

U. S. Foreign Exchange Operations: Needs and Methods

Introduction

The current international position of the United States clearly demonstrates the advantages that would exist if the United States had at its disposal the resources and techniques for undertaking foreign exchange operations as a permanent feature of public policy. The present international financial structure, characterized by convertibility of the major currencies, relatively free short-term capital markets, and the existence of large dollar holdings by foreigners (both public and private), has greatly enhanced the possibility of large recurring movements of capital out of and into the United States. Such movements of short-term capital, as the Federal Reserve System has learned from its experience of the past year, can greatly complicate the execution of an appropriate domestic monetary policy. Similar problems have been faced by monetary authorities abroad, in both the recent period and in earlier years. Solutions to problems relating to shifts in capital flows and their impact on national balances of payments, together with the relationship of such international flows to domestic monetary policies are perhaps best approached through joint action by central banks. It is no accident that individual European central banks have developed highly sophisticated techniques of operating in the foreign exchange market, and have supplemented individual operations by joint measures of both a formal and an informal, ad hoc, character.

Monetary authorities in the United States, on the other hand, have not, until recently, operated in the foreign exchange market, but have

maintained the stability (and primacy) of the dollar in the international currency structure by standing ready to buy gold from, and sell it to, foreign monetary authorities who either need or acquire dollars for exchange purposes. There can be little question that the interconvertibility of gold and the dollar at a fixed price will have to remain the keystone of the international currency structure. At the same time, foreign exchange dealings by the United States monetary authorities, when judiciously applied, can serve to reduce capital flows, to dampen speculation, to minimize potential reserve effects, and hence, to minimize the impact on the United States gold stock.

The basic purpose of such operations would be to maintain confidence in the dollar. Foreign exchange operations would, of course, not be a substitute for other appropriate and basic actions to maintain the integrity of the dollar, but would serve as a highly useful and flexible addition to other monetary and fiscal policy measures. The continuation and expansion of such operations as have recently been executed respecting the German mark could make the United States an important factor in the exchange market and thus help to enhance its bargaining position in any international approach to currency problems. Moreover, the holding of foreign currencies by the United States might strengthen confidence in such currencies and add to their usefulness in international trade and payments and hence contribute to an expansion of the movement of goods and services among countries.

I. Federal Reserve Operations for Its Own Account

Previous Experience

The Federal Reserve Bank of New York has had a number of accounts abroad, of which three with nominal sums remain at present. The three accounts are with the Bank of England, the Bank of France and the Bank of Canada. The reasons for opening the various accounts differ somewhat but maintenance of the accounts over recent years has been largely a matter of courtesy.

The account with the Bank of England was opened in 1917 and subsequently used for a number of transactions involving exchange operations, investments and the purchase and earmark of gold. The account at the Bank of France was opened in 1918 in order that we might establish a sight account for possible use in transactions for the stabilization of exchange rates.

The BIS account was opened in 1931 in the sum of \$10 million. In a letter from Mr. Harrison to Chairman Eccles in September 1936 it was stated that "The deposit was made for the same purpose, essentially, as the credits which the Federal Reserve Banks extended to foreign central banks during 1931. It was made in lieu of our having to respond to requests for assistance on behalf of various smaller European central banks." It was then used for the purchases of prime commercial bills for our account and finally closed in 1946.

An account with the Bank of Canada was opened in 1943, almost entirely as a courtesy measure. Other accounts included those with Iran,

Egypt, and India which were opened in our name in order that the Treasury would not be identified with certain transactions. These latter accounts have been closed.

Authority

Authorization for the opening of accounts abroad is contained in Section 14(e) of the Federal Reserve Act. Such accounts are subject to Regulation N and to other rules prescribed by the Board of Governors as contained in the "Statement of Procedure With Respect to Foreign Relationships of Federal Reserve Banks." Under Section 12A of the Federal Reserve Act, the investment of funds in the accounts are also subject to decision by the FOMC. Basic authority was granted in a November 13, 1936, resolution which authorized each Federal Reserve Bank to "purchase and sell at home and abroad cable transfers and bills of exchange and bankers acceptances payable in foreign currency to the extent that such purchases and sales are deemed necessary or advisable in connection with the establishment, maintenance, operation, increase, reduction or discontinuance of accounts of Federal Reserve Banks in foreign countries." Since at least 1944, the resolution has been reviewed regularly by the FOMC and, in each instance, the basic authority has not been rescinded. Finally, it should be noted that "due from" accounts with foreign banks may be participated among other Federal Reserve Banks; in the event of such participation, the operating bank make weekly reports to the participating banks.

