for Burns Papers – B33 (cont'd)

[– so FRB into k controls – concern for monetary autonomy]

– FRB bothered by SR k flows

– from "Eurodollar Market + its Public Policy Implications" prepared for Joint Eco Committee of Congress of US Feb 25, 1970 (US Govt Print Office, 1970) by I. Scott – notes problems for monetary autonomy

– notes that other study showed that without eurodollar market, foreign private dollar holdings

p. 28 in US would be $3.5 b less – would have found their way into official hands + been converted (potentially) into gold

– "The widespread impact of the Eurodollar market as a communications link between natl k markets could be effectively eliminated through the reinstitution of a thorough-going system of exch. controls. ... Their reinstitution ~~would also~~ could do much to

p. 32 destroy the institutional fabric of the market. The intl position of the dollar + the benefits to be gained through a liberalization of intl k movements must, on the other hand, be weighed in the balance."

memo of Oct 21, 1970 → – B. Solomon recommends that k controls be maintained through 1971 + ~~that~~ says "Fed. Res. could take an action to restrain the short-term k outflow from American banks to the Eurodollar market ... This action would

p. 5 make sense as part of a package designed to improve the rest of the bal p. Furthermore, it would be welcomed abroad as a cooperative act."

– he's is suggests

DR. MILTON GILBERT

Economic Adviser

Bank for International Settlements

Basle

~~Confidential~~

JOINT SUPERVISION OF THE EURO-CURRENCY MARKET

Developments in the Euro-currency market over the past several years have caused increasing interest among the central banks.

At one time there was some concern over the possibility of unsound practices by Euro-dollar banks from a purely banking standpoint, such as excesses of borrowing short and lending long or overextension of credit to particular borrowers. But up to the present, at least, experience has shown that these fears have had little foundation.

Discussion is now centred on the monetary rather than the purely banking aspects of the market - the sheer momentum of the market's growth and the size it has reached, the implications of this growth for monetary inflation, the potential of the market's large pool of resources for speculative pressures, the influence of the market on interest rates, the complications that arise for domestic monetary policy, the easy financing of balance-of-payments deficits and the possibility that the market's resources would add to monetary disturbances in the event of severe weakness of the dollar.

It is significant that this view was reflected by former chairman Wm. McChesney Martin in his recent speech in Basle, in which he said: "At present there is little, if any, multilateral supervision of these markets. One need raise no doubt about the soundness of the claims that are created and exchanged in these markets to suggest that a case can be made for giving to an international institution some responsibility for supervising these markets." At the IMF meeting in Copenhagen, Mr. Giscard d'Estaing expressed a similar view and Mr. Schweitzer, the Managing Director of the Fund, gave it as his opinion that "maybe the central bankers could do something" about the market.

At present, virtually all of the central banks influence the activities of their own banks in the market from a national point of view in one way or another, but there is no authority which concerns itself with the market's impact on world monetary conditions as a whole. It may be said that the rationale of joint supervision of the market by the major central banks is rather apparent. This, however, leaves open several questions: what sorts of situation might call for active supervision of the market; to what extent might such situations arise in any case with the existing degree of convertibility and freedom for capital movement; and how might active joint supervision be exercised?

Growth of the market

The expansion of the Euro-currency market has been without precedent in international monetary history. As measured by the foreign currency credit outstanding through the banks of eight reporting European countries, the net size of the market is estimated to have risen from its beginnings in the mid-1950s to about $11 milliard at end-1964 and to roughly $50 milliard by June 1970. To put this growth in perspective, it may be noted that since end-1964 domestic private-sector credit extended by banks in all OECD countries taken together went up by about $360 milliard, from $415 to 775 milliard.

Out of the net totals for all currencies given above the component in dollars was about $9 milliard at end-1964 and $41.5 milliard in mid-1970. Over 40 per cent. of this $32.5 milliard expansion occurred during the first halves of 1968 and 1969 alone under the impact of tight monetary policy in the United States. However, even from mid-1969 to mid-1970, when US banks' Euro-dollar indebtedness showed a slight decline, the Euro-dollar market expanded by about a further $8 milliard. And, despite large US bank repayments and the usual seasonal slack, the Euro-dollar market seems to have been well maintained during the third quarter of this year also. Hence, it is evident that a large flow of bank credit is generated through the Euro-market and that the expansion is continuing.

Sources and uses of funds

As may be seen in the table, the sources of funds for the growth of Euro-dollar credit have been broadly based and

Estimated net amount of Euro-dollar credit outstanding through banks in eight European countries, 1964-70

Items	1964	1965	1966	1967 June	1967 Dec.	1968 June	1968 Dec.	1969 June	1969 Dec.	1970 June
	end of period, in milliards of US dollars									
Total	9.0	11.5	14.5	15.0	17.5	22.5	25.0	33.5	37.5	41.5
Sources										
Reporting European area										
Banks[1]	2.7	4.5	5.8	5.1	5.7	7.5	8.1	8.6	9.1	10.2
Non-banks	1.8	2.2	2.8	3.6	4.0	4.8	5.2	8.1	9.4	10.0
Total	4.5	6.7	8.6	8.7	9.7	12.3	13.3	16.7	18.5	20.2
Outside area										
Other western Europe	0.8	0.8	1.0	1.2	1.4	1.5	1.9	2.1	2.7	2.8
United States	0.7	0.8	1.1	1.1	1.7	2.9	3.2	4.4	3.8	4.3
Canada	0.8	0.5	0.6	0.7	0.9	1.0	1.3	2.3	2.9	3.4
Japan	–	–	–	–	–	–	–	0.2	0.4	0.3
Eastern Europe	0.2	0.3	0.3	0.3	0.4	0.4	0.6	0.6	1.0	0.8
Other	2.0	2.4	2.9	3.0	3.4	4.4	4.7	7.2	8.2	9.7
Total	4.5	4.8	5.9	6.3	7.8	10.2	11.7	16.8	19.0	21.3
Uses										
Reporting European area										
Banks[2]	2.8	3.2	2.8	2.3	2.9	2.6	3.2	3.8	6.1	6.2
Non-banks	2.3	3.2	3.6	4.0	4.1	4.5	4.7	5.1	5.6	7.0
Total	5.1	6.4	6.4	6.3	7.0	7.1	7.9	8.9	11.7	13.2
Outside area										
Other western Europe	0.4	0.6	0.9	1.0	1.2	1.4	1.5	1.3	1.6	1.9
United States	1.8	2.1	4.4	4.2	5.2	8.8	9.5	16.7	16.5	16.4
Canada	0.4	0.6	0.6	0.6	0.7	0.9	0.9	1.2	1.3	1.6
Japan	0.4	0.5	0.6	0.8	1.0	1.4	1.6	1.3	1.4	1.8
Eastern Europe	0.4	0.5	0.6	0.7	0.7	0.8	0.9	0.9	1.0	1.2
Other	0.5	0.8	1.0	1.4	1.7	2.1	2.7	3.2	4.0	5.4
Total	3.9	5.1	8.1	8.7	10.5	15.4	17.1	24.6	25.8	28.3
Net positions[3]										
Reporting European area										
Banks	0.1	-1.3	-3.0	-2.8	-2.8	-4.9	-4.9	-4.8	-3.0	-4.0
Non-banks	0.5	1.0	0.8	0.4	0.1	-0.3	-0.5	-3.0	-3.8	-3.0
Total	0.6	-0.3	-2.2	-2.4	-2.7	-5.2	-5.4	-7.8	-6.8	-7.0
Outside area										
Other western Europe	-0.4	-0.2	-0.1	-0.2	-0.2	-0.1	-0.4	-0.8	-1.1	-0.9
United States	1.1	1.3	3.3	3.1	3.5	5.9	6.3	12.3	12.7	12.1
Canada	-0.4	0.1	–	-0.1	-0.2	-0.1	-0.4	-1.1	-1.6	-1.8
Japan	0.4	0.5	0.6	0.8	1.0	1.4	1.6	1.1	1.0	1.5
Eastern Europe	0.2	0.2	0.3	0.4	0.3	0.4	0.3	0.3	–	0.4
Other	-1.5	-1.6	-1.9	-1.6	-1.7	-2.3	-2.0	-4.0	-4.2	-4.3
Total	-0.6	0.3	2.2	2.4	2.7	5.2	5.4	7.8	6.8	7.0

1 Including conversions by the banks of domestic or third currency funds into dollars, plus dollar deposits by the official monetary institutions of the reporting area.

2 Including conversions by the banks of dollars into the domestic or third currencies; excluding, however, the Italian banks' use of Euro-dollars for third-currency loans to residents (included under non-bank uses).

3 A minus sign indicates that the area or grouping in question is a net supplier of Euro-dollar funds, whereas the absence of a sign indicates that it is a net user.

the relative contribution of the various areas has shown little change. A fairly important exception was the flow of funds to the market from the United States and Canada which increased from $1.8 milliard at end-June 1967 to $6.7 milliard at end-June 1969. Even this figure may be a significant understatement, since substantial US funds have probably entered the market in indirect ways, such as through trustee and nominee accounts in Europe. In other words, the figure for funds supplied from within the reporting area is too large and the supplies from the United States too small.

But the growth of Euro-dollars has been much more unbalanced on the uses side. Nearly two-thirds of the $24.5 milliard expansion between December 1964 and June 1969 was accounted for by US borrowing, whereas the reporting area's own takings increased relatively little. The pattern was, of course, moderately reversed in the subsequent twelve months, when well over half of the new funds were absorbed within the reporting area, whereas US takings declined somewhat.

<u>The character of the market</u>

The data on net positions of the various areas indicate more sharply the change in the character of the market over the past five years. While the United States is shown as a net taker of funds in 1964 and 1965, this reflected the normal placements of foreign liquid funds in the New York market; the real flow of funds between the US and the Euro-dollar market at that time was rather from the United States to the Euro-banks. Starting with the credit squeeze in 1966, however, the United States became the main borrower from the market and it has ended up with a very large net debtor position - probably overstated somewhat as suggested above. In other words, apart from relatively small net takings by Japan and eastern Europe, until recently the Euro-dollar market has been largely a mechanism that on balance channelled short-term funds from the outside world to the United States.

In its earlier years the Euro-dollar market was a market that emerged among banks in Europe which found that they could bid successfully for dollars and re-lend them at a narrow operating margin. More recently the character of the market has changed with the growing dominance of US banks in it. For example, only nine US banks had branches in London at the end of 1963, but the number has grown to about thirty-five at present, motivated essentially by the attraction of Euro-dollars.

The non-sterling liabilities of the London branches of US banks went up from $1.2 milliard at the end of 1963 to $23.4 milliard at the end of July 1970; and their share in the total non-sterling liabilities of banks in the United Kingdom increased over the same period from 24 to 50 per cent. The data available for the other European financial centres indicate that US banks are less important there; nevertheless, it is evident that US banks account for a large share of the market and an even larger share of its growth.

This surge of interest of US banks in the Euro-market reflects their desire to compete outside the United States for dollar deposits - even those from their own customers. As their head offices in the United States were handicapped because of the cost of reserve requirements and the limitations of Regulation Q, they put themselves on the same footing as foreign banks enjoy by shifting business to branches in foreign financial centres where dollar deposits are unencumbered by local regulations. As an official of the Federal Reserve has put it, 'the United States has been exporting its banking system'. Thus, the recorded growth of the market is partly illusory since, to a significant extent, the branches are just bookkeeping offices for transactions that are arranged in the United States. That is to say that the reported growth of the Euro-market has somewhat exaggerated its significance for Europe and for the world monetary system.

Factors underlying the market's growth

Regulations applicable to the use of the dollar itself by banks in the United States and to domestic currency operations of other banking systems constitute one key factor that explains the existence of the Euro-market, which is relatively free from such regulations. It is often thought that the existence and growth of the market has been due to the US balance-of-payments deficit. That explanation is, however, insufficient: if the dollars flowing from the deficit had all continued to be held in the United States itself, the market would not have arisen.

The factors which explain the existence of an active Euro-dollar market are: (1) the relative absence of regulations on foreign currency operations, particularly offshore operations, of banks outside the United States, coupled with the regulations which hamper banks' domestic currency operations - both in the United States and elsewhere; (2) the ability of the Euro-banks (including US banks' foreign branches) to compete effectively, both because they can operate on narrower margins and because they are not bound by interest rate conventions and cartel arrangements; and (3) the willingness of the world to use the dollar on a large scale, both because of its convenience and because of the feasibility of doing so.

Where the US external deficit comes into the matter is in helping to explain the growth and present size of the market. Without such a continuing deficit the market would have had to rely for its growth on attracting the foreign-held dollars that already existed at the time of its creation, plus its own ability to create dollar deposits; with these limitations it is hardly conceivable that the market could have reached its present size.

At the same time, however, it can be demonstrated that the cumulative US deficit, even if it had gone entirely into the Euro-dollar market, cannot account for the present net volume of Euro-dollar credit. In this connection, it is necessary to bear in mind that the US payments deficit, to the extent that it is financed by increases in official dollar liabilities of banks in the United States, cannot statistically account for the growth of the Euro-dollar market since these liabilities represent, by definition, dollars held in the United States itself. What counts therefore is the extent to which the deficit gives rise to increases in non-official dollar liabilities.

Over the five and a half years (used in the table) from end-1964 to mid-1970 the US liquidity deficit financed by increases in non-official liquid liabilities of the United States to foreigners amounted to $14.6 milliard. During the same period net Euro-dollar credit expanded from $9 to 41.5 milliard, i.e. by $32.5 milliard. Moreover, even if we add to the increase of private dollar balances during this period the amount of such balances outstanding at the beginning of the period - which was $12.5 milliard - it is clear that the total of privately-held balances outstanding at mid-1970 was less <u>either</u> than the net growth of the Euro-dollar market between end-1964 and mid-1970 <u>or</u> than the total of Euro-dollar credit outstanding at mid-1970. Furthermore, it is certain that a large amount of foreign-owned dollars is held directly in the United States as working balances and money-market investments - without passing through the Euro-market.

Thus, recent and more remote US payments deficits can only account for a share of the present volume of Euro-dollars outstanding. The rest were necessarily brought into being by the mechanism of the market. Essentially this has happened in two ways.

Firstly, Euro-dollars get on the books of the banks through flows of short-term funds outside the United States that are denominated in dollars as the vehicle currency, either for the convenience of the banks or the banks' customers, or because regulations would not have allowed the flows to take place in the domestic currencies involved.

Secondly, Euro-dollar assets and liabilities may be created by the Euro-banks as a group, just as banks create them in a domestic banking system, that is by making advances which are used, at least partly, within the Euro-dollar system. Formerly such credit creation was thought to be quite limited, as the leakages from the system were believed to be very considerable. However, with the growing share in the market of US bank branches, which have a considerable amount of business with US corporate branches and affiliates, there is now greater scope for the process of credit creation to operate.

It seems unnecessary to trace here the dynamic forces on the demand or the supply side that have stimulated the growth of the market, particularly as only a few major episodes could be isolated - such as the intense demand for dollars by US banks in 1969, which sucked liquidity into the market, or the flight from the franc in 1968, which supplied funds to the market. It is worth noting, however, that the part played by monetary authorities in the market's development has not been insignificant. In addition to the fact that the forces acting on the market from the private sector have often been forces created by central banks, there have also been times at which central banks have contributed directly, or via their own banking systems, to the market's supply of funds.

Problems raised by the market

The interest in multilateral supervision of the Euro-market stems from the problems which are believed to have arisen from, or to have been aggravated by, the market's behaviour. The nature of these problems has been suggested earlier, but some elaborations may be useful.

1) The market is a significant vehicle for the international expansion of bank credit which may at times be inflationary. The rapid rate of growth of the market itself gives substance to this view. The market increases the flow of credit in various ways: for example, by facilitating

international movements of funds from areas where monetary conditions are relatively easy to those where there are unsatisfied demands for credit; by credit creation within the market; by drawing down official reserves for use in private credit markets; and by increasing the credit multiplier through lower average reserve requirements. In theory the central banks could adjust their own objectives for the rate of expansion of their domestic money supply to allow for the effect of the market, but in practice it is difficult for them to do so, particularly if they have to do so unilaterally.

2) The market increases the international pool of liquid funds and facilitates their rapid shift from one market to another. At times this blunts the effectiveness of domestic monetary policy. Similarly, flows of funds facilitated by the market can interfere with balance-of-payments objectives.

3) The use of the market by the banking system in a particular country, permitted or facilitated by the central bank in one way or another, can cover up an imbalance in the balance of payments and can delay corrective action by the authorities. This is a rather obvious point and need not be elaborated, except to say that it can apply to surplus as well as to deficit countries.

4) The Euro-market can have an amplifying effect on interest rate developments in national markets, as was dramatically illustrated in the 1969-70 episode. The repercussions of the market in this regard are out of proportion to its marginal share of world credit flows. In domestic monetary management many central banks have aimed at controlling the money supply without changes in interest rates so violent as to disrupt financial markets. To pursue the same aim in the Euro-market would require a concerted effort.

