Research Department
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Managed Floating

Managed floating aptly describes the way in which the major industrial countries have operated in the foreign-exchange market since early 1973. As the term suggests, the objective of central-bank intervention in the market is no longer to maintain a fixed exchange rate, but rather to minimize fluctuations around the basic market value of each currency within an overall context of floating rates.

The system seemed to work quite well for a while, but in recent months it has come under increasing attack from France and other European countries. As an indication of a growing preference for a fixed exchange-rate regime, France recently joined the European "snake" currency bloc, and Switzerland, Italy and other countries have expressed a desire to join the bloc at some future date.

Unwarranted rate movements?

According to critics of the managed-float regime, exchange-rate movements over the past two years have been both excessive and unwarranted. Movements in the value of the dollar against the European snake currencies and the Swiss franc have been particularly volatile, ranging as high as 15 to 20 percent within only a few months' time. Fluctuations in the trade-weighted value of the dollar, on the other hand, have been considerably smaller, but still noticeable. Thus, while the trade-weighted value of the dollar is now slightly above the level of February 1973, there have been a series of swings about this level, the range of variation being roughly four percentage points (plus or minus) during this two-year period.

According to these critics, fluctuations in the value of the dollar against other currencies have been much greater than could be accounted for by international differences in inflation rates or interest rates. In this view, exchange-rate changes have been primarily the result of speculative capital flows, rather than fundamental economic forces. While recognizing that fluctuating exchange rates can serve to clear the market for foreign currencies, critics argue that the managed-floating system failed to achieve its basic objective—namely, to reflect relative changes in economic conditions through market-determined exchange rates.

Again, critics contend that speculative capital flows have had a destabilizing effect on exchange rates, requiring official intervention in the foreign-exchange market to dampen the wide fluctuations in rates. This feeling is widely shared among central bankers, as evidenced by their actions early this year, when they forcefully intervened in the foreign-exchange market to stem the speculative attack against what they deemed to be an undervalued dollar. The Federal Reserve Bank

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of New York sold over $750 million in foreign currencies in February-April 1975—the bulk of these interventions occurring during February's steep slide. Other central banks recorded total gross interventions of several times that amount during this period.

Destabilizing intervention?
Proponents of freely flexible rates, on the other hand, argue that extensive official interventions in the market themselves create excessive rate fluctuations. Instability may result, for example, when authorities attempt to restrain exchange-rate movements at a time when market forces are generating strong pressures for change. Private speculators, convinced that authorities will relent if the pressure becomes great enough, act in such a way as to amplify the pressure—and once the authorities finally give way, "overshooting" takes place.

The question of whether private (or official) "speculation" is stabilizing or not is basically an empirical matter. No final answers are possible because of the shortness of the period of fluctuating exchange rates, but a recent study by John Hodgson (University of Oklahoma) nonetheless helps to shed some light on the question. (His study covers monthly movements in the U.S. exchange rate vis-a-vis the yen, franc, deutschemark, pound and Canadian dollar over the 1971-74 period.) Hodgson identifies some instances in which private capital flows and official interventions had stabilizing effects on exchange rates, as well as instances where each had destabilizing effects. Generally, he argues that the broad movements observed in exchange rates tend to correspond to the rate movements predicted by macroeconomic variables, and in this sense exchange-rate movements were not "out of control" in the period studied. Thus, if his finding is valid, attempts to stabilize exchange rates without stabilizing underlying macroeconomic variables could contribute to exchange-rate instability.

Costs and benefits
A related question centers around the economic costs of exchange-rate fluctuations. Prior to the adoption of managed floating, it was frequently alleged that fluctuating rates would increase the cost of exchanging currencies in the foreign-exchange market, and that this could bring about a reduced volume of international transactions. Has this, in fact, been the case?

A casual inspection of the data might suggest so. The volume of international trade last year declined for the first time in several decades, and it is expected to continue falling in 1975. Similarly, the gross volume of long-term bonds floated on the Euro-bond market last year was almost two-thirds below the 1972 level. However, even the critics would not attribute these developments primarily to fluctuating exchange rates, but rather to the basic economic forces which have resulted in reduced activity in nearly every country of the world.

Several observers have also noted that foreign-exchange transaction costs, measured by the spread between buy-sell rates in the inter-bank market, have doubled or tripled since the adoption of managed floating. However, this was not true of the Canadian experience with floating rates in the 1950's. Also, this phenomenon could be less a reflection of floating rates than of other factors, such as the oil situation or the general uncertainty in foreign-exchange markets generated by the collapse of the fixed exchange-rate system. Nor is it clear that the buy-sell spread has widened enough to affect adversely the volume of international transactions.

While many central bankers and finance ministers may feel uncomfortable with the present regime of flexible rates, they also recognize the benefits accruing from it. First, the system has weathered the various crises, such as oil and world-wide inflation, which led to the abandonment of fixed rates. It is questionable whether perfectly stable rates could ever have been maintained under the difficult circumstances of the past several years. Second, flexible rates have eliminated (or at least mitigated) the need for trade and exchange controls, and in this sense have helped support a continued high volume of international transactions. Finally, the new system of fluctuating rates has probably helped to ease international tensions. Foreign countries are now free to pursue a more independent course of monetary policy, and old conflicts about the U.S. role in exporting inflation and about the adjustment responsibilities of surplus (or deficit) nations suddenly seem to have lost their relevance. Indeed, the continued existence of this regime of managed floating indicates that the perceived benefits have outweighed the perceived costs, at least to the present time.

Nicholas Sargen

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/30/75	Change from 7/23/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	84,849	– 214	+ 530	+ 0.63
Loans (gross, adjusted)—total	63,902	+ 147	– 2,464	– 3.71
Security loans	700	+ 11	– 904	– 56.36
Commercial and industrial	23,246	– 113	– 390	– 1.65
Real estate	19,560	+ 41	– 163	– 0.83
Consumer instalment	9,892	+ 25	+ 369	+ 3.87
U.S. Treasury securities	8,115	– 200	+ 3,244	+ 66.60
Other securities	12,832	– 161	– 250	– 1.91
Deposits (less cash items)—total*	84,899	+ 564	+ 5,604	+ 7.07
Demand deposits (adjusted)	23,527	+ 595	+ 1,426	+ 6.45
U.S. Government deposits	210	– 45	– 148	– 41.34
Time deposits—total*	59,562	– 240	+ 4,129	+ 7.45
States and political subdivisions	6,385	– 79	+ 193	+ 3.12
Savings deposits	20,604	– 44	+ 2,749	+ 15.40
Other time deposits‡	28,889	– 28	+ 701	+ 2.49
Large negotiable CD's	15,246	– 189	+ 219	+ 1.46

Weekly Averages of Daily Figures	Week ended 7/30/75	Week ended 7/23/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	67	– 1	39
Borrowings	6	6	477
Net free (+) / Net borrowed (–)	+ 61	– 7	– 438
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 1,123.3	+ 1,461.8	+ 1,416.5
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 143.6	+ 222.6	+ 480.3

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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