



MICHAEL G. RUKSTAD

## The Decline of the Dollar: 1978

In 1976, after almost four years of experience with floating rates of exchange among the major industrial nations, the International Monetary Fund sounded an optimistic note about the functioning of the world monetary system:

[T]he floating among major currencies has been characterized by some reduction in the amplitude of exchange-rate movements. . . . [This reflects] in part the fact that the disturbances in the global pattern of payments have been less severe than during the early period of floating rates; in part, however, they may represent an improvement in the ability of the market mechanism and official policies to cope with the realities of a more flexible exchange rate system.<sup>i</sup>

By early 1978, however, a depreciating dollar seemed to threaten that stability. From early 1977 until October 1978, the effective exchange rate (a weighted average of the exchange rates between the dollar and other currencies) declined by almost 13%. (See **Exhibit 6**.) Although news of the dollar's decline initially could be found only on the financial pages, not in the headlines, it was, in the words of one Carter administration official, "a very grim business."<sup>ii</sup> Policy makers were keenly aware of their limited experience with floating exchange rates. There were two questions they needed to answer if they were going to make the system work. First, why had the U.S. exchange rate declined? And second, what should the government do about it? The answers to these questions depended on the interpretation of the world's experience since the fixed rate system had first been established at the Bretton Woods, New Hampshire conference of 1944.

### Bretton Woods and Its Demise: 1944-1973

Under the Bretton Woods system of fixed exchange rates, which prevailed from 1944 through March 1973, crises had mounted from the early 1960s onward. The provisions of the Bretton Woods system allowed countries to devalue or revalue their currencies in order to correct "fundamental imbalances" in their external payments. Great Britain, for example, after several years of emergency measures to defend the pound sterling at \$2.80 in the face of serious payments deficits, devalued sterling by 14.3% to \$2.40 on November 18, 1967. In the next two years, speculators and investors sold French francs and bought German marks in large quantities, forcing France to devalue the franc in August 1969 by 11.1% and the Germans to follow suit with an upward revaluation of the mark by 9.2% two months later. (All devaluations and revaluations under Bretton Woods were relative to the dollar.)

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Research Associate Daniel Pope prepared this case under the supervision of Professor Michael G. Rukstad. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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The United States also took an active role in controlling the exchange rate of its currency. Faced with accelerating inflation, a balance of payments deficit which was to reach \$30 billion in 1971 and outstanding dollar liabilities to foreign governments and central banks of more than \$50 billion, President Richard Nixon took decisive action on August 15, 1971. Fearing that foreign holders of dollars would demand gold at the fixed price of \$35 an ounce, he announced that the United States would no longer allow foreign central banks and treasuries to trade their dollars for gold. This action directly undermined one of the basic principles of the Bretton Woods system. At the same time, Nixon also imposed a 10% surcharge on dutiable American imports (approximately half of total imports). This was akin to a partial devaluation of the dollar, because it raised the price of American purchases from abroad by 10%. Finally, the president instituted a 90-day wage and price freeze and subsequent controls aimed at slowing domestic inflation and improving international competitiveness of U.S. goods and services.

In the early 1970s, world economic leaders recognized the need for new international monetary arrangements; but they did not, for the most part, wish to abolish fixed exchange rates. In 1969, Undersecretary of the Treasury for Monetary Affairs Paul Volcker had described floating rates as popular “in academic circles, and that’s where they can stay.”<sup>iii</sup> Even the crisis of 1971 had not altered this opinion. Memories of the 1930s, when the fixed rates of the gold-exchange standard had fallen apart, haunted central bankers, finance ministers, and International Monetary Fund officials. In the 1930s, nations had competed in devaluing their currencies in order to take export markets from their competitors. At the same time, they had raised tariffs and other trade barriers, and these steps had stifled international trade and damaged the world economy. Between 1929 and 1933, the gold-exchange standard had been abandoned by 35 nations, including the U.K. and Japan in 1931 and the United States in 1933. Many other countries had imposed severe restraints on convertibility of their currencies.

The Nixon announcement of August 15, 1971 provoked fears that some of the travails of the 1930s might be repeated. Within days of Nixon’s speech, Pierre-Paul Schweitzer, managing director of the IMF, warned, “Unless prompt action is taken, the prospects before us is one of disorder and discrimination in currency and trade relationships which will seriously disrupt trade and undermine the system which served the world well . . . for a quarter of a century.”<sup>iv</sup>

Thus, in December 1971, finance ministers and central bank officials of the major industrial nations (the so-called Group of Ten) convened at the old Smithsonian Institution building in Washington, D.C. to work out the new exchange rate parities that almost all believed were needed. The conferees agreed that the United States would raise the dollar price of gold from \$35 to \$38 an ounce, which effectively devalued the dollar in terms of gold. Since a dollar would now purchase less gold, the existing gold reserves would cover more dollar liabilities. Japan, Germany and Switzerland consented to revalue their currencies significantly upward (which meant lowering the price of the dollar, and hence gold, in terms of their monies) while the British pound sterling and the French franc remained unchanged. Temporarily, the nations agreed to let currencies trade on financial markets at rates as much as 2.25% above and below the newly established parities. Fluctuations beyond that band would require government intervention. This would take the form of the central bank’s selling a currency which had appreciated too much or buying one which had fallen too far in value. President Nixon told the television cameras that the Smithsonian accord was “the most significant monetary agreement in the history of the world.”<sup>v</sup>

Despite the president’s hopes, the Smithsonian agreements lasted little more than a year. In January 1973, Nixon relaxed wage and price controls, and international monetary traders, fearing more rapid inflation in the United States, sold dollars and put their funds into nations with “strong” currencies—Japan, Germany, Switzerland and the Netherlands. During early February, in the space

of less than one week, the German Bundesbank purchased over \$5 billion to keep the dollar-mark relationship within the Smithsonian limits. Other nations' currency parities were also threatened by speculative flows. Recognizing that the Smithsonian parities were coming unglued, the Nixon administration sent Paul Volcker around the world to consult with finance ministers. Upon Volcker's return on February 12, 1973, Treasury Secretary George Shultz announced a 10% devaluation of the dollar. Meanwhile, most other members of the Group of Ten, led by Switzerland and Germany, gave up their efforts to maintain fixed exchange rates. They allowed their currencies to float, as Canada and the U.K. had already done during the previous year.

