BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

February 26, 1963.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Sherman

Attached is a memorandum from Mr. Coombs, Special Manager of the System Open Market Account, in which he requests authorization to undertake forward purchases in any or all of the foreign currencies authorized for System operations, up to a combined total of $25 million equivalent, for the purpose of allowing greater flexibility in covering commitments under swap arrangements. It is expected that Mr. Coombs' request will be discussed at the March 5 meeting of the Federal Open Market Committee.

It will be recalled that Mr. Coombs mentioned this matter at the meeting of the Committee on February 12, at which time it was understood that a decision on any proposal would be deferred pending the availability of a memorandum on the subject. (See page 10 of the preliminary draft of the minutes for that meeting.)

Merritt Sherman
Merritt Sherman, Assistant Secretary,
Federal Open Market Committee.

Attachment

To: Federal Open Market Committee

From: C. A. Coombs, Special Manager, System Open Market Account

Subject: Request for authorization of forward exchange operations.

The "Guidelines for System Foreign Currency Operations" provide that the Special Manager shall submit to the Federal Open Market Committee for advance approval proposals to initiate forward operations in any such currencies.

Authority is now requested to undertake forward purchases in any or all of the currencies authorized for System operations, up to a combined total of $25 million equivalent, for the purpose of allowing greater flexibility in covering commitments under swap arrangements.

Rationale of forward purchases for system account

When the System acquires foreign currencies under a swap agreement, it undertakes a commitment to deliver that foreign currency on a specified future date at the rate of the original swap agreement. (Cn that date, the System will also regain the dollars it gave up to acquire the foreign currency.) For example, when the System acquired £8.9 million ($25 million) on January 15 at $2.8056 per pound--under the $50 million standby swap agreement with the Bank of England--it contracted simultaneously to undo this transaction at the same rate on April 16, 1963. Any sale of the foreign currency balances thus acquired, whether in the market or to the foreign central bank, therefore involves incurring a "short" position--a future commitment that still has to be covered.

There is no technical reason why, in choosing a method to cover, the System should be restricted to spot operations. With a future commitment in a foreign currency that is certain as to amount as well as with regard to the rate at which that currency is resold for dollars, it is to the System's advantage to obtain the best possible terms for its acquisitions of the foreign currency. This may well mean that such a currency should be bought forward rather than spot. In particular, if the foreign currency is at a forward discount, it will be financially advantageous to the System to purchase its requirements forward rather than spot. For example, $5.6 million equivalent of the sterling acquired in the swap operation described above was sold to the Bank of England at $2.8057. This amount of sterling thus had to be reacquired by the System before maturity of the swap. As it happened, spot sterling weakened and cover was obtained at $2.8039 only a few days after the sterling sale. Yet, forward rates for dates within the swap period were well below the spot rate--e.g., one-month sterling was offered at around 19 points discount ($2.8020) at the time the System made the spot purchase of sterling to restore its balance.

Financial considerations are not, of course, the only factor to be taken into account when future commitments are being covered either spot or forward. A judgment also has to be made which of the two markets is the more suitable in terms of the broader objectives of System exchange operations. For example, System purchases in a thin forward market might raise the forward rate of the foreign currency substantially and thus create or intensify an incentive for outward flows of covered arbitrage funds from the U. S., a situation the System should avoid. Whether or not this is a factor, however, depends on the market situation--the forward sterling market is often very broad and active and can at times be used with less of an undesirable effect on rates than the spot market. To be sure, forward operations can also affect spot rates, and vice versa, but the degree of interrelationship between the rates varies greatly under different market conditions. Hence, a choice of markets to cover future swap commitments is a useful tool of policy.

February 25, 1963