Foreign Exchange Markets, July-December 1963

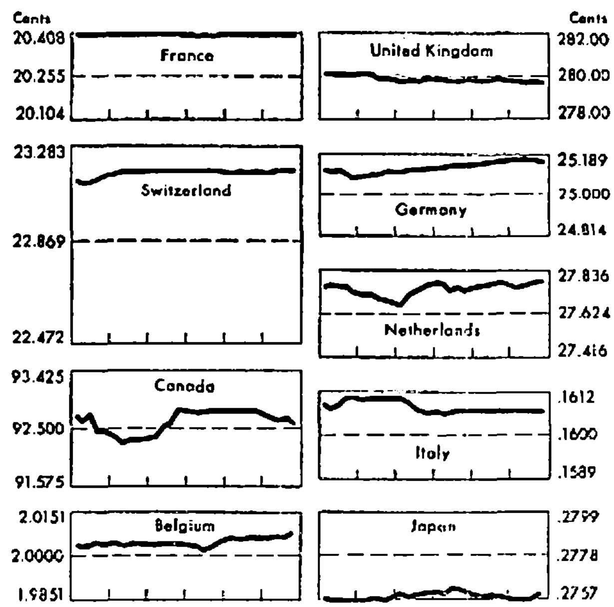
Reflecting the reduction of the United States balance-of-payments deficit during the second half of the year, the dollar's exchange market position came into somewhat better balance during the July-December period.[1] Several foreign currencies still remained strong or even advanced against the dollar, others closed with little net change after fluctuating in response to temporary factors, but the dollar also strengthened in some cases (see chart). Except for Germany, moreover, the reserve gains even of those countries whose currencies remained strong against the dollar were generally smaller than during the first half of the year. Hence, the markets for most currencies, including for example that for the French franc, appeared to be more nearly in equilibrium than they had been in earlier periods.

The decline in the United States payments deficit and the attendant improvement in dollar exchange rates can be traced primarily to a reduction in recorded capital outflows from the United States after the middle of the year. As regards short-term flows, the reduction in part reflects the gradual rise in United States money market rates—highlighted in July by the Federal Reserve discount rate increase, to 3½ per cent from 3 per cent, and the accompanying increase in Regulation Q ceilings—bringing domestic rates into closer alignment with short-term rates in other financial centers. With respect to long-term funds, the outflow from the United States has been curbed primarily by the July proposal of the Administration for an interest equalization tax on United States purchases of certain foreign securities. Thus, the latest available figures show that, although the United States balance-of-payments surplus on current account narrowed somewhat in the third quarter, the over-all payments deficit on regular transactions declined in that quarter to \$1.6 billion (seasonally adjusted annual rate) from \$5.0 billion and \$3.9 billion in the second and first quarters of the year, respectively. The third-quarter improvement appears to have carried over into the fourth quarter.

While some progress was being made toward a closer balance of supply and demand among major currencies, central bank cooperation continued to play a key role in moderating—and, in some cases, nipping in the bud—actual and potential disturbances. The most dramatic

EXCHANGE RATES IN SECOND HALF OF 1963

Noon buying rates on Wednesday of each week; cents per unit of foreign currency



Note: Upper and lower boundaries of charts represent official buying and selling rates for dollars against the various currencies.

— — — — par value of currency.

[1] For developments in the first half of 1963, see "Foreign Exchange Markets, January-June 1963", this *Review*, July 1963, pp. 104-7. Official United States exchange operations, and exchange market developments in 1963 as they relate to such operations, are discussed in "Treasury and Federal Reserve Foreign Exchange Operations", this *Review*, October 1963, pp. 147-52, the latest semiannual report by Charles A. Coombs, Vice President of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The present article deals mainly with exchange market developments and not with official operations and policies.

such instance occurred when the Federal Reserve Bank of New York immediately moved into the exchange markets following the assassination of President Kennedy and succeeded, in cooperation with other central banks, in completely preventing any disturbing market consequences.[2] It is clear that the exchange markets are now aware of the massive and readily usable resources available to the United States and other countries whenever there is a need to repulse speculative attacks on any of the major currencies.

CANADIAN DOLLAR

The Canadian dollar fluctuated more widely than other major currencies during the second half of the year. A reduction in the net long-term capital inflow to Canada was the primary factor in the decline of the rate early in the period, and the subsequent recovery can be attributed mainly to an improvement in Canada's trade balance during the third quarter, bolstered later in the year by massive wheat sales to Russia.

