Treasury and Federal Reserve Foreign Exchange Operations*

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During the first four months of 1967, sterling staged a strong recovery while international financial markets generally moved into better balance as inflationary pressures receded and credit conditions eased. Toward the end of May, unfortunately, the sudden eruption of the Middle East crisis jolted confidence in both the gold and foreign exchange markets. Money immediately flowed in heavy volume to the traditional haven of Switzerland, thereby imposing further strain on the Euro-dollar market from which funds were already being withdrawn in anticipation of midyear liquidity requirements. Sterling also came under pressure, reflecting concern that Britain might prove particularly vulnerable to adverse developments in the Middle East. In the gold market, fears that the Middle East hostilities might develop into a broader conflict briefly, but strongly, intensified speculative buying, already influenced by public discussions of United States gold policy, the Treasury's suspension of silver sales, alternating reports of imminent success or failure of negotiations to increase international liquidity, and tensions in the Far East.

These severe pressures in the gold and exchange markets in early June brought an immediate central bank response. To relieve the stringency in the Euro-dollar market, the Bank for International Settlements (BIS) drew $143 million on its swap line with the System and placed these funds in the market. This BIS operation, which was reversed in July, helped to settle the market and ease the pressures on sterling resulting from the pull of higher Euro-dollar rates. At the same time, the United States authorities, in cooperation with the Bank of England, acted to absorb sterling from the market by purchasing spot against forward resale a total of $112.8 million equivalent of sterling. In addition, the Bank of England strengthened its own resources by reactivating its swap line with the Federal Reserve through a drawing of $225 million in June. The Federal Reserve made even heavier drawings on its Swiss franc swap lines to absorb the flow of

Table 1

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

August 31, 1967

Institution	Amount of facility (in millions of dollars)
Austrian National Bank	100
National Bank of Belgium	150
Bank of Canada	500
National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	600
Bank of Japan	450
Bank of Mexico	130
Netherlands Bank	150
Bank of Norway	100
Bank of Sweden	100
Swiss National Bank	250
Bank for International Settlements	
Swiss francs/dollars	250
Other European currencies/dollars	300
Total	5,030

* This report, covering the period March to September 1967, is the eleventh in a series of reports by the Vice President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

Table II

DRAWINGS AND REPAYMENTS BY FEDERAL RESERVE SYSTEM UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962–August 1967

In millions of dollars

Institution	1962		1963		1964		1965		1966		1967		Total	Drawings outstanding on August 31, 1967
	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	July-August		
Austrian National Bank														
Drawings		50.0											50.0	
Repayments			50.0										50.0	
National Bank of Belgium														
Drawings		30.5	10.0	15.0		145.0	65.0	85.0		30.0	37.5	92.5	510.5	120.0
Repayments		15.5	25.0		15.0	100.0	50.0	110.0	35.0	30.0	10.0		390.5	
Bank of Canada														
Drawings				20.0									20.0	
Repayments				20.0									20.0	
Bank of England														
Drawings	50.0		25.0	10.0									85.0	
Repayments		50.0	25.0	10.0									85.0	
Bank of France														
Drawings	50.0			21.5									71.5	
Repayments		50.0		12.5	9.0								71.5	
German Federal Bank														
Drawings			150.0	136.0	55.0	50.0	15.0			140.0			546.0	
Repayments				226.0	115.0		65.0				140.0		546.0	
Bank of Italy														
Drawings		50.0					250.0	100.0		325.0			725.0	
Repayments			50.0				82.0	168.0	100.0	310.0	15.0		725.0	
Netherlands Bank														
Drawings	10.0	50.0	50.0	100.0		100.0		25.0		65.0		20.0	420.0	20.0
Repayments		50.0	10.0	70.0	80.0		100.0	25.0		30.0	35.0		400.0	
Swiss National Bank														
Drawings		50.0		80.0	25.0		150.0			75.0	185.0	33.0	598.0	173.0
Repayments			50.0	5.0	100.0		90.0	60.0		60.0	43.0	17.0	425.0	
Bank for International Settlements														
Drawings		80.0		150.0		100.0				75.0	185.0	15.0	605.0	200.0
Repayments		25.0	55.0	5.0	145.0		60.0	40.0			75.0		405.0	
All banks														
Drawings	110.0	310.5	235.0	532.5	80.0	395.0	480.0	210.0		710.0	407.5	160.5	3,631.0	513.0
Repayments		190.5	265.0	348.5	464.0	100.0	447.0	403.0	135.0	430.0	318.0	17.0	3,118.0	

dollars to Switzerland, while the Gold Pool kept the London gold market price under firm control.

