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REC'D RECORDS SECTION
JUN 28 1961

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

June 27, 1961.

TO: Federal Open Market Committee

FROM: Mr. Young

For your information, there is enclosed a copy of a memorandum dated June 16, 1961, with respect to Federal Reserve holdings of foreign currencies, along with a copy of a memorandum also dated June 16 relating to international cooperation of central banks.

These memoranda were recently presented to the Board of Governors and, at the Board's direction, are being distributed to all members of the Federal Open Market Committee.

Ralph A. Young

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

Enclosures

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REC'D IN RECORDS SECTION
JUN 28 1961

June 16, 1961
(Corrected 6/26/61)

To: Board of Governors

From: Ralph A. Young

Subject: Federal Reserve holdings of foreign currencies

CONFIDENTIAL (FR)

International cooperation between central banks to deal with destabilizing international flows of funds has become not only a subject of active discussion in recent months but also a reality. In March 1961, a number of continental European central banks gave large-scale assistance to the Bank of England to withstand the outflow of funds from the United Kingdom following the German and Netherlands revaluations. The Stabilization Fund of the U. S. Treasury acquired German marks, British pounds, and also Swiss francs in March, April and May 1961, in an effort to help counteract undesirable effects of fund flows resulting from these revaluations.

Following the April 18-19, 1961 meeting of the Economic Policy Committee of the Organization for European Economic Cooperation, in which the U. S. participated as a full member of the proposed OECD, a report to the governing Council of that Organization (Confidential) stated that "the [Economic Policy] Committee had been encouraged to note the effectiveness in recent weeks of cooperation between central banks, both directly and in restoring confidence."

On May 8, 1961, a group of central bank technicians, activated at the initiative of the Chairman of the Board of Governors of the Federal Reserve System and reporting to the directors of the BIS at their meeting on that date, strongly endorsed a network of cooperative arrangements between central banks as a first line of defense of currency convertibility, with the IMF serving as a second line of defense.

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As an important, and in fact necessary, step toward Federal Reserve participation in the cooperative defense of a system of international payments based on convertible currencies, I suggest that the Board consider instructing the Federal Reserve Bank of New York, in the course of its regular operations, to acquire and hold accounts in foreign currencies with major foreign central banks, in conformity with the Federal Reserve Act, Section 14.

1. Purpose of System foreign exchange holdings

Federal Reserve accounts in foreign exchange would have the following main purposes:

(a) Serve as a symbol of central bank cooperation.

(b) Provide a means for both spot and forward transactions in foreign exchange, whenever such operations were judged to be helpful.

(c) Facilitate actions to offset or cushion the impact of unusual, temporary and reversible flows of payments on the monetary reserves of major countries.

(d) Further the confidence of foreign central banks in holding monetary reserves in dollars.

(e) Be a factor in, and a supplement to, international money market liquidity and thus a general reinforcement of the modern mechanism of international currency convertibility.

2. Statutory provisions

The Federal Reserve Banks have the following powers under Section 14 of the Federal Reserve Act:

According to para. 1, "Any Federal reserve bank may, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances and bills of exchange . . . ."

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> According to para. 6,(e) every Federal Reserve Bank has the power ". . . with the consent or upon the order and direction of the Board of Governors of the Federal Reserve System and under regulations to be prescribed by said board, to open and maintain accounts in foreign countries, appoint correspondents, and establish agencies in such countries wheresoever it may be deemed best for the purpose of purchasing, selling, and collecting bills of exchange . . . ."

In 1933 the Board expressed its view that accounts with foreign central banks "may be maintained only for the purpose of facilitating the purchase, sale, and collection of bills of exchange and the conduct of other open market transactions of the kind specified in Section 14 of the Federal Reserve Act" (memorandum, prepared by Mr. Fred Solomon, of September 14, 1954). The Board may, however, wish to reinterpret the Act in the near future by a superseding statement.

At present, the Federal Reserve Bank of New York maintains accounts with the Bank of England, the Bank of France, and the Bank of Canada, but these are for nominal amounts only.

3. Timeliness of action

The Federal Reserve has not held substantial amounts of foreign currencies since the 1930's. If the practice is to be resumed, the present situation appears a particularly appropriate one in which to reactivate it.

For the first time since the beginning of the Second World War, major foreign currencies have again become formally convertible. Re-establishment of convertibility has given legal expression to the renewed strength of those currencies in the world markets and to their increasing use in settlement of international transactions. It is highly important for economic progress of the free world that this convertibility, achieved only after much effort and the provision of much U. S. foreign aid, be maintained.

