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

CONFIDENTIAL (FR)

January 30, 1969.

To: Federal Open Market Committee

From: Mr. Holland

Enclosed is a memorandum from the Manager, of today's date, entitled "Treasury Cash and Debt Ceiling Dilemma." It is contemplated that this memorandum will be discussed at the Committee's meeting of February 4, 1969, in connection with item 8 of the agenda. Also enclosed is a copy of a memorandum dated January 27, 1969, from Mr. Farrell to the Board of Governors, entitled "Immediate credit for Government deposits," to which Mr. Holmes refers in his memorandum.

A memorandum will be distributed shortly from the Committee's General Counsel on the subject of the legal aspects of proposals for assisting the Treasury in connection with cash and debt ceiling problems.

Robert C. Holland, Secretary
Federal Open Market Committee.

CONFIDENTIAL (FR)

January 30, 1969.

To: Federal Open Market Committee

From: A. R. Holmes, Manager of the System Open Market Account

Subject: Treasury Cash and Debt Ceiling Dilemma.

Over the next two months the Treasury will have to wrestle with the dual problem of meeting seasonal cash needs and at the same time keeping within the legal debt ceiling. Estimates by the Treasury indicate that this could be a serious problem. While these estimates may turn out to be conservative, they are not far different from those made within the Federal Reserve--at the Board and at the Federal Reserve Bank of New York. The Treasury is currently engaged in reviewing alternative methods of meeting their problem and is seeking the assistance of the Federal Reserve System. This memorandum reviews briefly the nature of the Treasury's problems, sketches the possible alternatives that the Treasury might pursue, and makes recommendations for standby Federal Reserve assistance to the Treasury, should it be needed.

The Nature of the Problem

On January 24, total Government debt outstanding subject to the debt ceiling amounted to $364.3 billion, only $700 million under the legal ceiling of $365 billion. The more or less automatic changes in the public debt that result from the flow of funds through various Government trust and agency accounts are enough to bring the debt uncomfortably close to the ceiling on various individual days in the next three months. In addition the Treasury will need $2 to $3 billion in new cash between now and early April.

At times in the past the Treasury has been able to avoid the debt ceiling by permitting the trust funds to redeem special nonmarketable Treasury certificates of indebtedness (thereby reducing debt subject to ceiling) and to use the proceeds of the redemptions to acquire Treasury securities in the market. You will recall that in February 1967 switches of some $800 million were made for this purpose. Such transactions, however, draw down Treasury cash and provide no solution for the present period since the Treasury already anticipates a cash shortage by early March.

Estimates of the Treasury's cash and debt position are difficult to pinpoint because of the uncertain timing of expenditures and receipts and the flow of funds through agency and trust accounts. These uncertainties require the Treasury to operate, to the extent possible, with adequate safety margins, or, when this is impossible, with an adequate standby arrangement that can assure the availability of cash to meet expenditures without exceeding the debt ceiling. The Treasury's emergency borrowing powers from the Federal Reserve are, of course, no satisfactory solution, so long as the debt ceiling is a problem, since such borrowing is also subject to the ceiling.

Keeping in mind the difficulties of pinpointing the Treasury's cash and debt position, the current outlook is about as follows. Assuming a full rollover of the $14.5 billion of Government securities maturing on February 17, outstanding debt would be about $100 million over the ceiling by February 27. Even assuming a 10 per cent attrition on the $5.4 billion maturing securities held by the public, outstanding debt would be uncomfortably close to the ceiling by February 27. While debt subject to ceiling drops at the end of February, the Treasury will be running out of cash in early March, facing a potential cash need of $700 million to $1 billion. Even though this cash were raised in ways that would not increase debt subject to the ceiling, the ceiling would again become a problem by about March 14 because of accruals in the trust accounts. While the paydown of the $2 billion outstanding March tax-anticipation bills on March 22 will reduce outstanding debt, the Treasury estimates that it will need $2 - $3 billion new cash by early April, and the debt ceiling problem will again be acute.

Some Possible Treasury Alternatives

Given this outlook, and the uncertainties involved, there is little wonder that the Treasury is concerned about exploring every possible alternative that could help meet cash needs while staying within the debt ceiling. Some of the alternatives that the Treasury is actively exploring--that do not directly involve recourse to the Federal Reserve System--are listed below.

