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December 27, 1966

Rodney H. Mills

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The French Banks' Operations in Foreign Currencies

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The French Banks' Operations in Foreign Currencies

<u>Introduction and Summary.</u>	1
I. <u>The Spot Position with Residents.</u>	6
1. Liabilities to residents.	6
2. Assets with residents	10
II. <u>The Spot Position with Foreigners</u>	10
1. Transactions with correspondents.	11
2. Other transactions with foreigners.	11
3. Changes in the spot position with foreigners.	12
III. <u>Forward Transactions and Swaps.</u>	14
1. Transactions with residents	15
2. Transactions with foreign correspondents.	17

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Introduction and Summary

The French banks' borrowing and lending operations in foreign currencies have undergone a rapid expansion since the major European currencies became externally convertible in December 1958. Spot assets and liabilities denominated in foreign currencies each now exceed \$2 billion and make up about 8 per cent of the banks' balance sheet totals.

The growing importance of their borrowings and lendings of foreign currencies primarily reflects the French banks' participation during recent years in the expanding international markets for short-term funds in dollars, sterling, and other leading currencies. These markets are largely interbank markets, and the bulk of the French banks' foreign currency operations are with correspondent banks in other countries. However, stress must be laid on the fact that, in addition to transactions with foreigners, French banks also have foreign currency claims against, and owe foreign currency claims to, customers residing in France: these consist mainly of loans and deposits of foreign currencies, in addition to forward exchange contracts. The banks' spot and forward positions with domestic customers often show

^{1/} This paper is essentially a summary of the article entitled "Note sur les opérations des banques françaises en devises étrangères" which appears in Statistiques et Etudes Financières, No.213, September 1966, published by the French Ministry of Economics and Finance. Nearly all the statistical series used in the original article end with September 1965. However, to the author's knowledge, this is the first time that data have been published on the banks' forward positions and on their spot position with residents in foreign currencies.

sizable imbalances between assets and liabilities. Because the banks must maintain an over-all balanced position in foreign exchange, the imbalances arising from their operations with domestic customers require them to make offsetting transactions with their foreign correspondents.

There has been some uncertainty among U.S. students of French monetary developments concerning the even balance in foreign exchange required of French banks; the nature of this balance should therefore be made clear. For many years the French foreign exchange regulations have required the banks to maintain equality (with certain minor exceptions) between their total assets in a particular foreign currency and their total liabilities in that same currency. These totals refer to the sum of the spot entries and the forward entries, each of these categories in turn including both the position with residents and that with nonresidents. Because of the distinctions between spot and forward and between resident and nonresident, foreign-currency assets and liabilities logically fall into four separate categories, as shown by the figures in Table 1 relative to the banks' positions in September 1965. Any one of these four separate positions may be unbalanced provided that the remaining three, taken together, show an equivalent imbalance in the other direction.

The required even balance is not precisely zero, however, because certain minor types of foreign currency assets (of which banknotes are one) need not be offset on the liabilities side. For this reason, the banks have had a small global net asset position ranging in recent years between \$40 and \$50 million. The data in Table 1 show that on September 30, 1965, the banks had an over-all net asset position of \$49 million, an amount equal to about 1 per cent of total gross spot and forward assets.

Table 1. The French Banks' Foreign Exchange Position
in All Currencies on September 30, 1965
(in millions of U.S. dollars equivalent)

	<u>Assets</u>	<u>Liabilities</u>	<u>Net Position</u>
I. <u>Spot position</u>			
A. With residents	132	- 303	- 171
B. With nonresidents	<u>1,992</u>	<u>-1,723</u>	<u>268</u>
Total spot	2,123	-2,026	97
II. <u>Forward position</u>			
A. With residents	202	- 177	25
B. With nonresidents	<u>1,897</u>	<u>-1,971</u>	<u>- 74</u>
Total forward	2,100	-2,148	- 48
III. <u>Spot and forward</u>			
A. With residents	334	- 480	- 146
B. With nonresidents	<u>3,889</u>	<u>-3,694</u>	<u>195</u>
Total spot and forward	4,223	-4,174	49

Note: The figures have been consolidated to eliminate debits and credits between French banks. Residents include residents of the overseas franc area as well as of metropolitan France. Operations with correspondent banks in the overseas franc area are included among the French banks' operations with resident customers.

