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

April 17, 1972

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Altmann

Enclosed is a copy of a memorandum to the Committee from Mr. Bodner, dated April 14, 1972, and entitled "Settlement of the Special Drawing with Germany." It is contemplated that this memorandum will be discussed at the meeting of the Committee on April 18, 1972.

Murray Altmann
Murray Altmann
Assistant Secretary
Federal Open Market Committee

Enclosure

CONFIDENTIAL (FR)

April 14, 1972

TO: Federal Open Market Committee

FROM: David E. Bodner

SUBJECT: Settlement of the Special Drawing with Germany

As the Committee is aware, the Account Management has for some months been discussing with representatives of the Deutsche Bundesbank the settlement of $50 million equivalent in drawings outstanding under the swap line. It has been our position that that settlement should be at a negotiated rate such that the Federal Reserve would pay the costs incurred by the devaluation of the dollar, and the Bundesbank would accept that share of the cost resulting from the revaluation of the mark. The Bundesbank has throughout insisted that it had no obligation under the revaluation clause. Following discussions at the April Basle meeting the Bundesbank -- while reasserting that position -- has offered to accept half of the loss resulting from the revaluation of the Deutsche mark. While the dollar amounts involved are not large, the Account Management regards the question as one of principle and would not recommend acceptance of the German proposal. The attached memorandum is a draft statement setting forth the Federal Reserve position regarding the settlement of the swap. It is intended that if the Committee approves this draft, it be sent (with appropriate introductory comments) to the Bundesbank in the form of a letter from the Special Manager. At the April 18 meeting of the Committee, I propose to recommend that the draft be referred to the FOMC subcommittee for consideration.

Attachment

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4/14/72

Federal Reserve Position Regarding Settlement of Swap with Deutsche Bundesbank

1. Background

On March 31 and on the first days of April 1971, a wave of speculative demand for marks obliged the Bundesbank to absorb massive amounts of dollars in holding the spot mark rate at its upper limit. On April 2 the Bundesbank sought to reassure the market of the intention of the German Government to maintain the existing parity of the mark by initiating a series of forward operations, offering three-month marks at the spot ceiling rate. After discussions between Mr. Coombs and Mr. Tungeler, it was agreed that the operation could have a greater impact on market psychology if the Federal Reserve System participated, dealing for System account, by offering forward marks at the same rate in New York after the Frankfurt market had closed.

In previous joint forward market operations by the Federal Reserve and the Bundesbank, the arrangements were such that as the System sold marks forward it would make parallel drawings under the swap arrangement. The principal reason for such drawings was to provide the Federal Reserve with protection against an unanticipated revaluation of the mark in circumstances in which the rationale of the market operation was precisely to persuade the market that such a revaluation was not being contemplated. This protection was obtained under the terms of the revaluation clause in the swap agreement. Thus, although the Federal Reserve had no need for the marks until the forward contracts matured, the swap drawings gave the System the revaluation protection it required upon entering into such a joint operation.

2. The 1971 Operation

A repetition of the earlier arrangements was considered for the joint operation in April 1971, but one of the Bundesbank's objectives at the time was to avoid further increases in its spot dollar holdings, and an immediate drawing by the Federal Reserve would have had that effect. On the other hand, it was agreed that if the Federal Reserve was to participate in forward mark sales it should be protected against any subsequent decision of the German Government to alter the parity of the mark. Consequently, it was agreed that as the System entered into contracts with the market to deliver marks three months forward, it would make simultaneous "contingent" drawings under the swap arrangement. These swap drawings would be "contingent" in the sense that they would be arranged at the time the forward sales were contracted but would be scheduled for delivery three months hence, when the marks would actually be needed. It was understood that, if in the interim the market situation reversed and the Federal Reserve was able to acquire the necessary cover in the market, the drawings would be cancelled prior to take-down. Since the Bundesbank agreed to provide the marks under the swap arrangement, the operation was brought under the revaluation clause of that arrangement. As in earlier operations this was entirely appropriate, since the objective of the operation was to maintain the German mark at its upper limit (or the dollar at its floor), within the framework of existing governmental agreements. Without such revaluation protection, any unilateral decision by the German authorities which would allow the exchange rate to move beyond the limit would expose the Federal Reserve to unanticipated losses in ultimately covering its mark commitments. When the operation was brought to an end in late April, forward mark sales by the Federal Reserve amounted to $75.7 million, of which $60 million was covered by means of "contingent" swap drawings, with the remainder to be covered out of System mark balances already on hand.

