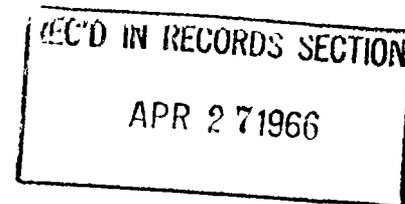


CONFIDENTIAL (F. R.)

MEMORANDUM



April 8, 1966

TO: Federal Open Market
Committee

SUBJECT: Commentary on Mr. Baker's
Memorandum Entitled "Federal Reserve
Operations in Foreign Exchange 1962-1965"

FROM: Charles A. Coombs

Mr. Baker's lengthy survey of System foreign exchange operations concludes by stating "there would seem to be a clear case for continuing the System's foreign currency operations as an experimental undertaking." In the course of arriving at this conclusion, however, Mr. Baker makes a number of references to System operations which were "less than completely effective" or were subject to other shortcomings. As I understand the Baker memorandum, the operations in which Mr. Baker seems to find certain difficulties are those listed on pages 24-35. In each of the cases cited, I and the other officers of the Foreign Department of the New York Bank feel that Mr. Baker's criticisms, either explicit or implied, can be readily refuted. I believe that the U. S. Treasury would take the same view, as would virtually all of our central bank partners in the swap network.

The first of the critical comments by Mr. Baker appears on page 25 in connection with a discussion of our forward operations in Dutch guilders in 1964-1965. The Baker memorandum acknowledges that these operations were effective in holding down the gain in official Dutch holdings over an eight- to nine-month period. But it goes on to say: "nevertheless, as it turned out, the System exposed itself to exchange risks (within the exchange spread) which

persisted for a number of months." This is a misstatement of fact which was brought to the attention of the author in an earlier draft, but seems to have inadvertently remained in the final draft. Our forward operations in Dutch guilders during this period were all negotiated at forward rates for the guilder above the spot ceiling. There was, therefore, no System exposure whatsoever to loss within the existing margins, and the eventual complete liquidation of these contracts left us with a profit of nearly \$400,000. Furthermore, we had negotiated with the Netherlands Bank arrangements fully protecting us in the event of a revaluation upward of the Dutch guilder. The "extended exposed position" cited by the Baker memorandum simply did not exist.

Secondly, the Baker memorandum recounts on page 26 our operation in the late summer of 1964 to widen the forward discount on sterling through buying spot and selling forward in order to prevent an undue arbitrage incentive for moving funds from New York to London. Here again the Baker memorandum acknowledges that this operation proved effective, and the Bank of England welcomed our action since the spot side of the operation brought an immediate reinforcement of the British reserves. The Baker memorandum goes on, however, to note that the forward contracts matured around the time of the November sterling crisis, and "The System therefore appeared to be placed in the position of working at cross purposes with the Bank of England." Leaving aside the point that none of us in August could predict a crisis in November, the maturing of the approximately \$25 million in System market forwards in November 1964 was a drop in the bucket compared with the enormous reserve losses then suffered for other reasons by the Bank of England. We have not had a single

suggestion from any source that the market was even aware of the System's forward maturities or that any erroneous impression was given of our "working at cross purposes with the Bank of England." The dominating fact in the market in November 1964 was rather the display of our cooperative attitude in the form of the increase in U. S. credit lines to the U. K. from \$500 million to \$1 billion.

Third, the Baker memorandum discusses on pages 26-29 the \$500 million authorization to acquire forward lira contracts from the Bank of Italy and suggests that this Committee authorization raises two "difficult questions":

(a) Is it appropriate for the System to engage in a transaction which enables another central bank to obscure its published accounts even though the transaction will reduce or postpone demands on the U. S. gold stock?

I do not find this question difficult at all, nor would the U. S. Treasury. The Bank of Italy chooses not to publish immediately its forward obligations. This is a practice which is followed by all of the central banks with which I am familiar, including the Federal Reserve. I am at a loss to understand, therefore, what possible grounds we could have for suggesting that the Bank of Italy should revise its accounting procedures, more particularly since the lira forward operation was suggested by the Italians as a means of saving us gold and protecting the Euro-dollar market. The Baker memorandum goes on to suggest that the volume of forward contracts in lire "is bound some time to attract the attention of some observer, with detrimental consequences for the credibility of System data." But the forward lira contracts assumed by the Treasury in 1962-63 were fully reported after a time lag of a year or so, and

aroused no adverse comment whatsoever. The market already knows that the System has authorized the acquisition of up to \$500 million of such lira contracts and will be given after some time lag a full accounting of these and other forward operations in our regular semiannual reports.

(b) The second "difficult question" arising out of the forward lire operation, according to the Baker memorandum, is whether the exchange guarantee given under the Italian forward contracts does not establish an undesirable precedent.

