'The crisis of the floating mark', from 30 jours d'Europe

Caption: In the June 1971 issue of the monthly publication 30 jours d'Europe, Jean Lecerf comments on the reactions of the European partners in Germany following the decision by the West German Government to allow the mark to float.

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The crisis of the floating mark

by Jean Lecerf

A dramatic episode in European history

Since the revaluation of the mark in late 1969, following the French devaluation in the summer, the monetary history of Europe and the world had been calm. Then, suddenly, things became critical.

The specialists were following the development of American budgetary and monetary policy with interest. After a sharp slamming on the brakes that had forced interest rates to soar, the American authorities had opted for the easiest routes to monetary expansion, leading to a no less spectacular fall in rates. Eurodollars had given something of a boost to the movement, attracted by high yields, first to the United States to the point where European funds almost dried up, and then back to Europe to the point where the central banks were submerged in liquidity.

Someone in Brussels had been closely observing this process for some months — Mr Raymond Barre, Vice-President of the European Commission. He noted the discomfort of the European countries, particularly Germany, which needed high interest rates, well above those in the United States, to combat rising wages and production costs. These high rates attracted capital, however, namely the dollars created in too much abundance by American monetary policy and, perhaps, also by the investments made by European central banks on the eurodollar market.

The situation was nearing saturation point. In a speech to the European Parliament, Mr Barre suggested that the European countries would have to react together against the dollar invasion.

On 28 April, the Ministers of Finance came together in Hamburg for their quarterly meeting, the first meeting since the plan for monetary union had been adopted. Mr Schiller invited them to dinner where he would make an important announcement on an unspecified matter. Mr Barre was to fly that very evening to the United States, where he was awaited by an audience of leading bankers and senior officials responsible for American monetary policy.

That evening, Mr Schiller talked about the consequences of the influx of dollars, which was becoming intolerable because it was converting the purchasing power created immoderately by the American authorities into purchasing power in Germany. He prepared his colleagues for the idea of a floating mark, which left them perplexed and envisaging all sorts of possibilities. Mr Giscard d'Estaing was strongly opposed to the idea and spoke of revaluing the price of gold, which would also mean devaluing the dollar. Reports of this conversation leaked into the press, and prices on the gold market rose.

240 million dollars in 40 minutes

A few days later, the opinion was published of a group of German economic institutes that advocated a floating exchange rate for the mark. Speculation was rife. Capital inflows into Germany actually reached a thousand million dollars in one day. On the same day, 240 million dollars inundated the Central Bank of the Netherlands *in 40 minutes*. Belgium, Switzerland and Austria were also invaded, and their foreign exchange markets were closed in an attempt to tackle the emergency.

On 6 May, however, Mr Giscard d'Estaing kept the French market open. The pressure it was coming under was much less intense because capital that entered France had to have exchange control authorisation before it could leave, something which deterred speculators.

The markets could be closed only for a few days, because a huge volume of payments of all kinds passes through them. Accordingly, a decision had to be taken quickly.

Mr Schiller suggested that the mark should be floated. What does this mean? Exchange rates remain fixed because, when free market rates differ from the official rate by more than the amount that international agreements allow, the central bank intervenes, which means that it buys or sells enough of its own currency for the exchange rate to return to normal. The result is that, in the event of an influx of dollars, the Bundesbank buys all those presented, without limit. In return, it is obliged to print marks, which, like a blast of oxygen, sets off an explosion in prices.

The German plan

The fact is that ‘floating’ the mark, which is, moreover, contrary to International Monetary Fund agreements, means that the Bundesbank no longer has to intervene on the market, leaving buyers and sellers face-to-face, even if prices deviate from the official rate. People who buy at a very high price therefore run the risk of losing money if prices fall, whereas, with fixed exchange rates, and with regard to a currency which is unlikely to be devalued but which may be revalued, the buyer may well make a profit rather than a loss. Since, in Germany, buyers also benefit from a rate of interest well above what they would obtain in their own country, the temptation is considerable. And since there is no risk, huge purchases are made without security. The floating mark, on the other hand, obliges speculators to take a risk and allows the Bundesbank not to change dollars if it does not wish to do so.

However, France and the Commission, closely attached to fixed parities, were very much against this system. After the autumn 1969 crisis, Mr Barre fought to get the Ministers of Finance to issue a formal declaration in favour of fixed exchange rates. This was because, as we shall see, the very idea of a common market and the common agricultural policy in a customs union that does not have a common currency requires fixed parities between Member States’ currencies. These markets cannot be kept open if the whims of the foreign exchange markets upset relations between prices in one country and another at any time.

Mr Schiller managed to bring the German Government as a whole round to his idea, but it did not put its decisions on hold. Like the other members, as part of economic and monetary union, it undertook to consult its European partners before making any change in the parity of its currency. What is more, Mr Schiller would like to make the floating of his currency a concerted European operation.