When the Bundesbank suspended trading on May 5, ceasing to buy dollars at the upper limit for the mark, this altered the situation in two ways. First, there no longer appeared to be a practical possibility of the System being able to cover its forward commitments, prior to their maturity, by buying spot marks at DM 3.63 or better in the market. The marks would have to be obtained from the swap drawings agreed upon for that contingency. Second, the risk that additions to the Bundesbank's dollar holdings would be a disturbing factor in the market was no longer relevant. Therefore, for the sake of good order the System requested that the $60 million of contingent swap drawings be activated, for value May 7, with the usual three-month maturity. The Bundesbank agreed, and the operation was confirmed by telex.

3. Subsequent Developments

On May 9, 1971, the German Government announced that it would suspend temporarily the limits around par while, however, maintaining the official parity. The government further indicated that it intended after an interim period to reestablish the previous intervention limits. The practical effect of the suspension of intervention was to permit the mark to float above the previous support range. This upward movement of the mark rate was subsequently reinforced by the Bundesbank's entering the market as a seller of dollars at premiums over the official ceiling for the mark. These circumstances prevailed through early August, when the swap drawings reached their first maturity. The Federal Reserve, regarding the situation as a temporary interruption of normal practices, proposed that the drawings be renewed on the same terms and conditions, and the Bundesbank agreed without objection or qualification. The drawings have been rolled over at each subsequent maturity, except that in November--as a gesture of good faith and an indication that it was not attempting to profit from the upward movement of the mark--the Federal Reserve used its remaining balances in hand to repay $10 million equivalent.

Taking into account the original purpose of the drawings, and the subsequent events--first, the German Government's decision in May to temporarily allow the Deutsche mark to float, later the U. S. Government's decision in August to temporarily suspend the gold convertibility of the dollar, and finally the successful negotiation of the Smithsonian Agreement of December 1971, in which both the German and American governments committed themselves to changes in the official parities of their currencies--it was consistent with the spirit of the swap arrangement to defer repayment until new parities were negotiated and ratified. The Federal Reserve regards the period subsequent to August 15 as analogous to that between May 9 and August 15--that is a period in which previously agreed exchange rates and intervention practices were suspended temporarily pending decisions on new parities. Consequently, the Federal Reserve would consider it unreasonable and contrary to both the spirit and the letter of the swap arrangement for the Bundesbank to insist that repayment should have been made in November or that repayment should now be made without the revaluation protection, it having been the primary purpose of the contingency drawings to provide just such protection.

The Federal Reserve believes it appropriate, and consistent with both the terms of the swap arrangement and the spirit of the central bank cooperation upon which that arrangement is based, that the drawings were renewed during the period of temporary floating rates and that they should be repaid on the basis of an equitable sharing of the costs arising from the parity adjustment now coming into effect. This would provide both parties with the exchange value protection accorded under the arrangement, with the Bundesbank protected against loss as a result of the devaluation of the dollar and the Federal Reserve protected against loss as a result of revaluation of the mark. The Federal Reserve has been and remains fully prepared to honor its maintenance of value guarantee on the dollars the Bundesbank holds under the swap drawings. It is clear to the Federal Reserve that the expected change in the official par value of the Deutsche mark will constitute a "revaluation" within the meaning of the original swap arrangement, and the Federal Reserve would expect the Bundesbank for its part to honor the revaluation clause of the swap arrangement. The Federal Reserve believes an equitable settlement should be reached on the basis of a negotiated rate which takes into account the official parity changes in the Deutsche mark and the U. S. dollar as determined by the Smithsonian Agreement.