During this crisis, exchange markets became disorderly and were closed from March 1 through March 18, 1973. When they reopened on March 19, the non-Communist world's major currencies were all floating. Although most smaller nations continued to peg their currency either to the currency of their largest trading partner or to a weighted average of leading currencies, the majority of the world's trade was now carried on among nations with floating exchange rates. (See **Exhibit 1** for exchange rate practices.)

Economists in both the Keynesian and monetarist camps looked on floating rates as intrinsically healthy for the world's economy. Under a fixed rate system, they contended, nations had to subordinate domestic monetary policies to the maintenance of the pegged rates. Countries with payments deficits would find their monetary reserves shrinking, and surplus nations would face an influx of funds which might prove inflationary. A payments deficit might also require higher real interest rates at home to attract capital inflows, to cut back on demand for imports, and to lower the price of exports.\* With flexible rates, the academics said, the price of a nation's currency would adjust to eliminate surpluses and deficits on the international accounts, so that nations could, as they saw fit, employ discretionary monetary and fiscal policy to deal primarily with domestic concerns. Thus, it was believed that flexible rates could help to insulate a country from foreign economic shocks.

Academics might like floating rates. But for most policy makers in the early 1970s, such rates were "an inevitable evil for the time being," in the words of the French finance minister. They were necessary because national governments and central banks were unable to preserve fixed rates in the face of massive flows of speculative capital from one currency to another. From the 1950s onward, European nations had removed barriers to capital mobility. Meanwhile, the growth of the Eurocurrency market (which may have reached as much as \$150 billion by 1971) and of multinational corporations meant that large amounts of "hot money" were available to seek the currency of the nation where the highest return was available.

Policy makers viewed floating not as a permanent solution but rather as a temporary expedient. From 1972 through 1974, foreign ministers, central bank officials and their deputies met in the IMF Committee of Twenty to reconstitute the world's monetary system. Even as floating rates became the norm in the industrial world, the Committee of Twenty continued to assume that fixed rates were the goal of reform. Although "floating rates could provide a useful technique in particular situations," the "Committee recognized that exchange rates must be a matter for international concern and consultation and that in the reformed system, the exchange rate regime should remain based on stable but adjustable par values."<sup>vi</sup>

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\* See the earlier BGIE case, *The U.K. and the Gold Standard: 1925*.

## 1973-1976: The Initial Performance of Floating Rates

The economic experience of the mid-1970s was paradoxical. On the one hand, forces quite independent of the world monetary system made these years a stormy era. On the other, the experience of floating rates persuaded even some of the most steadfast proponents of fixed rates that the float was the best way to handle the shocks the world was undergoing. Summarizing the experience, Thomas D. Willett, director of international monetary research at the Treasury Department, concluded: "Under extremely trying circumstances, generalized floating has proven itself to be a sound foundation on which to base the future evolution of the international monetary system."<sup>vii</sup>

The shocks to the world economy during these years were many and disparate. Clearly, the single most important blow was the impact of petroleum shortages and the OPEC cartel. The fourfold rise in petroleum prices in late 1973 boosted consumer prices in oil-importing countries and functioned as a "tax" that reduced aggregate demand in these nations. If the industrialized world were to escape recession in the years following the OPEC price hikes of 1973, some means of restoring aggregate demand would have to be found. At the same time, the economies of the industrialized nations suffered a rapid rise in agricultural and raw material prices, which could be blamed on causes as varied as the disappearance of the anchovy from the Pacific Coast of South America (since these fish were used in high-protein animal feed) and the sale of large quantities of American wheat to the Soviet Union at below-market prices.

These "supply shocks" meant simultaneous pressures towards inflation and stagnation. With inflation in the final quarter of 1973 raging at 12% in the capitalist industrialized nations, few leaders were eager to pursue expansionary fiscal and monetary policies. By early 1974, real GNP in these nations had begun to slip, and by the spring of 1975 the world was experiencing the worst economic slump since the 1930s.

Despite these woes, the floating exchange rate system seemed to be performing reasonably well. Earlier fears of competitive depreciation of currencies and the imposition of protectionist measures proved largely unfounded. The OPEC financial surplus was recycled into investments in the oil-importing nations especially the developing nations. The trend in the mid-seventies seemed to be toward exchange rate stability. In particular, the dollar's behavior appeared reasonably satisfactory. The dollar did dip sharply in the summer of 1973, a time of rapid American inflation, uncertainty about the Watergate affair, and fears that the dollar was still overvalued. The United States and other nations intervened to support the dollar by purchasing it with other currencies, and its foreign exchange value rose markedly during the second half of 1973. It dipped and rose again in 1974 and 1975, but from late 1975 through the autumn 1977, its effective exchange rate remained in a narrow range, within a few percentage points of the level that had been set at the 1971 Smithsonian accords. (See **Exhibit 6**.) When corrected for relative price changes, to give "real" effective exchange rates (a measure of the competitiveness of American goods and services in export markets), the dollar appeared to be even more stable. According to some calculations, the real effective exchange rate at the end of 1977 was the same as it had been in March 1973.<sup>viii</sup> (Compare this with the real exchange rates in **Exhibit 4**.) Major improvements in the U.S. balance of payments had accompanied exchange rate calm. Less reliant on imported energy than its industrialized competitors, the United States actually attained a current account surplus each year from 1973 through 1976. (See **Exhibit 3**.)

Although the pound sterling had declined in value very rapidly in 1976, necessitating a large loan to the U.K. from the International Monetary Fund, the experience of most industrialized nations had been reasonably favorable. Fluctuations in exchange rates were becoming more moderate and were apparently fulfilling their prescribed function. When a nation's currency depreciated, its

international competitive position generally improved and its payments deficit shrank. Similarly, as strong currencies rose in value, their payments surpluses tended to diminish.

