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The Exchange Rate Stabilization Attempts of 1925, 1933, 1936 and 1971

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Introduction

The Plaza Accord is controversial.[1] One the one hand it is hailed as "perhaps the high-water mark of international economic co-operation over the past 40 years" (in the words of Beattie 2010). On the other it is impugned as having had little effect on currency values, as heightening instability rather than reducing it (by causing the dollar to overshoot in the opposite direction), and even as having been indirectly responsible for the Japan's lost decade (as recounted if not necessarily endorsed in IMF 2011).[2]

Negotiations over exchange rates are always controversial. They are economically complex and politically fraught, since rhetoric is easy to offer while commitments are hard to keep. They tap into deep-seated beliefs about whether markets produce desirable outcomes and, if not, whether intervention can improve them. They prompt the question, debated by academics if not also practitioners, of whether international cooperation on monetary and financial matters is more likely to be productive or counterproductive.

One episode from 1985 is not exactly sufficient evidence for resolving these disputes. In this paper I therefore consider a number of earlier episodes when officials sought to implement

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[1] Prepared for the conference on "Currency Policy Then and Now: 30th Anniversary of the Plaza Accord," Baker Institute for Pulbic Policy, Rice University, 1 October 2015.

[2] For the general reader: the Plaza Accord was an agreement between the French, Germany, Japanese British and U.S. governments, signed on September 22, 1985 at the Plaza Hotel in New York with the goal of reversing the previous sharp appreciation of the U.S. dollar and stabilize currencies, broadly speaking, at more suitable levels.

agreements to move exchange rates to desired levels and stabilize them there.[3] In 1925 the United States, with leadership from the Federal Reserve Bank of New York, sought to cooperate with the United Kingdom in reversing the postwar depreciation of sterling and stabilizing the bilateral sterling-dollar exchange rate at pre-World War I levels. In 1933 the major countries of the world, led by the U.S., UK and France, sought to stabilize exchange rates and avoid another round of competitive devaluations following earlier depreciation of sterling and then the dollar against the gold-bloc currencies. In 1936 the Americans, British and French sought to facilitate depreciation and adjustment of the franc against sterling and the dollar while preventing the American and British currencies from becoming severely overvalued and at the same time avoiding another round of competitive devaluations that might neutralize efforts to realign the franc. And in 1971 the U.S. and its foreign partners sought a stabilization agreement under which the dollar would be adjusted downward by an amount adequate to correct U.S. balance-of-payments weakness while at the same time limiting the adverse impact on foreign economies that found themselves with a stronger dollar exchange rate as a result.

My analysis of these episodes can be thought of as an effort to put the Plaza Accord into a broader historical context. In each case I ask a series of questions about these agreements. First, what was the problem in foreign exchange markets that governments were trying to solve, to what extent was there a common diagnosis of that problem, and how widely was it shared? Second, what were the obstacles to cooperation? Third, how successful were the representatives of different countries in achieving their goals? Fourth and finally, were there unintended consequences, positive or negative, of their agreement?

In the conclusion I explore what light this historical analysis sheds on the Plaza Accord.

[3] Although, as we will see, there was not always a consistent definition over time of what was meant by "appropriate" or "stabilize," not surprisingly perhaps since neither is there agreement on such terms and concepts among negotiators.

Sterling-Dollar Stabilization in 1925

The year 1925 saw the culmination of efforts on the part of the United States to intervene in international financial markets with the goal of stabilizing the sterling-dollar exchange rate at prewar levels. Its intervention was successful but had unintended consequences.

World War I was more expensive for Great Britain than the United States, Britain having among other things entering the war three years earlier. When gold exports were embargoed in 1914, sterling depreciated against the dollar, but it was held at a relatively modest discount for the duration of the war through a combination of intervention and controls. With the abandonment of controls in 1919 sterling depreciated further, reaching a low of $3.60 against the dollar, down from a prewar parity of $4.86.

This floating exchange rate was widely viewed as suboptimal, given favorable perceptions of the performance of the prewar gold standard. The U.S. had become more of an international commercial and financial power as a result of the war, and American officials saw restoring stable exchange rates as essential for promoting U.S. exports of commodities, merchandise and finance. Sterling being one of the two leading international currencies along with the dollar, they viewed stabilization of the sterling-dollar rate as a key event that would lead other countries to follow. British officials, as the stewards of an even more outward-oriented economy, shared these concerns. Those British officials further saw restoration of the bilateral sterling-dollar rate to prewar parity as desirable for enhancing the position of London as an international financial center and as a matter of prestige.[4]

Starting in 1921, sterling was gradually pushed up in the direction of the prewar dollar parity through the maintenance of high interest rates in the UK. But restrictive policies limited

[4] Although, as is well known, there were a few prominent dissenters from this view.

investment and made for slower growth, which raised questions about their sustainability. Sterling's appreciation weakened the balance of payments and limited the Bank of England's accumulation of free gold reserves that might be used as a buffer against shocks. The hope was that once the prewar parity was reached, positive credibility effects might allow these constraints to be relaxed. The problem was getting there.