The Canadian dollar eased somewhat after the announcement of the Federal Reserve discount rate boost on July 16 and briefly became subject to heavy pressure following the Kennedy Administration's proposal of the interest equalization tax on July 18. The rate dropped sharply and momentarily touched its low of $0.92109 for the period. Most of the selling of Canadian dollars reflected commercial "leads and lags", although a virtual halt in purchases of Canadian securities by United States residents also contributed to the decline. After the United States and Canadian authorities reached an understanding that would substantially modify the impact of the proposed tax on Canadian issues in the United States,[3] the Canadian dollar advanced, temporarily rising above its par value of $0.92500. The exchange market then turned quieter through the end of August and into September, with the spot rate moving within a range somewhat below par while the forward Canadian dollar was quoted at moderate discounts. The Canadian dollar did strengthen slightly, however, following the rise in the Bank of Canada's discount rate to 4 per cent from 3½ per cent on August 11.

The market entered a new phase in September, with the Canadian dollar moving up in response to favorable export developments. On September 16, it was announced that the Soviet Union had contracted to buy about $500 million worth of Canadian wheat. In connection with these sales, substantial amounts of Canadian dollars were purchased for immediate and future delivery, and the rate advanced strongly in both spot and forward markets. Furthermore, the change in market sentiment resulted in anticipatory buying of Canadian dollars by other commercial interests. Under these pressures, the spot rate reached a peak of $0.92938 on September 26, and discounts on forward Canadian dollars disappeared. In tempering the advance, the Bank of Canada was able to recoup some of its earlier reserve losses.

Grain exports continued to be an important factor in the market thereafter, but by mid-October the Canadian dollar rate settled around the $0.92813 level, where it remained virtually unchanged in very quiet trading through the end of November. In December, the rate eased somewhat as United States dollars were being purchased in connection with year-end payments—particularly to the United States—of interest and dividends on loans to Canada and on foreign-held Canadian securities.

STERLING

The pound sterling declined slightly over the second half of the year, although the rate remained steady for prolonged periods. Trading was relatively quiet and orderly, without the speculative influences that had troubled the market earlier in 1963. One factor contributing to the decline in the rate was a partly seasonal increase in British imports, which was however in good part offset by strength in the balance of payments of the overseas sterling area. The reserves of the United Kingdom—which serves as banker for the sterling area—declined by $56 million in July-December, as a modest increase resulting from regular market transactions was more than offset by special British payments, including particularly the usual year-end repayments on official indebtedness to the United States and Canada.

The sterling rate fluctuated just above par during July, touching its high for the period—$2.8020—on July 9. The change in the Federal Reserve discount rate had little immediate effect on sterling, which remained above par through early August. With the gradual rise in United States short-term rates, however, the gap between New York and London money market rates steadily narrowed, and some banking funds from the United States and the Continent were reportedly switched from sterling into dollars beginning in August. The sterling rate moved slightly below par in mid-August.

[2] See "The Money Market in November", this *Review*, December 1963, p. 179.

[3] For a description of the understanding, see "The Money Market in July", this *Review*, August 1963, p. 124.

From then on through the remainder of the year, sterling fluctuated narrowly in that range in a very steady market. Both the sudden retirement of Prime Minister Macmillan (announced on October 10) and the assassination of President Kennedy tested that steadiness, but incipient speculative pressures quickly vanished in both cases. Although sterling declined further in December, reaching its low for the year of $2.7959 on December 23, this development reflected largely the usual year-end positioning of Continental banks. At the year end, the rate had recovered and sterling was firm at just above that level.

Discounts on forward sterling became smaller over the half-year period, primarily in adjustment to the narrowing of gross differentials in money market rates between New York and London. The discount on three-month forward sterling, which stood at about 0.5 per cent per annum early in July, closed the year at 0.2 per cent.

CONTINENTAL CURRENCIES

Among the major Continental currencies, the German mark was particularly in demand during the second half of 1963. After easing somewhat in July, the mark rate advanced fairly steadily during the remainder of the year. The advance was tempered by the German Federal Bank's purchases of dollars in the market, which contributed to official German reserve gains of $333 million in July-November. The major source of strength for the mark was a renewed sharp rise in German exports—mainly to other Common Market countries—which once more brought about large German trade surpluses. Also, the net inflow of long-term capital to Germany continued, although on a reduced scale. Late in November and through most of December, additional demand for marks developed in connection with the usual repatriation of funds by German commercial banks and firms for year-end positioning.