Previous operation of the accounts has been carefully circumscribed. Thus, in a letter dated May 8, 1944, from Mr. Spreul to

Mr. Peyton (President, Minneapolis Reserve Bank), it was stated that "The balances of the Bank of England, the Bank of France, and the BIS were approved by the Board of Governors at or near the figures shown; they could not be increased (except for minor adjustments) without the prior approval of the Board of Governors." In substance, operations by the Federal Reserve Bank of New York are possible with the approval of the Board of Governors, the FOMC, and after participation has been offered to the other Federal Reserve Banks.

A Proposal

One approach would be for the Federal Reserve Bank of New York to purchase foreign exchange, either in the market or from the Treasury in connection with the repayment of foreign official debt or a drawing on the International Monetary Fund. Purchases of exchange in the market would, in view of current pressure on the dollar, be quite limited; favorable balance-of-payments developments, however, would make such operations possible in the future.

In the case of transactions with the Treasury, the foreign exchange could be acquired by the Reserve Bank against the credit of dollars to the Treasury's account with the Federal Reserve Bank in a manner similar to the current practice with regard to the acquisition of gold certificates. The reserve effects of such operations would be similar to those involved in purchases of gold certificates and would require coordination with System open market operations as discussed below. Arrangements for the conduct of operations would have to be worked out

among the FOMC, the Board of Governors, the Federal Reserve Bank of New York, and other participating Reserve Banks. Some of the technical arrangements used by the System in the twenties and thirties might well be adaptable to current needs. In the immediate instance, for example, the proposed German debt repayment of some \$700 million could be made partially in dollars and partially in Deutsche marks (DM). The portion received by the Treasury in DM could be sold immediately to the Federal Reserve Bank against dollar credit to the Treasury. This procedure might serve to meet any requirement that the United States receive dollars in connection with the payment of foreign debt while, at the same time, furnishing foreign exchange resources for market operations and adding leverage to the conduct of United States international financial policy. The holdings of foreign money could then be used to operate in the exchange market, or, as occasion warranted, to "buy out" some portion of the Bundesbank dollar reserve, or to meet other objectives.

If operations were to be conducted by the Federal Reserve Bank on its own account, some provision would have to be made for protection against changes in the value of the currencies held, at least until such time as reserves had been accumulated. This could be provided by an agreement under which the United States would hold the Federal Reserve Bank harmless against loss arising out of devaluation of the foreign currency; appropriate legislation might be required in this connection.

Federal Reserve Coordination of Open Market Operations

Federal Reserve operations in foreign exchange would require the closest coordination with open market operations. Indeed, they might

become an integral part of such operations and could, in some circumstances, add desirable flexibility to System policy. On other occasions, the reserve effects of foreign exchange transactions might have to be offset by other open market operations in order to implement the Federal Open Market Committee's policy. Such offsetting operations would not represent an undue complication of System open market operations since in most cases the foreign exchange operations are likely to be alternatives for exchange operations by foreign monetary authorities, the timing and size of which have recently complicated the conduct of open market operations. System operations in foreign exchange, by permitting closer coordination as to timing and amounts, could have beneficial effects on over-all System operations in relation to the money market.

To illustrate the effect on reserves, assume, for example, a German payment of \$300 million in DM equivalent to the Treasury. The sale of these Deutsche marks by the Treasury to the Federal Reserve Bank would increase the Treasury's balance at the Reserve Bank and perhaps reduce the need for calls upon tax and loan accounts, or necessitate redeposits in "C" banks. Expenditures (or redeposits) by the Treasury would, of course, add reserve dollars to member bank accounts. Sales by the Federal Reserve Bank of DM in the market for dollars would directly reduce member bank reserve balances. Even in a strictly inter-central bank transaction important effects would be evident. Thus, if the Federal Reserve Bank used DM 100 million to buy \$25 million from the Deutsche Bundesbank, simply by utilizing book entries for the transaction, the account of the Deutsche Bundesbank on the books of the Reserve

Bank would be reduced by \$25 million; the Deutsche Bundesbank might have to sell Treasury bills from its investment account in order to replenish its deposit account with the Reserve Bank. A sale of Treasury bills in the market would immediately affect bank reserves. Clearly, all operations would require close and continuing coordination.

Meeting Requirements of Secrecy and Anonymity

It is of fundamental importance that foreign exchange transactions generally be subject to public analysis only with some delay. It is, therefore, necessary that published statements and data be appropriately devised. Some thoughts should first be given, however, to the question of immediate publicity if foreign funds are acquired in connection with official debt repayment. In all probability, the paying country as well as the United States will immediately announce the payment. Perhaps, however, no mention would need to be made of the fact that some part or all of such repayments did not take the form of dollars. On the other hand, if circumstances warranted, it might be useful to let it be known that a local currency repayment was made and that such funds were available for use in the exchange market.

