about the dollar's standing in the international monetary system and the international political position of the United States contributed therefore to the American support for the dollar. Another reason related to the dollar's international use was the concern that the dollar depreciation would incite OPEC to increase the international price of oil, because the US currency served as unit of account in the energy sector.

With regard to the DM/dollar exchange rate diplomacy, the asymmetry between the US and German positions in the international political system played a certain role. It is evident that the United States generally had an advantage over Germany in their bilateral relationship due to superior power resources and Germany's dependence upon US military protection. It has sometimes been said that the German authorities have been obedient to the United States in monetary and exchange rate matters and that this should be regarded as the price paid by Germany for the American commitment to its military security. This may have been the case in the 1960s when one could observe German docility and compliance with American wishes in monetary affairs. But as far as the management of the DM/dollar rate in the 1970s and early 1980s was concerned, Germany has not bowed down quite so loyally to US leadership. On the contrary, it has been able to resist US pressure on several occasions. Exchange rate questions have not been directly linked to defence issues, but only to closely related economic issues (with the exception of the rather insignificant deal at the Versailles summit in 1982 which involved Western policy towards the Soviet Union). It can be said that a "non-linkage norm" has been in force in US-German relations in the 1973–83 period as far as explicit linkages between the military sphere and exchange rate management were concerned.4

Indirectly, however, the supremacy of the United States in the overall balance of power has been reflected in DM/dollar exchange rate diplomacy. Within NATO and in dealing with the Soviet Union the Germans have found it to be in their best interest to submit themselves to the American leadership. In these fields and in trade policy Germany stood to lose more than the United States in case of a breakdown in transatlantic cooperation. This imbalance

4 The "non-linkage norm" is a tacit bargaining norm which forebids bargaining partners to tie negotiations on one set of issues to the resolution of differences on other questions, see Robert O. Keohane & Joseph S. Nye, Power and Interdependence, Boston, 1977, p.214. With regard to the role of the "non-linkage norm" in US-German relations, see Paul M. Johnson, "Washington and Bonn: dimensions of change in bilateral relations", International Organization, vol.33, no.4 (Autumn 1979), pp.451-480.
in the relative importance of the US–German relationship seems to have restrained the Germans somewhat in the way they pursued their exchange rate interests, vis-à-vis the United States. They feared apparently that serious and prolonged conflicts over exchange rate management would generate an uncooperative atmosphere which easily could spill over to other issues and hurt German interests there.

This restraint on German exchange rate diplomacy seems, however, to have affected its style more than its substance. The German policymakers did not abstain from defending their specific interests vis-à-vis the United States, but in public they always played down the seriousness of their occasional differences with the Americans over exchange rate policy. They also tried whenever possible to stage any confrontations with the United States in multilateral fora, where they would not be isolated, and where it was more likely that negative 'atmospheric' repercussions could be limited. Furthermore, the Germans tended to abstain from demonstrations of discontent with US policy, when such criticism was deemed ineffective in bringing about a change in US policy.

**Outlook for Collective Management of the DM/Dollar Rate**

The point of departure for this study of DM/dollar exchange rate management was the view that co-operation between the leading industrial countries is necessary to achieve stable relationships between the "key currencies" (dollar, D-mark, and yen) which, in turn, is crucial for the attainment of global monetary and economic stability. On the basis of this proposition and looking back over the story of DM/dollar exchange rate management in the first ten years of floating, it is fair to blame the United States for the instability in the DM/dollar rate and its consequences as far as it could have been reduced by a more co-operative exchange rate management.

On the German side there was a remarkable constancy in the approach to the floating DM/dollar rate. The German policymakers were constantly attentive to developments in the DM/dollar market and interpreted movements in the exchange rate in terms of their policy objectives. This means that they always had a preference concerning level and fluctuations of the DM/dollar rate. Although they preferred floating to any other exchange rate regime under the given circumstances, they had a pragmatic attitude with regard to the use of direct interventions and domestic monetary measures for exchange rate purposes.
The dominant objective behind the German efforts to influence the DM/dollar rate was domestic and international currency stability. In the pursuit of this aim they were always willing to collaborate with the United States.

