Treasury and Federal Reserve Foreign Exchange Operations*

By CHARLES A. COOMBS

The announcement on September 10 of new central bank arrangements in support of sterling helped to set the stage for the strong recovery of sterling this past winter. This operation brought about a definite turning in market sentiment, the effects of which were evident not only on sterling itself but on several other major currencies including the dollar. Indeed the air of impending crisis that had hung over the exchanges during so much of the year prior to last September faded rapidly once the success of the September 10 operation became evident. During the succeeding six months through February, the period covered by this report, the markets were generally calmer and more orderly than at any time in recent years.

More fundamental than the change in market psychology were the indications that a number of countries were moving away from positions of extreme deficit or surplus and toward better balance of payments equilibrium. The persistent payments deficit of the United States at last seemed to be yielding to the latest series of official measures, including most notably the voluntary foreign credit restraint program, backed up by gradually tightening credit conditions. At the same time, the United Kingdom position showed substantial improvement. Although there were fairly wide swings in the capital account, the British trade deficit was narrowing. At the other end of the spectrum, the huge surpluses of Italy and France began to taper off during the winter months as domestic activity expanded.

Other developments that helped to promote stability in the exchange markets this past winter were the actions taken by a number of foreign central banks to minimize the effects on international money and exchange markets of temporary domestic credit squeezes, year-end pressures, and abnormal strains. The Netherlands Bank, for example, resumed swap operations with Dutch commercial banks in the fall (taking in dollars spot and selling them forward), thus providing the domestic liquidity that the banks were seeking through repatriations of foreign assets without running up the central bank's holdings of dollars. Likewise the Italian authorities during the fall continued to engage in swaps with Italian commercial banks, in this case selling spot dollars to the banks under forward repurchase contracts in order to funnel back into private channels dollars that otherwise would have been drained off into official reserves. This type of exchange operation, which the Italians had resumed in 1964 when a large payments surplus had reemerged, reached record levels during 1965, and served not only to promote balanced conditions in the Euro-dollar market, but also averted the possibility of large-scale drains on the United States gold stock and consequent reduction in international liquidity. To facilitate the Italian operation, first the United States Treasury and then, in November, the Federal Reserve System agreed to share the forward exchange contracts assumed by the Italian authorities. Toward the year-end, when some Italian banks began to repatriate dollars they had previously placed abroad, the Italian authorities stepped up the pace of their swaps with other banks to offset partially the effect of these repatriations.

In addition to the Bank of Italy, the Swiss and German authorities also took steps to see that the usual repatriation of funds toward the year-end exerted as little disruptive influence on the international financial markets as possible. The German Federal Bank, for example, temporarily reduced commercial bank reserve requirements during

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Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS AND COMMITMENTS

Institution	Term of arrangement (in months)	Amount of total facility, February 28, 1966	System commitments		
			December 31, 1964	April 6, 1965	February 28, 1966
		In millions of dollars equivalent			
Austrian National Bank	12	50			
National Bank of Belgium	12	100	45	100	
Bank of Canada	12	250			
Bank of England	12	750			
Bank of France	3	100			
German Federal Bank	6	250	50	5	
Bank of Italy	12	450		200	
Bank of Japan	12	250			
Netherlands Bank	3	100	100	50	
Bank of Sweden	12	50			
Swiss National Bank	6	150		130	
Bank for International Settlements	6	300*	100	100	
Total		2,800	295	585	0

* Of which, half is available in Swiss francs and half in other European currencies.

December, thus easing seasonal pressures and, in conjunction with other developments, successfully avoiding the sizable repatriations that had characterized previous years. The Swiss National Bank, following the pattern that it had developed to deal with seasonal pressures in the past, began in early December to take dollars in from the market on a swap basis. Before the end of the month, it had purchased a record $385 million from Swiss commercial banks under swaps, and had in turn placed them back in the Euro-dollar market via the Bank for International Settlements (BIS). All these special arrangements helped to insure that temporary pressures would not cause dislocations in the exchange markets that could easily have complicated the recovery of sterling as well as posed problems in official reserve management.

With the reversal of pressures on sterling and the broad improvement in the position of the dollar, both the United States and United Kingdom authorities made good progress in reducing short-term commitments. Reflecting the success of the September 10 operation, the improving balance of payments trend, and the special central bank arrangements over the year-end, sterling showed sustained strength during the winter months and between September and February the Bank of England took in over $1 billion, exclusive of very substantial receipts used to liquidate maturing forward contracts. As a result, the British authorities were able to pay off not only the special end-of-August United States credits of $140 million, but the entire $750 million in drawings under the swap line with the Federal Reserve System as well.

