BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

CONFIDENTIAL (FR)

October 17, 1963.

TO: Federal Open Market Committee

FROM: Mr. Young

In response to the suggestion made at the October 1 meeting of the Committee, there is attached a staff memorandum, prepared under my supervision and reviewed by the Special Manager, which discusses the rationale of the System's swap arrangements, including general purposes and methods and the size of particular swap lines. It is hoped that this memorandum will prove helpful to the Committee in its consideration of the shaping of the System's swap network over time.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Attachment.

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RATIONALE OF THE SYSTEM'S SWAP ARRANGEMENTS

The basic purposes of the Federal Reserve's foreign exchange operations can be restated here as follows 1/:

(a) To cooperate with central banks of major industrial countries in maintaining orderly exchange markets and confidence in existing par values, and thus to help in strengthening the international payments system;

(b) To neutralize the impact of sudden large accumulations of reserves by foreign monetary authorities on the U.S. gold stock, and thus to avoid speculative movements of volatile funds against the dollar at times when the markets are unsettled; and

(c) In the longer run, to prepare the way for an increase in international liquidity through mutual holdings of convertible currencies widely used in international transactions, if such an increase should be required by the expansion of world commerce.

These purposes give recognition to a major aim of postwar U.S. international financial policy as embodied in the Bretton Woods Agreements Act of 1946 -- namely, to create a sustainable payments system based on fixed exchange rates and an established price of gold. Such a system, it has been believed, would most effectively help integrate national economic systems, attain an optimum allocation of productive activities between them, and maximize opportunities for expanding international commerce. In pursuing this aim, U.S. policy has had to focus particularly on the monetary programs of the highly developed industrial nations for the purpose of providing a hard core of well disciplined

1/ This forumulation differs somewhat from that adopted by the Federal Open Market Committee in its action to authorize System foreign currency operations on February 13, 1962, but is generally consistent with the adopted statement.

national monetary systems as the functional center of a fixed exchange rate system. Within this framework, the Federal Reserve has established its network of swap agreements. As has been widely recognized, these arrangements have provided an important supplemental source of international liquidity, available both to the United States and to the other participating countries.

Gradual extension of the area embraced by the system to the less developed economies, though with greater latitude for exchange rate adjustment as domestic conditions might warrant, was generally envisioned as an objective realizable over time under the encouragement of the example set by the industrial countries and the solicitous interest and active influence of the International Monetary Fund.

Methods of operation. With the U.S. balance of payments in substantial over-all deficit at the time the Federal Reserve program of foreign currency operations was initiated, only three channels existed through which the U.S. authorities could obtain foreign currencies:

(1) By gold sales;

(2) By persuading foreign monetary authorities to acquire additional dollar claims; and

(3) By persuading foreign monetary authorities to acquire longer-term claims on the United States denominated in their own currencies.

Gold sales for this purpose were patently contrary to one of the objectives of System operations -- namely, the conservation of the U.S. gold stock. At the same time, foreign monetary authorities were increasingly unwilling to hold additional dollar claims on an uncovered basis. Hence, for foreign currency operations to attain their objectives in circumstances of U.S. payments deficit, it became necessary to introduce a technique by which the System could acquire foreign currencies by giving foreign monetary authorities additional dollar balances guaranteed against exchange risk. This was the basic reason for the network of "mutual currency" or "swap" arrangements negotiated with 10 foreign central banks and with the Bank for International Settlements. 2/

When the System draws foreign currencies for temporary use under a swap arrangement, the foreign central bank comes into additional dollar holdings that are covered against exchange risk in an amount corresponding to the System's drawing. As the System uses the currencies that it has drawn, however (either through market sales or through a direct sale against dollars with the foreign monetary authority), the uncovered dollar holdings of the foreign authority are reduced, or prevented from rising, by a corresponding amount. In this way, although the foreign central bank in question ends up holding the same amount of total liquid dollar assets that it would have held in the absence of a swap drawing (and in the absence of a gold purchase with its excess "uncovered" dollars), its uncovered dollar holdings can be held down to the amount that -- for reasons of tradition or policy -- it is content to hold. And in this way, gold sales by the U.S. Treasury are avoided or at least temporarily deferred.

A central feature of the System's swap drawings is the stipulation that they be used only to offset swings in payments flows of an apparently temporary nature. While short positions taken by the System under the arrangements may be renewed a number of times, the FOMC has specified that a short position should not be continued for more than a year. In certain instances, however, it may (and sometimes has) become clear that payments swings initially deemed to be temporary are in fact symptoms of more fundamental and long-lasting

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2/ The third technique for acquiring foreign currencies -- direct borrowings in those currencies -- has come to be utilized by the U.S. Treasury in the past two years.

pressures. In this event, the System has been and will continue to be in a position to liquidate its short position through one or more of the following methods:

(1) Allow foreign gold purchases to occur;

(2) Acquire the needed foreign currency by auxiliary swaps against other foreign currencies in which the System has a long position (e.g., as in the swaps of sterling and marks for Swiss francs made with the BIS);

(3) Acquire the needed foreign currency from the Treasury which in turn obtains it by the sale of medium-term bonds (or through receipt of advance debt payments); and

(4) Acquire the needed foreign currency from the Treasury, which in turn would obtain it by a U.S. drawing from the IMF.