In contrast to the German approach, the American management of the DM/dollar rate followed a shifting course. In spite of the growing integration of the US economy into the world economy in the period under review, there was still a tendency in the United States to think of domestic and international economic policy as distinct, and the latter as the tail on the dog. The metaphor of the tail wagging the dog was often used to illustrate the point that it would be grossly inappropriate for the United States to change its domestic economic policies for exchange rate reasons. Preoccupied with domestic economic objectives US policymakers were inclined to disregard depreciations and appreciations of the dollar for long periods. Only when an extremely weak or an extremely strong dollar threatened some important policy objectives, Washington's attitude shifted from indifference to concern, followed by a corresponding shift from a passive to an active exchange rate policy. The latest case in point is the re-emergence of an active US exchange rate policy in 1985 after four years of "benign neglect" of the rising dollar. However, as on previous occasions US exchange rate policy may fall back to indifference and passivity once the international competitiveness of the US economy is restored and US policymakers turn to other objectives.

As a consequence of the different national inclinations, US-German cooperation in the management of the DM/dollar rate depended on the American attitude. When the United States was concerned about the exchange rate situation, and when US and German exchange rate preferences were compatible (which was usually the case), both sides were willing to co-operate. When the United States was indifferent with regard to the dollar's external value, no amount of foreign lecturing about the systemic need for US participation in exchange rate stabilization could persuade Washington to depart from a passive stance. Only when the advice was based on some kind of leverage - like the Saudi Arabian threat to raise oil prices in 1978 - there was a chance to make an impact on US policy.

The periods of "benign neglect" in US exchange rate policy tend to be harmful to the world economy. If, for instance, the US authorities had taken the German advice to tighten domestic monetary conditions earlier during the period of dollar weakness in the late 1970s, the world might have been saved the painful adjustment to US monetarism in the early 1980s. Worldwide recession,
the rise in unemployment, and the debt crisis of less developed and Eastern European countries might have been less severe. In other words, if the United States would bear in mind the recommendations of John Williams' "key currency" scheme, mentioned at the beginning of this study, and participate continuously in international efforts to stabilize the DM/dollar rate (and the yen/dollar rate) global monetary and economic stability would be greatly enhanced.

The changeableness in US exchange rate policy may be an inevitable product of the country's size and its political system, in particular the marked electoral cycle and a low degree of continuity in top policymaking positions. The United States might be able to conduct a more consistent and stable economic strategy if the Federal Reserve had the same strength and independence in the American policymaking system as the Bundesbank has in the German system. It is also possible that formalized rules for regular (e.g. quarterly) consultations between finance ministers and central bank governors of the five or seven leading Western countries might help to commit the United States to participate in collective exchange rate management on a permanent basis. Within such a forum it should at least be possible to reach consensus about exchange rate levels that are not acceptable - that are plainly disruptive of mutual objectives over the medium and long term. However, the only way to ensure that the United States will help to avoid unacceptable exchange rate levels, is a countervailing power to the dominant position of the United States in the international monetary system. The European option in this regard is a true monetary union between the EC-countries with a currency capable of rivalling the dollar in its international roles. Unless the Europeans can agree to combine their resources to match the United States in the monetary sphere, they have to continue to adjust to domestically-oriented US policies.
1. Official Publications

Deutsche Bundesbank (DB), Annual Report
- Monthly Report
- Auszüge aus Presseartikeln (AP)

Economic Report of the President
Federal Reserve Bank of New York (FRBNY), Quarterly Review
Federal Reserve Bulletin (FRB)
International Monetary Fund (IMF), Annual Report
- International Financial Statistics
US Information Service, Wireless Bulletin from Washington (WB)

2. Periodicals and Newspapers

The publications listed here have been used extensively as sources for the empirical analysis. Other periodicals and newspapers, which have been used more sporadically, are only mentioned in the footnotes to the main text.