Similarly, during 1965, System swap commitments were reduced by $450 million equivalent from a peak of $585 million in early April to $135 million equivalent at the end of the year, and the remainder of these drawings was paid off during January and February. Thus, by the end of February, the Federal Reserve swap network—now totaling $2.8 billion (see Table I)—was fully on a standby basis. During the four years since the first swap arrangement was initiated in 1962, total drawings by the Federal Reserve and foreign central banks amounted to more than $6 billion; of this total, $5.6 billion, or 93 per cent, was repaid within six months (see Tables II and III), and no drawings were outstanding for more than one year.

In addition to swap repayments, System and Treasury forward contracts—exclusive of technical commitments in Italian lire—which had reached a 1965 peak of $281 million in January were all paid off. The Treasury also acquired sufficient marks to repay $175 million equivalent of mark-denominated bonds during the period July-March, thus largely offsetting the increase in foreign currency bonds that had taken place earlier in 1965 (see Table IV).

Table II

DRAWINGS AND REPAYMENTS BY FEDERAL RESERVE SYSTEM UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962-February 1966

In millions of dollars equivalent

Institution Year	Drawings*	Repaid within			
		3 months	3-6 months	6-9 months	9-12 months
Austrian National Bank					
1962	50.0	50.0			
Total	50.0	50.0			
National Bank of Belgium†					
1962	30.5	30.5			
1963	25.0	25.0			
1964	145.0	62.5	37.5	45.0	
1965	150.0	70.0	75.0	5.0	
Total	350.5	188.0	112.5	50.0	
Bank of Canada					
1963	20.0	20.0			
Total	20.0	20.0			
Bank of England					
1962	50.0	50.0			
1963	35.0	35.0			
Total	85.0	85.0			
Bank of France					
1962	50.0		50.0		
1963	21.5	21.5			
Total	71.5	21.5	50.0		
German Federal Bank					
1963	286.0	143.5	142.5		
1964	105.0	105.0			
1965	15.0	15.0			
Total	406.0	263.5	142.5		
Bank of Italy					
1962	50.0	50.0			
1965	350.0	82.0	268.0		
Total	400.0	132.0	268.0		
Netherlands Bank					
1962	60.0	50.0	10.0		
1963	150.0	60.0	90.0		
1964	100.0		55.0	45.0	
1965	25.0		25.0		
Total	335.0	110.0	180.0	45.0	
Swiss National Bank					
1962	50.0				50.0
1963	80.0	5.0	20.0	55.0	
1964	25.0	25.0			
1965	150.0	90.0	12.0		48.0
Total	305.0	120.0	32.0	55.0	98.0
Bank for International Settlements					
1962	80.0	40.0	5.0	19.5	15.5
1963	150.0	5.0	65.0	80.0	
1964	100.0		35.0	65.0	
Total	330.0	45.0	105.0	164.5	15.5
All banks					
1962	420.5	270.5	65.0	19.5	65.5
1963	767.5	315.0	317.5	135.0	
1964	475.0	192.5	127.5	155.0	
1965	690.0	257.0	380.0	5.0	48.0
Total	2,353.0	1,035.0	890.0	314.5	113.5

* No drawings were outstanding at the end of the period.
† Data relate to disbursements and repayments under the $50 million fully drawn portion of the swap facility and to utilization of the $50 million standby portion available since December 1964.

Table III

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962-February 28, 1966

In millions of dollars

Institution Year	Drawings*	Repaid within 3 months	Repaid within 3-6 months
National Bank of Belgium			
1963	45.0	40.0	5.0
Total	45.0	40.0	5.0
Bank of Canada			
1962	250.0		250.0
Total	250.0		250.0
Bank of England			
1963	25.0	25.0	
1964	1,370.0	1,370.0	
1965	1,765.0	1,290.0	475.0
Total	3,160.0	2,685.0	475.0
Bank of Italy			
1963	50.0		50.0
1964	100.0		100.0
Total	150.0		150.0
Bank of Japan			
1964	80.0	30.0	50.0
Total	80.0	30.0	50.0
All banks			
1962	250.0		250.0
1963	120.0	65.0	55.0
1964	1,550.0	1,400.0	150.0
1965	1,765.0	1,290.0	475.0
Total	3,685.0	2,755.0	930.0

* No drawings were outstanding at the end of the period.

