French Exchange Rate Management in the mid-1920's lessons drawn from new evidence

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Summary

This paper challenges the conventional view of the existence of a pure floating regime in France during the mid-1920's. Our study of the archives of the Bank of France and the French Ministry of Finance, as well as a thourough examination of the exchange rates (FRF/USD) and (FRF/GBP) during the 1920's reveal that the French authorities did intervene on several occasions. How ever from these first direct actions, as well as some over abortive attempts, several lessons can be drawn about the effectiveness of interventions on a 'modern' echange rate market.

Exchange rate, Expectations, Speculation, Bank of France, French Treasury, Intervention, Dirty floating, Signalling effect, Credibility.

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INTRODUCTION

The classical reference to the work of R. Nurkse invites us to consider that "the post-war history of the French Franc up to the end of 1926 affords an instructive example of completely free and uncontrolled exchange rate variations" (1944, p.117). According to M. Friedman, Nurkse really uses this example only to defend his thesis on the potentially destabilizing effect of currency speculation. Recently, B. Eichengreen bases his argument on the French episode, stating : "A notable feature of post-war international money arrangements was the freedom of the float. As a rule, central banks did not intervene in the foreign-exchange market. The first half of the 1920's thus provides a relatively clean example of a floating exchange rate regime"(1996, p.47). For B. Eichengreen,"the French authorities only intervened in the exchange market for two months, in the spring of 1924 and during

the second half of 1926" (1982, p.73). Indeed, these two episodes became well-known following J-N Jeanneney's (1976) and J-C Debeir's (1978) publications for the former and the publication of "*Souvenirs"* by Governor Moreau (1954) for the latter. On the basis of B. Eichengreen's statement (1982), as he studies whether or not speculation had a stabilizing or destabilizing effect empirically, the hypothesis of the one-to-one relationship between the monetary base and exchange rate during the second semester of 1924 and the first semester of 1926 is made. J.Frenkel (1978), who uses the French example to check the PPP relationship, makes exactly the same assumption, he assumes, de facto, an absence of endogeneity in variations of the monetary base.

However, our study of the archives of the Bank of France and the French Ministry of Finance, as well as a thourough examination of the exchange rates (FRF/USD) and (FRF/GBP) during the 1920's reveals that the French authorities intervened on three other occasions ; once between November and December 1924, again from June to October 1925 and the lastly between May and June 1926. We will here analyse the motives, means and consequences of the actions as systematically as possible. Even if these interventions seem to be non-sterilized, the fact that the French authorities maintained the stability of nominal interest rates to

facilitate the sustainability of the public debt, (see G. Makinen and T. Woodward (1989)), leads us to bypass their effect on portfolios. However, their direct influence on exchange rates can be noted and our attention will be therefore focused on their signalling effects (see M. Mussa (1981) and P. Kenen (1987)).

Far more than contemporary studies, dedicated to interventions during the nineteen eighties and nineties, this original contribution encounters the problem of the state secrecy surrounding the means of action of the monetary authorities and therefore is an exploratory nature.

However, from these first direct actions, as well as some over abortive attemps, several lessons can be drawn about the effectiveness of an action in a forced exchange rate regime in a "modern environment". Aftalion (1927), very soon, underlined the key role played by speculators in the modification of the market and the importance of new information in the formation of exchange rates. He also identified some gregarious behaviour, describing the mechanisms of what we today call 'bubbles' or mimicking behaviour.

From an economic point of view, the French 1920's episode shows that the concept of credibility is central when considering the effectiveness of an intervention. Only credible intervention can

send a signalling effect powerful enough to obtain a reversal of the dominant opinion in a market where exchange rates are below their "equilibrium level". This credibility depends more on the perception the operators have of the authorities' financial and monetary intentions, rather than the means which are actually used. This opinion is shared in contemporary papers on the subject (see K. Dominguez and J. Frankel (1993), in particular).

From a strictly historical perspective, we show that the first of the role of the French monetary authorities in the regulation of the foreign-exchange market was fundamentally disturbed by the fact that the decisions taken about the means of action to be used, dictated the choice of the future monetary regime. Finally, even more fundamentally speaking, the reality of these interventions invites us to challenge the conventional view of the existence of a pure floating regime in France during the mid-1920's.

THE INSTITUTIONAL CONTEXT AND THE FIRST INTERVENTION OF MARCH 1924

At the time, the authorities on the exchange rate policy was bicephalous, with a clear asymmetry between the Ministry of Finance and the Bank of France. Indeed, until the Monetary Reform

of August 7 1926, the Bank of France was not empowered to intervene in the market either directly or alone. In addition, before October 16 1926 it did not have a foreign exchange department. If the Bank wanted to intervene it was necessary to get prior approval from the Ministry of Finance. This really meant that the decision was governmental and therefore took time, given its political nature. More generally speaking, the limits of the autonomy of the Bank of France in the post-First World War can be observed. It can nonetheless be noted that the Ministry of Finance also needed the Bank of France as it was extremely difficult to obtain foreign exchange (necessary for any defensive action), without the 'golden-guarantee' of the issuing institution, especially during the period of the depreciation and up until the reversal of the situation in July 1926. Technically speaking, all market intervention had to be led by duly mandated commercial banks (at this time, most frequently the Banque Lazard, but also Société Générale and Crédit Lyonnais). This deprived the authorities of direct contact with effective management of the foreign exchange market.

The well-known episode of March 1924 illustrates, among other things, the fact that the success of intervention crucially depends on the cooperation between the different parties involved

in monetary affairs. After two months of procrastination (see R. Philippe (1931) and J-N Jeanneney (1976)), those in charge at the Treasury and at the Banque Lazard succeeded in convincing Poincaré's government of the validity of an action : the spectre of the collapse of the Deutshmark convinced them of the necessity to respond to the offensive of speculation against the Franc. The Bank of France agreed to engage part of its gold reserves against two loans : one of four million Pounds negotiated on March 9 with four British banks, the other of 100 million Dollars from the Morgan bank. The latter was subordinated by the French government's commitment to press the Senate to adopt a rapid vote for measures of budgetary austerity. In this way, the authorities hoped to obtain a lasting reversal of the situation.