On a gross basis, the forward assets and liabilities seem surprisingly large: in September 1965, they were as large as the spot assets and liabilities. This can be explained by the fact that a large part of the forward transactions are "third currency" operations between two foreign currencies, and do not involve francs at all. These "third currency" operations, often undertaken at the instigation of a foreign correspondent, give rise to simultaneous forward purchases and sales of the two currencies that constitute the concluding half of a swap, of which the initial half was a spot exchange in the other direction.

From 1958 through 1965, four sets of influences were responsible for most of the changes that have occurred in the banks' positions in foreign exchange. First, the distrust of the franc in 1958, and the return of confidence in the French currency in the ensuing years, greatly affected the banks' forward position with residents. The need to maintain an overall balanced position in foreign currencies led to offsetting shifts, principally in the spot position with foreign correspondents.

Secondly, strong money market pressures in France in the first half of 1964, growing out of the stabilization program of 1963-64, induced the banks there to seek additional domestic liquidity by "importing" funds through the medium of swap operations with foreign correspondents. Under these arrangements, the French banks bought spot francs from correspondents, in exchange for dollars, and repurchased the francs forward. But the Bank of France also played a crucial role: the foreign banks obtained the necessary additional francs by selling dollars on the Paris exchange market, where they were bought by the Bank of France in the course of market intervention.

Thirdly, in late 1964 and during 1965 French monetary conditions were relaxed while financial markets in most other industrial countries were becoming tighter. In this period the French banks "exported" funds by reversing the franc-dollar swaps made earlier, and by making new swaps under which they bought foreign exchange spot against francs, and placed the exchange in foreign markets. (In this instance, the foreign correspondents sold the francs on the exchange market, i.e., in effect to the Bank of France.)

Finally, speculation against the pound sterling by French importers and exporters in late 1964 and most of 1965 caused the banks to shift, from being net sellers of forward sterling to residents (the usual situation) to being net buyers of forward sterling from these customers. In view of the requirement that their over-all sterling position be balanced, the French banks sold large amounts of forward pounds to British correspondents, who resold it to the Bank of England in the context of official support operations for forward sterling.

More than 200 French banks^{2/} (about 60 per cent of all the banks in France) are authorized to deal in foreign currencies, and such authorized banks are called intermediaires agréés. But nearly all of the business is done by a limited number of institutions that include the six largest commercial banks, a few of the banques d'affaires (mixed commercial and investment banks), and 33 branches and affiliates of foreign banks doing business in France.

^{2/} In this paper, for convenience of expression the term "French banks" is used to mean "banks in France." Thus, the term "French banks" includes the branches and affiliates of foreign banks doing business in France, and it excludes the branches and affiliates of French banks operating abroad.

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Table 2. The French Banks' Spot Position in Foreign Currencies, 1958-65
(in millions of U.S. dollars equivalent)

	December 31					1965	
	1958	1959	1962	1963	1964	Sept. 30	Dec. 31
I. With Residents							
A. Assets							
1. Advances to importers and exporters	n.a.	25	154	161	136	112	n.a.
2. Miscellaneous	n.a.	n.a.	n.a.	n.a.	n.a.	20	n.a.
<u>Total assets</u>	n.a.	n.a.	n.a.	n.a.	n.a.	132	n.a.
B. Liabilities							
1. Exchange awaiting payment	n.a.)	63	39	41	53	38	n.a.
2. Exchange awaiting sale	n.a.)		50	49	49	42	n.a.
3. Exchange not subject to surrender	n.a.	42	59	59	66	73	n.a.
4. EFAC accounts	n.a.	142	101	105	91	102	n.a.
5. Miscellaneous	n.a.	n.a.	n.a.	n.a.	n.a.	47	n.a.
<u>Total liabilities</u>	n.a.	n.a.	n.a.	n.a.	n.a.	303	n.a.
C. Net position (minus = net liabilities)	-330 ^{1/}	+180 ^{2/}	-109 ^{3/}	- 97 ^{3/}	-145 ^{3/}	-171	n.a.
II. With Nonresidents							
A. Assets							
1. With correspondents	n.a.	784	1,276	1,435	1,674	1,809	n.a.
(Sight deposits)	n.a.	(193)	(157)	(296)	(386)	(344)	n.a.
(Other assets)	n.a.	(591)	(1,118)	(1,139)	(1,288)	(1,464)	n.a.
2. Advances to customers	n.a.	--	73	91	84	133	n.a.
3. Foreign banknotes	n.a.	1	15	18	18	20	n.a.
4. Discounted drafts	n.a.	11	19	29	27	30	n.a.
<u>Total assets</u>	n.a.	796	1,383	1,575	1,803	1,992	n.a.
B. Liabilities							
1. With correspondents	n.a.	477	1,023	1,348	1,506	1,543	n.a.
(Sight deposits)	n.a.	(15)	(85)	(99)	(161)	(170)	n.a.
(Other liabilities)	n.a.	(462)	(937)	(1,249)	(1,346)	(1,373)	n.a.
2. Deposits of customers	n.a.	27	110	123	136	180	n.a.
<u>Total liabilities</u>	n.a.	504	1,133	1,471	1,642	1,723	n.a.
C. Net position (of which: net position with correspondents)	576	292	250	104	161	268	379
	(n.a.)	(306)	(253)	(87)	(168)	(265)	(n.a.)

