Foreign Exchange Markets, January-June 1964

Foreign exchange markets during the first half of 1964 continued to reflect increased confidence in the stability of the international financial system. To be sure, there were several occasions when speculative activity played a part in market developments during the first half of the year, including movements from the Italian lira, inflows of funds into Germany, and occasional pressures on sterling. But the effects of these pressures were for the most part confined to the particular currencies involved, and did not develop into threats to the dollar or to general currency stability.

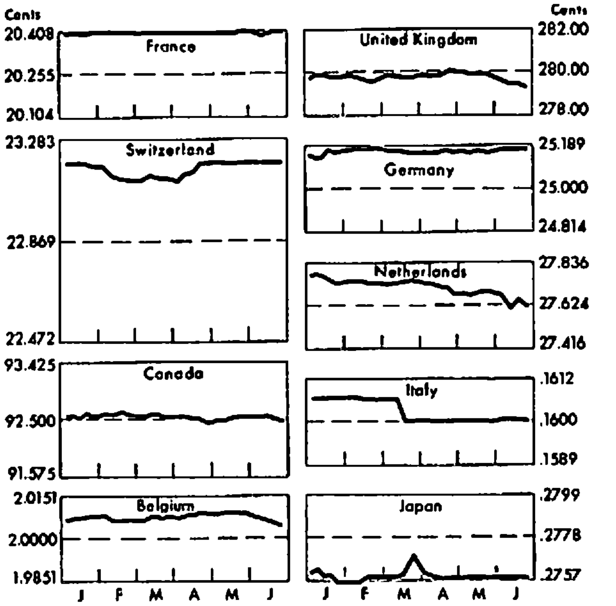
The virtual cessation of United States gold losses in the early part of the year was quickly taken as a sign of further improvement in the United States balance of payments, and contributed to the strength of the dollar. In point of fact, the United States international accounts came close to balance, on a seasonally adjusted basis, during the first quarter of 1964. By far the most important factor contributing to the reduction in the deficit between the first quarters of 1963 and 1964 was the sharp increase in the trade surplus, with exports rising approximately twice as fast as imports. Part of the striking improvement was clearly due to special factors, and it is already apparent that the first-quarter rate cannot be sustained throughout the remainder of the year. On the other hand, part of the improvement appears to represent real progress toward the elimination of the United States payments deficit.

With the improvement in the United States position early in the year, the focus of attention shifted across the Atlantic where problems of price-wage stability have become increasingly troublesome. The impact of these problems on the balance of payments of individual countries has varied greatly, but with the conspicuous exception of Germany there has been a general weakening in the trade balances of major European countries. In a number of cases, however, the trends on current account have been overshadowed by shifts in capital movements, mainly within Europe. Indeed, capital movements seemed to dominate the exchange markets during much of the first half of the year.

The first few weeks of the year are often characterized by a seasonal easing of certain Continental currencies (the German mark, the Swiss franc, and the Netherlands guilder) and a strengthening of sterling, as the customary year-end positioning by Continental commercial banks is reversed. Recently, however, the exchange market effects of these short-term capital flows over the year end have been offset to some extent by central bank action; furthermore, other capital flows during the first quarter tended to overshadow these seasonal movements. While there was some of the usual short-term flow out of Germany and Switzerland to the United Kingdom, there were also heavy speculative flows of capital from Italy into Switzerland and, to a lesser extent, Germany. In addition, funds moved to Germany from other European countries for investment in German securities. These heavy capital inflows reinforced Germany's growing trade surplus and resulted in substantial reserve gains that in turn contributed to some speculation on a possible revaluation of the mark. The counterpart to the strength of the mark appeared to be heavy Italian reserve losses, sharply reduced French reserve gains, and a weakening of sterling and the Dutch guilder.

EXCHANGE RATES IN FIRST HALF OF 1964

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 of dollars against the various currencies.

— — — — Par value of currency.

