BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



December 5, 1967

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

As you will recall, at the November 27 meeting Mr. MacLaury indicated that a memorandum from Mr. Coombs to the Committee was in preparation on the New York Bank's sterling-dollar swaps with U.S. commercial banks, for System and Treasury Account, during the week of November 20, 1967. A copy of that memorandum, entitled "Short-dated sterling swaps with U.S. commercial banks," and dated today, is attached.

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

Attachment

CONFIDENTIAL (FR)

December 5, 1967.

To: Federal Open Market Committee

From: C. A. Coombs

Subject: Short-dated sterling swaps with U.S. commercial banks.

At 4:30 p.m. New York time on Saturday, November 18, 1967, it was announced that sterling had been devalued. During much of the preceding week, market pressures on sterling had been held in check--despite widespread discussion of devaluation--by rumors that various credit packages to the U.K. were about to be announced. Then on Thursday afternoon in London (November 16) Chancellor Callaghan responded to a question in Parliament concerning the rumored credit package by saying that he could neither confirm nor deny such rumors, advised members not to believe what they read in the press, and asserted the Government would make its own decisions "in line with our understanding of the needs of the British economy--and no one else's." Under the circumstances, this reply was taken by the market as a clear signal that a decision had been taken to devalue the pound, and rumors quickly spread that any credit package was likely to be a post-devaluation affair. By the time the New York market opened on Friday, the Bank of England had already lost $600 million holding the rate at $2.7825, and the hectic selling continued throughout the day in New York. Altogether the Bank of England sold spot approximately $1.2 billion that Friday--nearly half the U.K. reserves--and early in the day provided an additional $125 million or so of support in the forward market.

With the announcement of devaluation on Saturday came word that Monday had been declared a bank holiday in London. On Sunday we learned from Bridge of the Bank of England that he intended to make it as difficult as possible for banks that had sold sterling spot (i.e., for value Tuesday) to obtain balances if they did not already have them. He not only wanted to punish speculators as such, but also recoup part of the Bank of England's Friday losses by forcing the cancellation of contracts on which sterling delivery could not be made. To this end, he planned to call a meeting of the major London dealers on Monday and instruct them 1) to sell no sterling other than for regular delivery (in this case Friday since Thursday was a holiday in the United States)--i.e., not provide any cash balances on Tuesday or one-day (Wednesday) delivery; and 2) to insure that exchange regulations prohibiting overdrafts in foreign accounts were strictly enforced.

On Sunday afternoon, George Chittenden, Vice President of Morgan Guaranty Trust Company, came to this Bank to discuss with Mr. MacLaury and myself the problem posed for his and other banks by the unanticipated closing of the London market on Monday. He pointed out that the banks had been deluged with offers of forward sterling by their clients on Friday, and that it had been impossible under the circumstances for the banks in turn to even their books (i.e., sell the sterling out) in the forward market. (Although the Bank of England claimed that it had bids for forward sterling in the market, we know that these bids were hard to find, that forward prices were not firm, and that the Bank of England in fact did relatively little business in the forward market.) If the banks wanted to continue to buy forward sterling from their clients, therefore, they had no alternative but to even out their positions by selling spot sterling before the close of business (since the Bank of England took all spot offered), even though they did not have the balances to deliver on Tuesday for the sterling sold. Ordinarily, if the London market had not been closed Monday, the banks that were short cash balances (even though their overall position was even) would have been able to buy the sterling they needed on Monday for one-day (Tuesday) delivery. These purchases would normally have been effected through short-dated--even one-day--swaps, in order to keep overall positions balanced. Indeed, the problem on Tuesday was compounded by the fact that some banks had acquired sterling balances to meet Monday's commitments through one-day swaps (buying sterling Monday and reselling it Tuesday). Since Monday was now a holiday, sterling that was supposed to have been delivered Monday was now due Tuesday, yet the cover that had been arranged for Monday's transactions was no longer available. Chittenden pointed out that it was normal practice for the banks in the first instance to sell out spot sterling to offset a forward purchase from a customer, since it was difficult even under ordinary circumstances to find a bid in the market for the same forward date. Having thus kept their overall positions in balance, the banks could match off the time sequence of their "book" through market swaps at their convenience.

It was clear that the change in the rules proposed by the Bank of England would damage not only speculators, but banks that had taken on forward sterling from their customers in good faith. The unpleasant alternative for banks that could not deliver sterling on Tuesday was either to default on their contracts, or to seek release from their spot contracts, in which case they would end up long the forward sterling they had bought from their customers at prices based on the old parity. Moreover, it was also clear that the inevitable confusion in the exchange markets following the sterling devaluation would be compounded if banks were forced into default or large losses through this change in the rules. On the other hand, we had to be sure that the predicament that Chittenden cited was not the result of poor judgment by one or two banks. Therefore, I suggested that the Foreign Exchange Committee take up this matter Monday morning and report its findings and recommendations to this Bank as quickly as possible.