Nevertheless, some disquieting problems remained. The industrialized nations had plunged into the recession almost simultaneously, but they climbed out at different rates. The recovery in the United States was more vigorous than in Germany and Japan. American industrial production rose at a 6.9% annual rate between the fourth quarter of 1976 and the third quarter of 1977. Germany's industrial production increased at a rate of 1.2% during the same period. Japan's rate was also 1.2%. Indeed, the United States was the only major industrial nation to achieve its forecast rate of real GNP growth during 1977. (See **Exhibit 5**.) At the same time, American prices began to rise more rapidly (6.1% for the U.S. producer price index compared to 1.8% for German wholesale industrial prices and only 0.1% for Japan's wholesale price index).

Rapid American growth took its toll on the U.S. balance of payments. On the current account, imports increased faster than exports. The nation spent \$45 billion on imported petroleum in 1977; combined with a declining surplus on trade in manufactured goods, the oil bill helped put the current account \$15.3 billion in deficit. Almost equally important to the overall payments deficit was the negative flow of \$13.4 billion in private funds on the capital account as private investors and speculators transferred investments and deposits from dollars to other currencies. In order to finance this deficit, German, Japanese and OPEC official dollar holdings increased dramatically. (See **Exhibits 2 and 3**.)

## 1977-1978: The Decline of the Dollar

### A. Onset: "Benign Neglect"

The depreciation of the dollar at the beginning of the new Carter administration in 1977 was at first rather gradual. Until late 1977, the effective exchange rate of the dollar remained near or even above the level it had reached when generalized floating began in March 1973. The decline was not equal against all currencies. For example, the dollar appreciated 9.4% against the Canadian dollar and 34.8% against the pound sterling between March 1973 and the end of 1977. The decline of the dollar was, properly speaking, its decline against several currencies, notably the German mark, the Japanese yen and the Swiss franc. The dollar depreciated 25.5% against the mark, 10.5% against the yen and 37.9% against the Swiss franc from March 1973 to December 1977. (See **Exhibits 6 and 4**.)

To most American policy makers in 1977 and early 1978, this dollar decline was part of the solution, not the problem. Nevertheless, depreciation was not the administration's preferred response to sluggish world growth and the American payments imbalance. The favored method was known as the locomotive theory. First espoused by economists at the Brookings Institution and the Organization for Economic Cooperation and Development, the doctrine held that the world's strong economies (notably the United States, Germany and Japan) should adopt expansionary policies that would raise their growth rates and increase their demand for imports. This would, in turn, stimulate the weaker economies and accelerate world growth, pulling the world economy like a locomotive pulls a train. According to this account, the unwillingness of Japan and Germany to shoulder the burden of pulling the world economic train by stimulating their domestic spending was keeping their imports low, their current accounts in surplus and their currencies strong. If they continued to refuse to pull, the next best solution was to be found in exchange rate readjustment. A depreciating dollar would at least make American products more competitive in the world market; and more expensive marks and yen would correct the German and Japanese payments surpluses.

The Carter administration feared that Japanese officials were hindering the adjustment process by engaging in a “dirty” float. They were said to be intervening in foreign exchange markets: selling yen and buying dollars in order to keep the yen’s value from rising too far. They were doing this, said many critics, in order to protect Japanese export competitiveness. (See **Exhibit 3**.) Vice President Walter Mondale headed a trade delegation to Japan in January 1977 and allegedly complained about the dirty float. “We knew what the Japanese were doing, and we told them to knock it off,” said C. Fred Bergsten, an economist who accompanied Mondale.<sup>ix</sup> At a Paris meeting of the Organization for Economic Cooperation and Development (OECD) in June 1977, Secretary of the Treasury Michael Blumenthal announced that exchange rate adjustments should “play their appropriate role” in restoring economic equilibrium.

Statements like these in 1977 persuaded foreign exchange dealers that Blumenthal, on behalf of the Carter administration, was “talking down the dollar.” Europeans complained of the secretary’s “open mouth policy.” The top international money trader at the New York Federal Reserve later put it pungently: “Every few days some dumb bastard from Treasury would get up and say that the United States would not intervene to fix the value of the dollar, only to counter disorderly markets. When people heard that, the cry went up: ‘Sell the bucks,’”<sup>x</sup> Was Secretary Blumenthal really trying to drive the dollar down? (After he left office, Blumenthal protested that his words had been misinterpreted. All he had meant to say was that the United States favored flexible rates and would not intervene in currency markets in order to peg the dollar at a given level. “I never said that I wanted the dollar to decline,” he insisted.<sup>xi</sup>

As the dollar’s decline commenced, Federal Reserve Chairman Arthur F. Burns pledged to a House banking subcommittee that the United States would protect the integrity of its currency, both domestically and internationally. A brief rally followed Chairman Burns’ pronouncement in August 1977, but the dollar continued to decline. During the second half of 1977, the dollar lost 10.0% against the mark, 10.3% against the yen and 18.7% against the Swiss franc. But some officials and economists responded that these figures were misleading, since they measured not only the decline of the dollar, but also the general appreciation of these strong currencies. Looked at in another light, the dollar’s decline was less alarming. The “effective exchange rate” (a weighted average) dropped by only about 5% in the second half of 1977. (See **Exhibit 6**.)

In any case, the declining dollar did little to improve the U.S. balance of payments in the short term. The fourth quarter 1977 deficit on the current account was (seasonally adjusted) nearly \$7 billion, or close to half the entire year’s \$15.3 billion deficit. To advocates of the locomotive doctrine, it was galling that German and Japanese current account surpluses in 1977 almost matched the U.S. deficit. In the first quarter of 1978, the American current account was again in deficit by \$6.9 billion. (See **Exhibit 3**.)