Börsen-Zeitung (BZ)
The Economist
The Financial Times (FT)
Finanz und Wirtschaft
Frankfurter Allgemeine Zeitung (FAZ)
The Guardian
Handelsblatt/Wirtschaft- und Finanzzeitung (Hb)
International Herald Tribune (IHT)
Journal of Commerce (JC)
Neue Zürcher Zeitung (NZZ)
Newsweek
New York Times (NYT)
Der Spiegel
Süddeutsche Zeitung (SZ)
Vereinigte Wirtschaftsdienste, Finanzen (VWD)
Wall Street Journal (WSJ)
Washington Post (WP)
3. Books and Articles


European University Institute

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### Table 1: US Interventions in the DM/Dollar Market, April 1973 - March 1983

<table>
<thead>
<tr>
<th>Period</th>
<th>DM-sales -mio.$-</th>
<th>DM-purchases* -mio.$-</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1973:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 April - 9 July</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>10 July - 31 July</td>
<td>220.5</td>
<td>-</td>
</tr>
<tr>
<td>1 Aug. - 15 Aug.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>16 Aug. - 31 Aug.</td>
<td>54.5</td>
<td>-</td>
</tr>
<tr>
<td>1 Sept. - 10 Sept.</td>
<td>8.2</td>
<td>-</td>
</tr>
<tr>
<td>11 Sept. - 16 Sept.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>17 Sept. - 26 Sept.</td>
<td>156.7</td>
<td>-</td>
</tr>
<tr>
<td>27 Sept. - 10 Oct.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>11 Oct. - 25 Oct.</td>
<td>21.0</td>
<td>-</td>
</tr>
<tr>
<td>26 Oct. - 30 Nov.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 Dec. - 25 Dec.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>1974:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Dec. - 10 Jan.</td>
<td>-</td>
<td>48.0</td>
</tr>
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<td>-</td>
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<td>29 Jan. - 21 Feb.</td>
<td>-</td>
<td>-</td>
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<td>22 Feb. - 28 Feb.</td>
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<td>-</td>
</tr>
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<td>1 March - 31 March</td>
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<td>3.7</td>
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<td>1 April - 30 April</td>
<td>51.6</td>
<td>-</td>
</tr>
<tr>
<td>1 May - 31 May</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 June - 30 June</td>
<td>29.2</td>
<td>122.8</td>
</tr>
<tr>
<td>1 July - 31 July</td>
<td>63.4</td>
<td>194.2</td>
</tr>
<tr>
<td>1 Aug. - 3 Sept.</td>
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<td>64.6</td>
</tr>
<tr>
<td>4 Sept. - 30 Sept.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 Oct. - 31 Oct.</td>
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<td>-</td>
</tr>
<tr>
<td>1 Nov. - 30 Nov.</td>
<td>187.9</td>
<td>-</td>
</tr>
<tr>
<td>1 Dec. - 15 Dec.</td>
<td>-</td>
<td>82.8</td>
</tr>
<tr>
<td>16 Dec. - 31 Dec.</td>
<td>75.1</td>
<td>-</td>
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<td><strong>1975:</strong></td>
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<td>153.5</td>
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</tr>
<tr>
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</tr>
<tr>
<td>1 March - 31 March</td>
<td>119.1</td>
<td>102.3</td>
</tr>
<tr>
<td>1 April - 30 April</td>
<td>42.6</td>
<td>244.6</td>
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<td>140.8</td>
<td>62.7</td>
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<tr>
<td>6 June - 31 July</td>
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<tr>
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<td>-</td>
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<td>9.1</td>
</tr>
<tr>
<td>1 Nov. - 31 Dec.</td>
<td>-</td>
<td>-</td>
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<tr>
<td><strong>1976:</strong></td>
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<td>1 Jan. - 31 Jan.</td>
<td>-</td>
<td>29.8</td>
</tr>
<tr>
<td>1 Feb. - 3 March</td>
<td>153.2</td>
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</tr>
<tr>
<td>4 March - 31 March</td>
<td>97.6</td>
<td>-</td>
</tr>
<tr>
<td>1 April - 30 April</td>
<td>-</td>
<td>80.0</td>
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<tr>
<td>1 May - 15 May</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Period</td>
<td>DM-sales</td>
<td>DM-purchases</td>
</tr>
<tr>
<td>----------------------</td>
<td>-----------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td>- mio.$</td>
<td>- mio.$</td>
</tr>
<tr>
<td>1976: 16 May - 31 July</td>
<td>-</td>
<td>92.9</td>
</tr>
<tr>
<td>1 Aug. - 15 Aug.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>16 Aug. - 15 Oct.</td>
<td>53.1</td>
<td>-</td>
</tr>
<tr>
<td>16 Oct. - 30 Nov.</td>
<td>22.9</td>
<td>114.9</td>
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<tr>
