Mr. Altmann

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D C 20551

April 23, 1973

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Broida

Enclosed for your information is a copy of a staff memorandum, dated April 20, 1973, and entitled "Report on banks' operations during exchange market crisis preceding February 12 devaluation." This report was prepared in response to the Committee's request at its meeting on February 13, 1973.

Arthur L. Broida
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Deputy Secretary
Federal Open Market Committee

Enclosure

CONFIDENTIAL (FR) April 20, 1973

TO: Federal Open Market Committee

FROM: Staff

SUBJECT: Report on banks' operations during exchange market crisis preceding February 12 devaluation.

This memorandum reports the results of a survey of 13 large U.S. banks[1/] regarding their operations for their own account and for account of customers during the exchange market crisis preceding the devaluation of the U.S. dollar on February 12, and reviews the regular weekly data on U.S. banks' loans to foreigners and on certain banking liabilities during this period and in the latter half of February.[2/] Monthly data on foreign assets of the U.S. agencies and branches of foreign banks, reported in connection with the VFCR program, are also used.

In the three weeks January 25-February 14, 1973, the U.S. payments deficit on the official settlements basis was $8.4 billion

1/ The questionnaire (a copy of which is attached as Appendix A) was prepared in consultation with the Federal Reserve Bank of New York. The following banks were surveyed by the staff at the respective Federal Reserve Banks:

New York (9): Bankers Trust, Chase, Chemical, First National City, Irving Trust, Manufacturers Hanover Trust, Marine Midland, Morgan Guaranty Trust, and Republic National.

Chicago (2): Continental Illinois and First National Bank of Chicago.

San Francisco (2): Bank of America and Wells Fargo

These banks accounted for 62 per cent of the foreign assets reported by U.S. banks in the VFCR program as of the end of February 1973, and for the bulk of the foreign exchange dealings for commercial customers by U.S. banks.

2/ In this memorandum "U.S. banks" refers to the U.S. offices of banks organized under U.S. and State laws; "banks in the United States" includes the agencies and branches of foreign banks.

(compared with a slight surplus in the preceding 3-week period). About half of this payments deficit was produced by transactions reflected in the statistical data.

The principal conclusions of the survey of 13 banks, which account for a large share of the foreign activities of all U.S. international banks, are as follows.

1) Shifts in the reporting banks' own foreign exchange positions and those of their foreign branches represented only a small part of the total increase in demand for foreign currencies in the period. The banks reported a total shift in their foreign currency positions against the dollar of less than $400 million. More than half of this shift was in the positions of their foreign branches; changes in head office positions were thus very small.[1/]

2) Commercial corporate customers' gross purchases of foreign exchange (spot and forward) from the banks surveyed and from their foreign branches increased significantly from a level that was already high by historical standards. In the 3-week period to February 14 these purchases were about $600 million greater than in the preceding 3-week period -- about $2 billion as against $1.4 billion. (The data lack precision; moreover they do not provide a basis for estimating changes in corporate foreign-currency asset positions, and hence are not additive to the

1/ The shift in the banks' spot positions may have been larger if they had net forward sales of exchange.

above-cited data on capital outflow.) About two-thirds of the estimated gross purchases by customers were from head offices, one-third from branches abroad.

3) U.S. banks noted a substantial increase in their loans to foreign commercial banks, which included overdrafts. Apart from these interbank credits, U.S. banks said they did not discern a strong demand for dollar credit from either domestic U.S. customers or foreign customers that they could attribute directly to the exchange crisis. Several of the banks surveyed noted, however, that the U.S. agencies and branches of foreign banks drew on credit lines at the reporting banks. These drawings were doubtless associated with the shifts described below in the foreign asset and liability positions of the agencies and branches during this period.

Consideration of the results of the survey in conjunction with regular data on banking transactions provides a broad picture of large U.S. banks' operations during the exchange market crisis. In general, these banks did not engage in aggressive speculation for their own account (point 1 on preceding page). There is no indication that they actively facilitated their customers' efforts to hedge exchange positions or speculate (point 2). They did not think there was a strong connection between the speculative outflow and the bulge in domestic commercial and industrial loans -- which rose by $3.2 billion in the 3 weeks to February 14, of which $1.3 billion served to replace commercial paper borrowings (point 3).

The growth in their own foreign assets was largely dollar-denominated, and included growth of overnight overdrafts by correspondent banks abroad as well as drawings on existing credit lines. Both the extension of credit in these forms and the drawing down by banks abroad of their balances in this country (liabilities of banks in the United States) provide indirect evidence of hedging and speculative activity abroad; these transactions at banks in the United States could be the result, for example, of foreign banks' reactions to Eurodollar deposit withdrawals and Eurodollar borrowings by businesses and investors located in other countries. It seems probable that much of this activity abroad occurred at foreign banks other than U.S. bank branches.

Analysis of the statistical data and survey results.