Several reasons were offered to explain the failure of the current account balance to respond well to depreciation. As William Nordhaus of the Council of Economic Advisers told a Senate committee in June 1978, “Unfortunately, things got worse before they got better. This is the well-known ‘J-curve’ effect.” In the short run, import and export commitments are frequently unchangeable. With depreciation, it will take more dollars to pay for the same volume of imports while export revenues remain stable for the time being.<sup>xii</sup> Second, many American exports, especially to Japan, were foodstuffs and raw materials. Demand for these goods, officials pointed out, was often inelastic, so that declining prices in strong currency countries did not greatly stimulate sales. At the same time, Americans who bought Japanese cars, cameras or electronics equipment often had strong brand preferences. Even the rapid rise of the yen did not prevent Japanese auto sales in the United States from rising by 1%.<sup>xiii</sup>

Finally, as foreign bankers and officials repeatedly pointed out, the U.S. economy was overheated. U.S. growth rates outstripped those of its industrial trading partners, but so did inflation rates. For the United States, consumer prices increased at 6.6% from March 1977 to March 1978; the corresponding figures for Japan and Germany were 4.3% and 3.2%.

### *B. A Move Toward Activism*

In its January 1978 report to President Carter, the Council of Economic Advisers restated the administration's belief that flexible rates had worked well: "In summary, while exchange rate fluctuations sometimes have been undesirably large and are often unpleasant reminders about unsatisfactory aspects of underlying economic conditions, the evolution of the system of market-determined exchange rates has been a major achievement of this decade."<sup>xiv</sup> Moreover, the council argued, official intervention to alter exchange rates was ineffective and undesirable. Private traders, including many of the world's largest commercial banks, have far more foreign exchange at their disposal than do official agencies. When central banks intervene to counteract market trends, they rarely can do more than slow down—at a high cost—the underlying movement. Moreover, intervention to eliminate trends would generally be unwise, because it would retard the process of restoring payments balances that result from exchange rate adjustments.<sup>xv</sup> Intervention was proper to counteract short-run, "disorderly market conditions," not longer-term trends.

Yet even before the Council of Economic Advisers' cautions appeared in print, the Carter administration moved to a more active defense of the dollar's value. On January 4, 1978, the Treasury Department announced that it had obtained an \$2 billion "swap line" from the German Bundesbank. The new swap arrangement complemented over \$20 billion of existing swap lines between the Federal Reserve and other central banks. Under swap arrangements, nations have stand-by lines of credit in their partners' currencies. They can support their own currency by borrowing foreign money on these lines of credit and then selling the foreign exchange to purchase their own money.

That very afternoon of January 4, the Treasury, the Fed and foreign central banks jointly intervened to support the value of the dollar. (See **Exhibit 9**.) Even before the Fed could execute the intervention, the announcement itself had lowered the value of the mark by about four percent against the dollar. The dollar gained a full six percent against the Swiss franc. One American commercial bank official described the intervention as a "fundamental change in exchange policy," but a European official perceived it as merely a "bluff."<sup>xvi</sup>

Two days after the interventions began, the Federal Reserve raised its discount rate from 6% to 6.5% because, "The recent disorder in foreign exchange markets constitutes a threat to orderly expansion of the domestic and international economy." The increase would, it was hoped, cool off domestic inflation and improve the capital account of the balance of payments by attracting funds from abroad. But some observers worried that the cure was worse than the disease and that tighter money might mean economic recession at home. Arthur Okun, a respected economic adviser to Democratic presidents, said he was "surprised, disappointed, and very concerned" by the Fed's step.<sup>xvii</sup>

In foreign exchange markets such statements and reports of discord within the administration heightened doubts that the dollar's fall was over. Despite frequent official support during January, the dollar fell back somewhat from the levels it had reached on January 5, directly after the initial intervention. The decline continued during February and the first part of March 1978.

As the spring of 1978 approached, however, there was a wave of optimism. President Carter and Chancellor Helmut Schmidt both asserted that their nations' economic policies were being

harmonized. On March 13, the German Bundesbank placed another \$2 billion dollars worth of marks in the Fed's swap line, and the U.S. Treasury announced that it was prepared to acquire dollar support funds from the International Monetary Fund as well. In April, President Carter announced that the United States would sell 300,000 ounces of gold each month for the next year. Putting this gold on the market was designed to raise the value of dollars in terms of gold and, it was hoped, other currencies. The next month, the Fed tightened domestic credit another notch by raising the discount rate from  $6\frac{1}{2}$  % to 7%. In June, G. William Miller, who had recently been appointed chairman of the Fed's Board of Governors, addressed a businessmen's group in Zurich; he predicted that the worst of the dollar's troubles were past. Newspapers reported a generally favorable response from the audience. A few days later, the International Monetary Fund issued an optimistic forecast of the American balance of payments. Figures later showed that the second quarter's current account deficit was already shrinking. It was \$3.3 billion, less than half the first quarter's deficit. (See **Exhibit 3**.)

Nevertheless, in June 1978 the dollar slipped again from its springtime plateau. The weakening was particularly severe against the yen, whose price in dollars rose by more than eight percent in June alone. The economic summit meeting in Bonn in July was no help. Shortly before it convened, the head of Japan's Economic Planning Agency told reporters that there was "great disappointment that President Carter seems to be going to Bonn empty-handed," unwilling to offer assurances that the United States would reduce energy imports and lower inflation rates.<sup>xviii</sup> Americans pointed to a forecast that the Japanese current account surplus for 1978 would be a whopping \$18 billion, three times the official Japanese estimate. At the Bonn gatherings, the Germans pledged to introduce proposals in Parliament that would increase government spending to stimulate the economy. Japan promised to reduce its trade surplus within a year by increasing domestic demand and voluntarily restraining exports. But Prime Minister Fukuda, "stern-faced and tight-lipped," at a press conference, refused to say that these measures would really solve the surplus problem.<sup>xix</sup> Carter, for his part, could offer little; from a peak of 8.8 million barrels a day in 1977, the United States vowed to reduce daily oil imports by 2.5 million barrels by 1985. Foreign exchange markets reacted to the Bonn summit with disdain and the dollar continued to slide down.