Although the immediate disturbances in the gold and exchange markets associated with the Middle East crisis were thus quickly dealt with, international financial markets remained uneasy during succeeding months while short-term funds continued to move across the exchanges in response to differentials in interest rates and credit conditions. Recurrent pressures on sterling, for example, seemed to reflect interest rate differentials marginally unfavorable to London, as well as hedging. At the close of August, the successful conclusion of the Group of Ten discussions on international liquidity brought about some covering of short positions in sterling while also relieving speculative buying pressure on the London gold market.

As in the past, dollar rates in the exchange markets were influenced both by the United States balance-of-payments deficit and the backwash from large shifts of funds among third countries. The Federal Reserve swap lines, after having reverted fully to a standby basis last February, were once again activated in May when the System began a series of drawings on its swap line with the Belgian National Bank in order to absorb a continuing influx of dollars into Belgium. Such drawings of Belgian francs rose to $120 million equivalent by the end of August, while drawings of $20 million equivalent of Dutch guilders were also required to absorb dollar acquisitions by the Netherlands Bank. By far the largest operation, however, was undertaken in Swiss francs in order to absorb $390 million that poured into the Swiss National Bank during May and June. There were only very limited opportunities to reverse these operations during the sum-

Table III

OUTSTANDING UNITED STATES TREASURY SECURITIES FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding on January 1, 1966	Net changes 1966	1967 Issues or redemptions (—) I	II	July-August	Amount outstanding on August 31, 1967
Austrian National Bank	100.7	— 50.3				50.3
National Bank of Belgium	30.2			—30.2		
German Federal Bank	602.1	—251.5			125.5	477.0
Bank of Italy	124.8					124.8
Swiss National Bank	257.3	— 46.2				210.8
Bank for International Settlements*	92.6			60.2		152.7
Total	1,207.8	—348.0		30.0	125.5	1,015.5

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

mer months, and at the end of August System swap drawings outstanding totaled $513 million (see Table II). Subsequently, in early September the Federal Reserve drew an additional $5 million under its arrangement with the National Bank of Belgium and $10 million from the Netherlands Bank.

During the period under review, the Federal Reserve swap network was expanded and further strengthened. In May, new swap facilities were negotiated with the central banks of Denmark and Norway in the amount of $100 million each and with the Bank of Mexico for $130 million. Then in July, against the background of the Middle East problem, the System negotiated increases in: (1) its Swiss franc swap lines with the Swiss National Bank and the BIS (each facility being increased by $50 million to $250 million), and (2) its swap line with the BIS providing for swaps of dollars against other European currencies (this facility rising from $200 million to $300 million). Thus, the Federal Reserve swap network now comprises bilateral agreements with fourteen central banks plus the BIS which provide mutual credit facilities totaling $5,030 million.

In April and May, the United States Treasury issued to the BIS certificates of indebtedness denominated in Swiss francs, the proceeds of which ($60.2 million equivalent) were used to reduce third-currency swaps negotiated with the BIS last February to liquidate previous Swiss franc drawings by the System. In July the Treasury issued the first of four scheduled 4½-year $125 million notes, denominated in German marks. These latest security issues, partly offset by redemption at maturity of Belgian franc-denominated bonds totaling $30.2 million, brought to $1,015.5 million total outstanding issues of United States Treasury foreign currency obligations (see Table III).

STERLING

During the first quarter of 1967, funds that had fled from sterling during the summer of 1966 began moving back at an accelerated pace. By early March, these inflows had enabled the Bank of England to liquidate completely the swap drawings from the Federal Reserve and to repay fully other sizable special credits from the Federal Reserve and the United States Treasury. (At their peak in August of last year, credits from the United States had reached $750 million. By the end of September they had been reduced to $575 million through substitution of other credit facilities.) Announcement of these repayments confirmed to the market the degree of recovery that had already taken place and triggered a spurt of buying that gained momentum as the month progressed.