<td>1 Dec. - 31 Dec.</td>
<td>74.5</td>
<td>-</td>
</tr>
<tr>
<td>1977: 1 Jan. - 31 Jan.</td>
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<td>90.1*</td>
</tr>
<tr>
<td>1 Feb. - 28 Feb.</td>
<td>20.9</td>
<td>-</td>
</tr>
<tr>
<td>1 March - 31 March</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 April - 4 May</td>
<td>30.1</td>
<td>-</td>
</tr>
<tr>
<td>5 May - 30 June</td>
<td>39.9</td>
<td>127.4</td>
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<td>1 July - 31 July</td>
<td>98.2</td>
<td>14.8</td>
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<td>1 Aug. - 31 Aug.</td>
<td>8.0</td>
<td>35.4</td>
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<tr>
<td>1 Sept. - 30 Sept.</td>
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<td>-</td>
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<td>1 Oct. - 31 Oct.</td>
<td>228.7</td>
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<td>1 Nov. - 30 Nov.</td>
<td>80.9</td>
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</tr>
<tr>
<td>1 Dec. - 31 Dec.</td>
<td>545.0</td>
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<tr>
<td>1978: 1 Jan. - 6 Jan.</td>
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<td>-</td>
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<tr>
<td>7 Jan. - 13 Jan.</td>
<td>509.9</td>
<td>-</td>
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<tr>
<td>14 Jan. - 31 Jan.</td>
<td>52.1</td>
<td>-</td>
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<tr>
<td>1 Feb. - 28 Feb.</td>
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<tr>
<td>1 March - 31 March</td>
<td>492.2</td>
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<td>1 April - 31 May</td>
<td>171.9</td>
<td>802.8</td>
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<td>1 June - 30 June</td>
<td>70.4</td>
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<td>1 July - 31 July</td>
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<td>664.7</td>
<td>763.9</td>
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<td>26 Oct. - 31 Oct.</td>
<td>976.7</td>
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<td>1 Nov. - 30 Nov.</td>
<td>2,920.8</td>
<td>-</td>
</tr>
<tr>
<td>1 Dec. - 31 Dec.</td>
<td>2,796.5</td>
<td>-</td>
</tr>
<tr>
<td>1979: 1 Jan. - 31 Jan.</td>
<td>201.2</td>
<td>735.1</td>
</tr>
<tr>
<td>1 Feb. - 8 Feb.</td>
<td>507.1</td>
<td>-</td>
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<tr>
<td>9 Feb. - 30 April</td>
<td>-</td>
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<tr>
<td>1 May - 14 June</td>
<td>-</td>
<td>994.7</td>
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<tr>
<td>15 June - 30 June</td>
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<td>177.9</td>
</tr>
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<td>5 Oct. - 31 Dec.</td>
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<td>939.6</td>
</tr>
<tr>
<td>1980: 1 Jan. - 31 Jan.</td>
<td>530.4</td>
<td>742.1</td>
</tr>
<tr>
<td>1 Feb. - 9 Feb.</td>
<td>240.8</td>
<td>-</td>
</tr>
<tr>
<td>10 Feb. - 14 March</td>
<td>-</td>
<td>2,866.7</td>
</tr>
<tr>
<td>15 March - 8 April</td>
<td>-</td>
<td>1,396.2</td>
</tr>
<tr>
<td>9 April - 15 May</td>
<td>1,370.2</td>
<td>659.8</td>
</tr>
<tr>
<td>16 May - 31 July</td>
<td>1,919.4</td>
<td>768.2</td>
</tr>
<tr>
<td>1 Aug. - 31 Aug.</td>
<td>69.6</td>
<td>793.9</td>
</tr>
<tr>
<td>1 Sept. - 15 Oct.</td>
<td>-</td>
<td>679.5</td>
</tr>
<tr>
<td>16 Oct. - 15 Dec.</td>
<td>170.3</td>
<td>4,574.5</td>
</tr>
<tr>
<td>Period</td>
<td>DM-sales -mio.$-</td>
<td>DM-purchases* -mio.$-</td>
</tr>
<tr>
<td>------------------------</td>
<td>------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>1981: 16 Dec. - 31 Jan.</td>
<td>128.4</td>
<td>1,521.6</td>
</tr>
<tr>
<td>1 Feb. - 23 Feb.</td>
<td>-</td>
<td>778.4</td>
</tr>
<tr>
<td>24 Feb. - 29 March</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>30 March</td>
<td>74.4</td>
<td>-</td>
</tr>
<tr>
<td>31 March - 31 Dec.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1982: 1 Jan. - 13 June</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>14 June</td>
<td>-</td>
<td>21.0</td>
</tr>
<tr>
<td>15 June - 31 July</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 Aug. - 10 Aug.</td>
<td>-</td>
<td>5.0</td>
</tr>
<tr>
<td>11 Aug. - 30 Sept.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1 Oct. - 10 Oct.</td>
<td>-</td>
<td>40.0</td>
</tr>
<tr>
<td>11 Oct. - 31 Dec.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1983: 1 Jan. - 31 March</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total, 1 April 1973 - 31 March 1983</strong></td>
<td><strong>29,577.2</strong></td>
<td><strong>29,325.9</strong></td>
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</table>