These pressures quickly abated in the case of sterling when the British authorities announced a 1 percentage point rise in the bank rate on February 27. Pressures on the lira were brought to a halt one month later by the announcement of a $1 billion package of official credits from abroad. At the same time, the German authorities took steps that led to some reversal early in the second quarter of the capital flows into Germany, thereby significantly moderating official reserve gains. Despite these measures, capital flows continued to exert a strong influence on exchange markets and the reserve positions of certain European countries during the second quarter. In particular, tight money market conditions in a number of European countries resulted in substantial shifts of funds, primarily from London to the Continent. In Switzerland, for example, very tight liquidity conditions early in the second quarter, followed by the usual midyear repatriation of funds by Swiss commercial banks, resulted in substantial inflows that kept the Swiss franc rate at the Swiss National Bank's unofficial buying rate for dollars. A similar situation developed later in the quarter, as pressures increased on the French commercial banks' liquidity positions, causing a repatriation of funds on a sizable scale. The fact that these and other capital movements during the first half of the year did not have more widespread repercussions in the exchange and gold markets was in large part attributable to continued international financial cooperation and increased confidence in the dollar.

STERLING

Early in January, sterling began to strengthen in its usual seasonal pattern, as Continental commercial banks reinvested funds in sterling assets following earlier repatriations to meet year-end liquidity needs. The inflow soon tapered off, however, and early in February sterling declined following the Board of Trade's announcement of January trade data showing an unusually large trade deficit. The trade figures, together with uncertainties generated by expectations of a spring general election, resulted in some outright selling of sterling and the emergence of "leads and lags" adverse to the pound. The rate weakened further later in February, as market rumors of a possible mark revaluation apparently pulled funds out of London. These various pressures on sterling quickly subsided, however, and on February 27, when the Bank of England's discount rate was raised from 4 per cent to 5 per cent, sterling recovered sharply. By the end of the month sterling had risen to $2.7982.

Sterling fluctuated narrowly around this level until early April, when it was announced that the British general elections would not be held until October. This decision immediately resulted in the covering of near-term sterling requirements by commercial interests that had previously postponed their purchases, and the spot rate rose to $2.8002 by the end of the month. This technical support for sterling, together with the strength of the payments positions of the overseas sterling area, bolstered sterling through the spring months. As a result, the rate held firm despite further evidence of some weakness in the British trade position. Sterling once again came under pressure toward the end of May, however, when the technical support for sterling faded and as very tight conditions in several Continental money markets drew funds from London. Banks in France and Switzerland, in particular, reduced sterling balances, and there was also some borrowing in the Euro-currency markets. The relatively high interest rates thus generated in the Euro-currency markets attracted some additional outflow of funds from London. Moreover, in early June there was a revival of speculation in favor of the German mark that again appeared to attract funds from sterling, and toward the end of the month the usual midyear Continental bank "window-dressing" put additional temporary pressure on sterling. With the persistent undertone of softness reflecting also market uncertainties about the pre-election outlook for sterling, the rate again fell below par, reaching its first-half low of $2.7909 near the end of June. Despite this relatively sharp decline in the rate, there was little evidence of speculation against sterling. Indeed, a good part of the spot sales of sterling to meet money market pressures on the Continent appeared to be covered by corresponding forward purchases, as the discounts on forward sterling narrowed during June to the lowest levels in recent months.

CANADIAN DOLLAR

The Canadian dollar moved narrowly just above par through most of the period. During the first quarter, the long-term capital inflow to Canada remained at a sharply reduced level while the inflow of short-term funds, though substantial, was inadequate to offset the enlarged current-account deficit. As a result, official reserves declined by about $70 million during the first three months in addition to the $60 million repayment to the International Monetary Fund (IMF). During the second quarter, for which little detailed balance-of-payments information is available, reserves rose by $68 million.

The spot market for Canadian dollars was relatively quiet through most of the six-month period, but there was considerable activity in the forward market as a result of grain sales to the Soviet Union. These sales generated heavy demands on the part of grain dealers for Canadian dollars against United States dollars for future delivery. (The contracts with the Soviets called for payment in United States dollars, whereas the grain companies had to purchase the wheat from the Canadian Grain Board with Canadian dollars.) After meeting the grain dealers' demands—and after covering these forward sales to some extent through spot purchases—commercial banks attempted to balance their positions by engaging in swap transactions, selling Canadian dollars spot against forward purchases timed to meet likely calls on their forward commitments to the grain dealers. Consequently, the forward Canadian dollar advanced to a premium while the spot rate tended to decline. In order to offset some of these pressures, the Bank of Canada sold United States dollars spot and purchased them forward, thus providing the counterpart to the commercial banks' swap needs. Nevertheless, the matching-off of commitments arising from the very large volume of grain sales continued to dominate transactions in the Canadian dollar market through the end of June, and the forward Canadian dollar remained at a premium of well over ¼ of 1 per cent while the spot rate moved narrowly around par.