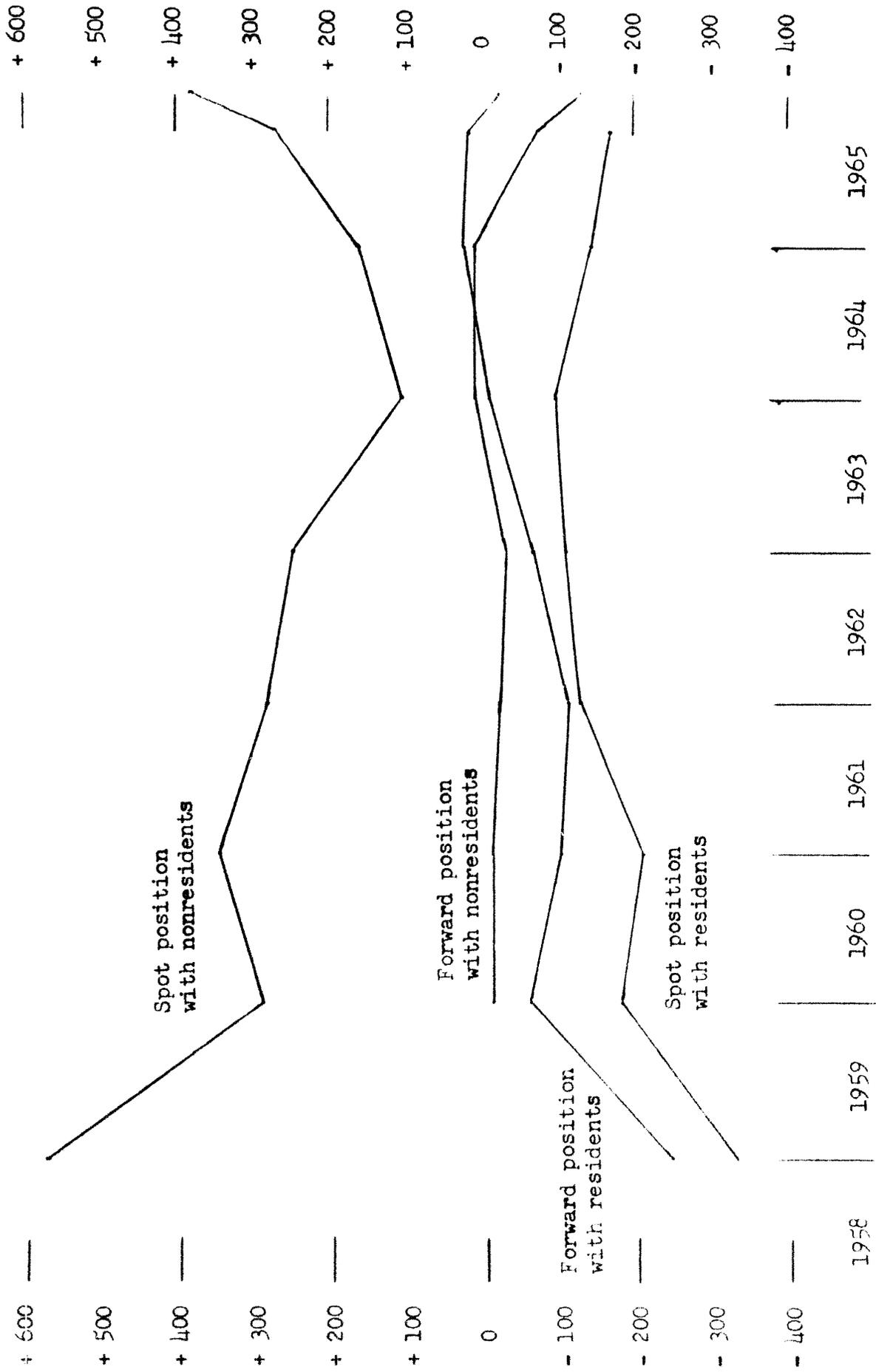
^{1/} The true net liabilities were slightly smaller than \$330 million. This figure is net of the "exchange position," i.e., net of those assets against which no equivalent amount of liabilities has been required. The "exchange position" has been small in years subsequent to 1958.

