Research Department
Federal Reserve
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The Lesson of Poincaré

Although it is an overstatement to suggest that the French national budget crisis of 1926 has an equal today in the budgetary and monetary problems of France and the United States, there are certain similarities that merit attention. Both the U.S. and France in the last few years have had record increases in their national debts. The U.S. is looking at the prospect of doubling its national debt over the next five years, while France's total franc-denominated debt is currently greater than Ffr. 400 billion, compared to Ffr. 150 billion in 1977.

But while the national deficits of both countries are mushrooming, we find quite a divergence in the behavior of the exchange rate. (See Chart.) The French franc has depreciated from 4.07 Ffr/$ in December 1979 to 7.6 Ffr/$ in June 1983. The U.S. dollar, on the other hand, remains much stronger than the relative prices between the U.S. and its major trading partners would seem to warrant.

There are probably many explanations for the divergent behavior of the two currencies, but certainly one must be expectations of how the central banks will behave in the face of the increasing financing needs of their federal governments. In this respect, the events that led up to the 1926 foreign exchange market crisis of the French franc provide a useful backdrop and some interesting lessons to the budgetary problems facing France and the U.S. today.

History of the franc

The law of 7 Germinal an XI (March 28, 1803) established the French franc (defined as five grams of silver nine-tenths fine or the equivalent) in terms of gold—one part gold to 15.5 parts silver.

Although it later moved away from bimetallism to a gold standard, the French franc remained for 125 years as originally defined. The printing of paper notes was controlled by the Banque de France, although paper money was not legally required to be backed by gold or silver unlike the legal requirements behind the paper currencies of most other countries at the time. Confidence in the central bank of France was enough, and this confidence was justified. In over one hundred years, only twice, during the crisis periods of 1848-49 and 1870-73, did the Banque de France suspend convertibility of its bank notes into specie. In establishing the French franc, Napoleon knew well the value of a sound currency in providing both economic and political stability.

The first major weakness in the French franc did not occur until after the First World War. To a large extent, France had financed the war by "advances" from the Banque de France to the French Treasury. Total bank notes in circulation grew from 5.7 to 37.9 billion francs between the end of 1913 and the end of 1920. Eleanor Dulles and Martin Wolfe, two historians of the French franc, have noted that the growth in bank notes in circulation was greater than that required by the private sector for the financing of real economic activity during the war and consequently led to a major increase in French prices. Retail prices, for example, rose by more than 130 percent between 1914 and 1918.

The rise in inflation in France did not, however, have much of an impact on the French franc/U.S. dollar exchange rate. One U.S. dollar bought 5.17 francs in 1914 and 5.45 francs in 1918. The franc failed to depreciate by an amount proportional to the differential rate of inflation between the U.S. and France because the central banks attempted to peg the exchange rate around the pre-war parity. After the war, when these pegging operations ceased, the franc depreciated roughly in line with the rise in

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inflation. By the end of 1920, the U.S. dollar bought 16.80 francs, compared with 5.45 francs two years earlier.

Reparations and the deficit

After the war, a debate ensued regarding the ability of the French government to pay back its loans to the Banque de France. The strong relationship between note issuance during the war and the rise in domestic inflation had been noticed and repayment of the loans was regarded as a deflationary policy. In December 1920, the Minister of Finance, Francois-Marsal, and Governor Robineau of the Banque de France reached an agreement, enacted into law, for the government to pay the central bank two billion francs annually. However, only one payment was made. Because of post-war reconstruction expenditures, the total government debt kept rising, and much of the new debt was again financed by direct advances from the central bank.

As with the cost of the war, little of the major increase in national expenditures was financed by increases in direct taxes. France had hoped that reparation payments from Germany would cover the costs of reconstruction, but because Germany was suffering from runaway inflation, the payments were often delayed and were much smaller than expected. In January 1923, France sent its army into the German Ruhr to obtain reparation payments by force. The cost of the occupation, however, proved greater than the economic benefits. When the Dawes Committee subsequently worked out a plan for German monetary reform and a plan for reparation that was satisfactory to France, the French withdrew. The message of the incident, however, was that the French national debt would have to be borne domestically. In 1924, taxes were increased sharply.

The following year saw the short reigns of six finance ministers. France's economic problems were horrific. The repayment of principal on the internal national debt amounted to two-thirds of the national budget. The threats of confiscatory taxation and inflationary finance as solutions to the budget crisis were readily apparent. The repayment of principal alone amounted to 22 billion francs in 1926, and the deficit totalled 36 billion francs. The link between deficits and monetary growth was clear—bank note circulation grew by about 25 percent. The result was a capital flight that caused the value of the French franc to plummet from 26.5 francs per dollar in January 1926 to 40.96 francs per dollar in July 1926.

