CONFIDENTIAL (FR)

December 12, 1961.



TO: Federal Open Market Committee

FROM: Mr. Sherman

SUBJECT: System Operations in Foreign Currencies.

The attached documents are the latest versions of the draft papers Nos. 1, 2, 4, and 5 previously circulated, and a new paper No. 7, which contains suggestions for possible legislation relating to System operations in foreign currencies.

The revisions of papers Nos. 2, 4, and 5 embody, in addition to some clarifying editoral changes, the following substantial suggestions made in the course of the meeting of the Committee of December 5, 1961.

(1) In Paper No. 2, Section II., the enumeration of purposes has been amended so as to make it clear that the increase in mutual currency holdings would apply only in the long run. A sentence has been added expressly stating that the operations shall not be used to obsuure basic changes in the U. S. balance of payments.

(2) Section VIII. of Paper No. 2 has been completely reworded. The proposal to establish a Subcommittee has been eliminated; instead, it is proposed that the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board be authorized, within the Guidelines issued by the Committee, to set maximum amounts for individual currency holdings and exchange rate limits, to review and approve understandings between the New York Bank and foreign central banks, and to take action in emergencies when the decision of the Committee cannot be sought in time. Apart from the self-explanatory emergency provision, this arrangement is proposed because it would be inadvisable to publish individual maximum amounts, exchange rate limits, and understandings

with foreign central banks, as might be necessary if these decisions were made by the Committee. All actions taken under this provision must be reported to the Committee for ratification and confirmation.

(3) Section IX. of Paper No. 2 has been amended to make it clear that the Committee must be continuously provided with all current statistical and other information that will enable it to review the New York Bank's transactions in and holdings of foreign currencies as to conformity with its instructions.

(4) Paper No. 4 now is a proposed action of the Committee itself. The section on temporary payments fluctuations (page 2) has been amended to eliminate reference to seasonal and cyclical swings and thus to make it clear that System transactions should aim only at moderating or cushioning the effects of unusual payments swings. The sections on administration of accounts and purchases of foreign currencies (page 6) have been amended to conform to the arrangement under Section VIII. of Paper No. 2.

(5) Paper No. 5 has been amended to conform to the new formulation of the purposes and specific aims of the operations in Papers No. 2 and 4, and to the new formulation of the treatment of seasonal and cyclical flows in Paper No. 4.

Mr. Hackley has made some editorial changes in Paper No. 1, and has prepared a new paper No. 7, which embodies suggestions for possible statutory clarification of the System's authority to engage in foreign exchange operations. The proposal would change existing law only insofar as it would clarify the authority of Reserve Banks to open foreign accounts, remove the restrictions on investment of foreign balances, and expressly authorize Reserve Banks to enter into direct transactions with the International Monetary Fund and the Stabilization Fund.

Paper No. 1

CONFIDENTIAL (FR) November 12, 1961.



Proposed Actions by the Board of Governors

A. Amendment to Regulation N

Regulation N, Relations with Foreign Banks and Bankers, is amended by changing the numbering of section 5 to section 6 and by inserting after section 4 the following new section:

SECTION 5. ACCOUNTS WITH FOREIGN BANKS

(a) Any Federal Reserve Bank, with the approval of the Board, may open and maintain accounts in foreign currencies with such foreign banks as may be designated by the Board.

(b) Notwithstanding other provisions of this Regulation, any officer or other representative of a Federal Reserve Bank which now maintains an account with a foreign bank or which opens an account with a foreign bank pursuant to this section may conduct such negotiations and enter into such agreements, contracts, or understandings with such foreign bank as may be authorized or directed by the Federal Open Market Committee in order to effectuate the conduct of open market transactions of the Federal Reserve Banks incident to the opening, maintenance, operation, increase, reduction, or discontinuance of such account; and, in any such case, such negotiations, agreements, contracts, or understandings shall be subject to such directions, regulations, and limitations as may be prescribed by, or pursuant to authority of, the Federal Open Market Committee.