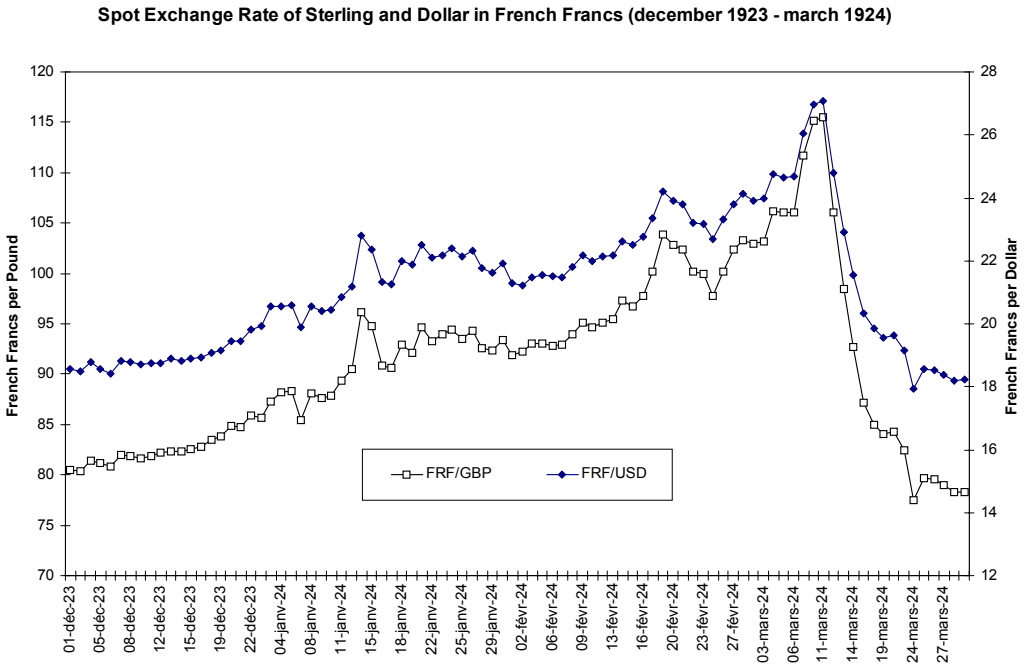

Fig 1. Source : Statistique journalière, Archives de la Banque de France.

Intervention began on Monday 10, with only the English loan and a small amount of currency at the disposal of the Bank of France. Each morning, bankers and officials from the Treasury and the Bank of France conferred and came up with a plan. As shown in figure 1, the action taken gave rise to a reversal of the trend from March 12 and March 13, when international speculators learnt of the up-coming vote on financial measures and the opening of the Morgan loan. In Paris, on Friday, March 14, Sterling and the U.S. dollar were worth 92.6 FF and 21.5 FF respectively, whereas on Monday 10 they had been worth 111.2 and 26.9 FF respectively. At the end of the same month, these two currencies were only worth 78.3 FF and 18.2 FF. The French Franc had

regained almost one third of its nominal value. Less than half of the Morgan loan had been enough to obtain this result and at the end of March the Ministry had already bought back enough currency to pay back two of the English loans. The Bank of France used the opportunity to constitute foreign exchange reserves (see Jeanneney (1976, p. 190)). The operation was a great success.

THE DEFLATIONARY INSPIRATION OF THE NOVEMBER-DECEMBER 1924 INTERVENTION

In June 1924, the newly appointed Herriot Government (left-coalition) stated its intention to continue the deflationary policy with which had been implemented since the 1920 François-Marsal Convention. To obtain appreciation of the French currency, note ciculation had to be maintained under the ceiling of forty one billion Francs. The figure for note circulation, published every Thursday, was an indicator of the government's monetary credibility. However, as it was also the variable of modification of the government's financial policy (through advances obtained from commercial banks) it was going towards the statutory limit. In reality, until April 1925, the Bank of France used to falsify its weekly statements to conceal the fact that the legal limit had been

exceeded. This is the affair of the so-called « false statements » of the Bank of France (see appendix 1). The confession of this fact would lead to the definitive failure of French Monetary Policy and a loss of all hope for the revaluation of the Franc. These facts can be consided as an instance of the type of domination of monetary policy by budgetary policy, as described by Sargent and Wallace (1981).

According to R. Philippe (1931, p.65), of the Banque Lazard, the general secretary of the Bank of France A. Aupetit first had the idea of market action in November 1924. As a result, the Bank of France could expect a reduction in note circulation. The following mechanism was indeed expected : the appreciation of the Franc would have a positive impact on public confidence and if it lasted would allow a general decrease in prices via the reduction of import prices, furthermore it would incurr a drop in 'monetary demand'. Herriot accepted this scheme, he presumably thought it would restore public confidence at a time when his government was issuing bonds. In fact, the action began two weeks after the launch of the Clementel loan and finished a few days before its close.

