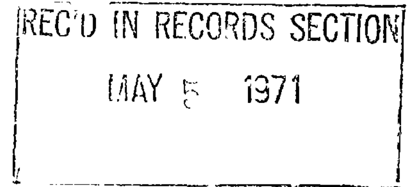
Authorized for public release by the FOMC Secretariat on 8/21/2020

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



May 5, 1971

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

The enclosed memorandum from Mr. Coombs, dated May 3, 1971, and entitled "System operations in forward marks" has been prepared for the information of the Committee pursuant to a request by Governor Brimmer at the meeting of April 6.

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

Enclosure

Authorized for public release by the FOMC Secretariat on 8/21/2020

FOMC RECORDS SECTION
MAY 5 1971

CONFIDENTIAL (FR)

May 3, 1971

To: Federal Open Market Committee

From: C. A. Coombs

Subject: System operations in forward marks.

In the decade since the U. S. authorities resumed intervention in the exchange markets, forward sales of foreign currencies have provided a useful technique of reassuring a nervous market or of influencing interest arbitrage flows of funds. The earliest forward transactions in 1961-63 were for the account of the U. S. Treasury, but since 1964 the Federal Reserve has engaged in forward market sales as well, usually in joint operations with the Treasury. The Committee's authorization with respect to forward operations has been modified periodically over the years, and paragraph 1 C(2) of the Authorization now sets a limit of $550 million of forward sales commitments to the market at any one time. Prior to the latest operation in forward marks there had been ten separate instances, typically a series of operations over a period of time, in which the System had entered into forward sale commitments. These were in four currencies: Belgian francs, Dutch guilders, German marks and Swiss francs, and came to a gross amount of $328 million in original commitments. On each occasion that the System has engaged in forward sales of foreign currencies, our immediate objectives have been reached at a minimum commitment of System resources. At the same time, experience has shown that intervention in the forward market can be effective only under certain circumstances, and the choice of an appropriate time is crucial if one is to minimize the risks of running up very substantial commitments with little effect on market psychology.

Authorized for public release by the FOMC Secretariat on 8/21/2020

Aside from the general risk involved in any operation--that we may fail to achieve our market objectives--the System takes a particular exchange risk each time it sells another currency forward. In undertaking forward commitments to sell a currency the System may be exposed to potential losses depending on the rate at which it ultimately obtains cover for those commitments. To date, all of the forward interventions for System account have been profitable. Operations were generally initiated when the forward rates were at substantial premiums over the spot rates, and in most cases even over the spot ceiling. There is always the risk, however, that the other currency might be revalued during the life of the forward contracts, leading to a quantum jump in the market rate and leaving the System with no other choice but to cover its commitments at a loss. This revaluation risk has been covered by a variety of means. Usually, as with the Swiss franc, Dutch guilder and Belgian franc operations, the respective foreign central bank has agreed to provide a revaluation guarantee. In those cases the intervention was carried out by the foreign central bank in its own market on behalf of the U. S. authorities and at the time the intervention was arranged, the bank agreed to a revaluation provision.

Intervention in German marks, on the other hand, has been carried out by the New York Bank in the New York market, and the arrangements have been different in each case. In the August-September 1968 operations, the System had sufficient balances in hand to cover the exchange

Authorized for public release by the FOMC Secretariat on 8/21/2020

and revaluation risks. In the November 1968 operations, however, this was not the case and the System drew on the swap line pari passu with sales of forward marks in the New York market. The spot mark balances obtained under the drawing were earmarked to cover the forward commitments, thereby leaving the System with a short position under the swap itself rather than vis-a-vis the market; this short position was then protected by the revaluation clause in the swap arrangement. Thus, the System obtained revaluation protection for its forward market sales by, in effect, shifting its short position from the market to the Bundesbank under the swap line.

Turning to the most recent operation, in late March and early April of this year speculative pressures had developed in the exchange markets, on top of the already huge interest arbitrage inflows into European countries, and several European central banks had begun to take in sizeable amounts of dollars. This situation became particularly acute in the three days March 31-April 2. On March 31, Wednesday, the Bundesbank announced a long-awaited cut in its discount and Lombard rates, but at the same time it tightened up on discount quotas, thus leaving the impression that it had no intention of easing monetary policy generally. In minutes, there was a surge in demand for marks, the spot rate moved to the ceiling, and a heavy dollar inflow into Germany developed. This inflow in itself helped generate speculative and hedging demand, which built up substantially over the next few days and began to spill over into the markets for the Swiss franc, Dutch guilder and Belgian franc.

