



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20561

December 12, 1980

STRICTLY CONFIDENTIAL (FR)  
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann *M. A.*

Attached is a memorandum from Mr. Truman dated December 11, 1980, providing background material on System foreign currency operations for the Committee's discussion of the subject under agenda item 2D at the meeting of the Committee on December 18-19.

Attachment

STRICTLY CONFIDENTIAL (F.R.)  
CLASS I - FOMC

December 11, 1980

TO: Federal Open Market Committee SUBJECT: Background Material on  
System Foreign Currency  
FROM: Edwin M. Truman Operations.

EMT

I. Introduction

System foreign currency operations are conducted under the Foreign Currency Directive. The most recent major revision of the Directive was adopted by the Committee on December 21, 1976, after extensive internal discussion and intensive discussion with the Treasury Department.<sup>1/</sup> The main purpose of the 1976 revision was to simplify the Directive and to bring it up to date in light of changes in the international monetary system and its functioning.<sup>2/</sup>

The basic provision of the Directive calls for System operations in foreign currencies to be generally directed at countering disorderly market conditions. However, this general provision is supplemented by a number of provisos. These provisos relate, for example, to IMF Article IV, Section 1, to the adjustment of System balances in light of future needs, to close and continuous consultation and cooperation with the Treasury, and to cooperation with foreign monetary authorities. Thus, the Directive is intended to be precise in its general guidance but flexible in application by not trying to anticipate every contingency. System foreign currency operations in recent years have never been guided by any kind of rigid formula or extreme posture either of pegging exchange rates or of complete withdrawal from the market.

---

<sup>1/</sup> The text of the current Directive is at Attachment A. The previous major revision of the foreign currency instruments was adopted in June 1966. The foreign currency instruments include the Authorization, Directive, and Procedural Instructions.

<sup>2/</sup> The revised Directive referred explicitly to the proposed IMF Article IV, Section 1, which the United States had recently ratified. The text of IMF Article IV, Section 1 is at Attachment B.

- 2 -

In practice, experience with the concept of disorderly market conditions has revealed a number of dimensions including: disorder characterized by abrupt intra-day or day-to-day exchange rate movements or by measures of market malfunction such as wide bid-asked spreads; disorder characterized by cumulative exchange rate movements that might threaten to feed on themselves; and disorder characterized by substantial exchange rate movements that carry rates to levels that are judged to be unrealistic in light of fundamental economic factors. The amount and strategy of intervention in a particular period has been a matter of judgment not only by Federal Reserve officials but also and essentially by Treasury officials. Such judgments have been influenced by a number of factors including interest rate developments here and abroad, actual and prospective inflation developments, trade developments, international political developments, and views concerning the likely effectiveness of exchange market intervention in general and in particular circumstances.

November 1, 1978 marks a significant date in the history of U.S. intervention operations. Under the November 1 program the U.S. authorities expressed their determination to correct an excessive depreciation of the dollar through massive intervention and other measures. Although the scale of U.S. intervention operations increased after November 1, 1978, and the Treasury became much more actively involved, the qualitative pattern of our intervention has been essentially unchanged since July 1973, when the United States first began to influence the floating dollar through intervention. When the dollar has been under downward pressure, we have intervened primarily in German marks acquired by incurring swap debt and, more recently, Carter note debt to slow the decline. When the dollar has been rising, we have

- 3 -

intervened to moderate that rise and to acquire foreign currencies to repay debt. From time to time we have also acquired small amounts of balances.

Now that the System has paid off its swap debts and accumulated foreign currency balances equivalent to \$2.0 billion and now that the Treasury has covered the Carter notes, two related questions have been raised in the Committee's discussion concerning U.S. intervention: (1) If the dollar continues to strengthen, how actively should we resist its appreciation? (2) Would it not be desirable to prepare for any future episode of weakness of the dollar by accumulating substantial balances of foreign currencies in order to limit the extent to which future intervention sales of foreign currencies have to be financed by going into debt?

The material that follows is designed to provide background for the Committee's discussion of these questions.

## II. Background Information

### A. Foreign Currency Position of the System and the Treasury

The holdings of foreign currency balances by the System and the Treasury as of December 10, 1980 are shown in Table 1. The total combined holdings of both institutions is \$10.7 billion equivalent (valued at historical exchange rates)<sup>1/</sup> with Treasury balances accounting for 81 percent of this total. The currency composition of both System and Treasury balances are

---

<sup>1/</sup> Total foreign currency balances are \$9.9 billion equivalent valued at current exchange rates. Unless otherwise noted, all foreign currency magnitudes cited in the text or shown in the tables are expressed as dollar values computed on the basis of exchange rates prevailing at the time of the original transaction (historical rates). Where appropriate, tables also indicate in parentheses the corresponding dollar values computed at current (December 10, 1980) exchange rates.

- 4 -

similar, with approximately two-thirds consisting of German marks and the remainder split about equally between Swiss francs and Japanese yen.

All foreign currency balances currently held by the System have been acquired through purchases, either directly in the market or from foreign central banks, customers, and correspondents. There are no claims on System balances (no offsetting debt) since there are no outstanding System swap drawings. In contrast, Treasury foreign currency balances have been acquired by a variety of methods in addition to intervention purchases, thereby incurring actual or potential offsetting claims against these balances. Specifically, as shown in Table 1, the Treasury has acquired German marks through the issuance of \$5.2 billion equivalent of Carter notes<sup>1/</sup>, IMF drawings of \$2.0 billion equivalent, and SDR sales of \$0.8 billion equivalent. Thus, current Treasury mark balance holdings of \$5.6 billion equivalent fully offset outstanding Carter note debt, but an additional \$2.4 billion equivalent of mark balances would be needed to fully reconstitute mark holdings acquired through IMF drawings and SDR sales.<sup>2/</sup> Treasury yen balances of \$1.8 billion equivalent were acquired almost entirely through IMF drawings and SDR sales, while Treasury Swiss franc balances of \$1.3 billion equivalent are offset by Carter note debt of nearly equal magnitude.

