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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

December 15, 1961.

REC'D IN RECORDS SECTION
DEC 18 1961

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

For your information, there is enclosed a copy of a memorandum from Mr. Thomas to Chairman Martin dated December 14, 1961, relating to Federal Reserve holdings of foreign currencies.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure.

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CONFIDENTIAL (F.R.)

December 14, 1961.

REC'D IN RECORDS SECTION
DEC 18 1961

To: Chairman Martin

From: Woodlief Thomas

Attached is an attempt to present a simplified theoretical basis for Federal Reserve holdings of foreign currencies, that might be helpful in clarifying, what seem to me to be, the most important reasons for favoring the proposal

Attachment

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CONFIDENTIAL (F.R.) December 14, 1961.

MONETARY PRINCIPLES UNDERLYING FEDERAL
RESERVE HOLDINGS OF FOREIGN CURRENCIES

Discussion of the proposal that the Federal Reserve should buy, sell, and hold foreign currencies has failed to elicit a consensus of views among System officials. Perhaps an explanation for this failure is that there has not been presented an acceptable broad, but relatively simple and understandable, monetary principle or theory that can serve as a basis for such action. The proposal has been discussed mainly in terms of procedures, operations for specific detailed purposes (some of which may be questionable or at any rate unappealing or not understood), legal aspects, and organizational features. These aspects are important, but the questions and doubts they raise might be resolved more easily if there were general recognition and acceptance of some broad principle or purpose that the operations are intended to serve.

I would suggest two general propositions as reasons for Federal Reserve holdings of foreign currencies. The first concerns the general monetary function of such holdings; the second, what agency of Government should perform this function.

(1) Monetary function of foreign currency holdings. Holdings of convertible foreign currency in some highly liquid form by a monetary authority should be viewed as complementary to holdings of gold. Acquisition of foreign currency holdings by a central bank has the same domestic monetary effect -- on bank reserves

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and the money supply — as acquisitions of gold. Sale of such currencies is likewise similar in its consequences to sale of gold. Differences in monetary effects of international settlements through shifts in gold holdings as compared with those effected through foreign exchange holdings by monetary authorities depend on supplementary actions of the authorities in offsetting domestic money market effects. Gold losses are more likely to induce restrictive policies than are increases in liabilities to foreigners, and conversely additions to gold stock might permit or encourage less restrictive policies than would reductions in foreign liabilities or increases in holdings of foreign assets.

In the world as it will grow and develop, and probably as it is now, the available supply of gold is likely to be inadequate by itself to provide all the monetary reserves needed or desired by all countries. It is essential, and will become increasingly so, that there be a broader international monetary base, capable of expansion to meet the needs of a growing world economy but at the same time subject to strict and well recognized disciplines of control. Unless and until some more satisfactory and acceptable method is devised, this broader international monetary base can be provided through the holding by some countries of part of their reserves in other currencies the convertibility of which is unquestioned.

As various countries build up their reserves, the number of currencies that might qualify as reserve currencies may increase. Can the United States continue to insist that its reserves should

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be all held in gold, while expecting other countries to hold some of theirs in dollars? If all countries insisted on holding only gold, the available monetary gold stock of the world would become more widely distributed and the U.S. gold stock would be greatly diminished.

As opportunities arise, the United States might build up some reserves in foreign currencies. It would be preferable to acquire them in lieu of gold at times when the United States has a positive balance of payments. At present this appears to be a remote possibility. In order to establish the precedent and the principle, however, small amounts of foreign currencies might be acquired, even though the effect — directly or indirectly — might occasionally mean some further loss of gold. Any such gold shifts might serve to strengthen other currencies and widen the base of convertible currencies. Foreign currencies could also be acquired through direct exchanges for dollars with other central banks.

In the future, as the U.S. balance of international payments fluctuates in amount and at times shifts back and forth from negative to positive, decisions may be made as to the extent to which balances will be settled through changes in foreign currency holdings or in gold. Standards for making these decisions would have to be evolved. Some of those have been mentioned in previously submitted memoranda on the subject.