All of these methods except IMF drawings have been used at one time or another to liquidate "stubborn" short positions of the System resulting from sales of foreign currencies drawn under the swap arrangements.

<u>Composition of the swap network</u>. Restriction of System swap arrangements to "major foreign convertible currencies" was implied (though not expressly stated) in the Guidelines for System Foreign Currency Operations, as approved on February 13, 1962, and amended on November 13.

The first paragraph of the Guidelines for instance, reads:

> Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of <u>major convertible currencies</u>. (Underscoring added.)

Similar references to "convertible" and to "major convertible currencies" were made by Chairman Martin in January and February of 1962 when he was testifying before Congressional committees on the System's intention to undertake foreign-currency operations.

In fact, the System has entered into swap arrangements with central banks in the following industrial countries: Austria, Belgium, Canada, France, Germany, Italy, Netherlands, Sweden, Switzerland, and the United Kingdom -- all of which have convertible currencies, and all of which, in some sense, can be considered to have "major" or at least important currencies. Along with the United States, and recently also Japan, all of these countries are also members of the Organization for Economic Cooperation and Development and all of them (except Switzerland and Austria) participate in the IMF General Arrangements to Borrow and thus belong to the "Group of Ten" that has come to have so many close economic consultations on a variety of common problems.

At present, Japan is the only member of the "Group of Ten" that does not have a swap arrangement with the System. This is attributable to the fact that Japan is also the only member of the group that has not accepted the obligations for current-account convertibility of its currency under Article VIII of the IMF agreement. In the near future, Japan is expected to make the yen formally convertible on current account. At that time, or in close anticipation of it, the System would presumably enter into a swap arrangement with the Bank of Japan. 3/ As the Special Manager has suggested, \$100-150 million would seem to be a reasonable amount for a standby arrangement with that Bank. Any smaller amount would be less than the present arrangement with the Netherlands, and less than 40 per cent of the present arrangements with Italy, both countries of lesser economic importance than Japan in world trade and finance.

3/ If the arrangement is concluded before the yen is made formally convertible, it might be with the stipulation that it would become effective as soon as Japan accepts the provisions of Article VIII.

If the network of swap arrangements with industrial countries is "rounded out" by including an agreement with the Bank of Japan, the question might be raised whether it could be usefully extended even further to include agreements with other countries having convertible currencies.

These countries include:[4/]
El Salvador
Guatemala
Haiti
Honduras
Ireland
Mexico
Panama
Peru
Saudi Arabia

Two of these countries, Ireland and Saudi Arabia, have currencies that are never used in international transactions and which are not traded in foreign exchange markets. Of the remaining countries, only Peru and Mexico would seem to be of sufficient economic importance to be considered as candidates for swap agreements. The turbulent economic and political history of Peru -- even during the postwar years -- would seem to disqualify that country, however, at least if the swap arrangements are not to be considered as an instrument for extending development assistance. Mexico has a much more solid record of financial stability and much sounder prospects for sustainable economic growth. Nevertheless, even in Mexico's case, it seems doubtful that a swap arrangement would serve any useful purpose. The arrangement would hardly serve to bolster confidence in the dollar, since Mexico's payments position is for the time being not strong enough for the market to believe that the peso could possibly be revalued against the dollar any time in the foreseeable future.

4/ Venezuela has a large gold reserve, but does not at the present time meet the Fund's requirements for convertibility; since 1960, Venezuela has had exchange controls and a greatly extended array of multiple exchange-rate practices -- measures that are inconsistent with Article VIII of the Fund Agreement.

Mexico also lacks as yet a developed money market. Accordingly, she is unlikely to receive sizable short-term reversible inflows from speculators or interest-arbitrageurs. Moreover, compared with the other countries with which the System has concluded swap agreements, Mexico remains highly vulnerable to intensified inflationary pressures, and to a significant deterioration in her commodity terms of trade. 5/

Size of particular swap lines

The general principle that ideally should govern the size of each swap arrangement is that it should neither be so large as to be obviously out of proportion to a possible swing in the country's dollar holdings, nor so small as to be unable to cope with swings that can reasonably be expected to occur in those holdings. Applying this general principle to specific arrangements is, however, a matter of judgment. On the whole, it seems desirable to have arrangements that are perhaps larger than absolutely necessary, rather than arrangements that may prove too small. For the larger the arrangements, the greater the official resources available for resisting speculative pressures on existing par values. Hence, the less likelihood that speculative pressures will become overpowering.

