MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held on Monday, July 9, 1973, at 4:30 p.m., at the call of Chairman Burns. This was a telephone conference meeting, and each individual was in Washington, D. C., except as otherwise indicated in parentheses in the following list of those participating:

PARTICIPATING:

Mr. Burns, Chairman
Mr. Hayes, Vice Chairman (New York)
Mr. Brimmer
Mr. Daane
Mr. Francis (St. Louis)
Mr. Holland
Mr. Mitchell
Mr. Morris (Boston)
Mr. Sheehan
Mr. Clay, Alternate for Mr. Balles
Mr. Winn, Alternate for Mr. Mayo (Cleveland)

Mr. Broida, Secretary
Mr. Altmann, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Bryant, Associate Economist
Mr. Coombs, Special Manager, System Open Market Account (New York)
Mr. Bodner, Deputy Special Manager, System Open Market Account (New York)

Mr. Coyne, Assistant to the Board of Governors
Messrs. Gemmill and Pizer, Advisers, Division of International Finance, Board of Governors
Mr. Pardee, Assistant Vice President, Federal Reserve Bank of New York (New York)
Mr. Balbach, International Economist, Federal Reserve Bank of St. Louis (St. Louis)

Chairman Burns said he had called this meeting to discuss System intervention in the foreign exchange market and certain related developments. He assumed that everyone participating fully appreciated the importance of preserving the confidentiality of the discussion. At the outset it might be useful to have a brief report on recent developments in the foreign exchange market, which he would ask Mr. Bryant to deliver.

Mr. Bryant observed that the dollar had declined sharply last week on exchange markets in continental Europe. During the week it dropped more than 10 per cent relative to the Swiss franc, more than 9 per cent against the German mark and French franc, and about 6-1/2 per cent relative to the Dutch guilder and Belgian franc. Trading in those currencies had become increasingly disorderly during the week; it was characterized by large, rapid, and erratic swings in rates and sporadically active but generally moderate to light trading volume. Conditions were particularly bad on Friday; several observers had described the market on that day as in a state of real panic. This morning the dollar opened sharply higher in Europe, following the release late yesterday at the Basle meeting of central bank governors of a statement which the members no doubt had seen. That statement reaffirmed a statement in the communique issued at the March 16 meeting of Finance Ministers and governors to the effect that "official intervention in exchange markets may be useful at appropriate times to facilitate the maintenance of orderly conditions," and it added a sentence indicating that the necessary technical arrangements were in place to implement the intervention that was agreed upon in principle in Paris. Later in the morning the dollar lost nearly all of its early gains in uncertain and confused trading in Europe. However, it then started to move up again, at about 11 a.m. New York time, after a news dispatch from Switzerland quoted "informed sources" as predicting U.S. intervention in support of the dollar "very soon." Other reports of a similar nature subsequently emanated from various European capitals, and the dollar continued to rise this afternoon. Compared with Friday's closing levels, the dollar had gained about 3 per cent relative to the mark, French franc, and guilder, and more than 2 per cent relative to the Swiss and Belgian francs. The Federal Reserve had received confidential information that the German Federal Bank purchased $34 million in dollars today in Frankfurt, acting without public announcement through an agent.

In reply to a question, Mr. Bryant said it was his impression that market participants were not aware of that purchase. However, Mr. Bodner might have better information on the matter.

Mr. Bodner said it appeared to him also that the market was not aware of the German intervention. As far as the New York Bank had been able to ascertain, there had been no corresponding intervention by other central banks today. The improvement in the dollar over the course of the afternoon seemed to reflect a spate of rumors about imminent intervention by the Federal Reserve and increases in the System's swap lines.

Chairman Burns noted that Messrs. Daane, Coombs, and Pardee had just returned from the governors' meeting in Basle. He invited Mr. Daane to summarize developments at the meeting.

Mr. Daane noted that the governors had held a long session yesterday afternoon, and an even longer evening session which ended about midnight Basle time. At the afternoon session there was a strong consensus among those present--setting the U.S. representatives aside--that the time had come for intervention by the United States, with such supporting actions by other central banks as seemed appropriate. The evening session was devoted to the language of a possible communique. Between the two sessions the Europeans had prepared a draft that would have made it quite clear that intervention was imminent. However, the final text, which Mr. Bryant had cited, said simply that technical arrangements were in place.