(c) Any Federal Reserve Bank may, when authorized or directed so to do by, or under the authority of, the Federal Open Market Committee, carry on or conduct, through any other Federal Reserve Bank which now maintains an account with a foreign bank or which opens such an account pursuant to this section, any open market transaction authorized by section 14 of the Federal Reserve Act. Transactions other than open market transactions, authorized by section 14, may be carried on or conducted through such other Federal Reserve Bank only with the approval of the Board.

(d) Notwithstanding other provisions of this Regulation, reports with respect to any accounts opened and maintained, or negotiations, agreements, contracts, or understandings entered into, pursuant to this section shall be made to the Board by a duly authorized officer of the Federal Reserve Bank involved at least quarterly and more frequently if so requested by the Board.

B. Designation of Foreign Banks

SUPPLEMENT TO REGULATION N

Pursuant to section 5(a) of Regulation N, Relations with Foreign Banks and Bankers, the Board of Governors authorizes the Federal Reserve Bank of New York, in addition to maintenance of existing accounts with the Bank of Canada, the Bank of France, and the Bank of England, to open and maintain accounts in foreign currencies with the following foreign banks:

National Bank of Belgium

German Federal Bank

Bank of Italy

Netherlands Bank

Swiss National Bank

All such accounts shall be subject to the provisions of section 5 of Regulation N, as amended.

C. Letter to Presidents of Federal Reserve Banks

Dear Sir:

Hereafter, the dollar cost of total foreign currency holdings of the Reserve Banks, acquired pursuant to the Federal Open Market Committee's instructions of ___________, 1961, should be reported on Form FR 34 in "Other assets" opposite a new caption "Foreign currencies".

The amount of such holdings will be shown separately in the Federal Reserve Bulletin table concerning the weekly and monthly consolidated statements of condition of all Federal Reserve Banks. However, these holdings will not be shown separately but will be included as part of "Other assets" in the weekly press statements issued by the Board and the Reserve Banks.

The International Financial Statistics section of the Bulletin will show each month averages of daily holdings of foreign currencies for the preceding month. In addition, a breakdown of the holdings by currencies will be shown as of the end of each quarter in the Bulletin issued three months later.

Very truly yours,

Merritt Sherman,
Secretary.

Paper No. 2

CONFIDENTIAL (FR) (Draft of proposed FOMC actions)

Federal Open Market Committee December 12, 1961.

## A. INSTRUCTIONS REGARDING OPEN MARKET TRANSACTIONS IN FOREIGN CURRENCIES

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 5 of Regulation N of the Board of Governors of the Federal Reserve System, as amended, and the Board's action of ______________, 1961, pursuant to Regulation N, the Federal Open Market Committee issues the following instructions governing open market operations incident to the opening and maintenance by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

### I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to these instructions (hereafter sometimes referred to as transactions in foreign currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

### II. Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the United States are:

(1) To help safeguard the value of the dollar in international exchange markets;

(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;

(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;

(4) Together with these banks and institutions, to help moderate such temporary imbalances in international payments as may adversely affect monetary reserve positions and thus to provide a first line of defense against international financial instabilities;

(5) In the long run to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy;

(6) To facilitate by these means the balanced growth of international trade and investment and thus to contribute to the promotion and maintenance of high levels of economic activity and employment, and of currency relationships favorable to the most efficient use of capital and credit resources and to the stability of international price levels.

System operations in and holdings of foreign currencies shall not be used, however, to obscure basic changes in the U.S. balance of international payments.

III. <u>Arrangements with Foreign Central Banks</u>

In making operating arrangements with foreign central banks on System exchange holdings the New York Bank shall reserve the freedom to change its balance, subject to the need for minimum working balances.

The Bank shall instruct foreign central banks regarding the investment of such balances in accordance with Section 14 (e) of the Federal Reserve Act.

The Bank shall consult with foreign central banks on coordination of exchange operations.

## IV. Maximum Quota for System Foreign Currency Holdings

Until otherwise directed by the Federal Open Market Committee, the maximum quota for the New York Bank's total holdings of foreign currencies for System Account shall be the equivalent of $______________, computed at cost.

With the approval of the Federal Open Market Committee, this maximum may be increased in the case of System participation in a U.S. drawing on the International Monetary Fund.