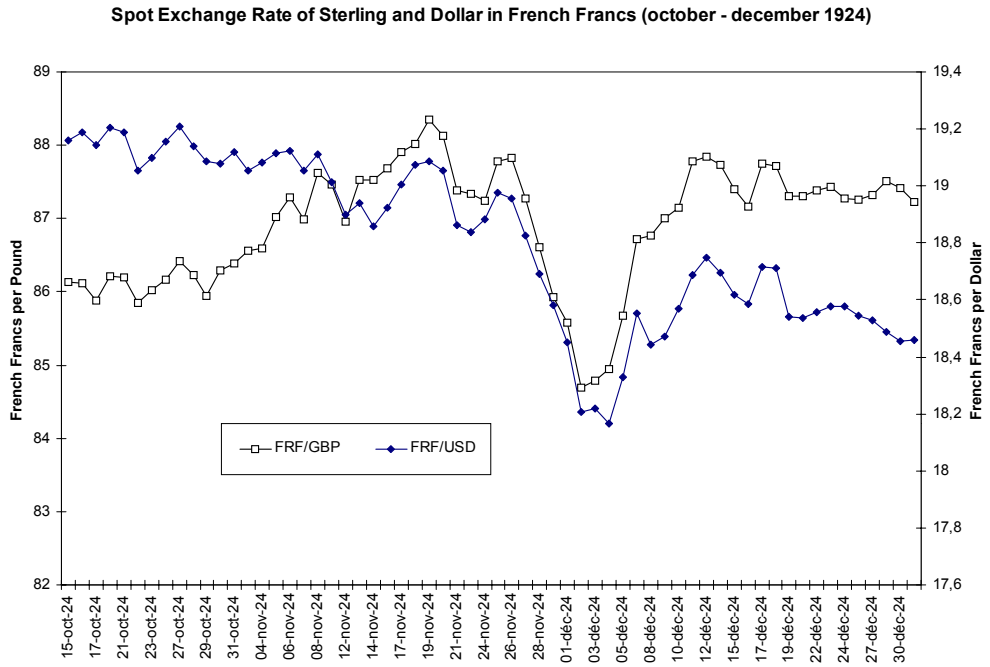

Fig 2. Source : Statistique journalière. Archives de la Banque de France.

The Banque Lazard intervened on behalf of the French monetary authorities from the end of November 1924 essentially by using the Sterling and dollars collected by the Central Bank after the March intervention, and without having to use the Morgan funds. Figure 2 shows the consequences of the operation : Sterling was worth 87.83 FF on November 26 ,whereas by December 2 it had fallen to under 85FF. The Dollar, on the other hand, which had been falling slowly, then dropped very dramatically : on November 26 it was worth 18.95FF and by December 4 it had dropped to 18.16FF. However, at the beginning of December foreign exchange demand grew stronger and stronger as the market clearly intended to take advantage of the fall in

exchange rates. The Bank of France -lacking the means - had to take the decision to stop the operation very quickly from December 12, as Sterling and the Dollar were worth what they had been prior to intervention.

In March 1925, intervention was again contemplated. The idea, this time, came from the Minister of Finance, E. Clementel ; according to him the targeted drop in the rates of the Dollar and Sterling would allow "a marked remission of the amount of notes in circulation in a short time."[1] Deflationary inspiration was the same. Clementel put thirty million dollars at the disposal of the Bank of France, fifteen million taken from the Morgan funds and the other fifteen million from a recent transfer between the Treasury and the Bank. For the government, this was a way of obtaining a little respite and a way of leaving the scene honorably ; that is, if note circulation had effectively dropped below the ceiling. Robineau waited until March 12 before formulating this request to the Board of the Bank. He did undoubtedly 'dawdle'. The next day, the Board noted that confidence in the Franc was lower than it had been in March 1924. With thirty million dollars, the

[1] Archives de la Banque de France, lettre de Clémentel à Robineau en date du 4 mars 1925, Procés verbal du Conseil Général, séance du 12 mars 1925.

Bank contended to only be able to contain the depreciation of the Franc, and thus such an action could not be justified. The Bank was also against a large scale operation : "the effectiveness of such operations remains always uncertain, given that the French Franc is grappling with the interests and strengths of the whole world. It is even more doubtful today and will be even more preoccupying, as long as the state of the Treasury remains as it is, despite the upcoming issue of a contribution check and opinion will clearly not be oriented towards revaluation of the Franc through the governments's budgetary program."[2] On the impulse of Regent Wendel (member of the opposition to the Cartel) the Bank of France now waited patiently for the revelation of its own false statements in order to quicken the fall of the Herriot government.

EXCHANGE RATES STABILIZATION BY THE TREASURY : THE JUNE-OCTOBER 1925 INTERVENTION

The long operation in the months of June to October 1925, mentioned for the first time in this paper, was the result of a personal initiative taken by the Minister of Finance : J. Caillaux.

[2] Archives de la Banque de France, lettre de Robineau à Clémentel, Procés verbal du Conseil général, séance du 13 mars 1925.

The Bank of France and the Banque Lazard were not in favour of it and no note of recommendation from the Treasury can be found on the subject. The Minister of Finance had two goals : naturally to stop the depreciation of the Franc, which had spiralled downward since the scandal of the false statements at the beginning of 1925, but furthermore to re-establish public confidence a few days before the launch of the Caillaux exchange-guarantee loan.

At the beginning of June, the possibility of an operation wherein all the foreign exchange at the disposal of the Bank of France and the totality of the Morgan funds would be used, was studied.." to not allow domestic or international speculation to operate in an empty market where offers are lacking "[3]. However, an incident between Caillaux and those in charge at the Bank of France, put pay to this plan. According to Philippe, the Bank of France was alerted by the Lazard Bank of mounting tension vis a vis the Franc in New York and refused to act, arguing that they did not have ministerial backing. It is said that in a state of anger, Caillaux uttered the following to Governor Robineau " I testify that

[3] Archives Economiques et Financières, B 32351, lettre de la banque Lazard frères & Cie à Caillaux, en date du 8 juin 1925.

from this day forward I will bestow my services to ensure this defence and I am resigned to do so without your approval".