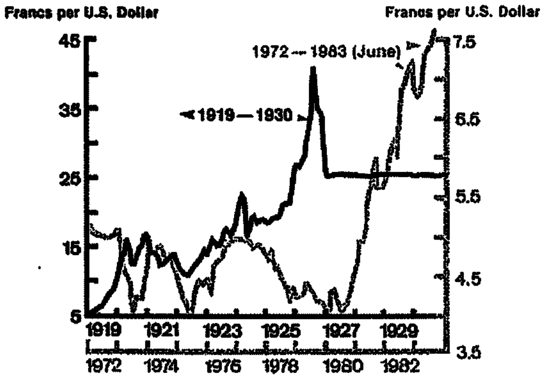
In June of 1926, Briand became premier and Caillaux, minister of finance. Caillaux proceeded to argue that he be given broad powers to make agreements with the Banque de France without parliamentary approval. But Parliament balked, and on July 17, the government was overturned. In the short period between July 15 and July 20, the franc depreciated from about 40 francs to the U.S. dollar to over 50 francs. A full financial and political crisis was at hand.

1926 and Poincaré

As in the current debates over the U.S. deficit, public concern seemed focused on the inability of the factions within government to find an economically workable and politically acceptable solution to the deficit problem. The extent of the political crisis can be measured by the longevity of the Herriot government; it lasted only forty-eight hours.

Precipitating its fall was the act of the governor of the Banque de France, Emile Moreau, who refused to lend any more money to the government unless the legal limit on the Banque's lending ability was approved. He brought this issue to a head on July 21, 1926, in a letter to M. de Monzie of the Treasury: "It is to be feared that...our weekly statement...will show an excess of advances to the state over the legal limit which will oblige the Banque to cease making payments everywhere for the account of the Treasury."

THE FRENCH FRANC/U.S. DOLLAR EXCHANGE RATE



On July 25, 1926, a new government was formed by M. Raymond Poincaré. Consistent with the nature of both the political and economic crises, he also assumed the position of minister of finance. Poincaré, an old-time conservative politician was almost 66 at the time of the crisis and had had considerable experience in previous governments. On the domestic front he was earlier instrumental in obtaining major electoral reform in the passing of a proportional representation bill. In foreign affairs he is recalled as having stressed the importance of continuity and clarity. For the French, Poincaré represented stability.

Almost as if by magic, the French franc began to stabilize in the foreign exchange markets after he took office. Poincaré's major policy efforts were to reduce government expenditures and to increase government revenues. He increased the applicability of a business turnover tax, raised the luxury tax and increased import duties, while at the same time lowering the tax rate on the highest income brackets from 60 to 30 percent.

Poincaré also gave the Banque de France an additional element of power and autonomy. A law was passed defining "agreements" of the central bank with respect to treasury loans and the limits on note circulation. The lack of political independence of the central bank from the Treasury had been an obvious source of the 1926 crisis. Moreover, the law gave the Banque de France the ability to engage in the buying and selling of foreign exchange, thereby permitting the bank to try directly to stabilize the franc in the exchange markets. Poincaré also argued before the Chamber of Deputies for a return to the gold standard and to gold convertibility to restore faith in the franc. From July to December 1926, the franc rose from 40.96 to 25.33 Ffr/$.

The franc's return to stability was indeed incredible. It remained relatively constant at around 25 francs to the dollar from 1927 to 1932, yet the Poincaré "miracle" contained nothing startlingly new in terms of policy. Instead, historians recall the simplicity, consistency and speed with which Poincaré's proposals were adopted. They believe these qualities were primarily responsible for fostering public confidence in the face of the potential for inflation from large government deficits that still existed and a central bank that lacked independence from the Treasury.

The lesson

As M. Poincaré experienced in 1926, the value of a nation's currency is sensitive to the relationship between the government agency that spends money and the agency that creates it. The present strength of the U.S. dollar in international markets, which appears greater than that warranted by relative price comparisons with its trading partners, may be a measure of confidence in our central bank. Excessive monetization of U.S. deficits in the months and years ahead could just as easily result in a U.S. dollar as "unexplainably weak" as it is currently "unexplainably strong."

The 1926 lesson of Poincaré is that deficits need not lead to currency depreciation if the central bank and the fiscal authorities can convince the public that they will not be monetized without restraint. Deficits need not be inflationary, but history has shown that they often are.

Joseph Bisignano

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/22/83	Change from 6/15/83	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	162,289	− 567	2,244	1.4
Loans (gross, adjusted) — total#	140,760	− 586	1,533	1.1
Commercial and industrial	44,179	37	714	1.6
Real estate	56,229	29	− 1,153	− 2.0
Loans to individuals	23,788	58	435	1.9
Securities loans	2,403	− 256	138	6.1
U.S. Treasury securities*	8,279	22	1,710	26.0
Other securities*	13,249	− 3	− 1,000	− 7.0
Demand deposits — total#	40,158	−3,955	2,992	8.1
Demand deposits — adjusted	28,540	−1,735	2,346	9.0
Savings deposits — total†	66,446	− 746	36,103	119.0
Time deposits — total#	65,206	931	− 29,837	− 31.4
Individuals, part. & corp.	59,161	1,013	− 26,175	− 30.7
(Large negotiable CD's)	18,686	694	− 15,745	− 45.7

Weekly Averages of Daily Figures	Week ended 6/22/83	Week ended 6/15/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	87	116	101
Borrowings	573	641	25
Net free reserves (+)/Net borrowed(−)	− 487	− 525	76

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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