Anglo-American cooperation was facilitated by the fact that key policy makers in the two countries shared these priorities and concerns. It was eased by the fact that there were only two countries involved in negotiations.[5] A complication was that the main proponent of coordinated intervention was the Federal Reserve and not the U.S. Treasury (where it is customary for treasuries to take the lead in exchange-rate management and agreements in the United States as in other countries) and, in particular, that the motive force was the Federal Reserve Bank of New York and not the Board of Governors (between which relations were not easy).

The main mover was Benjamin Strong, the influential governor of the New York Fed. Strong was an internationalist by temperament. With experience on Wall Street, he appreciated the advantages to New York as a financial center of successful restoration of an international system of stable exchange rates. He was also on close personal terms with Montagu Norman, governor of the Bank of England. Herbert Hoover, a critic, later called Strong "a mental annex to Europe."

By 1924 more than five years had passed since the conclusion of the war. Germany had stabilized the mark and other countries had stabilized their currencies at various levels, suggesting that, in the absence of early action to restore parity against the dollar, sterling and London might lose their traditional positions.

[5] The reality was more complicated, but only a bit, with negotiations over the Dawes Loan for Germany and stabilization loans for other European countries (the latter mainly through the League of Nations, of which the U.S. was not a member).

Strong and Norman therefore negotiated how to engineer the final push. Norman agreed to keep interest rates high. Strong, for his part, got his Fed colleagues to agree to a series of discount rate cuts. With leadership from New York, the Reserve Banks reduced their discount rates from the 4 ½ percent levels prevailing since early 1923 to 3-4 percent between May and October of 1924. In a 1924 statement prepared for the House of Representatives Committee on Banking and Currency, Strong cited international considerations as a rationale for lower discount rates and expansionary open market operations. These initiatives were designed "to render what assistance was possible by our market policy toward the recovery of sterling and resumption of gold payment by Great Britain."[6]

In addition, the Open Market Investment Committee authorized the New York Fed to purchase $300 million of Treasury bonds, pushing down yields and encouraging capital and gold to flow across the Atlantic toward Britain. But there was still the immediate need on the part of the Bank of England for an additional cushion of reserves.[7] To meet it, in early 1925 the Federal Reserve Bank of New York provided a $200 million line of credit to the Bank of England in exchange for an equivalent amount of sterling deposit credit, while Strong further encouraged J.P. Morgan & Co., with which he was on friendly terms, to provide a supplementary $100

[6] 69th Congress, 1st session, Stabilization, Hearings on H.R. 7895 before Cmomittee on Banking and Currency, part 1, p.336.

[7] There was some disagreement within British circles about whether a cushion was needed for the return to gold. Norman was strongly of the view that a cushion of at least an additional $300 million was needed. Otto Neimeyer (then still at Treasury, not yet at the Bank of England) disagreed on the grounds that the conditions attached to the American support, either implicitly or explicitly (that the Bank of England might be asked to raise interest rates) were undesirable. Neimeyer also doubted that $300 million would make much difference or alleviate the need for the Bank to raise interest rates in response to market pressure. Sir Warren Fisher (permanent secretary to the Treasury, the most senior civil servant at Treasury) disliked it because Britain would become indebted and subordinate to another country. Moggridge (1971), pp.79-81.

million credit to the British government.[8] Sterling continued to strengthen, and with this U.S. support in place it was stabilized at the prewar parity in April 1925.

These decisions were controversial at the time and became even more controversial subsequently. Keynes among others criticized the $4.86 rate as dangerously overvalued. Commerce Secretary Hoover objected that Strong's internationally-motivated policies were fueling financial excesses in the United States.[9] In his memoirs he pointed to the rapid growth of loans to stock brokers and dealers and sharp appreciation of share prices already in 1925.[10] In November he protested to the nominal head of the Federal Reserve Board, Daniel Crissinger, that Strong's policies were fueling speculation. He wrote members of the Senate Banking and Currency Committee, which had oversight of the Federal Reserve, making the same objection and, extraordinarily for a sitting commerce secretary, even drafted a letter for a prominent senator to sign and send on to the Fed. He enlisted two allies on the Board of Governors, Adolph Miller, formerly professor at the University of California, Berkeley, and Charles Hamlin, founding governor of the board, to register his objections. But none of this reversed prior policy.

The consequences of the agreement were not entirely as hoped. The British balance of payments failed to magically strengthen, forcing another negotiation among central bankers in 1927, this one involving not just Strong and Norman but also Hjalmar Schacht of the Reichsbank and Charles Rist of the Banque de France. In a renewed effort to prop up sterling, Strong and Norman asked the German and French banks to cut interest rates (which they refused to do) and to refrain from converting their sterling securities into gold in London (which they agreed to do, but only temporarily). Consequently the burden of adjustment fell on Norman and Strong. The

[8] Morgan had been an agent for the British government during the war and now had an interest in rebuilding international financial business between London and New York, in which it hoped to play a leading role.
[9] Hoover served as commerce secretary from 1921 to 1928 before assuming the presidency.
[10] Hoover (1941), p.9. This is where the aforementioned "mental annex" remark appears.

former agreed "to do whatever it takes" (in Mario Draghi terms) to maintain the sterling parity, while the latter once more cut interest rates and purchased securities to induce gold and capital to flow toward London.

Together their actions bought four more years of currency stability. But none of these steps addressed sterling's underlying weakness. When the Great Depression hit and then when, in 1931, the pound came crashing down, it essentially brought the dollar down with it.

