A *Highly Symbolic* Act

By Otmar Issing

Though symbolic, the 1971 changes were a major catalyst for development of the European Monetary Union and the euro.

To characterize U.S. President Richard Nixon's declaration of August 1971 as a highly symbolic act has two dimensions. "Highly" indicates that the declaration sent a message that had a great influence on international policies around the world. "Symbolic" signals that the effect came not from the substance of the announcement but from a mere change in perception.

Why only symbolic? The declaration of 1971 is widely seen as the end of the gold exchange standard (or gold-dollar system). This characterization of the international monetary system, which ended in 1971, goes back to the International Monetary Fund Statute ratified in 1945. Article IV, 1(a) specified: "The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944." This established a relation between the dollar and gold at a value of $35 per ounce. What followed in the 1960s were endeavors to preserve the official gold price via arrangements within the "gold pool." But was a gold exchange standard really established in 1945?

The gold standard of the nineteenth century collapsed with the outbreak of World War I. On a global level, the return to gold brought an important modification to the previous system in the form of the gold-exchange standard. Under this regime, countries or in most cases their central banks were allowed to hold their reserves in gold and/or foreign currencies that were pegged to gold. The crucial element of this regime is that it finally allowed money to be converted

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into gold at a fixed price. This was guaranteed by a fixed exchange rate and a fixed parity between the reserve currency and gold.

Was such a regime established in 1945? Definitely not. No legal obligation to redeem the U.S. dollar at a fixed price was introduced either domestically or internationally. For many years, the United States converted official dollar balances into gold at the price of US$35 on the request of foreign monetary authorities. This was a practice, not a legal obligation. It was obvious that, as foreign dollar reserves rose, this practice would (and must) come to an end. This finally became the official position of the United States in 1971. One major reason it did not happen much earlier was that Germany did not follow French President Charles de Gaulle's attack on the dollar by presenting its much higher dollar reserves to be converted into gold.

The position of the U.S. dollar as the leading currency in the post-World War II international monetary system was based not on its relation to gold but on the whole ensemble of factors necessary for a dominating role. First of all, the dollar was the only major currency in the world with full convertibility. When the post-war period of "dollar shortage" gradually shifted towards a situation of "dollar glut" due to the increasing balance of U.S. payment deficits, it became obvious that the principal element for a currency tied to gold was missing—the "golden brake on money creation."

The system of fixed but adjustable exchange rates founded in 1945 collapsed largely (though not only) because U.S. domestic policy neglected the country's responsibility for the global monetary system. The move toward flexible exchange rates was already under way in 1969, when Germany introduced a "floating exchange rate"—at that time intending to provide a limited phase of flexibility (*de facto* four weeks) to find out the appropriate level at which to fix the exchange rate again.

CONSEQUENCES FOR EUROPE

In Europe, the Nixon announcement was understood as a signal that the U.S.-dollar-centered post-World War II international monetary system of fixed but adjustable exchange rates had irrecoverably collapsed. Parity changes and flexibility in exchange rates had an immediate effect on the common agricultural policy of the European Economic Community, which was based on fixed administered prices. In general, the idea gained ground to isolate "Europe" from turbulence in foreign exchange markets.

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With the deutsche mark linked to the dollar, the Bundesbank had to buy increasing U.S. dollar amounts to defend the fixed parity. The consequence was an import of inflation triggered by the enforced rise in base money. Under the threat of massive capital inflows, the Bundesbank put high pressure on the government to abandon the fixed parity against the dollar. The German government was very reluctant, as such a unilateral move would be seen in France, with its enduring preference for fixed exchange rates, as an unfriendly act. Ultimately, however, it granted the urgent request of the Bundesbank. In March 1973, Germany adopted a flexible exchange rate for an unlimited future period, thereby escaping from the "uneasy triangle."

With this decision, the Bundesbank was able, for the first time in the period of free capital movements, to conduct a monetary policy geared towards maintaining (domestic) price stability, its main legal objective.

Under the umbrella of a flexible exchange rate to the outside world, a varying number of EEC members decided to limit exchange rate volatility between their currencies. A period of many years was marked by a sequence of arrangements, starting with the "snake," that led to the establishment of the European Monetary System in 1979.

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On the basis of the price stability-oriented monetary policy of the Bundesbank, the deutsche mark evolved to become the anchor of such arrangements.

In hindsight, one might argue that the collapse of the Bretton Woods system worked as a catalyst for developments in Europe, which culminated in the creation of the European Monetary Union and the birth of a new currency, the euro. In this context, the Nixon declaration has proven to be a highly symbolic act.

WHAT FUTURE?

For advocates of fixed exchange rates, what started in 1971–1973 and persists to this day is a "non-system." They demand a new arrangement. Representatives of forty-four countries met at Bretton Woods in 1944. It is hard to imagine that roughly two hundred countries could be brought together and agree on a new system.

Was a gold exchange standard really established in 1945?

The United States and its currency continue to play an important role, but are far removed from the position they embodied in 1945. As a challenge to the U.S. dollar, the euro has played a relevant but limited role so far. The future of this young currency is accompanied by many uncertainties. This is even more true for the renminbi.

The chances of an agreement on a new global system like that of Bretton Woods remain vague at best. A new system is more likely to emerge in an evolutionary process in which flexible exchange rates between the dollar, the euro, and probably the renminbi could provide a kind of competition in stability. Most other countries might consider fixing the relationship of their currencies to one of these three anchors. And who knows the future of cryptocurrencies?

Considering the dramatic changes the world has undergone since 1971, the present system (or non-system) has not performed so badly. It is hard to say whether a new grand design would be better equipped to survive in an environment of further rapid change. ◆