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During most of the postwar period, the dollar has been the only currency freely convertible into other currencies and for foreign official holders also into gold. The convertibility of the dollar came into question for the first time with the second half of 1960 when a confidence crisis seized the international exchange markets. Since then, confidence in the dollar has been largely restored. In this climate of restored confidence and particularly since the cooperative efforts of central banks played an important role in restoring it, resumption of inter-central bank holdings of foreign exchange could hardly be interpreted as a sign of weakness of the dollar.

4. Conditions for Federal Reserve holdings of foreign exchange

The proposed foreign exchange accounts would be confined to convertible foreign currencies. In practice, this would mean that the currencies accepted for account would be freely exchangeable for dollars at the time of acceptance. The concept of convertibility could not be interpreted as convertibility into gold, since at present only the United States freely converts currency holdings of foreign central banks into gold.

5. Financial risk of holding foreign currencies

The United States, as a matter of principle, does not give gold value guarantees to dollar holdings of foreign central banks. For this reason, the Federal Reserve is not in a position to request gold value guarantees from its foreign correspondents.

In the absence of reliance on gold value guarantees, the Federal Reserve might suffer devaluation losses. This risk might be minimized if an agreement could be reached under which the United States and the major foreign countries, in analogy to the Tripartite Agreement of 1936, would undertake to notify each other in advance of any devaluation.

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The Board may decide, however, that it is more important to participate actively and aggressively in the defense of the existing convertible payments system than to avoid limited risks of devaluation losses. In domestic open-market operations, the Board has always deemed it more important to influence the reserve position of the banking system in an appropriate direction than to avoid operating losses. Moreover, in contrast to many other central banks, the Federal Reserve System would hold only a small portion of its reserves in foreign-exchange balances.

6. Danger that cooperating countries will break faith

It is important to recognize that a practice of neutralizing unusual or volatile flows of funds between countries by changes in official currency holdings, through avoiding the disciplinary effects of gold movements, might encourage countries experiencing payments deficits or surpluses to postpone needed corrective action. Experience shows, however, that payments surpluses or deficits can mount up more quickly than financial measures to cope with them can be designed and applied. Time is needed to bring these corrective measures into play. The purpose of cooperative actions among central banks is to gain such time.

If countries benefiting from cooperation fail to adopt corrective programs, the mechanism of convertibility will break down. The same danger confronts every other alternative for mitigating the effects of unusual or volatile flows of international payments. The whole mechanism of convertibility under modern-day conditions has to be premised on the assumption that sound financial policies--monetary and fiscal--will be pursued by the major industrial countries that are partners in the convertibility mechanism.

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It seems a reasonable hypothesis for working purposes that, with proper safeguards, the advantages of cooperative central bank holdings of foreign currency accounts greatly outweigh the danger that participating countries will not adhere to the "rules of the game."

7. Rationale of central bank action to cope with abnormal currency trading

The purposes of the proposed reciprocal central bank holdings of foreign currency accounts could be achieved by other methods, including in particular reform and strengthening of the International Monetary Fund. The proposed reliance on central bank action is not meant to take the place of alternative methods, but rather to take advantage of the flexibility in action that central banks have as a supplement to alternatives. Central bank action would be particularly appropriate as a first line of defense against unusual and temporary flows of payments between major centers for the following reasons:

(a) Variation on central bank foreign exchange accounts can be sensitively adapted to international money market developments and to direct negotiation with the foreign central banks especially and adversely affected by them.

(b) Such actions would be more selective than IMF drawings and, further, can involve currencies of countries that are not members of the IMF, such as Switzerland.

(c) The actions taken would be part of a set of arrangements which would include continuous interchange of information and consultation provided by the soon-to-be inaugurated Organization for Economic Cooperation and Development and by the established facilities of the Bank for International Settlements.

(d) Publicity on the actions taken would be under Federal Reserve control.

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8. Standards for central bank holdings of foreign currency

It has been suggested that all major central banks cooperating in the maintenance of currency convertibility mutually agree to hold foreign currency accounts up to a specified limit. Since such an agreement would constitute the adoption of fixed lines of credit, I would question it.

It would seem to me, rather, that all parties should be completely free to vary the amount of their foreign exchange accounts at any time, under a general understanding as to the following points.

(a) The central banks of the major industrial countries would hold working balances in modest amounts in other convertible foreign currencies.

(b) Any country, at its own discretion, could decide whether to hold such currencies in larger amounts and more or less permanently.