The internationally motivated decision to cut interest rates in 1927 was resisted by other Reserve Banks, which were forced by the Board to go along for the first time in the history of the Federal Reserve System. This led to bad feeling and recrimination between New York and the other Federal Reserve Banks. This tension undermined their ability and willingness to work together to contain the spreading financial crisis in 1931-33.[11] That the agreement between Norman and Strong was taken at a private meeting between the governor of the New York Fed and foreign central bankers and then presented to the Board as a fait accompli was criticized in House of Representatives hearings in 1928.[12]

In addition, there was the fillip to stock market speculation (although economists differ, as always, on how important monetary policy was as opposed to other factors for events on Wall Street).[13] Strong had gaily told Rist that he was going to give "a little coup de whiskey" to the stock market." He ended up providing more. Adolph Miller, in a 1935 address, argued that the decision gave "a further great and dangerous impetus to an already over-expanded credit situation, notably to the volume of credit used on the stock exchanges…"[14] Hoover, in his

[11] I describe these consequences in Eichengreen (2015).
[12] Hearings Before the Committee on Banking and Currency of the House of Representatives, "Stabilization," Seventeenth Congress, First Session, HR11806.
[13] The case is perhaps most strongly made by Rothbard (1963).
[14] Miller (1935), p.449.

memoirs, essentially blamed the decision for not just the Wall Street boom but also the Great Crash and the Great Depression.[15]

This, clearly, is going a bit far (Hoover had an obvious interest in deflecting blame). Still, the successful 1925 stabilization agreement is a cautionary tale. It shows how policy makers, once they commit to moving the exchange rate and holding it at a certain level, may be forced to double down on their bets. It is a warning that an exchange rate agreement that does not have the full backing of governments will not be fully credible and may not hold. It cautions against elevating exchange rate stabilization to a primary goal of policy, especially when its pursuit causes policy to be diverted from more fundamental domestic goals like the maintenance of price and financial stability. The debate over whether the U.S. decision to loosen as a way of supporting the currency of an important foreign partner is eerily reminiscent of the debate over whether Japanese decisions to adjust policy at the Plaza in 1985 and then at the Louvre in 1987 helped to set the stage for the Japanese crisis and lost decade.

Failed Stabilization Effort of 1933

Britain's abandonment of the gold standard in September 1931 induced a score and more of countries to follow. It then took more than six months for monetary policy to be reoriented toward the needs of internal stability. Sterling fell as low as $3.40 before recovering to the $3.80-$4.00 range. Over the first half of 1932 the Bank of England cut interest rates from 6 to 2 percent. At mid-year Treasury established the Exchange Equalisation Account to intervene in the foreign exchange market (officially to prevent undue fluctuations, in the American view to keep the floating pound down), and the Chancellor of the Exchequer, Neville Chamberlain, assumed effective control of monetary policy.

[15] See footnote 10 above.

The depreciation of sterling, as a reminder that the commitment to the prevailing set of exchange rates was not irrevocable, ratcheted up the pressure on the United States. Expectations that the new president, Franklin Delano Roosevelt, would devalue led to a run on the dollar during the interregnum between the election in November 1932 and inauguration in March 1933.[16] That run in turn forced the bank holiday as Roosevelt's first act on assuming office and led to the decision to "temporarily" embargo gold exports.

Against this chaotic backdrop, the leaders of the principal countries sought to reach an agreement on currency stabilization. The idea of an international conference to address currency, trade and related issues had been in the air since at least 1930 and arose repeatedly in bilateral meetings among leaders. An international conference in Lausanne in July 1932 concluded with agreement to call another conference to consider currency stabilization and related issues; this was eventually scheduled for London in June 1933.[17]

The perception that exchange rate instability was a problem that contributed to the collapse of international trade and lending was broadly, if not universally, shared. French officials, many of whom had experienced exchange rate volatility, inflation and financial instability at first hand in the 1920s, argued strongly for the restoration of fixed rates. Not incidentally, France was now suffering growing problems of overvaluation and deflation as a result of the depreciation of sterling and now the dollar. The other gold bloc countries shared its concern.

British officials too worried about exchange rate instability. More specifically, they worried that FDR might aggressively devalue the dollar and push the sterling-dollar rate back to $4.86 or even above. Agreement by the United States not to intervene too aggressively in gold

[16] See Wigmore (1987).
[17] Kindleberger (1973), pp.200-1.

and foreign exchange markets was desirable from their point of view. At the same time, British policy makers, having seen the advantages of increased policy space, refused to limit their own monetary room for maneuver. In effect, they were happy to encourage an exchange-rate-stabilization agreement if it left their own hands untied.