5) The market provides a large pool of liquid resources that may feed speculative excesses. While not without some substance, it seems to us that this allegation has been

exaggerated. If one reviews the major cases of speculative fever over the past five or six years, one can say first that where the exchange market was acting against the threat of a currency devaluation, the Euro-market was of little importance. It could have aggravated the flight from, say, sterling, the French franc and the lira at various times, had large Euro-dollar borrowing in the currencies concerned previously been built up. Or very attractive rates in the Euro-market could have added to the outflow of domestic funds. But in fact neither of these influences seems to have been very significant in relation to these countries' total official financing requirements at the time.

In the case of the 1967-68 gold rush the availability of the market's funds was more significant. Nonetheless, they could hardly be called crucial to the total movement.

The rôle of the market was probably largest in the Deutsche Mark speculation. In the second and third quarters of 1969 the short-term inflow of funds to Germany outside the banks was $3.8 milliard and at the same time the German banks themselves increased their net foreign indebtedness by $1.1 milliard. The inflow outside the banks consisted largely of foreign firms building up balances with their branches in Germany, and of changes in the terms of payment (leads and lags). It is quite likely that both these were to a certain extent financed in the Euro-currency market.

Of course, even without the facilities of the Euro-market, speculative flows would occur when there is threat of a major monetary upset.

6) A final point may be mentioned, though it is rather difficult to formulate because it is somewhat nebulous. It is that the Euro-market has tended to speed up the increasing use of the dollar as a transactions and financing currency. There is evident unease at this growing dominance of the dollar and criticism of the processes which bring it about. Of course, this has been due not solely to US policies and regulations

but also to those of other countries. Obviously, if the competition of other currencies with the dollar is limited by restrictions on their use, then, naturally, the dollar will have only limited competition.

Perhaps more important is the fear, already mentioned, that the repercussions of a possible run on the dollar have been considerably increased as a result of the market's growth.

Procedure

In view of this range of problems to which the central banks may from time to time give joint consideration, what sorts of initiatives might be contemplated in the exercise of multilateral supervision of the market? Four sorts can be envisaged:

1) Obtaining a better and more up-to-date knowledge of developments in the market, through more regular and speedier reporting of the banks' foreign currency positions. In this connection, consideration could also be given to more frequent publication of Euro-currency statistics by the BIS.

2) Exchanges of views by central banks on certain aspects of the permanent regulations and practices in particular countries.

3) Exchanges of views by central banks on the ad hoc regulations or arrangements in particular countries.

4) Discussions concerning possible initiatives of the central banks, as was done in the past for end-of-year operations.

It hardly needs to be said that the aim of such initiatives should be to alleviate specific problems and not to lose the benefits of the market by stifling it. These benefits include the stimulation of banking competition, both internationally and in various domestic credit markets; the speed and efficiency with which the market is able to handle large transactions; and the advantages which result from the internationalisation of available liquidity through the market.

As a method of procedure the following suggestions may be made. Final consideration of any problems raised or proposals for initiatives would take place in a meeting of the Governors. However, a group of Deputies of the Governors, with the General Manager of the BIS as Chairman, would be established to sift and prepare matters for the Governors' consideration. Meetings of the Deputies' group would be periodical and would be called on the suggestion of any of the central banks or of the General Manager of the BIS. The General Manager would report to the Governors on the Deputies' discussions.

10th January 1971

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

January 11, 1971

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed are (1) a memorandum from the staff dated today and entitled "Euro-dollar problem: Federal Reserve matched-sale purchase transactions," and (2) a memorandum from Mr. Hackley dated January 8, 1971, and entitled "Legality of 'matched sale-purchase transactions' to induce banks to retain Euro-dollar holdings."

It is contemplated that a preliminary discussion of these materials will be held at the meeting of the Committee tomorrow, at the conclusion of the discussion of monetary policy.

It is requested that these materials be held in strict confidence.

Arthur L. Broida

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Enclosures

CONFIDENTIAL (FR)

January 8, 1971.

To: Federal Open Market Committee

From: Mr. Hackley

Subject: Legality of "matched sale-purchase transactions" to induce banks to retain Eurodollar holdings.

It has been suggested that, as a means of inducing American banks to retain Eurodollar liabilities, the System might offer Government obligations for sale to banks having such liabilities, with a simultaneous agreement to purchase such obligations at a specified date at a rate that would provide the banks with an attractive yield. This memorandum relates to the legality of such "matched sale-purchase" transactions.

Although in form such transactions would involve the sale and purchase of Government securities, it might be contended that in substance they would amount to a borrowing of money by the Reserve Banks and that the Reserve Banks have no authority to borrow money. At times in the past, purchases of securities with agreements to resell them at a certain date (straight "RP's") have been questioned as constituting loans of money rather than legitimate open market operations; but the validity of such transactions now appears to have the legal support of almost 50 years of "administrative practice" known to Congress. Although matched sale-purchase transactions have been used as a tool of domestic monetary policy since 1966 without legal challenge, they are not supported by such a long period of administrative practice.

One of the arguments advanced in the past in support of straight RP's is that, even if they amount to "loans", the Reserve Banks have statutory authority to lend money to both member banks and to individuals, partnerships, and corporations on the security of Government obligations. The Reserve Banks do not, however, have authority to borrow money - which, it might be argued, is the effect of matched sale-purchase transactions.

It might be contended that the proposed matched sale-purchase transactions would not be designed to effectuate legitimate purposes of Federal Reserve open market operations. Traditionally, such operations have been regarded as designed to affect the reserves of member banks and thereby to regulate domestic bank credit. The present proposal would be aimed solely at persuading American banks to retain Eurodollar holdings in order to prevent an outflow of dollars to foreign central banks that might threaten a reduction of the U.S. gold stock. It appears to be conceded that the Desk might have to offset the proposed transactions by substantial purchases of securities in order to effectuate current monetary policy; and this fact suggests that the proposed transactions would not be within the usual concept of open market operations.

On the other hand, there are considerations that would appear to support the legality of the proposed transactions.

In the first place, although it is not believed to be a strong argument, the transactions would be in the form of sales and purchases of Government securities and thus literally within the scope of the express authority of the Reserve Banks.

Even if in substance the transactions should be regarded as Reserve Bank borrowings, they would be no different in this respect from matched sale-purchase transactions conducted since 1966 as a means of absorbing bank reserves. The legality of such transactions has not been questioned and "administrative practice", even for a period of less than five years, might be regarded by a court as supporting the validity of the transactions. In this connection, it may be noted that in recent years drawings by the System under its network of "swap" arrangements have in effect constituted borrowings of money and that the legality of such drawings has not been questioned.

Finally, with respect to the purpose of the proposal, the System's foreign currency operations have been designed to "help safeguard the value of the dollar in international exchange markets" rather than to affect member bank reserves and bank credit. Such foreign currency operations were upheld legally in 1962 not only by Counsel for the FOMC but by the Treasury's General Counsel and, reportedly, by the Attorney General of the United States.

Section 12A of the Federal Reserve Act provides that the time, character, and volume of open market operations shall be governed with a view "to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country". It may be argued that, like foreign currency operations, the proposed securities transactions would clearly have a bearing, even though indirectly, upon the general credit situation of the country.

While the question is not free from doubt, it is my opinion, particularly on the basis of analogous precedents, that the proposed matched sale-purchase transactions contemplated by the present proposal would be legally supportable.

CONFIDENTIAL (FR)

January 8, 1971.

To: Federal Open Market Committee

From: Mr. Hackley

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Even if in substance the transactions should be regarded as Reserve Bank borrowings, they would be no different in this respect from matched sale-purchase transactions conducted since 1966 as a means of absorbing bank reserves. The legality of such transactions has not been questioned and "administrative practice", even for a period of less than five years, might be regarded by a court as supporting the validity of the transactions. In this connection, it may be noted that in recent years drawings by the System under its network of "swap" arrangements have in effect constituted borrowings of money and that the legality of such drawings has not been questioned.

Finally, with respect to the purpose of the proposal, the System's foreign currency operations have been designed to "help safeguard the value of the dollar in international exchange markets" rather than to affect member bank reserves and bank credit. Such foreign currency operations were upheld legally in 1962 not only by Counsel for the FOMC but by the Treasury's General Counsel and, reportedly, by the Attorney General of the United States.

Section 12A of the Federal Reserve Act provides that the time, character, and volume of open market operations shall be governed with a view "to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country". It may be argued that, like foreign currency operations, the proposed securities transactions would clearly have a bearing, even though indirectly, upon the general credit situation of the country.

While the question is not free from doubt, it is my opinion, particularly on the basis of analogous precedents, that the proposed matched sale-purchase transactions contemplated by the present proposal would be legally supportable.

January 11, 1971

TO: Board of Governors

FROM: Division of International Finance

SUBJECT: Euro-dollar problem: Federal Reserve matched sale purchase transactions

CONFIDENTIAL (FR)

This memorandum outlines the technical characteristics of Federal Reserve matched sale-purchase transactions with member banks designed to help moderate repayments of Euro-dollars. Sales would be made from the System's portfolio of U.S. Government securities with offsetting purchase contracts to buy the securities back at specified future dates. The effectiveness of the matched sale purchase transactions (MSP's) (and of a special Ex-Im security issued to achieve the same objective) would be increased if certain amendments which are set forth below were made in the Board's Regulation M.

An amendment by the FOMC to its continuing authority directive would be required to implement the proposal.[1/]

In the judgment of the staff, it would be most efficient for the FOMC to specify in its continuing authority directive certain general criteria for MSP transactions, such as the method of allocation to member banks, an outside limit on the maximum outstanding volume of matched sales purchase transactions, the maximum maturity of the instrument, and the maximum interest rate spread allowable between sale and

1/ Draft language appears in the Appendix.

repurchase price. Responsibility for making other decisions on the MSP program might then be delegated to a subcommittee, whose decisions would be dictated by operating experience.

Recommended Program:

It is recommended that the FOMC authorize a total outstanding volume of MSP's of $1-1/4 billion initially; as necessary, the Trading Desk could make such agreements at a rate of $300 million a week over the course of a month. It is recommended that FOMC require that the MSP be allocated to banks in proportion to their outstanding Euro-dollar liabilities to branches (plus branch holdings of MSP's and Ex-Im Bank securities) in the most recent computation period; reasons for rejecting other possible methods of allocation are discussed below.

The recommended maturity for the MSP (once the introductory period is passed) is four weeks, with maturity to fall shortly after the end of a computation period in order to adjust banks' holdings of MSP's to their Euro-dollar liabilities as quickly as possible. It is recommended that the Federal Reserve fix an appropriate yield spread for each offering of MSP's over the one-month Euro-dollar deposit rate, perhaps beginning with a spread of 1/8 percentage point.

Through MSP transactions, and through sale of high-yield Ex-Im Bank securities, allocated to banks along the lines set forth above, the Federal Reserve, and the U.S. Government, would share with the banks the cost of the Euro-dollar borrowings of their branches in excess of amounts relent abroad. The share borne by the Federal Reserve or the Government would be influenced both by the yield on the instrument and the volume of such instruments allocated. A total allocation of Ex-Im Bank securities and Federal Reserve MSP's (along the above lines) amounting to $3 billion would eliminate the excess cost on 3/8 of total Euro-dollar liabilities of about $8 billion; this would be equivalent to a cost saving of about 40 basis points on the total amount of borrowings, and may be compared to an estimated cost of Euro-dollars over domestic funds of roughly 1 percentage point.

Consultation with the Division of Research and Statistics and with the Trading Desk indicates that an MSP, patterned along these lines, could be implemented without creating serious problems for the management of domestic open market policy.

Discussion:

The particular characteristics of the proposed MSP to be examined further are the relation of the MSP to requirement-free Euro-dollar bases, the method of allocation to member banks, and the method of pricing the MSP.

Relation to requirement-free bases. The MSP could, as a matter of principle equally well be made with the U.S. head office or with the foreign branch. If the MSP is sold to the head office, there would be no necessary reduction in head office liabilities to foreign branches; the head office could purchase the MSP with the funds that otherwise might be used to repay Euro-dollar borrowings from branches. Thus, the bank would retain its requirement-free base, unless it took specific steps to reduce its base.

However, if the MSP were acquired directly by the branch (as would be the case with the Ex-Im security), there would ordinarily be a reduction in head office liabilities to branches as the branch paid for the security by reducing its claim on the head office.

It would be advisable to amend Regulation M to provide specifically that a bank's requirement-free base should not be reduced by amounts of MSP's or Ex-Im securities held by the branch.

Method of allocation. The security should be allocated among banks according to the volume of head office liabilities to branches plus branch holdings of MSP's (and Ex-Im securities) in the most recently completed computation period. This method of allocation would probably provide the best balance of equity and effectiveness. Banks with large outstanding head office borrowings from branches would obtain large allocations; banks that held MSP's at head offices and repaid borrowings following the initial allocation would obtain smaller amounts at future allocations.

Alternative methods of allocation that attempt to exert additional leverage on banks to maintain borrowings appear likely to involve significant inequities and/or deficiencies in coverage. Two examples are given below (on the assumption that the MSP's are held at head office):

a) MSP's could be allocated in such a way that banks that maintained Euro-dollar borrowings at or close to a recent level (e.g. the average in the December computation period) would receive larger allocations in proportion to their borrowings. Thus, one could provide that banks would receive allocations equal to X per cent of their Euro-dollar borrowings so long as borrowings (in the current computation period) were not more than 10 per cent below the December average, but otherwise allocations would be equal to 1/2 X per cent of borrowings.

This method of allocation would place banks that had maintained borrowings at or close to original base-period levels at a disadvantage compared to banks that had reduced borrowings earlier. A bank that reduced its Euro-dollar borrowings in February 1971 would obtain a smaller allocation than it would have obtained had it made the same reduction in early December. Such a method of allocation would be inconsistent with the commitment in the Board's press release of November 30, 1970:

> Although the steps announced today were deliberately made of modest scale, the Board has under review other measures that might be adopted for the purpose of tempering the repayment of Euro-dollars while avoiding penalty to banks that operate so as to retain their reserve-free bases.

b) Alternatively, one might provide that banks' eligibility to acquire the MSP would be inversely related to the shortfall of their Euro-dollar borrowings from the original base (May 1969 or November 1970, whicever is higher). Most of the MSP's will, in any event, be allocated to banks that in the December computation period were close to their original historical bases; these banks account for 75-80 per cent of total Euro-dollar borrowings. Allocating them a significantly larger than proportionate share of the MSP's would result in only a minimal allocation for banks that have repaid substantial amounts of Euro-dollars. Yet, these latter banks still have substantial amounts of borrowings outstanding; three major New York City banks that have reduced borrowings by 30-40 per cent from May base levels, still account for about $2 billion of borrowings.

A formula for allocation providing that banks with borrowings of at least 80 per cent of May 1969 bases (or November 1970 bases, if higher) would obtain MSP's equal to X per cent of borrowings, and other banks only 1/2 X per cent of borrowings, would encourage banks not to repay below 80 per cent of the original base, but might well appear to sanction repayments down to this level. It would probably be inadvisable to imply sanction of such a reduction (which would total nearly $1-1/2 billion, if it were general.)

It should be noted that there would be little or no basis in equity for application of a formula that used the original May 1969 base--given the widely differing positions of individual banks in May 1969.1/ Moreover, a special formula would be required for banks that have been using minimum bases (3 per cent of deposits) and are now required to establish historical bases by January 20.

Neither the MSP nor the Ex-Im security should be transferable to other banks, particularly in view of the fact that either would count toward avoiding reduction of a bank's requirement-free base. Transferability would result in sale of the allocations by banks that did not value their bases highly to banks that would retain their bases anyway. Thus, the MSP (or Ex-Im security) would tend to substitute for the most stable component of Euro-dollar borrowings.

Maturity. The MSP is more likely to be an effective technique for inducing banks to retain Euro-dollar borrowings if its maturity is relatively short; the shorter the maturity, the more closely branch or head office holdings of it can be matched to the bank's performance in retaining Euro-dollars.

1/ If an auction technique were used as a method of distributing a limited supply, banks that wished to maintain reserve-free bases anyway would bid most strongly for the securities, since the yield to them on the preferential asset would be pure gravy. As a result, the yield under the auction could be bid down to a point where it was not attractive to banks on the margin between repaying or retaining Euro-dollar borrowings.

With a maturity of four weeks, holdings could be adjusted following the end of each computation period; banks that repaid borrowings would obtain correspondingly smaller allocations upon maturity of their current holdings.