(c) No country would request other countries to increase their holdings of its currency merely to offset a deficit in its basic balance of international payments.

(d) Each country, however, would be expected to deal sympathetically with requests of other countries to expand their holdings in the case of clearly temporary and reversible flows of international payments.

(e) Whenever it appeared that the flow of payments did not show signs of reversal within a reasonable period, it would be expected that the expanded holdings of foreign currency would be consolidated by the debtor country into long-term debt (for instance, through drawings on the IMF).

9. Currencies to be involved

The currencies initially involved should include all or some of the following: the pound sterling, the Belgian franc, the French franc, the German mark, the Italian lira, the Netherlands guilder, and the Swiss franc.

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If a "borrowing plan" to supplement the resources of the IMF, at present under consideration in the IMF Executive Board, is adopted, the list of currencies could be increased to include those of other countries that have agreed to participate in that plan.

In any case, the Japanese yen ought probably to be included as soon as Japan accepts the obligation of formal convertibility in the IMF.

The question of including the Canadian dollar (which is convertible into other currencies but has no fixed limits for fluctuation in exchange value) should be decided on the basis of direct negotiations with the Bank of Canada. The Canadian Government might be willing to assume an obligation to limit the variations in the applicable exchange rate for the Canadian dollar.

10. Relation to Stabilization Fund holdings

At present, the Federal Reserve Bank of New York holds German marks, pounds sterling, and Swiss francs for account of the Stabilization Fund. The assets of the Stabilization Fund cannot, without Congressional action, be increased beyond the present amount of about $360 million. Part of this amount is immobilized under present exchange agreements with Latin American countries. The rest is not sufficient to cope with the swings in holdings of foreign exchange that might reasonably be expected to occur in periods of disturbed exchange market conditions. In fact, the dollar working balances of the United Kingdom alone are usually around $300 million.

For this reason, the proposed program would not conflict with the recent operations of the Stabilization Fund but would be a desirable

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supplement to them. It is our understanding that the Treasury recognizes this and would welcome assumption by the Federal Reserve of a role in cushioning unusual payments flows between major centers.

While the Board at some future time will have to determine a maximum limit of foreign currencies to be held for Federal Reserve account, so as to avoid criticism of risks assumed, the amounts in initial stages would be of moderate size, determined entirely by the availability of foreign currencies and the state of the U. S. balance of international payments. It would be the availability of System funds for a defense of currency convertibility between major countries in potentially sizable amounts that would be of primary importance in deterring exchange market disturbances, especially of a speculative character.

11. Clearance with Congress and Treasury

Although the statutory power of the Federal Reserve Banks to acquire foreign exchange cannot be doubted, especially if this foreign exchange is used for the purchase of foreign bills, it would seem advisable to clear the proposed participation of the System in foreign exchange markets with the chairmen and ranking members of the interested Congressional committees. For one thing, the System has abstained from foreign exchange operations since the early 'thirties. For another, Senator Glass on May 10, 1932 (75th Congressional Record, page 9834) delivered himself of a vigorous criticism of them. The situation today, it should be pointed out, is very different from that prevailing at the time of Senator Glass's criticism, since at present the aim would not be to bolster foreign currencies but to establish closer cooperation with foreign central banks for the

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benefit of convertibility of the U. S. dollar as well as of the other major world currencies.

Any foreign exchange operations on System account should be coordinated, of course, with those for account of the Stabilization Fund. Accordingly, there should be continuous and close consultation with the Treasury regarding their conduct.

The Treasury has not consulted with the National Advisory Council on the recent foreign exchange transactions of its Stabilization Fund. The Federal Reserve does not, therefore, seem to be under obligation to consult with the NAC on similar operations.

12. Supervision and conduct of operations

Under the Federal Reserve Act, the Board has full power to direct and regulate Federal Reserve Bank acquisitions and holdings of foreign currencies (Section 14, paras. 6 and 8). The Act also specifies that the FOMC has the power to decide the use of these accounts for the purchase of bills of exchange (Section 12A, para. 2).

The conduct of a program of System foreign exchange operations would need to be responsive to foreign exchange market developments and be effectuated in strictest confidence. Accordingly, the Board of Governors and the FOMC might wish to delegate their powers and responsibilities relating to day-to-day operations to a subcommittee, consisting of the Chairman and Vice Chairman of the FOMC and the Vice Chairman of the Board, with the Director of the Board's Division of International Finance acting as secretary. The New York Federal Reserve Bank would be designated as the System's agent for the administration of its operations in foreign exchange. It would be

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appropriate, though not essential, for the New York Federal Reserve Bank to invite the other Reserve Banks to participate in these transactions.