The immediate problem of publication involves the weekly statement of the Federal Reserve Bank of New York. At present, foreign exchange holdings are included in "Other Assets," a category which includes in addition to such "due from" accounts, loans and securities past due three months; assets acquired account (industrial loan and closed banks); reimbursable expenses and other items; accrued interest; premium on securities; overdrafts; deferred charges; currency and coin

exhibits, etc. Generally, on the weekly statement of the New York Reserve Bank, "Other Assets" is a relatively small item ranging between \$30 million and \$100 million. (On the consolidated statement for the System, the item generally ranges between \$125 million and \$400 million.) Substantial fluctuations in the item (say, \$50 million or more) might lead to rather immediate questioning and close analysis would probably reflect foreign exchange dealings with perhaps embarrassing promptness. There should be some way to avoid this adverse result. Possibly "Other Assets" might be grouped into a broader category so that the net impact of foreign exchange dealings would not be so readily evident.

Net operations would also be reflected in the statements of condition published as of month-end in the Federal Reserve Bulletin with a month delay, and in the statement on earnings and expenses (under the items "other income" and "other expenses") reported in the February Bulletin covering the previous year. These data, however, are published with some delay and pose no problem.

With respect to forward operations, disclosure could be avoided if such commitments were carried simply as memorandum accounts and thus not be made available in any published data; before adopting such a method, it would be necessary to consider to what extent a contingent liability should be shown.

Evaluation of Fed Operations For Its Own Account

A major advantage to be gained by Federal Reserve operations on its own account in the foreign exchange market arises from the fact that

the Federal Reserve Bank can create dollars while the Treasury is restricted to the use of funds held by it. This does not mean that there are no limits on what the Federal Reserve could or should do. There are very practical limitations upon such operations, the more important revolving about the need to meet other objectives of open market policy, current pressures in the exchange market, and/or the willingness of central banks to deal directly by providing local currency against dollars (or vice versa). In substance, the creation and destruction of Federal Reserve credit would provide vast resources for foreign exchange operations and defense of the dollar.

If the decision should be made to conduct Federal Reserve operations of this kind, there would be a vital need for sufficient latitude so that operations could be conducted effectively and promptly under such rules and regulations as the Board of Governors and the FOMC deemed appropriate. Finally, there is a subsidiary problem of arranging our weekly statements so as to avoid or delay publication of the details of our foreign exchange operations.

II. Operations as Fiscal Agent for the Treasury

Federal Reserve Bank of New York operations as fiscal agent of the Treasury operating through the Stabilization Fund involve an area in which considerable experience has already been gained.

Gross resources of the Stabilization Fund amount to about \$336 million. The composition of these resources and the amount that in practice would be available are approximately as follows:

	(In Millions of Dollars)		
	<u>New York</u>	<u>Washington^{A/}</u>	<u>Total</u>
Dollars	170.0	1.5	171.5
Gold	94.7	0	94.7
Securities	26.5	25.0	51.5 ^{B/}
Foreign Exchange	18.0	0	18.0 ^{C/}
	<u>309.2</u>	<u>26.5</u>	<u>335.7</u>
Total Resources		335.7	
Less Argentine pesos currently held		<u>18.</u>	
		317.7	
Less Stabilization Commitments (Argentina, Mexico, Chile)		<u>122.0^{C/}</u>	
		195.7	
Less Working Balance for Fund		<u>25.</u>	
Net Available Resources		170.7	

A/ As of January 31, 1961--little change since that date.

B/ An additional support order of \$45 million is on hand--advance refunding.

C/ Argentina can draw an additional \$32 million, thus making total drawings \$50 million. Mexico and Chile can draw \$75 million and \$15 million, respectively.

The above resources provide some latitude for operation, although exchange purchases in the market face at present the obstacle of current pressure on the dollar. Stabilization Fund operations are provided for

under Section 10 of the Gold Reserve Act which grants wide-ranging authority to the Secretary of the Treasury, with the approval of the President. Use of the Stabilization Fund, however, would be limited to current resources since it appears that permanent additions to, or reductions in, assets of the Fund would require Congressional approval and appropriation. There would, for example, seem to be considerable obstacles toward enlarging the Stabilization Fund by turning over to it, directly, official debt repayments from abroad. If, however, prepayments--particularly in local currencies--are contemplated, such prepayments might be sufficiently attractive so that Congress would approve allocation of those resources to the Stabilization Fund.