The Council of Ministers of the ‘Six’ therefore had to be convened rapidly. Mr Giscard d’Estaing, who was to chair the meeting, was in Morocco. The Ministers finally met in Brussels, on the 15th floor of the Charlemagne building in rue de la Loi, on Saturday 9 May, when Mr Schiller tabled his three-point plan:

(1) For a maximum period and within pre-established limits, the Member States of the Common Market would jointly let their exchange rates float with the dollar.

(2) They would take measures to ensure that their currencies did not diverge from each other by more than 0.75 % above or below the official exchange rate. In other words, this meant that, in an economic climate like the one that prevailed, the Bundesbank, which would not buy any more dollars, would undertake to buy lire or francs if those currencies tended to stray too much from the price of the mark. This would have a negative impact on the rate of exchange of the German currency and would ease pressure on the currency purchased.

(3) On 15 June, the date envisaged in Hamburg for the first tightening of the fluctuation bands between the currencies of the ‘Six’ in order to initiate economic and monetary union (0.60 % instead of 0.75 % above or below par), the operation would be carried out as planned.

For its part, France supported the Commission’s plan, which was based on maintaining current exchange rates while introducing foreign exchange control and a dual market for the dollar, which would make it possible to retain fixed exchange rates for commercial transactions and deny capital the benefit of official rates supported by the central banks. In addition a whole range of measures, particularly raising the rate for the mandatory reserves held by banks, abolishing interest paid on foreign accounts, measures to discourage loans abroad, etc. would put a brake on inflows of dollars.

The market economy rather than interventionism

What were the advantages and dangers of each plan?

Mr Schiller stressed that his plan would give Europe the *monetary personality* that it wished to acquire little by little. No one would dispute this. The five currencies would have appeared to be united by narrow fluctuation bands while they would not, at least for the period of the flotation, have a fixed connection with the other currencies. Meanwhile, as far as can be ascertained in the absence of any critical study of the project, it would have led to a kind of pooling of foreign exchange reserves, which the Germans had nevertheless always mistrusted. The links of economic union would have had to be tightened. Finally, it would stop the inflow of dollars into Europe, soak up imported inflation at source and oblige the United States to find other means of financing its deficit.

This project was given a poor reception, however. The criticisms were not aired in public, but we shall try to determine the major issues, at the risk of having to amend the analysis when they have been clarified.

The German project allowed the Common Market to function, but it ran the risk of jeopardising the position of currencies which, like the French franc or the Italian lira, did not need to be revalued, either in the form of fixed or floating parities. The French Ministry of Finance had no wish to get into debt with the Germans in order to support an operation that they had not wanted. The global balance of the Common Market did not justify a revaluation, either at a fixed or a floating rate.

Secondly, the current real fluctuation band between the European currencies is very weak: they are all close to the ceiling rate in relation to the dollar, like the pack in a cycle race who are all held back by the same lorry that they are unable to overtake. With floating exchange rates, each currency would go at its own pace, the fastest would leave the slowest behind, and fluctuation bands would probably become much broader, something which would upset the Common Market.

Finally, some people claimed that this operation would give the mark a privileged position, but this remains to be seen. Generally speaking, those who, in certain circumstances, undertake to pay off other people's deficits, even by means of loans, are not in a privileged position, and the Germans have always dreaded this. Dollar imperialism involves the opposite operation: having one's deficit financed by others.

Perhaps it was just a matter of style. The Germans announced, with more clarity than diplomacy, that, as the agreements currently stood, they were the sole masters of their currency, and that did not make it any easier to consider their proposals …

Since no document like Mr Schiller's had been had been distributed, it is more difficult to examine the Commission proposal. Its advantage was that it maintained current parities and avoided the upheavals in the Common Market which any change in parity would cause, and it also prompted the Community to decide collectively on the measures that would allow it to avoid being inundated by an influx of dollars.

The Germans criticised this plan for committing them to a command economy of which — because they preferred the market economy — they were suspicious because it would impose all kinds of financial difficulties and formalities upon manufacturers and traders. Finally, they quite rightly observed that it was always very difficult to distinguish commercial transactions from movements of capital and that speculators knew how to make the best of this type of grey area. For multinationals, and for all those who are engaged in foreign trade, a substantial part of 'speculation' merely involves moving, one or two weeks earlier or later, funds that would be exchanged anyway and which are connected to a specific commercial operation.

'Understanding' of the 'Six' and French reaction

The discussions went on until well after dawn. The TV stations filmed some journalists dozing, some writing, tables overloaded with empty beer bottles, and a few evening gowns that had gone from doing the jitterbug at the Common Market ball to observing monetary phenomena with more or less attention.

An agreement was reached just before 7 a.m. The Germans had maintained their resolve to let their currency float, but they wanted a press release specifying that they were acting if not with the agreement, then at least with the 'understanding' of their partners.