The New York Reserve Bank would be asked to designate an officer to be in immediate charge of these operations. Presumably he would be the Vice President in charge of the Foreign Department. He would be expected to conduct his day-to-day operations under a standing directive of the FOMC, subject to immediate reporting to and direction of the above subcommittee. He might be made a special manager, System Open Market Account, for foreign operations. In initial stages of the program, reporting to the FOMC on System foreign transactions would be by the chairman or vice chairman of the subcommittee.

13. Methods of acquisition of foreign exchange

The Federal Reserve Bank would acquire foreign exchange by one or more of the following methods:

(a) Purchase from member banks and other domestic foreign exchange dealers.

(b) Purchase from the Treasury's General Fund or from the Stabilization Fund.

(c) Purchase against dollars from foreign central or commercial banks.

(d) Purchase through sale of gold acquired from the Stabilization Fund to foreign monetary authorities.

14. Purchase of foreign bills

Purchase of bills accepted by commercial banks of unquestioned standing, and, if possible, endorsed by the central bank of the country in question, should not present any problem in the case of most continental European countries, where bank advances frequently take the form of acceptance credits.

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In the case of the pound sterling, the amount of such bills in the hands of banks is limited. Nevertheless, the very fact that the Federal Reserve would be willing to purchase such bills should greatly increase their availability. The responsiveness of the acceptance market to a change in financial conditions is clearly shown in the case of bankers' acceptances in the United States, the supply of which rose in the 18 months between October 1959 and April 1961 from $945 million to $2,254 million.

15. Publicity of transactions

From inception, the System has used a weekly condition statement to disclose the results of its operations to financial markets and the public generally. The financial effects of its transactions in foreign exchange would necessarily become public knowledge through this medium. To avoid undue public comment and discussion of this activity, in view of the sensitivity of foreign exchange markets to it, the Board may find it advisable to continue for the time being the present practice of reporting balances due from foreign banks under "other assets" rather than reporting them separately. At the same time, the principle of financial statement disclosure of all operations is one to which a central banking system must adhere if it is to sustain the full confidence of the public.

Accordingly, it might be desirable, when these balances begin to approach or exceed $100 million, that they be shown separately in the monthly statement published in the Federal Reserve Bulletin with a lag of one month, e.g., the foreign exchange holdings for say March would be published in the April Bulletin.

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Regular publication of a country breakdown of foreign currency holdings would be a desirable practice. Such a breakdown could be published quarterly with a lag of nearly four months, e.g., first quarter figures would be published in the June Bulletin.

The lags in publication timing proposed above would be the same as those applying to the disclosure of gold transactions of the Stabilization Fund.

16. Financial effects of System foreign exchange transactions

The transactions would affect (a) the condition statement of the Federal Reserve Banks, including both assets and liabilities, (b) the monetary reserve position of the United States and foreign countries, and (c) the international flow of payments. Each of these points is discussed below:

(a) Effect on the System condition statement.--If the Federal Reserve acquires the foreign exchange from domestic private holders, the transaction would result in an increase in member bank reserves.

If the Federal Reserve acquires the foreign exchange from a foreign commercial bank, the result would be the same, provided that the bank leaves the proceeds with a domestic commercial bank. If the Federal Reserve acquires the foreign exchange from a foreign central bank, or from a foreign commercial bank that sells the proceeds to its central bank, member bank reserves would be affected only when that central bank disposes of the proceeds.

If the Federal Reserve acquires foreign exchange from the Treasury, which in turn acquires it by selling gold to foreign monetary authorities or foregoing an increase in its gold holdings, the net effect would be an exchange of foreign currencies for gold certificates.

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(b) Effect on international reserves.--Since, conventionally, only gold is counted as a U. S. international reserve, any exchange of gold for foreign currencies would seem to diminish U. S. international reserves.

Insofar as the acquisition of foreign currencies from foreign central banks increases the dollar holdings of these banks, the transactions would increase the gross international reserves of the foreign country involved.

If it is assumed that world liquidity depends on the volume of gross rather than net reserves, acquisition of foreign currencies by the Federal Reserve from foreign central banks, by expanding both Federal Reserve holdings of foreign currencies and foreign holdings of dollars, would increase world liquidity.

The net reserve positions of both countries would remain unchanged, however, since the increase in holdings of foreign exchange is in both cases offset by an identical increase in foreign liabilities.