Other developments during March contributed to a surge of covering of short positions. These included announcements of (1) renewal of the credit lines from nine central banks and the BIS, (2) unexpectedly good fourth-quarter balance-of-payments figures, (3) a cut in bank rate from 6½ per cent to 6 per cent, which was taken as a sign of confidence, and (4) the Government's decision to continue strict control over price and wage increases through July 1968. In addition to having repaid early in March its swap with the Federal Reserve, the Bank of England later in the month used most of its record reserve gains to repay other short-term central bank debts. Thus, within a six-month period, the Bank of England had repaid $575 million to the United States authorities and $720 million to other parties. Remaining central bank credits linked specifically to changes in overseas sterling balances were liquidated early in the second quarter.

The influx of short-term capital continued in April and early May, though at a diminishing rate. The British authorities were able to announce a reserve increase of $145 million in April, as foreign short-term interest rates continued to fall and the United Kingdom budget message met with a generally favorable reception. As early as April, however, some market concern was beginning to be expressed about the trend in the trade figures, and by early May covered interest rate comparisons that had tended to favor London earlier in the year started to turn adverse. Shortly after the announcement on May 4 of the third cut in bank rate this year, from 6 per cent to 5½ per cent, Euro-dollar rates began to firm, despite subsequent steps toward further monetary ease by several Continental countries. Moreover, announcement on May 11 that the British trade deficit had jumped from $36 million in March to $115 million in April was followed a few days later by President deGaulle's sharply negative comments at a press conference on Britain's application to join the Common Market. By mid-May the combination of these adverse factors had led to the first net selling of sterling this year. Nevertheless, the British authorities proceeded with their plans to prepay $405 million on May 25 to the International Monetary Fund (IMF)—more than half of the amount due this December under the 1964 drawing—together with the whole amount ($80 million) borrowed in 1964 from Switzerland, thus further reestablishing available credit facilities.

On June 1, market expectations of an imminent outbreak of hostilities in the Middle East sparked a burst of selling of sterling. Such apprehension of war affected sterling not only directly but also indirectly through the Euro-dollar market, where precautionary withdrawals of funds combined with the usual pressures associated with midyear window dressing to create a sudden squeeze and a sharp hike in rates. These dual pressures were immediately met by a coordinated central bank response in both the exchange and Euro-currency markets. On June 1 the United States authorities, in consultation with the Bank of England, purchased a total of $92.9 million of sterling in the New York market on a swap basis, buying spot against forward sales. That same day the BIS began placing in the Euro-dollar market new dollar funds drawn under its swap arrangement with the Federal Reserve. By June 7, when a cease-fire resolution by the United Nations served to reduce tensions somewhat, the BIS had drawn a total of $143 million from the System and had placed these dollars, together with funds received from other central banks, in the Euro-dollar market. Meanwhile, the United States authorities had temporarily taken another $20 million of sterling out of private hands through additional swap purchases in New York. With the cessation of actual hostilities, covering by the market of short positions in sterling boosted the spot rate from a low of $2.7900 on June 6 to $2.7932 on June 7 while permitting the Bank of England to recoup much of the exchange that had been used during the preceding few days.

As the month progressed, however, rumors that Arab countries might withdraw sterling balances revived market anxieties while the announcement at midmonth of disappointing trade figures for May had a further disturbing effect. Finally, the pull of foreign interest rates, particularly during a brief squeeze in the Euro-dollar market at the end of June, exerted further pressure. To cushion the reserve impact of these adverse developments, the Bank of England drew $225 million during June under its $1,350 million swap arrangement with the Federal Reserve.

SWISS FRANC

During the first half of 1967, Swiss interest rates declined less rapidly than rates outside Switzerland. Indeed, during much of this period, the Swiss credit market remained relatively tight, and there was on the whole more incentive for foreigners to pay off previous Swiss franc borrowings than there was for Swiss residents to place new funds abroad. Even in the early months of the year, the reflux to foreign markets of funds repatriated by Swiss residents at the year-end was less than might have been expected on the usual seasonal pattern. As a result, the Federal Reserve was unable to acquire through the market sufficient francs to pay down completely earlier drawings under its swap lines with the Swiss National Bank and the BIS. To liquidate the residual balance of $75 million in Swiss francs due to the BIS, the United States authorities in February used $75 million equivalent of sterling balances to acquire Swiss francs from the BIS on a temporary swap basis. Subsequently, when the Swiss National Bank released to the Swiss commercial banks part of their deposits that had been blocked since 1961 the banks bought BIS Swiss franc promissory notes in the amount of $60.2 million equivalent. The BIS placed these francs at the disposal of the United States Treasury, which in exchange issued certificates of indebtedness denominated in Swiss francs. The Swiss franc proceeds of these issues were used to reduce the commitment under the sterling/Swiss franc swap to $14.3 million equivalent.