Roosevelt's views were unclear to the others because they were unclear to the president himself. As Herbert Feis, economic advisor to the State Department, wrote of the president later, "His ideas veered and waffled. Even now, with many records opened, it is not easy to trace their gyrations."[18] In April FDR seemed favorably predisposed toward the gold standard and exchange-rate stabilization, assuming that countries could agree to cooperate on the necessary reflationary measures. But by May he had become impressed by the very positive impact of depreciation of the dollar on commodity prices and the stock market.[19] He had also grown more pessimistic as a result of his bilateral meetings with European officials about the scope for cooperative reflationary action.[20]

When the American delegates to the London conference unexpectedly produced a temporary stabilization agreement then promised a proposal for stabilizing exchange rates on a permanent basis, FDR transmitted his famous "bombshell message" of July 3rd denigrating fixed exchange rates as "old fetishes of so-called international bankers" and blowing the American delegation and the conference out of the water.[21] This unilateral declaration was criticized as

[18] Feis (1966), p.144. Rauchway (2015) elaborates the point. A different view is Edwards (2015).
[19] Kindleberger p.206 writes, "As the dollar fell on international exchanges in May – going from $3.85 to the pound on April 29 to $4,00 on May 31 – Roosevelt became less and less interested in stabilization….He was prepared to agree on the dates of the conference – in mid-June. Nothing else was decided."
[20] Other advisors to the administration such as James Warburg of the State Department, Oliver Sprague of the Treasury, and George Harrison of the New York Fed continued to favour reestablishment of fixed rates and the gold standard, but they did not convince the president.
[21] Kindleberger (1973) writes "The deal worked out among the financial representatives called for the dollar to be stabilized at $4,00 to the pound and 0.04662 to the franc, with a 3 percent spread on either side….Each of the three central banks would support its currency by selling gold, up to a limit of four or five million ounces, equivalent to $80-$100 million. When this was used up, the agreement would be reexamined." Compounding the problem was

signaling U.S. isolationism and encouraging Italian ambitions in Ethiopia, Japanese ambitions in China, and German ambitions in Europe. Roosevelt, for his part, followed the example of Britain and Chamberlain, using his powers under the Thomas Amendment to the Farm Relief Act to seize direct control of the monetary reins. Starting in October, through the agency of the Reconstruction Finance Corporation, FDR purchased gold on the open market, pushing down the dollar and pushing the sterling/dollar rate back to roughly pre-1931 levels.

But the fatal mistake, in fact committed by Hoover and not Roosevelt, had been to call the conference in the first place. Doing so raised expectations, which were bound to be disappointed given the very different diagnoses and prescriptions of the representatives of different countries. The priority and solution in the eyes of the French was stabilizing exchange rates, ideally at pre-devaluation levels, and the problem was the reluctance of other governments to pursue the deflation necessary to meet those exchange-rate commitments. For the British, in contrast, deflation was the problem, not the solution, and the role of the exchange rate was to adjust so as to allow Chamberlain's to carry out his pledge to return prices to their 1929 levels.[22]

Hoover essentially agreed with the French and failed to comprehend that any president, including FDR, might fail to share his view. He made the mistake of agreeing to the conference

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how the American delegation in London had failed to keep the president and his advisors informed of its progress. This led FDR and his circle to misinterpret a temporary agreement to stabilize exchange rates for the duration of the conference as a permanent exchange rate accord. Kindleberger goes on: "The news of the [temporary] stabilization leaked to the press, and the exchange market firmed from $4.12 to $4.02; the commodity and stock markets declined. The Committee for the Nation sent President Roosevelt a telegraph calling for the dollar to be cut 43 percent, based on calculations for restoring U.S. prices, which implied a pound rate of $5.70. Roosevelt sent the delegation telegrams on June 17….saying that $4.00 was unacceptable…"

[22] Meltzer (2003) offers a different interpretation, with which I do not agree. The British, French and Americans, according to Meltzer, all agreed on the desirability in principle of the gold standard and fixed exchange rates but disagreed fundamentally on their appropriate level, the U.S. and the UK both wanting currencies that were devalued against foreign currencies, including against one another, while the French wanted to see pre-devaluation exchange rates restored, or a least the extent of U.S. and British devaluation severely limited. My view is that the parties disagreed fundamentally on the importance of exchange rate stability. The French and the early FDR viewed it as a priority, to which price levels and internal conditions generally should be forced to adjust, while the British and late FDR attached priority to price stability (to returning prices to 1929 levels) and saw the exchange rate as a variable that should be adjusted as needed to make this possible.

before an election, which he lost, which of course meant that he could not commit the U.S. to the conference agenda. FDR, on assuming the presidency, was compelled to appoint a delegation; that he sent a diverse delegation with varied and conflicting views on monetary stabilization was not inadvertent from this point of view. When those delegates unexpectedly indicated that they were on the verge of producing a stabilization agreement, he was forced to issue his bombshell message. All participants in some sense lost credibility as a result of these events.

The implication is: avoid convening ambitious exchange-rate-stabilization negotiations in the absence of a reasonable degree of agreement on the nature of the problem and what needs to be done. That agreement should encompass the relevant countries but also extend within governments. It should be shared by the relevant branches of government, and there should be reason to expect that it will be shared not just by current policy makers but also their successors.

The Tripartite Agreement, 1936

In January 1934, having successfully exerted upward pressure on commodity prices, Roosevelt re-pegged the dollar to gold at $35 an ounce (up from the $21 prevailing before 1933), although the U.S. now stood ready to pay out gold on demand only to foreign official holders that similarly maintained convertibility. FDR having pushed down the exchange rate, the sterling/dollar rate had recovered to $4.86 and even a bit higher (appropriately, it can be argued, given that the U.S. depression and deflation were even more serious than the British).