Pricing. It is recommended that the Federal Reserve set both the sale and the repurchase price on the MSP, as well as specifying an allocation for each bank. These prices would be fixed to provide a yield to the bank equal to the one month Euro-dollar deposit rate plus a small margin (e.g., 1/8 percentage point); at current Euro-dollar rates the yield would be about 6-1/4 per cent. Additional information on appropriate pricing may be obtained from the experience in offering the Ex-Im security.1/

An alternative technique that was examined by the staff was for the Desk to solicit bids from each bank for its specified allocation. The bank making the bid would presumably attempt to guess the Desk's reservation price. But given the purpose of the MSP (and the constraint that allocations reserved for one bank would not be offered to another bank), it was not clear how the Desk could arrive at meaningful reservation prices. Thus, it appeared advisable, at least in the initial offerings, for the Federal Reserve to set a price that clearly covered the cost of Euro-dollars plus a reasonable margin.2/

1/ The one-month rate would be appropriate both in light of the maturity of the MSP and of the fact that about 45 per cent of the Euro-dollar deposits of foreign branches mature within one month.

2/ Little is known about tax considerations that might affect the willingness of foreign branches to acquire securities. The issue is probably not significant so long as the margin between the yield on the MSP and the cost of Euro-dollars is very small.

Amount. Although the MSP, as outlined above would provide no special marginal incentive for banks to retain Euro-dollar borrowings, it would lessen the costs to banks of retaining requirement-free bases. (Alternative methods of allocation would provide marginal incentives, but at some cost in coverage or equity; see pages 5-7 above.) The cost sharing could take the form of either a high rate of return (over and above the cost of Euro-dollars) on a small volume of MSP, or a slight margin over the Euro-dollar rate on a larger volume of MSP's. By and large, the latter form of cost sharing would be preferable from the standpoint of minimizing the political risk.

If one assumes total liabilities to branches are $8 billion, an offering of $2 billion of MSP's (at a yield equal to the cost of Euro-dollars to the bank) would eliminate the excess of cost to banks on 1/4 of their total borrowings. This would be equivalent to a cost saving of 25 basis points on the total amount of borrowings. It would be a somewhat greater cost saving on that portion of their Euro-dollar borrowings that the banks are considering repaying, since in any case borrowings would not be repaid completely. If banks repaid $2 billion of borrowings in addition to reducing their liabilities to branches by $2 billion to enable the branches to acquire the securities, the second-round allocation to refund the maturing MSP would provide a larger cost saving: the $2 billion of refunding MSP's would be allocated to banks with $6 billion of borrowings (together with maturing MSP's); the cost saving would be 33 basis points on average outstanding borrowings. Thus, it would probably not be necessary to issue MSP's equal to the total volume of borrowings; at some point the cost saving would be sufficient to induce banks to preserve the remainder of their bases.

It would appear that a combined authorization of MSP's plus Ex-Im securities of, say, $3 billion would represent an adequate amount for planning, at least initially. Issuance of this amount would enable the Federal Reserve and the Government together to cover almost one-half of the excess cost of total Euro-dollar borrowings--at the present 1 percentage point cost of Euro-dollars over domestic funds--and to cover a somewhat higher proportion of the excess cost on those borrowings that are potentially subject to repayment. The entire amount may not be required, but the need can best be assessed only after the response of banks to the initial tranches has been determined.

APPENDIX

Add the following paragraph 4 to the Continuing Authority Directive With Respect to Domestic Open Market Operations:

"4. For the purpose of moderating movements of Euro-dollar liabilities of member banks, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for the System Open Market Account, to enter into special agreements ('paragraph 4 agreements') with member banks providing for the sale of U.S. Government securities by the Reserve Bank to the member bank on a cash or regular delivery basis, and for the purchase by the Reserve Bank from the member bank of the same amount of the same issues of securities within __ weeks or less, subject to the following conditions:

"A. A member bank shall be eligible to buy securities under paragraph 4 agreements in an amount equal to a specified fraction of its (A) daily average deposits described in § 204.5(c) of Federal Reserve Regulation D and (B) daily average net balances described in § 213.7(a)(1) (reduced by the daily average amount of any deposits subject to § 204.5(c)), each for the latest computation period as described in the specified sections. The fraction, which shall be the same for all member banks, shall be specified from time to time by the Federal Open Market Committee, or on behalf of the Committee by the Subcommittee named in paragraph 6 of the authorization for System foreign currency operations.

"B. The aggregate amount of paragraph 4 agreements outstanding at any one time shall not exceed $__ billion.

"C. Paragraph 4 agreements, which shall be non-transferable, shall specify prices for the sale of securities to the member bank and for the subsequent purchase of securities by the Reserve Bank from the member bank, in such a manner that the net yield to the member bank under the agreement is not more than __ basis points in excess of the current market rate on one-month Euro-dollar deposits.

"D. Within the limitations set forth above, the terms of paragraph 4 agreements, and the timing and size of specific offerings of such agreements, shall be subject to such directions as may be issued from time to time by the Federal Open Market Committee, or on behalf of the Committee by the Subcommittee referred to in paragraph 4A above."

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

PART 213--FOREIGN ACTIVITIES OF NATIONAL BANKS

[Reg. M]

Reserves Against Eurodollar Borrowings

1. Effective January 15, 1971, § 213.7(a) of Regulation M is amended to read as follows:

§ 213.7 Reserves against foreign branch deposits.

(a) Transactions with parent bank. During each week of the four-week period beginning October 16, 1969, and during each week of each successive four-week ("maintenance") period, a member bank having one or more foreign branches shall maintain with the Reserve Bank of its district, as a reserve against its foreign branch deposits, a daily average balance equal to 20 per cent of the amount by which the daily average total of

(1) net balances due from its domestic offices to such branches, and

(2) assets (including participations) held by such branches which were acquired from its domestic offices,[7]

during the four-week ("computation") period ending on the Wednesday fifteen days before the beginning of the maintenance period, exceeds the greater of

7/ Excluding (1) assets so held on June 26, 1969, representing credit extended to persons not residents of the United States and (2) credit extended or renewed by a domestic office after June 26, 1969, to persons not residents of the United States to the extent such credit was not extended in order to replace credit outstanding on that date which was paid prior to its original maturity (see definition of United States resident in footnote 9).

(i) the lowest corresponding daily average total[8] for any computation period ending after November 25, 1970, or

(ii) 3 per cent of the member bank's daily average deposits subject to § 204.5(a) of this chapter (Regulation D) during the current computation period, or the lowest corresponding daily average total[8] for any computation period beginning on or after December 24, 1970 and after the bank has had a foreign branch in operation for more than 90 days, whichever amount is the lesser:

Provided, That the applicable base computed under (i) or (ii) shall be reduced by the daily average amount of any deposits of the member bank subject to § 204.5(c) of this chapter (Regulation D) during the computation period.

* * * * *

2a. The change provides a means by which a member bank may retain its reserve-free base with respect to its Eurodollar borrowings from its foreign branches by counting within its base the amount of purchases by its foreign branches of certain Export-Import Bank obligations.

8/ Including the principal amount paid by a foreign branch of the member bank for obligations held by such branch that were purchased by it from the Export-Import Bank of the United States pursuant to its program announced on January 15, 1971, and excluding assets representing credit extended to persons not residents of the United States.

b. The requirements of section 553(b) of title 5, United States Code, with respect to notice, public participation, and deferred effective date were not followed in connection with this amendment because the Board found that following such procedures with respect to this amendment would be contrary to the public interest and serve no useful purpose.

By order of the Board of Governors, January 14, 1971.

Kenneth A. Kenyon
Deputy Secretary

RFS:srs

FEDERAL RESERVE
press release

6

For immediate release January 15, 1971

The Board of Governors of the Federal Reserve System today amended its regulations to permit U.S. banks to count toward maintenance of their reserve-free Eurodollar bases any funds invested by their overseas branches in Export-Import Bank securities offered under the program announced today by the Export-Import Bank.

The amendment is a further step resulting from the Board's continuing review of measures needed to temper the adverse impact of Eurodollar outflows on the U.S. balance of payments.

Eurodollar borrowings by a member bank are subject to a 20 per cent reserve requirement to the extent that they exceed a bank's reserve-free base.

For those banks that have had a minimum (3 per cent of deposits) reserve-free base, the Board postponed for four weeks, through the computation period ending February 17, 1971, the application of the automatic downward adjustment of their bases.

Attached is a copy of the amendment to the Board's Regulation M which governs the foreign activities of member banks.

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(1) net balances due from its domestic offices to such branches, and

(2) assets (including participations) held by such branches which were acquired from its domestic offices,[7/]

during the four-week ("computation") period ending on the Wednesday fifteen days before the beginning of the maintenance period, exceeds the greater of

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7/ Excluding (1) assets so held on June 26, 1969, representing credit extended to persons not residents of the United States and (2) credit extended or renewed by a domestic office after June 26, 1969, to persons not residents of the United States to the extent such credit was not extended in order to replace credit outstanding on that date which was paid prior to its original maturity (see definition of United States resident in footnote 9).

(i) the lowest corresponding daily average total[8/] for any computation period ending after November 25, 1970, or

(ii) 3 per cent of the member bank's daily average deposits subject to § 204.5(a) of this chapter (Regulation D) during the current computation period, or the lowest corresponding daily average total[8/] for any computation period beginning on or after January 21, 1971 and after the bank has had a foreign branch in operation for more than 90 days, whichever amount is the lesser: Provided, That the applicable base computed under (i) or (ii) shall be reduced by the daily average amount of any deposits of the member bank subject to § 204.5(c) of this chapter (Regulation D) during the computation period.

* * * * *

2a. The change provides a means by which a member bank may retain its reserve-free base with respect to its Eurodollar borrowings from its foreign branches by counting within its base the amount of purchases by its foreign branches of certain Export-Import Bank obligations.

8/ Including the principal amount paid by a foreign branch of the member bank for obligations held by such branch that were purchased by it from the Export-Import Bank of the United States pursuant to its program announced on January 15, 1971, and excluding assets representing credit extended to persons not residents of the United States.

b. The requirements of section 553(b) of title 5, United States Code, with respect to notice, public participation, and deferred effective date were not followed in connection with this amendment because the Board found that following such procedures with respect to this amendment would be contrary to the public interest and serve no useful purpose.

By order of the Board of Governors, January 15, 1971.

(Signed) Kenneth A. Kenyon

Kenneth A. Kenyon
Deputy Secretary

[SEAL]

CHAIRMAN BURNS

FOR INFORMATION
PRIOR TO CONSIDERATION AT A
MEETING OF THE BOARD.

CONFIDENTIAL (FR) January 18, 1971

TO: Board of Governors

FROM: Division of International Finance

SUBJECT: Reserve requirements and Euro-dollar borrowings

The table attached to this memorandum presents a calculation of the release of reserves involved in:

a) an across-the-board reduction in reserve requirements by 1/2 percentage point against net demand deposits up to $1 billion at all member banks, and

b) a special reduced rate of reserve requirement of 7-1/2 per cent against demand deposits to the extent that they are matched by Euro-dollar liabilities.

This possibility was noted in the last paragraph of the Division's memorandum of December 30, but no calculation was presented.

Under this proposal, the large banks would continue to hold reserves equal to 17-1/2 per cent against net demand deposits in excess of $1 billion; they would obtain a release of reserves of only $85 million as a result of step (a) above, compared to a release of $492 million for other banks. This smaller release for the largest banks would help offset criticism that might arise from the release of reserves involved in step (b) above: the special reduced requirement on amounts equal to Euro-dollar borrowings would release $890 million of reserves for the largest banks, and $64 million of reserves for the remainder.

The total release of reserves from both measures would be about $1.5 billion.

(As a matter of equity, if the Board were to consider establishment of a special reduced rate of requirement for reserve city banks, it might also establish a special reduced rate for country banks--although, in fact, country banks have not been significant borrowers of Euro-dollars. The appropriate rate for country banks might be 2-1/2 per cent.)

An alternative proposal would be to reduce reserve requirements on total net demand deposits of all banks by 1/2 percentage point, in combination with a special reduced rate of requirement. This would involve a total reserve release of $1.66 billion, of which $705 million would result from the general reduction in reserve requirements, and $954 million from the special reduced reserve requirement.

Estimated Reserves Released by Amended Demand Deposit Reserve Requirements for 17 Banks with Net Demand Deposits in Excess of $1 billion and for All Other Member Banks

(millions of dollars)

	(1) Net[1/] Demand Deposits	(2) Euro-dollar Borrowings[2/]	(3) Reserves Released by: 1/2% lower reserve ratio on Net DD up to $1 billion	(4) Reserves Released by: Special 7-1/2% reserve ratio on Net DD equal to Euro-$ borrowings	(5) = (3) + (4) Total Reserves Released
First National Boston	$1,175	$453	5	45	50
Bankers Trust	2,601	724	5	72	77
Chase Manhattan	5,633	2,263	5	226	231
Irving Trust	1,314	241	5	24	29
Morgan Guaranty	2,331	1,223	5	122	127
Chemical	3,298	820	5	82	87
First Nat'l. City N.Y.	4,835	649	5	65	70
Manufacturers Hanover	3,452	570	5	57	62
Mellon	1,208	117	5	12	17
Continental Illinois	2,087	674	5	67	72
First National Chicago	1,769	348	5	35	40
Nat'l Bank Detroit	1,337	2	5	*	5
Bank of America	5,182	794	5	79	84
United California	1,429	*	5	*	5
Crocker Citizens	1,316	--	5	--	5
Wells Fargo	1,442	39	5	4	9
Security Pacific	2,196	--	5	--	5
TOTAL	42,605	8,917	85	890	975
Other Member Banks	98,483	644	492	64	556
All Member Banks	141,088	9,561	577	954	1,531

1/ Daily average in the statement week ended December 9, 1970.
2/ Daily average in the four week computation period ended December 23, 1970.
*/ Less than $500 thousand.

January 15, 1971

CONFIDENTIAL (FR)

To: Federal Open Market Committee

January 18, 1971

From: Charles A. Coombs

Subject: Euro-dollar reflow problem

As the Committee is aware, I have been very much in favor of using some Government borrowing device to help absorb an unduly heavy return flow of Euro-dollars previously borrowed by U.S. banks. The device actually chosen to initiate such an approach, i.e., issuance of Export-Import Bank paper, strikes me as probably the best option available. As you know, a number of European government agencies have previously borrowed in the Euro-dollar market, thereby providing a useful precedent. I also like the tie-in of such Export-Import Bank borrowing in the Euro-dollar market with the foreign trade financing activities of the Bank. I was particularly pleased by the soft-pedal approach used in the press release and would expect that the action taken would be warmly received by both our banks and by the European central banks. In view of the limited amount of the Exim offering, which the market may well construe as a one-shot operation, I would not think that the offering would have any major stiffening effect on market rates in the Euro-dollar market and should thus minimize the risk of inducing still further outflows from this country of both foreign and resident money into the Euro-dollar market.

As the Committee is also aware, I had earlier suggested that the Treasury might also usefully explore the possibility of employing the BIS to mop up short-term Euro-dollar money for placement in deposits with the Stabilization Fund or in Treasury certificates ranging up to 30 days' maturity. I am still inclined to think that this might be the simplest and most efficient way of absorbing surplus Euro-dollars at this time. In this connection, the BIS may now be increasingly acting as intermediary in the placing of foreign central bank reserves in the Euro-dollar market, rather than in U.S. Treasury bills. Such shifts from normal placements of foreign official dollar reserves in New York to placements in the Euro-dollar market are almost identical in effect with U.S. bank repayments of Euro-dollar debt. Accordingly, may I suggest an approach to the European central banks who control the BIS, involving:

(a) An appeal to the European central banks to cease further placement of official reserves in the Euro-dollar market, either directly or via the BIS, and to shift existing Euro-dollar placements insofar as possible back into U.S. Treasury bills, and

(b) A request that the BIS management desist from encouraging other foreign central banks to shift money from U.S. Treasury bills into the Euro-dollar market via the BIS.

(c) A shift of a substantial part of existing BIS short-term placements from the Euro-dollar market into U.S. Government debt instruments at rates matching Euro-dollar rates in the overnight to 30-day range.

Even if the BIS route were not taken, I would still see considerable merit in U.S. Treasury placements of short-term paper with the London Branches of U.S. banks in amounts ranging up to, say, $2 billion. Whatever the Treasury fails to borrow through the Euro-dollar market may well have to be financed through sale of gold, SDRs, or drawings upon the IMF, not to mention interim drawings by the Federal Reserve upon the swap lines. On the other hand, direct and overt Treasury borrowing from the Euro-dollar market might well stiffen Euro-dollar rates unduly if the market were to assume that Treasury issues perhaps going well beyond a billion or so might be in the pipeline.

As for the third possibility, that of Federal Reserve "matched-sale-purchase transactions", I should be inclined to hold this approach in abeyance to help deal with a possible future emergency, which might well require even more striking departures from usual practice. So long as other, more normal possibilities of financing the deficit remain, I would be gravely concerned by four aspects of such Federal Reserve intervention:

First, I find myself deeply troubled by the essential feature of the operation, namely that the Federal Reserve would be creating dollars on the one hand and then borrowing them back at a premium price. I cannot escape the feeling that such an operation is inherently unnatural and know of no precedent in other central bank operations.