STERLING

By August 1965 the sterling crisis had stretched out over a full year. During this period, the Bank of England twice drew the full amount of the Federal Reserve swap line, $500 million by November 1964 and $750 million by August 1965, while also receiving sizable credits from other central banks. At the end of August, the Bank of England drew supplementary credits of $140 million from the Federal Reserve and United States Treasury. In December 1964 and May 1965, the British authorities drew the full $2.4 billion available to them from the International Monetary Fund (IMF) and received $120 million in medium-term credits from Switzerland: of that total of $2.5 billion, around $2.1 billion was used to repay earlier short-term credits from the Federal Reserve and other central banks. Throughout this period, not only the British financial authorities but central banks and treasuries all over the world lived under the constant threat that the pressures against sterling might have seriously disturbing effects upon the flow of world trade and payments.

While short-term central bank credits and subsequent funding operations through the IMF provided the basic defense line for sterling during this troubled period, inadequate recognition has been given to the success of Bank of England operations in the forward market which were conducted forcefully and with great technical skill during the course of the year. Such large-scale operations in the forward market not only exerted at critical moments a highly salutary influence on market confidence, but also had the vitally important effect of relieving pressure on the spot market and British dollar reserves by providing at reasonable cost the alternative of hedging in the forward market. In the absence of such forward operations, it seems all too clear that the drain upon British reserves and utilization of central bank credits would have been much heavier and consequently would have aggravated still further an already dangerous crisis.

As noted in the previous report in this series, one of the most striking features of the sterling market during the summer months of 1965 was the skepticism of the market regarding the effectiveness of the series of policy measures taken by the British Government to correct the deficit in the British balance of payments. There was, in fact, impressive statistical evidence that these policy correctives had begun to yield results; during the first eight months of 1965, for example, British exports had risen more than 5 per cent over the corresponding period of 1964, while the rise in imports was negligible. With price and wage pressures continuing, however, the market remained convinced that sterling was heading into a new and even more serious crisis, and by the late summer of 1965 market confidence in sterling had withered away almost to the vanishing point. At this moment, the British financial authorities were again confronted with a crisis situation which was in many respects even more dangerous than the flight from sterling in November 1964. As of August 31, the British drawing rights of $2.4 billion with the IMF had been exhausted, short-term credits from the Federal Reserve and United States Treasury had reached the sizable total of $890 million, while very heavy commitments in the forward market had also been assumed. The market was aware of the heavy depletion of foreign credit resources during the preceding year and increasingly questioned whether Britain's financial defenses would not collapse simply for lack of funds.

It would indeed have been a major tragedy if the forces of speculation had overwhelmed sterling at this point through lack of outside assistance, more particularly since selling pressure on sterling was showing signs of exhaustion and from time to time market shortages of sterling began to appear. The bonds of mutual interest linking the central banks and treasuries of the Western world again proved their strength, however, and in a special meeting at the BIS on September 5 the Bank of England and the Federal Reserve enlisted the assistance of nine other central banks and the BIS in a new operation in support of sterling. (Under these new arrangements, the Federal Reserve agreed to provide an additional $200 million for cooperative action on the exchange markets while the United States Treasury supplied a further substantial amount.)

This new operation was based upon a policy decision of the British Government to take determined action to arrest the inflationary trend of prices and wages which had been progressively undermining the position of sterling and creating market fears of devaluation. Announcement on September 1 of the British Government's intention to seek Parliamentary authorization of new powers to deal with the wage-price spiral had in fact brought an immediate improvement in market sentiment and a more buoyant tendency in the sterling rate. The central banks which agreed to participate in a new support operation for sterling were also well aware of the fact that speculative pressures over the preceding year had left sterling in a grossly oversold position, in both the spot and forward markets. In fact, the technical position of sterling in the exchange markets had become so favorable as to open up an excellent opportunity for executing a bear squeeze.

This official counterattack was launched on September 10 with good results. At 9 a.m. New York time and 2 p.m. London time, the Bank of England announced the negotiation with the central banks of Austria, Belgium, Canada, Germany, the Netherlands, Italy, Japan, Sweden, Switzerland, the United States, and the BIS of new arrangements which would enable appropriate action to be taken in the exchange markets with the full cooperation of the central banks concerned. Fifteen minutes later, the Federal Reserve Bank of New York, operating for System account, simultaneously placed bids for sterling totaling the equivalent of nearly $30 million with all the major banks operating in the New York exchange market at the then-prevailing rate of $2.7918. The market rate immediately reacted upward, and the Federal Reserve pursued the upward movement with new and higher bids until the rate of $2.7934 was reached; at this rate level, $8 million equivalent of sterling was sold by the market to the Federal Reserve. After the rate had held at this level for a certain interval, the New York Bank proceeded to bid the rate up still further. By the close of the day the rate had risen to $2.7945 and Federal Reserve sterling purchases totaled no more than $13 million equivalent.

