The implementation of the first stage against a backdrop of European and international monetary difficulties

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The implementation of the first stage against a backdrop of European and international monetary difficulties [1]

In the spring of 1971, given the overvaluation of the US dollar, the international monetary climate significantly deteriorated [2] with a substantial impact on European countries. [3] ‘The deepening dollar crisis triggered a massive influx of capital into Europe, upsetting the economies of countries with “strong” currencies. This influx was such that on 5 May 1971 the Federal Republic of Germany suspended dollar operations, in line with the recommendations of its economic institutes. This was almost tantamount to a decision to allow the mark to float, which was of course contrary to the recently established principle that a system of floating exchange rates inside the Common Market was not compatible with our objectives.’ [4]

The Finance Ministers of the Six held an emergency meeting on 8–9 May. Faced with the massive stream of unwanted capital, which jeopardised the stability policy, the German Minister for the Economy, Karl Schiller, suggested two alternative solutions. The first was a joint revaluation of all the currencies in the Community. To achieve the desired result it was recommended that either the fixed exchange rate system be eliminated, or the exchange rates between European Community currencies be changed and controls be introduced on foreign exchange transfers. The second option was to leave the German mark to float freely in order to ‘allow the market itself to determine the appropriate parity relationship’. [5] The French Government could not accept this prospect, being very attached to the principle of fixed exchange rates and the introduction of controls on capital transfers. [6] Its Italian counterpart was concerned about the fragility of the Italian lira, whereas the Belgian Government was disappointed that the two-tier dollar market represented a step away from the instrument advocated by the European Commission. In view of the close links between the Dutch and West German currencies, allowing the mark to float would have entailed doing the same for the guilder. In this context, Pierre Werner and Baron Snoy et d’Oppuers, his opposite number at the Belgian Finance Ministry, discussed the possibility of doing the same for the Belgian franc. But they both feared that if the parity between Benelux currencies was allowed to vary, it could undermine the smooth workings of this union, which was founded on a sound monetary basis. The Dutch, sharing these concerns, agreed to maintain, within Benelux, the system of restricted margins planned for the Six, with variation on either side of a par value limited to 1.5 %.

The British authorities made no official comment on the Community’s monetary worries. But a long-term delay in efforts to achieve economic and monetary integration suited some British interests. The German decision to allow the mark to float was a serious blow to the common agricultural policy, to which the United Kingdom was opposed. It also delayed monetary union, to which the City was hostile. The British, who advocated greater exchange rate flexibility, hoped that France’s relative isolation would soon enable such a solution to be adopted. As for the United States, it was only too happy to witness this European quarrel, [7] especially since this split in the European bloc gave it good reason to hope that it would be able to convince the IMF to adopt a flexible exchange rate system, thereby firmly establishing the pre-eminence of the dollar system.

When, on 5 May 1971, the West German Government decided to suspend trading in the mark, it seemed to throw doubt on the process of economic and monetary union. On 9 February 1971, the Finance Ministers of the Six had adopted the third medium-term economic policy programme, [8] of which one practical measure was to aim to reduce the fluctuation margins between the Member State currencies from 1.5 % to 1.2 % as from June 1971. The German authorities still hoped to restore fixed exchange rates very shortly, but given the persistent uncertainty surrounding the dollar, it became clear that the process would take longer than planned. [9] On 10 May [10] the German and Dutch Governments decided to stop defending the lower limit at which the dollar was pegged and allow their respective currencies to float. But this actually had the opposite of the intended effect; instead of a process of rapprochement, it led to a sort of fragmentation. [11]

In the midst of the international monetary crisis the Ecofin Council meeting on 12 May 1971 ended without decision having been reached on the continuation of economic and monetary union. On the same day the President-in-Office of the Ecofin Council, Valéry Giscard d'Estaing, explained to the National Assembly in Paris the measures the government planned to take to counter the European monetary crisis, affirming that '[…] we must uphold the spirit and the letter of the Bretton Woods Agreements, in other words return to a system of fixed exchange rates and maintain progress towards economic and monetary union.' [12] The considerable increase in international liquidities and the uncontrolled movement of large volumes of Eurodollars — boosted by speculation — were seen as the prime causes of the international monetary crisis.

