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

May 14, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is a memorandum from the staff dated May 13, 1975, and entitled "Foreign Account Repurchase Agreements Handled by the Trading Desk."

This memorandum, which was prepared in response to a recent question about Desk accommodation of foreign account RP's, is being distributed for the information of the Committee. If desired, it could be listed for discussion on the agenda for a future meeting of the Committee.

Attachment

CONFIDENTIAL (FR)
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DATE: May 13, 1975

TO: Federal Open Market Committee

FROM: Staff 1/

SUBJECT: Foreign Account Repurchase Agreements Handled by the Trading Desk.

Since August 1974, the Federal Reserve Open Market Trading Desk has been regularly arranging repurchase agreements (RPs) for foreign central bank correspondents. This facility was originally offered to the accounts as a means of temporarily investing large acquisitions of dollars, particularly by oil-producing countries, until longer-term placement of the funds could be accomplished. It was visualized that in the case of large receipts of funds within a short period of time, in some cases by countries not previously accustomed to handling large flows, there could be times when Treasury bills or other securities desired by the foreign accounts might not be available in sufficiently large supply. Also, in some cases, the foreign investor might need time to decide where it wanted to place its funds. In these circumstances, it was believed that RPs could provide a temporary investment while awaiting the availability of securities that the accounts would be willing to hold on a more permanent basis, or awaiting the decision-making process by the foreign investors. Another reason for offering a repurchase agreement facility was to provide a reasonably attractive domestic alternative to temporary investments in the Eurodollar market and thus enhance foreign official interest in

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1/ This memorandum was prepared mainly by Mr. Cooper of the Federal Reserve Bank of New York. It has been reviewed by Messrs. Holmes, Sternlight, and Axilrod, who concur in the analysis.

direct U.S. dollar investments. This form of investment, it should be noted, is a common one in the money markets employed by many market participants at least since the 1950's.

Within a short period of time, the RP proved itself to be a very useful instrument for the purposes outlined above. A number of accounts used them from time to time, rolling over maturing agreements for a succession of several days, or occasionally making arrangements that lasted up to a maturity as long as 15 days, while endeavoring to determine and accomplish their longer-term investment programs. Some accounts used it at times when they could not commit funds more permanently because of uncertainty as to the timing of prospective outpayments. In one particular case involving an oil producer, there was considerable uncertainty as to the kind of longer-term investment program that would best suit its needs. That account leaned heavily on the RP for an extended period of time, but has since cut back its use of the instrument in response to our urging. About 17 accounts have used the RP at one time or another since it was made available.

Over the period of nine months through April 1975, RPs were arranged by the Desk for foreign accounts on just about every business day in amounts generally ranging from around $60 million to nearly $1.5 billion, which was also the largest total outstanding on any day (April 16, 1975). A considerable portion of the RPs were only overnight, so that the rolling over of maturing agreements contributed significantly to the daily volume of new contracts. (A daily tabulation of foreign RPs and System transactions in the market through RPs and matched sale-purchase agreements is attached).

From the beginning, the foreign RPs were meshed with System open market operations whenever it was considered appropriate in achieving the reserve and/or money market objectives of the Desk. Thus, over the nine months (185 business days), RPs were arranged in the market on behalf of foreign accounts on only 49 days when there was no related System action either in the market or directly with the foreign accounts. On the remaining days, the Desk also took some action to affect reserves. These related transactions usually took the following forms:

1. On 33 days the Desk crossed the foreign RPs with the System Account through System matched sale-purchase transactions, while taking no related action in the market to affect reserves. This provided the Desk with a means of absorbing reserves unobtrusively when it was either unnecessary or considered undesirable for some reason to take overt action in the market. These operations had the same result as outright System sales to foreign accounts except that the effect on reserves was temporary, usually just overnight or over a weekend. On another six days, the Desk only crossed part of the foreign RPs with the System Account, thereby reducing the amount of foreign RPs done in the market, when it appeared desirable to do so from the System's standpoint.

2. On 38 days, the Desk did matched sale-purchase transactions with the foreign accounts and also arranged System matched sale-purchase transactions in the market on its own behalf. On those days, the Desk's absorption of reserves in the market was reinforced by its transactions with the foreign accounts. Alternatively, one might say that the size of the market action required to achieve the Desk's reserve objectives was reduced by the opportunity to absorb the foreign account funds.

