



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

March 24, 1981

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann *M. A.*

Attached is a memorandum from the Staff entitled "Proposed Changes in the FOMC's Foreign Currency Instruments," dated March 24, 1981.

It is contemplated that the proposed changes will be discussed at the meeting on March 31 under agenda item 12.

Attachments

Office Correspondence

Date March 24, 1981

To Federal Open Market Committee

Subject: Proposed changes in the FOMC's

From Staff

Foreign Currency Instruments.

At the December Committee meeting, in connection with the discussion of raising the informal limits on System holdings of foreign currency balances, Chairman Volcker instructed the staff to review the Foreign Currency Instruments to determine whether and, if so, how the present informal limits on System balances could or should be incorporated into the formal Instruments.^{1/} After such a review we have come up with some recommendations with respect to the informal limits on balances. In addition, we have noted a few sentences in the Authorization which should be amended to bring them into correspondence with recent developments. (A copy of the Instruments is attached.)

I. Treatment of Limits on System Balances

A. Incorporate into Authorization's Overall Open Position Limit

We recommend that to the extent there is any formal limit on balances (that is, a limit incorporated into the Foreign Currency Instruments adopted by the Committee) it simply be encompassed by the limit on the System's overall open position. The limit on the overall open position in the Authorization, in principle, already covers long positions as well as short positions.^{2/} This limit, amended as of December 1978, currently stands at \$8.0 billion equivalent.

^{1/} The present informal limits are stated as \$3,250 million equivalent in currencies other than the yen, with up to \$2,750 million in German marks and \$500 million in all other currencies, and \$1,000 million in yen. Current System holdings amount to \$2,566 million equivalent of marks, \$399 million equivalent of yen, and \$260 million equivalent of all other currencies.

^{2/} The overall open position is defined in paragraph 1.D of the Authorization as the sum, without regard to sign, currency by currency of short positions (net debt) and long positions (net assets).

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But this amount is shown as a footnote in the present foreign currency authorization, and a much smaller amount of \$1 billion is contained in the body of the text (see paragraph 1.D of the Authorization attached). We would recommend that the effective amount be embodied in the text, and that this amount be placed at \$8 billion. An alternative amount would be \$5 billion, which approximates the present size of the Committee's total informal limit on balances.

If this approach is adopted, a minor wording change in paragraph 1.D would also be in order. The last clause of the first sentence of that paragraph should be deleted and the first sentence would read as follows:

1.D. To maintain an overall open position in all foreign currencies not exceeding \$1.0 8.0 billion [or \$5.0 billion if the Committee prefers], ~~unless a larger position is expressly authorized by the Committee.~~

The clause suggested for deletion originally referred to an express authorization with regard to the August 1971 Swiss franc swap debt which has since been repaid. But it also suggested more generally that any change from the fundamental limit in the text should be viewed as temporary, related to a particular transitory situation. Even so, with a more realistic figure in the text, the phrase would seem redundant.

Increases or decreases in this limit in the Authorization (in the text or in a footnote) would have to be recorded in the minutes of action and in the record of policy actions each time the Committee made a change.

B. Continue Current Practice

If the Committee preferred to have some explicit limits on balances currency by currency (somewhat analogous to the limits in the swap agreements), then the current practice of having informal rather than formal limits would appear to be the most practicable. One advantage in such an approach is that the FOMC would not have to make public any changes in the informal limits.^{3/}

The structure of the present informal limits could be simplified by placing a limit on total System balances of \$4.25 billion, of which up to \$2,750 million may be in marks, \$1 billion in yen, and \$500 million in all other currencies taken together. This suggestion would not change the relevant amounts but would merely adopt a limit for the total of all balances rather than having a limit (as now) for all currencies other than the yen, with a separate limit for the latter currency.

C. Formal Limits on Balances

If the Committee were to prefer formal limits on balances, which we would not recommend, a new paragraph 1.E could be added.

1.E. BALANCES HELD WITHOUT COVER OF FORWARD
CONTRACTS SHALL NOT EXCEED A TOTAL OF [\$4.25]
BILLION EQUIVALENT.

Or limits on net holdings of individual currencies could be made explicit as follows:

1.E. BALANCES HELD WITHOUT COVER OF FORWARD CON-
TRACTS SHALL NOT EXCEED THE FOLLOWING LIMITS:

^{3/} Total holdings of the System, for its own account as well as warehoused for the ESF and Treasury, are made public in the monthly Federal Reserve balance sheet, but the composition by currency is not shown. The quarterly ESF balance sheet, which is published with a three-month lag, lists ESF outright holdings by currency. Combined System, ESF, and Treasury holdings of foreign currencies in the aggregate are also published monthly.