#### B. Historical Background

Tables 3-5 provide historical data on System and Treasury foreign currency balance holdings, along with information on the sources of financing of U.S. foreign currency operations, for selected dates over the period from March 1973 to the present.

---

<sup>1/</sup> A listing of Treasury issues of foreign currency securities is shown in Table 2.

<sup>2/</sup> The United States has no obligation to repay the IMF drawings or reverse the SDR sales.

- 5 -

Table 3 indicates that System foreign currency balances are currently \$2.0 billion equivalent, significantly larger than at any other time in the past. Prior to 1980, System balances at no time exceeded \$350 million equivalent. System sales of foreign currency at times of downward exchange market pressure on the dollar have been financed almost exclusively by swap drawings. Conversely, at times when the dollar has been in strong demand on exchange markets and the System has made intervention purchases of foreign currency, the foreign currency acquired has been used almost entirely to repay outstanding swap debt. Substantial balances have not been acquired prior to this year.

Table 4 shows that the Treasury held virtually no foreign currency balances prior to November 1978. Since then, the Treasury has built up substantial balances through issuance of Carter notes, IMF drawings and SDR sales. Current Treasury balance holdings of \$8.7 billion are at a peak historical level.<sup>1/</sup>

Table 5 indicates that since November 1, 1978 the scale of overall U.S. foreign currency operations has increased sharply both absolutely and relative to the intervention of foreign central banks, and the share of Treasury resources in financing U.S. intervention operations has also risen. Since the start of the floating exchange rate period in March 1973, there have been seven major episodes of U.S. intervention operations where foreign currencies were first sold in the market to support a declining dollar and subsequently repurchased as the dollar's exchange value recovered. As shown in Table 5, U.S. intervention during the periods prior to November 1, 1978 was on a much smaller scale than in the periods since then. For example, between October 1974

---

<sup>1/</sup> In addition to foreign currency balances, the Treasury held \$3.9 billion of SDR's and had a reserve position in the IMF amounting to \$1.8 billion as of December 3, 1980.

- 6 -

and March 1975, net intervention sales of foreign currencies equivalent to \$1.2 billion were made compared with net sales of \$5.9 billion equivalent in the last two months of 1978 alone.

In earlier periods, U.S. intervention was financed almost entirely through swap drawings by the System. In more recent periods, Treasury resources have played an increasing role. Since November 1, 1978, Treasury resources (almost entirely in the form of balances) have financed about half of total net U.S. intervention support for the dollar with the remainder financed through swap drawings by the System. In each of the intervention episodes since March 1973, intervention has primarily taken the form of sales and purchases of marks.<sup>1/</sup> Swiss francs, yen, and, to a much smaller extent, French francs, Netherlands guilders, and Belgian francs have also been used.

C. Profits and Losses on U.S. Foreign Currency Operations

The profits and losses incurred by the System and Treasury in recent years as a result of foreign currency transactions are shown in Table 6, along with the unrealized (exchange translation) profit or loss on current foreign exchange positions. The Treasury's current exchange translation loss of \$182 million is accounted for almost entirely by unrealized losses on yen balance holdings.<sup>2/</sup> The System currently has a net exchange translation loss of \$44 million on balances, with losses of \$70 million on mark balances and \$12 million on Swiss francs outweighing gains of \$37 million on yen balances. In general, for given net holdings of balances, exchange risk tends to be

---

<sup>1/</sup> Of total U.S. intervention support for the dollar since September 1977, 95 percent has consisted of sales of marks.

<sup>2/</sup> For purposes of calculating profits and losses, Treasury foreign currency balances acquired through SDR sales and IMF drawings are treated as if they were purchased directly for dollars.

- 7 -

reduced the more diversified are the holdings among different foreign currencies, since individual dollar exchange rates need not fluctuate together except for currencies participating in the EMS intervention arrangement.

The profit and loss numbers reported in Table 6 are calculated solely on the basis of exchange rate changes. When the United States holds foreign currency balances, there is an additional impact on interest earnings which is not reflected in these numbers. For example, the interest currently earned on the System's holdings of mark balances is far below what could be earned on dollar balances. The System, thus, is incurring an interest rate opportunity cost on its mark balances amounting to nearly \$10 million per month. Because of the relationship between interest rates and spot and forward exchange rates which is brought about by interest arbitrage, there is a presumption that this interest rate opportunity cost would tend to be offset by an exchange rate gain resulting from a rise in the dollar value of mark balances. This is because when the German interest rate is above the U.S. interest rate the mark is at a forward premium, reflecting market expectations that the mark will appreciate relative to the dollar.

D. Quantitative limits on System Foreign Currency Operations

The FOMC's foreign currency instruments (the Authorization, Directive, and Procedural Instructions) set quantitative limits on the System's foreign currency operations. These limits are expressed in terms of the System's overall open position (essentially the System's exposure in individual currencies summed across all currencies). The Authorization (paragraph 1.D) places an upper limit on the size of this position. (This limit is currently \$8 billion.) In addition, the Procedural Instructions place limits on the rate of change



- 8 -

in either direction of the overall open position as well as the daily rate of change in the position in an individual currency. The Manager of the System Open Market Account is normally required to clear with the full Committee any operation which would result in an inter-FOMC meeting change in the overall open position exceeding \$1.5 billion. The Manager is normally required to clear with the Subcommittee any inter-meeting change in overall open position exceeding \$600 million, and any one day change exceeding \$300 million. Subcommittee clearance is also required for any daily change in the System's net position in a single currency exceeding \$150 million.

