BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

November 8, 1963

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Sherman

Enclosed is a copy of a memorandum from Mr. Coombs regarding a recommendation on foreign currency operations that he plans to make at the meeting on November 12, 1963.

Very truly yours,

Merritt Sherman, Assistant Secretary,
Federal Open Market Committee.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: C. A. Coombs, Special Manager, System Open Market Account

SUBJECT: Request for authorization of spot purchases of Italian lire, and other European currencies, and of their simultaneous forward sales to the U. S. Treasury.

In early September, the U. S. Treasury embarked on a program of purchasing Italian lire from the Bank of Italy. By the end of October these purchases had reached $67 million equivalent; the larger part of the amount purchased was invested in an interest-earning lira deposit account at the Bank of Italy, and a smaller part was employed in a swap against Swiss francs. These purchases had two purposes:

(1) To help cushion the abrupt decline in Italy's monetary reserves; and

(2) To acquire partial cover for the Treasury's lira debt.

In October alone, the Italian authorities lost $270 million of their reserves in defending the lira. Even though the pressure on the lira has eased somewhat since the beginning of this month, the political situation as well as inflationary tendencies in Italy may, before long, again require heavy market intervention by the Italian authorities.

The Treasury's Italian lira debt (bonds with maturities ranging from March 1964 to September 1965) totals $199.5 million equivalent, as compared with lira acquisitions totaling $67 million. The Treasury could thus usefully purchase additional lire. The Treasury's Stabilization Fund, however, has limited resources and therefore is not in a position to add substantially to its lira holdings. Moreover, a similar situation might develop in the future in other European currencies in which the Treasury has debts outstanding, should these currencies, too, come under pressure.

Spot purchases by the System of Italian lire, and of other currencies as need and opportunity may arise, and their immediate forward sale to the Treasury would provide a solution to this dilemma. The spot purchases would give support to the foreign currencies in question. With their simultaneous forward sales to the Treasury, the Treasury would obtain cover for its foreign-currency debt without any immediate dollar outlay. The System's net foreign-currency position would remain unchanged.

It might be noted that operations of this type were contemplated at the time the System initiated its foreign currency program. Section III of the memorandum dated February 6, 1962, entitled "Scope and Character of Initial Foreign Currency Operations of the System," distributed before the meeting of the Federal Open Market Committee of February 13, 1962, read in part as follows:

> III. The Treasury would continue to conduct foreign currency operations under existing agreements with Germany, Switzerland, the Netherlands, and Italy. The System, however, would stand prepared to purchase currencies of these countries from the Treasury, either outright or under mutually satisfactory resale agreement, in the event that exchange market developments obliged the Fund to exhaust available resources....

To preclude any loss by the System, the forward sales would be executed at the same market rate as the spot purchases. (The spot purchases might have to be executed above par, since the foreign currency might require support even at such levels--as has been the case of the lira.)

The spot balances would be invested in time deposits or money-employed accounts with (or through) the central banks concerned; thus adding to the System's foreign interest earnings.

To provide flexibility, the forward sales to the Treasury would most conveniently be arranged on a three-month renewable basis. The entire operation would be liquidated when the Treasury repaid its foreign currency debt in question, either at or before maturity.

Since the Italian lira may require substantial support over the next few weeks, and since the Treasury's Stabilization Fund does not now command the needed resources, I intend to ask the Committee at its meeting on November 12 to authorize the Federal Reserve Bank of New York to undertake the operations just described up to a total amount of $100 million.