At the beginning of the summer the US balance of payments deficit reached a dramatic level. On the open market the price of gold soared. On 15 August 1971, President Richard Nixon announced that the US Administration had unilaterally decided to suspend the convertibility of the dollar to gold. [13] It also introduced a temporary 10 % surtax on imports. The vulnerability of a fixed exchange rate system to speculation, together with the systematic failure of the international authorities, such as the IMF, to coordinate and act upon national policies, meant that Bretton Woods was ultimately doomed. [14] After 15 August 1971 it became imperative to frame a new international monetary order. Europe was caught off guard. '[…] Due to the delays in introducing a Community system we were technically ill equipped and badly prepared mentally to respond in good order.' [15]

It was in this context that the Ecofin Council met on 19 August 1971. Repeating the proposals that he had made back in May, Karl Schiller went even further, advocating that European currencies should be allowed to float against dollar, but in a concerted manner. He argued that to ward off speculative movements of capital all the EEC currencies should be more flexible in relation to the dollar. The circumstances ruled out, 'at least in the short term, a return to a system of fixed parities within narrow fluctuation margins'. [16] Italy and the Benelux countries shared this view. These three partners framed a plan [17] — presented by Belgian Finance Minister Baron Snoy et d'Oppuers — which involved allowing all the European currencies to float against the dollar, while maintaining the system of limited margins within the Community. [18] The other countries did not agree to this initiative.

France defended a different position, supporting the two-tier foreign exchange market. For the purposes of trade the official exchange rates should be maintained, whereas for financial dealings a joint floating system should be adopted. It also outlined plans to retain fixed parities thanks to foreign exchange controls. [19] Concluding his statement, the French Finance Minister, Valéry Giscard d'Estaing, affirmed the French view that it would be 'illusory to consider […] further European integration without fixed exchange rates between the currencies of Community Member States'. [20]

So the Community partners were deeply divided on what monetary policy should be adopted. Since they were unable to agree on a joint strategy, they preferred to act separately. 'That day the Community missed a fine opportunity to unify monetary policy and form a united front against the monetary disorder which had taken hold worldwide.' [21]

Between August and December 1971 the turmoil in international money markets continued unabated, but the positions of Community Member States gradually converged. The Six, backed by the British, exerted considerable pressure on the US Administration to consider devaluation of the dollar and the fixing of a new official price for gold. On 10 September 1971 the European Commission addressed a memorandum to the Council of Ministers detailing its views on the measures planned by Europe to cope with the American decision to suspend the convertibility of the dollar to gold. [22] On this basis, the Six succeeded on 13 September in setting forth a joint position on the dollar, centring on demands for devaluation of the US currency and an end to the surtax on imports. [23]

Since the beginning of the monetary crisis, the differences between France and Germany had become more evident. In an effort to establish a common line of conduct, the two partners initiated parallel talks at several levels. The German and French diplomatic archives show that between June and the end of November 1971, five diplomatic consultations were held, in which the question of EMU was at the top of the agenda. During this period, the two central banks were in regular contact to ensure that they were familiar with their reciprocal arrangements. Having prepared the ground, President Pompidou and Chancellor Brandt agreed, on 3–4 December, on an overall agreement based on a return to fixed exchange rates, which was nevertheless more flexible than the Bretton Woods system. Under this arrangement the dollar would be devalued, the franc would stay at its existing level, and the mark would be revalued. It was also possible that the fluctuation margins between European currencies would be reduced. [24]

The Community also maintained its diplomatic pressure on the United States through the Group of Ten. [25] At the start of the talks (in London on 14 September 1971), the Americans demanded revaluation of the other currencies, a lowering of trade barriers and more even distribution of the international defence budget, whereas the ministers of the other countries suggested unilateral devaluation of the dollar by raising the price of gold. At the second meeting (in Washington on 26 September 1971), the parties still disagreed. The United States seemed prepared to allow the crisis to continue because speculation was resulting in revaluation of the other currencies, which was in fact its principal aim. The third meeting (in Rome on 30 November–1 December 1971) saw the beginnings of a compromise. [26] In his memoirs Pierre Werner recalls the US Secretary of the Treasury, John Connally, raising the idea of realigning the various currencies, including a possible 10 % devaluation of the dollar.