By mid-August, 1978 signs of distress were mounting. Congressman Henry Reuss, chairman of the Joint Economic Committee, was grimly warning, "We must not panic."<sup>xx</sup> The influential Reuss, an unwavering supporter of floating rates since the early 1970s, was a voice who could not go unheeded. The next day, when President Carter expressed concern about the decline of the dollar during his news conference, one banker commented, "I thought he said nothing and he said it badly."<sup>xxi</sup> Accompanying the president's words, however, were actions to support the dollar. Official gold sales were tripled. The Fed raised the discount rate in July and boosted it again in August to  $7\frac{3}{4}$  % "in view of recent disorderly conditions in foreign exchange markets."<sup>xxii</sup> Both the Bundesbank and the Fed intervened several times in August to support the dollar and hold down the value of the mark. (See **Exhibit 9**.) Nevertheless, throughout the second half of the month the mark cost more than 50¢, an important symbol of the weakening dollar.

American policy makers in the late summer found the situation frustrating. U.S. interest rates were up, forecasts of vigorous growth had been abandoned, and the real growth rate was predicted at a modest 3 to  $3\frac{1}{2}$  %. The Senate passed an energy program in September. Carter and Blumenthal were discussing ways to hold the federal budget deficit down. What else could they do? According to the *Wall Street Journal*, the solution was simple and obvious:

... [S]urely the price of the dollar depends on the supply and demand for the dollar. It declines because the Federal Reserve supplies more dollars than are demanded. For all the talk of swap networks, gold sales and so on, the *only* way the decline will be reversed is for the Fed to constrict the supply of dollars.<sup>xxiii</sup> (Compare **Exhibit 3**.)

*The Economist*, however, saw things differently. Too much monetary tightening could bring on an American recession, “a remedy as primitive as chopping off a foot to deal with an ingrown toenail.”<sup>xxiv</sup>

When governors of the International Monetary Fund and the World Bank convened in late September for their annual meeting in Washington their anger and distress were visible. Administration spokesmen had leaked word of the components of a new anti-inflation program, to be announced the next month, but this news failed to move the IMF and World Bank officials. Nor did the Fed’s increase of the discount rate to 8% on September 22 impress them. (The rate rose to 8<sup>1</sup>/<sub>2</sub>% on October 10.)

President Carter had adamantly opposed compulsory wage-price controls and had often pledged not to fight inflation by increasing unemployment. Indeed the Administration had succeeded in reducing unemployment from its record post-Depression high of 9% in March 1975 to 6% in October 1978. This was particularly remarkable since the growth rate of the labor force during 1977 and 1978 had been 3.1%—far above the 2.4% rate of the previous decade—forcing the Administration either to create an additional 1.4 million jobs or suffer an increase in the unemployment rate of 1.3%. The entry of the “baby-boom” generation and the increased participation by women in the labor force accounted for the increased number of job seekers.

The IMF and World Bank governors doubted Carter’s will or ability to control rising prices without drastic measures that would undoubtedly raise unemployment. “If you do only what we’ve read about,” one banker reportedly told Secretary Blumenthal, “the dollar will explode”—that is, it would depreciate violently.<sup>xxv</sup>

### C. October 1978: The Dollar Crisis

Soon after the IMF conference, Secretary Blumenthal instructed Anthony Solomon, under-secretary for monetary affairs, to list all options for defending the dollar. Blumenthal wanted a “strong package to really turn this thing around.”<sup>xxvi</sup> Blumenthal then worked to pressure President Carter to include in his anti-inflation plan a pledge to limit the federal deficit in the fiscal year 1980 budget to \$30 billion or less. Not until five hours before Carter went on television with his proposals on October 24 did the president accept this recommendation.

Faced with the unpalatable options of contractionary monetary and fiscal policies and mandatory controls, President Carter in his October 24 speech chose neither. The deficit-cutting pledge won mild applause from business circles, but other proposals—notably voluntary wage-price guidelines and regulatory reform—failed to impress the markets. The next day the stock market continued a steady downturn that saw it lose \$110 billion on paper during the last 12 trading days in October. On the international currency market, the dollar started to fall in Tokyo trading even before the end of Carter’s speech. The Fed and other central banks intervened with dollar purchases of \$2 billion, but the mark rose 1.8% and the yen 1.7% against the dollar in one day. (See **Exhibit 9**.) The Carter administration was now facing an inescapable dilemma. Having tried a series of moderate measures and seen each fail one by one, the administration now had to decide which goal was more important: a strong dollar, or a robust domestic economy. But it remained unclear under just what were the *proportions* of this trade-off. How badly might the domestic economy be injured by measures taken to strengthen the dollar?

**Exhibit 1** Exchange Rate Regimes of I.M.F. Members

<b>Industrialized</b>		<b>Developing</b>	
Floating	16	Floating	36
Fixed	4	Fixed in terms of:	
		Dollars	38
		French francs	14
		Other	36

**Exhibit 2** Measures of International Interdependence*(A) Size of Exports in GNP (%)*

	1958	1963	1968	1973	1978
United States	4.5	4.7	4.9	6.6	8.1
Germany	22.8	19.4	22.9	23.3	27.0
Japan	11.3	9.6	10.4	10.8	11.9
United Kingdom	20.3	19.1	20.4	22.9	29.0

*(B) Holdings of Financial Assets by Foreigners*

	1958	1963	1968	1973	1978
% of U.S. government debt	3.0	5.0	4.5	16.1	22.3
\$ Billions	6.9	12.6	12.5	54.7	137.8

*(C) Size of Eurocurrency Market*

	1968	1973	1975	1976	1977	1978
Gross Eurocurrency liabilities (\$ billions)	50	305	485	595	740	950
Eurodollars as % of total gross liabilities in all Eurocurrencies	NA	NA	78	80	76	74

Source: Parts A and B are calculated by author from IMF, *International Financial Statistics*, 1982; Part C is from Board of Governors of the Federal Reserve System and Morgan Guaranty Trust Company.

NA = not available.