Significant increases in drawing rights have recently been negotiated with central banks in Germany and the Netherlands, two of the strongest

5/ Mexico's commodity terms of trade might also show an unexpected sharp improvement. In view of the close linkage between her export receipts and her imports, however, as well as the pressure of development needs, it is unlikely that she would choose to revalue her currency if her export prices strengthened materially. Thus, the chance of a speculative shift out of dollars and into pesos seems quite remote.

industrial country currencies. At the same time, it has also seemed appropriate to increase the credit line with Italy, whose currency is currently under some downward pressure, probably because of outflows of volatile funds motivated by domestic uncertainties. Earlier this year, smaller increases were negotiated with Germany, France, and Italy, and a very large increase -- from $50 million to $500 million -- was negotiated with the Bank of England. Although this arrangement is much larger than the others, the importance of sterling in world markets together with the importance of the City of London as a center of international lending and borrowing suggest that its size is no more than reasonable as a first line of defense for sterling and the dollar.

On the surface, it is something of an anomaly that the arrangement with the Bank of France remains at $100 million, while the arrangements with the two comparable continental countries -- Germany and Italy -- are at $250 million. This discrepancy is explained in part by the conservatism of French officials. But it also reflects the persistent nature of the French surplus which, until very recently, has precluded System drawings under the swap with the Bank of France (aside from an initial "test drawing"), according to the ground rules of only using drawings to offset temporary foreign official dollar accruals.

The recent easing of the French franc in the exchange market, together with reports that the underlying payments position of France has weakened, suggest that steady dollar accumulations by that country may perhaps be a thing of the past. If so, there might be much greater scope for drawings (and repayments) under the swap arrangement with the Bank of France in coming years. For this reason, if the Bank of France were willing, it might be desirable to increase our French swap line to the $250 million level that is provided in the agreements with Germany and Italy. Some further increase in our two credit-lines in Swiss francs might also be considered. Switzerland is a small country, but the Swiss franc is the currency that seems to be in greatest speculative demand whenever market conditions become unsettled.

Such further expansions in the swap-lines, together with the recent increases in the arrangements with other European countries, would be large enough to cope with quite substantial swings in reversible payments flows out of the dollar and into strong currencies. It must be remembered also that drawings under these arrangements can be powerfully supplemented by U.S. Treasury forward operations and, where appropriate and agreeable to the creditor countries, by foreign-currency bond issues.

The Netherlands occupies an intermediate position between countries subject to very large potential payments swings (Canada, France, Italy, and Germany) and those subject to smaller swings (Austria, Belgium and Sweden). Thus the present size of the System swap arrangement with the Netherlands Bank may be appropriate. But further experience with the pattern of payments flows into and out of the Netherlands may, at some future time, show the need for an increase in the swap line with the Netherlands Bank. In recent months, for example, it has been necessary at times to supplement the effectiveness of System guilder drawings by forward operations of the Treasury's Stabilization Fund.

Obviously, the size of any swap arrangement must be acceptable to both parties, and an amount considered adequate by the Federal Reserve may appear too large or too small to its partner. But as the satisfactory experience with the agreements hitherto concluded has led to growing support of the arrangements by foreign central banks, suggestions for increases in the amounts involved are more and more likely to encounter synpathetic reaction.

Swap arrangements so far concluded between the System and foreign central banks are listed in Appendix A.

APPENDIX A

SWAP ARRANGEMENTS BETWEEN THE SYSTEM AND FOREIGN CENTRAL BANKS

Listed below, as of October 17, are the swap arrangements that have been concluded on behalf of the Federal Reserve System with foreign banks. These arrangements are for three-month periods except in the case of Belgium and Italy, which are for six months, and the U.K., which is for twelve months.

Foreign Bank	Date of Original Agreement	Latest (authorized) renewal	Amount (Millions of dollars)
Bank of France	March 1, 1962	August 6, 1963	100*
Bank of England	May 31, 1962	May 29, 1963	500*
Netherlands Bank	June 13, 1962	September 13, 1963	100*
National Bank of Belgium	June 20, 1962	June 20, 1963	50
Bank of Canada	June 26, 1962	September 26, 1963	250
BIS	July 16, 1962	October 18, 1963	100
Swiss National Bank	July 16, 1962	October 18, 1963	100
German Federal Bank	August 2, 1962	August 6, 1963	250*
Bank of Italy	October 18, 1962	October 18, 1963	250*
Austrian National Bank	October 25, 1962	October 24, 1963	50
Bank of Sweden	January 17, 1963	October 17, 1963	50
TOTAL			1,800

* Originally for $50 million.

The arrangements are on a standby basis except for the following:

Arrangement with:	Amount held under the arrangements 1/ By System (Millions of dollars equivalent)	By foreign bank (Millions of dollars)
Bank of France	2/ 0	15.5
Netherlands Bank	0	100.0
National Bank of Belgium	50	45.0
Bank for International Settlements	3/ 0	80.0
German Federal Bank	0	28.0
TOTAL	50	268.5

1/ Excluding interest.

2/ The System has, however, made a covering purchase of $12.5 million of French francs in the forward exchange market.

3/ The System has a forward commitment with the BIS to deliver $13.0 million of Swiss francs in exchange for an equivalent amount of sterling.