On 13–14 December President Pompidou met President Nixon to present the joint position adopted by the Community partners. The two leaders agreed on a swift realignment of the various currencies through devaluation of the US dollar and revaluation of the other currencies. On this basis, European, American, Canadian and Japanese representatives met on 17–18 December at the Smithsonian Institute to seal the Smithsonian Agreement. [27] The signatories undertook to set new par values between their currencies and to provide for 2.25 % fluctuation margins on either side of the official authorised rates. [28] This, then, was the US ‘monetary tunnel’ through which the ‘European monetary snake’ [29] would soon be passing. In view of the fact that European currencies were pegged against the US dollar (inconvertible to gold), the Community found itself once again tied to a currency and an economy over which it had no control.

On the whole, the Smithsonian Agreement offered immediate temporary solutions to the monetary crisis, but it did nothing to solve the real, structural problems sapping the basis of the International Monetary System. The dollar, which suffered its first devaluation since the end of the Second World War, remained inconvertible to gold. The agreement made little attempt to address the lack of symmetry in the adjustment, the political choice of an internal balance to the detriment of external equilibrium, problems of liquidities and the lack of confidence among international economic players. The end of the Bretton Woods system and the pressing need to erect a new International Monetary System seemed imminent.

The lull which followed on the foreign exchange markets and the relative harmonisation of the position of the Six on reform of the International Monetary System enabled cooperation on monetary matters to resume within the Community. On 21 March 1972 the Council adopted a resolution to set in motion the first stage of the Werner Plan. [30] The central banks, which were called on to gradually narrow the fluctuation margins between the currencies of Member States, concluded the Basel Agreement, which established a system for narrowing the fluctuation margins between the

Community currencies, with intervention and short-term support mechanisms. This was the 'monetary snake', the first European attempt to stabilise exchange rates. The currencies of the six Member States which founded the original Community and those of the candidates for accession due to join the Community in January 1973 (the United Kingdom, Denmark and Ireland) joined this mechanism. The aim of the 'snake' was to limit exchange rate fluctuations by preventing the disparity at any one time between two EEC currencies from exceeding 2.25 %. This mechanism was associated with a 'tunnel', which set the limits for fluctuation against the dollar — which was highly unstable but remained the international reference currency. This limit could be as much as 4.5 % (twice the fluctuation limit between the European currencies). Beyond these limits (2.25 % and 4.5 %), the central bank of the country concerned had to intervene. The special rules for Benelux countries were maintained and came to be known as the 'worm in the snake'. [31] Subsequently, to shore up the 'monetary snake', the central banks created the very short term financing facility, which would become 'a genuine arrangement for mutual credit between the central banks'. [32]

[1] Unless otherwise indicated, the source of all the documents cited in this study is www.cvce.eu.