^{2/} Approximate figure taken from a graph in the original article.

^{3/} The true net liabilities were slightly larger than these figures show, because these figures are net of the banks' liabilities to correspondent banks in the overseas franc area.

Net Foreign Currency Positions of the French Banks
(in millions of U.S. dollars equivalent)

on December 31, 1958-65, and on September 30, 1965



foreign exchange. The U.S. dollar and the pound sterling are employed in about four-fifths of all those French foreign trade transactions that call for settlement in a foreign currency.

Importers (and buyers of foreign services) who purchase foreign exchange on the Paris exchange market keep these funds on deposit with their bank pending actual disbursement. Foreign exchange may be held in this way for six months. These accounts, called "exchange awaiting payment," have not kept pace with the growth of imports in recent years, partly because of the increasing use of francs in making import payments and partly because an increasing share of total imports has come from other Continental European countries, with a consequent shortening of the average delay in making settlements. "Exchange awaiting payment" accounts were at first available only to importers of merchandise, but since October 15, 1965, all persons making foreign payments have been able to open such accounts and hold foreign exchange for six months between purchase and disbursement.

French exporters, sellers of services (e.g., shippers), and recipients of investment income in a foreign currency may keep this exchange in a French bank for three months before it must be sold on the exchange market. Earlier, the period of delay allowed was only one month from 1947 until December 21, 1963, when it was increased to the present three months.^{4/} These accounts are called "exchange awaiting sale." The faculty accorded exporters of holding exchange receipts for a while

^{4/} The possibilities for lags between export shipments and sale of the relevant proceeds on the exchange market are much longer than three months, however. French exporters can grant foreign importers delays in making settlements of up to seven months from date of delivery of the goods in the foreign country.

before being required to sell them allows for a certain amount of speculative movement in their accounts. Expectations of a possible devaluation or revaluation of a foreign currency relative to the franc induce exporters to speed up or slow down their sales of exchange, with consequent effects on the exchange rate and perhaps the accruals of reserves by the monetary authorities. But in practice the fluctuations in "exchange awaiting sale" have been small, never exceeding \$10 million equivalent in any one month.

A third type of foreign exchange account is termed "exchange not subject to surrender," and such accounts are supplied with the liquid proceeds of sales of capital assets formerly held abroad by French residents. A fourth category of account has up to now been the most important of the four main types, but it is presently in the process of disappearing; these are the so-called EFAC accounts.^{5/} As an incentive to exporters, from 1948 to the present year the exchange control laws allowed exporters to keep a fraction (8 to 15 per cent) of their receipts in EFAC accounts, for subsequent incidental expenditures abroad connected with export sales or for the importation, outside the import quotas, of commodities used in producing export goods. The gradual dismantling of import restrictions, and increased confidence in the franc compared with the period up to December 1958, have served to eliminate the attraction which this "retention quota" scheme once had for French exporters. Consequently, the regulations have not permitted new EFAC accounts to be opened since January 8, 1966, and all such accounts are scheduled to be closed out by April 1, 1967.

^{5/} EFAC is an acronym that comes from exportations--frais accessoires (exports--ancillary expenses).

2. Assets with residents

On the assets side of the French banks' balance sheets, claims in foreign exchange on domestic residents have taken the form largely of advances of exchange to importers and exporters. The exchange control regulations prescribe that advances of foreign exchange to importers generally can be made only after the merchandise has been delivered. To repay the loan, the French importer may buy forward exchange, or may wait and buy spot exchange when the repayment is due. Advances of foreign exchange to exporters may be granted after the exported goods have entered the French customs. The exporter immediately sells the exchange on the market, and repays the advance in foreign exchange no later than the date when he receives payment for his sales abroad.