The latter had agreed to sign the document only in return for amendments intended to limit very strictly the room for manoeuvre of countries that 'would broaden their fluctuation bands'. The 'Six' jointly reasserted that there was no reason to change current parities, specified that it had to be for a limited period, anticipated the joint determination, before 1 July, of a range of measures inspired by Mr Barre's project to *discourage excessive inflows of capital and neutralise their effects on the internal monetary situation*, and, finally, prohibited any unilateral measures relating to agriculture.

A few hours later, the Germans and the Dutch decided to allow their currency to float, while the Swiss revalued by 7 %.

When the foreign exchange market reopened on Monday, 10 May, the mark had revalued by around 4 % and the Dutch guilder by around 2 %. On the following days, the margin was weaker.

At the Mont des Arts in Brussels that day, the Ministers of Foreign Affairs finalised their common position for the following day's negotiations with the British. In a closed meeting with their Finance Ministry colleagues, they were about to discuss the problem of sterling when Mr Giscard d'Estaing declared: *The French Government believes that it is pointless to take part in the expert discussions on the establishment of economic and monetary union as long as the currencies of the Common Market countries float in relation to each other. It believes that this work should be resumed as soon as the Common Market countries have restored mutual monetary solidarity*.

Will the expert discussions seeking to bring the budgets into line, which had to be done that year in accordance with a new procedure and as part of economic and monetary union, be postponed and, if the flotation continues, for how long?

Some people took the view that this act was of rather limited significance that reminded them — though not to the same extent, of course — of the 'empty chair' policy from 1965. Others hoped that the pressure would hasten a return to a system of fixed exchange rates at the old parities. They did not feel that it was advisable to begin economic and monetary union in an unstable framework.

The consequences for the Common Market

The Belgian Government held a very lengthy meeting on Monday night. The Dutch had also asked them to float their currency so as not to upset the balance of prices within the Benelux. The intensity of the speculation and the inflationary impact that the revaluation of the mark had had there in 1969, which they had not followed, hardly left them any choice, but they would have liked not to have been alone.

The Belgians, meanwhile, were less affected by speculation. They could in addition filter it out, since they have had a dual foreign exchange market for some time, the official rate being guaranteed only for commercial transactions. The system works well. Revaluation would have been a handicap to trade with France.

It can therefore be seen how trade is disrupted when currencies are dissociated from each other. Producers in countries whose currency remains weak benefit when they sell their products because their prices in foreign currency fall. Pressure from foreign exporters eases. Meanwhile, people whose currency is appreciating feel they are disadvantaged. For them, it seems that they are having to pay customs duty, and they are tempted to claim one in their turn. This causes unrest in the Common Market.

And what about agriculture? This is even worse, since prices are fixed jointly and are guaranteed by a common mechanism. If the mark were worth 4 % more, the French would have a very great advantage on the German market. In 1969, German farmers secured compensatory rates on imports and subsidies for exports while the mark floated. They have asked for even more this time.

During a long marathon from Tuesday to Wednesday, the Ministers of Agriculture finally reached agreement on a similar system of compensatory duties.

The Germans would want them to apply even if the mark were revalued by only 1.5 %. The Commission proposal was retained: compensation will come into play at the real average rate, but only from 2.5 %. On the basis of a report from the Commission, the Council will review the situation on a monthly basis. This seemed preferable to setting a date for the end of the support system, so as to leave speculators in the dark.

One of the major problems was to ascertain whether it would be possible to avoid major speculation on agricultural products. In 1969, large quantities of wheat went from France to Germany because of exchange rate differences. Some people are skilled at constructing complex and profitable circuits starting on the basis of minute differences …

Towards a difficult period

All in all, a difficult period is imminent.

It will be difficult for the general Common Market, which will be divided more or less into several price zones that will hinder the fluidity of trade. It will be difficult for the agricultural Common Market, where subsidies and customs duties will have to be temporarily restored. It will be difficult for the European Commission, which will have to alleviate these disadvantages as best it can and finalise an effective system of protection against the invasion of dollars, other than one whose price is monetary uncertainty. It will be difficult for Germany, with its exporters hampered by the appreciation of the mark and by the speculation which is still to be feared on exchange rate trends, and on the return, easy or not or possible or not, to the former parities.

It will also, perhaps, be a difficult period for the United States, since the origin of the crisis is one of the mechanisms that allowed it to finance the enormous deficit in its balance of payments. It is, in fact, facing something of a revolt among its debtors. The problem will not arise immediately, since the recent speculation has eased the surplus of dollars by turning them into a European currency, but it will not be long before it poses new problems in more urgent terms.

The fever has abated. Provisional remedies have been adopted. The problem remains. To coin a phrase used by Mr Jean-François Deniau, Member of the Commission, is it ‘a bout of fever’ or ‘a chronic disease’? It will not be long before we know.

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