The French franc continued at or near its ceiling during the six-month period under review; the net demand for francs, however, tapered off in a somewhat irregular pattern. The franc was very strong during most of the third quarter, when the French trade balance improved. In late September, French demand for foreign exchange increased under the influence of rising raw material imports and of repayments of earlier foreign-currency borrowings by commercial interests. As a result, an active two-way market for francs developed and the rate moved marginally below its upper limit. By the end of October, the franc returned to its ceiling, as substantial direct investment in France continued and some inflow into new French securities issues took place. Meanwhile, in August, the French authorities were taking steps to curb inflows of short-term funds through tighter controls on French bank borrowing abroad. They also took anti-inflationary measures, including a boost in the discount rate from 3½ per cent to 4 per cent on November 14. In December, the franc rate again dipped below its ceiling on several occasions.

Switzerland continued to attract capital inflows that tended to offset the large Swiss trade deficit and thus to give strength to the franc rate during much of the second half of 1963. Swiss commercial banks occasionally contributed to the inflow when they repatriated funds from abroad, especially to meet a domestic liquidity squeeze in July and August and to provide for their quarter-end and large year-end needs. Funds also moved into Switzerland from time to time in response to various uncertainties, such as those that often accompany the International Monetary Fund meetings in the fall of the year and those that stemmed from domestic political developments in Italy prior to the formation of a new Italian government in December. As a result, the Swiss franc advanced late in July and remained at or near the Swiss National Bank's buying rate for dollars during the rest of the year.

The Dutch guilder declined gradually during July and August. At that time, the Dutch trade deficit was widening and Dutch commercial banks were placing funds abroad on a covered basis, except for a short period of stringency in the Amsterdam money market in July. By September, however, the guilder rate had begun to turn upward, and a general debate in the Netherlands over credit and wage policy gave rise to rumors that the guilder might be appreciated. This set off brief but heavy speculative purchases of guilders and the rate rose sharply until early in October when the revaluation rumors died down. Thereafter, the market became generally quieter and, with moderate fluctuation, the guilder rate gradually firmed through the year end.

The Belgian franc moved within a narrow range above its par value, reflecting a market that was essentially in balance for most of the six-month period. Both to restrain domestic credit expansion and to keep its own rates in line with those of the Belgian market, the National Bank of Belgium raised its basic discount rate from 3½ per cent to 4 per cent on July 18 and further to 4¼ per cent on October 31. After each of these moves, the Belgian franc advanced somewhat in the exchange markets and closed the year on a firm note.

The Italian lira advanced close to its ceiling late in July, reflecting renewed heavy borrowing abroad by Italian banks as well as receipts from tourism—a seasonal factor that normally provides strength to the lira during the summer months. Until they diminished in September, these influences essentially offset the large underlying Italian trade deficit, which was widening during the year partly as a result of price and wage pressures in that country. In September and October, a significant capital outflow from Italy occurred, primarily in connection with continued domestic political uncertainties, and the lira rate began to decline. The rate soon steadied—at some cost in official Italian reserves—and the capital outflow gradually diminished toward the year end after the new cabinet had been formed.

OTHER CURRENCIES

The Japanese yen remained close to its lower limit against the dollar throughout the second half of the year. Small fluctuations in the rate reflected mainly variations in Japanese borrowing abroad to help finance both new domestic investment and the country's current-account deficit. During the period, a considerable part of these borrowings was effected through the Euro-dollar market, but when that market tightened late in the year some Euro-dollar funds were withdrawn from Japan. In response to this development and to domestic inflationary pressures, the Bank of Japan in December permitted selective increases in ceiling rates on Euro-dollar borrowings and imposed higher reserve requirements against domestic demand and savings deposits. In response to these measures, the yen strengthened toward the year end.

In October, the government of China (Taiwan) unified the Formosan exchange rate system by abolishing the complicated system of exchange certificates and by establishing an official selling rate of NT$40.10 to the dollar; the official buying rate was held at NT$40.00 to the dollar, which had been in effect since early 1961. Also in October, the Government of Thailand established a par value for the baht—B20.80 to the dollar—in agreement with the International Monetary Fund. The new par value corresponds to what had been the prevailing rate against the dollar for over a year. In November, the Republic of the Congo (Leopoldville) devalued the Congolese franc from CF64 to the dollar to buying and selling rates of CF150 and CF180, respectively. The spread between the buying and selling rates is designed to provide additional revenue to the Congolese government.