Exhibit 3 Selected Performance Indicators

Year/Quarter	Real GNP	CPI	M-1	Current Account Balance	Change in Reserves
	Annual % Growth	Annual % Growth	Annual % Growth	(billions of dollars in year or quarter)	
<b>United States</b>					
1974	-3.5	12.1	5.1	1.7	-1.05
1975	2.4	7.2	4.6	18.4	-0.35
1976	4.6	5.0	5.8	4.3	-2.05
1977	5.5	6.7	7.9	-15.3	-0.24
1978:1	-0.1	8.0	6.3	-6.9	0.25
1978:2	8.7	10.6	10.3	-3.3	0.34
1978:3	2.6	8.3	7.9	-3.7	0.25
<b>Germany</b>					
1974	-1.7	6.5	10.6	9.8	0.25
1975	1.5	5.6	15.1	4.0	1.22
1976	4.9	3.8	6.5	3.8	-3.93
1977	2.6	3.7	10.4	3.8	-4.04
1978:1	-0.6	2.9	25.3	1.4	-2.33
1978:2	8.8	1.8	6.5	1.8	1.69
1978:3	2.3	2.9	10.5	2.5	-3.31
<b>Japan</b>					
1974	-0.2	24.4	11.1	-4.7	-1.26
1975	3.3	8.6	10.8	-0.7	0.66
1976	5.2	9.3	14.7	3.7	-3.08
1977	5.7	6.1	6.1	11.0	-6.53
1978:1	9.4	1.7	9.7	5.5	-6.31
1978:2	4.0	5.4	13.2	4.8	1.88
1978:3	3.9	7.1	17.2	4.5	-1.80
<b>United Kingdom</b>					
1974	-0.3	18.2	11.0	-8.3	0.45
1975	-2.0	25.3	19.0	-3.7	1.44
1976	4.9	15.0	10.3	-1.6	3.02
1977	-0.6	13.2	21.9	0.3	-14.08
1978:1	3.2	5.8	27.9	-0.6	0.09
1978:2	5.4	5.5	5.7	0.4	2.79
1978:3	4.6	12.5	20.4	-0.1	-0.15

Sources: Columns 1, 2, and 3, Federal Reserve Bank of St. Louis, International Economics, Conditions; Column 4, January 10, 1979, U.S. Department of Commerce, International Economic Indicators; Column 5, IMF, *International Financial Statistics*. All quarterly percentages are compound annual rates of change from the previous quarter, seasonally adjusted. Negative sign in "Change in Reserves" indicates an addition to reserves.

## Exhibit 4 Derivation of Real Exchange Rates

	1972	1973	1974	1975	1976	1977	November 1978
<b>Nominal Exchange Rates</b> (End of period index)							
\$/DM	100.0	118.6	133.0	122.1	135.6	152.2	159.6
\$/¥	100.0	107.8	100.3	99.1	103.3	126.0	156.8
\$/£	100.0	98.9	100.0	86.1	72.5	81.2	82.3
<b>Ratio of Domestic Prices to Foreign Prices</b> (End of period index)							
P <sub>\$</sub> /P <sub>DM</sub>	100.0	99.4	103.1	106.2	107.7	110.7	115.8
P <sub>\$</sub> /P <sub>¥</sub>	100.0	95.1	84.8	82.8	80.1	78.8	81.8
P <sub>\$</sub> /P <sub>£</sub>	100.0	97.4	93.1	81.9	74.3	68.3	67.8
<b>Real Exchange Rates</b> (End of period index)							
Real \$/Dm <sup>a</sup>	100.0	119.3	129.1	115.0	125.8	137.5	137.8
Real \$/¥	100.0	113.4	118.2	119.7	128.9	159.6	191.7
Real \$/£	100.0	101.5	93.1	105.2	97.5	118.9	121.3

Source: IMF, *International Financial Statistics*, 1982 Yearbook, indexes calculated by author

<sup>a</sup>Real \$/DM = \$/DM • P<sub>DM</sub>/P<sub>\$</sub> i.e., the real exchange rate is the nominal exchange rate times the ratio of foreign prices over domestic prices.

Note: If the purchasing power parity condition holds, then the changes in the nominal exchange rate will be equal to the changes in the ratio of domestic prices to foreign prices.

