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

May 12, 1978

STRICTLY CONFIDENTIAL (FR)
CLASS I FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida A.B.

Attached is a memorandum from Mr. Holmes, dated May 11, 1978, and entitled "Status of Negotiation with Bundesbank on Means of Repayment of Swap Drawings."

This memorandum will be considered at the FOMC meeting on May 16, under agenda item 2C.

Attachment

STRICTLY CONFIDENTIAL (FR)
CLASS I FOMC

May 11, 1978

To Federal Open Market Committee

From Alan R. Holmes

Subject: Status of Negotiation with Bundesbank on Means of Repayment of Swap Drawings

As requested by the FOMC at the March 21 meeting, I have held extensive discussions with my counterparts at the Deutsche Bundesbank to review the various mechanisms by which the Federal Reserve would repay its swap debt to the Bundesbank, which in early April had reached $1,844 million. I have reviewed the options with representatives of the U. S. Treasury, which had swap debt of $1 billion to the Bundesbank as of early April. Governor Wallich has also discussed these matters with policy level people at the Bundesbank, as well as at the U. S. Treasury. Scott Pardee and others at the New York Bank and Board staff representatives have held technical discussions with their counterparts at the Bundesbank and at the Treasury.

After its own study of the various options, the Bundesbank has indicated a strong preference that the swaps be repaid within one year, and that there be no extension of drawings or refinancing which would carry beyond a third renewal of an individual swap drawing. This means that we should take steps to acquire marks in the interim. The first hope is that repayment can be made out of acquisitions in the exchange market, on a recovery of the dollar rate from the depressed levels it had reached. To the extent that is not possible, the Bundesbank has offered to assist through direct sales to us of marks arising out of various types of non-market transactions. That bank has an arrangement with German commercial banks for them to offer to it any marks arising out of the conversion of non-resident borrowings in DM. So far this year, such capital export conversions have been running in excess of $500 million a month, and although they are likely to taper off, the volume of conversions should remain sizable. As you know we already have begun to acquire marks in this manner. In addition, the German government has occasional needs for dollars, and the Bundesbank is prepared to buy directly from us, providing marks we could use to repay debt. From these and other direct transactions with the Bundesbank much if not all of the Federal Reserve's (and the Treasury's) remaining swap drawings might be repaid over the course of the next six to nine months. If not all of the drawings can be repaid in this fashion, the Bundesbank has indicated that it will be willing to supply us directly with the remaining marks.

For our part, we have been able to acquire occasionally significant amounts of marks from foreign central bank correspondents, without having to go into the market as bidders for marks. I might add that on several recent occasions, when the dollar was rising particularly sharply on a given day, we have bought modest amounts of marks in the market.

On the basis of these arrangements, we have already been able to make some progress in paying down debt. As of today, we have repaid some $258 million of DM swap drawings, reducing the total to $1,585 million. These correspond to all of the drawings made during last October and November, thus postponing by two full months the need to reopen the question of what to do should we be unable to repay the swaps within 12 months of original drawing. Since the first swaps were at relatively high rates for the dollar, we have taken an interim loss of $13 million (our half of the gross loss of $26 million) but at current exchange rates our loss on the remainder of the debt now would amount only to an additional $3 million. If the dollar should continue to rise, we would be of course in a better position to reduce the loss, break even, or perhaps make a profit.

Our gross acquisition of marks have been shared with the Treasury on a 60-40 basis. The Treasury has repaid $163 million of its debt, leaving $837 million remaining. The Treasury has absorbed a loss of nearly $4 million on the swaps it has repaid, but if the remainder were repaid at current rates the Treasury would net a small profit on the overall operation in marks.

I believe the current arrangements to be a good way to proceed. They meet the Committee's objective of clearing up the debt in a timely fashion. There are enough options open to ensure us sufficient marks to repay the full debt over the coming months. Although the non-market acquisitions mean that we withhold marks from the exchange markets and thereby inhibit the dollar from rising, we avoid the potentially damaging psychological effects of a program of purchases in the market.