On the following day, in both London and New York, market forces took over and bid the rate up so strongly that the Bank of England intervened to limit the rise and in the process began an accumulation of dollars which

Table IV

OUTSTANDING UNITED STATES TREASURY SECURITIES, FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding January 1, 1965	Transactions (+) denotes issued; (−) redeemed: 1965 I	1965 II	1965 III	1965 IV	1966 January-February	Amount outstanding March 1, 1966
Austrian National Bank	50.3	+ 50.3					100.7
National Bank of Belgium	30.1						30.2
German Federal Bank	678.7			− 25.1	− 50.3	− 100.6	501.0
Bank of Italy				+ 124.8			124.8
Swiss National Bank	257.4						257.3
Bank for International Settlements*	69.5			+ 23.2			92.6
Total	1,086.0	+ 50.3	0	+ 122.9	− 50.3	− 100.6	1,106.6

Note: Discrepancies in amounts are due to valuation adjustments and rounding.
* Denominated in Swiss francs.

continued almost without interruption over the following five months. Since the intervention by the Federal Reserve on September 10 succeeded in triggering such a strong shift in market expectations, possibilities of simultaneous intervention in support of sterling by other central banks in their markets did not have to be called into play but remain available if and when needed.

The major swing in the position of sterling since the bear squeeze was initiated on September 10 has apparently reflected not only extensive short covering but also a major improvement in the British balance of payments position during the fourth quarter of 1965. Since the turn of the year, favorable seasonal forces have also come into play, with the result that the sterling rate moved into new, high ground during January and the Bank of England took in a further sizable amount of dollars. In February, however, poor trade figures for January and rumors of an early election (announced on February 28 for March 31) tended to unsettle the market by injecting new elements of uncertainty. Exchange traders understandably took a more cautious view, which became reflected in a narrowing of the sterling market and a reduced rate of reserve gains by the Bank of England.

As dollars have flowed back to the Bank of England since September, the Bank has shown a scrupulous regard for honoring the maturity dates of its short-term borrowing from foreign financial authorities. Of the total influx of more than $1 billion during the six months' period, September 1965 to February 1966, the Bank of England has devoted $890 million to repaying in their entirety credits received during the summer months of 1965 from the Federal Reserve and United States Treasury. Simultaneously, the Bank of England has succeeded in liquidating a very substantial part of its forward exchange commitments and has thereby strengthened its hand for dealing with any new pressures in the forward market. With so much of the inflow of dollars thus used in liquidating official debt and forward market commitments, the British Government, on March 1, deemed it useful to reinforce its official reserves by shifting $885 million of liquid dollar assets from its securities portfolio into the official reserves. This action raised British official reserves to a level of $3,648 million, an increase of $1,064 million over the end-of-August-1965 level. As noted by Chancellor Callaghan, these reserve availabilities are effectively enlarged by the reconstitution of the $750 million swap line with the Federal Reserve, an unused Export-Import Bank credit line of $250 million, and the remaining $500 million in the British Government securities portfolio to an over-all figure in excess of $5 billion. Together with the facilities from the September 10 package, this adds up to an impressive total of financial resources which can be readily deployed to deal with any recurrence of speculative pressure on sterling.

SWISS FRANC

The heavy demand for Swiss francs that had prevailed during most of 1964 appeared only sporadically during 1965. Indeed, francs frequently were on offer in the exchange markets—despite a sharp reduction in Switzerland's trade deficit last year. Under these circumstances, United States authorities were able to purchase large amounts of Swiss francs. Since March 1965, a total of $299.6 million of short-term Swiss franc commitments has been liquidated.

About one half the commitments that were repaid had been incurred during January and March to absorb dollars taken in by the Swiss National Bank at the end of 1964. After the turn of the year the franc rate began to ease, and the United States authorities were able to purchase Swiss francs throughout the spring and early summer; between March and July, purchases totaled some $239 million, including $20 million equivalent purchased from the Bank of England and $40 million acquired under a German mark-Swiss franc swap with the BIS. These francs were used to liquidate $202 million of the Federal Reserve's $250 million drawings under the swap arrangements and $37 million of Federal Reserve and Treasury forward market sales.

In mid-July, however, the Swiss franc rose to its effective ceiling of $0.2317½ in connection with the unwinding of midyear swaps and inflows of funds from London. Consequently, the Swiss National Bank bought dollars in its market, and the United States Treasury absorbed $23 million of these gains with the proceeds of a Swiss franc-denominated bond issued to the BIS. This bond sale raised the Treasury's Swiss franc bond indebtedness to $350 million equivalent.