* The DM-purchases include off-market transactions with "correspondents" of the Federal Reserve (see p. C-7 above).
Table 2: Changes in the Bundesbank's Net Foreign Position, April 1973 - March 1983 (excluding changes due to valuation adjustments).

<table>
<thead>
<tr>
<th>Period</th>
<th>Changes in the Net Foreign Position, Total</th>
<th>Caused by interventions in the DM/dollar market</th>
<th>Caused by the &quot;snake&quot; or EMS</th>
<th>Caused by other foreign exchange movements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>April - May</td>
<td>- 0.9</td>
<td>- 1.3</td>
<td>- 1.5</td>
<td>+ 1.9</td>
</tr>
<tr>
<td>June - July</td>
<td>+ 8.5</td>
<td>+ 0.7</td>
<td>+ 5.8</td>
<td>+ 2.0</td>
</tr>
<tr>
<td>Aug. - Sept.</td>
<td>+ 3.4</td>
<td>- 1.6</td>
<td>+ 4.3</td>
<td>+ 0.7</td>
</tr>
<tr>
<td>Oct. - Dec.</td>
<td>- 4.5</td>
<td>- 5.3</td>
<td>- 1.1</td>
<td>+ 1.9</td>
</tr>
<tr>
<td>1974</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan.</td>
<td>- 2.5</td>
<td>- 2.0</td>
<td>+ 0.3</td>
<td>- 0.8</td>
</tr>
<tr>
<td>Feb.</td>
<td>- 0.3</td>
<td>0</td>
<td>- 0.1</td>
<td>- 0.2</td>
</tr>
<tr>
<td>March - May</td>
<td>+ 6.1</td>
<td>+ 1.4</td>
<td>+ 4.0</td>
<td>+ 0.7</td>
</tr>
<tr>
<td>June</td>
<td>- 0.4</td>
<td>- 0.8</td>
<td>+ 0.1</td>
<td>+ 0.3</td>
</tr>
<tr>
<td>July - Sept.</td>
<td>- 6.4</td>
<td>- 2.2</td>
<td>- 3.5</td>
<td>- 0.7</td>
</tr>
<tr>
<td>Oct. - Nov.</td>
<td>+ 2.0</td>
<td>+ 2.1</td>
<td>- 0.7</td>
<td>+ 0.6</td>
</tr>
<tr>
<td>Dec.</td>
<td>- 0.4</td>
<td>+ 0.1</td>
<td>0</td>
<td>- 0.5</td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. - March</td>
<td>+ 5.0</td>
<td>+ 2.8</td>
<td>0</td>
<td>+ 2.2</td>
</tr>
<tr>
<td>April - Sept.</td>
<td>- 6.6</td>
<td>- 4.0</td>
<td>- 1.8</td>
<td>- 0.8</td>
</tr>
<tr>
<td>October</td>
<td>+ 1.1</td>
<td>+ 0.8</td>
<td>0</td>
<td>+ 0.3</td>
</tr>
<tr>
<td>Nov. - Dec.</td>
<td>- 1.6</td>
<td>- 0.2</td>
<td>0</td>
<td>- 1.4</td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan.</td>
<td>+ 0.1</td>
<td>+ 0.1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Feb. - March</td>
<td>+ 9.7</td>
<td>+ 1.6</td>
<td>+ 8.8</td>
<td>- 0.7</td>