The volume of outstanding advances of foreign exchange to French importers and exporters tended to increase up to mid-1964, when they reached \$157 million in June of that year. Since then they have declined, to the equivalent of \$112 million in September 1965, partly because the banks have charged higher rates of interest than before on their foreign exchange loans. Because of the decline in these advances and the stability of the corresponding liabilities, the French banks' net spot liability position vis-à-vis domestic residents increased from approximately \$100 million equivalent in June 1964 to \$171 million equivalent in September 1965.

(See Table 2.)

II. The Spot Position with Foreigners

Spot assets and liabilities vis-à-vis foreigners are many times larger than those with residents, and about 90 per cent of them are claims on, or claims owed to, other banks abroad. These correspondent banks include

the branches and affiliates abroad of French banks; the head offices of foreign banks with branches or affiliates in France; and foreign banks that have no direct link with France. However, while they are still small, dealings with nonbank customers located abroad have been expanding with particular rapidity during the 1960's.

1. Transactions with correspondents

Since May 1960, the exchange control regulations have given French banks complete freedom to borrow short-term funds in foreign currencies from their correspondents in other countries, and to employ foreign exchange in foreign markets. As shown in Table 2, on both the assets and the liabilities side, part of the operations with correspondents consists of holding sight deposits, and these are to be considered as working balances. In September 1965, sight deposits were 19 per cent of total spot assets with correspondents, and comprised 11 per cent of sight liabilities owed to correspondents. The remaining accounts with correspondents comprise time deposits (especially in the cases of Euro-dollars, Euro-sterling, and other Euro-currencies), Treasury bills, and other money market instruments, particularly bankers' acceptances.

2. Other transactions with foreigners

French banks are also free to accept deposits from companies and individuals abroad, and to lend foreign exchange to them. Advances made to nonbank customers in other countries, as of September 1965, amounted to \$133 million equivalent, while deposits received from such customers totaled \$180 million. Although still a small part of banks' total spot

assets and liabilities with foreigners, each of these types of operations has increased severalfold since 1959. Dealings with nonbank customers abroad, especially loans to them, have exhibited a strong sensitivity to changes in the degree of domestic monetary tightness or ease: in times of relatively easy credit conditions, for example, the banks tend to increase these loans faster than other credits. During the 1963-64 stabilization program in France, advances to foreign customers decreased from \$116 million equivalent in early July 1963 to \$84 million at the end of 1964. Subsequently, as monetary policy was relaxed, they rose to \$133 million by September 1965.

The remaining foreign-currency claims on foreigners include foreign banknotes in addition to discounted time drafts drawn by French exporters on foreign importers. Regulations require that, as a general rule, the maturity of such drafts, which are a form of short-term trade credit, may not exceed six months from date of delivery of the merchandise. When drafts are discounted the French exporter receives francs, and at that time the discounting bank is required to sell to the Exchange Stabilization Fund, for francs, foreign exchange equal to the amount of the draft. For this purpose the bank may draw on its existing foreign exchange balances or may rediscount the draft with a foreign correspondent. But in either case, because of the regulations the bank's net foreign exchange position does not change as a result of discounting foreign-currency drafts.

3. Changes in the spot position with foreigners

Since the late 1950's, the French banks have consistently been in a net creditor position as regards their spot transactions with foreigners. In part, this continuous net creditor position is a reflection of the

persistent net debtor position shown by the banks' foreign-currency position with domestic residents, which must be covered either by spot transactions with foreigners or by forward transactions. But even though the spot position with foreigners has persistently shown the French banks as net creditors, the size of this net creditor position has changed in ways that follow two distinct trends since the end of 1958. Practically all of these changes have reflected shifts in the net position with correspondents, since the shifts in the net position with nonbank customers abroad have been small.

At the end of 1958, the net creditor position on spot transactions with foreigners was very large, amounting to the equivalent of \$576 million on December 31 of that year. This position is shown in Table 2 on page 7. At that time, this position was not only a reflection of the spot net debtor position vis-à-vis residents, but also of the very big short position in the forward exchange market which the banks had built up by that date. Two years had elapsed in which devaluation of the franc was widely anticipated (and two effective devaluations in fact occurred, in August 1957 and on December 28, 1958). Accordingly, in 1957-58, French importers bought forward exchange from their banks on a heavy scale, while exporters sold exchange forward on a smaller scale than usual. On December 31, 1958 the French banks' forward sales of exchange exceeded their forward purchases by \$246 million equivalent. The banks covered these net forward liabilities largely by buying spot forward exchange which they kept with their foreign correspondents.