In order to forestall a rapid rise in the Swiss franc rate during March when Swiss banks repatriated funds for liquidity requirements, the Swiss National Bank announced early in the month that it would provide Swiss francs against dollars for end-of-quarter needs through short-term swaps with the Swiss commercial banks. This was the first time that the Swiss authorities had offered this facility other than at midyear and at the year-end. During the final weeks of March, the central bank took in $221 million on this basis and immediately reinvested the money in the Euro-dollar market to assist in moderating pressures in that market.

Following the end of the quarter, interest rates on sterling and dollar investments continued to decline, while the unwinding of the Swiss National Bank swaps with its commercial banks tended to tighten the Swiss market once again. Foreigners, particularly Italians, began to bid for

Table IV

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962-June 1967

In millions of dollars

Institution	1962		1963		1964		1965		1966		1967	Total	Drawings outstanding on June 30, 1967
	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half		
National Bank of Belgium													
Drawings			35.0	10.0								45.0	
Repayments			25.0	20.0								45.0	
Bank of Canada													
Drawings	250.0									17.6		267.6	
Repayments		250.0								17.6		267.6	
Bank of England													
Drawings			25.0		15.0	1,355.0	1,215.0	550.0	175.0	450.0	225.0	4,010.0	225.0
Repayments				25.0		1,170.0	1,055.0	435.0	475.0	275.0	350.0	3,785.0	
Bank of Italy													
Drawings				50.0	100.0							150.0	
Repayments					150.0							150.0	
Bank of Japan													
Drawings					50.0	30.0						80.0	
Repayments						80.0						80.0	
Bank for International Settlements*													
Drawings										285.0	225.0	510.0	143.0
Repayments										85.0	282.0	367.0	
All banks													
Drawings	250.0		60.0	60.0	165.0	1,385.0	1,215.0	550.0	175.0	752.6	450.0	5,062.6	368.0
Repayments		250.0	25.0	45.0	150.0	1,250.0	1,055.0	435.0	475.0	377.6	632.0	4,694.6	

* Includes, in addition to drawings in connection with Euro-dollar operations, BIS drawings of dollars against European currencies other than Swiss francs to meet temporary cash requirements. During the first six months of 1967, such drawings totaled $82 million.

Swiss francs to repay indebtedness previously incurred and started shifting their borrowings to currencies that were being lent more cheaply, notably German marks, while in addition there may have been some net repatriation of funds by Swiss banks. As a result, the spot rate moved up from $0.2307½ at the beginning of April to the effective ceiling of $0.2317½ by April 26, at which point the Swiss National Bank became a buyer of dollars for the first time in 1967. With credit conditions remaining tight and some nervousness developing about sterling and the prospects of a Middle East clash, the rate held at or close to the effective ceiling through most of May, and the Swiss National Bank added some $180 million to its reserves. The prepayment by the Bank of England in May of the $80 million credit extended to it in December 1964 resulted in equivalent dollar acquisitions by the Swiss National Bank.

During the first days of June the rumor, and then actual outbreak, of hostilities in the Middle East precipitated a heavy flow of funds to Switzerland. The dollar holdings of the Swiss National Bank, already swollen by the inflows in May, jumped by $212 million in the first week of June. In order to absorb these dollar flows, the Federal Reserve on June 2 and June 8 drew a total of $370 million equivalent of Swiss francs in equal amounts under its swap arrangements with the Swiss National Bank and the BIS; in addition, the Swiss National Bank purchased $30 million of gold from the United States Treasury. Although only a part of the shift of funds to Switzerland during this period represented transfers directly out of sterling, the Swiss authorities were prepared to cooperate with the Bank of England in countering the effects of such shifts. One by-product of this cooperation was the acquisition by the Federal Reserve of $28 million equivalent of Swiss francs which were used on June 16 to repay an equivalent amount of its drawings on the Swiss National Bank.