Second, in any circumstances short of a major emergency, in which such a System operation might be mounted for a brief holding action, I can see a considerable risk that the Federal might become progressively more deeply involved in financing on a longer term basis a sizable part of the U.S. payments deficit, thus assuming a responsibility which should fall directly upon the Treasury.

Third, the proposal for "matched sale-purchase transactions" represents a 180 degree turn from the previous approach of imposing penalties upon banks going below their Euro-dollar base. Having accepted the carrot of a $1 billion or so of such MSPs, the banks might push us into a further distribution of such MSPs by renewing their recent warnings of a massive running down of Euro-dollar debt and continue this process until the Federal had absorbed the bulk of their outstanding Euro-dollar debt.

Fourth, I can see a risk in the case of Federal Reserve intervention, even greater than that involved in a Treasury operation, that the massive potential of Federal Reserve operations in this area might very well lead to a stiffening of Euro-dollar rates in the maturity range in which we were operating, thereby opening up an even larger gap between U.S. and Euro-dollar rates with consequent inducement to shifts of both foreign central bank and U.S. resident money into the Euro-dollar market. We could get into a situation in which the Euro-dollar rate effects of Federal Reserve intervention might indirectly pull almost as much new money into the Euro-dollar market as we were absorbing by our intervention.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONFIDENTIAL (FR) January 26, 1971.

TO: Chairman Burns

FROM: Robert Solomon and A. B. Hersey

SUBJECT: The BIS Paper of January 10 on Joint Supervision of the Eurocurrency Market.

The paper mentions several problems connected with the Eurodollar market that have been of interest to central banks. After presenting some statistics and then discussing some of the factors responsible for the growth of the market over the years, the paper goes through the list of problems, briefly describing each. It concludes with suggestions for four sorts of joint action:

1. Improvement of statistics
2. Discussion of "certain aspects of the permanent regulations and practices in particular countries"
3. Discussion of "ad hoc regulations or arrangements in particular countries"
4. "Initiatives of the central banks," aimed "to alleviate specific problems," but not otherwise described.

The suggestion is made that "any problems raised or proposals for initiatives" might be considered in a meeting of the Governors after preparation by a group of Deputies of the Governors, which would meet periodically.

Comments

The paper is unfortunately not entirely free of overtones of annoyance at the continuation of the U.S. balance of payments deficit and at the increasing use in Europe of the dollar as a liquid asset to hold and as a currency in which loans are made. The paper also goes farther than it should in taking former Chairman Martin as authority for the view that "monetary rather than purely banking aspects" of the market deserve attention. Mr. Martin's statement, which is fully quoted, was quite noncommittal as to what sorts of reasons may exist "for giving to an international institution some responsibility for supervising these markets."

There follows a brief comment on each of the six "problems" described on pages 7-10 of the paper (and to some extent discussed in other parts of the paper).

1. Potentially inflationary expansion of bank credit internationally, which some countries find it difficult to allow for in adjusting their own domestic monetary and credit objectives. The paper exaggerates the magnitude of this problem. There is no reason for European countries to worry about the sizable amounts of credit the Eurodollar market extended in some years to U.S. banks or businesses. At mid-1970, the amount of Eurodollar credit outstanding to nonbanks within the European eight-country area and to banks and nonbanks in all other countries except the United States was $19 billion, according to the table given in the paper. In comparison with the $775 billion the paper cites as a total of "domestic private-sector credit extended by

banks in all OECD countries," this is a tiny figure. Moreover, in the absence of a Eurodollar market other forms of bank credit across national boundaries would unquestionably be larger than they now are.

2. International flows of funds facilitated by the market at times "blunt the effectiveness" of national monetary policies. This problem certainly deserves consideration and, in fact, is already receiving attention in Working Party 3 of the OECD. It is a problem that will face any group of countries trying to use monetary policy for domestic purposes in conditions where capital can flow more or less freely. It is a problem that would exist even if there were no Eurodollar market.

3. Use of the market can delay action to correct imbalances in the balance of payments. Although the paper says this point can apply to surplus countries as well as to deficit countries, it is doubtful whether anyone believes that revaluation of the German mark was delayed by measures that encouraged German commercial banks to place funds in the Eurodollar market, thereby diminishing a little the growth of German official reserves. The point is obviously aimed at the United States, which masked a large basic deficit in 1969 by attracting short-term funds. Italy did the same in 1963. In rebuttal, we would ask what further "corrective action" anyone thinks we should have been taking in the tight money year of 1969?

4. The market's "amplifying effect" on interest rate developments is "out of proportion to its marginal share of world credit flows."

This is a proposition for serious economic analysis to confirm or refute. (The emphasis here is on world levels of interest rates, rather than on the inter-country differences which contribute to problem number 2.) One conceivable conclusion from a study of the 1969 experience might be that without a Eurodollar market to turn to, the big U.S. banks might have driven U.S. market rates up even more than they did, which would certainly have put some pressure on other national markets as funds were attracted directly to the United States. However, it is a central fact about the Eurodollar market that interest rate competition, both for loans and for deposits, is less constrained in that market by official regulations and private conventions than in any national market. When borrowers of high credit standing, thwarted elsewhere, turn to the Eurodollar market they get the money they want, but at a price.

Supposing it were thought desirable, what sort of "concerted effort" could central banks conceivably undertake in the Euromarket that would somehow run parallel to their domestic actions "aimed at controlling the money supply without changes in interest rates so violent as to disrupt financial markets?" One proposal might be that all countries be prepared to regulate access of their borrowers and lenders to the market and that the application of such regulations be discussed regularly at Basle. A proposal to impose a set of interest rate ceilings on the market would be unlikely to carry; it would tend to destroy one of the great virtues of the market--namely, "the stimulation of banking competition, both internationally and in various domestic credit markets," as the BIS paper puts it.

5. The market may feed speculative excesses. The paper devotes several paragraphs to showing that this is not a major problem. One point explicitly made is that speculative flows could occur "even without the facilities of the Euro-market."

6. Dangers of "the repercussions of a possible run on the dollar" have been increased. The writers of the paper report "unease" at the "growing dominance of the dollar" and "fear ... that the repercussions of a possible run on the dollar have been considerably increased as a result of the market's growth." They do not attempt to consider what if any changes in practices -- short of abolition of the market, if that is conceivable -- might be undertaken to reduce such repercussions. For example, might it be useful to impose regulations requiring closer matching of the maturities of Eurodollar assets and liabilities?

If we had been drawing up such a list as this, we might have omitted two or three of these questions but we would have added another: should or should not central banks place reserves in the Eurodollar market (either directly or through the BIS). The writers of the paper seem to have assumed unquestion~~ably~~ingly that such operations (a type of central bank "initiatives") are not undesirable and may be required. This assumption needs to be questioned. The paper itself does note that "the part played by monetary authorities in the market's development has not been insignificant." From the United States point of view, the main thing to be sought in any discussion of this question would be a recognition by the governments and central banks of other countries that the United States cannot be held responsible for all the growth of official reserves in dollars.

It is hard to predict what kinds of recommendations for joint action might eventually come out of a Basle study of problems 2, 4 and 6 (the ones that seem most worth studying). Perhaps the Federal Reserve would be advised not to let Regulation Q ceilings again force U.S. banks to borrow heavily from the Eurodollar market. Perhaps countries will be advised to be prepared to control access of their nationals to ~~one~~ the market. If it were not for the EEC thrust toward narrower exchange rate margins, a recommendation for somewhat wider margins could well get serious consideration as a device for helping to preserve autonomy for national monetary policies. Perhaps the Bank of England would be asked to devise new regulations on Eurodollar deposit and loan maturities. Some of these ideas might be unwelcome to the American banks that operate in the market, but they might not raise serious problems from the national point of view of the United States.

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

STRICTLY CONFIDENTIAL (FR)

January 29, 1971

To: Federal Open Market Committee

From: Robert C. Holland, Secretary

Subject: Expression of views on MSP contingency plan.

At the direction of Chairman Burns, all voting members of the Federal Open Market Committee were contacted on or around January 19, 1971, to ascertain their views with regard to the possible contingency plan for Federal Reserve matched sale-purchase transactions with member banks to help moderate Euro-dollar repayments. That plan had been outlined in a staff memorandum dated January 11, 1971, and had been discussed by the Committee on a preliminary basis at its January 12, 1971, meeting.

In response to my telegram of January 19, 1971, seeking their views, nine of the twelve voting Committee members indicated that they agreed in principle with the proposed amendment of the continuing authority directive as a useful contingency plan, to be acted on finally at a subsequent time if deemed necessary. Governor Robertson, Governor Brimmer and President Hayes indicated they disagreed in principle with this type of approach.

The Committee members agreeing with the proposal generally felt that the contingency plan should be in readiness so that the Federal Reserve System would be prepared to do whatever it could if circumstances became compelling and all preferable courses of action were unavailing. However, these members felt strongly that sales of securities by the Treasury Department (or by the Export-Import Bank or other Government agencies) designed to moderate Euro-dollar repayments would be a much better method of dealing with the problem.

Some of the members of the Committee who approved in principle expressed various reservations concerning the MSP proposal. Question was raised about the legality of the transactions, and the possibility was noted that litigation might be brought by some bank not included in the arrangement. It was observed that the operation was easy to misinterpret and thus vulnerable to criticism if and when exposed to public view. Concern was also expressed that the Federal Reserve might be drawn into MSP's up to the full $8 billion of Euro-dollar liabilities presently outstanding at U.S. banks to their foreign branches. Several Committee members believed that the scheme for reduced reserve requirements against an amount of deposits equal to Euro-dollar liabilities might be preferable both politically and on substantive grounds. Finally, the view was expressed and agreed to by Board members of the Committee that if the MSP proposal were to be implemented, the duration of the Federal Reserve liability should, in principle, be limited to one year.

Committee members Hayes, Robertson and Brimmer, in disapproving of the plan, expressed several points of disagreement in principle. They believed that the problems associated with Euro-dollar repayments were primarily a Treasury responsibility. They were also very much concerned that if the FOMC began to engage in MSP transactions, there would be pressure for the System to finance more and more of the U.S. balance of payments deficit in this fashion, and for an indefinite span of time.

If events developed in a way that compelled Federal Reserve action, they much preferred resort to the proposal for reduced reserve requirements mentioned above. Additionally, Governor Robertson emphasized that, in his view, there was no justifiable legal foundation for either the purpose of the proposed System MSP transactions or the means chosen.

Governor Brimmer added that he felt the probable size of further Euro-dollar repayments was not large enough to warrant the kind of extraordinary action that MSP transactions would represent, given the likelihood that U.S. banks and their foreign branches would want to retain some of their Euro-dollar liabilities for operating purposes. President Hayes also objected to the idea of a central bank in effect borrowing back its own currency and at a premium.

In the light of these expressions of views by the members of the Committee, the Chairman instructed the staff to proceed with further development and refinement of contingency plans on both the MSP and the reduced reserve requirement proposals. In particular, the staff was directed to explore procedures that might help to limit the duration of any such Federal Reserve MSP operations to one year or less.

Chairman Burns

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 3, 1971

To Governor Daane

Subject: Central Bank Holdings of Reserves in Eurodollars

From Robert Solomon & A. B. Hersey

STRICTLY CONFIDENTIAL (FR)

This memorandum (1) describes very briefly the magnitude of central bank holdings of reserves in Eurodollars, (2) mentions some of the motives behind these holdings, (3) analyzes the effects of changes in these holdings on interest rates, exchange rates, flows of funds, aggregate foreign official reserves, and the U.S. balance of payments, and (4) considers briefly the question of what help or enlightenment might be got from a study of Eurocurrency market problems which the central bank governors who meet at Basle may be about to plan. (We are asked to keep information about this study highly restricted.)

Magnitude

Our estimate for ten leading industrial countries (Group of Ten and Switzerland) puts their official Eurodollar holdings at the end of 1969 in a range of \$1-1/2 to \$2 billion. Most of this we believe to have been held as dollar deposits with the Bank for International Settlements. We know that sterling area countries held \$500 million in dollar deposits with the BIS. (Total deposit liabilities of the BIS in all currencies were well above \$3 billion.) The BIS in turn held dollar assets amounting to \$1.3 billion in the United States and \$0.9 billion outside the United States.

DECLASSIFIED
AUTHORITY Fed. Res. System ltr. 11/16/82; State guidelines
BY [initials] NARA, DATE 9/10/09

(All these figures, except the BIS total deposit liabilities, are strictly confidential.) We believe that substantial amounts of Eurodollar deposits were held by other central banks outside the groups mentioned.1/

A year later, at the end of 1970, the official Eurodollar holdings of the 10 countries may have increased to something in the range of $3-1/2 to $4 billion. Meanwhile, the BIS reduced its balances in the United States to $0.3 billion and increased its dollar holdings elsewhere to $3.9 billion.

Thus, the year's increase in central bank Eurodollar reserves (including their deposits at the BIS) may have been around $2 billion for the 10 countries -- and, as the tables appended suggest, may have been more for the world as a whole. During the year the BIS shifted $1.0 billion from its holdings in the United States to the Eurodollar market, besides passing on to that market its funds from other resources. The total increase in funds supplied to commercial banks in the Eurodollar market (including deposits by the BIS) almost certainly exceeded the $3.0 billion rise in BIS dollar assets outside the United States. We think it likely that monetary authorities outside the Group of Ten (some in Europe, some in the Middle East, and others in the Far East or Latin America) were placing

1/ The International Monetary Fund in its 1970 Annual Report published a figure of $2.8 billion for the end-of-1969 "official holdings of Eurodollars" of an undefined group of 38 countries, based on "Fund staff information and estimates." Possibly there were important omissions of countries. In any case, the figure is difficult to use, because we are not told how the Fund's computation treated the dollar assets and dollar deposit liabilities of the BIS.

additional amounts of reserves in Eurodollars. The one thing we know precisely (from our confidential information) is the $3.0 billion increase in BIS dollar holdings outside the United States.

It is evident that the BIS played a key role last year in the growth of official Eurodollar holdings. The dual role of the BIS as a semi-official institution and as a money-making bank complicates any discussion of this matter, from the statistical foundations up.

Motives

From conversations we and some of the Federal Reserve Bank of New York officers have had at various times with foreign central bank officials, we judge that the large placements of reserves in Eurodollars during 1970 were motivated by relatively narrow and special considerations, without much attention to general consequences. Interest earnings were probably a major consideration in most cases. In two countries (Italy and Britain) the central banks are said to have had a special reason or justification for seeking high interest returns: these high yields were in some way to offset high interest payments on borrowings in the Eurobond or Eurodollar markets by government-controlled companies (undertaken to help finance the country's adverse balance of payments). In another country the central bank lays great store on the liquidity of its assets and finds very short-term Eurodollars preferable, for their liquidity, over U.S. Treasury bills of the maturities that would in practice be purchased; this central bank, however, does not allow its total uncovered dollar assets to build up much.

One central bank is said to have placed funds with the BIS primarily because the BIS asked it to. There is of course a long history of international cooperation involving the BIS: the BIS undertakes operations desired by central banks and the central banks provide some or all of the finance. The major example in recent years is the assistance to Britain under the sterling balances arrangements. It is only a step from the financing of central-bank-sponsored operations of that kind to the financing of activities initiated by the BIS.

Eurodollar placements by central banks outside the Group of Ten are also probably motivated chiefly by a desire for earnings. One class of placements, however, has a special history. These are the dollar deposits at the BIS of sterling area central bank holders who agreed, at the time of the sterling balances arrangement in 1968, that if they converted some of their sterling reserve holdings into dollars they would keep the dollars at the BIS. Such deposits would provide additional finance for reserve assistance to Britain. Deposits under this arrangement were built up in 1968 and 1969, and rose moderately further in 1970. As the Bank of England's liabilities to the BIS have now been paid off, these deposits of sterling area countries are now financing BIS Eurodollar assets.

The decision by the BIS to shift its time deposits from New York to the Eurodollar market during 1970 was a response to the easing in U.S. financial markets. Banks in this country had been paying above-ceiling interest rates to exempted depositors (including the BIS); these rates were competitive with Eurodollars. When issuance of CD's domestically became possible for the U.S. banks, the BIS could no longer get rates in New York comparable with what was available in London. The BIS could not continue paying interest at the Eurodollar rate level to its central bank depositors without shifting its funds out of New York.

Only one element of the increase from December 31, 1969 to December 31, 1970 in central bank Eurodollar holdings was entirely free of the earnings motive. At each year-end, the Swiss National Bank temporarily holds large Eurodollar assets -- more at the end of 1970 than a year earlier -- which it takes over from Swiss commercial banks through swaps against Swiss francs (spot sales of Swiss francs to the banks with forward repurchases). Here the motive is to relieve year-end liquidity pressures in the Swiss money market, and the motive for putting the dollars into the Eurodollar market -- from which the Swiss banks withdraw the dollars they swap to the Swiss National Bank -- is to relieve or prevent pressures in that market. Year-end interventions in the Eurodollar market were also undertaken in some years -- not recently -- by the BIS in cooperation with the Federal Reserve System: the System financed the operation by having the BIS draw on its dollar-DM swap line.