From the last week of June, the Treasury, therefore, sold its currency (over 1.3 million Sterling and more than 1.3 milion Dollars) without being able, however, to stop the Franc's depreciation : as shown in figure 3, Sterling reached a maximum of 108.55 Francs on July 1. It is without doubt that the announcement of the vote to increase note circulation by 6 billion on June 27, had a very negative effect on the exchange rate of the Franc. Nevertheless, the Ministry continued. Table 1, which relates purchases and sales of foreign exchange perfomed by the Treasury, shows that between June and October, the Lazard Bank not only bought currency (as it had done since the end of the First World War) which allowed the Treasury to cope with repayments of the foreign debt, but it also sold Sterling and Dollars in attempt to stabilize the exchange rate of the Franc.

TABLE 1

Foreign exchange purchases and sales on behalf of the Treasury in 1925 (thousands)

	STERLING		DOLLAR	
	Purchases	Sales	Purchases	Sales
January	525		4 350	
February	440		900	
March				
April	745			
May	2 370			
June	3 567	1 386	4 501	1 346
July	5 042	1 364	9 257	119
August	2 005	3 730	1 448	85
September	5 121	3 285	5 348	537
October	1 024	6 950	1 150	2 001
November	905		2 950	
December	2 749	976	6 337	
Total	24 494	17 662	35 833	4 088

Source : Archives Economiques et Financières, B 32351, Ministère des Finances.

It can be observed in July 1925, that while purchases were almost four times higher than sales, the trend was then reversed : from July 3, the Pound dropped to 103.47 F. Had all the means of action possible been used at the beginning of July ? Had the authorities given a strong market signal ? Had operators expected that the monetary authorities had the firm intention of controlling the external value of the Franc, and that it would therefore pay back, per contra, the Francs supplied on the market, from that moment on ? In any case, the rates did remain relatively stable

until the end of September, Sterling swung between 102F and 105F and the Dollar between 21F and 21.5F. This was the result of engaging 3 700 000 Pounds in August and 3 825 000 Pounds in September, the amount of Dollars used was lesser. The fact that sales of currency were higher than purchases may reveal the existence of a market 'pressure' leading to the Franc's decline. No more can be said about this, given the available data.

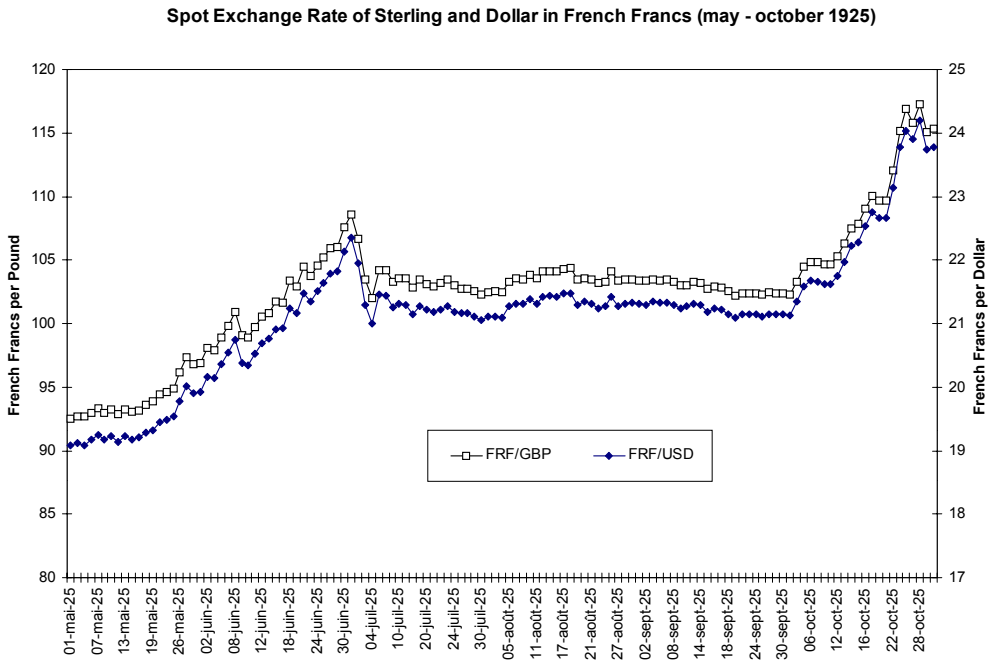

Fig 3. Source : Statistique journalière. Archives de la Banque de France.

During 1925, even if some purchases were motivated by stategic considerations, (that is to take advantage of the circumstances to constitute foreign exchange reserves in order to better channel looming tensions), the fact that the Treasury needed foreign exchange in the post-War period was an additional

factor in the Franc's depreciation. In 1925 alone, 35 million Dollars and almost 35 million Pounds were absorbed in this way.

From October 1, after three months of stability, the Franc suffered a dramatic depreciation in a wholly spectacular fashion. Whereas, on October 1, Sterling and the Dollar were worth 102.3F and 21.12F respectively, on October 14, these currencies had already reached 107.46F and 22.22F and by the 28th they stood at 116.9F and 24.02F. How can such a sudden and substantial drop be explained ?

Sicsic (1992) suggests that it is linked to the failure of the Caillaux loan which had had an effect from mid-September on. It may also be observed that the Franc's decline coincides perfectly with the unsuccessful conclusion of Franco-American negotiations over debt. The latter were made public on October 2, following the rejection of Caillaux's proposals. Without financial approval from the U.S., the perspective of monetary stabilization was rapidly disappearing. It seems that, from that moment on, nothing could stop the decline of the French Franc.

Seven million pounds Sterling were sold, but the Treasury was still unable to stop the Franc from spiralling : there was only a

very short respite from October 7 to October 9 (see figure 3). During the first two weeks of October, the Treasury used up the totality of the foreign exchange it had accumulated during the summer. If the difference between total purchases (16 759 999 Pounds) and total sales (16 716 768 Pounds) carried out between June and October is calculated, it can be seen that the positve balance was only 43 231 Pounds. This clearly shows that the Treasury had committed all the reserves of currency which had been collected during this period. As reserves were depleting rapidly, the Treasury considered using the Morgan funds, which had not yet been touched.