The Foreign Exchange Committee met at Chase Manhattan Bank at 10:00 a.m. Monday morning under the chairmanship of Alfred Barth, Executive Vice President. A delegation of the Committee, including Mr. Barth, Chairman, and Executive Vice President, Chase Manhattan Bank; Mr. Walter H. Page, Executive Vice President, Morgan Guaranty Trust Company; and Mr. G. A. Costanzo, Senior Vice President, First

National City Bank, came to my office at about 11:00 a.m. and in essence confirmed the points discussed above. The Committee recommended that the Federal Reserve survey the banks most actively involved in foreign exchange trading. For those banks that could certify that their short cash sterling positions resulted from transactions undertaken at the initiative of their commercial customers or correspondent banks, the Committee recommended that the Federal Reserve provide the necessary balances from its own holdings by means of short-dated swaps. (See Attachment A--a memorandum by Mr. MacLaury dated November 21--for a fuller description of this meeting.)

Since we felt that the Committee's recommendations had merit, we immediately began to survey banks in this District and, through the respective Federal Reserve Banks, banks in all the other Federal Reserve Districts, to determine the magnitude of the cash problem. At the same time we contacted Bridge at the Bank of England, who said that, while he had no intention of changing his tactics generally, he accepted the logic of the Foreign Exchange Committee's position and agreed that we could use our guaranteed sterling to provide cash balances to United States banks, if we were satisfied that the short cash positions were not the result of speculation by the banks themselves.

Since the type of transaction contemplated--a short-dated swap of System sterling balances--was not explicitly provided for in the Foreign Currency Directive, the Special Manager immediately put the matter to the Subcommittee of the FOMC provided for in paragraph 6 of the Authorization for System Foreign Currency Operations. A majority of the Subcommittee concurred that the Special Manager should use his judgment in dealing with the situation. My judgment was that action should be taken immediately by the System to provide the required sterling balances to United States banks in order to avoid adding further to disorderly conditions in the exchange markets, and to avoid unjust punitive consequences for United States banks as a result of actions taken by the U.K. authorities. To insure that no relief was provided to banks that were short sterling as a result of their own actions, the following certification was required of each bank involved:

CERTIFICATION TO THE FEDERAL RESERVE BANK OF NEW YORK

The undersigned bank hereby certifies that its net position in sterling as of the close of business on Friday, November 17, was ________, and that the cash shortage for delivery on Tuesday, November 21, was the result of transactions entered into at the initiative of commercial customers or correspondent banks of the undersigned bank.

______________________
(Name of Bank)

______________________
(Authorized Signature)

______________________
(Date)

This certification was read to an officer of each bank that wished to purchase sterling from the System, and subsequently letters were received from each bank confirming this certification in writing. In cases where banks had overall short positions, an amount equal to the bank's overall short position was deducted from the amount made available by the System, except in cases where the short position could be explicitly justified by the bank in question. A list of the banks to which sterling was sold, and the respective amounts, is appended as Attachment B.

The rates applied to the three-day swaps were those obtaining in the open market insofar as these could be ascertained: The System sold sterling value Tuesday at $2.4000, bought value Friday at $2.3925. With the concurrence of the Treasury, a similar operation was carried out for Treasury account value Wednesday-Friday. The total amounts involved were $87 million equivalent for System account and $22 million equivalent for Treasury account.

I believe that these transactions helped considerably to mitigate what otherwise could have been chaotic conditions in the exchange market on Monday and Tuesday. The System's willingness and ability to move quickly to provide assistance to United States banks in an emergency was widely appreciated, as indicated in Mr. Barth's letter, a copy of which is appended as Attachment C.

ATTACHMENT A

C O P Y

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

Date November 21, 1967

To F I L E S

From B. K. MacLaury

Subject Recommendation of Foreign Exchange Committee Re Short Cash Sterling Positions.