In mid-August the Swiss franc began to back away from its ceiling, as tensions associated with sterling subsided and the Swiss money market became easier. By October the franc had dipped to $0.2314 as short-term funds were placed abroad, and the Swiss National Bank began late that month to meet some of its current dollar requirements by selling Swiss francs to the Federal Reserve. These and other purchases enabled the System by early December to liquidate its remaining $48 million equivalent swap drawing from the Swiss National Bank. Also, during December, the final $22.5 million equivalent of Treasury forward market commitments was paid off.

It is significant that these repayments extended into

December, a period when the Swiss franc is usually at its ceiling as a result of repatriations of short-term Swiss assets. On previous occasions the Swiss National Bank met these pressures partly through outright purchases of dollars and partly through short-term swaps with the commercial banks. But in 1965 the Swiss National Bank began on December 1 to buy dollars from Swiss banks on the basis of one-month swaps. These swaps—which eventually reached a record level of $385 million—made it possible for the Swiss National Bank to minimize the increase in its uncovered dollar position. At the same time, the Swiss National Bank acted to insure that this inflow of dollars did not result in a tightening of the Euro-dollar market; as it absorbed dollars under these short-term swaps with the market, it simultaneously entered into gold-dollar swaps with the BIS and that institution immediately invested most of the dollars in the Euro-dollar market.

After the year-end the Swiss franc eased further below its ceiling, and during January and February the spot rate was generally below $0.2310, despite heavy trading volume on occasion. In February and early March, dollar requirements of the Swiss Confederation prompted the Swiss National Bank to purchase $33.5 million from the Federal Reserve with Swiss francs. Most of the francs were then used to repay $30 million of the System's $40 million equivalent German mark-Swiss franc swap with the BIS. Thus, by early March, outstanding United States short-term Swiss franc indebtedness had been reduced to only two German mark-Swiss franc third currency swaps with the BIS—one for $10 million equivalent for System account and one for $15 million equivalent for Treasury account. Both Federal Reserve swap lines in Swiss francs were fully on a standby basis, and there were no outstanding forward commitments, while medium-term indebtedness had increased by only $23 million to $350 million equivalent.

NETHERLANDS GUILDER

During the course of 1965, the Federal Reserve and Treasury were able to purchase at only nominal cost to United States gold reserves sufficient guilders to liquidate all outstanding commitments to the Netherlands Bank, the BIS, and Dutch commercial banks. Most of these obligations had been undertaken during the August 1964-January 1965 period when a strong Dutch balance of payments position and a flight from sterling contributed to large dollar gains by the Netherlands Bank.

Over-all United States commitments in guilders had reached a peak of $348 million equivalent by January 8, 1965. Progress in reducing these commitments was slow until the spring, when the Netherlands balance of payments weakened seasonally and the dollar began to show the first positive effects of corrective United States balance of payments measures. At that point, the United States authorities were able to begin purchasing sizable amounts of guilders from the Netherlands Bank, and by late July the System had repaid virtually all its $223.7 million equivalent in guilder commitments, while the Treasury had reduced its obligations by $89.2 million to $69.4 million equivalent.

Toward midsummer, the Netherlands Bank resumed taking in dollars. Consequently, at the end of July the United States Treasury purchased $25 million from the Netherlands Bank with guilders drawn from the IMF, and in August the Federal Reserve drew $25 million equivalent under its swap arrangement with the Netherlands Bank.

Beginning in late September the guilder eased gradually as funds flowed back to London, and later in the fall the demand for dollars picked up as Dutch imports accelerated, largely in anticipation of the imposition of new excise taxes on January 1, 1966. With the Netherlands Bank selling dollars in support of the guilder rate, the Federal Reserve Bank of New York was able to purchase from the Netherlands Bank guilders totaling $56.9 million equivalent between late September and mid-December and to repay at maturity all the remaining Treasury forward guilder commitments to the market. Continuing support operations by the Netherlands Bank in December further reduced its dollar holdings, and in late December this Bank was able to acquire sufficient guilders from the Netherlands Bank to repay all the remaining official United States commitments in guilders: $25 million equivalent under the System's swap arrangement with the Netherlands Bank and the two $12.5 million German mark-Dutch guilder swaps with the BIS for System and Treasury account.

BELGIAN FRANC

The dollar rate rose in Brussels at the end of 1965 after having been subject to virtually uninterrupted downward pressure for more than a year, and the Belgian market was in relative equilibrium during the first two months of 1966. As a result, the National Bank of Belgium ceased taking in dollars in the exchange market and instead found it necessary on occasion to buy dollars for current needs. Consequently, during this period the Federal Reserve was able to acquire sufficient Belgian francs to eliminate its short position in that currency.