The return of confidence in the parity of the franc after 1958 led to a large decrease in the banks' net forward liabilities, and also to a substantial reduction in their net spot assets with foreigners, the latter position dropping to \$251 million equivalent at the end of 1962. One effect of this contraction was to augment the accruals of official reserves.

In the years 1963-65, changes in French money market conditions largely dictated the shifts that occurred in the banks' foreign exchange position with foreigners, both spot and forward. A tightening money market from early 1963 to mid-1964 made French banks seek to increase their liquidity in domestic currency, and consequently led to a further decline in their net spot assets with foreigners; these fell to about \$100 million equivalent in June 1964. Thereafter, a gradual easing of market conditions was accompanied by a rise in net spot assets with foreigners, to \$379 million by December 1965. These shifts were intimately associated with shifts, in the opposite direction, in the banks' forward position, and are described further in the next section.

III. Forward Transactions and Swaps

The volume of the French banks' transactions in forward exchange has increased in recent years at a much faster rate than have their spot assets and liabilities in foreign currencies. Surveys made in the month of June each year for the past several years reveal a tripling, from 1960 to 1965, of the monthly volume of forward purchases and sales. Outstanding contracts, in September 1965, to purchase and to

deliver forward exchange were in each case more than \$2 billion equivalent, and at those levels were of the same order of magnitude as the corresponding spot entries in the banks' collective balance sheet. Surveys made in April 1964 and June 1965 showed that over 40 per cent of all forward transactions involved sterling, and that the percentage involving dollars was nearly as large.

Forward contracts are made with both domestic customers and foreign correspondents, the former being small in volume compared with the amount of contracts entered into with banks in other countries. Outstanding contracts with domestic customers in September 1965 were for between \$175 and \$200 million equivalent on each side of the balance sheet. Only part of the French banks' forward transactions involve a forward purchase or sale of foreign currency against francs: a large part of the forward transactions with correspondent banks do not involve francs at all, but rather are arbitrage transactions consisting of the simultaneous forward purchase and sale of two foreign currencies, one against the other.

1. Transactions with residents

For many years, the French exchange control regulations restricted the forward exchange market in Paris solely to use by importers and exporters of merchandise. Permission to engage in forward dealing was extended to shippers in 1962, and since October 15, 1965, forward operations have been open to all residents for both current settlements and capital transactions. The maximum allowed maturity of forward contracts

Table 3. The French Banks' Forward Position in Foreign Currencies, 1958-65^{1/}
(in millions of U.S. dollars equivalent)

	December 31					1965	
	1958	1959	1962	1963	1964	Sept. 30	Dec. 31
I. With Residents							
In U.S. dollars	n.a.	n.a.	n.a.	- 7	- 5	23	n.a.
In sterling	n.a.	n.a.	n.a.	- 1	49	37	n.a.
In other foreign currencies	<u>n.a.</u>	<u>n.a.</u>	<u>n.a.</u>	<u>- 3</u>	<u>- 22</u>	<u>- 44</u>	<u>n.a.</u>
Total with residents	<u>2/</u>	- 60 ^{3/}	- 66	- 11	22	16	- 21 ^{3/}
II. With Nonresidents							
In U.S. dollars	n.a.	n.a.	n.a.	- 51	43	53	n.a.
In sterling	n.a.	n.a.	n.a.	72	24	74	n.a.
In other foreign currencies	<u>n.a.</u>	<u>n.a.</u>	<u>n.a.</u>	<u>- 10</u>	<u>- 56</u>	<u>- 52</u>	<u>n.a.</u>
Total with nonresidents	n.a.	- 10 ^{3/}	- 30	11	11	- 73	- 130 ^{3/}
III. Total^{4/}							
In U.S. dollars	n.a.	n.a.	n.a.	- 47	38	80	n.a.
In sterling	n.a.	n.a.	n.a.	64	68	- 31	n.a.
In other foreign currencies	<u>n.a.</u>	<u>n.a.</u>	<u>n.a.</u>	<u>- 12</u>	<u>- 76</u>	<u>- 97</u>	<u>n.a.</u>
Total	-246	- 70	- 92	5	30	- 48	-151

^{1/} A minus sign indicates a short position.