[2] In 1968 and 1969 the huge balance of payments deficit in the United States was funded by an unprecedented influx of short-term capital. Thanks to the Eurodollar market and extremely tight US monetary policy, the dollar credits brought into circulation by these deficits were held by private investors. They were consequently not presented for conversion on the foreign exchange markets. The two-tier gold system (established in March 1968 and maintaining dollar convertibility by force of law) had consequently not been put to the test. Central banks had no reason to ask the United States to convert dollars into gold. But the situation started to change in May 1970, when the US monetary authorities relaxed their grip on interest rates. American banks started considerably deleveraging on the Eurodollar market, where interest rates had fallen very low, below those in force in Europe itself. See Berger, Guy, 'Le conflit entre l'Europe et les États-Unis', in *Revue française de science politique*, 22nd year, No 2, 1972, pp. 348–356, in particular pp. 352–353. In contrast, West Germany had to cope with strong growth, forcing the Bundesbank to introduce high short-term interest rates. This attracted an influx of short-term capital, which in turn drove the value of the German mark up against the US dollar. To ensure that the mark remained within the fluctuation margins set by the Bretton Woods Agreements, the Bundesbank purchased $1 billion in the space of 40 minutes just before the markets closed on 5 May 1971! See Hetzel, Robert L., 'German Monetary History in the Second Half of the Twentieth Century: From the Deutsche Mark to the Euro', *Economic Quarterly — Federal Reserve Bank of Richmond*, Vol. 88/2, Spring 2002, pp. 29–64, particularly p. 40.

[3] See section 1.3, 'The economic and monetary environment at the end of the 1960s'.

[4] Speculation against the American dollar and in favour of the West German mark decided the Federal Government to close the foreign exchange market on 5 May 1971. The Netherlands and Belgium did the same. Werner, Pierre, *Itinéraires luxembourgeois et européens. Évolutions et souvenirs: 1945-1985*, 2 volumes, Éditions Saint-Paul, Luxembourg, 1992, Volume 2, p. 138

[5] *Betr.: Gegenwärtige wirtschaftspolitische Lage.* 6 May 1971. Internal Ministry of the Economy memorandum (Troll), W II 3, Az. 75-11-02-01, Helmut Schmidt's papers. *Archiv der sozialen Demokratie der Friedrich-Ebert-Stiftung*, Bonn, Vol. 8635

[6] A diplomatic memo dated 27 July 1971, drafted by the Cooperation Directorate of the Foreign Ministry and entitled *La nécessité d'une initiative européenne*, notes that 'the German Government is trying to take advantage of the latest monetary crisis to control (imported and domestic) inflation using free-market methods. By allowing the mark to float upwards, without any guidelines or time limit, Bonn is thwarting speculation and holding back growth. […] German economists have always maintained that economic and monetary union could only be founded on exchange rates which reflect the real economic forces at work. […] Bonn is afraid of having constantly to prop up the failing currencies of some of its partners.' Ministry of Foreign and European Affairs of the French Republic, EC Collection, Directorate for Economic and Financial Affairs, Economic Cooperation Department, PM series, Vol. 973 EMU, File PM 19.8. Diplomatic Archives, La Courneuve

[7] Ibid., reference to an open letter sent by a group of American economists to the Wirtschaftsforschungsinstitute (Economic Research Institute) congratulating it on having recommended that the mark should be allowed to float.
[8] 'Third medium-term economic policy programme', in Official Journal of the European Communities, Brussels, 01.03.1971, No L 49/5. (Document consulted on 10 October 2012.)

[9] See the letter from Brandt to Pompidou, dated 9 May 1971. Willy Brandt archives, Bundeskanzler Collection, Vol. 51, quoted by Wilkens, Andreas, 'Willy Brandt und die europäische Einigung', in *Die Bundesrepublik Deutschland und die europäische Einigung 1946–2000. Politische Akteure, gesellschaftliche Kräfte, internationale Erfahrungen*, König, Mareike; Schultz, Mathias (Ed), Franz Steiner Verlag, Stuttgart, 2004

[10] Pierre Werner noted this date in his memoirs, but other sources mention 9 May as the date of the decision by Germany, the Netherlands and Belgium to allow their currencies to float freely. See Kleps, Karlheinz, 'On the way to the next monetary crisis', in *Intereconomics*, No 4, 1972, p. 107
[11] See Albert, Michel, 'La désunion monétaire européenne', in *Revue française de science politique*, 22nd year, No 2, 1972, pp. 382–390

[12] Declaration by Valéry Giscard d'Estaing to the National Assembly, 12 May 1971, in *La politique étrangère de la France*. Texts and documents, edited by the French Foreign Ministry. First semester, October 1971. *La Documentation Française*, Paris, 1 January 1971 to 31 December 1972 series, pp. 162–167

[13] This meant suspending the convertibility of the dollar to gold, but also to other reserve currencies based on gold (such as special drawing rights, or SDRs, created by the International Monetary Fund in 1969 in response to the system's need for liquidity).
[14] See section 1.1, 'The international monetary context in the post-war period'.

