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

January 5, 1972

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed for your information is a copy of a memorandum from Mr. Bodner, dated January 4, 1972, and entitled "System Losses on Foreign Exchange Transactions in 1971."

Arthur L. Broida

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Enclosure

CONFIDENTIAL (FR)

January 4, 1971

TO: Federal Open Market Committee

FROM: David E. Bodner

Subject: System Losses on Foreign exchange Transactions in 1971.

Contrary to experience in previous years, the foreign exchange operations of the Federal Reserve System generated a net loss in 1971, amounting to $8.2 million. This compared with profits of $3.5 million for distribution in 1970 and a previous cumulative total of $21.8 million of profits since the inception of the swap network.[1/] This memorandum briefly reviews the reasons for the loss in 1971, and assesses the immediate prospects for 1972. The respective shares of loss will be reported in the annual statements of the Reserve Banks as a deduction from earnings under the title "Loss on foreign exchange transactions."

For the first seven months of 1971, the System had net profits on foreign exchange operations amounting to $3.7 million. These profits arose in connection with liquidation of guaranteed sterling holdings, sales of German marks to the Netherlands and to the market, repayments of Swiss-franc swap commitments, and write-up of Swiss franc balances following the franc's revaluation last May. The profit would have been even larger except that the System had incurred a loss on the liquidation of Dutch-guilder swap commitments. These net profits were more than offset by losses from repayment of swap drawings after August 15.

1/ The System also has recorded substantial interest earnings on foreign exchange balances. These amounted to $2.6 million in 1971, which raised the cumulative total since 1961 to $322.8 million.

As you know, swap drawings by the Federal Reserve have been used as a shield for the U.S. gold stock and other international reserve assets by providing foreign central banks with a short-term exchange value guarantee on dollars that they might otherwise wish to convert. As the U.S. payments deficit mounted last year, other central banks accumulated large amounts of dollars and several asked the System to provide cover under the swap arrangements. When President Nixon suspended dollar convertibility on August 15, the Federal Reserve had a total of $3,045 million of commitments under the swap arrangements. With the subsequent rise in foreign currency rates in the market, and with the efforts by the U.S. to negotiate a realignment of currency rates, it became inevitable that the System would take a loss on these obligations, particularly since it was, and is, the Treasury's position that those debts should as far as possible be settled through the market rather than through the use of reserve assets. As individual swap drawings matured, they were generally renewed, given the fact that the negotiations were still proceeding and that reflows had not yet developed. The National Bank of Belgium, however, requested the System to begin making repayments through purchases in the exchange market, and some $145 million of the original $635 million equivalent of Belgian franc drawings was repaid on that basis. The System also paid down $10 million equivalent of German marks, but this was out of balances on hand and resulted in a nominal profit. Agreement on a currency realignment was reached in Washington on December 18, based on the United States' promise, pending settlement of other international issues, to propose to Congress a suitable means of devaluing the dollar. Since devaluation is precisely the contingency that the swaps protect foreign creditors against, the System has to make good on that guarantee. As reflows subsequently began to develop in the exchange market, the System purchased sufficient sterling to repay $35 million of its swap debt to the Bank of England. Thus, at the end of the year, the remaining drawings outstanding under the swap line were $2,855 million.

Looking ahead to 1972, additional losses can be expected on the liquidation of the swap drawings. At present we estimate that these losses could amount to $140-$150 million, based on the assumption that the currency realignment negotiated in December is ultimately ratified by the governments and that reflows drive the currencies to their respective floors.[2/] Negotiations are continuing with other central banks looking toward agreement on an appropriate sharing of the losses in cases in which the new "central" rate reflects a combination of the proposed U.S. devaluation and a proposed revaluation of the other currency. It is anticipated that in those cases (Belgium and Germany) the respective central banks will honor the revaluation clauses in the swap agreements. As the losses are incurred, they will affect the System's over-all earnings, and will reduce the amounts to be transferred to the U.S. Treasury each month. Even for one month, however, the System's transfers to the Treasury are much larger than the total expected loss, and it is likely that the losses will be spread out over several months.

2/ It should be noted that, insofar as Federal Reserve swap drawings substituted for sales of reserve assets, the Treasury will have correspondingly larger "revaluation profits" on those assets. Treasury losses on foreign currency bonds outstanding probably will run to about $110 million.