If the main monetary function of gold under present-day conditions is as a means of international settlement, and if convertible currencies are "as good as gold" for this function, it would seem desirable to change the System's established method of computing the reserve position, as soon as holdings of foreign exchange are shown separately. From then on, the ratio of the sum of gold certificate and foreign exchange holdings to liabilities would be shown in addition to the conventional gold-certificate ratio. To include holdings of foreign currencies in U. S. monetary reserves would make U. S. practice conform to the provisions of the IMF Agreement (Article XIX, para. a).

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(c) Effect on international payments.--The proposed transactions could be used to prevent an inflow of foreign funds (or a reflux of domestic funds from abroad) from becoming a drain on the gross reserves of the foreign countries involved. The Federal Reserve would acquire the foreign exchange sold by holders wishing to transfer their funds from abroad to the United States, and the foreign country would suffer merely an increase in liabilities to the Federal Reserve rather than a decline in its gold or foreign exchange holdings. If foreign central banks act in a similar way in the case of an outflow of private funds from the United States, the United States would be spared a decline in its gross gold and foreign exchange reserves and would merely experience an increase in its liabilities to foreign official holders.

While there might not be much difference between an increase in foreign liabilities or a decline in a country's reserves from the point of view of strict logic, the psychological effect might well be less disturbing in the first case. If this were true, as many believe it would be, the proposed transactions would cushion financial markets against the psychological impact of a deterioration in a country's international financial position from temporary or speculative causes.

This very effect may be considered dangerous because of its soporific influence on public opinion. For this reason, it would be important to emphasize continuously that these actions would be only interim measures pending the application of policies that would cure the substance rather than gloss over or obscure the symptoms of an underlying international disequilibrium.

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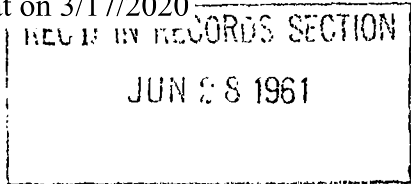

June 16, 1961.

To: Board of Governors

From: Ralph A. Young

You may find the attached paper, "International Cooperation of Central Banks," by J. Herbert Furth, to be a helpful supplement to my memorandum of June 16 on Federal Reserve holdings of foreign currencies.

Attachment.

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June 16, 1961.

International Cooperation of Central Banks

By J. Herbert Furth

The methods by which central banks may attain closer cooperation in a world of convertible currencies may involve (A) a broad coordination of monetary policies in general, and (B) specific actions to meet specific problems of common interest.

A. General coordination of monetary policies

Short of establishing an international central banking system, in which the national central banks would be assigned the role played by the individual Federal Reserve Banks within the Federal Reserve System, the only way to achieve reasonable coordination of general monetary policies among the major countries of the free world is a process of continuing consultation.

This consultation needs to include not only the exchange of pertinent economic data but also the exchange of ideas, such as critical analyses of the instruments of monetary policies, past experiences with various policies, projections of future developments, new developments in monetary theory, and suggestions for new practices and procedures.

These exchanges may be expected to give each central bank a better understanding of the influences that shape the policies of other central banks as well as its own, of the alternatives that have to be chosen in given circumstances, and of the constraints to which its own policies are subject by virtue of the monetary policies and problems of other countries.

Coordination does not mean that central banks are to be expected to follow the same policies. Divergent actions may be necessary, for instance, in order to eliminate an existing disequilibrium, domestically, in international payments, or as to both. If a given country lags behind

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in secular growth, its central bank might, without criticism by others, adopt more expansive policies than the rest; or if the cyclical situation differs from one country to another, the central banks might simulatneously pursue quite different counter-cyclical policies.

On the other hand, coordination of monetary policies does mean that, if a central bank follows policies deemed inappropriate or undesirable by the others, it would expose itself to criticism of varying strength from other central banks. Sooner or later, this criticism would presumably have to be taken into account, particularly if its policies were not achieving the objective expressed in their defense.

The mere exchange of information, experience, and ideas may appear to be a relatively weak form of cooperation, but it is a form entirely appropriate for a community of independent sovereign nations. Moreover, its lack of glamour avoids the danger of exaggerated expectations and subsequent disappointment. In the domestic sphere, the prestige of monetary policy has often been hurt by irresponsible claims (most often made by persons not connected with central banking) concerning the role and influence of monetary management. In order to save the prestige of international cooperation of central banks from a similar fate, it would be prudent to stress from the very beginning the limitations of its scope.