3. On 15 occasions, the Desk undertook to arrange RPs in the market for both foreign accounts and on behalf of the System on the same day, thereby investing the foreign account funds and responding to reserve needs in separate market actions that were independent of each other. This course of action proved to be rather complicated, however, because of different ground rules applicable to the System and foreign account repurchase agreements, mainly with respect

to the type of collateral that is acceptable, rights of termination before maturity, and the method of calculating margin and proceeds. It was considered awkward and unnecessarily confusing to the market for the System to approach dealers for RP propositions with one set of ground rules for its own account and different ground rules for its customer accounts.

4. In view of the foregoing considerations, the Desk undertook on 43 occasions to arrange matched sale-purchase transactions with foreign accounts while on the same day executing System RPs in the market in sufficient volume to offset the impact of the matched agreements and also inject the desired net amount of reserves into the banking system. This was accomplished by simply increasing the amount of System RPs in the market by the amount of matched agreements arranged with foreign accounts, so that the difference between the System's RPs in the market and the matched transactions with the foreign accounts provided the injection of reserves deemed appropriate for that day.

On those occasions, described in paragraph 3 above, when the Desk undertook both types of RPs in the market on the same day, it was generally because the timing of foreign RP orders and Desk decisions to provide System credit to the market did not permit the coordinated approach described in paragraph 4. Thus it sometimes happened that foreign RPs were executed in the market at a time when it appeared that no System action was called for; then late in that same day, a tightening money market may have caused the Desk to arrange System RPs in order to inject more reserves. Alternatively, the Desk sometimes arranged System RPs early in the day, before it was known that there would be sizable foreign RPs requested; when the foreign requests were received, it was considered preferable to execute them in the market rather than cause the reserve absorption that would result from arranging matched transactions with the System.

In providing the RP facility to the foreign accounts, the Desk and related functions of the Reserve Bank anticipated that there would be an increase in the volume of transactions that had to be handled. However, some part of the increase would presumably have occurred anyway, since part of the foreign-held dollars would undoubtedly have been invested through the Desk (in Treasury bills or bankers' acceptances), even if the RPs had not been made available. So far, the Desk has been able to handle the increased business with few problems although some strains were apparent during relatively short periods of peak activity in November and February. Meanwhile, this Bank has urged at least one foreign account to place its funds on a more permanent basis. Market forces have also worked in this direction to some extent by narrowing the spread between RP rates and those on Treasury bills and other short-term money market instruments.

There are certain advantages to the System in arranging short-term RPs for the foreign accounts. It enables the System to keep track of large and volatile flows of funds that would be unknown or obscure at best if they were channeled by the foreign accounts through outside agents. More importantly, the Desk has the opportunity to coordinate the foreign flows of funds and its own operations with a view to achieving monetary policy objectives within the context of maximum efficiency in the money market.

When a foreign RP is made directly in the market, dealers are informed that the transaction is for customer account. While the market is not informed about each occasion when the Desk undertakes matched agreements with foreign accounts, market participants are well aware that this is always a possibility--just as they realize that the Desk may be arranging outright purchases or sales of securities with foreign accounts. Consideration has been given to informing the dealers, when relevant, that a particular amount of the System RPs with the market are being undertaken merely to offset System matched agreements with foreign accounts, but this has not been done up to this point, as there did not appear to be sufficient reason to identify for the dealers one particular factor absorbing reserves--since the System's decision to make RPs could just as well reflect a variety of factors such as a temporary build-up in Treasury balances.

As noted, the market is aware that the System always has the option of making RP-type transactions directly with foreign account. Thus, if the foreign RP is made in the market (either directly or indirectly), there is some possibility that dealers will attempt to interpret the transaction as another clue to the lower bound on the Federal funds rate (since instead of making foreign RPs in the market, the Desk could have absorbed reserves by making a matched sale-purchase transaction with the foreign account). Such market reactions have not, however, unduly complicated monetary policy operations, and in any event are no different from possible market reactions to outright U.S. Government security transactions with foreign account.

A possible disadvantage to the Desk in handling the foreign account RPs could occur at times when there is a general shortage of collateral such as existed at times in 1973 and 1974. Under those conditions, the placement of large amounts of foreign account funds in RPs could immobilize collateral that might otherwise be available to the Desk for purposes of making RPs for the System and thus inhibit the Desk in its efforts to achieve reserve and money market objectives. Upon examination, however, it seems likely that in the absence of opportunities to do RPs, the foreign account funds would be invested more permanently on an outright basis, thereby immobilizing potential collateral for even longer periods of time. Moreover, given the prospective deficits and huge borrowing needs of the Treasury over the next couple of years, it is unlikely, at least in the near term, that there will be any shortage of securities eligible to serve as collateral for either System or foreign account RPs.