In addition to these formal limits contained in the foreign currency instruments, the Committee has maintained separate informal limits on holdings of foreign currency balances, both total holdings and holdings of any one foreign currency. Currently, the limit on total balances excluding yen is \$2.0 billion, with holdings of any single currency other than marks limited to \$500 million and holdings of marks limited to \$1.5 billion. The limit on balances of yen is \$1.0 billion. These informal limits on balances are somewhat asymmetrical in that no similar separate limit has ever been placed on outstanding swap drawings other than the limit imposed by the size of the swap line.

Prior to April 1979, the informal limit on the System's total holdings of foreign currency balances was \$500 million. At the April 17, 1979 meeting of the Committee, a discussion of the informal limit was held. (One of the papers prepared as background for that broader discussion is at Attachment C.) At that meeting, the informal limit on the System's total holdings of foreign

- 9 -

currency balances (other than yen) was raised to \$1.0 billion, and the separate \$1.0 billion limit on holdings of balances of yen was established.<sup>1/</sup>

E. System Warehousing of Treasury Balances

The Treasury's Exchange Stabilization Fund is limited in the amount of foreign currency balances which it may hold. Because of this limitation, the System has agreed to warehouse foreign currencies for the ESF and the Treasury, i.e., purchase foreign currency spot from the ESF and simultaneously sell the same currency forward to the ESF at the same exchange rate.<sup>2/</sup> The System's spot holdings of foreign currency are increased by warehousing but the offsetting forward sale of foreign currency to the Treasury leaves the System's overall foreign exchange exposure unchanged. Thus, the Treasury or ESF retains the foreign exchange risk. The System earns the interest return on the foreign currency balances and forgoes the interest return on the equivalent amount of dollar-denominated investments, since the Desk sells U.S. Treasury securities to offset the reserve increasing effects of the initial intervention operation.

The Committee has agreed to warehouse up to \$5 billion of foreign currencies for the Treasury and the ESF. As of December 10, total warehoused balances stood at \$2.8 billion, including \$1.6 billion of marks and \$1.2 billion of Swiss francs.

---

<sup>1/</sup> The separate limit on net holdings of yen was established in light of the possibility at that time that the System might want to add significantly to its yen balances in a cooperative effort to limit the yen's depreciation. In the event, System holdings of yen balances were not increased at that time; however, purchases of about \$200 million were added to System holdings of yen balances in March and April of this year, bringing the total to \$435 million as is shown in Table 1.

<sup>2/</sup> The Treasury's cash balance position remains unchanged when the ESF makes intervention purchases of foreign currency and then warehouses the foreign currency purchased with the System; the reduction in Treasury cash balances caused by the original foreign currency purchase is offset by the subsequent spot sale of foreign currency to the System in the warehousing operation.

- 10 -

F. The Interest Rate Impacts of U.S. Intervention

A shift in exchange market sentiment, e.g., in favor of the dollar relative to the mark, will be reflected in an attempt by private asset holders to sell mark-denominated assets and buy dollar-denominated assets. This will tend to raise the dollar's value in terms of the mark on foreign exchange markets and at the same time tend to lower dollar interest rates slightly and raise mark interest rates slightly.

If the Federal Reserve intervenes to counteract this rise in the exchange value of the dollar, it will buy marks and sell dollars. The dollars sold will add to the public's holdings of U.S. Treasury securities because the intervention's potential expansionary impact on the U.S. money supply is automatically offset in daily open market operations. Assuming that the Bundesbank also takes actions to keep the German money supply unchanged, the net effect of the intervention is to increase the supply of dollar-denominated assets and decrease the supply of mark-denominated assets available to private asset holders, tending to offset the impacts of the original shift in private exchange market demand. Thus, intervention purchases of marks against dollars aimed at moderating a rise in the dollar's exchange value relative to the mark tend also to moderate any interest rate pressures generated by a shift in exchange market sentiment. It is possible that interest rates on U.S. Treasury securities may rise slightly relative to rates on other dollar-denominated assets, since these are the specific dollar assets supplied as a result of the intervention and its sterilization.

U.S. intervention might have an additional effect on foreign interest rates if it influences the policy actions of foreign monetary authorities. For example, if the Bundesbank tended to raise mark interest rates in response

- 11 -

to a depreciation of the mark, U.S. intervention purchases of marks to moderate its depreciation might lead the Bundesbank to raise interest rates by less than would otherwise be the case.