The monthly meetings of the central bankers serving as directors of the Bank for International Settlements in Basle and, on a more comprehensive basis, the Working Groups consisting of top Government officials that have been meeting in Paris preparatory to the establishment of the Organization for Economic Cooperation and Development, could furnish the institutional framework for continual consultation.

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B. Specific policy actions

Whatever the effectiveness of consultation, the achievement of the common goal of international payments stability would presumably be hampered from time to time by the risk that large temporary flows of volatile payments might occur. At such times, reciprocal action might help to prevent such flows from reaching critical dimensions, or help to cushion, if not fully offset, the effects of those flows that nevertheless occurred.

To illustrate, if a country pursued a policy of active credit ease with accompanying relatively low interest rates in order to catch up with growth in the rest of the world, short-term as well as long-term capital might flow from that country to others with higher interest rates, thus depriving it of some supply of the very funds it desired to have available for accelerated growth. Unless this outflow is checked, the policy of credit ease may thus fail to achieve its objective.

Central banks would then need to supplement any general coordination of policies by mechanisms directed at avoiding or neutralizing unwanted capital movements. The policy tools used in this mechanism would not necessarily be different from those applicable in an uncoordinated world economy. Their utilization, however, would take into account the relative positions of the countries in the world economy rather than predominantly their domestic situation, viewed in isolation.

Payments flows susceptible to policy actions

The effectiveness of any central bank policies adopted to stem flows of volatile payments will depend largely on the character of such flows, and especially on the question whether the flows are mainly due to lack of confidence in the maintenance of established exchange rate (and convertibility) patterns, or to other reasons.

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In the case of a country whose currency is expected to depreciate (or to become inconvertible) or to appreciate, no conceivable action by way of central bank cooperation can be as successful as the application of appropriate domestic economic measures. This is so because under existing international arrangements every country is primarily responsible for the maintenance of the par value (and convertibility) of its own currency. Moreover, if market opinion is convinced that existing exchange rate patterns are untenable (or that a country might abandon convertibility rather than permit its currency to be devalued), the resulting payments flows are about certain to reach amounts that would overwhelm whatever defensive mechanism is adopted.

For instance, no reasonable interest rate differentials or forward exchange premia or discounts could offset prospective losses or gains from sizable changes in exchange rate (or the losses from the blocking of foreign balances). Mutual central bank holdings of each other's currencies would be equally ineffective since the flows would be likely to exceed any reasonable limit of such holdings.

It might be possible to stem such flows by means of exchange-rate guarantees (in terms of gold or of the currency whose appreciation is expected) given by the central banks to holders of potentially volatile funds. Under convertibility conditions, however, these funds would include domestic as well as foreign holdings, and the amounts to be covered by an effective guarantee would therefore threaten to reach astronomical figures. Moreover, the exchange-rate guarantee has been expressly repudiated as a tool of U.S. policy (Public Resolution of June 5, 1933).

Unusually large flows of payments not involving expectations of changes in exchange rates (or of inconvertibility) may, however, be counteracted by central bank actions that attempt either to eliminate or

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reduce these flows, or to neutralize their effects. Actions of the first kind would include monetary measures directed at equalizing interest rates, or foreign-exchange operations directed at influencing forward rates. Actions of the second type would include arrangements for currency "swaps" or for mutual currency holdings.

Limitations of policy actions

Even in the case of movements of funds that in themselves would be susceptible to the influence of central bank actions, the effectiveness of those actions might be limited by the following considerations:

(a) International developments can never be the sole factors determining central bank policies. Domestic developments always must receive attention, no matter how great the desire for international cooperation, and these developments may make it impossible to choose those actions that would be most likely to solve international problems. The objective of discouraging international flows of volatile payments may, in a specific situation, be considered less important than stimulating the domestic economy or resisting inflationary pressures. If the international situation favors an expansive monetary policy but the domestic situation requires restrictive policy (or vice versa), international cooperation may at most induce central banks to choose those actions that are least likely to aggravate the international problem while correcting the domestic disequilibrium (or vice versa). Such cooperation, however, cannot eliminate the underlying dilemma. Moreover, some specific methods of solving a particular international problem (e.g., Government regulation of capital movements) may be unacceptable because they would be inconsistent with the country's politico-economic philosophy.

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(b) In a market economy, the impact of central bank action may be offset by market forces. If loan demands are not pressing significantly against the supply of loanable funds, for instance, no reasonable restriction of supply can make interest rates rise.