1. Change in the debt ceiling.

An increase in the debt ceiling sufficient to cover expected cash needs would of course be the most satisfactory solution, since it would restore the Treasury's flexibility in raising new money. There are obvious problems for the new Treasury team and for the Administration in taking this route at this particular time. Apart from the political problem of seeking an increase in the debt ceiling in their first month of office, the Treasury and the Administration have not yet had sufficient opportunity to review the 1970 budget and its implications for the debt ceiling in fiscal 1970. A temporary increase in the debt ceiling covering the remainder of fiscal 1969 could be sought, and a second approach made after the budget review has been completed. A change in the debt ceiling would obviously be the preferred solution and the Treasury is currently giving this approach active consideration. However, the Treasury feels it would be unrealistic to push this approach without some support by Congressional leadership, and such support is at present doubtful. Even if the decision were made to seek new legislation, however, the possibility of delay (or refusal) by Congress in enacting the proposed legislation would make it necessary for the Treasury to continue its contingency planning.

2. Raising cash through agency financing.

The Treasury is seeking to recoup, whenever feasible, funds that it has advanced to Government agencies. Such repayments give the Treasury cash without increasing debt subject to the ceiling, although they may require an increase in Agency debt. As you know FNMA has just raised $250 million by the issue of debentures for payment on February 6. Most of the proceeds of this sale are earmarked for repayment to the Treasury, and additional amounts may be received from the Commodity Credit Corporation and the Ex-Im Bank.

3. Monetization of gold held in ESF.

The Exchange Stabilization Fund currently holds $450 million in gold. The Treasury could monetize part or all of that amount by issuing gold certificates to the Federal Reserve, thereby raising cash. Action with respect to gold will require policy decisions about (1) the desirability of showing, at this particular time, the first rise in the weekly figures on the Treasury gold stock since 1961, and (2) the relative advantages to be gained by maintaining a "kitty" that could be used to meet a gold outflow arising out of unexpected international developments without requiring a reduction in the weekly Treasury gold stock figures.[1/] In the past it has been considered important to maintain such a contingency reserve. Whether the full $450 million is needed for that purpose will be subject to review.

1/ It should be noted that figures on total gold holdings, including ESF holdings, are published in a less conspicuous place, namely in tables in the Federal Reserve and Treasury Bulletins, but with a one-month lag.

4. Noninterest bearing notes held by IMF.

In connection with U.S. subscriptions to the International Monetary Fund, and other IMF operations, the Treasury has issued noninterest bearing notes to the IMF which are included in debt subject to the ceiling. A large part of these notes have been converted, in agreement with the IMF, to letters of credit which are not subject to the ceiling, including $1 billion converted on January 17, 1969, after lengthy negotiations. The IMF still holds $825 million of such notes and is apparently reluctant to convert them to a letter of credit. The Treasury feels it unwise to press the IMF further, and there seems to be no basis for questioning that judgment.

Treasury Recourse to the Federal Reserve

Use of the alternatives outlined in the preceding section--i.e., raising cash through repayment of agency borrowing from the Treasury and the possible monetization of gold--could raise some funds for the Treasury without affecting the debt ceiling. Conceivably, this would be enough for the Treasury to squeak through, but in view of the narrow margin involved and all the uncertainties of the estimates, the Treasury feels in need of a more adequate backstop. They have consequently explored various avenues whereby the Federal Reserve might provide temporary emergency assistance. It should be expected, in any event, that the Treasury may have to run down the balance it maintains with the Reserve Banks from normal levels, and, where the debt ceiling provides leeway, to make use of its emergency borrowing rights. In addition, the Treasury has considered the following more specific possibilities of System assistance.

1. Immediate credit by Reserve Banks for Government deposits.

The Treasury request, in a letter dated September 19, 1968, from the Fiscal Assistant Secretary of the Treasury to the Chairman of the Presidents' Conference Committee on Fiscal Agency Operations, that the Reserve Banks give consideration to immediate credit for Government deposits, is a familiar matter to members of the Open Market Committee. As you know, counsel at the Federal Reserve Bank of New York has expressed the opinion that the Federal Reserve is not authorized to grant immediate credit to the Treasury while it denies such credit to other depositors. I understand that General Counsel of the FOMC is of the same opinion. Any such credit would have to come under the Treasury's special borrowing rights, and hence would be subject to the debt ceiling. The Presidents' Conference rejected the Treasury's request on policy grounds as well. Recent developments in that area are described in the attached memorandum from John Farrell. Still more recently, the Treasury has advised that, while they do not agree with the legal position taken by the Federal Reserve, they would not press the immediate credit proposal at this time, particularly if the Federal Reserve would give favorable consideration to other means of assistance during the emergency period.

