BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

April 27, 1966.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

Enclosed is a copy of a memorandum by Mr. Furth entitled "Questions Relating to the System's Foreign-Exchange Operations" and addressed to Mr. Young. It is being distributed for use of the Committee in further consideration of the matters discussed in Mr. Baker's memorandum of March 21, 1966 and Mr. Coombs' commentary thereon of April 8, 1966.

Robert C. Holland, Secretary,
Federal Open Market Committee.

April 27, 1966

To: Mr. Young

From: J. Herbert Furth

Subject: Questions relating to the System's foreign-exchange operations.

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Mr. Baker's memorandum on "Federal Reserve Operations in Foreign Exchange, 1962-1965" and Mr. Coombs' comments on that memorandum (dated April 8, 1966) combine to focus attention on some important questions about those operations. The differences in opinion between Mr. Coombs and Mr. Baker seem largely to stem from differences in the interpretation of the Committee's intent, as expressed in the record and especially in the instruments governing the System's foreign-exchange operations.

At some points, the disagreements between Mr. Coombs and Mr. Baker appear to result from mutual misunderstandings. Thus, Mr. Baker seems to have misunderstood comments on his earlier drafts, and therefore left in his memorandum a misstatement regarding an alleged exposure of the System to exchange risks within the exchange spread in connection with forward operations in Netherlands guilders. Mr. Coombs has rightly called attention to this mistake; but in turn, he seems to have misunderstood the gist of the questions Mr. Baker has asked in this connection--questions that have little to do with the problem of exposure to exchange risk in that particular case but are concerned with the interpretation of the concept of "temporary" flows of funds.

The following remarks are designed to abstract from such misunderstandings and to restate those issues that may be considered most relevant in substance.

1. Forward operations in Netherlands guilders--Mr. Coombs and Mr. Baker agree that these operations started in late 1964 and were not liquidated until mid-1965. Mr. Baker raises the questions, first, how the term "temporary" in reference to flows of private funds or increases in foreign official dollar holdings should be applied to operations other than swap drawings, and second, how this term should be reassessed under changing market conditions. Both questions seem to be worthy of the Committee's consideration.

2. Forward operations in sterling, 1964--Mr. Coombs and Mr. Baker agree that these operations were started in August 1964 and liquidated in November 1964, although by that time sterling was experiencing a serious crisis. Mr. Coombs rightly asserts that this liquidation did not harm the Bank of England because its effects were negligible in comparison with the increase in credit lines granted to the Bank of England at the same time. But Mr. Baker does not contend that any harm was done in this particular case; rather, he raises the question of whether the System should not avoid the risk of harm in appearing to work at cross purposes with a friendly central bank. Again, this question seems to be worthy of the Committee's consideration.

3. Forward operations in Italian lire--Mr. Baker asks whether "the guarantee against loss in the case of dollar devaluation for so large a block of Italian forward contracts does not establish an undesirable precedent." Mr. Coombs denies the undesirability of the precedent because "the central feature of the joint Treasury-Federal Reserve exchange operations undertaken over the past five years has been the offer of exchange guarantees to foreign central banks in the form of swap drawings, forward market contracts, and foreign currency bonds." In the existing instruments, however, the Committee has not authorized guarantees in those forms without restrictions; on the contrary, it has generally laid stress on restricting the System's foreign-exchange operations to specific circumstances, e.g., to "disequilibrating fluctuations in the international flow of payments . . . and especially those that are deemed to reflect temporary forces or transitional market unsettlement" or to "abrupt changes in spot exchange rates" (Authorization, Section III, points 1 and 2).

Mr. Baker asserts that no such specific circumstances were present in the Italian case, and Mr. Coombs does not contend that they were. Hence, Mr. Coombs' remarks conceivably could be interpreted as meaning that he would be prepared to offer similar guarantees to any foreign central bank requesting them, not only for its own dollar holdings but also for those of the foreign country's commercial banks, and perhaps not just for 3 - 12 months but indefinitely. On such an interpretation the System would stand ready to give some form of exchange guarantee for the full $21 billion of short-term dollar assets held by foreign central and commercial banks. While this presumably is not Mr. Coombs' position, it seems important, as a matter of planning, to consider the conditions under which the System would be prepared to give such guarantees.

4. Initiation and liquidation of swap drawings--Mr. Coombs and Mr. Baker agree that a certain fraction of swap drawings will inevitably need to be repaid from extraneous sources rather than by means of a reversal of the flow of funds that was the initial cause of the drawing. They also agree that in all cases the drawings succeeded in forestalling gold purchases of the foreign central bank concerned. Mr. Baker believes, however, that the System's operations were not generally effective in "encouraging foreign official holding of uncovered dollars." Mr. Coombs argues that the System's operations are not designed to establish a "link" with foreign willingness to hold uncovered dollars.

It may well be contended that--while forestalling foreign gold purchases is obviously important and useful--one of the main basic purposes of the System's operations should be to help restore full confidence in the stable value of the dollar, and that the clearest expression of such confidence would be increased willingness to hold uncovered dollars. If the System aimed merely at forestalling foreign gold purchases, it could perhaps attain such a limited goal simply by giving all foreign official holders of short-term dollar assets an automatic exchange-value guarantee, as proposed by some eminent economists. In any event, the question of whether the System should aim merely at forestalling foreign gold purchases or, more broadly, at helping to restore full confidence in the stable value of the dollar seems important enough to warrant the Committee's attention.

5. Sterling spot sales, 1965--Mr. Coombs and Mr. Baker agree that the System reduced its spot holdings of sterling at a time when sterling was under heavy speculative attack. Mr. Coombs states correctly that the decision was properly checked "with Treasury, FOMC, and Bank of England officials," and that the action did not do any material harm to the position of sterling since its effects were more than offset by the large short-term credit granted to the Bank of England during the same period. But Mr. Baker raises a question of principle: how far should the System act to reduce the risk of exchange losses when the action threatens to put pressure on a friendly central bank in times of difficulties?

Clearly, the acquiescence of the foreign central bank cannot be decisive; the foreign central bank has no alternative but to acquiesce, especially when the System's action is accompanied by an increase in assistance in other forms. But a reduction in uncovered currency holdings, even if associated with an increase in covered holdings, is clearly a vote of non-confidence in the currency, and as such is bound to have adverse repercussions on the monetary authorities of the affected country and of third countries, and in the case of a leak--a contingency that can never be wholly excluded--on the market. This problem, too, deserves the Committee's attention.

JHF