December 11, 1980

Table 1

System and Treasury Foreign Currency Resources  
as of December 10, 1980  
(\$ million equivalent)

	<u>German Marks</u>	<u>Japanese Yen</u>	<u>Swiss Francs</u>	<u>Other</u>	<u>Total</u>
<u>System</u>					
Balances	1,370 (1,300)	435 (472)	217 (205)	16 (17)	2,038 (1,994)
<u>Swap drawings</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net position	1,370	435	217	16	2,038
<u>Treasury</u>					
Balances	5,575 (5,162)	1,768 (1,586)	1,314 (1,164)	0	8,657 (7,912)
Funds Raised	7,995	1,635	1,207	0	10,837
Swap drawings	0	0	0	0	0
Carter notes	5,230 (4,767)	0	1,207 (1,108)	0	6,437 (5,875)
SDR sales	765	635	0	0	1,400
<u>IMF drawings</u>	<u>2,000</u>	<u>1,000</u>	<u>0</u>	<u>0</u>	<u>3,000</u>
Net position	-2,420	133	107	0	-2,180
<u>Total United States</u>					
Balances	6,945 (6,463)	2,203 (2,058)	1,531 (1,369)	16 (17)	10,695 (9,907)
<u>Funds Raised</u>	<u>7,995</u>	<u>1,635</u>	<u>1,207</u>	<u>0</u>	<u>10,837</u>
Net position	-1,050	568	324	16	-142

Note: Dollar values are computed on the basis of historical exchange rates with corresponding current rate values shown in parentheses where appropriate. Net position equals balances held minus funds raised. Funds raised equals swap drawings plus Carter notes outstanding, SDR sales, and IMF drawings. Foreign currency balances warehoused by the Treasury with the System are shown as Treasury balances. Treasury mark balances include \$233 million equivalent of marks purchased forward but not yet delivered.

December 11, 1980

Table 2

Treasury Issues of Foreign Currency Securities  
(Carter Notes)

<u>Date Maturing</u>	<u>Maturity Length</u> (Years)	<u>Interest Rate</u> (Percent per annum)	<u>Dollar Value</u> ( <u>\$ million equivalent</u> )	
			<u>Date of issue</u>	<u>(12/10/80)</u>
<u>German mark</u>				
September 1, 1981	2-1/2	6.30	678	(623)
December 15, 1981	3	5.95	936	(884)
February 26, 1982	2-1/12	8.50	558	(483)
May 12, 1982	2-1/2	8.55	449	(403)
July 1, 1982	3-1/3	6.70	669	(619)
December 15, 1982	4	6.20	667	(630)
May 12, 1983	2-1/2	8.50	668	(596)
July 26, 1983	3-1/2	8.45	<u>605</u>	<u>(523)</u>
			5,230	(4,767)
<u>Swiss franc</u>				
July 17, 1981	2-1/2	2.35	747	(686)
January 17, 1983	4	2.65	<u>460</u>	<u>(422)</u>
			1,207	(1,108)
<u>Total</u>			6,437	(5,875)

December 11, 1980

Table 3

System and Treasury Net Foreign Currency Position,  
Selected Dates March 1973 - December 1980  
 (\$ million equivalent)

<u>Date</u>	<u>System Balances</u>	<u>System Swap Drawings</u>	<u>Net Position</u>		
			<u>System</u>	<u>Treasury</u>	<u>U.S. Total</u>
April 30, 1974	6	365	-359	3	-356
September 30, 1974	62	0	62	4	66
March 31, 1975	18	1,066	-1,048	5	-1,043
September 30, 1977	67	0	67	0	67
October 31, 1978	14	1,573	-1,559	-641	-2,200
December 31, 1978	48	5,458	-5,410	-2,698	-8,108
June 14, 1979	313	0	313	-1,267	-954
October 5, 1979	271	3,790	-3,519	-5,586	-9,105
April 4, 1980	842	0	842	-4,843	-4,001
July 11, 1980	510	1,184	-674	-5,741	-6,415
December 10, 1980	2,038	0	2,038	-2,180	-142

Note: All dollar values are computed at historical exchange rates. System net position equals foreign currency balances minus swap drawings. Balances held spot under a matching commitment to sell forward (resulting from Treasury warehousing or swap drawings by foreign central banks) are omitted. Swap drawings by the System made prior to August 1971 are omitted. Details of the Treasury's net position are shown in Table 4.

December 11, 1980

Table 4

Treasury Net Foreign Currency Position,  
Selected Dates March 1973 - December 1980  
(\$ million equivalent)

<u>Date</u>	<u>Foreign Currency Balances</u>	<u>Funds Raised</u>				<u>Total</u>	<u>Net Position</u>
		<u>Swap Drawings</u>	<u>Carter Notes</u>	<u>SDR Sales</u>	<u>IMF Drawings</u>		
April 30, 1974	3	0	0	0	0	0	3
September 30, 1974	4	0	0	0	0	0	4
March 31, 1975	5	0	0	0	0	0	5
September 30, 1977	0	0	0	0	0	0	0
October 31, 1978	9	650	0	0	0	650	-641
December 31, 1978	4,187	890	1,595	1,400	3,000	6,885	-2,698
June 14, 1979	7,283	0	4,150	1,400	3,000	8,550	-1,267
October 5, 1979	2,964	0	4,150	1,400	3,000	8,550	-5,586
April 4, 1980	5,994	0	6,437	1,400	3,000	10,837	-4,843
July 11, 1980	5,096	0	6,437	1,400	3,000	10,837	-5,741
December 10, 1980	8,657	0	6,437	1,400	3,000	10,837	-2,180

Note: All dollar values are computed at historical exchange rates. Balances include spot holdings and forward commitments to receive foreign currencies (due to balances warehoused with the System or outright forward purchases). Total funds raised equals swap drawings plus Carter notes outstanding, SDR sales, and IMF drawings. Net position equals foreign currency balances minus total funds raised. Balances held under a matching commitment to sell forward (resulting from swap drawings by a foreign central bank) are omitted.