</tr>
<tr>
<td>April - June</td>
<td>- 3.6</td>
<td>- 0.6</td>
<td>- 1.4</td>
<td>- 1.6</td>
</tr>
<tr>
<td>July - mid Oct.</td>
<td>+ 6.7</td>
<td>+ 0.8</td>
<td>+ 8.0</td>
<td>- 2.1</td>
</tr>
<tr>
<td>mid Oct. - Dec.</td>
<td>- 4.1</td>
<td>+ 0.4</td>
<td>- 3.9</td>
<td>- 0.6</td>
</tr>
<tr>
<td>1977</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. - June</td>
<td>- 0.8</td>
<td>+ 0.7</td>
<td>- 1.5</td>
<td>0</td>
</tr>
<tr>
<td>July</td>
<td>+ 2.0</td>
<td>+ 1.4</td>
<td>0</td>
<td>+ 0.6</td>
</tr>
<tr>
<td>Aug. - Sept.</td>
<td>- 2.0</td>
<td>- 0.1</td>
<td>- 0.3</td>
<td>- 1.6</td>
</tr>
<tr>
<td>Oct. - Dec.</td>
<td>+11.3</td>
<td>+ 9.3</td>
<td>+ 3.1</td>
<td>- 1.1</td>
</tr>
<tr>
<td>1978</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Jan. - mid Jan.</td>
<td>+ 3.0</td>
<td>+ 2.5</td>
<td>+ 0.3</td>
<td>+ 0.1</td>
</tr>
<tr>
<td>mid Jan. - mid Feb.</td>
<td>- 2.0</td>
<td>+ 1.0</td>
<td>- 0.9</td>
<td>- 2.1</td>
</tr>
<tr>
<td>mid Feb. - 31 March</td>
<td>+ 3.5</td>
<td>+ 4.4</td>
<td>- 0.1</td>
<td>- 0.7</td>
</tr>
<tr>
<td>April - June</td>
<td>- 4.1</td>
<td>- 1.5</td>
<td>- 0.1</td>
<td>- 2.5</td>
</tr>
<tr>
<td>July - mid Oct.</td>
<td>+12.8</td>
<td>+ 1.8</td>
<td>+10.1</td>
<td>+ 0.9</td>
</tr>
<tr>
<td>mid Oct. - Dec.</td>
<td>+ 7.3</td>
<td>+16.0</td>
<td>- 1.1</td>
<td>- 7.6</td>
</tr>
<tr>
<td>Period</td>
<td>Changes in the Net Foreign Position, Total</td>
<td>Caused by interventions in the DM/dollar market</td>
<td>Caused by &quot;snake&quot; or EMS</td>
<td>Caused by other foreign exchange movements</td>
</tr>
<tr>
<td>---------------------</td>
<td>-------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>--------------------------</td>
<td>--------------------------------------------</td>
</tr>
<tr>
<td>1979</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Jan. - 12 March</td>
<td>- 6.9</td>
<td>- 2.2</td>
<td>- 1.3</td>
<td>- 3.4</td>
</tr>
<tr>
<td>13 March - 31 March</td>
<td>- 3.0</td>
<td>- 1.3</td>
<td>- 0.5</td>
<td>- 1.2</td>
</tr>
<tr>
<td>April</td>
<td>- 1.7</td>
<td>- 6.4</td>
<td>- 0.1</td>
<td>+ 4.8</td>
</tr>
<tr>
<td>1 May - 13 June</td>
<td>- 4.5</td>
<td>- 4.1</td>
