'The snake loses its skin', from 30 jours d'Europe (April 1974)

Caption: In an article for the April 1974 edition of the monthly publication 30 jours d'Europe, the journalist, Patrick Bonazza, sets out how the European currency snake operates and outlines the obstacles that it must overcome.

Source: 30 jours d'Europe. dir. de publ. FONTAINE, François ; Réd. Chef CHASTENET, Antoine. Avril 1974, n° 189. Paris: Service d'information des Communautés européennes. "Les mues du serpent", auteur:Bonazza, Patrick , p. 10-12.

URL:
http://www.cvce.eu/obj/the_snake_loses_its_skin_from_30_jours_d_europe_april_1974-en-34079234-a59c-4241-90e7-b9e40752d8ca.html

Last updated: 06/07/2016

The snake loses its skin

The mechanism of the Community snake is much more than a foreign exchange technique. Experience has shown that it is not viable without economic and political harmony among the Nine. Abolishing the disparity between monetary rates therefore seems to be a sacred dream that involves a complete political attitude.

When the Finance Ministers of Germany, Denmark and the Benelux countries left Wittenburg Castle, near The Hague, on 7 March, monetary Europe seemed to be more divided than ever. On the one hand, the Five, encouraged by the European Commission, have chosen not merely to remain faithful to the April 1972 European exchange-rate agreement but actually to consolidate it. On the other, France, Italy, the United Kingdom and Ireland have opted for greater freedom in their exchange-rate policy. Is the breakdown irreversible? Whatever the case, neither camp seems to be resigned to it. In The Hague, the Five clearly let it be understood that they were still ready to welcome the renegades from the European exchange-rate agreement. France, meanwhile, has decided to let the franc float until June, and it is now inviting the Nine to reflect on new common exchange-rate policies. At the heart of the debate is the famous ‘snake’.

A strange banknote

Monetary union is scheduled for 1980. Mr Smith travels to Italy and settles his hotel bill with a new banknote. It is a strange banknote for contemporary Europeans — it is made out simultaneously in French francs, lira, German marks, guilders and so on. Some might say it is merely a matter of printing, but far from it. For Mr Smith to be able to pay his expenses in this way, the monetary authorities of the Nine have had to work patiently on the arduous task of eliminating the most minute variation in exchange rates between their currencies. The strange banknote is, in fact, bringing to fruition the sacred dream of Community economic and monetary union. For the time being, the target is, quite understandably, a long way off. Each of us has had the painful or pleasant experience of fluctuating exchange rates. We will have to start virtually from scratch. The famous ‘snake’ is moribund, and no one can agree on how to resuscitate it. So it is goodbye to the strange banknote.

What is the snake?

So what is this ‘snake’, and why are we keeping a compassionate vigil at its bedside? The ‘snake’ is the image chosen to depict a foreign exchange-rate situation that is completely original as far as international monetary circumstances are concerned. It was dreamed up on 10 April 1972 by the central bankers of the Nine. The principle was to reduce the maximum differential in exchange rates between any two Community currencies to 2.25 %. To understand why it should be 2.25 %, we need to go back to 18 December 1971. On that day, the representatives of the major Western countries, meeting at the Smithsonian Institute in Washington, sanctioned the devaluation of the dollar. At the same time, they decided that the rates of Western currencies could not deviate by more than 2.25 % above or below parity (i.e. the official value) with the American currency.

Technically, this means that differences in exchange rates between two Community currencies may amount to 4.5 % but only 2.25 % with respect to the dollar alone. What is more, these figures relate only to differentials qualified by the experts as ‘instantaneous’, or in other words, recorded at a clearly determined time. In practice, between two periods, the differentials may amount to 9 % between Community currencies (twice the ‘instantaneous’ differential), compared to 4.5 % between each of these currencies and the dollar. The Community countries felt that this differential between the exchange rates of their currencies was far too broad. It was feared at the time that it might jeopardise the operation of the common agricultural policy and the customs union. This was why the Nine chose to restrict the range of exchange-rate fluctuations between their currencies to 2.25 % (actually 4.5 %). It should be noted that relations between the latter and the dollar were not changed in any way by the 10 April Basle Agreement. Under the Smithsonian Agreement, the Community currencies would vary in relation to the dollar within a foreign exchange band that was also restricted to 4.5 %. The ‘snake’ therefore had its ‘tunnel’.

In itself, the Community foreign exchange-rate situation was nothing out of the ordinary. In the past, ('instantaneous') foreign exchange-rate differentials between European currencies had regularly been below the 2.25 % determined in Basle. It was 2 % on the day after Bretton Woods, and 1.5 % with the 1958 European monetary agreement, for example. In early 1971, before the monetary crisis and immediately after the introduction of economic and monetary union, the Community had even tried the (albeit stillborn) experiment of a contraction to 1.2 %. Yet now, even the exchange-rates of the Benelux currencies cannot deviate by more than 1.5 %.

Having said that, less than two years after it came into force, even with seemingly modest objectives, the European exchange agreement has lost many of its supporters — at least in the Community, although, paradoxically, two third countries, Norway and Sweden, are still playing by the rules. Two basic causes of this problem can be identified: the cost of the snake and the problem of gold.