GERMAN MARK

The German mark eased early in January, as German commercial banks reinvested abroad part of the funds previously repatriated at the year end. By mid-January this reflux of bank funds apparently came to a halt, and as the continuing inflow of long-term funds from other European countries intensified, the mark rate turned upward. This rise in the rate, coupled with projections of a very large German trade surplus in 1964, touched off revaluation rumors. Thus, the already large German payments surplus was swollen during February by outright speculative capital inflows. This heavy demand for marks subsided in March; in fact, the mark came under some selling pressure when a proposed withholding tax on interest income of nonresidents from German bonds resulted in withdrawals of long-term funds from the German securities markets, and the German Federal Bank sold a substantial amount of dollars in market operations. At the same time, the German Federal Bank moved to encourage an outflow of German funds into dollar investments: beginning March 10, the Bank provided dollars on a swap basis—selling dollars spot and repurchasing them forward—to German commercial banks for purchases of United States Treasury bills at a preferential discount on the forward purchases of ½ per cent per annum, compared with the current market discount of over ¾ per cent. Through most of April and May the mark fluctuated narrowly in a relatively balanced market, as further substantial liquidations of German bond holdings by foreigners and short-term outflows into the Euro-dollar market apparently offset the surplus on current account. In the month of April alone, there was a net long-term private capital outflow from Germany of $62 million equivalent, the first such outflow since mid-1962. In June, however, the mark again strengthened with a reappearance of revaluation rumors, and remained in heavy demand through the end of the month as German banks repatriated funds for midyear positioning.

SWISS FRANC

The Swiss franc eased below the central bank's buying rate for dollars in February, as the heavy net capital inflows of earlier months diminished and once again exposed the large Swiss current-account deficit. The rate soon firmed, however, and a subsequent succession of temporary and not necessarily related factors kept the franc under upward pressure for most of the six-month period. Initially, this pressure came from the movement of funds into Switzerland from Italy. By mid-April, when the inflow from Italy had eased, Swiss banks and corporations began to repatriate funds from abroad to meet pressures generated by a liquidity squeeze in Switzerland. Swiss funds were withdrawn from investments in the German bond market, and some Swiss interests also borrowed abroad at short term. These inflows pushed the spot Swiss franc up to the Swiss National Bank's buying rate for dollars, but the forward franc weakened at the same time as Swiss interests purchased foreign currencies foward to cover their borrowing abroad. With liquidity conditions in Switzerland remaining relatively tight through May, Swiss residents continued to repatriate funds. Furthermore, interest rates in the Euro-Swiss franc market rose sharply. As a result, foreigners began to purchase Swiss francs to pay off maturing Swiss franc loans rather than renew them at relatively high interest rates, and thus reinforced the strength of the spot rate. Finally, just as this demand for francs was tapering off, it was replaced by the usual midyear demand for francs by Swiss commercial banks and a resumption of inflows from Italy, with the result that the Swiss franc held at its ceiling throughout most of the second quarter.

