TELEGRAM

FEDERAL RESERVE COMMUNICATIONS SYSTEM

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON

CONFIDENTIAL (FR) January 19, 1971

Hayes - New York
Heflin - Richmond
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This is with reference to possible Federal Reserve program of matched sale-purchase transactions with member banks to help moderate Euro-dollar repayments, as outlined in staff memorandum dated January 11, 1971, which Committee discussed on preliminary basis at meeting on January 12.

Considering the many factors that must be taken into account before decision can be made as to whether such a program should be implemented, and the need to coordinate plans and operations with other Government agencies interested in problem, Chairman Burns proposes the following three-stage approach to decision-making on this matter:

Stage 1: Determination as to whether a majority of Committee agrees in principle with proposed amendment of continuing authority directive as a useful contingency plan, to be acted on finally at a subsequent time if deemed necessary. If this approach seems to be a likely one to Committee, staff will continue working on it. In this connection, the draft amendment to the directive attached to staff memorandum of January 11 has been further refined, and is shown in present draft form at end of this telegram along with comments on substantive changes from previous draft.

Stage 2: (If determination under stage 1 is favorable.) Formal vote by FOMC to adopt such an amendment to continuing authority directive, thereby authorizing Subcommittee named in amendment to proceed if and as needed with actual operations. Presumably Chairman will call for this formal Committee vote if and when developments make it desirable for System to be in a position to undertake promptly such operations. If circumstances permit, formal vote will be called for only at or after a meeting at which Committee has had full opportunity to discuss matter.

Stage 3: If circumstances require, action by Subcommittee to instruct Account Manager to undertake actual operations, within limits established by amendment to directive, and with such specific instructions from Subcommittee as appear desirable.

In Chairman Burns' judgment, action under stage 1 is advisable now for purposes of orderly planning and coordination with other agencies. Mr. Solomon and I will be telephoning you later today or tomorrow to provide further background on procedure and substance. Please advise following that telephone conversation whether or not you would agree in principle, as a basis for contingency planning, to an amendment of continuing authority directive by the addition of a paragraph 4 along the following lines:

"4. For the purpose of tempering the impact of Euro-dollar movements on the United States balance of payments, the Committee authorizes and directs the Federal Reserve Bank of New York, for the System Open Market Account, to enter into special agreements with member banks ('paragraph 4 agreements') providing for the sale of U.S. Government securities by the Reserve Bank to the member bank on a cash or regular delivery basis, and for the purchase by the Reserve Bank from the member bank of the same amount of the same issues of securities within a specified period, subject to the following conditions:

"A. A member bank shall be eligible to buy and sell securities under paragraph 4 agreements in an amount equal to a specified percentage of its (1) daily average deposits subject to § 204.5(c) of Federal Reserve Regulation D, (2) daily average total of the net balances and assets described in § 213.7(a)(1) and (2) (reduced by its daily average deposits subject to § 204.5(c)), and (3) foreign branches' daily average holdings of securities under paragraph 4 agreements and the Export Import Bank program announced January 15, 1971, each for the latest computation period as described in the specified sections. The percentage, which shall be the same for all member banks, shall be specified from time to time by the Committee, or on behalf of the

Committee by a Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate).

"B. The aggregate amount of securities held by member banks under paragraph 4 agreements shall not exceed $2 billion at any time.

"C. Paragraph 4 agreements, which shall be non-transferable, shall be arranged so as to provide a net yield to the member bank closely related to the current market rate on Euro-dollar deposits of comparable maturity.

"D. Within the limitations set forth above, the terms of paragraph 4 agreements, and the timing and size of offerings of securities under such agreements, shall be subject to such directions as may be issued from time to time by the Committee, or on behalf of the Committee by the Subcommittee referred to in 4A above."

In addition to clarifying changes, text given above incorporates the following substantive changes from earlier draft:

Introductory language: Next-to-last clause calls for repurchase of securities "within a specified period" rather than "within (blank) weeks." Staff still recommends a 4-week maturity, once introductory period is passed; this change is suggested to allow for the introductory period, and other deviations from 4-week maturity that Subcommittee may possibly find desirable on technical grounds.

4A: Technical changes have been made to conform with current proposed amendments to Board regulations.

4B: Limit on aggregate amount of security holdings (left blank in previous draft) has been written as $2 billion. Staff memo had recommended an initial authorization of $1-1/4 billion, but now believes it would be desirable to permit somewhat greater leeway, to reduce possible need for later amendments to increase leeway.

4C: Text now calls for net yield to member bank "closely related to the current market rate on Euro-dollar deposits of comparable maturity"; previous draft had called for net yield "not more than (blank) basis points in excess of current market rate on one-month Euro-dollar deposits." Under previous language, staff had contemplated specifying a maximum spread of perhaps 5/8 point, although it recommended beginning actual operations with a spread of 1/8 point. Present judgment is that it would not be desirable to indicate publicly how large a spread the System is willing to allow, particularly if there is found to be no need to go as high as 5/8 point. Change from "one-month" to "comparable" maturity is suggested in view of possibility that some agreements may be for maturities other than 4 weeks.

HOLLAND

ALB:nlo

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