Unlike the Swiss operations mentioned above, central bank actions intended to influence their domestic market conditions have sometimes taken the form of drawing on their dollar reserves in the United States to make swaps at preferential rates with their commercial banks, to induce the banks to shift out of domestic liquid assets into Eurodollars. At times another important intention was to cut down a country's official reserve gains. Though the effects in the Eurodollar market of such actions might resemble those of a central bank placement of its own assets in the market, the motives of the central bank were quite different: when a central bank subsidizes covered dollar placements by the commercial banks it is giving up earnings, not seeking them. And effects on the magnitude of the world aggregate of official reserves were of course very different.

Effects

Central bank placements of reserves in Eurodollars rather than U.S. Treasury bills tend -- other things being equal -- to depress Eurodollar interest rates relative to short-term rates in the United States. Any such change in Eurodollar rates has some effect on the inflow of deposits and the outflow of loans in Eurodollars. To the extent that there is a net increase in the dollar liabilities of banks doing Eurodollar business, it has to be matched by an equal increase in their assets (including net assets in other currencies). Temporary changes may occur in their holdings of non-interestbearing bank balances in the United States, but if U.S. financial markets are not willing to absorb excess funds from Eurodollar banks at high enough interest rates, those funds will soon find an outlet in assets elsewhere.

Financial conditions in the various national markets together with the regulations of the authorities in each country affecting international flows are the factors that basically determine the direction and volume of flows of funds through the Eurodollar market from certain countries at any given moment to certain others. When the flows thus determined are supplemented by an injection of central bank reserves, the prevailing directions of flows through the market will not be altered, but either the volume of outflows must increase in some directions or there must be some backing up and shrinkage of inflows from others.

In 1970 the prevailing direction of flow through the Eurodollar market was from the United States to Germany and other countries in Europe and elsewhere. U.S. banks were reducing their liabilities to their branches in the market by amounts larger than the counterflows from the market to the United States such as withdrawal of Eurodollar deposits by U.S. investors, dollar borrowings from Europe by U.S. companies, placements of funds by foreign banks with their branches and agencies in the United States, and so on.

Eurodollar interest rates had fallen off from their exceptionally high 1969 levels, favoring the generation of counterflows such as these. In the second half of 1970, however, the decline in European rates lagged considerably behind the decline in U.S. rates. Eurodollar rates did move down, but at levels generally well above U.S. rates while below many European national rates. Under these conditions, the addition to supplies of funds in the Eurodollar market coming from central bank placements of reserves in Eurodollars in 1970 probably accelerated the net flows from the market to private borrowers and depositors outside the United States, and probably had little if any effect in generating counterflows to the United States. So far as trans-Atlantic flows were concerned, the effects of U.S. monetary policy through easing financial market conditions in the United States almost certainly outweighed the effects of central bank Eurodollar placements through giving Eurodollar rates a downward push. At the same time, the efforts of European central banks to maintain relatively tight conditions in their national markets ensured that flows out of the market to European countries, their own included, (and to other areas) would increase. Thus the increase in the aggregate of official net reserves held by the rest of the world outside the United States exceeded the official settlements deficit of the United States (i.e. the increase in U.S. net reserve liabilities).1/

No misrepresentation of the facts was made by any central bank. From an accountant's point of view a dollar asset is a dollar asset, whether in the form of a U.S. Treasury bill, a bankers acceptance, a bank deposit in New York, a deposit at the BIS, or a bank deposit in London.

Probably few central bank officials were aware of the effects of their actions (and the actions of the BIS) on aggregate world reserves.

As we enter 1971, it becomes a matter of some importance to judge whether central bank and BIS holdings of Eurodollars are likely to increase further or decrease, and what effects a change in either

1/ After allowance for additions to total official reserves of gold and SDRs. Unresolved statistical discrepancies no doubt also contributed to the extremely large difference that appears in the statistics.

direction might have on payments balances and reserves. If central banks and the BIS were to reduce their Eurodollar holdings in 1971, the aggregate growth in world dollar reserves would tend to be less than the rise in U.S. reserve liabilities,[1] instead of exceeding it as in 1970. Net outflows of funds from the Eurodollar market to European and other countries through the dealings of Eurodollar banks with private borrowers and lenders would diminish. But would the shrinkage in those outflows from the Eurodollar market match in volume the shrinkage and reversal in central bank placements? So long as U.S. short-term interest rates remain well below those prevailing abroad, the prevailing direction of flow of funds through the Eurodollar market is likely to continue to be outward from the United States. Might the outflow from the United States to the Eurodollar market be stimulated by the firming and rise in Eurodollar interest rates that might be a consequence of central bank and BIS withdrawals of deposits? It is certainly conceivable that the change in relative magnitudes of foreign reserve gains and U.S. official settlements deficit could occur partly through a rise in the U.S. deficit -- i.e., not wholly through a diminution of foreign reserve gains.

Because of these considerations it would probably not be in the interest of the United States to urge central banks and the BIS to reduce their Eurodollar deposits rapidly, even if that were

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1/ This difference is of course affected also by some statistical noncomparability.

thought possible. The first aim might be to check the further growth of these deposits. Later, as European national interest rate levels were lowered, there might be less risk of swelling the U.S. official settlements deficit and more certainty of sharply slowing the growth of foreign reserves.

The Basle study

The proposed study of Eurocurrency market problems, which the central bank governors who meet at Basle may plan to undertake, would come at an opportune time. It is disappointing, however, that the BIS paper of January 10, 1971 (copy attached), outlining the possible scope and procedure of a study which might lead to "joint supervision of the Eurodollar market," fails completely to give any consideration to questions concerning central bank and BIS placements of deposits in Eurodollars.

Of the six problems the BIS paper names, three clearly deserve some study. These relate to the blunting of effectiveness of national monetary policies by international flows of short-term capital through the Eurodollar market, to the apparent magnification of swings in general levels of interest rates caused by the play of demand and supply in this market (which is free of any official or conventional rate ceilings or other such regulations), and to the possibilities that a run on the dollar could have extra repercussions through its effects in the Eurodollar market. In the study of such questions, it will be important that due consideration be given to the effects of central bank and BIS placements of dollars. Have these helped to create problems? May there be circumstances in which such placements -- e.g., at yearends -- can alleviate difficulties? But above all, from the point of view of the United States, and for the future success of the SDR system, can we allow uncontrolled expansion of world reserves through Eurodollar placements to continue?

Regardless of what is done at Basle, studies of problems of international capital flows, coexistence of independent national monetary policies, and the growth of reserves will continue in the OECD at Paris and in the IMF at Washington. If questions of central bank and BIS placements of Eurodollars are not studied effectively at Basle, the United States should move to get them onto the agendas elsewhere.

The necessary first step in any study of Eurocurrency market questions is improvement of statistics, as the BIS paper of January 10 suggests. The most serious gap in the present statistics, as Federal Reserve staff representatives pointed out at the July 1970 meeting of central bank experts convened by the BIS, is the lack of any compilation of commercial bank Eurodollar liabilities to central banks and the BIS. Disappointingly, the January 10 paper says nothing about this. An early step in preparing for a study should, therefore, be an agreement in principle by the central bank governors who meet at Basle that it is important to have precise knowledge about placements of Eurodollars by central banks and the BIS.

cc: Chairman Burns
Governor Robertson

PUBLISHED DATA

Table 1

BIS Assets and Liabilities
(in millions of dollars)

	Dec. 31 1969	Dec. 31 1970	Change in 1970
Assets:			
Gold assets	1,501	1,512	+ 11
Other assets	4,880	6,574	+1,694
Total assets or liabilities	6,381	8,086	+1,705
Liabilities:			
Gold deposits	1,981	1,794	- 187
Currency deposits:			
Central banks	3,555	5,781	+2,226
Others	385	123	- 262
Notes	273	153	- 120
Other liabilities and capital accounts	187	235	+ 48

Table 2

Differences Between Total Official Dollar Holdings 1/
and U.S. Dollar Liabilities to Official Holders 2/
in Ten Countries
(in millions of dollars)

	Dec. 1969	Mar.	June	Sept.	Nov. 3/ 1970
United Kingdom	86	510	815	331	970
Germany	231	286	516	554	707
Italy	419	405	38	374	597
France	81	227	428	304	359
Switzerland	424	66	302	331	- 154 +1,100 4/
Belgium	291	219	260	267	282
Netherlands	72	49	35	50	114
Sweden	52	25	20	20	17
Japan	142	180	212	236	166
Canada	120	38	42	56	65
Total	1,918	2,005	2,668	2,523	3,123 +1,100 4/ 4,000 5/

1/ Per BIS multilateral surveillance tables: U.S. dollars convertible foreign exchange plus dollar components of other items so far as known to us.

2/ Liquid and nonliquid.

3/ U.S. liability data for December 1970 are not yet available (Feb. 3).

4/ Approximate amount of year-end swaps of Swiss National Bank with Swiss commercial banks, adding to former's yearend holdings of Eurodollars.

5/ Rounded tentative estimate for yearend. The rounding allows for some declines in December for U.K. and perhaps others.

Note: To allow for possibility of discrepancies for unknown reasons, the estimates of Eurodollar holdings in the text are given in terms of ranges below the yearend figures shown in this table.

STRICTLY CONFIDENTIAL (FR)

Table 3

BIS Deposit Liabilities, With Comparisons
(in millions of dollars)

	Dec. 1969	Mar.	June	Sept.	Dec. 1970
Total deposits, all currencies1/	3,940	4,264	4,812	4,534	5,903
U.S. (Fed.Res. & Treasury) holdings at BIS	237	333	287	289	288
Ten Countries' dollars outside U.S.2/	1,918	2,005	2,668	2,523	4,000 5/
BIS deposit liabilities to sterling area countries3/	506	498	557	515	540
Residual4/	1,279	1,428	1,300	1,207	1,075 5/

1/ As in Table 1.
2/ As in Table 2.
3/ Under 2nd sterling balances arrangement (strictly confidential).
4/ Understates other deposits to the extent that line 3 overstates deposits of the ten at BIS.
5/ Rough approximations. See Table 2.

STRICTLY CONFIDENTIAL (FR)

Table 4

BIS Dollar Assets
(in millions of dollars)

	Total	In U.S.	Other
Dec. 1967	1,326	487	839
Dec. 1968	1,054	52	1,002
Dec. 1969	2,153	1,262	891
Mar. 1970	2,541	1,653	888
June	3,278	1,205	2,073
Sept.	3,103	504	2,599
Dec.	4,136	286	3,850

Table 5

Analysis of Changes in Aggregate Net Official Reserves
(in millions of dollars)

	1969 Year	1970 Q-1	1970 Q-2	1970 Q-3	1970 Q-4	1970 Year
Increase in total net official reserves ex U.S.1/	-0.3	5.9	5.2	3.8	5.9	20.8
Counterparts:						
Additions to monetary gold	0.1	0.2	0.0	0.0	0.1	0.3
SDR allocations	--	3.4	0.0	0.0	0.0	3.4
Increase in U.S. reserve liabilities less reserve assets	-2.7	2.8	2.1	2.6	3.2	10.7
Other2/	2.3	- .6	3.1	1.2	2.7	6.4
Possible composition of "other":						
Increase in 10 countries' Eurodollars3/	0.7	0.1	0.7	-0.2	1.5	2.1
Increase in sterling area dollar deposits at BIS	0.3	0.0	0.1	-0.1	0.0	0.0
BIS shift out of U.S.(into U.S., -)4/	-1.1	-0.4	0.5	0.7	0.2	1.0
Residual, possibly including increase in other Eurodollars	2.4	-0.3	1.8	0.8	1.0	3.3

1/ Country net reserves. BIS "net reserves" are considered to be zero. IMF accounts also wash out. "Net" is intended to refer to deduction of inter-central bank liabilities and use of IMF credit.

2/ Represents increase in liabilities of commercial banks for the Eurodollar deposits of central banks and BIS, plus other kinds of liabilities to central banks not netted out in line 1 (e.g., U.K. banking and money market liabilities in sterling, and French liabilities to franc zone monetary authorities) plus unresolved statistical discrepancies.

3/ Taking the figures in Table 2 as a rough indication.

4/ If BIS holdings of dollars in the United States rise exactly as much as central banks' dollar deposits with BIS, obviously no increase occurs in commercial bank Eurodollar liabilities through those transactions. The U.S. balance of payments counts liabilities to the BIS as reserve liabilities, and in this case it provides a full counterpart to the increase in central banks' "Eurodollar" holdings at the BIS.

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

February 8, 1971

STRICTLY CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

Enclosed for your information is a copy of the recent BIS staff memorandum concerning the Euro-dollar market to which Mr. Coombs made reference at the January meeting of the Committee.

In view of the sensitive nature of this document we request that it be held in strict confidence.

Arthur L. Broida

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

~~Confidential~~

JOINT SUPERVISION OF THE EURO-CURRENCY MARKET

Developments in the Euro-currency market over the past several years have caused increasing interest among the central banks.

At one time there was some concern over the possibility of unsound practices by Euro-dollar banks from a purely banking standpoint, such as excesses of borrowing short and lending long or overextension of credit to particular borrowers. But up to the present, at least, experience has shown that these fears have had little foundation.

Discussion is now centred on the monetary rather than the purely banking aspects of the market - the sheer momentum of the market's growth and the size it has reached, the implications of this growth for monetary inflation, the potential of the market's large pool of resources for speculative pressures, the influence of the market on interest rates, the complications that arise for domestic monetary policy, the easy financing of balance-of-payments deficits and the possibility that the market's resources would add to monetary disturbances in the event of severe weakness of the dollar.

It is significant that this view was reflected by former chairman Wm. McChesney Martin in his recent speech in Basle, in which he said: "At present there is little, if any, multilateral supervision of these markets. One need raise no doubt about the soundness of the claims that are created and exchanged in these markets to suggest that a case can be made for giving to an international institution some responsibility for supervising these markets." At the IMF meeting in Copenhagen, Mr. Giscard d'Estaing expressed a similar view and Mr. Schweitzer, the Managing Director of the Fund, gave it as his opinion that "maybe the central bankers could do something" about the market.

At present, virtually all of the central banks influence the activities of their own banks in the market from a national point of view in one way or another, but there is no authority which concerns itself with the market's impact on world monetary conditions as a whole. It may be said that the rationale of joint supervision of the market by the major central banks is rather apparent. This, however, leaves open several questions: what sorts of situation might call for active supervision of the market; to what extent might such situations arise in any case with the existing degree of convertibility and freedom for capital movement; and how might active joint supervision be exercised?

Growth of the market

The expansion of the Euro-currency market has been without precedent in international monetary history. As measured by the foreign currency credit outstanding through the banks of eight reporting European countries, the net size of the market is estimated to have risen from its beginnings in the mid-1950s to about $11 milliard at end-1964 and to roughly $50 milliard by June 1970. To put this growth in perspective, it may be noted that since end-1964 domestic private-sector credit extended by banks in all OECD countries taken together went up by about $360 milliard, from $415 to 775 milliard.

Out of the net totals for all currencies given above the component in dollars was about $9 milliard at end-1964 and $41.5 milliard in mid-1970. Over 40 per cent. of this $32.5 milliard expansion occurred during the first halves of 1968 and 1969 alone under the impact of tight monetary policy in the United States. However, even from mid-1969 to mid-1970, when US banks' Euro-dollar indebtedness showed a slight decline, the Euro-dollar market expanded by about a further $8 milliard. And, despite large US bank repayments and the usual seasonal slack, the Euro-dollar market seems to have been well maintained during the third quarter of this year also. Hence, it is evident that a large flow of bank credit is generated through the Euro-market and that the expansion is continuing.