The Chairman then noted that Mr. Coombs had held discussions during the weekend with officials of certain European central banks about an exchange risk formula to replace the revaluation clause in the System's swap contracts with those banks. He asked Mr. Coombs to report the outcome of those discussions.

Mr. Coombs remarked that it had been agreed in the negotiations, which had been held with representatives of the central banks of Germany, France, Belgium, and the Netherlands, that the simplest and most effective way of dealing with the question would be to omit from the text of the swap arrangements any references to formal revaluations or devaluations and to provide simply for equal sharing of any profits or losses on System drawings that resulted from movements in market rates. It was understood that any System drawings would be repaid within six months unless both parties agreed to an extension, and that the foreign currency needed to effect repayment would be acquired in the market or directly from the central bank concerned; in other words, that reserve assets would not be used. There was an understanding that the formula was a temporary one; it was subject to renegotiation on short notice at any time, and in any event it would be reconsidered at the end of September.

Mr. Coombs added that he had met on Saturday afternoon with the heads of the foreign departments of the major European central banks to discuss the possibility of intervention, the kinds of risks involved, and the operating procedures that might be followed. The Europeans pressed for intervention, believing that the appropriate time had come. In the review of risks no points were raised that had not already been thoroughly considered. As to operating procedures, it was suggested that if the Federal Reserve began intervening in the New York market at, say, 9 a.m. one morning, the Europeans would follow through in their markets the next morning, backing up whatever gains the System had been able to achieve. In his judgment, the behavior of the market today revealed what the participants wanted--namely, some assurance of official interest in the level of exchange rates. Today's market behavior was in reaction to rumors; in his judgment much larger reactions could be expected to actual operations, and to the announcement of swap line increases indicating that large sums were available to finance such operations. In his view the iron was hot and this was the time to hit it.

In reply to a question by Mr. Holland, Mr. Coombs said that any operations undertaken by the European central banks in their markets would be for the account of those banks and not for System account. Accordingly, the provision for sharing profits and losses would not apply to those operations.

Mr. Daane noted that some European central banks had in fact proposed that the formula for sharing equally both profits and losses apply to operations by the Europeans as well as to those by the System. The U.S. representatives had indicated that such an arrangement would not be acceptable and the proposal was withdrawn.

The Chairman reported that the Subcommittee of the Open Market Committee had met earlier in the day--with Mr. Hayes participating from New York by telephone conference arrangement--to consider the proposals Mr. Coombs had described for sharing exchange risks and for the other terms under which the System would draw on its swap lines in order to finance exchange market intervention. After reviewing the matter in some detail, the Subcommittee had approved the proposals.

The Chairman then observed that it would be helpful to the Committee to have Mr. Coombs describe his present thinking about the possible manner and scale of intervention. The members recognized, of course, that actual operations would depend on prevailing conditions and might be affected by unexpected developments.

In reply, Mr. Coombs said the thought uppermost in his mind--and probably also in the minds of his counterparts in European central banks--was the need for caution. He would propose to start off quietly, probing the markets for three currencies--German marks, French francs, and Belgian francs--to get some impression of how the balance between supply and demand was moving. If the market appeared vulnerable at some point, he would propose to make large offerings of foreign currencies. He did not believe that actual sales of currencies would be very large, and he would not propose to chase exchange rates very far; the purpose would be to make the System's presence known and to indicate to market participants what might happen on some future occasion. If, on the other hand, the market appeared to be resistant, he would not attempt to push it against its will; there would be no point in contending with basic forces.

The basic objective, Mr. Coombs observed, would be to influence market psychology, by providing evidence of official interest and concern. Obviously, psychology could also be heavily influenced from moment to moment by developments of other kinds, but with some good fortune, System operations could make a very important contribution.

Mr. Francis asked whether the goal would be to stabilize exchange rates near their present levels or at some other point.

Mr. Coombs replied that in his judgment, and in that of European central bank officials, the existing exchange rates for the dollar were distorted; in terms of underlying relationships those rates should be much higher than they were. If the market atmosphere could be changed by official operations rates would, he believed, move on their own to what could be fairly described as more normal levels.

Mr. Morris asked about the Treasury's attitude toward intervention by the System.

Chairman Burns replied that the Treasury was sympathetic to intervention, but had not yet arrived at a final position because the Secretary wanted to discuss the matter with the President.

Mr. Morris then asked whether a press release regarding System intervention was contemplated and, if so, what it might say.