December 11, 1980

Table 5

United States and Foreign Exchange Market Intervention,  
Selected Episodes March 1973 - December 1980  
 (Net purchases (+) or sales (-) of dollars, in millions)

Episode	System	United States		Foreign	Memo: Percentage change in the weighted-average dollar
		Treasury	U.S. Total		
(1) 7/10/73-7/31/73	274	0	274	-2,246	-0.9%
8/1/73-8/15/73	-278	0	-278	-542	3.2%
(2) 2/1/74-4/30/74	359	43	402	-2,985	-7.0%
5/1/74-9/30/74	-283	0	-283	-339	4.1%
(3) 10/1/74-3/31/75	1,167	0	1,167	849	-7.5%
4/1/75-7/31/75	-1,095	0	-1,095	1,777	6.8%
(4) 1/5/76-2/11/76	205	0	205	97	-0.1%
2/12/76-5/19/76	-183	0	-183	-3,260	3.5%
(5) 9/30/77-12/31/78	5,540	2,667	8,207	39,220	-16.2%
(9/30/77-10/31/78)	(1,675)	(650)	(2,325)	(30,738)	(-19.5%)
(11/1/78-12/31/78)	(3,865)	(2,017)	(5,882)	(8,482)	(4.1%)
1/1/78-6/14/79	-5,677	-1,418	-7,095	-13,659	4.4%
(6) 6/15/79-10/5/79	3,839	4,572	8,411	4,229	-5.4%
10/6/79-4/4/80	-4,349	-952	-5,274	-23,522	10.8%
(7) 4/5/80-7/11/80	1,416	1,380	2,796	1,549	-10.9%
7/12/80-12/10/80	-2,553	-3,626	-6,179	-403	9.3%

Note: Foreign intervention consists of intervention in dollars by other G-10 countries, plus Switzerland, Denmark, Norway, and Ireland. Transactions related to repayment of pre-August 1971 U.S. swap obligations are omitted. Forward market intervention is included.

December 11, 1980

Table 6

System and Treasury Profits (+) and Losses (-)  
On Foreign Currency Operations  
(\$ million)

<u>Date</u>	<u>System</u>	<u>Treasury</u>	<u>U.S. Total</u>
Realized:			
1973	1	0	1
1974	4	0	4
1975	8	0	8
1976	6	0	6
1977	5	0	5
1978	-33	-66	-99
1979	-11	178	167
1980 (to date)	29	117	146
Exchange translation:			
December 31, 1978	-59	-50	-109
December 31, 1979	-65	-647	-712
December 10, 1980	-44	-182	-226

Note: Losses related to repayment of pre-August 1971 swap drawings are excluded. These losses totaled \$0.8 billion for the System and \$1.3 billion for the Treasury. Opportunity costs or gains related to interest payments or receipts on foreign currency operations are also excluded.

Attachment A

FOREIGN CURRENCY DIRECTIVE

Reaffirmed March 18, 1980

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U. S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.
2. To achieve this end the System shall:
  - A. Undertake spot and forward purchases and sales of foreign exchange.
  - B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.
  - C. Cooperate in other respects with central banks of other countries and with International monetary institutions.
3. Transactions may also be undertaken:
  - A. To adjust System balances in light of probable future needs for currencies.
  - B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.
  - C. For such other purposes as may be expressly authorized by the Committee.
4. System foreign currency operations shall be conducted:
  - A. In close and continuous consultation and cooperation with the United States Treasury;
  - B. In cooperation, as appropriate, with foreign monetary authorities; and
  - C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

- 2 -

7. The Chairman is authorized:

A. With the approval 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 Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Attachment B

ARTICLE IV

Obligations Regarding Exchange Arrangements

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

- (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
- (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
- (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
- (iv) follow exchange policies compatible with the undertakings under this Section.

Note to Attachment C

On page 13 of the attached paper (Section II.B.2. (Legal Considerations)) it is stated that: "The Federal Reserve is prohibited by law from holding foreign currency securities." With the enactment of the Monetary Control Act, this prohibition was removed. The Act authorizes the Federal Reserve to hold "... obligations of, or fully guaranteed as to principle and interest by, a foreign government or agency thereof." We are now in the process of reviewing our investment procedures.

Federal Reserve investments under this authority have been limited to securities with less than one year of remaining maturity. The only foreign currency securities so far acquired by the Federal Reserve are \$24 million equivalent of Swiss government three-month money market certificates purchased in October and November.

Attachment C

STRICTLY CONFIDENTIAL (FR)  
CLASS I - FOMC

TO: Federal Open Market Committee  
FROM: John E. Morton and  
Edwin M. Truman

DATE: April 10, 1979

SUBJECT: U.S. Holdings of  
Foreign Currency Balances

SEM  
ENT

Summary

This paper lays out for the Committee considerations relevant to two questions: (I) Should the United States accumulate substantial holdings of foreign currency balances? (II) If the United States were to accumulate substantial holdings of foreign currency balances, should the Federal Reserve System hold a significant portion of such balances for its own account?

The most important consideration with regard to U.S. accumulation of foreign currency balances is U.S. exchange rate policy. If U.S. policy is aimed only at countering short-run disorderly market conditions, then the United States would need to hold only limited amounts of foreign currency balances -- aside from balances covering debt denominated in foreign currencies. If U.S. policy also is designed to resist exchange market movements that carry the dollar's value beyond what are deemed to be reasonable levels in either direction, then the United States might want to be prepared to accumulate substantial holdings of foreign currency balances over time. The more active U.S. intervention policy is in the future, especially with respect to resisting significant downward pressures on the dollar, the more reasonable it would be for the

-2-

United States to take every opportunity to add to its holdings of foreign currency balances, even though such accumulations would tend to depress the dollar in the short run. However, congressional and foreign official acquiescence to such accumulations would appear to be highly desirable.