The Federal Reserve swap line of $100 million with the Belgian National Bank was heavily utilized during the first eight months of 1965. Early in the year the facility was fully drawn by the Federal Reserve, and although subsequent developments made it possible to repay these drawings by the end of July, a renewed downward movement of the dollar rate in Brussels during August in connection with the United Kingdom's balance of payments difficulties led to further employment of the swap line. Thus, at the beginning of the period covered by this report, the Federal Reserve had utilized $55 million equivalent of Belgian francs available under the $100 million arrangement.

In mid-September the Belgian franc moved away from its ceiling when the situation in the United Kingdom began to improve, and the Belgian National Bank sold dollars in order to maintain smooth conditions in the market. Consequently, early in October the Federal Reserve was able to purchase $15 million of francs from that bank and to reduce correspondingly its Belgian franc commitments under the swap line. The franc temporarily returned to its ceiling in November, however, and the Federal Reserve System absorbed $10 million from the Belgian central bank with funds available under the swap facility. Then in December the franc eased once again, and the National Bank of Belgium sold $15 million equivalent of francs to the System. Thus, by the year-end, uncovered System commitments in Belgian francs amounted to $35 million equivalent. In early 1966, the National Bank again sold dollars when commercial demand for dollars developed in Belgium, and the System was then able to cover its remaining franc commitments. By January 14, the Federal Reserve swap line with the National Bank of Belgium was fully available.

GERMAN MARK

Germany's official reserves fell by $377 million last year, and a further drop occurred during the first two months of 1966. This decline reflected mainly a sharp increase in German expenditures for foreign goods and services as a result of boom conditions in the domestic economy. As Germany's trade and services account moved into deficit last spring, marks began to come on offer in the exchange markets and the spot rate eased significantly below its ceiling for the first time in nearly two years. By June the rate had dipped below par, as the German trade surplus virtually disappeared. Then, beginning in October, demand for marks picked up, mainly in connection with foreign subscriptions to German mark bond offerings by foreign borrowers and the adoption in Germany of a more restrictive monetary policy—the effect of which was in part to prompt a repatriation of German funds and substantial borrowings abroad by German corporations. Under the circumstances, the spot mark rose to parity late in the month and held there until mid-December, while marks for three-month forward delivery moved to a discount. The customary large year-end repatriation of funds did not occur, however, partly because the German Federal Bank had moved to ease bank liquidity, and thereby to temper the inflow of funds for year-end purposes, by suspending for December the August 1964 increase of 10 per cent in commercial bank reserve requirements, and partly because of the inflow of short-term funds in earlier months. In fact, by the time the Christmas holidays were over, the mark had begun to come on offer as a result of repayments of corporate borrowings abroad and some short-term outflow of funds. With Germany's over-all balance of payments continuing in deficit, the mark eased further in January and February, reaching $0.2490 in mid-February.

In June 1965, the decline in the mark rate had prompted this Bank to initiate substantial purchases of marks, both in the New York market and directly from the German Federal Bank, in order to strengthen the over-all official United States foreign currency position, to begin repayment of outstanding United States Treasury mark-denominated bonds, and to liquidate other commitments. In all, United States authorities purchased a little over $300 million equivalent of marks between late June 1965 and March 1, 1966.

These mark purchases were used for a variety of purposes. Initially, the System on July 8 sold to the BIS $40 million equivalent of marks for Swiss francs on a three-month swap basis and used the francs to liquidate its remaining Swiss franc drawing under the swap arrangement with that institution. Then in July the Treasury substituted $15 million of marks for sterling in a sterling-Swiss franc swap with the BIS, and in July and August the System and Treasury each substituted another $12.5 million equivalent of marks for sterling in outstanding sterling-guilder swaps with that institution.[1] The largest operation in marks, however, consisted of repaying at maturity a total of $175 million of United States Treasury German mark-denominated bonds. The Treasury had begun to issue such bonds to the German Federal Bank in January 1963, and commitments eventually reached a peak of $679

[1] In the fall of 1964, both the System and Treasury needed guilders to absorb dollars from the Netherlands Bank and consequently swapped some of their excess sterling balances for guilders with the BIS, purchasing the guilders spot and selling them forward against sterling. By substituting marks for sterling in these swaps, both the System and the Treasury were in effect reconstituting their sterling balances while leaving unchanged their forward commitments to deliver guilders and Swiss francs to the BIS.

million equivalent by 1964. Repayments were initiated on July 12 when a $25 million equivalent bond matured. Subsequently, bonds of $50 million equivalent each were repaid on October 1, 1965 and on February 1 and March 1, 1966. The Federal Reserve and the Treasury meanwhile added $20 million and $14 million of marks, respectively, to their balances available for future operations.

