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REC'D IN RECORDS SECTION
DEC 15 1961

CONFIDENTIAL--(F.R.)

December 14, 1961

To Members of the Federal Open Market Committee and Presidents not currently serving on the Federal Open Market Committee

From Alfred Hayes
Vice Chairman

You may be interested in the attached memorandum entitled "The Balance-of-Payments Impact of a Small Increase in the Treasury Bill Rate", since it bears on matters that are of current concern to the Federal Open Market Committee.

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C O N F I D E N T I A L--(F.R.)

OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK OF NEW YORK

DATE ~~December 14,~~ 1961

TO Mr. Hayes

FROM Peter Fousek

SUBJECT: The Balance-of-Payments Impact of a Small Increase in the Treasury Bill Rate

This note outlines various ways in which even a small increase--say, 1/4 of one per cent--in the 3-month United States Treasury bill rate can help to buttress our balance-of-payments position and protect our gold stock.

1. General considerations. Changes in short-term interest rates influence, of course, not only movements of private United States funds, but also flows of private foreign-owned funds. The over-all payments deficit is directly affected by movements of United States-owned short-term capital, but is only indirectly affected by flows of foreign-owned private short-term funds.

When foreign private investors reduce their short-term dollar investments, their offerings of dollars in the exchange market tend to put the dollar under pressure, and can have an important adverse effect on market expectations. Moreover, the greater part of the dollars so offered flows into the hands of foreign central banks, and increases the pressure on our gold stock. Persistent weakness of the dollar in the foreign exchange market and resulting gold outflows can lead to loss of confidence, which tends in turn both to accelerate the outflow of foreign funds and also to encourage outflows of United States funds, thus increasing the payments deficit.

Policy should, of course, aim not merely at stopping any outflows of short-term funds, but also at bringing about an actual inflow. The very substantial outflow of short-term capital that occurred in 1960 has not yet been reversed. This is in striking contrast to the recent British experience.

2. Covered interest arbitrage and short-term investment. Evaluating the danger of covered interest arbitrage only in terms of British Treasury bills is highly misleading.

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British Treasury bills are not the only short-term instrument available in London. Thus, there have been recent reports that some funds from the United States have been invested on a covered basis with British hire-purchase houses and local authorities at rates of one per cent or more above the British bill rate.

Furthermore, interest arbitrage takes place vis-a-vis other countries and not just Britain. For example, the level of United States bill rates is an important element in the investment decisions of Swiss commercial banks. A small increase in our bill rate should materially help, together with Stabilization Fund efforts to influence the Swiss franc forward rate, to induce the Swiss commercial banks to increase their short-term dollar investments.

It must also be emphasized that the forward exchange market--contrary to some views--does not necessarily adjust so as to offset fully small changes in interest rates. Thus, changes in the forward rates for sterling did not offset the recent narrowing of interest rate differentials between New York and London.

3. Uncovered interest arbitrage and short-term investments. The recent substantial differential between United States and British Treasury bill rates--around 2 3/4 per cent--provided a clear incentive to move funds to London on an uncovered basis for those who felt that the risk of sterling devaluation over the near-term future was negligible. Some uncovered funds have reportedly moved to London this fall, but it is not possible to estimate their volume. Some of these shifts were not necessarily just for short-term investment, but involved movements by those who needed sterling sometime in the future, either for direct investment or for the settlement of commercial and other payments. It is indeed rather surprising that the volume of uncovered shifts of United States funds from New York to London has not been larger in recent months. Several market letters

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have recently commented that some corporate treasurers now regret not having taken advantage of the much larger uncovered differential that existed until a few weeks ago. Clearly, this is an area where United States investors are still learning, and there is a real danger that more and more corporations and other investors will take advantage of these opportunities.

A reduction of the current 2 3/4 per cent differential by only 1/4 of one per cent might seem at first glance unlikely to achieve great results with respect to such movements. It is true, of course, that such a small reduction would be unlikely to stop uncovered outflows of funds completely. Nevertheless, such a move might exert an appreciable restraint upon the current outflow. Investment decisions result from a balancing of profits and risks, and at the margin a 1/4 of one per cent increase in the bill rate might well tip the balance of advantages against moving to London for some investors.

Uncovered movements of funds should not be considered only vis-a-vis Britain, but also vis-a-vis other countries, particularly Canada, Germany and Switzerland. United States investors are precluded by German and Swiss regulations from making profitable money market investments in Germany and Switzerland. But German and Swiss investors, especially banks, do have a free choice between their own and the United States market. With German 3-month Treasury bill rates at 2 per cent and Swiss 3-month deposit rates at just over 2 per cent, a 2 3/4 per cent bill rate might well attract important amounts of funds on an uncovered basis. (The alternative for these investors of profitably shifting funds to London on an uncovered basis is, of course, already available.)

4. Shifts in short-term financing. Shifts by borrowers, both American and foreign, between the United States market and other markets are probably even more important for the balance of payments than are flows of investment funds. Many British, American and other concerns have a choice of raising funds through

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bankers' acceptances either here or in London. In the past, changes in the relative cost of financing in these two centers on a covered basis have led to shifts in borrowing between these two markets. Currently, it is only slightly cheaper to borrow in London on this basis than in New York. The further small increase in bankers' acceptance rates in New York which might follow a rise in the United States Treasury bill rate could easily provide the extra margin that would result in a shift of borrowers from the New York market to the London market.

5. The psychological impact. The magnitude of the psychological impact of even a small increase in the 3-month Treasury bill rate on the decisions of both private investors and traders and of foreign central banks is even more difficult to estimate, but it would probably be substantial.

Many foreigners, and Americans too, are seriously disturbed about the continuation of large United States balance-of-payments deficits, and the inadequacy of measures so far taken to restore equilibrium in our payments position. A small increase in the bill rate could help strengthen confidence in the dollar. Every day banks, traders, and investors decide whether to hold or borrow more or less dollars. Any strengthening in confidence in the dollar could tip some of these decisions in our favor. A most important area where such decisions affect our balance of payments are the so-called leads and lags, i.e., changes in the timing of commercial payments for our exports and imports as well as of those merchandise transactions between foreign countries which are invoiced in dollars. This is one of the most volatile elements in any country's international transactions and, for the United States, confidence swings in the leads and lags could amount to hundreds of millions of dollars, even with marginal changes in sentiment. Sentiment, of course, would also be reflected in other transactions, particularly those involving private working balances.

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As to foreign central banks, their dollar holdings are in most important cases now more than adequate for working balance or normal short-term investment purposes. It is no exaggeration to say that the international credit of the United States is strained today. Many important countries are approaching the point where they willingly would add to their dollar holdings only if they detect what they would believe to be a movement to more appropriate policies on our part. Some central banks are under pressure from their Treasuries to increase the gold proportion of their reserves. A small increase in our bill rate could strengthen the hand of some major central banks vis-a-vis their Treasuries.

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The influence of the above factors should not be minimized on the ground that a quantitative estimate of the over-all impact is not feasible. This is especially true in view of our precarious international position, and the danger that the pressure on the gold stock will increase over the next few months. A small increase in the bill rate should not only help to strengthen the position of the dollar, but should also minimize any market disruptions that might occur in the future, if our international position forced us to raise the discount rate substantially. The closer the bill rate gets to 3 per cent now, the smaller would be the jump that would accompany an increase of, say, one per cent in the discount rate sometime in the future. In view of the sharp increase in our payments deficit since mid-year, the possibility of such a crisis move should not be lightly dismissed. If the deficit and the pressure on the gold stock continue unabated, a run on the dollar is entirely possible, if not probable.