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OFFICE CORRESPONDENCE

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TO Federal Open Market Committee

FROM Charles A. Coombs

SUBJECT: Possible Increases in Swap Arrangements with Austria, Denmark, and Norway.

On Wednesday, October 1, at the IMF-World Bank Meetings in Washington, Dr. Hans Kloss, Director General of the Austrian National Bank raised with Mr. Bodner the possibility of an increase by $100 million, to a total of $200 million, in the swap arrangement between the National Bank and the Federal Reserve. Dr. Kloss explained that, despite a strong current account in the Austrian balance of payments, outflows of funds from Austria in response to high Euro-dollar rates and speculation over the German mark had led to a 3 billion schilling($116 million equivalent) reserve loss so far this year. Austrian reserves remain ample and should benefit from recent policy measures by the Austrian authorities, but international uncertainties remain such that the National Bank would like to have some additional room to maneuver. (Dr. Kloss also said that the National Bank would encash the remaining $25 million equivalent schilling-denominated U. S. Treasury security it holds.)

Mr. Bodner reported his conversation with Dr. Kloss to me and I suggested that he pass it on to Chairman Martin, Mr. Hayes and Governor Daane, who were attending the Fund and Bank Meeting. At the same time, it seemed to me that an increase in the Austrian arrangement alone would create an asymmetry with the swap lines with the Danish and Norwegian central banks and that we might soon face similar requests for $100 million increases in those two lines. Although their economic situations differ considerably in detail, the three countries have roughly equivalent status in international finance, as reflected for example in the close correspondence of their IMF quotas (Austria, $175 million; Denmark, $163 million; and Norway, $150 million). Moreover, all three countries have been facing similar balance-of-payments situations this year; despite strength on current account, Denmark and Norway have also suffered outflows of funds in response to higher interest rates abroad, especially in the Euro-dollar market, and the recurrent speculation over the German mark parity. Rather than have the swap arrangements realigned later on a piecemeal basis, it seemed reasonable to ask the Danes and Norwegians now if they would want to increase their swap arrangements jointly with the Austrians. Chairman Martin, Mr. Hayes and Governor Daane generally agreed with this approach and accordingly on Thursday, Chairman Martin met with Governor Hoffmeyer of the Danish National Bank and Mr. Hayes spoke with Governor Brofoss of Norway. Governor Hoffmeyer said he would very much welcome an increase in the Danish swap network for $200 million at this time. Governor Brofoss indicated that he would favor a similar increase in the Norwegian swap line, although he did not regard it as an urgent matter; he felt however that it would be important psychologically to have an increase in the Norwegian line if the arrangement with Denmark was increased.

Looking at the underlying balance-of-payments and reserve positions of the three countries, Austria has managed its international position rather well in the 1960s. When the System's swap arrangement was first established with the Austrian National Bank, in October 1962, Austria was in balance-of-payments surplus; and the $50 million drawing by the Federal Reserve at the time, in expectation of some reversal of the flow of funds to Austria, was liquidated at maturity when a reversal no longer seemed in prospect. At that point the Austrians purchased gold, but later that year they took on some $50 million equivalent of medium-term schilling-denominated U.S. Treasury securities. Between the end of 1961 and end-1964, Austrian reserves rose by nearly $500 million, to $1.3 billion, and fluctuated around that level through the end of 1966. In 1966-67, the Austrian economy moved into recession, and the slack in import demand was a major factor in a renewed payments surplus, which raised reserves to above the $1.5 billion level. Thereafter, expansionary fiscal and monetary policies by the Austrian government and an upsurge in exports spurred the recovery of industrial output, which has continued to rise into 1969. The strength in exports has led to a significant improvement on current account this year, but outflows of funds in connection with high Euro-dollar rates and speculation over the mark have led to the reserve losses which are of concern to the Austrian authorities. The burst of mark speculation last May was particularly costly, and the National Bank bolstered its reserves by drawing $50 million under the swap arrangement with the Federal Reserve--the first use of the facility by Austria. Austrian reserves subsequently recovered during the summer tourist season and the drawing was repaid at maturity on July 21. At the suggestion of the U. S. Treasury, on July 1, the National Bank encashed, prior to maturity, a $25 million equivalent schilling-denominated obligation of the Treasury, leaving outstanding the $25 million security the Austrians now wish to liquidate.