[15] Werner, Pierre, *Itinéraires*, Vol. 2, p. 138. See also the interview with Raymond Barre, Vice-President of the European Commission in charge of economic and financial affairs, published by the Swiss business monthly, *Vision*, in which he set forth his proposals for putting an end to Europe's monetary difficulties. *Vision. Le magazine économique européen*, editors Christine Coville, Igor Gordevitch, Frank Norall, Jean Colson, chief editor Philippe Heymann. June 1971, No 7, Geneva, SEPEG. (Document consulted on 10 October 2012.)

[16] Minutes of the restricted session of the European Council of Ministers, Brussels, 19 August 1971. Historical Archives of the Deutsche Bundesbank, R/1869 d/71, B 330, Vol. 10851

[17] 'Proposition des délégations de Benelux. Avant-projet d'arrangement monétaire entre les membres de la Communauté économique européenne' [Proposal by the Benelux delegations. Preliminary draft for a monetary arrangement between the members of the European Economic Community], August 1971. See 'Système de régime de change en vigueur dans les pays du Benelux depuis le 23 août 1971. Communication de la représentation permanente de la Belgique à la Commission' [Exchange rate regime in force in the Benelux countries since 23 August 1971. Communication from the Belgian Permanent Representation to the Commission]. European Community, Secretariat of the Monetary Committee, Brussels, ref. OR II/506/71-F, 31 August 1971. In the Pierre Werner family archives, ref. PW 042, case entitled 'Union économique et monétaire. Mise en œuvre: 1971–1972' [Economic and monetary union. Implementation: 1971–1972]

[18] Faced with their partners' refusal to endorse this proposal, the Benelux countries decided to allow their currencies to float against the dollar, while maintaining the rate between one another within the ±1.5 % fluctuation margin. In fact this represented a miniature monetary snake *sui generis*. It should also be noted that the Belgian and Luxembourg francs were linked by a one-to-one exchange rate established as part of the monetary union between the two countries. The National Bank of Belgium acted as a central bank for the two countries. Belgian bank notes were legal tender in Luxembourg, in addition to a limited number of national bank notes which the Luxembourg authorities could issue.

[19] See Pompidou, Georges, *Entretiens et discours. Volume II: 1968–1974*, Plon, Paris, 1975, 321 p. Source: Communiqué issued by Georges Pompidou on the international monetary situation (Paris, 18 August 1971). (Document consulted on 10 October 2012.)

[20] Minutes of the restricted session of the European Council of Ministers, Brussels, 19 August 1971. Historical Archives of the Deutsche Bundesbank, R/1869 d/71, B 330, Vol. 10851

[21] Werner, Pierre, *Itinéraires*, Vol. 2, p. 141

[22] 'Memorandum from the Commission to the Council on the problems raised by the present monetary situation (10 September 1971).' In *Bulletin of the European Communities*, September–October 1971, No 9/10, Office for Official Publications of the European Communities, Luxembourg. (Document consulted on 10 October 2012.)

[23] See 'Comments by Mr Werner after the Council of Finance Ministers in Brussels'. Incoming diplomatic telegram, ref. No 87, Luxembourg, 14 September 1971. Ministry of Foreign and European Affairs of the French Republic, EC Collection, Directorate for Economic and Financial Affairs, Economic Cooperation Department, PM series, Vol. 979 EMU consultations, File PM 19.11. Diplomatic Archives, La Courneuve. For a broader presentation, see the press conference given by Georges Pompidou on 23 September 1971. In Pompidou, Georges, *Entretiens et discours*, Plon, Paris, 1968–1974, Volume II, 1975, pp. 38–47.