^{2/} It appears that the position with residents accounted for nearly all of the \$246 million total short position.

^{3/} Approximate figure taken from a graph in the original article.

^{4/} The totals are not precisely equal to the sum of the separate positions with residents and nonresidents because certain transactions of minor significance could not be allocated to either separate category.

equivalent short position on September 30, 1964, to a \$30 million long position on March 31, 1965. This change reflected a shift in the position in forward sterling, from a short position of \$15 million equivalent to a long position of \$54 million, as shown in Table 4. In those six months, French importers of merchandise from sterling area countries sharply reduced their forward purchases of sterling in the expectation that the price of spot sterling might soon be reduced, while exporters to the sterling area accelerated their forward sales of sterling. (Normally, in their dealings with residents, the French banks have a short position in forward sterling; the customers who buy sterling forward are mostly importers of raw materials from the sterling area.) The banks' total forward position with residents remained long through the third quarter of 1965. Confidence in the maintenance of the sterling parity strengthened in the final few months of the year, and by the end of 1965 the French banks again had a small short forward position with residents.

2. Transactions with foreign correspondents

Forward operations with correspondent banks in other countries-- which account for a high percentage of all forward operations--may be outright purchases and sales of forward exchange, or they may constitute the concluding half of a swap transaction.

Outright purchases and sales are made to cover an unbalanced position on spot transactions or on forward operations with domestic customers. The most interesting outright dealings with correspondents were in connection with the speculative activities in sterling on the

Table 4. The French Banks' Forward Position in Foreign Currencies, 1963-65^{1/}
(end of period; in millions of U.S. dollars equivalent)

	1963	1964				1965	
	Dec.	April	June	Sept.	Dec.	March	Sept.
I. With Residents							
In U.S. dollars	- 7	- 4	--	8	- 5	11	23
In sterling	- 1	4	- 18	- 15	49	54	37
In other foreign currencies	- 3	- 31	- 32	- 35	- 22	- 34	- 44
Total with residents	- 11	- 31	- 50	- 42	22	31	16
II. With Nonresidents							
In U.S. dollars	- 51	- 21	73	- 4	43	- 30	53
In sterling	72	29	55	89	24	- 7	- 74
In other foreign currencies	- 11	62	3	13	- 56	36	- 52
Total with nonresidents	11	70	125	98	11	- 1	- 73
III. Total^{2/}							
In U.S. dollars	- 47	- 12	86	15	38	- 21	80
In sterling	64	26	37	67	68	49	- 31
In other foreign currencies	- 12	33	34	22	77	1	- 97
Total	5	47	89	60	29	29	- 48

^{1/} A minus sign indicates a short position.

^{2/} The totals are not precisely equal to the sum of the separate positions with residents and nonresidents because certain transactions of minor significance could not be allocated to either separate category.

part of French importers and exporters in 1964-65. It was remarked earlier that, because of this speculation, the French banks made large net purchases of forward sterling from residents, so that their position with residents in forward sterling shifted from a \$15 million equivalent short position in September 1964 to a \$54 million long position in March 1965, this being a net shift of \$79 million. Simultaneously, the banks' position in forward sterling with nonresidents shifted sharply in the opposite direction, as the French banks covered their forward purchases from residents by selling large amounts of forward sterling to correspondents abroad who, in this instance, were British banks. As shown in Table 4, the French banks' position in forward sterling with nonresidents shifted from an \$89 million equivalent long position in September 1964 to a \$7 million short position in March 1965.

At that time, banks in the United Kingdom were selling forward foreign exchange to their own customers on a heavy scale. The British banks might have covered those forward sales by buying foreign currencies spot; but the Bank of England wished to prevent such purchases because they would be a drain on the official British reserves. Therefore, the Bank of England supported the forward sterling market and induced the British banks to cover by buying forward sterling from their foreign correspondents, in particular their correspondents in France, and reselling it to the Bank of England for the needed forward exchange.

The French banks can, of course, also cover an unbalanced forward position with residents by buying or selling spot exchange rather than forward exchange. This was the case in 1958, when the large short position on domestic forward operations was covered by buying spot exchange and keeping it on deposit with correspondents.

Forward operations that are an integral part of swaps are employed very extensively in dealings with correspondents. A swap is in essence a spot purchase or sale accompanied by a simultaneous forward purchase or sale in the opposite direction; it is an exchange of two currencies accompanied by agreement to reverse the exchange at a later date at a predetermined rate of exchange. A French bank may make a swap with a correspondent that involves the exchange of two foreign currencies, or it may make a swap involving francs and a foreign currency.