CANADIAN DOLLAR

The Canadian dollar eased gradually below parity by midsummer, with the spot rate declining as low as $0.92¼ in early July. This easing was partly seasonal but also reflected a sharp rise in imports, in response to the continuing high level of Canadian economic activity, as well as the initial impact of the United States voluntary foreign credit restraint program. That program, while leaving untouched essential long-term capital flows to Canada, gave rise to large outflows of short-term United States funds, and Canadian banks drew heavily on resources available in the Euro-dollar market. Beginning in late July, however, the spot Canadian dollar began to firm, as a bulge in Canadian bond offerings in the United States together with substantial Russian purchases of Canadian wheat and flour added to upward seasonal pressures. Heavy demand for Canadian dollars in August and September resulted in substantial official reserve gains; these were partially absorbed by the United States Treasury in September when it swapped temporarily with the Bank of Canada Canadian dollars that it had drawn from the IMF for eventual sale to countries repaying the Fund. More balanced conditions prevailed in October, and reserve increases that month reflected essentially the progressive unwinding by the Treasury of its swap with the Bank of Canada.

In the final two months of the year, the exchange market was less even, the spot rate fluctuating rather widely in response to alternating pressures. The rate dipped when the market learned of the United States Government's request in late November that Canadian issues scheduled for placement in the United States prior to the year-end be deferred until early 1966, and again in response to the December 6 United States measures raising domestic interest rates and curbing capital outflows. The rate recovered quickly, however, once initial uncertainties disappeared and the market readjusted to the generally tight short-term money market conditions in Canada and the year-end preparations for some $200 million of portfolio-capital inflows scheduled from the United States in January 1966.

By early December, the Treasury had sold virtually all the $60 million of Canadian dollars drawn from the IMF in September. In anticipation of a new United States drawing of Canadian dollars from the IMF, the Treasury swapped with the Bank of Canada US$10 million for Canadian dollars. This swap was repaid from the proceeds of a $100 million Canadian dollar drawing from the Fund on January 4, 1966.

ITALIAN LIRA

During 1965, Italy's balance of payments surplus doubled to $1.6 billion as domestic economic activity continued sluggish. The impact of this record surplus on international financial markets and reserves was minimized, however, since United States and Italian monetary authorities undertook a variety of measures to offset the inflow of dollars. In this respect, a recent statement by Paolo Baffi, General Manager of the Bank of Italy, is of interest. Mr. Baffi noted that during the 1940's and 1950's Italy had achieved an outstanding success first in stopping inflation and then in achieving a high and stable rate of growth. He went on to say: "Our distinction during the sixties has been so far of a more doubtful nature, since it has been based mainly upon the extraordinary magnitude of our balance of payments swings. Now that we are in the upswing and approaching a total gold and foreign exchange reserve of $5 billion, we have not chosen to add to that distinction by making ourselves a nuisance. We have always been ready to cooperate in all appropriate ways so that the present international monetary system would work while progress is being made on the slow path of reform. Just to give an instance, we have extensively used the recent surplus in our balance of payments to reduce drastically our borrowing in the Euro-dollar market. This reflow of dollars from Italy to the Euro-dollar market was partly due to market considerations, but also was the result of the readiness on the part of the monetary authorities to provide to our banks alternative facilities."[2]

A major portion of Italy's potential reserve gain was reabsorbed directly by the Italian commercial banks under swap arrangements with the Italian authorities. In addition, some $572 million of official Italian dollar gains was absorbed by the United States authorities during the period January-August 1965 (as detailed in the previous report): swap drawings by the Federal Reserve on its expanded arrangement with the Bank of Italy totaled $350 million ($250 million of which was repaid from

[2] Statement at the meeting of the National Industrial Conference Board in New York City on October 7, 1965.

the proceeds of lira drawings on the IMF which the Federal Reserve purchased from the United States Treasury, the United Kingdom, and Ceylon); a Treasury lira-denominated bond for $125 million equivalent was sold to the Bank of Italy; $17 million was purchased with lire drawn from the IMF; and $80 million was absorbed by a Treasury sale of gold.[3] In February 1966, the Federal Reserve was able to acquire sufficient lire to repay the remaining $100 million equivalent swap drawing with the Bank of Italy.

