

The birth of the central bank currency swap



Currency swaps (and all kinds of swaps) are considered as a 'standard' tool in trading and asset management under the fiat hegemon. But how exactly did the first central bank currency swap arise? What was the need that precipitated its creation?

Dr. Charles Coombs, who retired as Senior Vice President of the Federal Reserve Bank of New York in 1975, informs us in *'The Arena of International Finance'* (†) about the central bank-to-central bank currency swap's birth. The foundation of the Bretton Woods system, established just prior to the end of World War II, was the gold/dollar 'parity' and the 'parity' between the dollar and non-dollar currencies. The fiat dollar was fixed at 35 to one ounce of fine gold. In turn, other national fiats were 'pegged' against the dollar and could move within a range. These ranges had to be actively policed and any movement outside of the range corrected by intervention of some sort.

William McChesney Martin, Chairman of the Federal Reserve Board in 1961, consulted with his Treasury superiors about 'action' in the foreign exchange markets. Prior to February 13th 1962, the Federal Reserve System could not assume debts in foreign currencies. Dr Coombs:

'The primary objective of the Federal Reserve foreign exchange operations, as expressed in the Committee's authorization of February 13th 1962, was "to help safeguard the value of the dollar in the international exchange markets." As an initial base of operations, we immediately bought from the Treasury some \$30 million of the stronger foreign currencies and opened accounts with a number of the European central banks. There was some thought in Washington circles then that we might endeavour to build up such foreign exchange balances to levels adequate to finance major operations in the exchange markets and even contribute to a long-term growth of international liquidity.'

As a strategy to defend the dollar, this was quickly overlooked: the European currencies on the balance of the Federal Reserve could depreciate. Furthermore, the currencies needed couldn't be purchased in the volumes required by the Federal Reserve. There was another problem:

'Strange as it may seem, the European currencies were from the operating point of view of the Federal Reserve effectively inconvertible, one into the others. To foreign central banks, on the other hand, the dollar could be used to settle bills anywhere on the face of the globe...'

Dr. Coombs informs us that Julien-Pierre Koszul, head of the Foreign Department at the Bank of France, came up with the solution to these problems via the suggestion of a central bank-to-central bank currency swap. A currency swap between private parties is of a totally different nature to currency swaps between the central banks that have the ability to create the fiat currency with the stroke of a pen. A communiqué dated February 28th 1962, to the Bank of France from the Federal Reserve, established the first of a series of central bank swaps. In this communiqué, we are informed that:

'Federal Reserve proposes a 3-month French franc-dollar swap in the amount of \$50 million. On March 1 we shall credit your [Bank of France] account [with the Fed] \$50 million. Please credit French franc equivalent to Federal Reserve Bank of New York Account A' advising by cable amount credited and market rate of exchange. The swap will have an initial maturity of three months. On maturity, the swap will be liquidated at the same rate of exchange.

It is understood that you will place the resultant dollar balance on March 1 in a non-transferable US Treasury certificate of indebtedness which the Secretary of the Treasury is prepared to issue to you at par to mature three months after the date of issue but redeemable upon two days' notice and to bear interest at a rate based upon the average rate of discount on the auction of the last issue of three month Treasury bills. The certificate will be issued and redeemed at the Federal Reserve Bank of New York as fiscal agent of the United States. It is further understood that our franc balance with you will bear the same rate of interest.

This swap arrangement, including the US certificate of indebtedness, will be renewable on agreement of both parties.

To protect both parties against the remote risk of a revaluation of either currency we suggest the following procedure: We place with you a standing order to be executed when necessary for that purpose to purchase for our account French francs in any amount sufficient to replenish any earlier drafts upon our franc balances created by the swap. We accept from you a similar standing order to be executed when necessary for that purpose of replenishing any earlier drafts upon your dollar balances created by the swap.”

Of course, where the mechanics of this central bank currency swap arrangement differed from private currency swaps was the initial creation of the \$50 million on one side and 500 million French francs on the other. The creation of this ‘fictitious’ (more fictitious?) money was lambasted in the common press at the time. How could the Federal Reserve use this ‘ammunition’ granted? If the franc were to appreciate towards its upper limit against the dollar, the Federal Reserve would sell francs for dollars to attempt to reverse it. Conversely, if the franc were to depreciate towards its lower limit, the Bank of France would redeem their certificate of indebtedness (two days’ notice) and sell the dollars acquired for francs. The Federal Reserve never used the proceeds of this particular arrangement and it was maintained on a standby basis.

However, the die had now been cast and similar swap arrangements were coordinated with the Bank of England (\$50 million, May 1961) the Dutch and Belgian central banks (\$50 million each, June 1962.) The first actual intervention using these new swap facilities was in June 1962: the Fed sold \$30 million of Belgian francs and Dutch guilders. The dollars acquired by the Fed could not be used in exchange for gold at the ‘window’ – an unintended American benefit?

The Belgian franc and Dutch guilder debt assumed by the Fed was paid back when the Belgian and Dutch central banks found themselves in need of dollars a few weeks later. The Swiss National Bank was added to the swap network in July 1962 and the Bundesbank, Bank of Italy, National Bank of Austria and Riksbank soon followed.

A crucial aspect of this swap network was the extreme firepower – conjured from nowhere – that it offered to the various central banks. Should Canada happen to be facing balance of payment issues that might threaten the Canadian dollar parity, as was the case in July 1962, the Bank of Canada could draw on their dollar balance at the Federal Reserve and sell dollars – in massive volume unavailable to the private market – for Canadian dollars. When ‘corrective domestic action’ had been taken (or forced) upon Canada, the idea was that the Canadian dollars acquired could be recycled to the central banks of trading partners who needed Canadian dollars thus cancelling the (dollar) debt incurred – so the theory went. What if the dollar debt incurred from these actions couldn’t be repaid from a lack of return flows? The central banks involved were ‘relieved’ of the problem and the (foreign currency) debt transferred to the relevant treasury. In early 1963, when a repayment of the swap with the Swiss National Bank was looking unlikely due to no return Swiss franc flows, the Treasury issued a 564 million franc (\$129 million) ‘Roosa’ bond (named after Robert Vincent Roosa, Treasury Undersecretary for Monetary Affairs under Kennedy.)

By the mid-1970s, this when-needed central bank-to-central bank swap network had ballooned to over \$20 billion. It’s worth highlighting that \$50 million in 1963 could be exchanged for c.43 tonnes of gold and that \$20 billion in 1975 could be exchanged for c.4,300 tonnes of gold. The fiat swap network was trying to stay ‘ahead’ of the amount of gold it could control. When swap facilities were used to defend currency parities, often was the case that substantial foreign currency debts built up sooner or later with the Treasury. This makes perfect sense if we take a step back and appreciate that the initial threat to the parity was from America’s balance of payment problems! When all of this is added together, it’s no surprise that the fiat of maintaining ‘35 American numbers’ (dollars) to an ounce of gold fell apart in August 1971.

What’s the relationship between central banks now? They aren’t as open about their actions as they were back then, but it wouldn’t be surprising if the swap network is still very much there...and very much active. With no ‘parity’ against gold, foreign currency central bank debts could quite easily be offset against each other and disappear – if not currently then perhaps at some point in the future if the return flow of currency comes.

This shows an important facet of fiat: it came from nothing...and that's where it's itching to return dragging us all with it.

(†) *The Arena of International Finance*, Charles A. Coombs. John Wiley & Sons, 1976.