This question seemingly overlooks the fact that the central feature of the joint Treasury-Federal Reserve exchange operations undertaken over the past five years has been the offer of exchange guarantees to foreign central banks in the form of swap drawings, forward market contracts, and foreign currency bonds. In general, the U.S. Treasury and Federal Reserve have stood prepared to mop up through such exchange-guarantee operations surpluses of dollars appearing on the books of foreign central banks within the swap network. The problem is hardly one of avoiding an undesirable precedent, but rather of converting such countries as France, which rejects the exchange-guarantee technique and insists on gold, to accept our approach.

Fourth, in its discussion of swap drawings on pages 29-32, the Baker memorandum states that "it is sometimes difficult to assess clearly the reason for individual swap operations, especially in the cases where the initiative for the System's actions came from the other party to the transaction rather than from the System itself." But there is no reason at all for any obscurity on this point; in virtually every instance swap drawings by the System were expressly

and clearly intended to forestall gold purchases by the foreign central bank concerned and in this sense they were fully effective, dollar for dollar. The same applies to most of our forward operations.

Next, the Baker memorandum notes that some repayments of swap drawings were accomplished only by recourse to exceptional sources such as foreign currency bond issues or gold sales, and draws from this the inference that "despite what was thought at the time of their execution, the System's operations did not always turn out to have been in response to temporary flows of funds" Of the total of \$2,353 million of swap drawings made by the System during the past four years, \$1,864 million or 79% has been repaid without the assistance of gold sales, foreign currency bonds, U.S. drawings on the IMF, or third currency swaps. In view of the impossibility of accurately predicting the balance-of-payments trends of a dozen countries, including the U.S., I am inclined to think that we may have achieved within the last four years a higher percentage of repayments through market operations than we can count upon in the future. In most instances of drawings on the swap line, neither the foreign central banks concerned nor the Federal Reserve Bank of New York has ever made a firm prediction that the drawing could be reversed within a specified period of time. We have rather been confronted with an immediate problem of absorbing surplus dollars in order to forestall gold losses. In most cases we could see hopeful signs of a prospective swing in the market situation which might enable us to reverse the drawing in less than a year's time. In a good many instances, moreover, the very fact of these swap drawings have probably encouraged foreign central banks and

governments to undertake policy moves which assisted in unwinding the swap drawing. But what is most important here is not whether we can in all cases accurately forecast the prospective duration of the market swing, but whether we are prepared, if the swing continues beyond the term appropriate to central bank operations, to substitute other forms of financing. Measured by this criterion, the record is clear. Both the Federal Reserve and foreign central banks drawing on the swap network have rigidly adhered to the principle of paying off, if necessary through gold sales, recourse to the IMF, and foreign currency bonds, any swap drawings which threatened to drag on too long. Of total central bank drawings of \$6 billion on the swap network during the past four years, 93% have been paid off within six months and all have been completely liquidated in less than a year. Finally, the Baker memorandum suggests that our swap operations have not succeeded in encouraging foreign countries to hold an increased amount of uncovered dollars. We have never made any efforts to link the two, and I am at a loss to understand what this complaint is all about. Quite obviously, foreign willingness to hold uncovered dollars primarily depends on confidence in the dollar and this raises questions which go far beyond System exchange operations.

Fifth, the Baker memorandum refers on pages 32-33 to the sale to the Bank of England in the spring and summer of 1965 of \$28 million of outright sterling held by the System. The basic reason for this action was that the \$56 million balance in outright sterling previously built up by the System, plus another \$79 million acquired by the U.S. Treasury, was clearly on the high side in relation to our joint prospective needs for such sterling balances, and

had been pushed to this level in late 1964 partly in order to encourage a very shaky British government to keep its nerve. Both the Treasury and the Trading Desk at the New York Bank planned, and this intention was conveyed to the Bank of England, to reduce such outright holdings of sterling at the earliest convenient opportunity. As the pound sterling failed to register any significant recovery, during the winter and spring months of 1964-1965 we faced a mounting risk that no convenient opportunity for bringing down our sterling balances might ever appear and that we were thereby exposed to a possible loss on a devaluation of sterling. This problem was discussed with Treasury, FOMC, and Bank of England officials and a joint decision was taken to reduce both Treasury and System holdings by a total of \$56 million, divided equally between the two agencies. Since then the Treasury has run down its balance almost to zero, while we have retained a working balance of roughly \$20 million equivalent. The comment in the Baker memorandum that such transactions "put added pressure on the Bank of England's reserve position at a time potentially adverse to it" would seem to overlook the fact that we provided during the same period on combined Treasury and Federal Reserve account a total of \$1,²390 million of short-term credit. In effect, we made a minor shift during the summer of 1965 in the form of our assistance to the Bank of England while very considerably increasing the total amount.