Sources and uses of funds

As may be seen in the table, the sources of funds for the growth of Euro-dollar credit have been broadly based and

Estimated net amount of Euro-dollar credit outstanding through banks in eight European countries, 1964-70

Items	1964	1965	1966	1967		1968		1969		1970
				June	Dec.	June	Dec.	June	Dec.	June
	end of period, in milliards of US dollars									
Total	9.0	11.5	14.5	15.0	17.5	22.5	25.0	33.5	37.5	41.5
Sources										
Reporting European area										
Banks[1]	2.7	4.5	5.8	5.1	5.7	7.5	8.1	8.6	9.1	10.2
Non-banks	1.8	2.2	2.8	3.6	4.0	4.8	5.2	8.1	9.4	10.0
Total	4.5	6.7	8.6	8.7	9.7	12.3	13.3	16.7	18.5	20.2
Outside area										
Other western Europe	0.8	0.8	1.0	1.2	1.4	1.5	1.9	2.1	2.7	2.8
United States	0.7	0.8	1.1	1.1	1.7	2.9	3.2	4.4	3.8	4.3
Canada	0.8	0.5	0.6	0.7	0.9	1.0	1.3	2.3	2.9	3.4
Japan	-	-	-	-	-	-	-	0.2	0.4	0.3
Eastern Europe	0.2	0.3	0.3	0.3	0.4	0.4	0.6	0.6	1.0	0.8
Other	2.0	2.4	2.9	3.0	3.4	4.4	4.7	7.2	8.2	9.7
Total	4.5	4.8	5.9	6.3	7.8	10.2	11.7	16.8	19.0	21.3
Uses										
Reporting European area										
Banks[2]	2.8	3.2	2.8	2.3	2.9	2.6	3.2	3.8	6.1	6.2
Non-banks	2.3	3.2	3.6	4.0	4.1	4.5	4.7	5.1	5.6	7.0
Total	5.1	6.4	6.4	6.3	7.0	7.1	7.9	8.9	11.7	13.2
Outside area										
Other western Europe	0.4	0.6	0.9	1.0	1.2	1.4	1.5	1.3	1.6	1.9
United States	1.8	2.1	4.4	4.2	5.2	8.8	9.5	16.7	16.5	16.4
Canada	0.4	0.6	0.6	0.6	0.7	0.9	0.9	1.2	1.3	1.6
Japan	0.4	0.5	0.6	0.8	1.0	1.4	1.6	1.3	1.4	1.8
Eastern Europe	0.4	0.5	0.6	0.7	0.7	0.8	0.9	0.9	1.0	1.2
Other	0.5	0.8	1.0	1.4	1.7	2.1	2.7	3.2	4.0	5.4
Total	3.9	5.1	8.1	8.7	10.5	15.4	17.1	24.6	25.8	28.3
Net positions[3]										
Reporting European area										
Banks	0.1	-1.3	-3.0	-2.8	-2.8	-4.9	-4.9	-4.8	-3.0	-4.0
Non-banks	0.5	1.0	0.8	0.4	0.1	-0.3	-0.5	-3.0	-3.8	-3.0
Total	0.6	-0.3	-2.2	-2.4	-2.7	-5.2	-5.4	-7.8	-6.8	-7.0
Outside area										
Other western Europe	-0.4	-0.2	-0.1	-0.2	-0.2	-0.1	-0.4	-0.8	-1.1	-0.9
United States	1.1	1.3	3.3	3.1	3.5	5.9	6.3	12.3	12.7	12.1
Canada	-0.4	0.1	-	-0.1	-0.2	-0.1	-0.4	-1.1	-1.6	-1.8
Japan	0.4	0.5	0.6	0.8	1.0	1.4	1.6	1.1	1.0	1.5
Eastern Europe	0.2	0.2	0.3	0.4	0.3	0.4	0.3	0.3	-	0.4
Other	-1.5	-1.6	-1.9	-1.6	-1.7	-2.3	-2.0	-4.0	-4.2	-4.3
Total	-0.6	0.3	2.2	2.4	2.7	5.2	5.4	7.8	6.8	7.0

1 Including conversions by the banks of domestic or third currency funds into dollars, plus dollar deposits by the official monetary institutions of the reporting area.

2 Including conversions by the banks of dollars into the domestic or third currencies; excluding, however, the Italian banks' use of Euro-dollars for third-currency loans to residents (included under non-bank uses).

3 A minus sign indicates that the area or grouping in question is a net supplier of Euro-dollar funds, whereas the absence of a sign indicates that it is a net user.

the relative contribution of the various areas has shown little change. A fairly important exception was the flow of funds to the market from the United States and Canada which increased from $1.8 milliard at end-June 1967 to $6.7 milliard at end-June 1969. Even this figure may be a significant understatement, since substantial US funds have probably entered the market in indirect ways, such as through trustee and nominee accounts in Europe. In other words, the figure for funds supplied from within the reporting area is too large and the supplies from the United States too small.

But the growth of Euro-dollars has been much more unbalanced on the uses side. Nearly two-thirds of the $24.5 milliard expansion between December 1964 and June 1969 was accounted for by US borrowing, whereas the reporting area's own takings increased relatively little. The pattern was, of course, moderately reversed in the subsequent twelve months, when well over half of the new funds were absorbed within the reporting area, whereas US takings declined somewhat.

The character of the market

The data on net positions of the various areas indicate more sharply the change in the character of the market over the past five years. While the United States is shown as a net taker of funds in 1964 and 1965, this reflected the normal placements of foreign liquid funds in the New York market; the real flow of funds between the US and the Euro-dollar market at that time was rather from the United States to the Euro-banks. Starting with the credit squeeze in 1966, however, the United States became the main borrower from the market and it has ended up with a very large net debtor position - probably overstated somewhat as suggested above. In other words, apart from relatively small net takings by Japan and eastern Europe, until recently the Euro-dollar market has been largely a mechanism that on balance channelled short-term funds from the outside world to the United States.

In its earlier years the Euro-dollar market was a market that emerged among banks in Europe which found that they could bid successfully for dollars and re-lend them at a narrow operating margin. More recently the character of the market has changed with the growing dominance of US banks in it. For example, only nine US banks had branches in London at the end of 1963, but the number has grown to about thirty-five at present, motivated essentially by the attraction of Euro-dollars.

The non-sterling liabilities of the London branches of US banks went up from $1.2 milliard at the end of 1963 to $23.4 milliard at the end of July 1970; and their share in the total non-sterling liabilities of banks in the United Kingdom increased over the same period from 24 to 50 per cent. The data available for the other European financial centres indicate that US banks are less important there; nevertheless, it is evident that US banks account for a large share of the market and an even larger share of its growth.

This surge of interest of US banks in the Euro-market reflects their desire to compete outside the United States for dollar deposits - even those from their own customers. As their head offices in the United States were handicapped because of the cost of reserve requirements and the limitations of Regulation Q, they put themselves on the same footing as foreign banks enjoy by shifting business to branches in foreign financial centres where dollar deposits are unencumbered by local regulations. As an official of the Federal Reserve has put it, 'the United States has been exporting its banking system'. Thus, the recorded growth of the market is partly illusory since, to a significant extent, the branches are just bookkeeping offices for transactions that are arranged in the United States. That is to say that the reported growth of the Euro-market has somewhat exaggerated its significance for Europe and for the world monetary system.

Factors underlying the market's growth

Regulations applicable to the use of the dollar itself by banks in the United States and to domestic currency operations of other banking systems constitute one key factor that explains the existence of the Euro-market, which is relatively free from such regulations. It is often thought that the existence and growth of the market has been due to the US balance-of-payments deficit. That explanation is, however, insufficient: if the dollars flowing from the deficit had all continued to be held in the United States itself, the market would not have arisen.

The factors which explain the existence of an active Euro-dollar market are: (1) the relative absence of regulations on foreign currency operations, particularly offshore operations, of banks outside the United States, coupled with the regulations which hamper banks' domestic currency operations - both in the United States and elsewhere; (2) the ability of the Euro-banks (including US banks' foreign branches) to compete effectively, both because they can operate on narrower margins and because they are not bound by interest rate conventions and cartel arrangements; and (3) the willingness of the world to use the dollar on a large scale, both because of its convenience and because of the feasibility of doing so.

Where the US external deficit comes into the matter is in helping to explain the growth and present size of the market. Without such a continuing deficit the market would have had to rely for its growth on attracting the foreign-held dollars that already existed at the time of its creation, plus its own ability to create dollar deposits; with these limitations it is hardly conceivable that the market could have reached its present size.

At the same time, however, it can be demonstrated that the cumulative US deficit, even if it had gone entirely into the Euro-dollar market, cannot account for the present net volume of Euro-dollar credit. In this connection, it is necessary to bear in mind that the US payments deficit, to the extent that it is financed by increases in official dollar liabilities of banks in the United States, cannot statistically account for the growth of the Euro-dollar market since these liabilities represent, by definition, dollars held in the United States itself. What counts therefore is the extent to which the deficit gives rise to increases in non-official dollar liabilities.

Over the five and a half years (used in the table) from end-1964 to mid-1970 the US liquidity deficit financed by increases in non-official liquid liabilities of the United States to foreigners amounted to $14.6 milliard. During the same period net Euro-dollar credit expanded from $9 to 41.5 milliard, i.e. by $32.5 milliard. Moreover, even if we add to the increase of private dollar balances during this period the amount of such balances outstanding at the beginning of the period - which was $12.5 milliard - it is clear that the total of privately-held balances outstanding at mid-1970 was less <u>either</u> than the net growth of the Euro-dollar market between end-1964 and mid-1970 <u>or</u> than the total of Euro-dollar credit outstanding at mid-1970. Furthermore, it is certain that a large amount of foreign-owned dollars is held directly in the United States as working balances and money-market investments - without passing through the Euro-market.

Thus, recent and more remote US payments deficits can only account for a share of the present volume of Euro-dollars outstanding. The rest were necessarily brought into being by the mechanism of the market. Essentially this has happened in two ways.

Firstly, Euro-dollars get on the books of the banks through flows of short-term funds outside the United States that are denominated in dollars as the vehicle currency, either for the convenience of the banks or the banks' customers, or because regulations would not have allowed the flows to take place in the domestic currencies involved.

Secondly, Euro-dollar assets and liabilities may be created by the Euro-banks as a group, just as banks create them in a domestic banking system, that is by making advances which are used, at least partly, within the Euro-dollar system. Formerly such credit creation was thought to be quite limited, as the leakages from the system were believed to be very considerable. However, with the growing share in the market of US bank branches, which have a considerable amount of business with US corporate branches and affiliates, there is now greater scope for the process of credit creation to operate.

It seems unnecessary to trace here the dynamic forces on the demand or the supply side that have stimulated the growth of the market, particularly as only a few major episodes could be isolated - such as the intense demand for dollars by US banks in 1969, which sucked liquidity into the market, or the flight from the franc in 1968, which supplied funds to the market. It is worth noting, however, that the part played by monetary authorities in the market's development has not been insignificant. In addition to the fact that the forces acting on the market from the private sector have often been forces created by central banks, there have also been times at which central banks have contributed directly, or via their own banking systems, to the market's supply of funds.

Problems raised by the market

The interest in multilateral supervision of the Euro-market stems from the problems which are believed to have arisen from, or to have been aggravated by, the market's behaviour. The nature of these problems has been suggested earlier, but some elaborations may be useful.

1) The market is a significant vehicle for the international expansion of bank credit which may at times be inflationary. The rapid rate of growth of the market itself gives substance to this view. The market increases the flow of credit in various ways: for example, by facilitating

international movements of funds from areas where monetary conditions are relatively easy to those where there are unsatisfied demands for credit; by credit creation within the market; by drawing down official reserves for use in private credit markets; and by increasing the credit multiplier through lower average reserve requirements. In theory the central banks could adjust their own objectives for the rate of expansion of their domestic money supply to allow for the effect of the market, but in practice it is difficult for them to do so, particularly if they have to do so unilaterally.

2) The market increases the international pool of liquid funds and facilitates their rapid shift from one market to another. At times this blunts the effectiveness of domestic monetary policy. Similarly, flows of funds facilitated by the market can interfere with balance-of-payments objectives.

3) The use of the market by the banking system in a particular country, permitted or facilitated by the central bank in one way or another, can cover up an imbalance in the balance of payments and can delay corrective action by the authorities. This is a rather obvious point and need not be elaborated, except to say that it can apply to surplus as well as to deficit countries.

4) The Euro-market can have an amplifying effect on interest rate developments in national markets, as was dramatically illustrated in the 1969-70 episode. The repercussions of the market in this regard are out of proportion to its marginal share of world credit flows. In domestic monetary management many central banks have aimed at controlling the money supply without changes in interest rates so violent as to disrupt financial markets. To pursue the same aim in the Euro-market would require a concerted effort.

5) The market provides a large pool of liquid resources that may feed speculative excesses. While not without some substance, it seems to us that this allegation has been

exaggerated. If one reviews the major cases of speculative fever over the past five or six years, one can say first that where the exchange market was acting against the threat of a currency devaluation, the Euro-market was of little importance. It could have aggravated the flight from, say, sterling, the French franc and the lira at various times, had large Euro-dollar borrowing in the currencies concerned previously been built up. Or very attractive rates in the Euro-market could have added to the outflow of domestic funds. But in fact neither of these influences seems to have been very significant in relation to these countries' total official financing requirements at the time.

In the case of the 1967-68 gold rush the availability of the market's funds was more significant. Nonetheless, they could hardly be called crucial to the total movement.

The rôle of the market was probably largest in the Deutsche Mark speculation. In the second and third quarters of 1969 the short-term inflow of funds to Germany outside the banks was \$3.8 milliard and at the same time the German banks themselves increased their net foreign indebtedness by \$1.1 milliard. The inflow outside the banks consisted largely of foreign firms building up balances with their branches in Germany, and of changes in the terms of payment (leads and lags). It is quite likely that both these were to a certain extent financed in the Euro-currency market.

Of course, even without the facilities of the Euro-market, speculative flows would occur when there is threat of a major monetary upset.

6) A final point may be mentioned, though it is rather difficult to formulate because it is somewhat nebulous. It is that the Euro-market has tended to speed up the increasing use of the dollar as a transactions and financing currency. There is evident unease at this growing dominance of the dollar and criticism of the processes which bring it about. Of course, this has been due not solely to US policies and regulations

but also to those of other countries. Obviously, if the competition of other currencies with the dollar is limited by restrictions on their use, then, naturally, the dollar will have only limited competition.

Perhaps more important is the fear, already mentioned, that the repercussions of a possible run on the dollar have been considerably increased as a result of the market's growth.

Procedure

In view of this range of problems to which the central banks may from time to time give joint consideration, what sorts of initiatives might be contemplated in the exercise of multilateral supervision of the market? Four sorts can be envisaged:

1) Obtaining a better and more up-to-date knowledge of developments in the market, through more regular and speedier reporting of the banks' foreign currency positions. In this connection, consideration could also be given to more frequent publication of Euro-currency statistics by the BIS.

2) Exchanges of views by central banks on certain aspects of the permanent regulations and practices in particular countries.

3) Exchanges of views by central banks on the ad hoc regulations or arrangements in particular countries.

4) Discussions concerning possible initiatives of the central banks, as was done in the past for end-of-year operations.

It hardly needs to be said that the aim of such initiatives should be to alleviate specific problems and not to lose the benefits of the market by stifling it. These benefits include the stimulation of banking competition, both internationally and in various domestic credit markets; the speed and efficiency with which the market is able to handle large transactions; and the advantages which result from the internationalisation of available liquidity through the market.

As a method of procedure the following suggestions may be made. Final consideration of any problems raised or proposals for initiatives would take place in a meeting of the Governors. However, a group of Deputies of the Governors, with the General Manager of the BIS as Chairman, would be established to sift and prepare matters for the Governors' consideration. Meetings of the Deputies' group would be periodical and would be called on the suggestion of any of the central banks or of the General Manager of the BIS. The General Manager would report to the Governors on the Deputies' discussions.

10th January 1971

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Notes on Meeting of BIS Steering Committee
on Eurodollar Market (Amsterdam--February 18)

The meeting of the Steering Committee was held in Amsterdam on February 18. Those in attendance were Chairman Zijlstra (Netherlands), Baffi (Italy), Hollom (U.K.), Emminger (Germany), Hay (Switzerland), Theron (France), Joge (Sweden), de Strycker (Belgium), Gilbert and Dealtry (BIS), Kessler (Netherlands). Japan was represented by their new representative in London and Canada had no representative.

Chairman Zijlstra began by summarizing and distributing the attached note which in effect gave a list of topics for the proposed study. He then called on a go-round beginning with me and I commented as follows:

(1) I questioned whether the implication of the list of problems was that these problems were attributable to the Eurodollar market mechanism per se. In other words, how much of these effects would occur with or without the Eurodollar market itself?

(2) We generally supported moving forward with the study but I was troubled a bit by the timetable as to the order of listings of the topics. Zijlstra had indicated that he thought the topic list in his note was roughly in order of priority. For my part, I wondered whether the placements problems merited somewhat more immediate attention, perhaps by the BIS gold and foreign exchange group.

(3) The outline seemed a bit shy in analyzing the demand factors.

(4) Without prejudging the composition of the group under Item 6(f), would it be desirable to have a fact-finding group of technicians at a somewhat lower level? By fact-finding I meant a group not simply concerned with statistics but also with market structure, credit quality, matching maturities, etc.