<td>+ 2.3</td>
<td>- 2.7</td>
</tr>
<tr>
<td>14 June - 23 Sept.</td>
<td>+ 15.1</td>
<td>+ 18.6</td>
<td>+ 8.8</td>
<td>- 12.3</td>
</tr>
<tr>
<td>24 Sept. - 6 Oct.</td>
<td>+ 2.8</td>
<td>+ 2.4</td>
<td>0</td>
<td>+ 0.4</td>
</tr>
<tr>
<td>8 Oct. - 31 Dec.</td>
<td>- 7.0</td>
<td>+ 0.4</td>
<td>- 1.1</td>
<td>- 6.3</td>
</tr>
<tr>
<td>1980</td>
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<td></td>
</tr>
<tr>
<td>1 Jan. - 8 April</td>
<td>- 14.4</td>
<td>- 15.4</td>
<td>- 3.9</td>
<td>+ 4.9</td>
</tr>
<tr>
<td>9 April - 9 July</td>
<td>+ 0.5</td>
<td>+ 6.6</td>
<td>+ 0.1</td>
<td>- 6.2</td>
</tr>
<tr>
<td>10 July - 7 Nov.</td>
<td>- 10.6</td>
<td>- 5.9</td>
<td>- 6.6</td>
<td>+ 1.9</td>
</tr>
<tr>
<td>10 Nov. - 31 Dec.</td>
<td>- 2.6</td>
<td>- 3.6</td>
<td>- 0.1</td>
<td>+ 1.1</td>
</tr>
<tr>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Jan. - 19 Feb.</td>
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<td>- 4.7</td>
<td>- 1.6</td>
<td>+ 1.5</td>
</tr>
<tr>
<td>20 Feb. - 10 Aug.</td>
<td>+ 10.1</td>
<td>- 12.5</td>
<td>+ 20.8</td>
<td>+ 1.7</td>
</tr>
<tr>
<td>11 Aug. - 2 Sept.</td>
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<td>- 0.4</td>
<td>+ 1.2</td>
<td>- 0.2</td>
</tr>
<tr>
<td>5 Sept. - 31 Sept.</td>
<td>- 8.2</td>
<td>- 4.0</td>
<td>- 5.4</td>
<td>+ 1.2</td>
</tr>
<tr>
<td>1982</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. - Feb.</td>
<td>- 2.1</td>
<td>- 1.5</td>
<td>- 0.6</td>
<td>0</td>
</tr>
<tr>
<td>March</td>
<td>+ 1.3</td>
<td>- 0.5</td>
<td>+ 0.9</td>
<td>+ 0.9</td>
</tr>
<tr>
<td>April - mid June</td>
<td>+ 2.7</td>
<td>- 0.8</td>
<td>+ 3.5</td>
<td>0</td>
</tr>
<tr>
<td>mid June - Dec.</td>
<td>+ 1.3</td>
<td>- 3.8</td>
<td>- 0.2</td>
<td>+ 5.3</td>
</tr>
<tr>
<td>1983</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. - mid March</td>
<td>+ 17.1</td>
<td>+ 0.4</td>
<td>+ 12.6</td>
<td>+ 4.1</td>
</tr>
<tr>
<td>mid March - end March</td>
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<td>0</td>
<td>- 7.8</td>
<td>+ 0.7</td>
</tr>
<tr>
<td>April 1973 - March 1983</td>
<td>+ 20.9</td>
<td>- 10.4</td>
<td>+ 47.8</td>
<td>- 16.6</td>
</tr>
</tbody>
</table>