Following the cease fire in the Middle East, the demand for francs abated, only to pick up again on a moderate scale just before midyear. Once again, the Federal Reserve drew on its swap arrangements to absorb these inflows; it added $33 million to its drawings on the Swiss central bank and $15 million to its drawings on the BIS, bringing the total of Swiss franc drawings outstanding on July 3 to the equivalent of $390 million, out of credit lines then totaling $400 million. The drawing on the Swiss National

Bank was reduced on July 28 to $180 million, when the Swiss National Bank purchased $10 million from the System against Swiss francs to meet Swiss official requirements. In view of continuing uncertainties in financial markets and unsettled conditions in the Middle East during the summer, it was agreed in mid-July that the Federal Reserve swap lines in Swiss francs with the Swiss National Bank and the BIS should be expanded by $50 million each to a new combined total of $500 million. (At the same time, the $200 million swap facility with the BIS in European currencies other than Swiss francs was increased by $100 million equivalent to $300 million.)

The capital inflows in May and especially in June led to increased liquidity in Switzerland and eliminated the need for any special measures, such as short-term swaps, to meet midyear needs. Indeed, there was some easing in Swiss interest rates. In order to reinforce this trend, the Swiss central bank on July 10 reduced its discount rate from 3½ per cent to 3 per cent, explaining that the move was "likely to facilitate the reestablishment of interest rate differences existing normally between Switzerland and foreign countries and thus also the reflux abroad of the excess liquidity registered in the past two months". Following this move, and as Euro-dollar rates became relatively more attractive, some movement of funds out of Switzerland began to develop, and by late August the franc had eased considerably. When the rate reached $0.2304⅛, the Swiss National Bank began selling dollars to the market. The Bank subsequently purchased $7 million from the System which used the Swiss franc counterpart to reduce its outstanding drawings in Swiss francs. Such Federal Reserve drawings thus amounted to $373 million as of the end of August.

GERMAN MARK

The German economy has been operating at less than capacity this year, and the slack in domestic activity has been reflected in a substantial drop in imports and buoyant exports. As a result, the German trade surplus nearly quadrupled from $555 million in the first half of 1966 to $2.2 billion in the first half of this year. Had it not been for the very large outflows of short-term funds stimulated by the significant easing in German monetary policy, this trade surplus could have created severe strains in international credit markets and the foreign exchange market. Thus, the series of reductions in the discount rate and in reserve requirements during the first eight months of this year, while designed primarily to stimulate the flagging domestic economy, were very helpful from an international standpoint as well.

Following the usual seasonal pattern, there was a substantial reflow of funds from Germany just after the year-end, and the Federal Reserve was able to acquire in the market and through special transactions sufficient marks to liquidate by mid-February the $140 million drawn on the swap line with the German Federal Bank in December 1966. During March and April, the spot rate generally held close to its upper limit but the central bank did not add significantly to its reserves. By mid-May, however, the mark began to ease as the cumulative influence of easy money policy induced heavy outflows of commercial bank funds. At the same time, German firms that had taken up sizable amounts of funds abroad began making repayments as credit became more readily available in Germany.

The easing trend in spot marks became more pronounced toward the end of June, when the German Federal Bank announced the fourth reduction in reserve requirements this year. To encourage retention in Germany of this newly released bank liquidity, the German Federal Bank at the same time altered its pattern of exchange market activity. For several months, the central bank had been concerned that its policy of active ease had been more successful in stimulating outflows of funds than in reducing domestic interest rates. By widening its announced buying and selling rates and permitting a rapid fall in the spot rate, the central bank sought to increase the degree of uncertainty about future rate movements, particularly for those who were investing abroad at very short term on an uncovered basis. As the spot rate dropped sharply in early July to just below par, investors immediately began to purchase forward cover to avoid the risk of a future rise in the rate and the cost of such cover back into marks jumped from about ¾ per cent for three-month maturity, for example, to over 1¾ per cent and remained close to 1½ per cent through August.