The Chairman replied that decisions on that question had not yet been made. If operations were undertaken there no doubt would be some sort of public statement, but it was not clear whether it would be a press release or a less formal statement. The nature and timing of an announcement would be discussed if and when word was received that the President had approved intervention.

Mr. Francis remarked that it was still not clear to him whether the System would have some specific exchange rate target in view--for example, to reverse the declines in rates for the dollar that had occurred over the past week.

Mr. Coombs observed that the objective would be not to establish any artificial pattern of rates but rather to dissipate the present speculative fever and to push rates in the general direction of the levels that would equilibrate underlying supply and demand relationships.

In reply to a question by the Chairman, Mr. Coombs said that the levels at which exchange rates would eventually settle would be determined by market forces.

Mr. Francis remarked that one might attribute the present levels of exchange rates to the workings of market forces.

The Chairman commented that the present situation was one in which speculators, having no confidence in currencies or governments, were moving from one currency to another. Perhaps such a situation could be said to reflect "market forces," but it could also be described as chaotic. The purpose of intervention would be to restore some order to the market.

Mr. Francis observed that the experience of the past several years was not such as to lead to great confidence in the results of another effort at intervention.

Chairman Burns commented that there was support for that observation. However, there also was support for the observation that the recent experience with floating exchange rates had not been a very happy one.

Mr. Francis then remarked that there were elements in the present situation that lay far beyond the reach of foreign currency operations. As a nation, the United States wanted to sell goods abroad in order to restore its trade surplus; but, paradoxically, embargos had been placed on certain goods that the country's trading partners particularly wanted to buy. When one considered also the absence of real progress in solving the problem of inflation, it seemed likely that any gains from intervention would prove to be temporary.

The Chairman said he would agree that little long-run gain could be expected from intervention unless it were accompanied by effective measures in the area of domestic economic and financial policy. He would add, however, that work was going forward on the development of a domestic program. While he could not predict the outcome of that work, he was hopeful that basic decisions would be reached soon and that they would prove to be constructive.

Mr. Hayes remarked that he endorsed the proposal for intervention with enthusiasm. As Chairman Burns and Mr. Daane would recall, as early as the ABA's International Monetary Conference --held in Paris in early June--questions were being raised about the possible need for official action. Since then, as the disorder in the market increased, the belief that official action was needed had become increasingly widespread. He thought action now would be timely and highly beneficial.

Mr. Winn said he was not sure he fully understood the responses to Mr. Francis' questions about the objectives of intervention. Specifically, it was not clear to him how far the System would go in terms of the magnitude of the rate movements to be sought.

In reply, Mr. Coombs said he thought it would be necessary to make decisions on a day-to-day basis; since market conditions would undoubtedly be changing, it would seem futile to attempt today to establish any specific rate targets for, say, one, two, or three weeks from now. If intervention had the hoped-for effects on confidence, a relatively small push now and then could result in a substantial change in exchange rates. If rates tended to become sticky, reflecting continuing heavy demands for European currencies, it would be desirable to step back and reassess the situation. At present, he would not be inclined to recommend large-scale intervention if there appeared to be continuing strong pressures against the dollar. An important question would relate to the origins of any such pressures.

In reply to a question by Mr. Francis, Mr. Coombs said the U.S. balance of payments would not necessarily be one source of pressures against the dollar; it appeared that payments were in balance--and perhaps even in surplus--in the second quarter. More likely sources were psychological factors of various kinds, such as uncertainties regarding the probable effectiveness of Phase IV. As those uncertainties were clarified their influence on the market would change, and it would be important that the Desk's tactics remain sufficiently flexible to adapt to such changes.

Mr. Daane said he was persuaded, both by first-hand observation and by analyses presented at the Paris meeting of Working Party III and elsewhere, that current exchange rates for the dollar did not reflect fundamental market forces; rather, they reflected psychological factors relating to confidence. He agreed that it would be undesirable to try to offset any massive pressures against the dollar that might emerge, but he believed that the problem was not of that type. The basic problem, in his view, was the widespread feeling abroad that the United States had not been evidencing a sense of a responsibility for the dollar.

Chairman Burns added that the demonstration that this country cared about the value of its currency and was ready to protect that value, at least to some degree, could have a salutary effect on attitudes toward the dollar around the world.

