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

June 15, 1977

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committe

FROM: Arthur L. Broida ALB

Attached are two staff memoranda, from Mr. O'Connell and from Messrs. Gemmill and Keir, respectively, on the subject of repurchase agreements for foreign central banks.

It is contemplated that these memoranda will be considered at the June 21 meeting of the Committee, in connection with the discussion of Mr. Volcker's memorandum on the same subject that was distributed yesterday.

Attachments

CONFIDENTIAL (FR)
CLASS II FOMC

Date June 14, 1977

To Federal Open Market Committee

From Mr. O'Connell

Subject: The Use of Repurchase Agreements for Foreign Central Banks and International Institutions.

RECOMMENDATION: If the Committee determines that it would be desirable to continue to provide an RP facility for foreign and international accounts, it is recommended that the Committee's Authorization For Domestic Open Market Operations (the "Authorization") be amended to reflect certain changes in such operations necessitated by a recent Internal Revenue Service ruling. Specifically, it is recommended that the Committee authorize the Federal Reserve Bank of New York ("FRBNY") to arrange RPs with dealers and corresponding back-to-back RPs with foreign accounts--the third alternative presented in the memorandum from the FRBNY.

DISCUSSION: Under the second paragraph of § 12A of the Federal Reserve Act and § 270.4(a) of the Committee's Regulations, a Federal Reserve Bank shall engage in open market operations under section 14 of the Act only in accordance with the Committee's Regulations and with the authorizations and directives issued by the Committee from time to time. As discussed more fully in the separate memorandum from the FRBNY, the FRBNY has for the past several years been providing an RP facility in U.S. Government and Federally-sponsored agency securities to its foreign accounts. Specifically, as an accommodation to its foreign accounts, the FRBNY has been investing idle account balances in RPs with the System Open Market Account ("SOMA") and with dealers. As a result of a recent IRS ruling discussed in the FRBNY memorandum, it now appears that such RP arrangements with dealers may have certain untoward tax effects for such foreign accounts and that all transactions may have to be arranged either with SOMA or with the FRBNY as principal to retain their tax exempt status.

Under ¶ 1(a) of the existing Authorization, the FRBNY may buy or sell U.S. Government securities from or to foreign and international accounts maintained at the FRBNY for the account of SOMA only "to the extent necessary to carry out the most recent policy directive adopted at a meeting of the Committee". The problem presented by arranging all foreign account RP transactions with SOMA is that on certain days such transactions may be inconsistent with the latest directive and thus deemed unauthorized by ¶1(a). It is possible to say that any such transactions would nevertheless be authorized so long as proper offsetting actions were otherwise taken in the market. While such view can be legally supported on the basis that the total of actions under ¶ 1 for a given day must be consistent with the latest Committee directive, a separate authorization would be preferred from a purely legal viewpoint in order to make clear the lawfulness of the FRBNY's actions under the Act and FOMC Regulations. Counsel is influenced in this regard by the careful specificity with which the Committee has authorized other open market operations. Thus, it is recommended that either the second or third alternative in the FRBNY memorandum be adopted if the Committee decides to maintain the RP facility.

Of these latter two alternatives, we would prefer the third alternative because it raises the least possible legal questions about past practices. By specifically referring to foreign account RPs with SOMA, the second alternative raises the question of whether similar specific authority should not also have been included in ¶ 1(a) to cover such transactions and may cause confusion as to whether SOMA RP transactions with foreign accounts are authorized only under such new paragraph or may also be conducted under ¶ 1(a) when consistent with the latest directive. The third alternative avoids such problems by leaving undisturbed the authority to engage in SOMA transactions with foreign accounts under ¶ 1(a) and by proposing an alternative to the smaller class of transactions most directly affected by the IRS ruling--FRBNY transactions with dealers.

June 15, 1977

TO: Federal Open Market Committee

FROM: Robert Gemmill & Peter Keir

SUBJECT: Pros and Cons of System Matched-Sale Purchase Transactions with Foreign Accounts

During the FOMC's informal, May 27, discussion of foreign RP-type transactions with the New York Desk, Governor Wallich recommended a fresh staff look at the advantages and disadvantages of these arrangements. This memorandum has been prepared to respond to that request--using a pro and con format. For background on the nature and history of Desk operations in these instruments, reference should be made to the staff document on this subject prepared at the Federal Reserve Bank of New York.1/

It is perhaps worth reiterating here that when funds flow into foreign official accounts at Federal Reserve Banks, the initial effect is to drain reserves from the U. S. banking system. This reserve absorption effect is immediately offset if the Desk--in its capacity as agent--reinvests the foreign funds in money market instruments, acquired through private dealer channels. The initial reserve drain is not offset, however, if the Desk chooses to meet the foreign investment need directly from the System portfolio--either by an outright sale of securities or by a System MSP.