Despite this year's losses, the Austrian reserve position is fundamentally strong. At the end of August, reserves were at $1,458 million, of which $583 million (a relatively large proportion compared with other continental European countries) was in foreign exchange, mainly dollars. Austria has a large creditor position with the IMF, against a $175 million quota. On the basis of current quotas, Austria should be allocated some $78 million of the $9.5 billion of special drawing rights to be created over the next three years.

Denmark and Norway joined the swap network in April 1967 (jointly with Mexico). Although Denmark devalued the krone by 7.9 per cent at the time of the sterling devaluation in November 1967, the swap arrangement was inactive until June 1968. At that time the Danes drew $25 million, largely to meet a temporary reserve gap in connection with French and

British drawings on the IMF, and the swap was paid off at maturity in September. Denmark drew again last January, for $25 million, when reserves were under some pressure as a result of outflows of short-term funds, and repaid the drawing in March. Even larger outflows in April and May, mainly in connection with speculation over the mark, prompted the National Bank to draw the full $100 million available under the swap arrangement; at the same time, the U.S. Treasury extended a $50 million additional swap facility to Denmark, which as it turned out was not drawn upon. As the speculation receded the National Bank obtained sufficient dollars to liquidate the swap drawings on the Federal Reserve in June. The U.S. Treasury arrangement remains on a standby basis, but it is anticipated that it may be terminated if the Committee approves the suggested increase in the Federal Reserve swap line.

Denmark has also tightened monetary policy, partly to restrain domestic inflation and partly to keep internal interest rates more competitive with those abroad; in two steps earlier this year the central bank discount rate was raised by three percentage points to 9 per cent. Danish reserves have declined rather sharply this year, from nearly $450 million at the end of 1968 to some $286 million at the end of August, but the swing in reserves has largely reflected external influences--the high Euro-dollar rates and the mark speculation--rather than a fundamental weakness in Denmark's competitive position. Devaluation has clearly helped the Danish current account, and although imports are now rising more rapidly than last year export growth is expected to continue to outpace the rise in imports. Denmark has a $163 million quota with the IMF and has drawn its gold tranche, leaving a repurchase obligation of some $40 million. Out of the $9.5 million equivalent of SDRs to be created over the next three years, Denmark should receive some $72 million.

The swap arrangement with Norway has never been drawn upon by either party. The Norwegian authorities are also concerned over incipient inflationary pressures at home and the effects of both high interest rates abroad and speculation over the mark. Monetary policy has been tightened, with increases in commercial bank reserve requirements in June and July and a one percentage point hike, to 4 1/2 per cent, in the Bank of Norway's discount rate in September --the first change in that rate since 1955. In relative terms, however, the Norwegian krone has not suffered as much pressure as many other European (and Scandinavian) currencies, partly because Norway has benefited from an improved balance on shipping transactions. Although Norwegian reserves, at $651 million at the end of August, are off somewhat from the end of last year, they remain at an historically high level. Norway has a $150 million quota with the Fund, and at the end of August had a gold and super-gold tranche credit position of $82 million. Over the first three years of activation of the SDR plan, Norway should receive roughly $67 million of the $9.5 billion equivalent to be allocated.

In sum, the three countries considered here are basically in a sound financial and reserve position. The risks they face stem mainly from pressures emanating from the Euro-dollar market (which to a large degree would reflect monetary conditions in the United States) and from international currency uncertainties related to speculation on the mark parity (a problem which hopefully may soon be solved). Over the longer term, we should expect these countries to follow reasonable economic policies toward rapid adjustment of international imbalances. Moreover, I am sure that the central bank in each of these countries will continue to make responsible use of the Federal Reserve swap facility, as it has in the past. Consequently, I recommend that the Committee approve increases of $100 million each in the swap arrangements with the central banks of Austria, Denmark, and Norway.