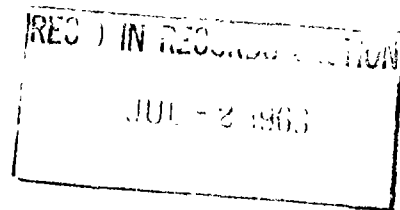




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



July 2, 1968

STRICTLY CONFIDENTIAL (FR)

Enclosed for your information is a copy of a memorandum dated July 1, 1968, from the Committee's General Counsel regarding the legality of Federal Reserve participation in a proposed arrangement for funding sterling balances. Such an arrangement is currently in process of negotiation.

Very truly yours,

A handwritten signature in cursive script that reads "Kenneth A. Kenyon".

Kenneth A. Kenyon,
Assistant Secretary,
Federal Open Market Committee.

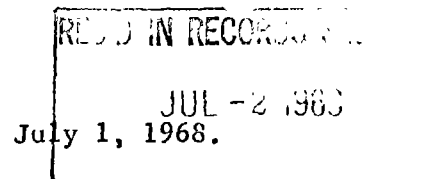
Enclosure

KAK:me

Sent to Mr. Hayes, Vice Chairman, FOMC; & Messrs. Hickman, Kimbrel, Galusha Member, FOMC; Messrs. Bopp, Scanlon, Clay, Coldwell, Alternate Member, FOMC; & Messrs. Heflin, Francis, & Swan, Presidents FRBanks of Richmond, St. Louis, & San Francisco, respectively, Mr. Latham, First Vice President, FRBank of Boston

To Messrs. Sherman, Broida, Bernard

STRICTLY CONFIDENTIAL (F.R.)



To: Board of Governors
From: Mr. Hackley

Subject: Legality of Federal Reserve participation in proposed funding arrangement for sterling balances.

Question has been raised as to whether the Federal Reserve may lawfully participate in the manner contemplated by a proposed "package" for funding sterling balances. While the question is not free from doubt, it is my opinion that such participation would be legally defensible.

Briefly, it is understood that the proposal is as follows:

The United States Treasury, through the Exchange Stabilization Fund, would enter into an arrangement with the BIS under which the Treasury would undertake to make three-month renewable dollar-sterling swaps with the BIS up to the amount of the U. S. share in the proposed package of \$2 billion. This share would amount to from \$600 million to \$700 million. Drawings by the BIS under the swap arrangement would be used to finance drawings of dollars by the Bank of England against the BIS. Such drawings by the Bank of England against the BIS and by the BIS against the Treasury could be made during a period of three years; they could remain outstanding during a succeeding two-year period; and they would be repaid in quarterly installments over the following five-year period.

If and to the extent that the resources of the ESF should become insufficient to meet drawings by the BIS, along with other commitments of the ESF, it is contemplated that the Federal Reserve would "warehouse" sterling for the ESF in an amount that theoretically could reach \$600 million or \$700 million. However, it is also contemplated

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that the Treasury would provide assurance to the Federal Reserve of its readiness to take back the warehoused sterling within a reasonably short period.

The Federal Reserve Banks have no express statutory authority to buy securities of foreign governments or foreign central banks or to make extensions of credit to such governments or banks. However, the Reserve Banks have statutory authority to purchase and sell "cable transfers" in the open market, at home or abroad, from or to domestic or foreign banks, firms, corporations, or individuals. (F.R. Act, sec. 14; 12 U.S.C. 353) They also have authority, with the approval of the Board of Governors, to open accounts with foreign banks. (F.R. Act, sec. 14(e); 12 U.S.C. 358) On the basis of these provisions, I concluded in a memorandum of November 2, 1961, that the program for foreign currency operations by the Federal Reserve would be lawful. This conclusion was concurred in by the General Counsel for the Treasury Department and by the Attorney General of the United States.

Among other features of the original program, my memorandum of November 2, 1961, dealt specifically with the question whether the Federal Reserve could lawfully purchase "cable transfers" (foreign currencies) from the Exchange Stabilization Fund. While recognizing that the question was not free from doubt, I concluded that such purchases would not fall within the restrictions of section 14(b) of the Federal Reserve Act with respect to direct purchases of Government obligations from the Treasury by the Federal Reserve. This conclusion was based on the rationale that an "open market" in cable transfers embraces any person with whom a Reserve

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Bank may feel free to deal, including the United States Treasury, that is a part of that market. A distinction was made between such transactions and purchases of obligations of the United States since the Treasury is the issuer of such obligations and, consequently, is not a part of the open market.

