



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

CONFIDENTIAL (FR)

January 31, 1969.

To: Federal Open Market Committee

From: Mr. Holland

Enclosed is a memorandum, dated today, from the Committee's General Counsel, entitled "Legal Aspects of proposals for assisting Treasury in connection with cash and debt ceiling problems." It is contemplated that this memorandum (along with that from Mr. Holmes, distributed earlier) will be discussed at the Committee's meeting of February 4, 1969, in connection with item 8 of the agenda.

A handwritten signature in cursive script, appearing to read "Robert C. Holland".

Robert C. Holland, Secretary
Federal Open Market Committee.

Enclosure.

REC'D IN RECORDS SECTION

SEP 24 1973

January 31, 1969.

To: Federal Open Market Committee
From: Mr. Hackley

Subject: Legal aspects of proposals for assisting Treasury in connection with cash and debt ceiling problems.

In his memorandum of January 30, 1969, Mr. Holmes describes three proposals for possible temporary assistance to the Treasury in its effort to avoid breach of the statutory debt ceiling: (1) immediate credit by the Reserve Banks for Government deposits; (2) speed-up of payments to the Treasury of interest on Federal Reserve notes; and (3) System warehousing of foreign currency assets held by the Treasury. The following comments focus on the legal aspects of these proposals.

(1) Immediate credit for Government deposits. - I concur in the opinion expressed by counsel at the New York Reserve Bank that the giving of immediate credit by the Reserve Banks for all items deposited by the Treasury would amount to a direct extension of credit to the Treasury that is not authorized by the law. The practice by which, under the present time schedules of the Reserve Banks, immediate credit or deferred credit up to two days is given for items received from member banks has itself always been subject to some legal question on the ground that the giving of such credit for items before they are finally collected amounts to an unauthorized extension of credit to member banks. This practice has been defended on the ground that any resulting credit to member banks is incidental to the efficient administration of the check collection functions of the Reserve Banks.

*See Minutes
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However, a departure from the practice that would result in immediate credit for all items deposited by the Government would appear clearly to constitute simply a means of extending credit to the Treasury rather than a proper incident to collection operations and would therefore, in my opinion, be even more subject to legal question.

(2) Interest on Federal Reserve notes. - Payments to the Treasury of interest on Federal Reserve notes at a rate fixed by the Board pursuant to section 16 of the Federal Reserve Act are now made on a monthly basis. I see no legal objection to a procedure under which such payments would be made on a weekly or even a daily basis.

(3) Warehousing of foreign currency assets. - Mr. Holmes recommends that the Committee consider the desirability of authorizing the Federal Reserve Bank of New York to "warehouse" foreign currency held by the Stabilization Fund in order to provide the Treasury with additional cash, i.e., to purchase such currency with an understanding that the Treasury would buy it back within a reasonably short time.

In July 1968, I expressed the opinion that the warehousing of sterling by the Federal Reserve in connection with the then-proposed sterling assistance arrangement, although not free from doubt, would be legally defensible as an open market purchase of foreign currency through cable transfers, pursuant to section 14 of the Federal Reserve Act, even though such purchases would incidentally result in extensions of credit directly to the Treasury and indirectly to the Bank of England. According to Mr. Holmes, "the Treasury's problem is not related in any

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way to current developments in the international situation"; and his memorandum states that the Special Manager wants "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 initiation." Thus, it might appear that the only purpose of the present proposal would be to make additional cash temporarily available to the Treasury.

The authority of the Reserve Banks under section 14 to buy and sell cable transfers in the open market - the basis for purchases and sales of foreign currencies - is not subject to any limitations as to the purposes of such transactions. Accordingly, if such transactions with the Treasury are "open market" transactions (as was concluded in my memorandum of November 2, 1961, with subsequent concurrence by the General Counsel of the Treasury and apparently also by the Attorney General of the United States), the fact that their purpose may appear to be solely to provide the Treasury with additional cash does not affect their legality.

Section 12A of the Act provides that open market purchases and sales "shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country." The proposed warehousing transactions might not be regarded, in the usual sense, as conforming with this requirement. However, Mr. Holmes' memorandum expresses the view that either a breach of the debt ceiling or failure of the Treasury to pay its bills "could

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have financial repercussions, both at home and abroad, that might seriously impair the dollar." Moreover, circumstances might arise under which, in order to avoid these alternatives, the Treasury might be obliged to sell in the market large amounts of foreign currency holdings of the Stabilization Fund; and any such action could, of course, result in "disorderly conditions in exchange markets" within the meaning of the Foreign Currency Directive. Consequently, if the proposed warehousing transactions are designed to avoid any of these possibilities, they would clearly have a very vital "bearing upon the general credit situation of the country."

In these circumstances, it is my opinion that there would be no legal objection to adoption of the proposal for Federal Reserve warehousing of foreign currencies for the Treasury in the manner described in Mr. Holmes' memorandum. This opinion is premised, of course, upon the assumption that legislation increasing the debt ceiling cannot reasonably be expected in time to resolve the Treasury's problem.

It must be recognized that adoption of the proposed arrangement could subject the System to criticism. It might be charged, for example, that the proposed warehousing transactions would constitute a direct extension of credit to the Treasury by the Federal Reserve and would be contrary to the spirit if not the letter of the law, particularly in view of the express provisions contained in section 14(b) of the Federal Reserve Act for direct borrowing by the Treasury

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from the Federal Reserve within prescribed statutory limits. However, for the reasons here indicated, I believe that the transactions would be legally defensible as not being designed primarily to aid the Treasury but as intended to avoid developments that would have an adverse impact upon the "credit situation of the country."

Paragraph 1 of the Authorization authorizes the New York Reserve Bank to engage in the foreign currency operations subsequently described in the Authorization "to the extent necessary to carry out the Committee's foreign currency directive". The transactions here proposed would not seem inconsistent with the general intent of the Directive as reflected in the statement of "basic purposes" set forth in paragraph 1, one of which is to "help safeguard the value of the dollar in international exchange markets." However, paragraph 2 of the Directive provides that "Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary" to accomplish the purposes specifically described in the remainder of paragraph 2. Similarly, paragraph 4 of the Directive provides that "Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only" for the specific purposes subsequently described in paragraph 4. Since two of the purposes for which the proposed transactions would be undertaken (to avoid breach of the debt limit and failure to meet contractual obligations) might not clearly fall within

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any of the specific purposes listed in paragraphs 2 and 4 of the Directive, it would be desirable for such transactions to be expressly authorized by the Committee.

Moreover, it would seem desirable to amend paragraph 1 of the Authorization by the addition of the underlined phrase in the passage shown below:

"The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto:"

This amendment would be helpful in making clear - in this and similar cases - that the language of the Authorization extends to operations under express authorities given by the Committee as well as those under the specific language of the Directive.