Swaps by French banks involving two foreign currencies are very often entered into at the initiative of the foreign correspondent, in instances where the latter wants temporarily to increase or decrease its liquidity in domestic funds. Swaps of this type are especially numerous in the French banks' operations with their correspondents in Germany. A German bank might want to acquire DM in exchange for a foreign currency, e.g., dollars, for a fixed period of time. It might then make a swap with a correspondent in France, by which the French bank gives up DM for dollars now and receives DM for dollars at the specified later date. It should be noted that swaps involving two

foreign currencies inflate the gross values of the French bank's forward assets and liabilities, but they do not affect its overall net position in foreign exchange, either spot or forward.

Swaps of francs for foreign currency, or vice versa, arise out of two sets of circumstances. One concerns the coverage of an unbalanced position on forward operations with residents. A short position on such operations, for example, might be covered with a spot purchase, but this has the potential disadvantage of reducing immediately the French bank's liquidity in francs. An alternative solution is to obtain forward exchange outright, but the foreign correspondent might be unwilling or unable to sell forward exchange outright because that might mean taking an uncovered position itself. To obviate these difficulties, the French bank can buy exchange spot and then swap the exchange for francs from its correspondent. In this way the foreign correspondent's position in each foreign currency remains balanced, and the French bank's liquidity in francs is unimpaired for the duration of the swap.

Swaps involving francs and a foreign currency are also prompted in large degree by changes in money market conditions. Shifts in conditions on the Paris money market in 1964-65 in fact gave rise to the largest changes which the French banks' forward position with correspondents has experienced since 1959. To increase its liquidity in local currency or in foreign exchange, a French bank can sell or acquire spot foreign exchange on the exchange market and still maintain a balanced position in foreign exchange

by covering forward. However, the usual practice is to make a swap with a foreign correspondent. French banks have been authorized for many years to enter into swaps whereby they sell exchange spot and buy it forward. But it was not until October 15, 1965, that they were allowed to make swaps of the opposite nature.

The French banks' forward position with correspondents showed rather minor variations up until 1964. The position then shifted very sharply: from a small long position of \$11 million equivalent on December 31, 1963, to a large long position of \$125 million on June 30, 1964. (See Table 4 on page 19.) In those six months, the Paris money market became much tighter as a consequence of anti-inflationary monetary and fiscal measures and some reduction in the external surplus. Tension reached a peak in May 1964, when rates for three-month funds in Paris averaged over 6 per cent. To obtain liquid francs, French banks swapped foreign currencies to their foreign correspondents; under the terms of the swaps, they agreed to take back the exchange later. Such swaps showed up in both the aforementioned increase of \$114 million in the net asset position on forward transactions, and in an equivalent reduction in the French banks' net spot assets with their correspondents. Most of the swaps involved U.S. dollars: the banks' forward position with correspondents in dollars shifted from a short position of \$51 million in December 1963 to a long position of \$73 million in June 1964. Outstanding swaps rose \$45 million in the month of May alone.

The foreign exchange which the foreign correspondents acquired under the swaps was sold for francs on the Paris exchange market, where it was bought by the Bank of France. These purchases by the Bank of France were necessary if the swaps were to increase the liquidity in francs of the French banks (considered as a whole), because a net creation of francs was necessary. If foreign exchange had not been transferred from the foreign correspondents to the Bank of France, the formers' franc balances with their French correspondents would have declined, and this would have reduced the French banks' franc liquidity by as much as the swaps increased it.

After May 1964 the French authorities took steps to ease the money market, partly to reduce the volume of such swaps. The Paris market was further eased in 1965, whereas Euro-dollar rates strengthened in the second half of 1965. The French banks were thus induced to place funds abroad, which they began doing after mid-1964 by undoing swaps with foreign correspondents. Later, the banks were authorized, on October 15, 1965, to make swaps in the form of a spot purchase of foreign exchange accompanied by a forward sale.^{6/} As a result of this change in regulations, in the final quarter of 1965 they made swaps of this type, and by the end of 1965 they had a large \$130 million short position on forward operations with nonresidents.

^{6/} Until that time, the banks had not been allowed to lend francs to foreigners, and swaps of this type were construed as loans of francs.