Devaluation by the U.S. and the other members of the dollar area now intensified the pressure on the currencies of the gold bloc that still maintained convertibility at an unchanged gold price. The Belgian franc was the first gold-bloc currency to fall, in 1935.

Markets then trained their sights on France. Not without reason: the country now had an increasingly overvalued currency as a result of these exchange rate developments abroad. Successive French governments and the Banque de France had shunned all significant reflationary monetary policies, consigning the country to a deepening deflation. As unemployment mounted, support for the parties of the center-right and their orthodox policies crumbled. The result, predictable in hindsight, was the electoral victory of the Socialist-led Popular Front headed by Léon Blum.

The situation was not unlike that in the United States three years earlier. Given the condition of the economy and the promise of the opposition party, soon to assume office, to take whatever steps were needed to stabilize prices and restart economic growth, it was not hard to see devaluation coming. At the same time, a considerable segment of the French political and financial establishment remained wedded to the gold standard, given the country's traumatic experience with a floating exchange rate a decade earlier. Blum himself, while possessing many admirable qualities, was no financial expert. Not unlike Roosevelt, he wanted to satisfy the demands of those who saw merit in maintenance of the gold standard and an unchanged franc exchange rate and also those who urged economic stabilization and reflation, both at the same time. It was not clear, when faced by the incompatibility of the two objectives, which way he would jump.

Once Blum formed his government in June 1936 and devaluation came to appear increasingly imminent, French policy makers were animated by two further considerations. First, they were concerned that any change in the franc exchange rate should be dressed up as an international agreement rather than constituting an admission of failure by a new government that had effectively made a campaign pledge not to devalue. As part of that agreement they might even secure commitments of support from the British and French authorities, or so it was hoped. Second, the French sought assurances that if they did devalue, then the needed improvement in international competitiveness would not be neutralized by further competitive devaluations by the British and Americans or by their imposition of retaliatory tariffs.

The British and Americans, for their part, were concerned that the French devaluation should not be excessive, undercutting their own competitiveness. Harry Dexter White, newly appointed to the Treasury, warned in May 1935 that France was apt to devalue by too much, creating new maladjustments. White recommended negotiating an international agreement to prevent this.[23] At the same time, the British and Americans were also concerned that France should devalue by an adequate margin, since a small devaluation that did not restore competitiveness might to more to undermine confidence than restore it and be followed by a second devaluation, roiling financial markets.

In addition, the Americans and British again wanted to keep their options open: Britain had the Exchange Equalisation Account to intervene in the foreign exchange market if sterling's strength looked excessive; the U.S. administration now possessed a similar account, the Exchange Stabilization Fund established by the Gold Reserve Act of 1934, and FDR retained the option of devaluing the dollar further under the provisions of that same act. As for British priorities, Drummond (2008, p.201) describes how the British view under Chamberlain had evolved by this point: "The pound would not be [competitively] devalued, but neither would it be pegged to gold or the dollar until the world had been freed of the trading and financial barriers that had made the old gold standard unworkable."

To be sure, others like Frederick Leith-Ross (chief economic advisor to the government and architect of the Treasury View) and various officials of the Bank of England continued to

[23] Clarke (1977a), p.15.

hanker after pegged rates, but to no avail. Similarly, others concerned with U.S. policy, for example Jacob Viner (who served as an advisor to Treasury Secretary Henry Morgenthau) and Alvin Hansen (who wrote a paper as a consultant to the State Department in 1935), saw exchange rate uncertainty as a major factor discouraging trade and hindering recovery and were more positively inclined toward a meaningful exchange rate arrangement. But as had been the case of proposals for such an agreement in 1933, the president was not convinced. FDR's reaction to Hansen's proposal for a stabilization agreement was that "the man should absolutely be fired."[24]

By June 1936, Morgenthau was convinced that the French should devalue before being forced into doing so by the markets. But the Blum government needed the act to be dressed up in a diplomatic cloak and, consequently, resisted until September. The French pushed for a formal agreement between the three governments specifying new central rates surrounded by fluctuation bands, a bit wider than before, and commitments of bilateral support between the participating exchange equalization funds.[25] But this was more than the U.S. and British governments could accept: both now saw the exchange rate as properly subordinate to domestic price stability and were not willing to tie their policies to France.[26]

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[24] Clarke (1977a), p.12.

[25] On September 9th, just before devaluing, the French submitted a text to Washington and London proposing an agreement whereby the three currencies would be stabilized against one another, and that the specified limits "shall not be modified except by common agreement or subject to notifying the contracting powers in the case of exceptional and unforeseen circumstances, the final objective of the contracting parties being the general return to the international gold standard when the conditions necessary are found to be realized." Drummond (2008), p.206.

[26] Negotiations started with a visit in June 1936 by Emmanuel Monick, France's financial attaché in London, to Washington, DC. Monick told the U.S. that France would devalue, and FDR agreed that the US would not retaliate so long as the French devaluation was not excessive and US prices would not fall. The problem, Monick conveyed to the Americans, was that the British were unwilling to make a similar commitment. The British sought a formula whereby they could bless the French devaluation, and encourage the French not to make it excessive, while maintaining their room for maneuver. In July they promised not to retaliate by devaluing the pound or by imposing discriminating duties so long as France chose a rate of not more than 100 francs to the pound. At the same time, in a letter to the French at the end of July, Chamberlain stated in no uncertain terms that he was not providing a guarantee that sterling would be stabilized at any particular level. See Clarke (1977a), p.30 et seq.