(c) Attempts at influencing a specific economic variable may have side-effects that would tend to nullify the effectiveness of the action. To illustrate, a policy directed to increasing the interest-rate level, adopted to stimulate the inflow of funds, may lead to movements in the spot or forward exchange market that would hamper the inflow.

(d) The market may interpret central bank actions as signals, with the result that effects may be the opposite of those intended. Just as, in the case of counter-cyclical action, an increase in the discount rate may be taken as foreshadowing a rise in economic activity and thus may activate rather than dampen demands for loanable funds, intervention in the money or exchange market intended to keep volatile funds at home may be taken as indicating a coming foreign-exchange crisis, and may thus accentuate tendencies toward an outflow of funds.

Equalization of interest rates

If capital flows are stimulated by large differences in interest-rate levels, central banks may try either to alter the differentials by changing the domestic rate level, or to isolate the rates in the international sector of the money market.

(a) Attempts at changing the domestic rate level are subject to such limitations as may be imposed by domestic considerations. A rise in rates over and above the level appropriate for domestic reasons is likely to act as checkrein on a cyclical upswing and on secular growth. On the other hand, a fall in rates below the level appropriate for domestic reasons runs the risk of stimulating inflationary pressures. Central banks

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may endeavor to make long-term rates, which are believed to be especially important for the domestic economy, move in a direction opposite to the movement of short-term rates, which are believed to be particularly important for international movements of volatile funds. Such attempts, however, may set in motion investor reactions that may undo the greater part of the central bank efforts to influence the rate pattern.

Moreover, the response to central bank action may be partly as intended and partly run opposite to projections. Action to curb a speculative boom in equity values, for instance, may stop the inflow of funds into the equity market but, by creating expectations of falling long-term interest rates, may induce an inflow of funds into the bond market.

(b) Rates in the international sector of the money market may be isolated from those in the domestic sector either by granting preferential rates to all foreigners, or at least to foreign central banks, or by permitting foreign official institutions to invest in special securities at fixed interest rates, which would remain unchanged regardless of fluctuations in market rates. 1/

Establishment of fixed rates for foreign official holdings would, in contrast to the granting of varying preferential rates, have the advantage of avoiding rather than stimulating international competition for funds. Moreover, since the fixed rates would sometimes be higher and sometimes lower than local market rates, the action would not exert a constant upward pull on local rates. Foreign official institutions may be interested in fixed rates because they usually aim at permanency rather

1/ This section is based upon a proposal made several years ago by Mr. Klopstock, Manager, Research Department, Federal Reserve Bank of New York.

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than at short-run maximization of yields, and nevertheless are reluctant to freeze their funds in long-term securities. The funds might be prevented from flowing into the local market whenever market rates are higher than the fixed rates by an agreement among the participating institutions.

Forward exchange transactions

International flows of short-term capital usually respond more to "covered" interest-rate differentials (i.e., to differentials net of the cost of forward-exchange cover) than to "uncovered" differentials.

Unwanted flows may, therefore, be avoided by forward transactions which influence forward rate premia or discounts and thus the "covered" interest-rate differentials. While forward transactions may thus have the same economic effect on international flows as attempts at influencing interest rates, they do not necessarily have the domestic consequences that an interest rate movement might have.

Forward transactions provide an implicit guarantee of the existing exchange-rate pattern for the period involved in the transaction. In this way, they may exert not only a direct financial but also a psychological influence, by helping to persuade the market that the monetary authorities involved do not intend to alter the existing exchange-rates. Since the transactions can be in terms of a currency the appreciation of which is expected, they might reduce capital flows not only out of a weak currency but also into a strong one.

On the other hand, forward transactions share with actions to influence interest rates the danger of unwanted side effects. Forward transactions that reduce, for instance, the discount on the dollar in relation to the German mark, increase the covered interest-rate yield of a dollar credit granted by a German exporter to a U.S. importer.

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Therefore, it acts, even though to a small degree only, as a kind of export subsidy to the German exporter. If it happens that a country experiencing a capital inflow also has a large trade surplus, as is the case of Germany today, forward transactions, while helping to reduce the capital inflow, may in turn help a small bit to increase the trade surplus.

Central bank influence on forward rates, like its influence on interest-rate differentials, could be used not only to stem existing flows of funds but also to create new flows. Such flows might be deemed desirable to offset a deficit in a country's basic balance of payments. In this way, a deficit might be covered up and the countries involved might be tempted to postpone corrective action. Such use of central banking tools would obviously serve to increase rather than decrease the danger of persistent international disequilibrium.