Table 3: Key Data on Economic Trends in the United States, 1970–1983

<table>
<thead>
<tr>
<th>Year</th>
<th>Economic growth GNP at constant prices, % change from prior year</th>
<th>Inflation CPI, % change from prior year</th>
<th>Unemployment % of total civilian workforce</th>
<th>Balance of Payments balance on current account, billions of US dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>-0.2</td>
<td>5.9</td>
<td>4.9</td>
<td>2.3</td>
</tr>
<tr>
<td>1971</td>
<td>3.4</td>
<td>4.3</td>
<td>5.9</td>
<td>-1.4</td>
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<tr>
<td>1972</td>
<td>5.7</td>
<td>3.3</td>
<td>5.6</td>
<td>-5.8</td>
</tr>
<tr>
<td>1973</td>
<td>5.8</td>
<td>6.2</td>
<td>4.9</td>
<td>7.1</td>
</tr>
<tr>
<td>1974</td>
<td>-0.6</td>
<td>11.0</td>
<td>5.6</td>
<td>2.1</td>
</tr>
<tr>
<td>1975</td>
<td>-1.1</td>
<td>9.1</td>
<td>8.5</td>
<td>18.3</td>
</tr>
<tr>
<td>1976</td>
<td>5.4</td>
<td>5.8</td>
<td>7.7</td>
<td>4.2</td>
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<td>7.0</td>
<td>-14.5</td>
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<td>7.7</td>
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<td>-15.4</td>
</tr>
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<td>11.3</td>
<td>5.8</td>
<td>-1.0</td>
</tr>
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<td>13.5</td>
<td>7.0</td>
<td>0.4</td>
</tr>
<tr>
<td>1981</td>
<td>2.6</td>
<td>10.4</td>
<td>7.5</td>
<td>4.6</td>
</tr>
<tr>
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<td>-2.1</td>
<td>6.2</td>
<td>9.5</td>
<td>-11.2</td>
</tr>
<tr>
<td>1983</td>
<td>3.7</td>
<td>3.2</td>
<td>9.5</td>
<td>-40.8</td>
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</table>

Source: Economic Report of the President, U.S. Department of Commerce
Table 4: Key Data on Economic Trends in Germany, 1970 - 1983

<table>
<thead>
<tr>
<th>Year</th>
<th>Economic growth GNP at constant prices, % change from prior year</th>
<th>Inflation CPI, % change from prior year</th>
<th>Unemployment % of total labour force</th>
<th>Balance of Payments balance on current account, billions of DM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>5.8</td>
<td>3.4</td>
<td>0.6</td>
<td>3.2</td>
</tr>
<tr>
<td>1971</td>
<td>2.7</td>
<td>5.3</td>
<td>0.7</td>
<td>3.1</td>
</tr>
<tr>
<td>1972</td>
<td>3.0</td>
<td>5.5</td>
<td>0.9</td>
<td>2.5</td>
</tr>
<tr>
<td>1973</td>
<td>5.3</td>
<td>6.9</td>
<td>1.0</td>
<td>11.5</td>
</tr>
<tr>
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<td>7.0</td>
<td>2.2</td>
<td>26.6</td>
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<td>1975</td>
<td>-1.6</td>
<td>6.0</td>
<td>4.0</td>
<td>9.9</td>
</tr>
<tr>
<td>1976</td>
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<td>1977</td>
<td>2.8</td>
<td>3.7</td>
<td>3.9</td>
<td>9.5</td>
</tr>
<tr>
<td>1978</td>
<td>3.5</td>
<td>2.7</td>
<td>3.8</td>
<td>18.1</td>
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<td>1979</td>
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<td>4.1</td>
<td>3.3</td>
<td>-11.1</td>
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<tr>
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<td>3.3</td>
<td>-28.6</td>
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<td>1981</td>
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<tr>
<td>1982</td>
<td>-1.1</td>
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<td>6.7</td>
<td>8.7</td>
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<tr>
<td>1983</td>
<td>1.3</td>
<td>3.0</td>
<td>8.1</td>
<td>10.1</td>
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Source: Deutsche Bundesbank, Annual Reports