1/ This document--entitled Use of Repurchase Agreements for Foreign Central Banks and International Institutions at the Federal Reserve Bank of New York--is attached to the memo to the FOMC on this subject from President Volcker.

Arguments as to the desirability of continuing MSP's with foreign accounts focus essentially around two general questions: (1) whether this instrument is needed to promote cordial central bank relations and provide essential information on foreign financial flows; and (2) whether MSP's with foreign official accounts add a useful dimension of flexibility to day-to-day System open-market operations that would be missed if abandoned.

Arguments Favoring Continued Use of MSP's with Foreign Accounts

A. Contribution to cordial central bank relations. The Federal Reserve maintains close working relations with all major central banks. These contacts reflect the position of the United States in the international financial system and the role of the U. S. dollar as an international reserve currency. In maintaining these relationships the Federal Reserve provides a wide range of services--including the holding and investing of monetary reserves of foreign countries, the facilitation of payments from foreign central bank deposits, and the provision of technical assistance. These services contribute to cordial relations with other central banks, and more generally to the successful functioning of the international financial system.

While the MSP facility is only one element in the total range of services provided foreign central banks, it is highly valued by a sizable number of these institutions. Withdrawal of the facility could tend to erode relations with these banks and possibly affect more than just their investments in MSP's. Continuation of the facility, on the other hand, if achievable without significant cost or burden to the System will help to maintain cordial relationships.

B. Contribution to understanding of foreign financial flows. To the extent that foreign central banks conduct their dollar-denominated transactions through the FRBNY rather than through commercial banks, the System has greater opportunities for gathering intelligence that may aid in the interpretation of exchange market and other financial market developments. Examples of this include the extent to which OPEC has shifted to longer-term investments, and indications of shifting reserve assets from one currency to another, say from sterling into dollars. An abandonment of MSP arrangements with foreign central banks might encourage these banks to hold more of their accounts outside the Federal Reserve System and thus risk an erosion of this source of intelligence.

C. Contribution to strength of the U. S. dollar exchange rate. Under certain circumstances, the availability of particular investment facilities through the Federal Reserve might have the effect of strengthening the exchange rate for the U. S. dollar.

This could occur if some foreign central banks were faced with a choice of holding monetary reserves either in the Federal Reserve Bank of New York or in a foreign currency asset abroad, although typically such fundamental decisions regarding currency composition of reserves are made on the basis of broad policy considerations regarding diversification and exchange-rate relationships rather than on considerations of yield.

A strengthening of the rate could also occur if some foreign central banks were induced to hold reserves at the Federal Reserve Bank of New York rather than shifting them to U. S. commercial banks. (Currently about 80 per cent of the foreign official reserve holdings in the United States are held through Federal Reserve Banks.) A shift of funds from Federal Reserve Banks to U. S. commercial banks in the United States would not, by itself, have any impact on the dollar exchange rate, but an exchange rate effect could ensue if as a result of such a shift U. S. commercial banks were induced to step up their foreign lending.

Finally, a strengthening of the dollar could occur if the investment facilities with the Federal Reserve reduced the likelihood that foreign official placements would be made in the Eurodollar market and that these in turn would lead to increased market demands for foreign currencies.

D. Benefits to Open Market Operations. On the domestic policy side, MSP's with foreign accounts add a dimension of flexibility to Desk open market operations. They are especially useful in situations where staff projections suggest a need to absorb reserves even though current money market conditions are tending toward the tight side of the Committee's desired range. In such circumstances, the Desk may be reluctant to absorb reserves through transactions in the market for fear of misleading participants about System objectives and thus causing unintended movements in money market rates. Foreign MSP's provide an unobtrusive means of achieving the desired reserve absorption with a minimum impact on interest rates.

When there is a need to provide reserves, the Desk commitment to make MSP's with foreign accounts (and thus absorb reserves) does, of course, add to the volume of reserves the System must supply. In most cases the Desk can meet these expanded needs without difficulty, by increasing the volume of System RP's with dealers. In the few instances where a shortage of market collateral has restricted the achievable volume of System RP's, the New York Bank has persuaded foreign accounts to cut-back their demands for sale-purchase accomodation. The alternative foreign account investments made in these cases have usually been purchases of Treasury bills or Eurodollar placements.

A discontinuation of System MSP's with foreign accounts could reduce the ability of the Desk to moderate the money market and bank reserve effects that result from large international dollar flows and from marked reductions in U. S. Treasury balances at Federal Reserve Banks.