Authorized for public release by the FOMC Secretariat on 8/21/2020

By Friday, April 2 nearly $1.8 billion had been taken in on a spot basis by the respective central banks. Of this, the Bundesbank's spot gains over the three days were a gross of $1.3 billion. To deal with the mounting inflow, on Thursday the Bundesbank swapped some $600 million back into the market, but the German authorities recognized that such an operation could not be sustained in the face of the large continuing demand for spot marks. Accordingly, when the spot inflow continued on Friday, the Bundesbank moved to reassure the market by initiating forward operations, in the form of sales of forward marks at the ceiling for spot marks, that is, 3.63 marks to the dollar. At the same time the Bundesbank inquired whether the U. S. authorities would be prepared to join in such operations in New York after the German market closed. The Treasury concurred in our judgment that such an operation would be worthwhile, and we began that day to sell forward marks for Federal Reserve account. As cover for such operations, we had only $26 million of marks on hand, and so I discussed with Bundesbank officials ways and means of covering our prospective short position in marks in order to fully guard against the risk of a revaluation of the mark. As noted above, the last time we had operated in forward marks we had covered our short position by concurrently drawing marks under the swapline, and thereby had acquired the revaluation guarantee under the swap arrangement. Such drawings on the swap line had added to the spot dollar position of the Bundesbank, but in 1968 the dollar holdings of the Bundesbank were less of a problem

Authorized for public release by the FOMC Secretariat on 8/21/2020

than they are now. On this occasion, in order to avoid increasing the dollar holdings of the Bundesbank _pari passu_ with our forward operations, it was agreed that we might cover our short position in forward marks by making contingent drawings on the swap line for value 90 days' hence, when the forward market contracts would mature. If before the maturity date of the forward contracts we were able to cover through the market or in direct transactions with the Bundesbank these contingent drawings on the swap line would be cancelled. In essence the technique is the same as that employed in 1968, with the drawings simply delayed 90 days. I think this is an effective means of providing us with a revaluation guarantee which is, of course, essential.

The operation proved successful in quickly dampening the speculative pressures. Demand for spot marks dropped off after the weekend of April 3-4 and the spot rate generally has been away from the ceiling ever since. Moreover, by the following Wednesday, the Bundesbank reported that speculative influences had moved into the background and normal interest arbitrage incentives had begun to reassert themselves. Covered outflows had in fact developed by that time; Euro-dollar rates had firmed, partly in response to higher rates in the U. S. and to the $1.5 billion Treasury borrowing from branches of U. S. banks, and German rates had fallen far enough so that for short-term maturities, at least, incentives were favorable to move funds out of Germany and into Euro-dollars. At this point, demand for forward marks began to

Authorized for public release by the FOMC Secretariat on 8/21/2020

reflect covered outflows of funds from Germany. Through April 23 the Bundesbank had sold a total of $759 million equivalent of three-month forward marks while the Federal Reserve had sold $65.5 million equivalent; to cover its commitments, as described above, the System had scheduled drawings, should they be needed, of $60 million for value dates in July.

Comment on the forward mark operation from the press and market sources was favorable. The German press has cited its effect in calming the markets, and several of the exchange traders in the New York market commented that our presence in forward marks had been a reaasuring factor here, particularly on the long Easter weekend when the German market was closed and when some of the other continental European currencies, which were not being supported, were trading above the ceiling. Finally, representatives of the Swiss National Bank have stressed to us the importance of the operation for calming their market; once the flow into Germany halted, much of the pressure on the Swiss franc also abated.

With speculative influences receding, and the demand for forward marks increasingly reflecting interest arbitrage considerations, it was the judgment of the Bundesbank, in which we concurred, that the operation should be wound up at the earliest practicable date. There were several additional flurries in the market, however, that delayed the Bundesbank's withdrawal. In particular, reports emanating from the

Authorized for public release by the FOMC Secretariat on 8/21/2020

EEC Finance Ministers meeting on April 27 stirred up renewed nervousness in the markets and resulted in heavy demand for forward marks in Germany. Then on April 28 the Bundesbank decided at mid-day to terminate its operation in the forward market in order to permit the forward rate to move to a premium that would reflect interest parity. The abrupt withdrawal of the Bundesbank from the forward market during the course of the day produced widespread market criticism both here and abroad, and this Bank, after consultation with the Bundesbank, placed a sizeable offer of forward marks in the market at a rate slightly above the level corresponding to the interest parity. By the following day the exchange markets formed the judgment that the leakages from the EEC Finance Ministers meeting reflected such complete disagreement among the Ministers that no imminent alteration of exchange parities was likely. Speculative demand for marks temporarily faded away and the forward rate stabilized on its own slightly above the ceiling for the spot rate, while spot intervention by the Bundesbank was limited to relatively small amounts conducted through an American commercial bank. Through the 28th the Bundesbank's forward sales totaled $1,509 million; those of the System came to $75.7 million.