

CONFIDENTIAL (FR)

July 28, 1965

To: Federal Open Market Committee

From: C. A. Coombs

The latest Basle meeting provided an opportunity to discuss with representatives of the German Federal Bank the problem created for the System by inflows of dollars to Germany from third countries. This problem had been clearly demonstrated in the flight from the lire last year, and there was the possibility of speculative pressures building up against other currencies in the months ahead. As authorized by the Committee at its meeting on June 15, 1965, I raised on an informal basis the possibility of the System's temporarily relinquishing a portion of its swap line with the Federal Bank on the understanding that the Federal Bank in turn would provide bilateral credit facilities in the same amount directly to the country from which dollars seemed to be coming. Without committing themselves immediately on this particular approach, the German representatives did indicate that the Bundesbank might be prepared to contemplate an increase in its swap line with the System in the amount of \$250 million equivalent, thus raising the total to \$500 million equivalent, to better accommodate potential inflows of dollars from countries other than the U.S.

From the point of view of the System, such a doubling of the German swap line would not only be a useful preliminary step in anticipation of a possible multilateralization of the swap line, but would in any case bring the German swap into more balanced alignment with our other

-2-

swap partners, particularly the Italians and the British. Moreover, at a time when the markets and the world press are full of rumors about an impending breakdown of international financial cooperation, positive action to reinforce the network of central bank cooperation would be of great value. I therefore request that the Special Manager be authorized to negotiate an increase in the swap line with the German Federal Bank to \$500 million equivalent.

In the course of conversations at Basle earlier this month, it also became clear that the Management of the Bank for International Settlements would welcome an opportunity to participate on a larger scale in the network of inter-central bank swap arrangements. At present, our swap facilities with the BIS amount to \$150 million equivalent in Swiss francs. The fact that this swap was denominated in Swiss francs was partly a matter of geographical accident; the BIS happened to be located in Switzerland. There is no inherent reason, however, why the BIS could not obtain other European currencies through bilateral arrangements with the central banks concerned just as it now obtains Swiss francs on our behalf from the Swiss National Bank. The added flexibility of an arrangement of this type would clearly be of advantage to the System, since it could be used to supplement the facilities available on a direct basis with any of our present partners.

Experience has shown that temporary market strains can at times exhaust these direct facilities, particularly in the case of the Dutch guilder and Belgian franc. When the swap line proved inadequate in the past, the System has sometimes turned to forward operations as an alternative

-3-

method of reducing accumulations of uncovered dollars in official reserves. This was the case, for example, with our forward guilder operations this past winter. Such operations, however, may not always be feasible since they depend on favorable market conditions.

In the tentative discussions with the BIS in Basle, it was suggested that the present swap arrangement be increased by \$150 million equivalent to \$300 million equivalent, it being understood that this additional facility would be used by the System to acquire currencies other than Swiss francs--provided, of course, that these currencies are among those in which the Federal Reserve Bank of New York has been authorized to operate under the continuing authority directive. If and when the System wished to avail itself of this additional facility--which would generally be only when the needed currencies were not readily available under the direct swap lines with the central banks in question--the BIS would undertake to obtain the desired currency from the central bank concerned, on the understanding that each case would be weighed on its own merits. We understand that the Netherlands Bank and the Belgian National Bank would be agreeable to an arrangement along these lines, and there is no reason to believe that other central banks--with the possible exception of the Bank of France--would not give sympathetic consideration to BIS requests on this basis. I therefore recommend that the Committee also authorize the Special Manager to negotiate an increase in the swap line with the BIS on the terms outlined above.

-4-

In view of the prevailing uncertainty in exchange markets, it is believed that consummation and announcement of the proposed swap supplements would have a salutary psychological effect. Moreover, the possibility cannot be excluded that utilization of the supplements might become advisable to avert acute unsettlement in exchange market conditions. For these reasons it seems desirable to obtain Committee approval before its next scheduled meeting on August 10, 1965.