Staying within the snake can be costly

Prior to the Basle Agreement, the principal concern of the monetary authorities was to respect the conventional fluctuation bands (4.5 % from the time of the Smithsonian Agreement) between the exchange rates of their currencies and the rate of the dollar. Any European central bank, knowing that the rate of its currency was at its highest (+2.25 %) or lowest (–2.25 %) in relation to the dollar, could therefore sell or purchase the American currency on the foreign exchange markets. With each one independently monitoring exchange rates in this way, the Community monetary authorities indirectly managed to restrict exchange rate variations between their currencies. This was how the dollar came to be seen as the only intervention currency. With the Basle Agreement, the central bankers, solely out of respect for the European exchange-rate agreement, promoted the Community currencies to the rank of intervention currencies. Let us assume that the German mark is the highest valued currency in the 'snake' and the French franc is the lowest, the differential between these two currencies threatening to exceed 2.25 %. The Bundesbank would then purchase francs on the Frankfurt market, which would allow the French currency to remain within the 'snake'. The mechanism might appear insignificant if debts were reimbursed. Thirty days after the end of the month, the Banque de France would actually have to repurchase the francs bought by the Bundesbank. The assumption is not purely academic — last September this 'little game' cost France the equivalent of 2 000 million dollars.

This particularly heavy bill had to be settled after a bout of speculation against the franc that was sparked off by upward pressure on the Dutch guilder. The example shows how pressure on currency rates may cause significant outflows of foreign currency from certain Community Member States.

The 'snake' was not spared these difficulties, which are basically connected to the weakness of the dollar in conjunction with the strength of the German mark. Most currencies in the 'snake' could not accompany the upward variations in the mark, otherwise their currencies might appreciate too much against the dollar. This contradiction was exacerbated when the IMF Group of Ten, noting that the second devaluation of the dollar (9 February 1973) had not had the expected effect — speculation against the German mark was unrelenting — decided purely and simply that the Nine would jointly allow their currencies to float against the American currency. In other words, the 'tunnel' no longer had a reason for being.

It nevertheless proved possible to ease the pressure exerted within the 'snake', thanks to the revaluation of the German mark (3 % on 14 March 1973 and 5.5 % on 29 June 1973) and the Dutch guilder (5 % on 17 September). Well before these 'oxygen blasts', however, several Community States had already declined to apply the European exchange-rate agreement — the United Kingdom and Ireland from 23 June 1972, and Italy from 13 February 1973. France wanted to avoid the risk of excessive costs by leaving the 'snake' on 19 January last.

Unfreezing gold

The Basle Agreement lays down that intervention in Community currencies is to be reimbursed on the basis of the composition of monetary reserves. A distinction is accordingly made between 'hard' reserves (gold and assets tied to gold, such as Special Drawing Rights — SDRs) and 'weak' reserves (currencies, particularly the dollar). Reimbursement of the ‘weak’ part poses no problem at all. The ‘hard’ part, however, it is another matter altogether. The central banks no longer wish to dispose of their gold at an ‘official’ price (42.22 dollars per ounce), deemed to be ridiculous compared to the free market rate (160 to 165 dollars per ounce in March). Bypassing this difficulty, France reimbursed its debt to Germany last November by paying only ‘hard’-reserve SDRs.

This special case in no way relieves the intensity of the problem of transfers in gold, which is currently being studied in all the capitals of the Nine. The central bankers of the Community quite logically came up with compromises to ensure that the Basle Agreement continued to operate smoothly. One of these, a provisional one, allowed Italy to pay off future debts from July to September 1972 completely in dollars. The other, in force since 1 January 1973, offered countries that had disposed of gold at 42.22 dollars per ounce the opportunity to repurchase it as soon as a solution and a definitive price had been found for the problem of transfers of gold between Community central banks. This compromise, however, seemed less and less acceptable to countries like France and Italy, who made their reintegration into the ‘snake’ conditional upon the finalisation of a solution.

A political attitude

There are, therefore, many obstacles in the way of a return to the normal life of the ‘snake’. In the long term, nevertheless, the Community, if only for political reasons, cannot tolerate the coexistence of a ‘mini-snake’ and currencies floating as they please. What is more, in order to paper over the cracks of monetary Europe, some people envisage the creation of new types of ‘snake’. For example, the French Minister of Finance, Valéry Giscard d’Estaing, recently invited his Community partners to reflect on how to make the exchange-rate control established at Basle less constraining (or less expensive, if you prefer). By way of example, he suggested that maximum exchange-rate variations should be differentiated in line with the Community currencies (1.5 % between the guilder and the Belgian franc; 2.25 % between the guilder and the German mark, and an even higher margin with the lira or the French franc). An alternative would be to retain the maximum differential of 2.25 %, ‘but with the possibility of the central banks, without public discussion, relaxing it for certain currencies for a certain period.’ Mr Giscard d’Estaing also stressed that the operating ‘costs’ of the new European exchange-rate agreement should be shared equitably among all the countries, rather than burdening only those whose currencies occupy the lower slope of the ‘snake’.

Other models can easily be imagined. The Nine could carry out a general realignment of the exchange rates of their currencies and ‘start from scratch’ by slightly broadening the Community exchange-rate band. If accepted, derogations from the agreement should be subject to very strict conditions involving a right of supervision for each country on the progress of the economies of the others. But are we not in the process of rebuilding Europe? After all, revitalising the ‘snake’ clearly boils down to setting out, with more determination than ever, on the road towards Community economic and monetary union.

That being the case, the problems are well known. To find a ‘snake’ for the Nine, the Community Member States must reinforce their solidarity (by substantially augmenting monetary support in the short run and by starting to pool part of their reserves, for example), they must agree to sacrifice a certain amount of sovereignty (failing which any coordination of economic and monetary policies, which are crucial to exchange rates, is inconceivable), and adopt a common position towards the dollar (though this raises the whole problem of economic relations with the United States).

The ‘snake’ is, therefore, more than just a foreign exchange-rate technique. It is the material form of the political commitments of our leaders.

Patrick Bonazza