During the period under review, there were discussions between Germany and the United States, together with the United Kingdom, concerning military forces in NATO and the balance-of-payments consequences of United States and United Kingdom troop deployments in Germany. In early May, the United States authorities released an exchange of letters growing out of these discussions between the President of the German Federal Bank, Karl Blessing, and the Chairman of the Federal Reserve Board, William McChesney Martin, Jr., in which the former indicated that the Federal Bank intended to continue its practice of not converting dollars into gold as part of a policy of international monetary cooperation. This statement was made with the agreement of the German Federal Government, which at the same time took note of the

Federal Bank's intention to purchase $500 million of United States Government medium-term securities in four equal quarterly instalments beginning in July. The first $125 million equivalent German mark security was issued on July 3.

DUTCH GUILDER

During the early part of 1967, the guilder came on offer as the Dutch trade balance moved into deficit, primarily due to slackening demand by some of its major trading partners. At the same time, the recovery of sterling attracted additional outflows of guilder funds. Under the circumstances, the Netherlands Bank released dollars to the market and further reduced its dollar reserves by converting into dollars the guilder tranche of a multicurrency drawing from the IMF by Spain. The Netherlands Bank then replenished its dollar reserves by buying $35 million from the Federal Reserve against guilders. The Federal Reserve used the guilders to repay by the end of January the remaining commitment under a $65 million swap drawing made during the summer of 1966.

The Dutch economy continued to ease, and in mid-March the Netherlands Bank reduced its discount rate from 5 per cent to 4½ per cent. (The rate had been raised to 5 per cent in May 1966 in order to damp down the then overheated economy.) The move also brought interest rates in the Netherlands more nearly into line with those in other centers. At the same time, the Netherlands Bank removed the penalty deposit requirement for banks exceeding credit ceilings. Despite these moves, money market conditions in the Netherlands remained tighter than abroad and Dutch banks withdrew funds from other markets. Under the circumstances, the Dutch authorities began to rely increasingly on swap transactions in the exchange market—that is the purchase of dollars spot against forward delivery—as a regular method of relieving money market pressures. Dollars taken in by the central bank on a swap basis reached fairly substantial levels beginning in May and rose to a peak of $150 million in early June.

In the early summer, the backwash of the hostilities in the Middle East and renewed pressures on sterling dominated the foreign exchange markets. As additional funds moved into Amsterdam, the guilder rose sharply and the Netherlands Bank took in dollars both outright and on a swap basis. Accordingly, at the end of July the Federal Reserve drew $20 million of guilders under its $150 million swap line with the Netherlands Bank and used the proceeds to absorb an equivalent amount of dollars on the books of the Dutch central bank. Following a further flow of funds into the Netherlands, in early September the Federal Reserve made an additional drawing of $10 million equivalent.

CANADIAN DOLLAR

During the early part of 1967, movements in the Canadian dollar rate were influenced by fluctuations in the volume of new Canadian bond flotations in the New York market and by short-term capital flows. A flurry of new issues in January, together with the take-down of proceeds of previous issues and the repatriation of funds from the United States, more than offset adverse seasonal factors and the Canadian dollar moved above par ($0.9250) where it held through mid-February. At the end of February, as the rate of new external issues abated and adverse seasonal factors asserted themselves, the rate moved below par and remained there during the rest of winter and early spring.

The Canadian dollar began moving into a period of seasonal strength late in the spring as grain shipments started up again. Then in June an increase in the level of bond issues lent further strength to the Canadian dollar, pushing it above par. An additional—although quite temporary—boost was given to the spot rate when unfounded rumors of an increase in the Canadian-Russian wheat agreement were prompted by the arrival in Canada of a Russian trade delegation. During the summer, tourist receipts were unusually large as the success of EXPO 67 drew an exceptional number of visitors to Canada. Consequently, the Canadian dollar remained quite strong during July and August, fluctuating in a narrow range around $0.9300. Official gold and foreign exchange reserves nevertheless declined moderately during the first seven months of the year (by $53.3 million), with the decline in large part ($31.8 million) the result of purchases by the Canadian authorities of Canadian Government debt held by United States residents.

BELGIAN FRANC

The Belgian franc moved above par in January as lightly slackening activity in the Belgian economy contributed to a more than seasonal drop in imports, and the current account shifted from deficit to surplus during the winter. There was no real pressure in the exchange market, however, and official holdings of gold and foreign exchange were little changed through the first quarter.