No legal or procedural impediments appear to exist to the Federal Reserve System's holding of substantial foreign currency balances. However, the Treasury is able to hold a certain amount of such balances itself in the ESF and can warehouse additional amounts with the System. Therefore, a critical consideration is the extent to which the Federal Reserve's role in foreign exchange market intervention policy is thought to hinge on the Federal Reserve's holding foreign currency resources in addition to the resources available under the Federal Reserve's swap arrangements.

I. Should the United States Accumulate Foreign Currency Balances?

A. Policy Issues

1. Intervention Objectives. Traditionally foreign exchange market intervention has been undertaken predominately in the spot market by foreign central banks which acquired and held substantial dollar balances for this purpose. U.S. intervention has tended to be on a small scale relative to that of foreign central banks and short-term in nature, financed primarily through the Federal Reserve swap network and aimed at countering short-run disorderly conditions.



-3-

Recently this traditional pattern has changed, most notably in connection with the November 1, 1978 dollar-support program. U.S. intervention has recently become a larger proportion of total intervention, longer-term in nature, and aimed at countering disorder in a broader sense, i.e., resisting exchange-rate movements that are deemed to take the dollar to unreasonable levels. In the five-year period 1973-1977, U.S. intervention accounted for only 5 per cent of total exchange market intervention in dollars by major central banks<sup>1/</sup>. Since the beginning of 1978, U.S. intervention has constituted nearly one fifth of total intervention, and since November 1, 1978 nearly one third of total intervention has been undertaken by U.S. authorities.

In light of the recent more active posture of U.S. intervention policy, and in light of the relatively small share in U.S. reserves of SDRs and reserve position in the IMF, <sup>2/</sup> the United States may want to consider acquiring substantial foreign currency balances in order to substitute for, or supplement, the resources available via the Federal Reserve's swap network. This conclusion assumes that U.S. exchange market intervention continues to be confined primarily to operations in the spot market.

2. Exchange Rate Effects. In general, foreign currency balances could be built up either through longer-term borrowings

---

<sup>1/</sup> This figure was derived by summing without regard to sign net monthly intervention in dollars by the central banks of the G-10 countries plus Switzerland.

<sup>2/</sup> As of the end of February, U.S. holdings of SDRs and reserve position in the IMF amounted to \$3.8 billion.

-4-

(such as those recently undertaken by the Treasury) or through purchases, either in the market or directly from foreign central banks. Longer-term borrowings would not normally affect exchange rates; however, they do not add to net U.S. holdings of foreign currency balances. Purchases of a foreign currency from a foreign central bank also would not in itself have effects on exchange rates unless such purchases led to larger combined net purchases of the foreign currency in the market--see point 3 below.

Market purchases of foreign currencies to add to U.S. foreign currency balances weaken the foreign exchange value of the dollar relative to what it otherwise would be. If the United States accumulated through market purchases substantial balances of foreign currencies, the United States' net position in foreign currencies might be expected to be larger on average than has been the case in recent years. Consequently, the dollar on average would have a lower foreign exchange value. In other words, U.S. policy with respect to the accumulation of foreign currency balances through market purchases will be reflected in the dollar's exchange value as long as the intervention activity of foreign central banks is unaffected, and, conversely, U.S. intervention policy with respect to the dollar's exchange value will be reflected in U.S. holdings of foreign currency balances.

These considerations point to the conclusion that it would be inappropriate in the near term for the United States rapidly to acquire large-scale balances of foreign currencies through market purchases unless it is U.S. policy deliberately to hold down or to

-5-

depress the foreign exchange value of the dollar. A policy of starting gradually to build up foreign currency balances through small-scale market purchases of foreign currencies at times when the dollar is rising against these currencies would have only small exchange-rate impacts because the purchases would be small by assumption. Such a policy could be implemented immediately and re-examined periodically in light of future developments.

3. Implications for Official Dollar Balances. U.S. market purchases of foreign currencies at times when the dollar is appreciating will tend to substitute for or inhibit a run-down of official dollar balances by central banks of countries, e.g., Germany, Japan and Switzerland, which may consider their current dollar holdings excessive. To the extent that this occurs, these countries will be less willing to make intervention purchases of dollars at future periods of downward pressure on the dollar, leaving the United States with a greater responsibility for providing intervention support for the dollar. Thus, one long-run implication of increased U.S. holdings of foreign currency balances may well be that the United States will be forced to assume a more active role in exchange market intervention -- a process that may already have begun.

4. Foreign Relations. If U.S. intervention support for the dollar were financed from foreign currency balances instead of swap drawings, this may reduce somewhat the need to obtain concurrence of foreign authorities for U.S. exchange market operations. However,

-6-

coordination with foreign authorities would still be required in several respects. First, U.S. intervention from balances might well be undertaken in conjunction with swap financed intervention; indeed, some might argue that U.S. foreign currency balances should preferably be used simultaneously with swap drawings. However, foreign central banks might expect the United States to use its balances of foreign currency before drawing on swap lines. Second, the United States would wish to have foreign central banks intervene in a manner which would reinforce and complement U.S. intervention. Third, in order for the United States to build up foreign currency balances (either through longer-term borrowing or market purchases), or use such balances, de facto approval of foreign authorities would be essential.

5. Congressional Attitudes. Congressional attitudes toward such a step should be considered. First, a decision permanently to maintain substantial foreign currency balances might be seen as implying a fundamental shift in U.S. intervention policy away from a strategy of countering short-term disorderly conditions in exchange markets. In the past, certain members of Congress have strongly opposed U.S. accumulation of foreign currency balances. For example, a 1975 report by the Subcommittee on International Trade, Investment and Monetary Policy (then chaired by Congressman Rees) endorsed by the House Banking, Currency and Housing Committee (chaired by

-7-

Congressman Reuss) recommended, "Only as a result of the most extraordinary circumstances should swaps remain outstanding more than a year. U.S. monetary authorities should not accumulate additional reserves in the form of foreign currencies." Second, maintenance of substantial foreign currency balances might be seen by Congress as increasing potential losses on U.S. exchange market operations.