There are certain risks, however, in an excessively large volume of foreign RP funds. For one, an undue amount of the time and resources of the Trading Desk staff could be absorbed in managing these transactions. For another, these funds can be highly volatile, and there could be short-run disturbances in the financing of the dealer market should foreign sources become large lenders to dealers and the market thereby become dependent on these sources. Foreign central banks do not, in the nature of the case, have the longer-run interest in stable relationships with the dealer market that many U.S. commercial banks and corporations have; and they may be more likely to withdraw funds without regard to the needs of the domestic money market and irrespective of interest earnings. Thus, the staff believes that efforts should continue to be made by the Federal Reserve Bank of New York to encourage foreign central banks to invest dollar holdings on a more permanent, longer-run basis rather than through the RP route.

SUMMARY AND CONCLUSIONS

The opportunity to invest short-term dollar holdings in RPs was offered to foreign accounts in 1974 for specific purposes and was quickly recognized as a useful medium for temporary placement of funds at times when longer-term commitments could not be undertaken for one reason or another. Despite the increased burden of handling the transactions, the Desk and related areas of the Bank have not encountered any great administrative problems. Neither has the use of the facility interfered noticeably with the achievement of the System's reserve or money market objectives. Advantages to the foreign accounts are greater flexibility in handling their short-term dollar holdings and the ability to avoid the risk of price fluctuations while working on longer-range investment programs. Advantages to the System are the ability to keep track of huge flows of funds passing through the money market more accurately and the opportunity to offset or mitigage their effect on the money market when it suits the Desk to do so. From the standpoint of general market stability, the investment of the funds in RPs is probably less unsettling than outright purchases of securities and subsequent sales would be.

One potential disadvantage to the System, that of competition for available collateral, is more apparent than real, given the prospective supply conditions over the next several years. If shortages of collateral again develop, the Desk would, of course, have to reassess the priorities of the System and the foreign accounts. If foreign RPs were to become very large, other disadvantages would include undue absorption of Trading Desk resources and the potentiality of excessive dependence of the dealer market on volatile foreign sources of funds.

It appears, on balance, that foreign account RPs, in the magnitude handled so far, have posed no real problems for the Trading Desk and the market, and that the advantages of continuing relationships with foreign accounts and knowledge of foreign flows have outweighed the thus far minor disadvantages of RP transactions. However, in order to guard against excessive foreign activity in the RP market and undue complications in monetary policy operations, the Federal Reserve Bank of New York is continuing to encourage foreign accounts to employ their dollar holdings on a more permanent basis. Should there be increased demand for RP investments by foreign account, the Bank would be prepared to intensify its efforts in this direction in order to keep such activity to manageable levels.

System Open Market Account Matched Sale-Purchase Transactions
and Foreign Accounts Repurchase Agreements
(In thousands of dollars)

Commit. Date -1974-	Foreign Account RPs: In Market	Foreign Account RPs: With System	System Transactions in the Market: Matched	System Transactions in the Market: RPs for FRBNY
Aug. 5		450,000		
6			1,760,000	
7		361,400		
8		99,900		
9			670,000	
12		401,400		
13		100,200		
14		100,100		
15	300,100			
16	85,000			489,380
19	100,000			450,450
20	100,000			745,100
21	104,375			
22	400,100			
23	64,400			510,200
26	60,000			1,075,460
27		60,175	1,670,000	
28		60,145	2,866,000	
29		361,600		
30		100,405		
Tot. Aug.	1,213,975	2,095,325	6,966,000	3,270,590
Sept. 3	100,000	100,440		
4	120,000	100,465		1,705,630
5		100,445		
6		100,410	1,270,000	
9		75,235		
10	400,000	100,200		
11	25,000	266,665		
12		320,925		
13		610,475		1,326,700
16	805,882			
17		472,295	1,990,000	
18		615,685	1,710,500	
19	467,630			
20	427,797			
23		534,465		1,072,695
24	165,000			
25		213,885	612,500	
26	358,000			
27		225,730		605,900
30	419,831			
Tot. Sept.	3,289,140	3,837,320	5,583,000	4,710,925