In April the franc began to strengthen further as the current account continued in surplus and from May onward the franc held at or near its upper intervention point.

In part, this strength reflected an inflow of short-term capital despite steps by the central bank to ease monetary policy somewhat, including three discount rate cuts during the first half of the year. During the rest of the period, the National Bank of Belgium was compelled to take in substantial amounts of dollars. Inflows in late April and early May led the Federal Reserve to absorb $30 million that had been acquired by the National Bank by utilizing its $150 million swap line with that Bank. In an unrelated transaction, the United States Treasury during May repaid two maturing Belgian franc denominated bonds totaling $30.2 million originally issued in 1963 using francs it had acquired in late 1966 when the dollar was in demand in Belgium.

The Federal Reserve used an additional $7.5 million of the swap line in June but shortly thereafter repaid $10 million by selling dollars to the National Bank to meet Belgian Government needs. In July and August demand for francs was intensified as commercial banks increased their inflow of short-term capital. (The scope for the banks to employ in Belgium the proceeds of foreign borrowings increased with the removal in late June of the credit ceilings that had been previously applied on a voluntary basis.) The renewed pressures on sterling also contributed to the substantial inflow as commercial interests and banks reduced their holdings of sterling. In order to absorb dollars purchased by the National Bank during this period, the Federal Reserve used a further $92.5 million under the swap arrangement plus $3 million of Belgian franc balances. Thus at the end of August, total swap drawings by the Federal Reserve stood at $120 million. Following a further flow of funds into Belgium, in early September the Federal Reserve made an additional drawing of $5 million equivalent.

ITALIAN LIRA

The deficit that had emerged in late 1966 in Italy's balance of payments continued during the first two months of 1967, reflecting seasonal factors and intensified import demand associated with an expanding economy. In addition, there were sizable exports of capital, partly in anticipation of changes in the Italian tax laws. Under the circumstances, United States monetary authorities were able to acquire sufficient lire to repay short-term lira commitments totaling $114 million, of which the final $15 million portion was liquidated at the beginning of 1967.

In March, Italy's balance of payments began to strengthen, although the reemerging surplus was considerably less than during the comparable period a year earlier as import demand expanded further and capital exports continued. As economic expansion generated mounting financial requirements on the part of Italian residents for both foreign exchange and local currency, Italian banks reduced their net claims on foreigners by nearly $275 million during the first six months of the year. During the same period, Italian official reserves, including Italy's position in the IMF, increased by $55 million.

About midyear the Italian payments position moved into the period of seasonal strength and the demand for lire intensified. The Italian authorities began to acquire substantial amounts of dollars, though on a lesser scale than the previous year. The Federal Reserve did not draw upon its $600 million swap line with the Bank of Italy during the period, but outstanding Federal Reserve and Treasury technical commitments in forward lire were rolled over periodically during 1967.