6. Implications for International Monetary System. A U.S. decision to build up substantial foreign currency balances would have to be considered in relation to longer-run U.S. objectives for the evolution of the international monetary system. In particular, such a move might appear to perpetuate and strengthen the reserve currency system at a time when the United States is sympathetic to discussions of substitution account ideas aimed, in part, at reducing the reserve role of currencies. On the other hand, such a policy change by the United States might merely be viewed as the natural consequence of the diminished international and reserve role of the U.S. dollar.

7. Implications for the Diversification of Reserves. If the United States held a substantial portion of its international reserves in the form of foreign currencies, this might encourage some smaller foreign central banks to shift the composition of their portfolios out of dollars.

B. Technical Issues

1. Size of Balances. What should be the magnitude of U.S. holdings of foreign currency balances? Net U.S. intervention purchases

-8-

of dollars during 1978 totaled over \$7 billion. If intervention from balances were to play a significant role in U.S. intervention operations -- in particular, if balances were seen primarily as a substitute for the swap network -- balances of at least \$5 billion and perhaps \$10 billion would have to be held. Significantly smaller holdings (e.g., \$2 billion or less) could supplement swap financed intervention, but would not lessen significantly U.S. dependence on the swap network for major intervention operations.

2. Currency Composition. What would be the criterion for determining the composition of U.S. holdings of foreign currency balances? In recent years U.S. intervention has been predominantly in German marks, and to a much lesser extent in Swiss francs and Japanese yen. If this practice were expected to continue, balances could be held in this same proportion, e.g., 80 per cent in marks. If future U.S. intervention should become less concentrated in marks and more evenly spread among foreign currencies, e.g., French francs, Dutch guilders, etc., a more diversified portfolio of foreign currency balances would be desirable. It might be noted that if the Federal Reserve began to accumulate substantial holdings of foreign currency balances, participants in the swap network with weaker currencies might encourage the Federal Reserve to purchase their currencies as a substitute for, or supplement to, their own drawings on the swap network.

-9-

3. Profit and Loss Accounting. U.S. profits and losses in foreign currency operations could be affected in several ways if the United States held substantial balances. If the foreign currency balances were acquired by direct purchases from the market or foreign central banks, unrealized profits (losses) would be recorded as the dollar fell (rose) against the foreign currency held even if no "intervention" was undertaken. If such balances were large, such unrealized (but currently recorded) profits or losses could be substantial. For example, the Treasury has experienced \$200 million in unrealized losses on the yen balances acquired through SDR sales and IMF drawings in early November as the yen has depreciated against the dollar. Realized profits or losses on intervention from balances purchased in the market would depend on the difference between the purchase price and the sale price of the foreign currency. Profits or losses (both realized and unrealized) on intervention from balances obtained through long-term borrowing would be similar to those arising from swap financed intervention without the risk-sharing provisions of the current swap arrangements.

4. Publicity. If the United States accumulated substantial holdings of balances of foreign currencies, consideration might have to be given to more frequent publication of information on such holdings. At present, U.S. total holdings of foreign currencies are published monthly, with about a one-month lag, in the Treasury and Federal Reserve Bulletins. Federal Reserve holdings are also included in

-10-

"other assets" in the weekly condition statement. Therefore, substantial changes in U.S. holdings of foreign currency balances, to the extent that the balances were held by or at the Federal Reserve, would become known quickly. This could lead to public pressure for fuller disclosure of U.S. reserve holdings -- most major foreign countries publish their reserves weekly -- and to official efforts to conceal large changes in U.S. balances.

5. Investment Facilities. Arrangements would have to be made for investing U.S. foreign currency balances. Several issues arise in this connection, as noted in the Holmes-Pardee memorandum. For example, German law apparently prohibits the Bundesbank from paying interest on foreign deposits, and the Swiss impose a negative interest rate on foreign deposits. Investment of balances in the Euro-market (either directly or through the BIS) would violate the recently reaffirmed standstill agreement among G-10 central banks.

II. Should the Federal Reserve System be the Holder of Foreign Currency Balances Accumulated by the United States?

A. Policy Issues

1. Federal Reserve Policy Role. Until recently U.S. intervention has been financed almost exclusively through the Federal Reserve swap network. From the resumption of U.S. intervention during the floating exchange-rate period in July 1973 to the opening of the Treasury swap line with the Bundesbank in January 1978, over 95 per cent of U.S. intervention purchases of dollars was financed through



-11-

Federal Reserve swap drawings. However, over the past year Treasury resources have played an increasing role, and Treasury intervention has been primarily from balances obtained through flotation of foreign currency securities, sales of SDRs, and IMF drawings. In November and December 1978, the nearly \$6 billion in net U.S. intervention purchases of dollars was financed two thirds from System swap drawings and one third from Treasury foreign currency balances. The Treasury currently holds over \$6 billion of foreign currency balances, including \$3.3 billion warehoused with the System. To the extent that U.S. intervention out of or to add to balances expands in relative importance, and the Treasury continued to be the only U.S. authority holding balances, the de facto influence of the Federal Reserve in determining U.S. intervention policy might be reduced. Given the increasing importance of international considerations in determining U.S. monetary policy, many would consider it important that the Federal Reserve retain a significant voice in U.S. intervention policy.