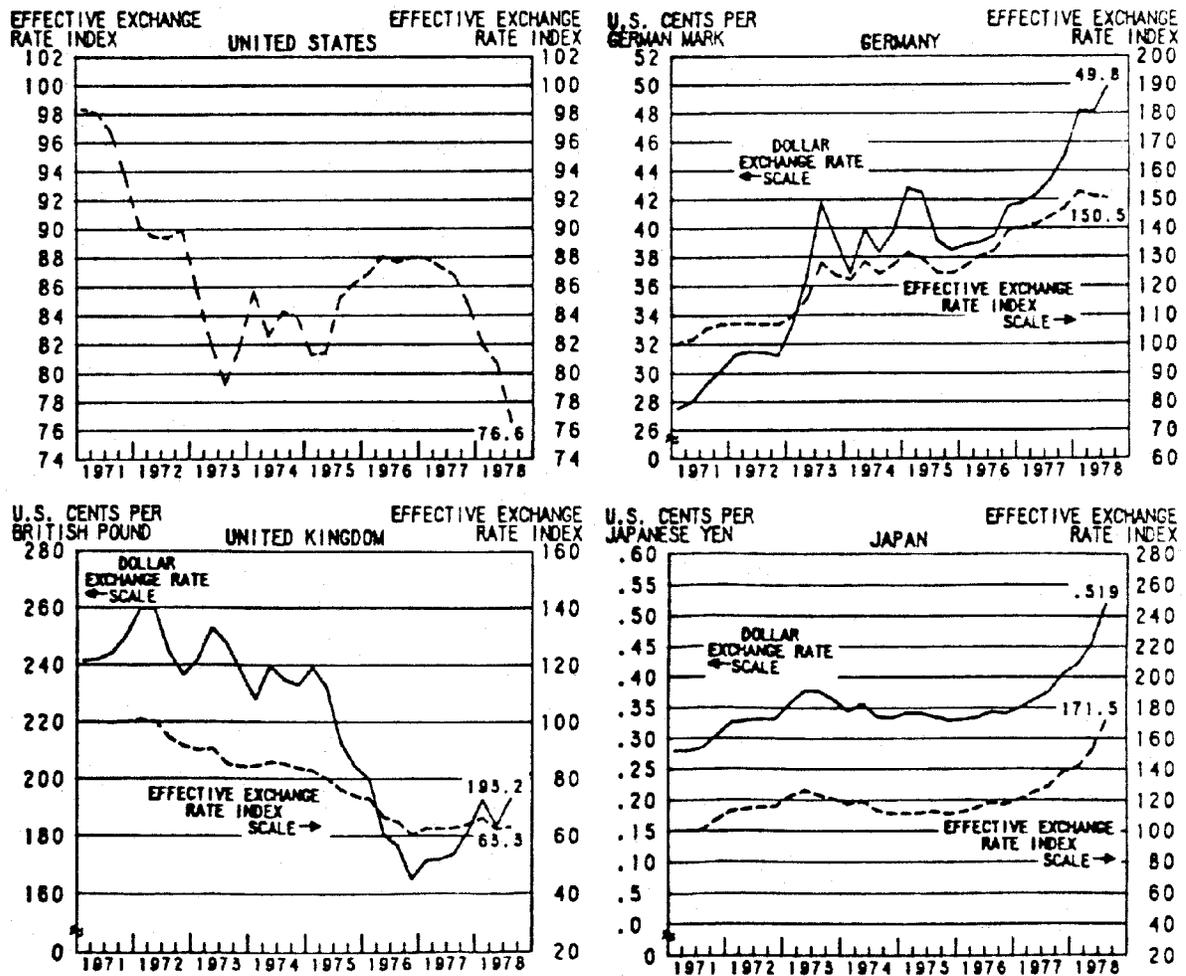
## Exhibit 5 National Forecasts and Realized Real GNP Growth for 1977

Country	Change From	Early 1977 Forecast	Realized
United States	Fourth quarter to fourth quarter	5.75-6	5.75
Canada	Year to year	3-4	2.25
France	Year to year	4.6	2.75
West Germany	Year to year	4.5-5	2.50
Italy	Year to year	2.6	2.00
Japan	Fiscal year to fiscal year	6.7	5.00
United Kingdom	Year to year	1.2	0.50

Source: *Economic Report of the President*, 1978, p. 107

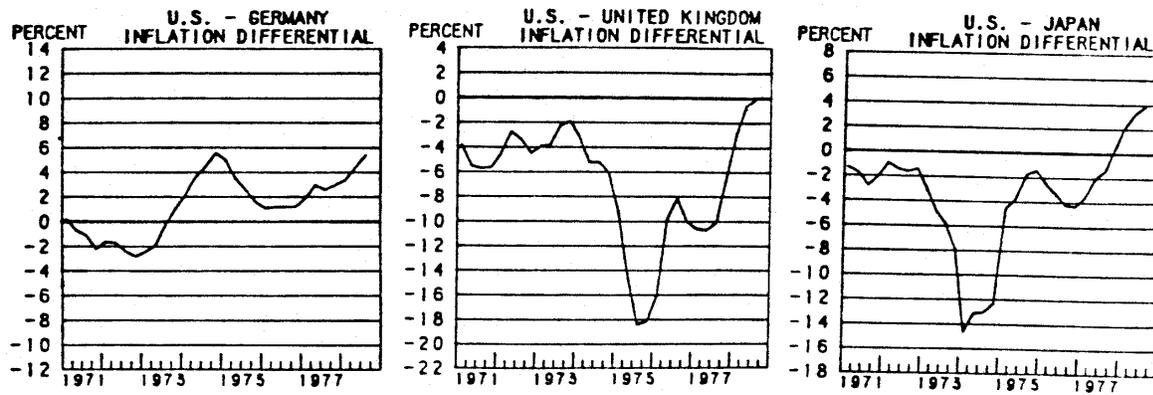
Exhibit 6 Movements in Exchange Rates: 1971-1978

Effective exchange rate changes are an indicator of the extent to which the external value of a country's currency has moved relative to other currencies. Effective exchange rate changes are computed as an index, combining the exchange rates between the currency in question and 20 other major currencies with weights derived from the international monetary fund's multilateral exchange rate model. Each weight represents the model's estimate of the effect on trade balance of the country in question of a change of one percent in the domestic currency price of one of the other currencies. The weights, therefore, take account of the size of trade flows as well as the relevant price elasticities and the feedback effects of exchange rate changes on domestic costs and prices. The measure is expressed as an index based on the par values in May 1970.