CONFIDENTIAL

Messrs. Barth (Chase Manhattan), Costanzo (First National City), and Page (Morgan Guaranty) called on Mr. Coombs at approximately 11:00 a.m., November 20, to present the Foreign Exchange Committee's recommendation (following a discussion at Chase earlier that morning) concerning American banks' short cash positions in sterling for value Tuesday. (The general nature of this problem had been discussed by Chittenden of Morgan Guaranty with Coombs on Sunday, November 19.) Although the banks did not wish to disclose their individual positions to each other, it was agreed that because of the Bank of England's declaration of a bank holiday, November 20, in London, following devaluation of the pound over the week-end, a number of banks were caught short of cash sterling balances for delivery on Tuesday, November 21. This short cash position was the result of forward sales of sterling to the banks by their customers on Friday when the banks, in turn, could not obtain forward cover in the market. In order to keep their over-all positions even, the banks were forced to sell spot sterling for value Tuesday, November 21, even though they did not have cash sterling to deliver against these spot sales. The Committee felt that the banks had been put in this predicament through no fault of their own, and specifically not through any desire to speculate against sterling themselves. Had it not been for the bank holiday declared on Monday, and the Bank of England's unwillingness to provide cash sterling on Tuesday, the banks would have covered their cash sterling needs through short-dated swaps as was their normal practice. In order to determine the over-all size of the problem, they suggested that the Federal Reserve telephone each bank and get its short cash position for Tuesday and Wednesday. They also suggested that the Federal Reserve consider doing short-dated swaps with the banks that were short, providing the sterling from the Federal Reserve's own holdings. The Committee said that each bank acquiring sterling from the Federal Reserve on this basis would give a certificate indicating that its short cash position was the result of transactions undertaken at the initiative of commercial customers or correspondent banks.

Mr. Coombs pointed out that there were a number of problems in such an operation from the point of view of the Federal Reserve. One of the most critical was assuring ourselves that all banks with short cash positions were given equal treatment in any operation that we might undertake, and that we could determine with assurance that we were not bailing out speculators against sterling. The Committee understood these and other problems, but felt that the good name of American banks in the exchange market was at stake, that the banks were unjustly being made the scape-goat in the Bank of England's effort to make any speculators pay up and that the market would be sufficiently confused in any case that the confusion should not be compounded by broken contracts or defaults that would result from any massive failure to deliver sterling.

ATTACHMENT B

Three-day swaps for System Account
(Tuesday over Friday)

| | Amounts in pounds sterling | Dollar equivalent |
|---|---|---|
| Continental Bank International | 4,300,000 | 10,320,000 |
| The Chase Manhattan Bank N.A. | 1,700,000 | 4,080,000 |
| Irving Trust Co. | 1,493,000 | 3,583,200 |
| Harris Trust and Savings Bank (Chicago) | 70,000 | 168,000 |
| The First National Bank of Boston | 2,964,000 | 7,113,600 |
| Manufacturers Hanover Trust Co. | 400,000 | 960,000 |
| Morgan Guaranty Trust Co. of New York | 24,450,000 | 58,680,000 |
| Manufacturers National Bank of Detroit | 600,000 | 1,440,000 |
| Bank of America (New York) | 360,000 | 864,000 |
| | 36,337,000 | 87,208,800 |

Two-day swaps for Treasury Account
(Wednesday over Friday)

| | | |
|---|---|---|
| Marine Midland Grace Trust Co. of New York | 475,000 | 1,149,500 |
| Bank of America (New York) | 1,750,000 | 4,235,000 |
| Bank of America National Trust and Savings Assn. (San Francisco) | 4,250,000 | 10,285,000 |
| Manufacturers Hanover Trust Co. | 2,400,000 | 5,808,000 |
| Irving Trust Co. | 300,000 | 726,000 |
| | 9,175,000 | 22,203,500 |

C O P Y

THE CHASE MANHATTAN BANK
National Association

1 Chase Manhattan Plaza, New York, New York 10015

ALFRED W. BARTH Executive Vice President

November 22, 1967

Mr. Alfred Hayes, President
Federal Reserve Bank of New York
33 Liberty Street
New York 10015

Dear Al,

As Chairman of the Foreign Exchange Committee I should like to avail myself of this opportunity to express to you and your associates my profound thanks for the rapid and understanding cooperation which the New York market received from the Federal Reserve Bank through its Vice President, Charles A. Coombs. Had it not been for the intervention of the Fed, Monday and Tuesday of this week could indeed have been very turbulent days.

Tonight I shall be leaving the Bank for a prolonged vacation before my obligatory retirement on February 29, 1968 and I should like to suggest to you that you appoint my very able colleague and successor, Mr. Herbert Patterson, Executive Vice President as member of the Foreign Exchange Committee during the ensuing year.

It has been a great satisfaction to me to cooperate with you and your associates at the Fed and with warmest wishes, I am, as ever

Sincerely yours,

(Signed) Alfred W. Barth