1) In the 3 weeks ending February 14, the U.S. payments balance moved into massive deficit. On the official settlements basis the deficit was $8.4 billion (compared with a slight surplus in the preceding 3-week period). This deficit reflected (1) something like $1/2 billion of deficit on current and Government capital accounts; (2) about $2 billion of outflow from balances held at banks in the United States (including foreign agencies and branches) by banks abroad (including U.S. banks' branches) and other private holders; and (3) about $6 billion of other net private capital outflows and unrecorded transactions (compared with $6-1/2 billion net in the full year 1972). Of this $6 billion, about $2 billion is accounted for by increases in the foreign assets of banks in the United States (including foreign agencies and branches).

With a rearrangement of the classification, it appears that about $4 billion of the 3-week deficit in private capital transactions shows up in asset and liability figures of banks in the United States, leaving about $4 billion for other private assets and liabilities.

2) The survey does not help much toward identifying the nature of the latter $4 billion -- the net movement in private assets and liabilities (of foreign as well as U.S. residents) <u>outside the U.S. banking system</u>. Corporations here and abroad doubtless purchased large amounts of foreign exchange from banks abroad, as well as from banks in the United States other than the 13 banks surveyed. Such purchases could have been financed in many ways: by drawing down liquid assets in the United States, by selling stock market securities, by obtaining dollar advances from affiliated companies in the United States, by borrowing dollars from banks here or abroad, and so on. Also, normal sales of foreign exchange for dollars to make dollar payments in the United States could have been delayed, causing increases in U.S. residents' accounts receivable from abroad. Many of these transactions would not show up directly or indirectly in the data for U.S. banks' foreign assets and liabilities; and would therefore form a part of the $4 billion to be explained.

3) Of the other $4 billion part of the total movement, the part that leaves its trace in the banking statistics, $2 billion shows up in a reduction in private balances at banks in the United States, including <u>U.S. banks' liabilities</u> to their foreign branches and the

liabilities of U.S. agencies and branches of foreign banks to their overseas affiliates. Such liabilities often fluctuate from week to week in response to random forces, but the $2.0 billion outflow in the three weeks to Frbruary 14 seems clearly related to the change in the exchange market atmosphere that began to develop before the end of January. (In the three weeks to January 24, these liabilities had risen by $1.5 billion. Liabilities of U.S. banks to their foreign branches accounted for $1.0 billion of the earlier rise and for $1.1 billion of the decline in the three weeks to Frbruary 14).

These liabilities to banks abroad often change in response to changes in interest rate differentials, especially between Federal funds and overnight Eurodollars. On this occasion, although 1-month and 3-month Eurodollar deposit rates were already rising contraseasonally during January, the overnight Eurodollar rate did not begin to rise until Thursday, February 8, shortly before official exchange markets in Europe were closed after that Friday's business. It seems possible that the withdrawal of balances from the United States by banks abroad in late January and early February was in part not a voluntary response by those banks to the normal demands for Eurodollar credit that had been pushing up Eurodollar loan and deposit rates, but an involuntary reaction to sudden large loan demands and withdrawals of Eurodollar deposits for conversion into Euro-Swiss-franc or Euro-DM deposits. In this situation, despite the relatively high yield of Federal funds, the banks were constrained to adjust their positions by drawing down their dollar balances in the United States in order to buy Swiss franc claims on Switzerland or German mark claims on Germany.

4) Finally, the weekly reporting banks' statistics and the VFCR reports from the U.S. agencies and branches of foreign banks indicate an increase in external assets of banks in the United States that probably amounted to roughly $2 billion in the three weeks to February 14. Weekly data on the foreign assets of the agencies and branches of foreign banks are not available, but the increase in the month of February was $1.2 billion. The 3-week increase in foreign loans at the weekly reporting banks was $1.2 billion, and the increase in their balances with foreign banks was $0.3 billion.

As already noted, the bulk of this increase in foreign claims of weekly reporting banks was in loans and overdrafts denominated in dollars, and hence was not evidence of speculation by the banks.

Nor is the increase in banks' balances with foreign banks evidence of speculation, per se, since spot holdings may merely represent cover against forward sales. The survey indicated that at the head offices of the 13 banks the shift in foreign exchange positions was only about $150 million, from a short position of about $100 million to a position about $50 million long of foreign currencies. Some banks were still in a short foreign-currency position; only three had long positions over $15 million, and of these only one was over $25 million.

5) The outflow of funds from U.S. agencies and branches of foreign banks to their head offices and to other foreigners, which amounted during the month of February to more than $2 billion (including reduction of liabilities and increase in claims) necessarily involved, within the United States, withdrawals by the agencies and branches of funds they had been lending in the money market and/or new borrowings by them from U.S. banks. Some of the banks in the survey commented on such borrowings. It is a question of judgment as to whether this shift in the money market supply/demand position of the foreign agencies, arising from factors external to the United States, was or was not large enough to affect significantly the level of the Federal funds rate.

* * *

March crisis. The foreign exchange crisis of March 1 was reflected in U.S. payments statistics in the week ending March 7, when the official settlements deficit was $4.3 billion. Outstanding loans to foreigners by weekly reporting banks rose about $0.8 billion in that week, and liabilities of the agencies and branches of foreign banks to private foreigners were reduced by $0.2 billion, but liabilities of U.S. banks to their branches increased by $0.7 billion. Thus less than one-tenth of the week's over-all deficit was reflected in these figures.