## V. Currencies Authorized for Purchase

The New York Bank is authorized to purchase for System Account any or all of the following foreign currencies:

Pounds sterling

Belgian francs

French francs

German marks

Italian lire

Netherlands guilders

Swiss francs

## VI. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

Unless the New York Bank is otherwise instructed in accordance with Section VIII., below, all authorized transactions shall be at prevailing market rates within the margins set by Article IV, Section 3 (i) and (ii) of the Articles of Agreement of the International Monetary Fund.

## VII. Participation of Federal Reserve Banks

All Federal Reserve banks shall participate in the foreign currency operations for System Account in the same proportion as their holdings of U.S. Government securities in the System Account bear to the total amount of such securities in that account.

## VIII. Administrative Procedures

The Federal Open Market Committee authorizes the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate)to take the following actions within the guidelines issued by the Committee:

(1) To designate maximum amounts of individual authorized foreign currencies to be purchased, sold, and held at

any time by the New York Bank;

(2) To establish minimum and maximum rates of exchange for the New York Bank's open market purchases and sales of authorized foreign currencies;

(3) To review and approve all agreements and understandings between the New York Bank and foreign central banks under Section III., above; and

(4) In cases in which it is necessary to reach a decision on operations before the Committee can be consulted, to give instructions to the New York Bank.

The Committee authorizes the Chairman and in his absence the Vice Chairman of the Committee and in the absence of both the Vice Chairman of the Board of Governors:

(1) Under instructions of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

(2) From time to time to advise the Secretary of the Treasury concerning foreign currency operations conducted pursuant to these instructions, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities;

(3) To transmit to the National Advisory Council on International Monetary and Financial Problems such reports and information as are required by Section 4 (c) of the Bretton Woods Agreements Act.

All actions authorized under this Section shall be promptly reported to the Committee for ratification and confirmation.

IX. Special Manager of System Open Market Account

The New York Bank shall select one of its officers, who shall be satisfactory to the Federal Open Market Committee, to serve as Special Manager of the System Open Market Account for foreign currency operations.

The Special Manager shall direct that all transactions in foreign exchange and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee, and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

X. Amendment of Action

The Federal Open Market Committee may at any time amend or rescind these instructions.

B. STANDING DIRECTIVE

The Federal Reserve Bank of New York is directed:

(a) to purchase and sell for System Account cable transfers payable in the currencies of any or all of the following countries: Belgium, France, Germany, Italy, the Netherlands, Switzerland, and the United Kingdom;

(b) to conduct its operations in those currencies in accordance with the instructions of the Federal Open Market Committee of ______________, 1961, so as to achieve the following aims:

(i) to offset or compensate, when appropriate, the effects on U.S. gold reserves of those fluctuations in the international flow of payments to or from the United States that are deemed to reflect temporary disequilibrating forces or transitional market unsettlement;

(ii) to temper and smooth out abrupt changes in spot exchange rates and moderate forward premiums and discounts judged to be disequilibrating; and

(iii) in the long run, to provide a means whereby reciprocal holdings of foreign exchange may contribute to meeting needs for international liquidity as required in terms of an expanding economy.

Paper No. 4

CONFIDENTIAL (FR)

Federal Open Market Committee

(Draft of Suggested Initial Action of the FOMC)

December 12, 1961.

GUIDELINES FOR SYSTEM OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

In conformity with the action of the Federal Open Market Committee of ______________, 1961, the Federal Reserve Bank of New York is instructed to start operations for System Open Market Account on the basis of the following guidelines.

Aims of Operations

The transactions of the Federal Reserve Bank of New York are to be conducted within the broad purposes set forth in the action referred to above with a view to the following specific aims:

(a) Offsetting or compensating, when appropriate, the effects on U.S. gold reserves of those fluctuations in the international flow of payments to and from the United States that reflect temporary disequilibrating forces or transitional market unsettlement;

(b) Tempering and smoothing out abrupt changes in spot exchange rates and moderating forward premiums and discounts judged to be disequilibrating; and

(c) In the long run, providing a means whereby reciprocal holdings of foreign exchange may contribute to meeting needs for international liquidity, as required in terms of an expanding economy.