Mr. Hayes concurred in the Chairman's observation. He added that a public announcement of the contemplated expansion in the System's swap network could, in itself, have a highly beneficial effect on market attitudes.

Mr. Coombs said he might take this occasion to report on the present status of the negotiations regarding swap line increases. As the members would recall, at the March 20 meeting he had been authorized to negotiate increases aggregating up to $6 billion, with the changes in individual lines subject to the approval of the Chairman. At the June 19 meeting he had reported that tentative agreements had been reached for increases aggregating $5,950 million in eight swap lines; and at that meeting the Committee had authorized him to negotiate increases of $50 million each in five additional lines. During the weekend in Basle the Dutch had indicated that they were prepared to expand their line with the System only by $200 million, rather than by $400 million as previously contemplated. In the interest of the objective he had mentioned in earlier discussions, of bringing the size of the total swap network close to $18 billion, he proposed to compensate for the cutback in the Dutch increase by expanding one of the System's two lines with the BIS by $250 million.

Chairman Burns remarked that the proposed change from the list of increases discussed earlier appeared to be minor, and he saw no problems with it.

> Secretary's Note: Following this meeting, Chairman Burns, pursuant to an action of the Committee on March 20, 1973, approved the following increases in System swap lines, and the corresponding amendments to paragraph 2 of the authorization for foreign currency operations, effective July 10, 1973: $1 billion each in the lines with the central banks of Canada, France, Germany, and Japan; $750 million in the line with the Bank of Italy; $400 million each in the lines with the central banks of Belgium and Switzerland; $250 million in the line with the BIS providing for swaps of dollars against "other" European currencies; and $200 million in the line with the Netherlands Bank. Effective the same date, and pursuant to an action of the Committee on June 19, 1973, the swap lines with the central banks of Austria, Denmark, Mexico, Norway, and Sweden were increased by $50 million each and paragraph 2 of the authorization was correspondingly amended. Accordingly, effective July 10, 1973, the table in paragraph 2 of the authorization for foreign currency operations was amended to read as follows:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	2,000
Bank of France	2,000
German Federal Bank	2,000
Bank of Italy	2,000
Bank of Japan	2,000
Bank of Mexico	180
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	1,400
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against other European currencies	1,250

With respect to Mr. Hayes' comment, the Chairman continued, the question of the form and timing of an announcement regarding the swap network expansion, like that concerning a public statement on intervention, would be taken up after a final decision had been reached regarding intervention.

Mr. Morris remarked that he had raised a question earlier regarding a press release on intervention because he believed it would be important to make it clear to the public that the System was acting to calm disorderly markets and was not trying to peg exchange rates.

The Chairman said he agreed with Mr. Morris. He asked whether Mr. Coombs did also.

Mr. Coombs replied affirmatively. He added that, because market participants were inclined at the moment to take a skeptical view of official statements, any detailed exposition of objectives or of ground rules for intervention was likely to be counter-productive; to achieve the maximum impact on market attitudes it would be desirable to let the System's actions speak for themselves and to say very little. In his judgment it would be best in any announcement to rely mainly on a reference to the statement in the communique issued at the Paris meeting of Ministers and governors last March to the effect that official intervention might be useful at appropriate times to facilitate the maintenance of orderly market conditions.

Chairman Burns observed that in a discussion earlier today Board members had agreed that he alone should be responsible for any announcements or public statements that might emanate from the Federal Reserve on the subject under discussion. He asked whether other Committee members would have any objection to such a procedure.

No objections were expressed.

The Chairman then said he would like to turn to two other procedural matters. First, he thought it would be desirable for Mr. Coombs to make daily reports to him with respect to foreign currency operations. He, in turn, would undertake to keep the other members of the Subcommittee--Messrs. Hayes and Mitchell--informed.

It would be understood that if at any time any member of the Subcommittee had a question about operating procedures or objectives, a meeting of the Subcommittee would be called promptly to discuss that question.

In response to the Chairman's inquiry, Messrs. Hayes and Mitchell indicated that such a procedure would be satisfactory to them.

Chairman Burns noted that the second procedural matter related to the Committee's foreign currency authorization and its foreign currency directive, under which the Special Manager's operations were conducted. In view of recent changes in the international monetary environment, he believed it would be useful to have the staff reappraise those instruments and develop tentative drafts of revised instruments for consideration by the Committee.

There was general agreement with the Chairman's suggestion.

Thereupon the meeting adjourned.

Secretary