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GERMAN MARKS	\$2,750 MILLION EQUIVALENT
JAPANESE YEN	\$1,000 MILLION EQUIVALENT
ALL OTHERS	\$ 500 MILLION EQUIVALENT

The second approach would call even more attention to the System's intentions with respect to the accumulation of balances of individual currencies.

II. Other amendments in Authorization

A. Paragraph 3

This paragraph states that Desk transactions should be at market exchange rates, with the specific exception of purchases from foreign central banks for the purpose of liquidating System swap drawings. This exception authorized a practice utilized under pre-August 1971 terms of swap agreements, and is no longer applicable. Terms of swap agreements as well as certain investment transactions involve the use of non-market rates under certain limited circumstances. Language could be added to the paragraph if the Committee wished to spell out the circumstances.

~~3. Currencies-to-be-used-for-liquidation-of
System-swap-commitments-may-be-purchased-from
the-foreign-central-bank-drawn-on;-at-the-same
exchange-rate-as-that-employed-in-the-drawing
to-be-liquidated. Apart-from-any-such-pur-
chases-at-the-rate-of-the-drawing; All trans-
actions in foreign currencies undertaken under
paragraph 1(a) above shall, unless otherwise
expressly authorized by the Committee, be at pre-
vailing market rates. FOR THE PURPOSE OF PROVIDING~~

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AN INVESTMENT RETURN ON SYSTEM HOLDINGS OF
FOREIGN CURRENCIES, OR FOR THE PURPOSE OF
ADJUSTING INTEREST RATES PAID OR RECEIVED
IN CONNECTION WITH SWAP DRAWINGS, TRANS-
ACTIONS WITH FOREIGN CENTRAL BANKS MAY BE
UNDERTAKEN AT NON-MARKET EXCHANGE RATES.

B. Paragraph 5

This paragraph deals with the investment of System foreign currency balances. In view of the provision in the Monetary Control Act which allows the System to invest in securities of or fully guaranteed by foreign governments, it would be desirable to add a sentence in paragraph 5 of the Authorization to make clear that such investments should be short term, i.e., simply a convenient vehicle for holding liquid foreign currency reserves:

5. Foreign currency holdings shall be invested
insofar as practicable, considering needs for
minimum working balances. SUCH INVESTMENTS
SHALL BE IN LIQUID FORM, AND GENERALLY HAVE
NO MORE THAN 12 MONTHS REMAINING TO MATURITY. . . .

C. Paragraph 6

The first sentence should be amended to make it more general and reflective of current practice. Foreign Currency Subcommittee members are kept informed on a continuing basis of operations. The entire Open Market Committee receives a daily report, via the Board staff's 2:30 call report, and the Manager's various reports explain operations in some detail.

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6. All operations undertaken pursuant to the preceding paragraphs shall be reported **daily** PROMPTLY to the FOREIGN CURRENCY SUBCOMMITTEE AND THE COMMITTEE. . . .

Attachment

AUTHORIZATION FOR FOREIGN CURRENCY OPERATIONS
Amended May 20, 1980

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following 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 U. S. Treasury, with the U. S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions.

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceedi ~ \$1.0 billion, unless a larger position is expressly authorized by the Committee. For this purpose, the overall open position in all

foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.^{1/}

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

<u>Foreign bank</u>	<u>Amount of arrangement (millions of dollars equivalent)</u>
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	500 ^{2/}
Swiss National Bank	4,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

^{1/} On December 19, 1978, the Committee authorized an overall open position in foreign currencies of \$8.0 billion.

^{2/} Pursuant to an action taken by the Committee on May 20, 1980, the amount of the reciprocal currency arrangement with the Bank of Sweden was raised to \$500 million, effective May 23, 1980, for a period of one year, after which it will revert to its former level of \$300 million.

3. Currencies to be used for liquidation of System swap commitments may be purchased from the foreign central bank drawn on, at the same exchange rate as that employed in the drawing to be liquidated. Apart from any such purchases at the rate of the drawing, all transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U. S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported daily to the Foreign Currency Subcommittee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board Members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager for Foreign Operations for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

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;

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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.

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.

PROCEDURAL INSTRUCTIONS WITH RESPECT TO
FOREIGN CURRENCY OPERATIONS

Reaffirmed March 18, 1980

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager for Foreign Operations, System Open Market Account, shall be guided by the following procedural understandings with respect to consultations and clearance with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager for Foreign Operations shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager for Foreign Operations shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available);

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

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B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager for Foreign Operations shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System, and about any operations that are not of a routine character.