Within the resources, the holdings of (and operations in) foreign currencies could be readily handled. Operations could be either in the spot or forward market, although there would be some real advantage, in favor of forward transactions since such operations tend to afford maximum use of the Stabilization Fund's resources. Insofar as forward contracts involved parallel operations with foreign central banks, it would be sufficient for the Fund to hold a partial reserve adequate to cover any possible loss in the event of default. Thus, for example, if the Bundesbank were to fail to honor its contracts with us under present arrangements, it would be necessary for the Fund actually to buy spot marks for delivery to meet the contract at maturity. The Fund would have to have dollars to pay for the spot marks but it would immediately receive dollars when it delivered the spot marks to the purchaser under its forward contract. The possibility of loss would lie in the difference between the original contract price and the spot rate on the day the purchase would have to be made. If the foreign central bank were not under a parallel

commitment, then a partial reserve would need to be held to cover possible losses in buying spot currencies (or shorter forward currencies) to meet contractual obligations. If parallel contracts were held, a reserve equal to 10 per cent of total obligations would seem desirable, subject to the proviso that the reserve would be adequate to cover total obligations undertaken for any given day. If no parallel contract was involved, a reserve somewhat larger than 10 per cent would probably be needed. Use of Fund resources would then actually be expanded by some multiple of the amount currently available. Thus, under parallel contracts, the \$170 million noted as available in the table above might cover forward contracts of up to, say, \$1 billion.

Spot operations would undoubtedly be necessary on occasion. Obviously such purchases would deplete the reserve by the dollar equivalent. Operations accordingly would be restricted to the amounts actually available in the Fund as noted above.

Supplementing Stabilization Fund Resources

Added foreign exchange resources might be made available from a drawing on the International Monetary Fund or foreign debt repayments if such receipts were deposited in a special account of the Treasury which might be called the "Special Foreign Exchange Account," with transactions being channeled through the Stabilization Fund and with the Federal Reserve Bank of New York acting as agent. Such a procedure might be feasible if--as seems likely--the resources of the Stabilization Fund could not readily be supplemented by direct allocation.

Meeting Requirements of Secrecy and Anonymity

Insofar as Treasury statements are concerned, details of the Stabilization Fund are published quarterly with a delay of five months or so. Published figures are for end-of-quarter. Operations during the period are also shown on a net basis in the detailed statements of income and expense contained in the Treasury Bulletin. Thus, there seems to be sufficient publication delay from the Treasury side to meet requirements. With respect to Stabilization Fund assets in the form of securities or foreign exchange, information is available only from the above sources with the noted delay; these assets do not appear in data published by this Bank or the Board.

Current statements by this Bank and the Board, however, do reflect Stabilization Fund holdings of dollars and gold. Dollar assets are included in "Other Deposits" on our weekly statement and the System's consolidated statement. The over-all category includes a range of other items such as nonmember bank clearing accounts, Regulation K reserves, deposit accounts of the IADB, IBRD, IDA, IFC, IMF, UN No. 1, etc. There is some nominal variation in this amount over weekly periods, but if net transactions in foreign exchange were of a substantial nature (say, \$50 million or more), fairly close analysis of foreign exchange operations could be gained from these figures. Again, some regrouping of categories or use of special accounts would be necessary.

Gold holdings of the Stabilization Fund may be obtained with about a one-month delay from the Federal Reserve Bulletin, which shows the total gold stock and so-called Treasury stock. Moreover, a gold sale or purchase

would be reflected in earmarked gold, but again with about a month to a six-week delay (the February Federal Reserve Bulletin shows data for January 31, 1961).

Published data may be illustrated as follows, bearing in mind that figures would be net, and hence any individual transaction might be offset. For illustration, assume that the Stabilization Fund purchases DM 50 million in the market with dollars currently in the account.

1. Effect on Fund's foreign exchange account: would not appear in Federal Reserve Bank or System data but would be reflected in the quarterly data of the Treasury, with a six to eight-month delay.

2. Fund's dollar account: the item "Other deposits" on our weekly statement would show a decline, and the transaction also would be reflected in the Treasury's quarterly report, but with delay.

3. Reserve accounts: would show an increase in member bank reserves on the Federal Reserve Bank weekly statement.

Essentially, the only real problem related to the foreign exchange position of the Fund would lie in our weekly statement which would show a direct impact on the Fund's dollar holdings, as reflected in the item "Other Deposits." In order to minimize immediate analysis of operations over the short-run, it would be desirable to include a wider range of items in these categories. However, operations could under present conditions be masked to some extent by careful supervision of the account and a selective use of "swaps."

III. Conclusion

The approaches discussed above to foreign exchange dealings are suggested possibilities. Whatever the technique used, the United States will run some risk of changes in currency values. To have effective protection of the dollar, such risks--minimized by careful management--would seem a relatively small price to pay. Once a basic choice is made as between operations for the account of the Federal Reserve Banks and operations by the Reserve Bank for the Treasury as fiscal agent, detailed investigation of coordinating techniques and the requirements of secrecy can be made. It may be that fiscal agency operations offer some advantages in the way of speed and simplicity. However, there are distinct benefits to be gained from Federal Reserve operations for its own account. Foreign exchange operations by central banks are considered a normal part of their activities, and there is much to be said for utilizing resources that are not directly limited by a required cash position.

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