This conclusion was implicitly concurred in by the General Counsel of the Treasury and by the Attorney General. Consequently, despite the unusual circumstances attending the present proposal, the proposed "warehousing" of sterling by the Federal Reserve for the ESF would constitute a lawful open market purchase of foreign currency of the kind approved by these earlier legal opinions.

Administrative practice known to Congress lends legal support to this conclusion. Since February 1962, when it was first adopted, the FOMC's Authorization for Foreign Currency Operations has specifically provided that the New York Reserve Bank is authorized "to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U. S. Stabilization Fund" This statement, specifically recognizing purchases of foreign currencies from the Stabilization Fund as open market purchases, has been included each year since 1962 in the Authorization as published in the Board's Annual Reports to Congress.

The warehousing of sterling for the ESF in the manner proposed could be regarded as in actual fact a direct financing of the Treasury by the Federal Reserve, as well as an indirect extension of long-term

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credit to the Bank of England. However, for the reasons previously indicated, I believe that such warehousing by the Federal Reserve is legally defensible and would be upheld if the question should be litigated.

The law does not contain any restriction with respect to the maturity of obligations that may be purchased by the Federal Reserve in the open market (other than municipal tax anticipation obligations) or with respect to the length of time that such obligations may be held by the Federal Reserve. However, the program for Federal Reserve foreign currency operations has always contemplated that swap drawings and other foreign currency transactions should be undertaken only for reasonably short periods. For example, the Committee's Authorization specifically provides that all drawings under a swap arrangement shall be fully liquidated within 12 months, unless the Committee, because of exceptional circumstances, specifically authorizes a delay. Obviously, purchases and sales of foreign currencies by the Federal Reserve and transactions under swap arrangements may and do result in extensions of credit to foreign central banks, but such extensions have heretofore been confined to short periods of time and could properly be regarded as incidental to open market operations. An operation such as that here proposed, if it should impose upon the Federal Reserve an open-ended commitment, would constitute a radical departure from previous practice since it would be tantamount to a commitment for a period of 10 years. In such a form the arrangement might be regarded as involving an outright long-term extension of credit to the Treasury and the Bank of England rather than transactions incidental to open market operations. Consequently, question as to the

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legality of Federal Reserve participation in the plan would be substantially increased. Such questions would be lessened if provisions were included that would specifically limit any Federal Reserve holdings of sterling to reasonably short periods, such as 12 months (by analogy to the limitation with respect to swap arrangements), and that would otherwise negate any impression that the Federal Reserve was extending continuous credit over a long period of time.

If the proposal should be approved, it would be necessary to amend paragraph C(1) of the FOMC's Authorization for System Foreign Currency Operations. That paragraph now authorizes the New York Reserve Bank to have outstanding forward commitments to deliver foreign currencies to the Stabilization Fund up to \$350 million equivalent. In view of the nature of the arrangement here proposed, this figure presumably would have to be increased to \$950 million or \$1050 million. If the sterling "warehoused" by the Federal Reserve should be guaranteed sterling, it would also be necessary to amend paragraph B(3), which now limits the amount of sterling that may be purchased on a covered or guaranteed basis to \$300 million equivalent.

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STRICTLY CONFIDENTIAL (FR)

July 2, 1968

PROPOSAL FOR U. S. PARTICIPATION IN STERLING
BALANCES CREDIT PACKAGE

It is proposed that the Treasury, through the ESF, participate as principal in the arrangement with the BIS; that is, the Treasury would undertake a commitment to make three-month renewable dollar/sterling swaps with the BIS for the U. S. share (approximately \$600 million). As outlined in the BIS plan, such swaps could be drawn upon by the BIS - to finance drawdowns of sterling balances - during a three-year period and, after a two-year grace period, would be repayable during a five-year period ending ten years after the initiation of the scheme.

When and to the extent that the swap was drawn upon by the BIS, the dollars would be made available by the ESF. If the resources of the ESF are insufficient to meet these and other commitments, the Federal Reserve would be prepared to warehouse temporarily for the ESF necessary portions of the sterling it acquires as a result of the swap with the BIS.

In view of the principle that the Federal Reserve should confine its foreign operations to short-term maturities, the Treasury will provide assurance to the Federal Reserve of its readiness, upon request, to take back the warehoused sterling within a reasonably short period. In any event, the Treasury will stand ready, upon three months' prior notice, to reacquire each warehoused drawing at any time beginning one year from the date of warehousing. Any rewarehousing of sterling involved in a particular drawing will be at the discretion of the Federal Reserve.