ITALIAN LIRA

The Italian lira was under heavy selling pressure in the early months of the year, as a result of a wider current-account deficit, an outflow of capital, and further repayments of foreign indebtedness by Italian commercial banks. Thus, the Italian authorities lost a substantial amount of dollars in supporting the rate at about $0.001607. The downward pressures were reinforced early in March by increasing speculation against the lira, and Italian reserve losses accelerated. On March 14, the Italian authorities announced that approximately $1 billion in external assistance was at their disposal to supplement official reserves and to back up the fiscal and monetary measures already taken to correct the underlying balance-of-payments deficit. This credit package included: (1) a $100 million swap arrangement with the United States Treasury (in addition to the partly drawn swap facility with the Federal Reserve System for $250 million), (2) a $200 million stand-by credit from the Export-Import Bank, (3) $250 million in three-year credits from the United States Commodity Credit Corporation, and (4) additional credit facilities from the Bank of England and the German Federal Bank. The speculative pressures on the lira abated immediately following the announcement of this package, and the Bank of Italy temporarily withdrew its support from the market, permitting the spot lira to drop to about $0.001600½ where it settled in relatively balanced trading. At the same time, the discounts on forward lire immediately narrowed; the discount for the three-month maturity, which had widened to nearly 7 per cent just prior to the announcement, narrowed to about 3 per cent. Since the announcement of the credit package and the subsequent Italian drawing of $225 million on the IMF, the lira has held just above its par value. In late June, there was some renewed selling pressure on the lira, but there were also signs of some strengthening of Italy's payments position during the second quarter. Italian commercial banks continued to reduce their net foreign indebtedness, and the Bank of Italy announced a reduction in its net drawings under the swap arrangements with the Federal Reserve System and other foreign central banks.

OTHER CONTINENTAL CURRENCIES

The Netherlands guilder gradually declined during most of the first half of 1964 after having reached its high for the year to date on January 6, when the Netherlands Bank raised its discount rate from 3½ per cent to 4 per cent. At times exchange market developments were dominated by the short-term capital movements of Dutch commercial banks, which customarily place temporary excess funds abroad and repatriate them as required to meet liquidity needs. However, the guilder's decline during the half year fundamentally reflected the deterioration in the Netherlands trade position. Even after a further increase in the discount rate to 4½ per cent on June 4, the guilder strengthened only momentarily. By June 10 the rate had fallen below par for the first time since the revaluation of March 1961, and it continued to fluctuate around par for the remainder of the month.

The French franc remained at, or close to, its ceiling throughout the first half of the year. However, French official gold and foreign exchange reserves rose by only $76 million during the first four months of the year—a considerably smaller increase than during the comparable period a year earlier—as a wider trade deficit, capital flows to Germany, and the reversal of previously favorable "leads and lags" reduced the over-all French payments surplus. In May, however, French reserves jumped by nearly $150 million, with French banks repatriating funds to meet extremely tight conditions in the Paris money market and commercial interests shifting their payments terms once again in favor of the franc. In view of these developments, the Bank of France early in June announced changes in credit and reserve regulations designed to reduce the squeeze on the commercial banks' cash positions without relaxing the general policy of restraint. The franc rate immediately eased off its ceiling but, by the middle of June, was again at, or close to, its ceiling despite a further reduction in reserve requirements.

The Belgian franc moved within a narrow range through most of the first half of the year, but declined fairly rapidly after mid-May, and was slightly below its early-January level at midyear. The Swedish krona was slightly below par ($0.1933) through the first two months of the year. In March, however, when the authorities introduced several measures to supplement the restrictive effects of the discount rate increase announced at the end of January, money market conditions tightened, and Swedish commercial banks began to repatriate foreign assets. As a result, the krona strengthened sharply to about $0.1947 at the end of March and remained at, or close to, its ceiling through most of the second quarter.

OTHER CURRENCIES

The Japanese yen remained at, or close to, its floor against the dollar throughout most of the first half of 1964. A continuing increase in Japan's current-account deficit was only partially covered by long- and short-term capital inflows. The yen strengthened briefly in mid-March, when the Bank of Japan raised its discount rate to 6.57 per cent, but then returned to its floor and remained there through midyear.

In January, Venezuela ended exchange controls and moved toward unification of its exchange rate structure. The central bank's buying rate for transactions with the petroleum companies was raised from 3.09 to 4.40 bolivars per dollar, thus reducing the implicit "exchange rate tax" on the companies' local-currency outlays. In addition, the exchange rate for imports was raised from 3.35 to 4.50 bolivars per dollar. Also during the first half of the year, Korea replaced its complex multiple exchange rate system with a single fluctuating rate; the initial new rate of 255 won per dollar compares with a previously fixed official rate of 130 won per dollar. Brazil eliminated preferential exchange rate treatment for imports of wheat, petroleum, and newsprint by requiring that exchange for such imports be purchased at the free market rate of about 1,200 cruzeiros per dollar rather than at the Bank of Brazil's official selling rate of 620 cruzeiros per dollar.

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