Currency "swaps"

In a market economy, central bank action usually is neither able nor designed to avoid all swings in the flow of payments. In spite of methods used to influence interest rates and forward-exchange rates, as well as in circumstances in which central banks are unwilling or unable to apply such methods, cases may arise in which volatile payment flows reach dimensions that may be deemed dangerous to the maintenance of international equilibrium.

Central banks may try to prevent these flows from exerting undue influence on the international reserve position of their respective countries. If a country's position is generally assessed in terms of its gold reserve, the central banks may, in particular, wish to avoid

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undesired changes in gold reserves. Such changes are brought about whenever funds withdrawn from one country to another are sold to the central bank of the country that has received the funds, and that bank presents them to the central bank of the country of origin for redemption in gold. Even if there is no request for redemption in gold, the same effect may be achieved if the central bank of the creditor country presents the funds to the central bank of the debtor country for conversion into dollars or into the creditor's national currency (Fund Agreement, Art. VIII., Sec. 4), provided that the debtor country does not hold sufficient balances in those currencies and has to acquire them by selling gold, say, to the International Monetary Fund (Fund Agreement, Art. V, Sec. 6).

The central bank of the creditor country may, however, avoid gold movements for the time being by agreeing to hold the foreign currency against a promise of _future_ delivery of its own currency (or of gold or dollars). These transactions are distinguished from ordinary forward transactions because forward transactions concern _future_ currency holdings on _both_ sides (e.g., a German exporter sells his future receipts of dollars against future delivery of marks) while in the case of "swaps" _present_ holdings are exchanged for _future_ delivery of the same or another currency. This type of transaction has apparently been undertaken by the continental European banks in cooperation with the Bank of England to neutralize the effects of the capital outflow from the United Kingdom into continental Europe, which followed the German and Netherlands revaluations. The German Bundesbank, for instance, apparently returned to the Bank of England the dollar holdings, which German holders of sterling had acquired by selling

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sterling against dollars and which they had subsequently resold to the Bundesbank, against the promise of future redelivery of dollars or gold, presumably at the exchange rate underlying the original transactions. As the result of this transaction, the private investors who originally held sterling came to hold German marks; the Bundesbank came to hold the sterling originally held by the private investors; and the Bank of England managed to retain its dollar holdings.

Obviously, this maintenance of the status-quo of the Bank of England can last only as long as the swaps are renewed. If this renewal does not take place, and if there has been no counterflow from Germany to the United Kingdom in the meantime, the Bank of England must eventually deliver dollars or gold to the Bundesbank, and the situation becomes the same as if the swaps had never taken place. This example shows that swaps can neutralize capital flows only if these flows are temporary and reverse themselves within a relatively short period. If this assumption proves incorrect, the swaps can serve only as interim holding operations, enabling the countries involved to seek a more permanent solution, either by correcting the basic causes of the flow, or at least by arranging longer-term take-out credits, such as Fund drawings.

Like forward transactions, the swaps provide an implicit exchange-rate guarantee for the currencies involved. Since central banks usually undertake only transactions involving their local currencies and dollars, this guarantee would generally be in terms of dollars. There is no reason, however, why central banks should not also operate in other currencies, so that the guarantee could be in terms of a currency the appreciation of which is expected.

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Mutual holdings of foreign exchange

Unusual payments flows can be most decisively prevented from affecting the international reserve position of the countries involved when the central banks concerned agree to hold the foreign currencies sold to them by private holders.

If these agreements fix maximum amounts and maximum time periods, they have the same effect on the debtor country as "standby arrangements" with the Fund (Decision of the Fund's Executive Board, October 1, 1952). If no fixed limits are set, the central banks may vary the balances according to the requirements of the international situation. To illustrate, the banks may reach a general understanding that they would not increase their balances in case of an inflow due to a persistent deficit in the basic balance of payments of the debtor country, but would do so in case of an inflow due to payments flows of an apparent temporary and reversible nature. In this way, the banks could avoid the danger of having their cooperation used for the purpose of hiding the effects of a fundamental international disequilibrium and delaying corrective actions.

Whereas forward and swap transactions usually are limited to relatively short periods (three or six months), mutual holdings of foreign exchange may be continued indefinitely without the need for explicit renewals. On the other hand, in the absence of specific agreements on "maintenance of value," they lack the guarantee against devaluation losses implicit in forward and swap transactions. For these reasons, mutual holdings may be more attractive to debtor countries, and more risky for creditor countries, than forward or swap transactions.