Temporary Fluctuations in Payments Flows

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include responses to short-run increases in international policital tension, differences in phasing of international economic activity that give rise to unusally large interest rate differentials between major markets, or a rise in market rumor of a character likely to stimulate speculative transactions.

Increase in U.S. Gross Reserve Strength

System holdings of foreign exchange may be acquired directly from foreign banks in exchange for dollar holdings at prevailing exchange rates. Such reciprocal holding transactions shall have the broad purpose of enlarging U.S. gross reserve strength to satisfy rising world needs for dollars without reducing U.S. net reserves, and may serve to complement stand-by credits negotiated through the facilities of the International Monetary Fund.

Guidelines for System Holdings of Foreign Currencies

The guiding principles for System holdings of foreign currencies are, first, that the maximum amount be not too large in relation to System resources considering risks involved, and second, that the amount be not so small as to rob the operations of market influence. The maximum would be realized only when the U.S.

balance of international payments attains a large surplus, permitting the ready accumulation of major convertible currenceis.

The setting of amounts of individual currencies to be held by the System shall be guided by two considerations: first, the importance of the individual currency in international transactions (measured, for example, by the country's IMF quota or by its contribution to the "borrowing arrangement"); and second, a country's willingness to hold part of its reserves in dollars.

Spot holdings of a currency should generally be kept sufficient to meet forward contracts in that currency (exclusive of contracts made under parallel arrangements with foreign monetary authorities which provide their own cover) expected to mature in the following three-week period.

Foreign exchange holdings above a certain minimum should be invested as far as practicable in conformity with Section 14 (3) of the Federal Reserve Act.

General Guidelines for System Exchange Transactions

System exchange transactions should mainly be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of volatile funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

The New York Bank should, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

The Committee may at times, however, authorize the Bank to operate for the purpose of influencing market rates if this seems advisable in order to cope with unusual market conditions or to counteract destabilizing speculative transactions.

Except under special instructions, the Bank should not purchase or sell more than 15 per cent of the established maximum quota for each currency in any one calendar week.

If market offers to sell or buy intensified as System holdings increased or declined, this would constitute a clear signal for a review of the System's evaluation of international payments flows. This review might suggest direct transactions with the foreign central bank involved to be able to accommodate a larger supply or demand, and a temporary change in the quota for System holdings of a particular convertible currency.

As a general principle, it will be desirable for the U.S. gold stock to rise in times of balance-of-payments surplus and to decline in times of deficit. The New York Bank should aim at limiting its purchases of authorized foreign currencies to part of the inflow in periods of surplus, and at limiting its sales to part of the outflow in periods of deficit.

Starting operations at a time when the United States is not experiencing a net inflow of any eligible foreign currency may require that initial System holdings (apart from sums that might be acquired from the Stabilization Fund) be purchased directly from foreign central banks. Hence, the Bank may arrange for a direct exchange of spot currencies with foreign central banks to avoid the use of gold in acquiring currencies.

It should be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

Transactions in Spot Exchange

The guiding principle for transactions in spot exchange should be that, in general, market movements in exchange rates, within the limits established in the IMF Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discountinued pending a re-assessment by the Committee of supply and demand forces.

Transactions in Forward Exchange

As a beginning for operations in the forward market, the New York Bank may take over from the Stabilization Fund any outstanding contracts for forward sales and purchases of eligible currencies in which the Fund is now dealing. Occasion to engage in further forward transactions will arise mainly when forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to a disequilibrating movement of short-term funds.

Administration of Accounts in Foreign Countries

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks of Belgium, France, Germany, Italy, the Netherlands, Switzerland and the United Kingdom are to be referred for review and approval to the members of the Committee designated in Section VIII. of the Committee's Instructions.

Purchases of Foreign Currencies

The New York Bank is authorized to acquire and hold the currencies of the countries named in the preceding paragraph up to amounts to be specified by the members of the Committee designated in Section VIII. of the Committee's Instructions.

Within these maximum quotas, the Bank may purchase these currencies from the Stabilization Fund at the rate at which the Stabilization Fund in turn has acquired them, or at the current market rate, whichever is lower.

The Bank may also purchase these currencies from other sources at prevailing market rates.