Arguments Against Continued Use of Matched-Sale-Purchase Transactions with Foreign Accounts

A. Encouragement of Private Market Forces. In the absence of some important public purpose, Federal agencies--as a matter of principle--should avoid competing with private firms in providing goods and services. Private institutions are willing and able to offer foreign central banks most of the services the System now provides at reasonable prices. Indeed, they have shown considerable ingenuity in adapting the services offered to the needs of investors, and recently they have placed emphasis on accommodating foreign demands for short-term money market investments. Some central banks have taken advantage of these private financial services.

Thus, a basic issue is whether the importance of the public purposes served by the System's MSP facility for foreign central banks is great enough to justify the competition with the private market that is embodied.

B. Need for information on foreign financial flows. The case for continuing System MSP's with foreign official accounts places considerable stress on the added intelligence about foreign financial flows that is derived from System participation in these operations. These MSP's average only a little over $1 billion a day, compared to about $80 billion of total official foreign exchange reserves held in custody at the Federal Reserve Bank of New York. Because MSP's are a significant focal point of day-to-day changes in foreign reserve positions, however, their significance from an intelligence standpoint is greater than such comparisons might suggest.

If System MSP's with foreign accounts were discontinued, the Federal Reserve would still have substantial sources of information on foreign financial flows. Moreover, it could ask foreign central banks to provide information directly regarding large dollar transactions in our market.

C. Impact on the U. S. dollar exchange rate. It seems unlikely that the elimination of foreign access to System MSP's would exert a significant impact on the decisions of other central banks regarding the currency composition of their reserves. To date the MSP option has provided only a small net addition to foreign central bank earnings on dollar assets held at Federal Reserve Banks.

Also, it seems unlikely that shifts of official reserves from Federal Reserve Banks to private commercial banks would provide any significant encouragement to U. S. banks to step up their foreign lending and thus affect the dollar exchange rate. In earlier years, some foreign central banks maintained reserves with commercial banks in order to develop a closer customer relationship, but at present--with U. S. commercial banks already holding large foreign loans on their books and becoming more cautious regarding additional loans--the effect, if any, would be substantially smaller.

Finally, while withdrawal of the MSP facility might lead to increased foreign official placements in the Eurodollar market--which in turn might lead to larger foreign lending--the fact that U. S. banks and U. S. agencies and branches of foreign banks are regularly arbitraging between U. S. markets and the Eurodollar market argues against the likelihood that a significant exchange rate effect would result, even if shifts in some foreign official accounts should prove to be somewhat larger than the volume of MSP's now being done for those accounts.

In short, the bases for concern that discontinuance of the System MSP facility for foreign accounts would create significant exchange rate consequences in today's markets are highly tentative and conditional.

D. Impact on Central Bank Relations. While the provision of the MSP facility undoubtedly contributes to cordial relations with central banks that value its use, there is already a risk of impairing relations with these banks when interest in the service outpaces the ability of the System to provide it without interfering with Desk operations. The foreign department at the New York Banks has developed *ad hoc* ground rules designed to constrain overall use of the MSP facility, by limiting the timing and size of access by individual foreign central banks.

The plan--now being considered by the New York Bank staff--to institute formal user charges on foreign MSP's and to request foreign accounts to hold additional balances where appropriate would provide a more formal means of allocating use of the MSP facility.

E. Benefit to Desk operations. The case for continuing MSP's with foreign accounts rests importantly on the added flexibility the instrument provides the New York Desk on days when it is seeking to absorb reserves unobtrusively. There is little question that MSP's with foreign accounts have proved useful for this purpose.

It must be recognized, however, that foreign account MSP's have disadvantages in the opposite situation, when the Desk needs to supply reserves; at such times, the MSP commitment adds to the volume of reserve supplying operations required. When this total is very large, it may be difficult for the Desk to make all of the System RP's it would like to, because of temporary shortages of collateral in the dealer market. On several occasions when a collateral shortage has developed, the Desk has requested foreign central banks to reduce their reliance on System MSP's and to shift to alternative investments.

It should be noted that this problem has arisen in a period of essentially easy money, when the supply of collateral available in the dealer market ordinarily is plentiful. In periods of tight money the collateral problem could become much more severe, necessitating more frequent and more severe rationing of access to the MSP facility--although under tight money conditions alternative money market investments would tend to be more attractive than System MSP's. Obviously, with more severe rationing, the appeal of the MSP's facility would be reduced.

Fortunately, the need for large Desk operations to offset week-to-week swings in the supply of bank reserves may diminish in the near future. During recent years the factor most responsible for swings in bank reserve availability has been fluctuations in the Treasury's balance. Since Congress now appears to be disposed to enact new legislation permitting the Treasury to earn interest on deposits held with commercial banks, week-to-week fluctuations in the Treasury balance may soon be greatly reduced. Such a development would, of course, greatly reduce the value to the System of foreign account MSP's as a device for absorbing reserves unobtrusively.