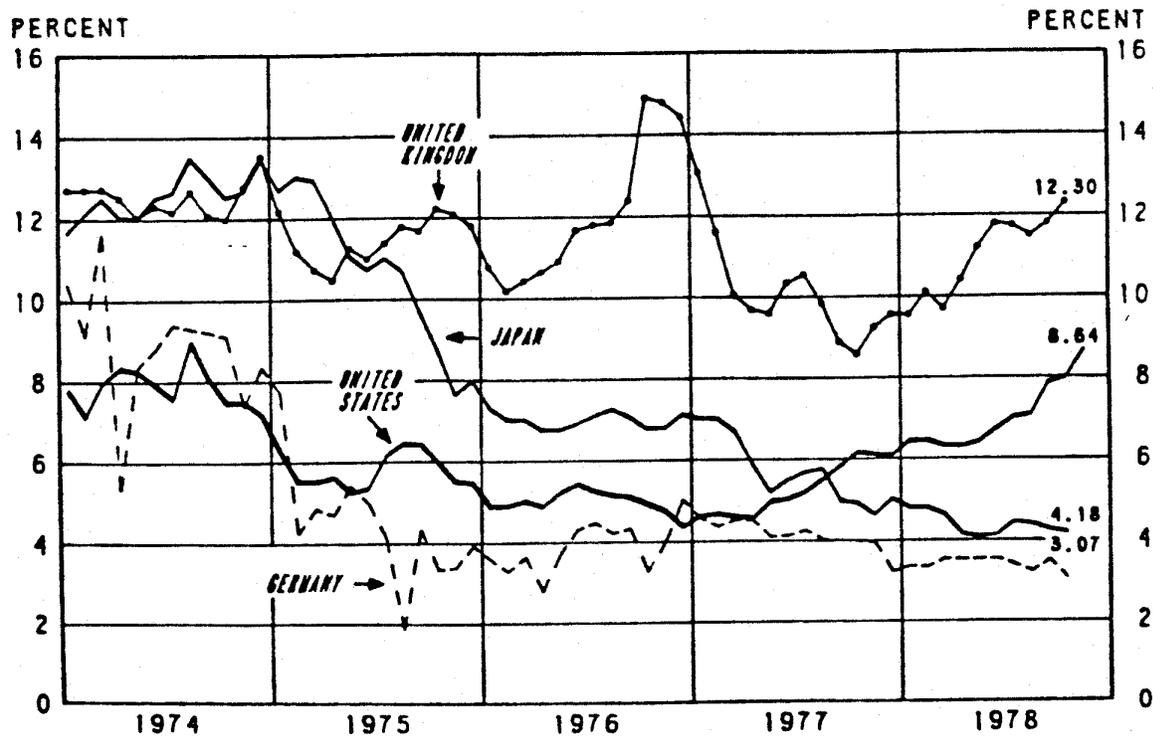
Prepared by Federal Reserve Bank of St. Louis

Exhibit 7 Relative Rates of Inflation<sup>a</sup>: 1971-1978



<sup>a</sup>Comparison of rates of change in consumer price index over corresponding four-quarter periods. Example: The United States-Belgium inflation differential for January 1977 is computed by subtracting the percentage change in the Belgian CPI over the January 1976-January 1977 period from the percentage change in the United States CPI over the same four-quarter period. Data are seasonally adjusted.

Exhibit 8 Short-Term Interest Rates—International Comparisons: 1974-1978



Source: International Monetary Fund

**Exhibit 9** Federal Reserve and Treasury Department Intervention in Foreign Exchange Markets

<b>Period</b>	<b>Sale of Foreign Currencies<sup>a</sup></b>	<b>Purchases of Foreign Currencies<sup>b</sup></b>	<b>Net Support for Dollar<sup>c</sup></b>
February 1974 - July 1974	\$527.0	\$317.1	\$209.9
August 1974 - January 1975	742.3	208.4	533.9
February 1975 - July 1975	1,045.0	1,260.5	-215.5
August 1975 - January 1976	106.5	240.4	-133.9
February 1976 - July 1976	270.4	288.6	-18.2
August 1976 - January 1977	175.6	205.0	-29.4
February 1977 - July 1977	212.4	150.7	61.7
August 1977 - January 1978	1,736.8	35.4	1,701.4
February 1978 - July 1978	NA	NA	1,511.0

Source: Calculated by author from "Treasury and Federal Reserve Foreign Exchange Operations," *Federal Reserve Bulletin*, September 1974 - September 1978 and March 1975 - March 1979.

<sup>a</sup>Support for dollar through intervention sales of foreign currencies. Figures equal millions of dollar equivalents.

<sup>b</sup>Purchases of foreign currencies either to support foreign currency values or to repay obligations from previous dollar support interventions. Figures equal millions of dollar equivalents.

<sup>c</sup>Sales-purchases. Positive values imply net support for dollar during period.

Note: Figures do not include purchases of Swiss Francs and Belgian francs to repay debts incurred before August 1971.

NA = Not available.

## Endnotes

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- <sup>i</sup> IMF Annual Report, 1976, p. 32.
- <sup>ii</sup> *Wall Street Journal*, November 1, 1978, p. 1.
- <sup>iii</sup> Cited in Gerald M. Meier, *Problems of a World Monetary Order*, 2d ed., Oxford University Press, 1982, p. 129.
- <sup>iv</sup> *Ibid.*, p. 126.
- <sup>v</sup> Cited in Robert Solomon, *The International Monetary System: 1945-1981*, Harper & Row, 1981, p. 208.
- <sup>vi</sup> *Ibid.*, p. 248
- <sup>vii</sup> Thomas D. Willett, *Floating Exchange Rates and International Monetary Reform*, American Enterprise Institute Studies, No. 172, 1977, p. 67.
- <sup>viii</sup> "Summary Measures of the Dollar's Foreign Exchange Value," *Federal Reserve Bulletin*, October 1978, p. 788.
- <sup>ix</sup> Quoted in Michael Moffitt, *The World's Money*, p. 134.
- <sup>x</sup> *Ibid.*, pp. 114-115.
- <sup>xi</sup> Solomon, p. 346.
- <sup>xii</sup> U.S. House Hearings, *Decline of the Dollar*, 1978, p. 49.
- <sup>xiii</sup> *Ward's Automotive Yearbook*, 1979. (Figures are for the five best-selling Japanese brands.)
- <sup>xiv</sup> Economic Report of the President, 1978, p. 134.
- <sup>xv</sup> *Ibid.*, pp. 121-122.
- <sup>xvi</sup> *New York Times*, January 5, 1978, p. D7.
- <sup>xvii</sup> *New York Times*, January 13, 1978, p. D1.
- <sup>xviii</sup> *New York Times*, July 9, 1978, p. A1.
- <sup>xix</sup> *New York Times*, July 18, 1978, p. D13.
- <sup>xx</sup> *New York Times*, August 16, 1978, p. 145.
- <sup>xxi</sup> Solomon, p. 348.
- <sup>xxii</sup> *Federal Reserve Bulletin*, September 1978, p. 777.
- <sup>xxiii</sup> *Wall Street Journal*, August 30, 1978.

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xxiv *The Economist*, August 26, 1978, p. 9

xxv *Fortune*, December 4, 1978, p. 41.

xxvi *Ibid.*, p. 41.