Insofar as possible, the Bank should purchase a currency only at or below its par value, and should lower the rate at which it is prepared to purchase a currency as its holdings of that currency approach the established maximum.

If the Bank is unable to build up its holdings of an authorized currency to at least one-half of the maximum through such purchases at or below par and if such a build up seems desirable, the Committee may authorize the Bank to purchase the currency at prevailing market rates above its par value.

Sales of Foreign Currencies

Insofar as possible, the Bank should engage in sales of an authorized currency only at rates at or above its par value, and should raise the rate at which it is prepared to sell a currency as its holdings of that currency approach zero.

Other Transactions

Proposals of the Special Manager for other transactions, or for transactions at rates other than those outlined in the two preceding sections, should be referred to the Committee for concurrence before entering into arrangements for their execution.

Accounting Procedures

The Special Manager shall include in his reports to the Federal Open Market Committee a statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

Paper No. 5

CONFIDENTIAL (FR)

(Explanatory paper)

Board of Governors of the
Federal Reserve System and
the Federal Open Market Committee

December 12, 1961

AIMS AND SCOPE OF SYSTEM FOREIGN EXCHANGE OPERATIONS

The basic purposes of System operations in and holdings of foreign currencies would be:

(1) To help safeguard the value of the dollar in international exchange markets;

(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;

(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;

(4) Together with these banks and institutions, to help moderate such temporary imbalances in international payments as may adversely affect monetary reserve positions and thus to provide a first line of defense against international financial instabilities;

(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy;

(6) To facilitate by these means the balanced growth of international trade and investment and thus to contribute to the promotion and maintenance of high levels of economic activity and employment, and of currency relationships favorable to the most efficient use of capital and credit resources and to the stability of international price levels.

Specific Aims

In pursuing these broad purposes, System open market operations in foreign currencies would have the following specific aims:

(a) To offset or compensate, when appropriate, the effects on U.S. gold reserves of those fluctuations in the international flow of payments to and from the United States that reflect temporary disequilibrating forces or transitional market unsettlement;

(b) To temper and smooth out abrupt changes in spot exchange rates and to moderate forward premiums and discounts when judged to be disequilibrating; and

(c) In the long run, to provide a means whereby reciprocal holdings of foreign exchange may contribute to meeting needs for international liquidity, as required in terms of an expanding economy.

Temporary Fluctuations in Payments Flows

Temporary fluctuations in payments flows are fluctuations expected to correct themselves when their strength is spent.

Fluctuations in payments flows, unless offset, cause changes in the U.S. gold stock and in foreign dollar reserves. Since financial markets keep alert and responsive to such changes, effects on the international payments system may become unfavorable when they are unduly abrupt and large.

Thus, a rapid decline in the U.S. gold stock, or a rapid increase in foreign dollar reserves, may affect adversely international confidence in the dollar and endanger the present international reserve currency standard.

On the other hand, a rapid increase in the U.S. gold stock, or a rapid fall in foreign dollar reserves, may revive fears of international illiquidity and of an international "dollar shortage," and thus hamper or slow down the removal of restrictions and other obstacles to the expansion of world trade.

Usual and unusual flows -- The flow of U.S. international payments shows a distinct seasonal swing, with outpayments relatively larger than inpayments in the second and third quarters, and inpayments relatively larger in the fourth and first quarters. The seasonal swing of the British net reserve position is at times the opposite of ours. Other major industrial countries also experience significant seasonal swings in international payments.

Postwar cyclical variations in domestic economic activity have been accompanied by some cyclical variation in exports and imports and in capital movements. While the regularity of these cyclical patterns has not been fully identified and delineated, their existence is sufficiently known for them to be taken into account in foreign exchange operations.

These usual swings in payments can serve as guides in gauging unusual payments flows. They may also provide exchange market supply and demand conditions propitious for the accumulation of foreign currency holdings that can be later used in transactions to moderate or cushion temporary instabilities when they arise.

Unusual movements may reinforce usual swings in a way apt to create market anxieties, especially in circumstances of high market sensitivity and responsiveness to disturbing international events. These anxieties accentuate gold hoarding tendencies and promote speculation as to the future value of reserve currencies. Hence, all reasonable steps need to be taken to diagnose unusual swings.