In the end the French got not a joint declaration but three separate, loosely harmonized statements by the three governments. The three statements dated September 26th implicitly recognized the new exchange rate of 105 to the pound (where the pound was now at roughly $5.00) as broadly appropriate. But the statements contained no numbers, instead speaking in general terms of “consultation” and “cooperation.”

Morgenthau hailed the agreement as the “greatest move taken for peace in the world since the World War,” anticipating Richard Nixon’s characterization of the Smithsonian Agreement as “the greatest monetary agreement in the history of the world.”[27] The reality was more limited. Although the statements spoke of consultation and cooperation, there was no commitment to cooperate in holding exchange rates at those levels. Over the winter of 1936-7, the French intervened to prevent the franc from falling further, while the British intervened to prevent sterling from strengthening excessively. The U.S. Treasury sterilized gold inflows starting in December 1936 to prevent the U.S. price level from rising faster (to prevent the U.S. real exchange rate from becoming overvalued).[28] But there was no formal cooperation between governments. Each country was on its own. Ultimately, the weak currency country, France, was forced into a further devaluation in 1937, as a result of the negative supply shock imparted by the other policies of the French government in 1936-7.[29]

There are few systematic assessments of the effects of the Tripartite Agreement. One exception is Eichengreen and James (1991), who find that exchange rates were somewhat less volatile after the Tripartite Agreement than before.[30] Their interpretation is that exchange rates

[27] Colton (1987), p.188.
[28] U.S. gold sterilization policies are discussed in Irwin (2012).
[29] A recent assessment of those policies is Cohen-Setton, Hausman and Weiland (2015).
[30] Lewis (1949) agrees with this assessment. Sauvy (1967) and Drummond (1979) disagree, concluding in favor of no discernible impact. In addition, international real interest rate differentials were smaller due to a decline in covered interest differentials, exchange risk premia and real exchange rate variability.

had been restored to more appropriate levels as a result of the agreement, obviating the need for sharp changes in levels like those affecting sterling in 1931, the dollar in 1933 and the franc in 1936 (with the renewed depreciation of the franc in 1937 constituting a partial exception).

The lesson of the Tripartite Agreement is to avoid excessively ambitious commitments that you may be unable to meet. The Agreement was possible because the three countries concerned had an interest in seeing the franc devalued by enough to correct the French economy's problem of overvaluation but not by so much as might significantly damage the competitiveness of its partners, and they had similar views of what constituted enough but not too much. The Agreement avoided an excessive devaluation that might have elicited currency or tariff retaliation. It moved exchange rates in more sustainable directions and had a modestly stabilizing impact on foreign exchange markets. It helped make realignment palatable to the French by allowing them to package it, for domestic consumption, as part of an international agreement, while not committing the governments involved to subordinate their domestic objectives to cooperation on exchange rates in any meaningful sense. In currency stabilization agreements, sometimes less is more.

1971 Smithsonian Agreement

The story of the Smithsonian negotiations of December 17-18, 1971 is sufficiently well known that it can be recounted selectively here, in a manner tailored to the questions in the introduction. The situation was not unlike that in 1936. The problem then was that the French franc was overvalued, and the challenge for negotiators was to agree on a realignment that was sufficient to correct this problem but not so large as to create serious problems for the country's partners. It was to prevent other countries from taking offsetting steps that might neutralize the improvement in French competitiveness. And it was to agree on the structure of the exchange rate system now that the currency formerly at its center (in this case the franc) was no longer tied to gold.

In 1971 the problem was the dollar that was overvalued, as evident in the fact that the U.S. was hemorrhaging gold reserves.[31] The challenge was to get foreign countries to accede to dollar devaluation sufficient to stem U.S. gold losses and not to offset any increase in the dollar price of gold by depreciating their currencies commensurately.[32] It was to prevent the Congress from imposing new import duties if other governments failed to go along. And it was to agree on the structure of the new system once the dollar was no longer freely convertible into gold at a fixed price.

The recognition that dollar devaluation was needed was widely shared, although engineering the devaluation had to surmount a collective action problem: other countries fearing a loss of competitiveness generally preferred that the dollar be devalued against someone else's currency rather than their own. This created an argument for an international conference where a set of new parities against the dollar could be collectively agreed. The U.S. employed good-cop, bad-cop tactics to elicit agreement from other countries to convene the meeting at the Smithsonian. The bad cops, President Nixon and Treasury Secretary John Connolly, closed the Gold Window in August, sounding the death knell for gold convertibility, and imposed a 10 percent import surcharge, signaling that they would use trade policy as a sanction against

[31] The source of those gold losses need not detain us here. One interpretation was that expansive U.S. monetary and fiscal policy was responsible for dollar overvaluation and the U.S. balance-of-payments deficit. Another view, known as the Triffin Dilemma, was that U.S. deficits were intrinsic to the operation of the system, given the growing demand of other countries for international reserves, which could be met only by their accumulation of U.S. dollars and/or conversion of the latter into gold. The second view pointed to the need for an increase in the dollar price of gold, while the first highlighted the need for a change in dollar exchange rates and, to maintain them, appropriate adjustments in U.S. monetary and fiscal policies.