Commit. Date	Foreign Accounts RPs In Market	Foreign Accounts RPs With System	System Transactions in the Mark Matched	System Transactions in the Mark RPs for FRBN
-1974-				
Oct. 1		281,625		893,900
2	148,640			
3	435,000			417,550
4		149,480		832,600
7		68,165		
8		122,270	3,200,000	
9		148,535	2,046,000	
10		63,215	1,020,000	
11		117,390	580,000	
15	4,000			2,196,400
16		625,335		1,557,500
17	280,000			
18		233,795		
21		280,720	1,200,000	
22		70,060	819,000	
23	105,000			
24	58,000			
25	187,000			
28	58,000			901,700
29		105,435	918,000	
30		58,220	467,000	
31	232,000			
Tot. Oct.	1,507,640	2,324,245	10,250,000	6,799,650
Nov. 1		197,665		
4		250,335		885,300
6		202,070		1,339,700
7		222,800		
8		388,495		
12		314,505		
13		255,220	1,455,000	
14	327,700			
15		214,545		
18	1,145,555			762,600
19	1,095,365			783,300
20		1,103,980	700,000	
21	1,106,500			
22	1,005,800			
25		833,060		2,113,800
26		208,460		1,194,555
27		209,270		1,572,100
29		325,055		1,237,650
Tot. Nov.	4,680,920	4,725,460	2,155,000	9,889,005

Commit. Date	Foreign Account RPs		System Transactions in the Mark	
	In Market	With System	Matched	RPs for FRBNY
-1974-				
Dec. 2		224,055		1,521,200
3	200,000	188,120		
4		451,885	3,107,000	
5		312,910		
6	312,000			
9	325,500			
10		127,210		2,327,020
11		127,240		
12	85,900			
13	387,900			
16		1,054,510		1,418,400
17		409,870		
18	409,400			1,399,900
19	411,350			881,580
20		441,735		1,577,950
23		325,255		2,777,800
24				843,380
26		323,850		2,191,900
27		215,445		1,100,580
30		118,275		
31		287,208	1,140,250	
Total Dec.	2,132,050	4,607,568	4,247,250	16,039,710
-1975-				
Jan. 2		182,100		1,764,380
3		74,785		468,800
6	168,500			
7		84,150	925,000	
8		87,420	2,116,000	
9		64,575	1,155,000	
10	130,300			
13	193,500			454,250
14		205,870		
15		130,700	683,000	
16		630,855		
17		631,590		
20	272,015	60,595		
21		348,575		2,416,050
22		348,705		1,836,815
23	343,500			
24	331,000			
27		530,155		2,256,005
28		333,540		894,700
29		346,490		
30	357,000			
31		297,690		1,057,400
Total Jan.	1,795,815	4,357,795	4,879,000	11,148,400

Commit. Date	Foreign Account RPs In Market	Foreign Account RPs With System	System Transactions in the Market Matched	System Transactions in the Market RPs for FRBNY
Feb. 3	204,800			
4		192,095		1,123,400
5		195,425	1,232,000	
6		198,335	1,265,000	
7		222,190	680,000	
10	218,500			
11		224,835		2,413,250
13	242,500			798,555
14		1,083,960		1,372,250
18	1,276,875			
19	717,500			
20	708,400			
21		558,060		1,945,200
24	499,900			
25	490,700			
26		484,820		2,764,800
27	517,640			
28		830,145		2,264,400
Total Feb.	4,876,815	3,989,865	3,177,000	12,681,855
Mar. 3		856,180		2,286,300
4	840,800			
5		219,795	1,480,000	
6		441,580	1,565,000	
7		272,670		
10		262,580		
11		163,870	1,500,000	
12		142,140	2,815,000	
13		234,930	1,445,000	
14		235,310	1,125,000	
17		238,510	514,000	
18		239,665	790,000	
19		239,560	478,000	
20	141,400	-	-	-
21	160,400	-	-	-
24		180,760	-	2,727,500
25	361,500			
26		345,590	-	869,350
27	229,800	147,765	-	-
31	298,700	-	-	
Total Mar.	2,032,600	4,220,905	11,712,000	5,883,150

Commit. Date	Foreign Account RPs In Market	Foreign Account RPs SOMA	SOMA Transactions in the Market Matched	SOMA Transactions in the Market RPs for FRBNY
Apr. 1	234,700			
2		266,915		
3		226,875		
4		92,370	2,140,000	
7M	157,300	-	-	-
8		182,035	675,000	
9		517,895	1,315,000	
10		1,396,745	1,270,000	
11		132,310		
14M	398,000	-	-	-
15	1,345,300	-	-	-
16		1,459,125	-	2,825,800
17		958,790		1,766,100
18	537,300	-	-	-
21		505,050		1,305,000
22		271,950		
23		258,500		884,300
24		334,135		2,361,050
25	317,500	-	-	-
28M		213,105		2,442,575
29	181,200	-	-	1,688,800
30		159,270		1,587,660
Total Apr.	3,171,300	6,975,070	5,400,000	14,861,285
May 1		108,095		2,018,900
2		105,190		1,002,100
5	102,700			
6		97,630		-
7				709,500
8		179,975		1,984,060
9	123,500	-		-