Instabilities in international payments may reflect in particular responses to short-run increases in international political tensions, differences in phasing of economic activity that give rise to unusually large interest rate differentials between major markets, or a rise in market rumors of a character likely to stimulate speculative transactions. These movements are reflected not only in recorded flows of short-term capital but also, at times to an even larger extent, in "leads and lags" of commercial payments and in other unrecorded flows.

Whatever the causes and whatever the form under which the instabilities appear, experience of the recent past indicates that potentials for volatile fund movements are large. Expansion and contraction of Federal Reserve holdings of foreign exchange could be used to mitigate for short periods the incidence of these flows on the U.S. gold stock and foreign dollar reserves.

Such operations need to be conducted in the light of a careful diagnosis of longer-term underlying forces so as to avoid operations that might prevent or obstruct desirable adjustments from taking place.

Exchange Transactions

In general, market movements in exchange rates, within the limits set by the International Monetary Fund Agreement or by central bank practices, should index affirmatively the interaction of underlying economic forces and market expectations and thus serve as efficient guides to current financial decisions, private and public. At times, however, short-run fluctuations in rates may be unduly influenced by speculative forces, or for other temporary reasons the basic payments situation may be obscured.

In either case, System transactions might try to help reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments and thus facilitate the efficient performance of the market functions.

Intervention in the foreign exchange market is not analogous to intervention in the Government securities market for the following two reasons:

(1) The United States Government is required by the Bretton Woods Agreements to prevent the price of the dollar in terms of foreign

currencies from fluctuating in excess of one per cent above or below its par value in terms of gold ($35 per ounce of gold). Other countries that are members of the IMF are similarly obligated. Thus, international agreement limits the range of rate fluctuations of the major currencies to 1 per cent above and below par. Intervention in the form of gold transactions or foreign exchange operations is then mandatory if the market exchange rate falls outside that margin. In contrast, prices of Government securities may fluctuate within wide margins, without any obligation of the monetary authorities to maintain fluctuations within a narrow range around an established par value.

(2) For a country like the United States, whose international payments run but a small fraction of total domestic payments, the volume of central bank transactions in foreign exchange can confidently be expected to remain negligible in comparison with the volume of central bank operations in Government securities. Therefore, while the effect on member bank reserves of System open market operations in Government securities could be used to offset that of System transactions in foreign currencies, the reverse would not be practicable. It is difficult to imagine that System transactions in foreign currencies could present either a serious problem of coordination with open market operations in Government securities or a serious risk of unwanted expansion or contraction of Federal Reserve credit.

Increase in U.S. Gross Reserve Strength

Concern has been expressed about the ability of the present international monetary system to generate the growth in liquid resources needed for a sustained rapid expansion in world trade. With world gold production tending to rise more slowly than world trade, ever larger dollar exchange holdings have been relied upon by other countries to supply liquidity needs. This rise in foreign dollar holdings has reflected almost continuous large deficits in U.S. international payments.

A further large build-up by other countries of monetary reserve holdings in dollars or in sterling, resulting from further reserve country deficits, would threaten to undermine confidence in these two currencies. Hence, it is argued that the present international monetary system must collapse either because it will fail to provide enough growth in liquidity to support current world price levels or because it will lead to growing distrust in the maintenance of convertibility and in the stability of the dollar and sterling.

There is indeed some substance in this pessimistic diagnosis. It will turn out to be false only if appropriate adaptations are progressively made in institutional arrangements so as to permit a growing supply of reserve currencies (particularly of dollars) while also permitting maintenance of basic balance in reserve currency payments. As seen now, needed institutional improvements include:

(a) An enlarged capacity of the International Monetary Fund to supplement for a period the liquidity resources of countries with convertible currencies used in international transactions.

(b) An increased supply of money market paper, such as bankers' acceptances and short-term securities, in countries with convertible currencies that have not now adequately developed markets for such paper.

(c) A capability on the part of central banks of leading industrial countries to expand their reciprocal holdings of foreign exchange, when appropriate, thus enabling them more effectively to mobilize their gross reserve strength.

An arrangement of the first kind is expected to be consummated by the end of this year, in the form of an activation of the Fund's authority to lend and borrow international currencies in case of need.