[32] "There were strong doubts," as Volcker later put it, "about the willingness of other countries to permit a sizable adjustment, however initiated." Volcker (1978-79), p.6.

countries that hesitated to negotiate.[33] The good cop, Paul Volcker, traveled to Europe to reassure foreign leaders that the U.S. was interested in a negotiated solution.

The Smithsonian Agreement included the necessary realignment of the dollar, where other countries saw a collective 10 percent appreciation of their currencies, although some (like Germany and Japan) contributed more than others, depending on the perceived strength of their economies and their dependence on U.S. foreign policy protection.[34] The dollar was realigned to more appropriate levels. Its adjustment was not offset by other countries. The U.S. did not have to resort to tariffs and other undesirable expedients to achieve this goal; the import surcharge imposed in August was lifted following the successful conclusion of negotiations. It was "no mean feat to manage a devaluation of the proud dollar in a way that did not turn American opinion and policy inward," as Volcker (1978-79, p.6) later put it.[35]

The new system was a compromise between the champions of fixed and adjustable exchange rates. Other currencies were again linked to the dollar, but surrounded now by wider fluctuation bands than before (+/-2 ¼ versus +/-1 percent). The dollar was no longer freely convertible for official foreign holders of dollars as had been the case before August (something that was reflected in the fact that the market price was now significantly higher than the official price). This compromise reflected the fact that there was less than full agreement on how the post-Bretton Woods System should be structured. There was strong disagreement within the U.S. administration between the proponents of fixed and floating exchange rates (Arthur Burns and

[33] Johnson (1973) refers to U.S. use of "its muscle power to force the others to make exchange rate adjustments that the United States considered necessary for its own interests but the others were reluctant to make."

[34] The French franc was revalued against the dollar by 8.57 percent, the German deutschemark by 13.57 percent, the yen by 17.9 percent. The exact numbers reflected a compromise between Nixon and French President Pompidou, who met in the Azores to hammer out their differences prior to the Smithsonian conference.

[35] Volcker later argued that the weakness of the Smithsonian Agreement was that other countries were reluctant to see larger revaluations against the dollar. Feldstein (2013), p.106. Others, like the present author would argue that a larger realignment, even had it been feasible, would not have resolved the underlying contradictions of the system and would have only put off the day of reckoning. See Eichengreen (1993).

Volcker on the one hand, George Schultz on the other). As a result, the U.S. was unable to firmly commit to either fixed or flexible rates.

Similarly, there were significant differences between other countries over how much exchange rate flexibility was appropriate. West Germany had already adjusted the deutschmark/dollar exchange rate more than once as necessary for the maintenance of price stability, and increasingly it saw exchange rate stability as a lower priority than internal stability, so defined.[36] Canada, reflecting its positive experience with floating, recommended wider adoption of a flexible system. France, in contrast, remained wedded to fixed exchange rates and gold convertibility, in part reflecting the enduring influence of the interwar experience recounted above.[37] Japan saw itself as an export economy; while it was prepared to revalue the yen as much for political as economic reasons, it was reluctant to see generalized floating for fear that this would interfere with the growth of international trade (see Angel 1991).[38]

The Smithsonian agreement did not include a commitment on the part of the United States to run a particular set of monetary and fiscal policies so as to defend the new system of parties. It did not entail a commitment to keep inflation in a specified range. As such, it focused on ends rather than means.[39] In this respect it was not unlike the 1936 Tripartite Agreement, and it ultimate met the same fate. Already in 1972 there were complaints that American inflation was excessive (reflecting the pressure Nixon was placing on the Federal Reserve in an election year) and that it was infecting other countries. U.S. capital outflows resumed. Under the circumstances, it is not surprising that “the greatest monetary agreement in the history of the

[36] Thus, Germany had revalued the deutschmark in October 1969 and floated it against the dollar in May 1971. Austria moved all but simultaneously, revaluing by 5 percent, while Switzerland revalued by 7 percent, and the Dutch floated.
[37] Thus, in the immediate aftermath of Nixon’s closing the Gold Window, Germany proposed a joint float of EEC currencies, which France opposed.
[38] In the end, the Japanese government was converted by the import surcharge and threats of more of the same (Irwin 2013).
[39] To paraphrase the assessment in Sachs (1986).

world" proved ephemeral. On February 12, 1973, the new Treasury Secretary, George Schultz, announced a ten percent devaluation of the dollar (an increase in the price of gold from $35 to $42.22 an ounce.) This only encouraged speculation against what remained of the parities negotiated in December 1971.

By the summer of 1973, after a bit more than a year, the new system of parities had collapsed. The Smithsonian Agreement left little in the way of an enduring legacy.

Implications for the Plaza

Other papers in this volume analyze the Plaza Agreement in detail. Here I merely suggest how the Plaza should be viewed in light of the prior history of exchange-rate-stabilization agreements.