Caillaux clearly was ready to use the latter if necessary : in June, he had already given instructions to the Treasury so as to make sure early of the liquidity of the amounts available. This premature request, confirms that intervention was the Minister's personal initiative. In August, whereas Moret deplored the low yield obtained from these funds, Caillaux once again stated his request for liquidity. "As the Minister has decided to maintain the liquidity of the Morgan funds in order to be able to act if intervention in the exchange market was necessary, the Treasury

has to take this consideration into account while trying to invest the fund as well as possible"[4].

At the beginning of October, Painlevé (the Prime Minister at the time) contacted the Bank on this subject "given the current trend in the exchange market, I think the time has come to use a first instalment (tranche) of 10 million dollars"[5]. The proposal did not get approval. Robineau stated his reservations to the General Council of the Bank : "in the present circumstances, the Council would undoubtedly not have taken the initiative to suggest such an intervention, which would demand, it thought, much greater contingents, given the seasonal requirements of the market and the exceedingly preoccupying state of the Treasury. It apprehends seeing successive instalments of exchange rates reserves being spent, reserves which have protected the market from foreign speculation for the past eighteen months, and which it seems imperative to conserve. It can however, only defer to governmental decisions"[6]. If the operation were to fail, the government alone would be responsible for it. However, on October 9, Painlevé

4 Archives Economiques et Financières, B 33198, note pour le Ministre n°7281, signé par Moret en date du 27 août 1925.

5 Archives Economiques et Financières, B 33198, lettre de Painlevé à Robineau en date du 8 octobre 1925.

6 Archives Economiques et Financières, B 33198, lettre de Robineau à Painlevé

ordered the Bank of France to transfer ten million Dollars, drawn on the Morgan Funds, to the Lazard Bank in New York. A letter, from Caillaux to Robineau, dated October 12, confirmed this transfer. In reality, however, this amount was not used. The operation was stopped in circumstances which still remain unclear. The mounting lack of confidence in the Franc may have led the Minister to deem its committment unnecessary : the Cabinet was also in the grip of internal political conflict.

THE MAY-JUNE 1926 INTERVENTION : DIFFERENCE OF OPINION BETWEEN THE TREASURY AND THE BANK OF FRANCE IS EXACERBATED.

The Treasury held sole responsibilty for the intervention in May-June 1926. In a memo dated May 5 1926, Moret warned of the dangers linked to the Franc's sustained depreciation, which had been going on for the past few months. The acceleration of this decline was fuelled by the general rise in prices, the cost of which would become extremely high. Inflation first threatened the fragile equilibrium of the budget, owing to the increase in expenditure it would cause later. There was also a factor of social discontent,

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en date du 8 octobre 1925.

demands for higher wages were giving rise a situation of mounting tension. Furthermore, the Franc's total collapse was to be avoided. The experience of the Deutschmark in 1922-1923 still haunted memories. The Director of the Treasury. in particular, expressed his concern that " the exchange rates of these last few days and data obtained from various market sources may lead us to expect a climate of panic which would give rise to even sharper drops if the Government does not intervene and decide on immediate market action"[7]. Moret did not conceal his reservations on the success of such an operation to the Minister, given the extreme lack of confidence in the Franc. The Dollars in the Morgan fund alone would not suffice and according to Moret it would be imperative for the Bank of France to secure part of its gold reserves against loans from the Federal Bank.

Péret immediately approached the Bank of France and warned : "the circumstances seem to justify short-term intervention"[8]. At the same time, the Minister of Finance demanded that the Bank of France make the dollars from the Morgan funds, which belonged to the Treasury, available. This

[7] Archives Economiques et Financières, B 33198, note pour le ministre en date du 5 mai 1926.

occurred on May 10. On the same day, he expressed the possibility of using part of the Central Bank's cash reserves as security. The Morgan funds would be insufficient and it was going to be necessary to obtain new loans in foreign exchange. Péret first spoke of 100 million Dollars and then of 150 million Dollars (May 20 1926). While, for the Minister, this was essentially a defensive measure, it was also meant to lastingly restore confidence in assets denominated in French Francs. The committment of foreign loans secured against the gold reserves of the bank would constitute a strong signal which would squeeze currency speculation to a point where it would no longer be necessary to use the foreign currency and hence the gold reserves. Later, it would open the way to structural measures...

The Bank's reaction was violent and negative. It emphasized the problem of lack of volume effect against the potential importance of the signalling effect. In a first letter, dated May 6, addressed to the Ministry, the Bank underlined that using the Treasury's dollars would only give short-term respite, and greater action would be unrealistic given the great lack of public confidence which prevailed in the Franc. There was, therefore, no

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8 Archives Economiques et Financières, B 33198, lettre de Péret à Robineau en date du 5 mai 1926.

need to obtain foreign loans, particularly if the Bank of France had to commit its gold reserves to do so : "the Board still believes that such a measure is dangerous and should be discearded as a threat to confidence in the currency, the preservation of which has always been a priority"[9]. The Bank believed the outcome of the intervention would be negative and as a result it would be unable to pay back the short-term loans to which it had subscribed. It would not be able, therefore, to get back its gold, which was to constitute a predjudice the day the Franc recovered its gold-convertibility.

For the Bank of France, only the return of public confidence would allow the Franc to appreciate. In spite of that, the Minister of Finance thought that, if the Bank could be moraliy and technically involved in the first operations with the dollars of the Morgan funds, it would be brought eventually to lend 'its gold' and thus perpetuate the first results. On May 19, at the Elysée Palace, Robineau, Rothschild and Wendel acknowledged that the commitment of the Morgan Dollars, which did not belong to the Bank, could not be opposed. Briand and Péret purposefully recorded : "the assent must be given by the Bank of France to use

9 Archives de la Banque de France, Procés verbal du Conseil Général, séance du 11 mai 1926.

the Morgan funds, insinuating that without that assent they would never assume responsibilty for even short-term intervention''[10]. Péret must have thought that once the Bank became part of the operation, it would follow. The very next day, he wrote to Robineau : "using the Morgan funds could only obtain insufficient results and leave us ill-equipped to cope with the inevitable reaction which follows any intervention. It is, therefore, imperative that additional means be obtained, as quickly as possible, for our currency to be saved''[11]. On May 20, the Bank had still not given in.