Baffi said he was puzzled as to why another group had to be set up as we already had the BIS gold and foreign exchange group. They had not had any problems in Italy with respect to the Eurodollar market contributing to domestic inflation. In fact, their difficulty had been the other way around. Namely, the existence of an international market with relatively high rates had led to clandestine capital exports and put pressure on their central bank reserves at a time when they were not adequate. Basically, however, he thought it was perhaps necessary to accept some repercussions of an international money market and an internationally oriented world economy. Thus, he would not go too far in thinking of terms of restrictions but would let the market mechanism serve a useful purpose in allocating international liquidity and control the international liquidity via SDR creation.

Joge (Sweden) felt we already have sufficient technical material so saw no necessity for additional technical examination. However, he felt that central bank placements were not appropriate and that some policy agreement on this score was needed sooner rather than later.

Hollom supported the broad conclusions of the Zijlstra note but suggested not prejudging what might be done and raised question as to whether perhaps flows outside the Eurodollar market might be even less amenable to control.

Emminger made the following observations:

(1) We should not decide on setting up a group or groups till later.

(2) There had been a considerable adverse impact on domestic monetary policy in Germany to the tune of more than \$6-1/2 billion in one year. This had been instrumental in undercutting their domestic monetary policies. He noted that the inflow to nonbanks was outside official control and "cannot be undone" by central banks. Once corporations already have the liquidity, the central banks can only undo the secondary effects on the liquidity of the banking system. For example, with respect to new credit needs in Germany, in the July-October period of 1970 one-half had been supplied by foreign sources and one-half by their domestic banking system.

(3) The existence of the Euro markets had been responsible for the problems. Their borrowers had been able to get the money easier from the Euro market than if there had been no market nearer than a major New York bank. Furthermore, the huge volume of funds in the Eurodollar market was the result of the U.S. cumulative deficit creating such a large pool of money that it did indeed inflate the problem of trying to manage the domestic economies.

(4) As to implications for the international monetary system, he would not simply accept the Baffi thesis that because we live in an international monetary system we have to accept the interest rate movements of the American monetary system. Instead we have to find ways of preserving the autonomy of internal monetary policies to be able to influence their own situation. He was driven to think whether maintenance of monetary stability at home necessitated deviations from the liberalization of capital movements. The problem seemed to become

one of open inflation vs. convertibility. The problem allegorically was how to live with the elephant, even a kind elephant (i.e., the U.S.). Clearly the pool of funds in the Eurodollar market was not always a stabilizing factor for the international monetary system. Specifically there was a circular movement or carousel effect when the Bundesbank tried to rechannel the inflow of funds.

(5) As to central bank placements through the BIS, he felt that we should re-examine the attitude of central banks toward such placements which, as Governor Daane had noted, could have a destabilizing effect on reserves as well.

(6) The Euro market was not always a positive factor in the adjustment process but rather an "irregular source of international liquidity." Thus he was glad we were studying the implications of the international monetary system.

(7) In short, he would go ahead with the study, placing particular emphasis on 6(a) and (b). As to (b), he felt that central banks could influence the Eurodollar market in a way to alleviate the destabilizing effects on the international monetary system. Thus he welcomed the U.S. Ex-Im offering and said the Germans, too, had attempted to sterilize inflows, but while they considered it "an internationally justified action," it was criticized in the OECD report.

de Strycker said they would stress the two questions of impact on internal monetary policies and impact on the international monetary system. However, he felt there was some danger of limiting the study to Euro currency markets since the problem was one of gradual internationalization of money markets rather than the Euro market per se and on this point would underscore Governor Daane's initial observation. For example, as capital inflows into Belgium in 1967 and 1969 were due to leads and lags and the terms of payments, not the existence of Euro markets. There was relatively little direct flow between Belgium and the Euro markets.

His second observation was directed toward including in the study the possibilities of avoiding the disturbing influence on the international monetary system. In other words, if they were affected by the elephant, should the elephant be entirely free to ignore the effects of its own policies? Specifically, we should study whether the instruments of U.S. policy can be used in a way to have more or less disturbing effects. Otherwise the European countries might have to try to find ways to insulate their markets from international money markets which immediately lead to the danger of interfering with capital movements.

As a final observation, he noted that there already was a technical committee functioning in the BIS and was not clear how a new committee would differ from the present technical committee.

Hay commented that he did not know whether we needed a technical committee or should simply use the BIS staff. He felt we did need to know more about the technical problems before reaching any policy conclusions. For their part, he thought the most important facet of this study was to look at the question of the multiplier in credit creation attributable to the Eurodollar market. In Switzerland, when Eurodollar rates were high, funds (normally long-term funds) were placed in short-term Eurodollar obligations. Specifically, since the massive U.S. bank repayments of Eurodollars the quality of debtors has changed from well-known U.S. banks to nonbanks borrowing in the Euro market. Thus he wondered how liquid the market really was and felt we need to know more about how the market was constructed. As far as repercussions on the domestic market, until the U.S. and Eurodollar, rates declined, the Swiss were helped in their own monetary policies, but now repatriation was undermining restraint.

Theron said that they fully agreed on the need to study markets a la Giscard d'Estaing. Thus it was necessary both to know more and to have a policy with respect to the Euro market. Before any policy conclusion, however, we needed the knowledge both statistical and structural. He would support Hay's comments on the need to determine the monetary creation involved. As for impact on their own market, the French were able to protect themselves through exchange control which regulated borrowing by nonbanks. He wondered, therefore, whether in order to regulate it was necessary to rely on exchange controls.

The Japanese representative made generally favorable noises about going forward with the study. He noted that they had been able to check the domestic impact of any undue inflows through direct controls on banks and nonbanks. Most of his comment was devoted to the difficulties they are currently experiencing in the shift underway from yen borrowing to dollar borrowing on the New York market. On the import financing side, there was a potential shift of some $600 million with the present acceptance rate in New York of 4-1/2 per cent. Similarly, on the export financing side some significant fraction of the $3 billion of Japanese financing could be transferred to the U.S. acceptance market. The other problem he stressed was that of foreign investment in Japanese equities which earn both an 8 per cent rate and had the potential gain from a yen revaluation.

Milton Gilbert discounted the usefulness of a technical committee to improve the statistics, noting that the experts group which met once a year had tried to do so but had been unable to do so with no support from the governors. In any case, there were "limits on improvement" and the statistics would never serve to answer the policy questions. Re the framework for a possible policy committee, there were two main approaches: (1) to look at the growth of the market and what it means and (2) to look at specific problems and "complaints."

As to the first approach, why do central banks find the growth of the market itself disturbing? what is it due to? is the market taking on a life of its own? what is the significance of the growth? As to the specific problems and complaints, it was obvious that the Euro market was disturbing to the monetary policies of certain countries. But prior to the establishment of a policy committee there was no way to get it on the table, so to speak, for mutual consideration. Therefore, a policy committee might provide a ready mechanism permitting an exchange of views.

Kessler felt that it would be useful and appropriate to have discussion among the central banks. Felt they should look at the market in the broad sense, recognizing that even in the absence of the Euro currency market the problems were still there and that what we were really studying was the international money market as de Strycker had suggested. For example, if the Netherlands banks were not engaged in lending to ~~xxxxxxxxxxx~~ nonresidents and foreign banks, they would still have the U.S. deficit to contend with and would still be experiencing a tendency toward balance-of-payments surplus in the Netherlands. But in fact they do give enormous amounts of credits to nonresidents and to nonbanks. He acknowledged that central bank placements could possibly be inflating the European reserves independent of a U.S. deficit but "exacerbated by a U.S. deficit." In any case, we ought to know more about the statistics and the way banks participate in the market and look at the possibilities of controlling it or seeing whether we can somehow influence the trend.

Chairman Zijlstra then summed up the morning discussion as follows:

(1) It was agreed that the catalog of items under Point 6 was a good point of departure for the proposed study.

(2) There was also fairly general agreement on the order of priorities in that list.

(3) There was agreement that the Euro currency market could have an adverse impact as per both 6(a) and (b). 6(c) and (d) suggested going deeper into the problem and looking at whether we could do something, both on the supply and demand side. On the demand side, there was a question of deliberalizing. For example, the Germans were completely free while in the Netherlands despite having good controls there was a $1 billion inflow of capital in 1970.

(4) As to influencing the supply, it was generally recognized that part of the problem would be on our hands with or without a Euro market. Nevertheless, if we broadened the study to look at all aspects of the international adjustment process, this would be too broad and he would advise against it.

(5) It was clear that several of the speakers noted that the Eurodollar market introduces one or two major multipliers with credit-creating potential.

(6) Most would agree that we should not start with point 6(e) but rather that we needed 6(a)-(d) first.

(7) As to point 6(f), he had in mind the kind of group a la page 11 of the Milton Gilbert paper distributed at the January Basle meeting, namely a sort of standing committee to keep the market under surveillance and report to governors.

At the outset of the afternoon discussion, I once again raised the question of priorities in terms of not delaying possible work by the gold and foreign exchange group on the question of central bank placements and still felt that a fact-finding group in a broader sense might be worthwhile. Our experts had earlier concluded that we did not have enough information on commercial bank Eurodollar liabilities to central banks and the BIS. Finally, I wondered whether it would be useful to think in terms of several groups or perhaps several papers being assigned on some of the topics.

Emminger said he wanted to add one addendum as to the structural change now going on in which there was an increasing inclination of Eurodollar banks to grant medium-term loans on the basis of short-term money. One bank had told him they had made commitments over the last 12 months totaling $25 billion with only 40 per cent of the commitments used. While the figure was clearly suspect it was still a significant development.

Baffi defended his earlier statement that he was favorably disposed to the development of an international money market reflecting his own experience. The Euro market had not had an expansionary effect in Italy and he still believed that any system of market allocation makes for better resources allocation. There remained the problem of multiplier and therefore he was favorably disposed to a research group at a high level and for providing for some cross-fertilization of ideas by the BIS. His own feeling was that if there were fixed parities and a free flow of goods the same results would ensue with or without a Euro market.

Joge reiterated that while it would be useful to have experts analyze the nominal increase in the market, we really had enough to look at with the question of central bank ~~diversion of~~ diversion of dollar assets to the Euro market.

Hollom stressed again the need for analyzing very carefully any possible policy steps to see differences in impact and underscored the need for "careful exploration before reaching any policy conclusions."

Emminger took issue with Baffi, saying that he could agree with him if the inflows had been due to substantive attractions (e.g., higher profits, etc.). But the reason for the 1970 inflow into Germany was simply a difference in the monetary policies of different countries and particularly the U.S. Thus, on his basic philosophy he said we needed to maintain variety or otherwise would simply be giving in to the requirements of the American monetary system. He said that Milton Friedman in a recent visit to Frankfurt had said that any thought of German monetary policy was "nonsense"; as long as we were on a fixed rate system, their policy was simply a function of the Federal Reserve

Board. His conclusion was that it would be useful to have a standing committee on policy considerations and before Ferras death had thought that the chairman should be the managing director of the BIS and that the group should meet each month in connection with the monthly BIS meeting. As to work program of such a group, he would:

(1) Ask the group to look immediately at the question of central bank placements in the Eurodollar market and the effects on the whole system.

(2) Use the group to provide a platform for complaints looking toward coordinated actions. For example, the German problem had been brought to Working Party 3 but it would be preferable to take it up in a standing group of central bankers.

(3) Charge the group with thinking up rules to assure the liquidity of the market.

As to composition of the group, he would have a standing committee on a high level with power to recommend to the governors. He also felt there was room for a fact-finding "information" committee. He would give a mandate to such a technical committee, using the existing committee on gold and foreign exchange operations rather than setting up a new committee.

de Strycker said he would make four concluding comments:

(1) As to the necessity of limiting the research effort, he agreed that there was a need to limit but was not sure that it should be just confined to the Euro market which was an "artificial statistical concept." In lending or borrowing dollars no one cared whether it was from the "Eurodollar market" or directly from American banks, European banks, etc.

(2) As to the effects on domestic money markets, it was not necessarily disequilibrating or a source of inflation. In the Belgian case, any addition of imported funds was offset by the destruction of domestic liquidity.

(3) As to the elephant, it may be perfectly all right for other animals to stay close to the elephant when it is in the center, but not when it is on the side of the boat!

(4) Re the establishment of a standing committee, he had no objection to "watching developments" but had considerable doubts about "promoting or mitigating trends." As to who the committee should be, he felt it basically should be the group around this table who were the "top associates of their governors" and who could do the preparatory work for consideration by the governors.

Hay questioned the logic of Zijlstra's order of priorities and expressed a preference for starting with 6(c). He would also look at 6(e) and was open-minded as to whether the group should be the BIS or another group of experts, but probably they should come back to this (today's) policy group.

Theron expressed complete agreement with Hay. He felt there was a need to start with 6(c) but could study other items at the same time. He felt that the study should be immediately started by each of us.

The Japanese made no further comment except to once again welcome the study.

Kessler said that the main problem he saw was that of the multiplier and to what extent it was increased by the Euro market. He felt it might be useful to have another round of discussions, particularly on points 6(a) and (b) as to what was the most important subject matter for a policy group to explore. As had been pointed out, the central banks were already in the business so to speak and therefore we might already be at the point where it was desirable to have a holding operation. Therefore, at the meeting it might be useful to organize a discussion and to have some figures as to how foreign central banks are engaged in the business. He felt this could be done.

Milton Gilbert then tried to minimize the central bank placement question, pointing out that with the total Euro market of $55 billion, central bank placements could at the most only account for $5 to $6 billion. I responded that his comparison of the magnitudes was misleading and, even if one accepted it, it did not mean that $5 to $6 billion of central bank placements was a minor party of the increase in reserve holdings of the European countries.

Zijlstra finally summed up the day's discussion as follows:

(1) It was agreed that further discussion of the Eurodollar market could be useful and was even necessary.

(2) Point 4 of his sketch focussed on a real process. Even if one agreed this could occur without the Eurodollar market it magnified in the process. Therefore point 4 and point 6 of his outline covered the problem completely.

(3) Re paragraph 6 of his outline, if one concluded that the effects of (a) and (b) were negligible, then one would not proceed with (c)-(f). Today, however, most had indicated the effects were not negligible.

(4) It was clear to him that we needed another round of discussion by this group before making recommendations to the governors and to enable the governors to form a mandate for the policy group.

(5) Re the composition of such a policy group, we would have to await the conclusions of the governors--it might be the same composition of today's group or more or less the same composition. In any case, the aim of this steering group should be to provide a mandate that the governors relay to such a standing policy committee.

(6) Therefore, between now and the next meeting of this group at the time of the Basle meeting in April, he would ask for papers on one or more of the topics listed in paragraph 6, particularly on (a) and (b) and possibly (c) and (d). He would invite such papers from anyone (although he specifically singled out Emminger) and suggested such papers should be as short as possible. It would be useful to have some experts look at the market's credit creation potential.

(7) Finally, Zijlstra said that while the question was "delicate," he would try to find out more as to BIS activities in connection with central bank placements.

After considerable discussion of whether the Steering Group should meet/ again the day before the April BIS meeting (which I opposed because I assume Chairman Burns would be at the April meeting), it was agreed to meet either the afternoon of March 25 or the morning of March 26 in Paris since many if not most of the steering committee would already be in Paris in connection with meetings of Working Party 3 and G-10 Deputies. In the meantime, papers were invited and we were asked to think about a possible mandate which could be prepared after the March 25 meeting, looked at between then and the April meeting, and put up for governors' review at the April meeting.

D. J. F. Dijkstra

February 17, 1971

BIS Working Group

(1) There is a growing urge to regulate the Euro-dollar market, and more generally the Euro-currency market, one way or another. As the BIS note states:

This view was reflected by former Chairman Wm. McChesney Martin in his recent speech in Basle, in which he said: "At present there is little, if any, multilateral supervision of these markets. One need raise no doubts about the soundness of the claims that are created and exchanged in these markets to suggest that a case can be made for giving to an international institution some responsibility for supervising these markets." At the IMF meeting in Copenhagen, Mr. Giscard d'Estaing expressed a similar view and Mr. Schweitzer, the Managing Director of the Fund, gave it as his opinion that "maybe the central bankers could do something" about the market.

(2) This urge for making regulations clearly stems from more general monetary considerations. According to the BIS note (page 1) "Discussion is now centred on the monetary rather than the purely banking aspects of the market - the sheer momentum of the market's growth and the size it has reached, the implications of this growth for monetary inflation the potential of the market's large pool of resources for speculative pressures, the influence of the market on interest rates, the complications that arise for domestic monetary policy, the easy financing of balance-of-payments deficits and the possibility that the market's resources would add to monetary disturbances in the event of severe weakness of the dollar."

(3) The problem is twofold and consists of:
- (a) the impact of the Euro-currency market on the effectiveness of the monetary policies of the various countries;
- (b) the impact of the Euro-currency market on the working of the international monetary system.

(4) The influence of Euro-currency banks on the effectiveness of monetary policy and on the working of the international monetary system mainly rests on their deposit-making and

lending activity vis-à-vis non-residents, both banks and non-banks. To the extent that deposits are made with banks the latter's lending potential, both at home and abroad, is increased and monetary restraint therefore made more difficult. To the extent that credits are given to non-banks (end-users) the influence is not just a potential one: these credits contribute to an increase in the money supply of the receiving country.