Arrangements of the second kind need further study and exploration. In any case, they can be realized only through relatively slow adaptations in the instruments and practices of international finance.

Arrangements of the third kind have been developed among the central banks of major industrial countries in connection with the recent sterling crisis, but need Federal Reserve participation to make the circle of participating industrial countries complete. Thus, a Federal Reserve action to hold foreign exchange would serve to complement the International Monetary Fund stand-by credit arrangement now being negotiated.

This action would also be consistent with the position taken by the United States during postwar years which has stressed the need for foreign central banks to give up exclusive reliance on gold as a medium of international monetary reserves. As long as the United States itself keeps its official reserves exclusively in gold, proposals designed to encourage foreign countries to keep part of their reserves in dollars have a hollow sound and smack of special pleading.

Initial Scale of Operations

Ideally, a System practice of holding foreign currency assets should be launched in a period when the U.S. balance of payments has been showing a definite tendency to over-all equilibrium. This would enable the System to proceed flexibly in coping with seasonal swings in payments flows or in adapting to cyclical or other unusual flows regarded, all tendencies considered, as relatively temporary. It would also enable the System to project such gradual expansion in holdings as might be deemed to be appropriate from the standpoint of longer term liquidity needs.

To illustrate the pattern of System response to an unusual inflow of foreign payments of a temporary character in an apparent situation of sustainable basic balance, the Federal Reserve would inform the central banks of the countries experiencing an unusual outflow of dollar payments of its willingness to make marginal amounts of dollars available for payments in the United States in exchange for holdings of their currencies. If they accepted the offer, foreign central banks would to some extent be enabled to avoid either depleting their dollar holdings or having to acquire dollars by means of gold sales.

The action would represent tangible evidence of System cooperativeness in meeting a temporary payments flow problem, and so encourage the foreign central banks in question to act reciprocally at any time the payments flow reversed itself.

Under conditions of sizable payments deficit such as have obtained recently and evidently are continuing, System operations in the foreign exchange markets would necessarily be subject to important constraints.

It is recognized that the imbalance recently and currently shown in U.S. payments must be eliminated and that national policies of a corrective nature must be pursued. Pending such correction, however, there is still room for a System program of foreign currency holdings to be initiated on a modest scale, primarily for the purpose of establishing an effective mechanism of operations to cope with future contingencies. Even when total U.S. international payments show a deficit, there may be a significant surplus in individual foreign currencies. Moreover, such action might have the effect of establishing with other central banks both the desire and willingness of the Federal Reserve System to cooperate actively with them in smoothing out abnormal payments fluctuations, in mitigating undesirable changes in gold reserve positions, and in coping with flows of volatile funds.

From a technical standpoint, the Federal Reserve Bank of New York has acquired considerable experience in foreign exchange operations for the U.S. Government and for foreign correspondents, and in the past eight months also through its transactions for the

Stabilization Fund. But the System can learn still more by diligent observation, intensive analysis of experience as it is acquired, and systematic research into market practices and seasonal and cyclical patterns of payments flows and exchange rate movements.

The need to build greater staff knowledge about, and Open Market Committee experience with, international financial operations is another argument for limiting foreign currency activity in the beginning to a moderate scale. For much of the knowledge required for a constructive foreign currency operation can be gained only through the process of the operation itself.

Paper No. 7 December 12, 1961.

CONFIDENTIAL (FR)

POSSIBLE AMENDMENTS TO LAW

If it should be decided to seek legislation clarifying the authority of the Federal Reserve System to deal in foreign exchange, this might be done by including in an appropriate bill sections along the following lines:

1. Amend the first paragraph of section 14 of the Federal Reserve Act (12 U.S.C. 353) to read as follows:

> "SEC. 14. Any Federal Reserve Bank may purchase and sell in the open market, either from or to banks, firms, corporations, or individuals, bankers' acceptances and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank."

[This amendment would eliminate from the present first paragraph of section 14 references to purchases and sales "at home or abroad" to or from foreign banks, firms, corporations, or individuals. It would also omit the obsolete reference to rules and regulations of the Board of Governors.]