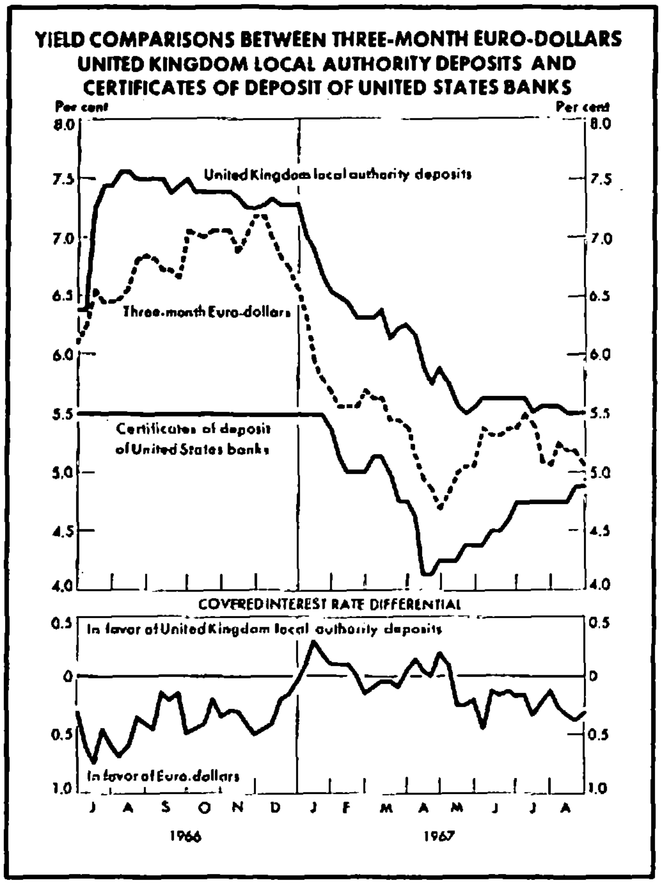
OTHER CURRENCIES

During the period under review, there were no System transactions in Austrian schillings, French francs, Japanese yen, Danish kroner, Norwegian kroner, Swedish kronor or Mexican pesos. Nor were there any drawings by the United States Treasury on the IMF. As of the end of August, net United States indebtedness to the Fund was $922.2 million.

EURO-DOLLAR MARKET

The Euro-dollar market eased considerably during the first four months of 1967, after having been subjected to considerable strain last year. Excessive reliance on monetary policy in a number of countries had pushed domestic interest rates to historically high levels which affected the international money market as well. United States banks in particular turned to the Euro-dollar market in an effort to recoup deposits being lost as certificate of deposit rates reached ceiling levels under Regulation Q and became uncompetitive with commercial paper. Thus, between late June and the peak in mid-December, United States banks added some $2.4 billion to their borrowings through foreign branches. Later, year-end liquidity requirements placed additional demands on the market. In the final weeks of 1966, concerted action was taken by the BIS and a number of central banks to counter these year-end pressures, and the constellation of Euro-dollar rates began to ease. (For a description of these operations, see this *Review*, March 1967, pages 43-51.)

The decline in rates was even more pronounced after the turn of the year. By late April, three-month deposits



were quoted at $4^{11}/_{16}$ per cent, lower than at any time in 1966 and 2½ percentage points below their peak of late November (see chart). This sharp decline in rates reflected, in addition to the usual seasonal pattern, decidedly easier monetary conditions in the United States and Germany and to a lesser extent in other countries as well. By the end of the first quarter, United States banks had reduced their liabilities to foreign branches mainly in London by some $1.25 billion from the mid-December peak, while German and Swiss institutions added substantially to their net foreign currency assets abroad. A large part of the foreign funds shifted to London during the early months of the year were converted into sterling, reflecting both the relative attractiveness of sterling-denominated short-term assets and the return of confidence in that currency. As indicated on the accompanying chart, British local authority deposits commanded a modest edge over Euro-dollars early in the year and again in April, even allowing for exchange cover. On an uncovered basis, of course, there had been a substantial interest margin in favor of sterling assets right along, but this incentive became of practical significance in terms of shifts of funds only with the return of confidence.

The trend in interest rate relationships shifted during the second quarter as conditions in the Euro-dollar market began to tighten, partly reflecting a similar movement in United States short-term rates. Banks in some countries began to withdraw funds from the Euro-dollar market while those in other countries accelerated the pace of their previous borrowing. At the same time, placement of German funds tapered off and United States banks on balance were no longer repaying previous borrowings. Rates in the Euro-dollar market began to rise in May, and with the outbreak of hostilities in the Middle East in June, precautionary withdrawals of funds combined with preparations for mid-year to cause a sharp jump in rates. The increased interest incentive to shift funds from sterling to the Euro-dollar market added a further element of pressure on sterling. Accordingly, as indicated in the section on sterling, the BIS immediately began to place sizable amounts of dollars in the Euro-dollar market, financing $143 million of such placements by drawing on the swap line with the Federal Reserve. These operations quickly calmed the market, and, with the cessation of fighting, the rapid rise in rates came to a halt.

Apart from a brief period of stringency at midyear and in early July, Euro-dollar rates have generally tended downward in recent weeks despite renewed borrowings by United States banks through their branches that have brought these liabilities back to a level approaching last December's peak. Some new funds have come into the market as a result of the United States payments deficit as well as from short-term outflows from Germany and Switzerland. In addition, there has been a shift of funds out of sterling, partly because the covered incentive between sterling and Euro-dollar investments has favored the latter for several months now.