The operation did in fact begin on May 21 in the afternoon. Figure 4 shows that the Franc rose in a spectacular way from May 20 : on May 19 Sterling and the Dollar were worth 170.8 and 35.11 Francs respectively, the following day they had fallen to 163 and 33.5 Francs. Jeanneney (1976) states one of Wendel's opinions, according to which, the Lazard Brothers in association with the Maison Louis-Dreyfus would have taken a position towards the Franc a few days earlier. Desiring to make profit, they would have

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10 Archives de la Banque de France, compte rendu de la réunion tenue le 19 mai 1926 à l'Elysée, annexe au Procés verbal du conseil général de la séance du 20 mai 1926.

11 Archives de la Banque de France, lettre de Péret à Robineau, Procès verbal du conseil général, séance du 20 mai 1926.

committed foreign exchange (their own) from May 20 onwards. However, this is not proven, a letter from Lazard Brothers, dated May 22, seems to suggest the contrary. It reveals that the Lazard Bank was doubtful of the success of the intervention :"indeed, we should not, at any time, dissimulate the difficulty of the task and we remain convinced that even if the operation is entered into with all the necessary guarantees, its success can still not be seen as certain."[12] So the Bank Lazard regarded the failure of the operation as probable and was already careful to deny all responsibility. Why, therefore, in such circumstances would it have taken position ?

The appreciation of the Franc was certainly more likely to have been the result of expectations by certain 'well informed' agents, wise to massive up-coming intervention in the exchange market. The exceptional meeting, held at the Elysée Palace on May 19, reminds us of the counter-offensive of March 1924. Moreover, on May 20, a government communiqué announcing that it intended to use all the resources at its disposal, was released. This news could also have influenced expectations.

12 Archives Economiques et Financières, B 33198, lettre de la banque Lazard à Péret en date du 22 mai 1926.

Whatever the reason, the first results were positive (see figure 4). On May 26, Sterling and the Dollar were worth 149.5 and 30.8 Francs respectively (whereas on May 19, thay had reached 170.8 and 35.1 Francs). To obtain such a result it had been necessary to commit 35 million dollars on the market. The Morgan funds were therefore exhausted very rapidly and it became necessary to find a new means of action. However, the Bank of France maintained its position, despite repeated requests by Peret and Briand.

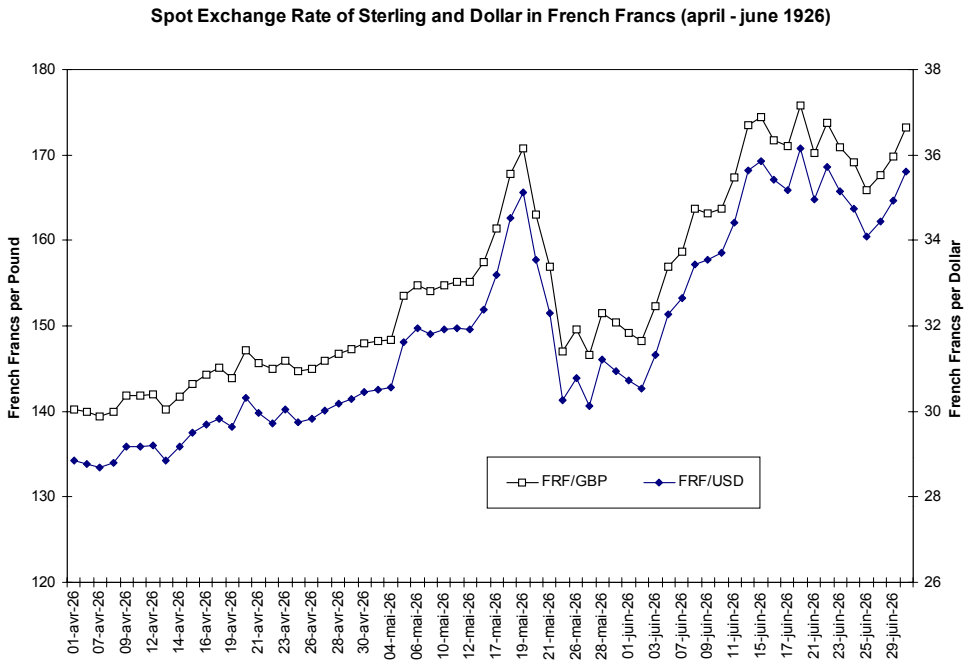

Fig 4. Source : Statistique journalière. Archives de la Banque de France.

On May 27 and 28, the time came to take a decision, Moret wrote : "the balances carried forward on foreign currency are

tightening incessantly : they are currently attaining 13 Francs for one Pound on three months, which means 35 % per annum. It is not surprising that the franc is being sold short more and more and in such conditions a certain release in the exchange market may be expected"[13]. Expectations on the French Franc were still pessimistic (foreign currency was still being carried over), operators were still borrowing francs short term, hoping to pay them back once the franc would have depreciated again. For Moret, strong intervention, provoking additional appreciation of the franc, would "bear squeeze" speculators and lead to a reversal of the situation as it had in March 1924.

The Pound and the Dollar were stable at around 150 Francs and slightly over 30 Francs respectively. The Lazard Bank also felt that stopping action at this point would have extremely serious consequences and that it was absolutely necessary to obtain the support of the Bank of France. The Treasury appealed yet again, but to no avail.

