

Research Department
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Herpetology

After the relative calm of late 1975, foreign-exchange markets have been rocked since January by a wave of speculative attacks on a number of key European currencies. Downward pressures on the Italian lira, Spanish peseta, British pound, French franc and Belgian franc were accompanied by considerable upward pressures on the German mark and the Swiss franc, while the dollar remained relatively unchanged on a trade-weighted basis. Although the crisis began elsewhere, in Italy and the U.K., it eventually centered on the "snake" bloc currencies of Western Europe.

A knowledge of herpetology—the science of snakes—might help explain the failure of these currencies to wiggle together, but there are rational economic explanations as well for this phenomenon. Some perceive these strains to be the result of destabilizing private speculation, while others feel that differentials in inflation rates and trade patterns are responsible. In addition, many central bankers are concerned that the situation could deteriorate into one of competitive depreciations reminiscent of the 1930's.

Destabilizing speculation

The popular view among most European central bankers is that the situation reflects the destabilizing forces of private speculation. The inability of central banks to restore "orderly market conditions," in turn, is perceived as a failure on their part to coordinate intervention policy effectively. In late

January and early February, for example, it appeared that central banks in the snake bloc countries had succeeded, through massive joint interventions, in resisting a major currency realignment. The victory was short lived, however, as the French franc, Belgian franc, and Danish krone came under renewed pressure in mid-March, following sharp declines in the Italian lira and the British pound.

On March 15, French Finance Minister Fourcade announced that France was provisionally withdrawing the franc from the snake "to protect French currency reserves." Support operations reportedly cost the French central bank more than \$1.5 billion in the preceding week, and considerably more than \$3 billion since the beginning of the year. Belgian authorities meanwhile abandoned efforts to maintain margins within the narrower Benelux "worm" bloc due to substantial losses of foreign exchange reserves.

In announcing the French withdrawal from the snake, Finance Minister Fourcade indicated that the franc's plight was an indirect consequence of the sharp drop in sterling, as well as continued declines in the lira. Close to one-fifth of France's trade is with Britain, Italy, and Spain, and the French apparently believe that these currencies could continue to pull the franc down if their situation is not brought under control. Some French analysts have even suggested that British authorities were responsible for the pound's sudden

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collapse in early March. The Bank of England reportedly sold sterling when there was a tendency for it to appreciate, setting off a subsequent selling spree by private investors who interpreted the action as a sign that British authorities wished to see sterling lower. The lira's decline in March, moreover, was attributed to the unwillingness of Italian authorities to intervene to maintain the franc-lira rate.

This argument implies that British and Italian authorities have not intervened forcefully enough, or undertaken sufficient measures, to prevent currency depreciation. There is no evidence, however, to indicate that either country has deliberately tried to drive down the exchange rate. If anything, European central banks have strongly resisted exchange-rate changes, even when market factors indicated that changes could be warranted.

Inflationary pressures

An alternative explanation of the crisis is that private investors perceived large differentials in inflation rates and trade patterns between the two groups of European countries, and thus anticipated that changes would be made in their relatively fixed exchange rates. Inflation rates in Belgium (13%), France (10%), Italy (11%), Spain (16%), and the United Kingdom (24%), are from two to four times

higher than in Germany (6%) and Switzerland (7%), and differentials have widened in recent months. This situation, in turn, has contributed to divergences in the trade positions of the two groups of countries.

The situation is further complicated by the use of the dollar as the principal intervention currency. With the U.S. inflation rate (9%) between the German-Swiss rates and other European countries' inflation rates, one would expect the mark and Swiss franc to appreciate against the dollar, and the other currencies to depreciate relative to the dollar—and this has been precisely the case.

Some observers argue that, to the extent that the present strains reflect differences in inflation rates rather than destabilizing speculative pressures, a different light may be cast on the desirability of central-bank interventions. Under these circumstances, if a central bank intervened to prevent a desirable currency depreciation, the action would tend to postpone necessary market adjustments. Hence, in this view, official interventions themselves could become a source of instability.

The persistence of inflation differentials also raises questions about the viability of a joint European float. Fixed exchange rates among

Common Market countries are clearly desirable for maintaining stable trade patterns, given the importance of intra-bloc trade among these countries. The basic issue, however, is whether fixed exchange rates can be maintained when countries do not follow identical monetary policies and when they differ over desired inflation-unemployment trade-offs. According to many outside observers, the more divergent monetary policies are in snake countries, the greater is their need for increased exchange-rate flexibility. In this view, the current snake problems primarily reflect a failure of central banks to coordinate monetary policy, rather than a failure to coordinate intervention policy.

Competitive depreciation?

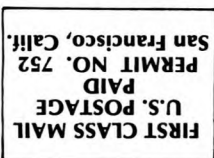
How real is the threat of competitive depreciations? Those observers who are skeptical about floating exchange rates have worried about this threat ever since the managed-float system was initiated in March of 1973. To lessen the prospects, international financial authorities developed voluntary guidelines for the "interim period" of international monetary reform, whereby central banks would refrain from selling their domestic currencies to drive down their value. At the same time, central banks were encouraged to smooth unnecessary exchange-rate fluctuations by "leaning against the wind."

Until March of this year, all of the European central banks strongly resisted exchange-rate changes. Then came the British and Italian initiatives. Yet despite the criticism of their actions, there is no evidence that they have violated the guidelines. Moreover, to the extent that pressures on these currencies reflect inflationary forces, the British and Italian central-bank actions in not strongly resisting exchange-rate depreciation would be entirely appropriate.

Finally, the existence of double-digit inflation in most European countries should act as an important constraint on the possibility of future competitive depreciations. While depreciation would tend to enhance a country's employment situation, it would also tend to exacerbate inflationary pressures by bidding up prices of imported goods and import substitutes. This consideration of course was less important in the 1930's, when high unemployment was accompanied by price deflation.

In sum, European countries today are encountering many of the same problems which plagued the international monetary system in the late 1960's and 1970's. Their dilemma is one of maintaining relatively fixed exchange rates in the face of differential inflation rates, in a world where capital remains highly mobile.

Nicholas Sargen



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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/10/76	Change from 3/03/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	87,561	+ 1,152	+ 1,287	+ 1.49
Loans (gross, adjusted)—total	65,932	+ 1,107	- 676	- 1.01
Security loans	2,057	+ 1,153	- 208	- 9.18
Commercial and industrial	23,043	- 1	- 1,114	- 4.61
Real estate	19,497	+ 20	- 367	- 1.85
Consumer instalment	10,614	- 7	+ 737	+ 7.46
U.S. Treasury securities	8,834	- 155	+ 1,950	+ 28.33
Other securities	12,795	+ 200	+ 13	+ 0.10
Deposits (less cash items)—total*	87,512	+ 1,191	+ 2,740	+ 3.23
Demand deposits (adjusted)	24,430	+ 765	+ 1,282	+ 5.54
U.S. Government deposits	364	- 237	- 75	- 17.08
Time deposits—total*	61,287	+ 802	+ 1,425	+ 2.38
States and political subdivisions	6,381	- 130	- 376	- 5.56
Savings deposits	24,960	+ 102	+ 5,854	+ 30.64
Other time deposits‡	27,407	+ 609	- 3,274	- 10.67
Large negotiable CD's	12,242	+ 788	- 4,574	- 27.20
Weekly Averages of Daily Figures	Week ended 3/10/76	Week ended 3/03/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	9	88		48
Borrowings	0	3		0
Net free(+)/Net borrowed (-)	+ 9	+ 85		+ 48
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 1,352	+ 1,502		+ 2,004
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 547	+ 148		+ 1,574

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.