Although the Italian payments surplus remained substantial, it diminished considerably during the winter months, partly for seasonal reasons. After August, reserve gains were largely limited to a temporary bulge over the year-end reflecting repatriated funds. In general, swaps between the Italian authorities and the Italian commercial banks offset official dollar receipts, and no additional direct absorption of dollars from the Italian authorities was necessary. Such swaps had already reached substantial proportions as early as March 1965, and it was agreed at that time that the United States Treasury would begin sharing with the Italian authorities technical commitments for these swap contracts with the Italian banks. The Treasury had undertaken similar commitments, beginning in January 1962 and continuing until the contracts between the Italian authorities and Italian banks were fully liquidated as Italy's balance of payments swung into deficit in 1963.[4]

Not only did these arrangements have the effect of reducing Italy's potential demand for gold, but they helped materially to avoid a potentially disturbing squeeze for dollars that might have arisen on the international markets as a result of the United States balance of payments program. As Italian banks received dollars from the Bank of Italy under these swap arrangements, they placed funds in the Euro-dollar market, thereby replacing funds being repatriated to the United States. Since the Federal Reserve had an interest in assuring the maintenance of market balance and since the volume of Italian swap contracts was still increasing during the fall, it was agreed that the System should join with the Treasury in the operation. Thus, in late November the Federal Reserve Bank of New York was authorized to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating both the retention of dollar holdings by private foreign holders and the orderly flow of short-term funds through international money markets.

OTHER CURRENCIES

There were no official United States transactions in Austrian schillings, French francs, Japanese yen, or Swedish kronor during the period under review.

INTERNATIONAL MONETARY FUND

As outlined in previous reports in this series, the United States began in 1964 to draw currencies from the IMF for sale to countries having repurchase obligations to the Fund. Two drawings of Canadian dollars were made during the period covered by this report—one for $60 million on September 28, 1965 and one for $100 million on January 4, 1966. These operations brought to $760 million equivalent the total of United States technical drawings under this program. In addition, the United States in July 1965 had drawn $300 million equivalent in five European currencies in a regular Fund drawing and used the currencies to repay short-term swap commitments of the Federal Reserve and to absorb dollars from several European central banks. As an offset, however, other countries have continued to draw dollars from the Fund, thereby reducing the Fund's holdings of dollars in excess of 75 per cent of the United States quota and thus reducing this country's repayment obligation to the Fund. Consequently, at the end of February 1966 net United States indebtedness to the Fund was only $516 million.

In 1964, a draft agreement was signed by the governors of the Fund, providing for increases of 25 per cent or more in members' quotas. Such quota increases must be paid to the Fund partly in a country's own currency and partly in gold. In order to compensate the United States and the United Kingdom—the two reserve currency countries—for gold losses incurred as a result of other members' conversions of dollars and sterling into gold for payment of their gold subscriptions, the agreement also provided that the IMF would deposit up to $350 million of gold with the Federal Reserve Bank of New York and the Bank of England. Insofar as the United States is concerned, these compensating operations began last September and as of February 28 the Federal Reserve Bank of New York held for United States Treasury account $37 million of gold so deposited by the IMF. These deposits are reflected in the Federal Reserve's statement of condition under "Other assets" and "Other deposits".

[3] This purchase by Italy represented a partial reconstitution of the $200 million of gold sold to the United States during 1964.

[4] See this *Review* (September 1964), page 168.

THE GOLD MARKET

International political tensions and exchange speculation resulted in very heavy private demand for gold on the London market through most of 1965. In addition, Communist China bought a fairly sizable amount of gold. Under these circumstances, prices tended to rise somewhat above the levels of the past two years.

At the beginning of 1965 the private demand for gold was stimulated by continuing apprehension regarding the future of sterling, widespread speculation on the consequences of the French decision to convert a large amount of dollars into gold—as well as French criticism of the gold exchange standard—and the worsening conflict in Vietnam. Thus, during the winter months, the fixing price rose as high as \$35.17¾ and the Pool had to supplement market supplies. During the spring the gold market was calmer but, as speculation against sterling revived in early summer and as Communist Chinese buying reached its peak, the fixing price was allowed to rise to \$35.19⅜. Thereafter, the situation improved significantly, as the exchange markets quieted with the recovery of sterling and as the Soviet Union resumed large-scale gold sales to finance purchases of wheat from the West. Nevertheless, there were periodic surges of demand as a result of the continued enlargement of the Vietnam war and the emergence of new crises on the Indian subcontinent and in Rhodesia. By the year-end, the volume of activity on the London gold market had receded to more normal levels and the Gold Pool had registered a small surplus.