After having "dumped" over half the Morgan funds onto the market and faced with the fact that it could no longer obtain new

13 Archives Economiques et Financières, B 33198, note pour le ministre en date du 28 mai 1926.

currency, the Lazard Bank stopped all action on June 3. However, at the Ministry of Finance all hope had not been lost. During a meeting with Robineau and Briand on June 5, Péret told the Governor that the newly formed Board of experts, had voted unaminously, minus two votes (one of which was that of the vice-governor of the Bank, P. Ernest-Picard), in favour of the Bank committing its gold reserves. A few days later, on June 14 to be exact, a quarrel broke out between the members of the Board : Rist insisted that a motion be voted for the bank to deliver its gold reserves, Ernest-Picard was against and threatened to resign.

Left to itself, the Franc depreciated yet again : on June 8 Sterling and the Dollar were already worth 163.7 and 33.4 Francs respectively and by June 14 they had attained 173.4 and 35.6 Francs. Peret had not managed to turn the situation around. He resigned from office on June 15, regretting not having been able to find support from the Bank of France.

ECONOMIC LESSONS, THE IMPORTANCE OF CREDIBILITY WAS ALREADY APPARENT

In a floating exchange rate regime, intervention on the part of the monetary authorities is meant, either to smoothe short-term fluctuations on the foreign exchange market or to bring about a trend reversal in a situation judged as ever more irrational by looking to correct market perceptions. During the nineteen twenties, interventions were not aimed at reducing the excessive volatility of exchange rates. At the time, this was not a structural factor in the reduction of social well-being. They were used by the French authorities to curb the prolonged decline of the Franc, ('leaning against the wind'). Thus, firstly, the strength of the 'tempest ' must be gauged by briefly analyzing the features of the dynamics of the exchange market between 1924 and July 1926.

The period is dominated by financial constraints which weighed heavily on the French government (see R.M. Haig (1929)). The policy of fixing interest rates - in order to facilitate the management of the public debt - made money supply endogenous to the demand for public bonds (see Makinen and Woodward (1989)). In a context where fiscal uncertainty was lessened (paradoxically a capital levy was never introduced under the left-coalition), this demand basically depend on the real yield of the bonds, that is to say inflationary expectations. With fixed nominal

interest rates, the price level was undetermined : its value was dependent only on the expectations concerning its future evolution. Modifications in these involve a variation in the general level of prices and, therefore, expectations were self-fulfiling. On this basis, it seems that intervention on the foreign exchange market could be successful if and only if it managed to provoke a lasting reversal of price expextations through its signalling effect.

Was this really the intention of the French monetary authorities ?

If on two occasions (March 1924 and May 1926) the monetary authorities agreed on the necessity to intervene to avoid the Franc following the downward path of the Deutschmark and each time they did maintain the hope of a lasting reversal of expectations in the exchange market, we have to note, however, that more often they had circumstantial objectives and were really only waiting for some respite.

In November 1924, the Bank of France wished to lower the figure of note circulation, at a time when it may have still seemed possible to cover up the scandal of the 'false statements' (the Bank no longer wanted to do this in March 1925, as it intended using the affair to bring down the Herriot government). As far as the Ministry of Finance was concerned, its main intention was to

reverse the dynamics of the foreign exchange market to improve its financial situation on a temporary basis : it wanted either to ensure the success of a loan as at the end of 1924 or during the summer of 1925 or hinder the growth of the nominal value of administrative expenditure, as in May 1926.

On account of the limited motivations and the pursuit of certain individual personal interests, the French monetary authorites did not consider the credibility of their defensive actions, that is to say the context in which would be operating, its compatibilty with the monetary and financial environment of the time or more precisely, of the way in which the market perceived the French situation.

The three interventions of November 1924, June 1925 and May 1926 were effective in the very short-term, as the authorities managed to turn the trend of the market around for a few days or even for a few weeks. It can be noted however that, both the effect of surprise and the secrecy which surrounded these actions were reduced. The political nature of the decision and the intermediation of commercial banks favoured the announcement to a few "initiated" individuals a few days before. On several

occasions, an official communiqué forewarned the public of pending intervention. On the basis of the existence of asymmetric information between the authorities and the market, the traders presumably anticipated a change of tactics in French economic policy. If ,in principle, the concept of credibility articulates the means, the effects and the context, we do have to underline that this capacity to provisionally reverse the depreciation of the Franc does not seem to be linked to the means employed : in May-June almost all the Morgan funds were used without success whereas in March 1924 less than half had been enough to obtain a reversal of expectations ; and during the summer of 1925 very few means were used to obtain respite. Contemporary studies on the subject all reach the same conclusion. (see namely K. Dominguez and J.Frankel (1993)).

In the long term, these interventions were ineffective, as nothing changed the market perception ,albeit incorrect, of the fundamentals of the French economy. The authorities did not send any other signals destined to reassure traders : no increase in fiscal pressure, no reduction of public expenditure, and, above all, no will to put any inclusive and coherent plan to stabilize the Franc. Besides, and more precisely, this sequence of signals had ensured

the success of the operation in March 1924. The detailed chronology of this episode shows that it was more the announcement of the setting up of a programme to reequilibrite public finances rather than that of intervention which permitted the reversal of expectations. Indeed, the episode of stabilization also puts things into perspective, underlining the importance of interventions for the reversal of expectations. The policy of stabilization proposed by the Board of experts at the beginning of July 1926 (object of a broad consensus amongst economists and politicians) considered that obtaining foreign loans so as to guarantee the stability of exchange rates by direct intervention in the foreign exchange market was essential (the figure of 100 million dollars was announced, but at the beginning of August Moret thought that twice the amount would be necessary). As a matter of fact, the change in regime during the summer of 1926, was so transparent and credible (see T.J. Sargent (1983) and R, Dornbusch (1989)) and the inflow of capital was so great that the Poincare government did not need to use this currency and that the intervention which began in December 1926 and continued until June 1928 had the objective of avoiding too greater an appreciation of the Franc. (see K. Mouré (1998)).