2. Speed-up of payments to Treasury of interest on uncovered Federal Reserve notes.

The speed-up of payments to the Treasury of interest on outstanding Federal Reserve notes not secured by gold certificates, on either a temporary or permanent basis, could ease the Treasury's cash position somewhat. Investigation of the feasibility of such a speed-up has been undertaken and a report thereon is contained in the separate memorandum from Mr. Farrell. Moving the February payment up from the normal mid-March date would help meet the Treasury's early March cash need. Interim payments of the accrued interest in February and March should add about $100 million net to the Treasury's cash position.

3. System warehousing of foreign exchange assets held by Treasury.

The Exchange Stabilization Fund at the present time holds $730 million in guaranteed sterling and $90 million in deutschemarks. Since the disposal of assets is one obvious way to raise cash in an emergency, the Treasury is raising the question whether the Federal Reserve would be willing to "warehouse" foreign exchange assets held by the Stabilization Fund in case this is absolutely needed in meeting the dual requirements of the Treasury's cash needs and the debt ceiling. Disposal of these assets in the market does not, of course, represent a practical approach to the problem.

The Treasury points out that the Exchange Stabilization Fund is currently tying up close to $800 million of Treasury cash to finance its holdings of gold and foreign exchange. The Federal Open Market Committee has previously authorized the "warehousing" by the Federal Reserve of up to $1 billion in foreign exchange if needed to help the Exchange Stabilization Fund in the temporary financing of its foreign exchange position. Of this total authorization, $650 million was approved in connection with the special sterling assistance arrangement negotiated in September 1968, an arrangement that has not yet involved any Treasury acquisition of sterling. A $150 million authorization was approved at the time of the sterling credit package in November 1967, and the original $200 million was for the purpose of facilitating Treasury repayments of outstanding securities denominated in foreign currencies. At the moment no part of the $1 billion is in use.

The Committee could, if it so desired, amend its instructions so as to permit the Federal Reserve to warehouse current ESF holdings of foreign exchange, on a temporary basis, if needed to help the ESF finance its foreign exchange position, at the same time that the ESF was transferring dollars to the Treasury General Fund to meet the Treasury's emergency cash need. While the Treasury's problem is not related in any way to current developments in the international situation, it is apparent that the Treasury would have more cash available if it were not carrying such a large position in foreign exchange.

Since the Treasury does have other alternatives that it will be pursuing, the warehousing of foreign exchange can be viewed as a last resort assistance by the Federal Reserve to be utilized only if needed. Recourse by the Treasury to such an expedient is not an agreeable prospect, and the Committee will want to consider carefully its implications with respect to Congressional intent with respect to debt ceiling legislation. The alternatives, however, of either a breach in the debt ceiling or of failure of the Treasury to pay its bills are unthinkable. Such developments could have financial repercussions, both at home and abroad, that might seriously impair the dollar and, indeed, the very credibility of the United States Government.

With this in mind I would recommend that the Open Market Committee at its meeting on February 4 consider the desirability of warehousing of foreign exchange held in the Exchange Stabilization Fund if it is needed to assist the Treasury in the emergency period. Since the Treasury will need this special Federal Reserve assistance only if other alternative approaches fail to meet the problem, I doubt that it would be necessary for the Committee to take formal action on February 4. Nevertheless, suitable forms of authorization will be provided members of the Committee prior to the meeting.

All that would appear necessary on February 4 is for the Committee, if it approves the recommendation, to indicate informally that it would look with favor on the warehousing proposal and to agree on a form of authorization. Formal action by the Committee could be postponed until the need became clear. The members of the Committee could take formal action promptly by telegram on receipt by the Chairman of a formal Treasury request for assistance. In the meantime the Treasury could be assured of the desire and willingness of the Federal Reserve to cooperate in meeting a national emergency if one, in fact, developed.

I have discussed this proposal with the Special Manager of the System Open Market Account. He would want it clearly understood that the suggested warehousing of foreign exchange has no relation whatsoever to the current international situation, and is not being undertaken at his initiative. He would, however, have no objection to the proposal if the Committee believed it desirable to extend assistance to the Treasury in this form.