[24] During the talks between France and Germany, President Pompidou demanded substantial revaluation (6 %) of the mark. For his part, Brandt was concerned about the consequences for industrial exports of an excessive increase in the cost of the mark. See Bernard, Jean-René, 'Georges Pompidou et l'effondrement du système de Bretton Woods', in *La France et les institutions de Bretton Woods 1944–1994*. Symposium at Bercy, Paris on 30 June–1 July 1994. Comité pour l'histoire économique et financière de la France, 1998, pp. 121–125

[25] The Group of Ten, constituted in 1962, consisted of the government representatives of eight IMF members (Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom and the United States) and the central bank representatives of two others, Germany and Sweden. Switzerland (which was not yet a member of the IMF) joined in 1964, but the group continued to be known as the G-10. After the crisis which erupted on 15 August 1971, the G10 met three times, in London on 14 September, in Washington on 26 September (on the sidelines of the annual meeting of the IMF) and in Rome on 30 November–1 December 1971.

[26] See Nappi, Carmine, *La réforme du système monétaire international: une chronologie et interprétation des événements*. *L'Actualité économique*, Vol. 54, No 2, 1978, pp. 263–286. See Werner, Pierre, *Itinéraires*, Volume 2, p. 140.

[27] On 18 December 1971 the Group of Ten presented the main monetary measures approved in Washington by the ministers and governors of central banks of the ten countries participating in the General Arrangements to Borrow. Communiqué from the 'Group of Ten' (Washington, 18 December 1971), in *Bulletin of the European Communities*, January 1972, No 1, Luxembourg. (Document consulted on 10 October 2012.)

[28] The full agreement addressed the following points: removal of the 10 % surtax on a large share of US imports; increase in the price of gold from $35 to $38 an ounce, equivalent to an 8.57 % devaluation of the dollar; inconvertibility of the dollar to gold was maintained. The realignment of the other currencies, including the effect of the 8.57 % devaluation of the dollar, yielded the following gains in relation to the dollar: Swedish krone, 7.49 %; German mark, 13.58 %; Dutch guilder, 11.57 %; Belgian franc, 11.57 %; French franc, 8.57 %; Italian lira, 7.48 %; pound sterling, 8.57 %; and Japanese yen, 16.88 %. The IMF was tasked with establishing a new system by which member countries could allow their exchange rates to fluctuate within a margin of 2.25 % on either side of the central exchange rate resulting from this new realignment. The Americans were very pleased with what became known as the Smithsonian Agreement, having obtained a significant realignment of their main competitors' currencies in exchange for a slight reduction in the value of the dollar through a rise in the price of gold. It should be pointed out that this 'concession' was in fact very slight: although central banks could theoretically exchange $38 for an ounce of gold, in practice this was impossible because the US dollar

retained its inconvertibility to gold.

[29] See Communiqué from the 'Group of Ten', Washington, 18 December 1971, in *Bulletin of the European Communities*, January 1972, No 1, Luxembourg.

[30] 'Resolution of the Council on the achievement by stages of economic and monetary union in the Community (21 March 1972)', in Official Journal of the European Communities, C 38, Luxembourg, 18 April 1972, pp. 43–46. At the same time the Ecofin Council approved several legislative measures designed to check inflationary pressures inside the Community and counter increasingly frequent foreign exchange crises. (Document consulted on 10 October 2012.)

[31] The Council meeting on 6 March 1972 reached agreement on narrowing the margins. On 23 August 1971 the Benelux countries had introduced a system of tighter margins (1.5 % instead of 2.25 % in the subsequent Community-wide agreement). This system operated for some time alongside the snake, but with no close coordination of monetary policy between Belgium (also representing Luxembourg) and the Netherlands, it soon disappeared.

[32] See Scheller, Hanspeter, 'Le Comité des gouverneurs des banques centrales de la Communauté économique européenne et l'unification monétaire européenne', in *Histoire, économie & société*, 2011, Vol. 30, No 4, pp. 79–100