Taking the French experience as an example, it seems that interventions do not play a major role in the the process of reversal of expectations. They can only be effective when accompanied by monetary and budgetary measures. It can also be seen that the French authorities way of learning to deal with the management of exchange rates was hesitant : motivation was unclear and neither the timing nor the credibility of actions were envisaged. The novelty of the economic phenomena at stake and the specificity of the historic circumstances can partially explain these prevarications.

LESSONS OF HISTORY: THE WEIGHT OF UNCERTITUDE SURROUNDING THE STABILIZATION OF THE FRANC AND THE IMPURE NATURE OF A FLOATING REGIME.

When put into perspective, it can be seen from the four defensive actions we have studied, that co-operation, -even when it was in some cases imposed- between poles of the monetary authority (Minister and director of the Treasury on one side, the Bank of France on the other) constituted the prerequisite for the success of an intervention, even if it did not guarantee it. The

perennial state of discord beetween the monetary powers under the left-coalition represented a factor of uncertitude which was harmful for the credibility of the action. The repeated failure to halt the fall of the Franc certainly constituted a factor which aggravated the exchange rate crisis in the spring of 1926. In fact, the disagreement on the possibility of intervention conceals far greater divergence on the choice of a monetary regime for France. When Keynes, as a conclusion to his open letter to the French Minister of Finance in January 1926, asks the question "is there any sufficient objection to using the gold in the Bank of Franc to anchor the Franc exchange ?"(1926,p.23), he knew that since the publication of *Tract on Monetary Reform* he was practically alone in defending the thesis of superiority of the forced exchange rate regime over the Gold Standard and that in France the question of the Issuing Institution commitment of its gold reserves was truly at the centre of monetary debate.

If, after the war, perfect consensus among the monetary authorities prevailed on the introduction of a deflationary policy allowing the return of former parity between the Franc and gold, from mid-1922, in the face of Germany's proven financial weakness and the ever-increasing difficulty to support the National

debt, the Treasury denounced the chimeric nature of such an action. Treasury called for a more realistic monetary policy that is to say, a stabilization-devaluation of the national currency. Until 1926, the Treasury was in open conflict with the Bank of France (which remained in favour of the revaluation of the Franc). The Bank's gold, essential for forceful intervention in the exchange market did not have the same importance for the two institutions. For the Bank of France committing its reserves would jeopardize the future revaluation of the Franc ; it was unable to dissociate the Gold Standard principle of stability from the issue of the level of 'metallic' definition of the Franc. For the Treasury, which had accepted the idea of lowering the gold value of the Franc, the loss of gold was not really a problem. The French monetary authorities' failure to bear squeeze expectations cannot be dissociated from their divergences on the future definition of the 'metallic' value of the Franc. As from the end of the month of June 1926, men who supported the idea of stabilization-devaluation of the Franc were at the head of the Bank, French monetary intentions became clearer and stabilization more credible. The market was then ready to swing its opinion.

To conclude, we must obviously emphasise that the existence of these actions in the foreign exchange-market leads us to reconsider the hypothesis of exogeneity of the monetary base in France in the mid-1920's and leads us to to reject the conventional view of the existence of a perfectly pure floating regime at this period. These interventions should not be overlooked and the French Franc is not as it is traditionally presented, the archetype of a floating currency. By the same token, surely, this French episode calls for a more detailed examination of the behaviour of other European central banks during the period ?

Finally, these interventions can be re-introduced into the Nurkse/Friedman debate on the stabilizing or destabilizing nature of speculation. As they did, in fact, revealed the discord between monetary authorities and their inability to control the economic situation, they had the counter-productive effect of bringing into the open the absence of anchorage for expectations: in such conditions is it not difficult to consider only the traders' actions as destabilizing ?

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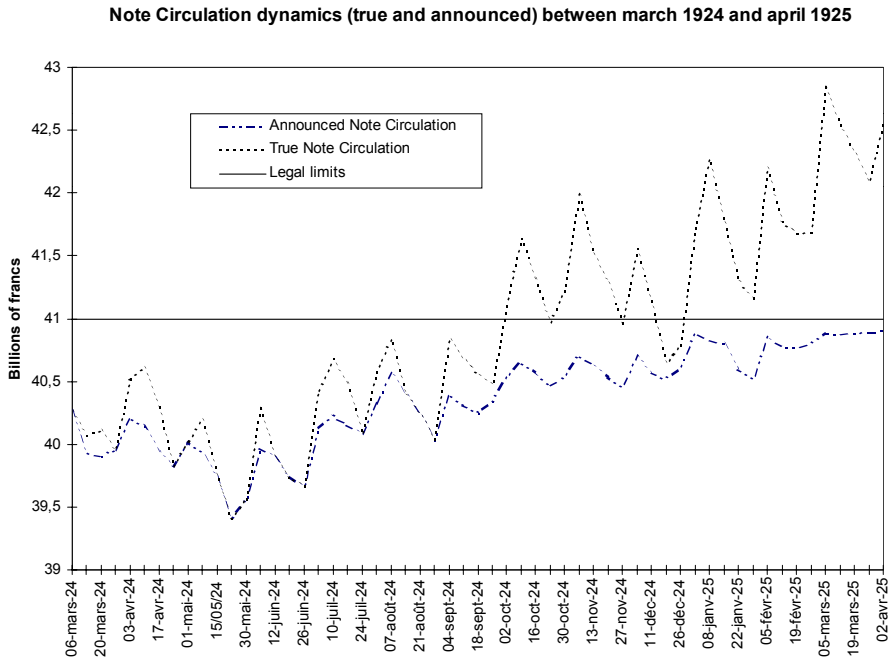
Appendix 1



Source : Archives Economiques et Financières, B 18675, Ministère des Finances.