2. Amend subsection (e) of section 14 of the Federal Reserve Act (12 U.S.C. 358) to read as follows:

> "(e) To establish accounts with other Federal Reserve Banks;"

[This amendment would eliminate all present provisions of section 14(e) relating to the opening of foreign accounts and appointment of foreign correspondents and agencies. Such provisions would be included in the new section 14A set forth below.]

3. Eliminate subsection (g) of section 14 (12 U.S.C. 348a).

[The present provisions of section 14(g) would be included in the new section 14A set forth below, since they relate to international operations.]

4. Insert after section 14 of the Federal Reserve Act a new section to read as follows:

"SECTION 14A. INTERNATIONAL OPERATIONS

"(a) Any Federal Reserve Bank may deal in foreign exchange and in instruments of credit and securities to the extent necessary to carry out the purposes of this section. Such transactions may be conducted with the International Monetary Fund, the Stabilization Fund established under section 10 of the Gold Reserve Act of 1934, and foreign central banks or stabilization funds, and in the open market, at home or abroad, with domestic or foreign banks, firms, corporations, or individuals.

"(b) Operations under this section shall be for the purpose of safeguarding the international value of the dollar, improving the system of international payments and moderating temporary imbalances therein, and by these means facilitating the balanced growth of international trade and investment and thus contributing to the attainment and maintenance of (i) high levels of economic activity and employment and (ii) currency relationships favorable to efficient use of capital and credit resources and to stability in international price levels.

"(c) Any Federal Reserve Bank may, with the consent or upon the order and direction of the Board of Governors of the Federal Reserve System and under rules and regulations prescribed by said Board, (i) open and maintain accounts in foreign countries, appoint correspondents, and establish agencies in such countries wheresoever it may be deemed best for the purposes of this section, and (ii) open and maintain banking accounts for such foreign correspondents or agencies, or for foreign banks or bankers, or for foreign states as defined in section 25(b) of this Act. Whenever any such account has been opened or any such agency or correspondent has been appointed by a Federal Reserve Bank, with the consent of or under the order and direction of the Board of Governors of the Federal Reserve System, any other Federal Reserve Bank may, with the consent and approval of the Board of Governors of the Federal Reserve System, be permitted to carry on or conduct, through the Federal Reserve Bank opening such account or appointing such agency or correspondent, any transaction authorized by this section under rules and regulations to be prescribed by the Board.

"(d) The Board of Governors of the Federal Reserve System shall exercise special supervision over all relationships and transactions of any kind entered into by any Federal Reserve Bank with any foreign bank or banker, or with any group of foreign banks or bankers, and all such relationships and transactions shall be subject to such regulations, conditions, and limitations as the Board may prescribe. No officer or other representative of any Federal Reserve Bank shall conduct negotiations of any kind with the officers or representatives of any foreign bank or banker without first obtaining the permission of the Board of Governors of the Federal Reserve System. The Board of Governors of the Federal Reserve System shall have the right, in its discretion, to be represented in any conference or negotiations by such representative or representatives as the Board may designate. A full report of all conferences or negotiations, and all understandings or agreements arrived at or transactions agreed upon, and all other material facts appertaining to such conferences or negotiations, shall be filed with the Board of Governors of the Federal Reserve System in writing by a duly authorized officer of each Federal Reserve Bank which shall have participated in such conferences or negotiations."

[This new section would cover all "international operations", including not only the new authority for dealing in foreign exchange but also the present provisions of section 14(e), relating to foreign accounts, agencies, and correspondents (with some modifications), and the present provisions of section 14(g) regarding supervision by the Board of Governors of all foreign relationships of the Reserve Banks.]

5. Amend subsection (b) of section 12A of the Federal Reserve Act (12 U.S.C. 263) to read as follows:

"(b) No Federal Reserve Bank shall engage or decline to engage in open-market operations under section 14 and operations under section 14A(a) of this Act except in accordance with the direction of and regulations adopted by the Committee. The Committee shall consider, adopt, and transmit to the several Federal Reserve Banks, regulations relating to such operations."

[This amendment would place under regulation of the Federal Open Market Committee not only open market transactions under section 14, but also operations under the new section 14A.]