For the four weeks from February 15, to March 14, the payments deficit was \$3.4 billion, and the rise in outstanding loans of weekly reporting U.S. banks to foreign commercial and others was \$1.3 billion. The weekly reporting banks' balances with foreign banks declined \$0.1 billion. There was little net change in bank liabilities to commercial banks abroad and other foreigners; liabilities of U.S. banks to their branches rose by \$0.7 billion, while liabilities reported by New York agencies and branches changed little on balance, and other liabilities fell by \$0.7 billion. No information is available on loans by the U.S. agencies and branches of foreign banks. Nor was a survey made of foreign exchange transactions by banks. It would be reasonable to assume that if such information were obtained, we would still be a long way from a full picture of the transactions associated with the crisis. Domestic commercial and industrial loans of weekly reporting U.S. banks rose by \$3.4 billion in this four-week period, while outstanding dealer-placed commercial paper declined by \$1.3 billion. Even if a significant part of this domestic loan expansion financed growth of corporate claims abroad, it is likely that much of the speculative buying of foreign currencies took place abroad.

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(except columns 4, 5, and 7)

Weekly Data on Changes in External
Assets and Liabilities of Banks in United States
(in millions of dollars)

Week ended	Liabilities to Private Foreign: U.S. Banks to Branches (1)	Liabilities to Private Foreign: Liab. of N.Y. Agencies & Br. of Foreign Banks 1/ (2)	Liabilities to Private Foreign: Other (3)	Assets of Weekly Reporting Banks: Loans 2/ (4)	Assets of Weekly Reporting Banks: Bal. with Fgn. Banks (5)	Net Total (1)+(2)+(3)-(4)-(5) (6)	Assets of Ag.& Br. of Foreign Banks (VFCR) (7)	Net Total (6)-(7) (8)	Official reserve trans. balance (-=deficit)
Jan. 3	- 285	- 712	- 76	- 35	+ 33	-1,071	...	...	+ 472
10	+ 804	+ 373	- 235	- 92	- 66	+1,100	...	...	+ 170
17	+ 207	+ 760	- 71	- 75	- 15	+ 572	...	...	+ 82
24	+ 367	- 279	- 30	+ 45	- 60	+ 73	...	...	+ 47
31	- 373	+ 49	- 159	+ 174	+ 27	- 684	...	...	+ 253
Feb. 7	- 22	- 70	- 39	+ 340	+ 67	- 538	...	...	-2,380
14	- 697	- 787	+ 52	+ 715	+ 184	-2,331	...	...	-6,293
21	+ 463	+ 148	- 6	+ 202	- 12	+ 415	...	...	- 394
28	- 367	- 439	- 45	+ 72	- 212	- 711	...	...	+1,529
Mar. 7	+ 676	- 248	+ 77	+ 778	+ 119	- 392	...	...	-4,284
14	- 47	+ 512	- 697	+ 215	- 17	- 430	...	...	- 203
21	- 129	+ 62	+ 289	+ 205	- 52	+ 69	...	...	+ 792
28	- 163	+ 155	+ 78	+ 39	+ 1	+ 30	...	...	+ 87
Apr. 4	- 116	- 256	- 142	- 385	+ 46	- 175	...	...	+ 932
4 wks. of Feb.	- 623	-1,148	- 38	+1,329	+ 27	-3,165	1,245	-4,410	-7,538
3 wks. Jan. 25 to Feb. 14	-1,092	- 808	- 146	1,229	+ 278	-3,553	...	...	-8,420
7 wks. Jan. 25 to Mar. 14	- 367	- 835	- 817	2,496	+ 156	-4,671	(1,245+)	...	-11,772

1/ Primarily the liabilities of the N.Y. agencies and branches of foreign banks to their head offices and affiliates abroad.

2/ Loans to foreign commercial banks, loans to foreign governments and official institutions, and foreign component of commercial and industrial loans.

APPENDIX A

Survey of Bank Operations during the period January 22 to February 9, 1973

1) Did your bank change its spot or forward foreign exchange position on balance over that period? If so, by how much? How did your position at the close of the period compare with your average position during the first three weeks of January?

a) Please answer the above questions for the aggregate positions of your foreign branches.

2) How much foreign exchange did you sell to customers in the period, and how does that compare with sales in the preceding three weeks?

a) To the extent possible, we would appreciate the same information with respect to the operations of your foreign branches.

3) How large were foreign drawings on dollar loans or other types of credit during the period, and how does that compare with total drawings in the preceding three weeks? To what extent would you attribute this to normal seasonal requirements?

4) Did you experience unusually large loan demands from domestic customers in this period? To what extent was this related in your judgment to an outflow of funds from the U.S.?

5) If you experienced abnormally large demands for foreign currency purchases or dollar loans in this period from domestic customers, to what extent was either of these attributable to a) large corporate customers, b) other corporate customers, c) other financial institutions, or d) the general public?

6) What was the increase in liabilities of your foreign branches or affiliates (if any) to a) your bank, b) other U.S. residents, between January 22 and February 9, 1973?