2. Foreign Analogs. The division of responsibility between the central bank and treasury/finance ministry in determining intervention policy varies considerably among foreign countries. In particular, no clear correlation between ownership of intervention resources and influence over intervention policy is apparent. In Germany, the Bundesbank holds all foreign currency balances and makes day-to-day intervention decisions. However, the German Ministry of Finance exerts indirect influences on overall Bundesbank policy.

-12-

In Britain, foreign exchange reserves are owned by the Treasury in the form of deposits at the Bank of England. The Bank carries out exchange market intervention and decides on short-run intervention tactics. Longer-run intervention strategy is set by the Treasury. In Japan, foreign exchange reserves are held by both the Bank of Japan and the Finance Ministry in roughly equal proportions. The Bank of Japan acts as an agent for the Japanese Finance Ministry in carrying out intervention. In Switzerland, France, and Italy foreign exchange reserves are owned by the central bank. The main responsibility for intervention policy resides with the central bank in Switzerland and with the finance ministries in France and Italy.

3. Monetary Policy Effects. Federal Reserve purchases of foreign currencies as well as subsequent sales from balances to support the dollar have effects on U.S. monetary aggregates similar to those of conventional open market operations. However, such effects are the same as those which result from swap financed intervention and can be offset or neutralized as they have been in the past.

4. Congressional and Treasury Reactions. A shift in Federal Reserve policy towards building up substantial foreign currency balances would have to be acceptable to the Treasury and to the Congress. The Treasury might consider such a move as an incursion into its policy domain. The Congress might view the move as an undesirable expansion of the scope and risks of overall U.S. exchange market intervention policy. In particular, Federal Reserve accumulation of balances

-13-

should be structured so that it would not be viewed as an evasion of Congressional oversight of ESF operations.

B. Technical Issues

1. Treasury Resources. The Treasury can hold foreign currencies in the General Fund or through its Exchange Stabilization Fund. However, the limit on ESF holdings of foreign currency balances (to the extent that these balances are not warehoused with the Federal Reserve) is its holdings of dollar-denominated assets. This limit can fluctuate over time, but its recent normal level has been around \$2 billion. Given this constraint on ESF foreign currency holdings, the Federal Reserve might in the future be able to acquire foreign currency balances (along with the corresponding foreign exchange risk) through direct purchases from the Treasury.

2. Legal Considerations. The Federal Reserve is prohibited by law from holding foreign currency securities. However, methods have been devised for the System to hold foreign currency deposits in other forms. The ESF can invest in securities denominated in foreign currencies, but the General Fund cannot do so.

3. Procedural Considerations. If the Federal Reserve decided to build up substantial foreign currency balances no substantive change in the FOMC's Foreign Currency Directive or Authorization for Foreign Currency Operations would be required. Paragraph 1.B. of the

-14-

Foreign Currency Authorization empowers the Desk "To hold balances of ... the foreign currencies listed in paragraph A above." Paragraph 3 of the Directive states in part that "Transactions may also be undertaken: A. To adjust System balances in light of probable future needs for currencies." The limit on the System's over-all open position in paragraph 1.D. of the Authorization would have to be amended as foreign currency balances were built up. Paragraph 3 of the Procedural Instructions requires the Manager to consult" ... about any transactions that are not of a routine character." In light of the above, addition of a separate, formal authorization covering System holdings of such balances would not appear to be necessary.

December 18, 1980

STRICTLY CONFIDENTIAL (FR)  
CLASS I-FOMC

TO: Federal Open Market Committee

FROM: Edwin M. Truman *EMT*

Attached is an update of Table 1 from the paper that was distributed to the Committee on December 12 in connection with item 2D on today's agenda.

Attachment

STRICTLY CONFIDENTIAL (FR)  
CLASS I-FOMC

December 18, 1980

Table 1

System and Treasury Foreign Currency Resources  
as of December 18, 1980  
(\$ million equivalent)

	<u>German</u> <u>Marks</u>	<u>Japanese</u> <u>Yen</u>	<u>Swiss</u> <u>Francs</u>	<u>Other</u>	<u>Total</u>
<u>System</u>					
Balances	1,433 (1,379)	435 (474)	217 (206)	16 (17)	2,101 (2,076)
<u>Swap drawings</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net position	1,433	435	217	16	2,101
<u>Treasury</u>					
Balances	5,723 (5,376)	1,768 (1,595)	1,314 (1,170)	0	8,805 (8,141)
Funds Raised	7,995	1,635	1,207	0	10,837
Swap drawings	0	0	0	0	0
Carter notes	5,230 (4,816)	0	1,207 (1,115)	0	6,437 (5,931)
SDR sales	765	635	0	0	1,400
<u>IMF drawings</u>	<u>2,000</u>	<u>1,000</u>	<u>0</u>	<u>0</u>	<u>3,000</u>
Net position	-2,272	133	107	0	-2,032
<u>Total United States</u>					
Balances	7,156 (6,755)	2,203 (2,069)	1,531 (1,376)	16 (17)	10,906 (10,217)
<u>Funds Raised</u>	<u>7,995</u>	<u>1,635</u>	<u>1,207</u>	<u>0</u>	<u>10,837</u>
Net position	-839	568	324	16	69

Note: Dollar values are computed on the basis of historical exchange rates with corresponding current rate values shown in parentheses where appropriate. Net position equals balances held minus funds raised. Funds raised equals swap drawings plus Carter notes outstanding, SDR sales, and IMF drawings. Foreign currency balances warehoused by the Treasury with the System are shown as Treasury balances. Treasury mark balances include \$233 million equivalent of marks purchased forward but not yet delivered.