A first implication of that history is that exchange rate agreements are helpful when they bring exchange rates in line with appropriate monetary and fiscal policies, but not when they force appropriate monetary and fiscal policies to be modified in order to support arbitrary exchange rate targets. To put the point another way, policy makers privilege exchange rate targets, subordinating their pursuit of more fundamental goals of policy like price stability and high employment, at their peril. In 1985 the high dollar was associated in the popular mind and, more specifically, in the minds of U.S. business leaders with the Federal Reserve's relatively tight anti-inflationary monetary policy. There was pressure on the Fed to relax its stance in order to bring down the dollar and avoid further hollowing out U.S. industry. Given the country's recent experience of inflation and the sacrifice made reduce the inflation rate to more tolerable levels, relaxing Fed policy in order to facilitate dollar realignment was undesirable. Public statements and limited foreign exchange market intervention in January followed by the Plaza Agreement in September facilitated that realignment without requiring an adjustment in Federal

Reserve policy.[40] German negotiators similarly resisted a rigid agreement that might have required them to divert monetary policy from the fundamental goal of low inflation, preferring to rely, appropriately under the circumstances, on public statements and sterilized foreign exchange market intervention. Intervention was used to support the continued pursuit of appropriate monetary policies by moderating their uneven impact and dissipating incipient protectionist pressures that, had the exchange rate not adjusted, might have created irresistible pressure for the Fed's disinflationary stance to be relaxed. This was an example of an agreement designed to bring exchange rates in line with appropriate monetary policies. Anglo-American agreements in the 1920s, when hitherto appropriate monetary policies were modified to bring them in line with arbitrary exchange rate targets, were a prominent counterexample.

A second implication for the Plaza is that it was wise to defer convening an international meeting to discuss the exchange-rate issue until there was broad agreement among the three governments involved, notably those of the U.S., Germany and Japan, on the desirability of facilitating further adjustment in the dollar exchange rate.[41] There had to be a change in U.S. international economic policy leadership, from Donald Regan to James Baker, before this precondition was met. The experience of 1933 cautions against prematurely raising expectations and engaging in unproductive negotiations if internal divisions are likely to prevent their successful conclusion. It also points to the wisdom of convening such negotiations after an election, as opposed to immediately before, so that policy continuity can be assured.

[40] I leave to other chapters the task of analyzing the relative importance of these and other developments in exchange-rate movements, though I am broadly in agreement with the assessment in Frankel (1994).

[41] Henning and Destler (1988) suggest, in a related point, that the success of the Plaza was due in part to the fact that negotiations were organized through the G-5 (which included, in addition to the U.S., Japan and Germany, France and the UK). This avoided the large-numbers problem that would have complicated negotiations organized through the IMF or OECD. This argument is consistent with the observed contrast between the 1933 World Economic Conference and 1936 Tripartite Agreement, although some of the other episodes analyzed above fit less easily with their viewpoint.

A third implication is that a productive outcome at the Plaza was facilitated by the fact that agreement among governments encompassed not just principles but specific magnitudes, as it had, for example, in 1936 and to a lesser extent in 1971. At the Plaza the U.S., Germany and Japan all agreed, accounts suggest, on a 10-12 percent depreciation of the dollar against the deutschmark and the yen relative to September 1985 levels.[42] But while there was broad agreement on the desirability of exchange rates in that range, there was little appetite for an ambitious stabilization agreement of a sort that governments were unlikely to successfully maintain, given divergent conditions in the three economies. The Plaza communique therefore omitted, appropriately, mention of specific levels or ranges for exchange rates. As in 1936 (and unlike 1971), less was more.

Fourth, there could be constructive negotiations at the Plaza because there was broad agreement within governments – as well as between them – about the desirability of exchange rate adjustment. This had not been the case in the United States, in particular, before 1985, when the Fed had favored some form of action, including presumably sterilized intervention, to prevent and reverse excessive dollar appreciation but the Treasury under Regan, strongly wedded to free-market ideology, did not agree. Henning (1994) reminds us not to dismiss entirely the existence of differences of opinion or at least emphasis within governments; his account is a reminder of how the Fed subsequently became more concerned with dollar weakness (which it feared could become inflationary) than Treasury, and of how the Bank of Japan was less alarmed than the Ministry of Finance by the increasing strength of the yen (which the MOF feared could damage Japanese manufacturing). But the fact is that there was considerable agreement within

[42] Frankel (1994) observes that this became a focal point for discussions as a result of “a never-released ‘non-paper’ drafted by [Assistant Secretary of Treasury for International Affairs David] Mulford for a secretary preparatory meeting of G-5 Deputies in London on September 15…” Funabashi (1988) goes further, asserting that the U.S. made a formal proposal to this effect that was accepted by the other governments.

governments as well as between them about the goals of exchange-rate policy, which enabled national authorities to negotiate more productively. Again, this was very different from 1933.

Finally, the Plaza realignment worked because it was consistent with the economic fundamentals. In 1936, the fundamentals had pointed to a weak franc and a strong pound and dollar, while the Tripartite Agreement accelerated movement in that direction and prevented governments from frustrating it. In 1985 a weaker dollar and stronger yen were consistent with the competitive positions and needs of the U.S. and Japanese economies, while the Plaza accelerated movement toward exchange-market levels consistent with those fundamentals and similarly prevented governments from frustrating it.

The bottom line of this historical review is that the circumstances under which exchange rate stabilization and intervention agreements can be successfully negotiated and when they produce desirable results are relatively rare. Arguably, 1985 was one of these instances.

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