One guiding principle might be that movements due to clearly transitory factors, which temporarily place more demands on the foreign

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exchange market than the customary factors in that market can be expected to absorb, might be settled through central bank foreign exchange operations rather than through gold movements. Examples of typical kinds of considerations for settling through foreign exchange holdings rather than through gold would include:

(a) Regular seasonal, or perhaps clearly cyclical, movements of funds between currencies. As in the case of domestic open market operations, the bulk of Federal Reserve or other monetary authority transactions in foreign exchange might fall in this category; there is little or no reason why shifts in gold holdings should be used for such settlements;

(b) Avoidance of gold drains that might induce short-run psychological, confidence, or expectational effects which would stimulate capital flight;

(c) Avoidance of undue exchange rate movements -- in spot or perhaps more usefully in forward rates -- that might have transitory psychological effects of an undesirable nature.

(2) <u>Should the Federal Reserve or the Treasury perform the task of holding foreign currencies?</u> If the operations are viewed as the performance of a monetary function, it is altogether appropriate for the Federal Reserve to hold and operate in foreign currencies. Under existing practices, for all practical purposes, gold movements are rather quickly and fully reflected in the Federal Reserve position

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and in the reserve base of the banking system, unless offset by other Federal Reserve operations. Generally the Treasury fairly promptly monetizes any gold it acquires, in order to raise funds to pay for it; conversely it must reimburse the Federal Reserve for any gold it sells. Treasury intervention in the process, from a monetary standpoint, is little more than a fiction.

To be sure, the Treasury may pay for gold out of its revenues or the proceeds of borrowings, and the Treasury did undertake to "sterilize" gold in this manner on a substantial scale for a brief period in the 1930's. Its operations of this nature recently, however, have been confined to the limited resources of the Stabilization Fund. The British Government has handled its gold holdings in such a manner. This is an unnecessary process, however, as long as the central bank has adequate means for regulating the availability of bank reserves.

Since official operations in foreign exchange would be in essence complementary to, or substitutes for, gold movements, there is no monetary reason why they should not be carried out directly by the Federal Reserve. Treasury intervention would be unnecessary. Even if it were desired that such operations have no monetary effect, this purpose can be accomplished through Federal Reserve operations of an offsetting nature.

Any such operations conducted by the Federal Reserve should be governed by monetary and other economic standards and not by political considerations. They should be subject to the discipline

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of most of the recognized "gold-standard rules of the game", modified in view of the broadened base and techniques of operations. They should be confined to currencies with assured convertibility prospects and not be used to bolster currencies of countries in or approaching a state of fundamental disequilibrium. The Federal Reserve could conform to and enforce such standards more easily than the Treasury.

If it be desired, as a matter of Governmental policy, to undertake such operations for political purposes or to support dangerously weak situations, then the Treasury might appropriately conduct them. Distinction should be maintained, however, between Federal Reserve holdings of foreign currencies, that should rightfully be considered as a part of the basic monetary reserves along with gold, and operations by the Treasury for purposes of aiding weak situations.

Conclusion. If these underlying principles are recognized and observed, a strong case can be made for having the Federal Reserve gradually acquire holdings of foreign currencies. These holdings could be viewed as complementary to gold reserves and be increased or decreased as the balance of payments varies and as particular currencies are needed or are in supply. Such operations should be subject to a well-recognized and generally accepted set of disciplinary rules.

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Moderate operations of this nature could be conducted under existing law, but sooner or later, new legislation should be obtained for two purposes: (1) Needed as soon as possible is authority for the Reserve Banks to hold Treasury bills issued by other governments, and (2) eventually, permission for foreign currency holdings to be counted as reserves by the Reserve Banks (or a lowering or abolition of the gold reserve requirement) may be necessary. Arrangements of this or a similar nature will most likely be needed at some time in the next decade to assure adequate international liquidity reserves.