(5) The major policy problem facing us is whether the Euro-currency market has an adverse impact on the effectiveness of domestic monetary policy, and if so, to what extent. In the affirmative, the following problem is how to mitigate or eliminate such impact. This might be achieved by influencing supply or demand, or both.

(6) Consequently the following problems need to be studied:

(a) the impact of the Euro-currency market on the effectiveness of domestic monetary policy;

(b) the possible implications of such impact on the working of the international monetary system;

(c) which factors are determining supply on the Euro-currency market (including the relevant U.S. balance-of-payments deficit, the market's credit creation potential, and the central banks' placements of part of their reserves in this market); possibilities of influencing supply;

[illegible]

(d) possibilities of influencing demand on the Euro-currency market;

(e) improvement of statistical information on the operations in this market;

(f) possible suggestions from the Working Group might include the set-up of a standing committee (within the BIS) for the purpose of watching closely the developments in the Euro-currency market in order to be able to promote a desired trend or to prevent or mitigate an undesired one.

CHAIRMAN BURNS

For Information Only

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date: March 22, 1971

To: Board of Governors

Subject: Eurodollar Repayments by U.S. Banks.

From: Robert Solomon

CONFIDENTIAL (FR)

The attached memorandum by Mr. Robert Bradshaw analyzes the impact of the special Export-Import Bank issues on the rate of repayment of Eurodollar liabilities by U.S. banks. The conclusion is that there was no more than a temporary pause--probably explained by the announcement effect of the first EXIM issue--in repayments.

RS

Attachment.

CONFIDENTIAL (FR)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 19, 1971.

To Mr. Robert Solomon

From Robert C. Bradshaw

Subject: Some Observations on Changes in U.S. Banks' Euro-dollar Borrowings since September 1970.

The purposes of this memorandum are (1) to review the changes that have occurred from September 1970[1/] to date in U.S. banks' daily average Euro-dollar borrowings (and foreign branch holdings of special Ex-Im Bank securities); (2) to compare the changes in daily average borrowings over this period with changes in the Wednesday series on gross liabilities to foreign branches (which appears in Chart 2 of the "International Developments" materials distributed at weekly Board briefings) to determine whether these two series give essentially the same picture of the general trend of U.S. bank Euro-dollar borrowings; (3) to examine the data available for any indication of the influence that the Ex-Im security offering may have had on the rate of decline in the <u>total</u> of borrowings from foreign branches plus foreign branch Ex-Im security holdings.

<u>Changes in "Overall Euro-dollar Positions" Since the Computation Period ended September 2, 1970.</u>

As indicated in Table 1, the banks' daily average net liabilities to foreign branches plus assets sold to foreign branches and foreign branch holdings of Ex-Im securities -- the total of which

1/ By September 1970 most banks using an historical base had eliminated reservable borrowings such that further reductions in borrowings would result in equal losses of reserve-free bases.

we will simply refer to as the banks' "overall Euro-dollar positions" -- declined by about $4.1 billion from the computation period ended September 2, 1970 through the computation period ended March 17, 1971. Thus, the average decline per computation period was a little under $0.6 billion.

The most striking deviations from this roughly $0.6 billion per computation period rate of decline in "overall Euro-dollar positions" have occurred in the two most recent computation periods. In the period ended February 17 -- during which the first Ex-Im security offering was made -- the total declined by only $287 million; preliminary data for the computation period ended March 17 indicate a decline of $875 million in the banks' "overall" Euro-dollar positions. Some possible reasons for and implications of this (apparently temporary) slowdown in the rate of reduction in positions in the February 17 period will be discussed in the third part of this memorandum.

Comparison to Wednesday Series on Gross Liabilities to Foreign Branches

The reason for making this comparison is simply to determine whether the two series lead us to the same basic conclusions about the general trend of developments in the banks' Euro-dollar positions. It is the Wednesday data (outstanding) that are regularly presented to the Board in chart form; we have not taken the opportunity in the past to present the daily average computation period data in perspective. Although there are definitional differences in the two series, apart from the fact that one represents averages for a period and the other outstandings on single dates, 1/ the two series (in the period covered in the Table) do portray the same general order of magnitude of changes in the banks' Euro-dollar positions -- for extended periods of time.

Both series show a decline of about $4.1 billion in the period covered by Table 1. But, because of the substantial day-to-day changes that frequently occur in the borrowings data (particularly around month-ends), the shorter the time period of comparison of the data the greater the chance that changes in these two measures of the banks Euro-dollar positions will diverge considerably.

It is important to remember that for purposes of measuring changes in the banks' Euro-dollar positions as reflected in the U.S. balance of payments accounts the relevant data are, of course, changes in outstandings between the terminal dates of weeks, months, quarters, or whatever. Neither series in Table 1 presents the data on this basis. But the daily average data are the measure of changes in "overall Euro-dollar positions" which are probably the most relevant from the banks' point of view -- reflecting changes in reserve-free bases and, in combination with Euro-dollar rates and other relevant

1/ In Table 1 the Wednesday data are presented as averages for the four Wednesdays within the computation periods.

rates of interest, the costs of carrying a given "overall Euro-dollar position.

Observations on the Possible Impact of the Ex-Im Security Offerings on Recent Changes in "Overall Euro-dollar Positions"

As we noted earlier there was a rather striking decline in the (absolute) rate of reduction in Euro-dollar positions in the computation period ended February 17. One interpretation that can be given to this fact is that the $1 billion Ex-Im security offering (which had a January 25 payment date) induced the banks to reduce the rate of decline in their "overall Euro-dollar positions" -- because part of the costs of maintaining these positions in the February 17 period might be (would probably be?) offset by preferential rates of return on Ex-Im notes to be issued in future periods.[1/]

Naturally, there is no way of knowing how much the banks would have reduced their average Euro-dollar borrowings in the February 17 computation period in the absence of the Ex-Im offering. Other factors which may have affected their behavior include such things as (1) interest rate developments in U.S. money markets and

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1/ The Ex-Im issue was allocated in proportion to each banks' share of total Euro-dollar borrowings in the December 23, 1970 computation period. Most banks probably concluded that there would be future Ex-Im issues (or a roll over of the initial issue) allocated on the basis of their Euro-dollar borrowings in coming periods. If the Ex-Im issued had been announced as a "once and for all" offering (and a "once and for all" effort on the part of U.S. authorities to influence the rate of Euro-dollar repayments) there is little reason to believe that the banks would have substantially altered the rate of reduction in their overall positions from what that rate would have been in the absence of the Ex-Im issue.

the Euro-dollar market and (2) the banks' attitudes (which need not be invariant) about the possible benefits to be realized in future periods from maintaining their reserve-free bases (other than possible benefits associated with their share of subsequent Ex-Im offerings). First, we will discuss the possible influence of the Ex-Im offering.

The first Ex-Im allocation was equal to about 10 per cent of the banks' Euro-dollar borrowings in the computation period ended December 23, 1970. The banks found the first issue quite attractive (it was oversubscribed by about 100 per cent) with a rate of return of 6 per cent, plus the benefits of tax and loan credit; in effect, they were able to finance the purchase of the issue in U.S. money markets rather than in the Euro-dollar market by reducing liabilities to foreign branches (substituting various domestic sources of funds) in an amount roughly equal to the branches' acquisition of the Ex-Im securities.

All other things being equal, how might the Ex-Im offering have affected the banks' desired rate of reduction in "overall Euro-dollar positions"? The current cost savings to be realized by further reductions in Euro-dollar borrowings were unaffected by the Ex-Im issue.[1/] However, the banks presumably had to make some estimate of the future revenues that might be sacrificed on subsequent Ex-Im issues (and/or a refunding of the first issue) by further reductions

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1/ The reference here is to be consolidated (domestic offices -- foreign branches) cost of source of funds.

in Euro-dollar borrowings. In making such an estimate the banks had to consider: (a) Would there be a subsequent issue (and/or refunding), and if so, in what amount? (b) In what manner would the bank's share of the issue be tied to future changes in its Euro-dollar borrowings?1/ (c) What rate of return (net of financing costs) could be expected on the issue? Beyond these considerations the banks were also faced with the possibility that some other policy instrument might be introduced that would only reward banks that kept up their borrowings.

There is little basis for judgment about how the banks might have evaluated the probable trade-off between current cost savings realized and possible future revenues sacrificed by further reductions in "overall positions". In the February 17 period the cost differentials between Euro-dollars and domestic sources of funds averaged roughly one per cent -- a bank could save about one cent (at an annual rate) in gross interest costs on each dollar of liabilities to foreign branches repaid and replaced by domestic sources of funds. Under the assumption that a bank expected its share of Ex-Im issues outstanding in the future to remain about 10 per cent of its Euro-dollar borrowings (or its "overall position") the bank would expect to sacrifice about 10 cents in ability to buy Ex-Im securities for every dollar of Euro-dollar repayments. If it is

1/ That is, the net liabilities to foreign branches plus assets sold to foreign branches component of its "overall Euro-dollar position".

assumed further that the bank expected to be able to finance future Ex-Im holdings with funds obtained in the U.S. money market at a cost about one per cent below the rate of return on new Ex-Im issues[1/] then, under these assumptions, the bank would (a) save one cent (at an annual rate) in gross interest costs on each dollar of Euro-dollar borrowings repaid; (b) expect to sacrifice one-tenth of one cent (annual rate) in net earnings on future Ex-Im holdings. Thus, under these assumptions, roughly 10 per cent of the current excess costs of retaining Euro-dollar liabilities would be offset by expected future net returns[2/] on Ex-Im holdings.

If the expectations assumed above even roughly approximate those actually held by the banks after the first Ex-Im issue it seems unlikely that the change in expected cost and return calculations (as affected by the Ex-Im issue) would have been sufficient to induce the sizable reduction in the rate of repayments that occurred in the February 17 period. The assumptions above are not, of course, completely arbitrary; but there is no way of discerning how well they approximate the banks' actual expectations.[3/]

1/ The gross margin on the first issue was about 1-1/4 per cent (excluding tax and loan benefits) for a bank that financed the Ex-Im purchase with a 60-89 day CD sale at the time of the Ex-Im issue; the margin, on the same basis, was only slightly less on the second Ex-Im issue.

2/ As calculated by the margin expected between future Ex-Im issue rates and the future cost of financing the acquisition of Ex-Im issues in domestic money markets. The assumption is made throughout that the banks expect Euro-dollar rates to be above the cost of funds of comparable maturity in domestic markets.

3/ The assumptions made imply "static" expectations on the part of the banks -- that is, the expectation that allocation ratios and the margin to be made on future Ex-Im issues would be roughly the same as on the first Ex-Im issue.

It was stated earlier that factors other than the Ex-Im issue could have been important in explaining the (apparently temporary) reduced rate of decline in "overall Euro-dollar positions" in the February 17 period. It does not appear, however, that interest rate developments in the U.S. and in the Euro-dollar market during the February 17 period were likely a major factor affecting the slowdown in the repayment rate. There was a marked slowdown in the rate of decline of the Federal funds rate in the February 17 period; but there was an acceleration in the rate of decline in CD rates and flows into time deposits at commercial banks continued at a very high rate.[1/] The cost differential between call Euro-dollars and Federal funds narrowed by about 40 basis points, on average, from the previous computation period -- reflecting a decline of about 65 basis points in the average call Euro-dollar rate and a decline of about 25 basis points in the average Federal funds rate. However, the excess of one- and three-month Euro-dollar rates over CD rates for comparable maturities increased moderately. Unfortunately, there is no a priori basis for judging how to weight the influence of rate developments among maturities on the banks' behavior, or for distinguishing between the effects of changes in the banks' demand and all other influences on the rate differentials referred to above.

A special factor relevant to the computation periods ending January 20 and February 17 was the Board's decision to eliminate

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1/ See Table 2.

reserve-free bases equal to three per cent of deposits. In late November 1970 the Board amended Regulation M to allow the banks then using a three per cent of deposits base to establish historical reserve-free bases (not to exceed three per cent of deposits) in the computation period ended January 20, 1971 -- after which three per cent of deposits bases would be eliminated and automatic downward adjustment would apply to the historical bases established in that period. The Board later extended the period for establishing historical bases (for the banks not already using an historical base) to the computation period ended February 17, 1971. (This was done to allow the banks to re-evaluate their positions in light of the introduction of Ex-Im security offerings.)

From the computation period ended September 2, 1970 through the computation period ended December 23, 1970 the banks then using a three per cent of deposits base reduced their average Euro-dollar positions by about $370 million (about $90 million per computation period on average) to a total of about $280 million. But in the January 20 period these banks raised their average borrowings by $110 million.[1/] There is little doubt that this reversal in the banks' behavior reflected the Board's amendment to Regulation M discussed above.

1/ Fourteen of these banks increased their borrowings by a total of $170 million while 11 others reduced borrowings by $60 million.

Thus, in the absence of this special factor, the banks' aggregate Euro-dollar positions would certainly have declined by even more than the $638 million show in Table 1 in the computation period ended January 20, 1970.

In the computation period ended February 17 the 15 banks using previously established historical bases reduced their "overall positions" by about $300 million while the other banks raised their "overall positions" by less than $20 million.[1/] The further increase in borrowings by the banks not previously using an historical base <u>probably</u> reflected their desire to share in future Ex-Im issues more than their desire to establish historical bases above the level already established in the computation period ended January 20. (The limited amount of data presently available on an individual bank basis in the current computation period indicates that the banks previously using three per cent of deposits bases have reduced their borrowings in the current period by at least as much as their borrowings rose in the computation periods ended January 20 and February 17 combined.) On balance it appears that the Board's decision to allow these banks to establish historical bases in the January 20 and February 17 periods had its major impact in the former period and that the influence of

1/ In this period 20 of the banks previously using a three per cent of deposits base (eight of which had zero positions in the two previous computation periods) raised their positions (including Ex-Im holdings) by $118 million while 17 others reduced their positions by about $100 million.

this "special factor" on the rate of reduction in (aggregate) "overall Euro-dollar positions" in the February 17 period was not substantial.

There seems little reason to believe that the slowdown in repayments in the February 17 period reflected revised attitudes, on the part of the banks previously using historical bases, toward the value of retaining reserve-free bases. It is possible that these banks' reserve-free bases could reach some "plateau" where further reductions would be weighted more heavily than before against the cost savings to be realized from reducing borrowings[1/]; but the fact that the reduction in "overall positions" has apparently returned to previous rates in the current (February 18 -- March 17) computation period implies that no such "plateau" has yet been reached.

The following comments summarize the discussion to this point and add a few general observations: (1) A logical case <u>can</u> be made that the Ex-Im policy should not have been expected to substantially affect the cost and return calculations relevant to the banks' decisions regarding the rate of reduction in their "overall Euro-dollar positions"; <u>but</u> the strength or weakness of this case depends upon one's assumptions about the banks' expectations with respect to future Ex-Im issues. (2) The major impact of the Ex-Im policy on the rate of reduction in positions in the February 17 period might have been through its so-called "announcement effects" -- a signal that U.S. authorities were

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1/ Depending upon their expectations about the extent to which reserve-free bases may be employed in the future.

apparently prepared to take the steps necessary to prevent any further substantial reflow of Euro-dollar funds; if the Ex-Im policy proved insufficient then some other form of "carrot" or "stick" might be introduced. The impact of such "announcement effects" may have diminished with the passage of time and the absence of any further official action other than an Ex-Im issue half the size of the first issue. (3) Interest rate developments in the U.S. and the Euro-dollar market can probably not be given very much weight in explaining the reduced rate of repayments in the February 17 period (or the return to a high repayment rate in the current period for that matter). (4) Certain "special factors" were operating in the January 20 and February 17 periods to affect the behavior of banks previously using three per cent of deposits bases; but these factors (see pp. 9-10) were probably rather limited in their impact on the aggregate rate of repayments in the February 17 period. (5) These is probably no basis for attributing the reduced rate of repayments in the February 17 period to revised attitudes toward the future value of reserve-free bases.

On balance, perhaps the most weight should be given to the "announcement effects" explanation of the banks' behavior in the February 17 period -- if for no other reason, because the remaining alternative explanations appear insufficient to explain developments in that period.

March 19, 1971

Table 1
"Euro-dollar Positions" of U.S. Banks as Measured by Computation Period Daily Average Data and Weekly (Wednesday) Data
(millions of dollars)

Computation Period Ended	Computation Period Data 1/ Total	Change	Wednesday Data 2/ Total	Change
1970 -- 9/2	11,854		10,671	
9/30	11,408	-446	10,428	-243
10/28	10,706	-702	9,890	-538
11/25	10,056	-650	9,106	-784
12/23	9,555	-501	8,382	-724
1971 -- 1/20	8,917	-638	7,832	-550
2/17	8,630	-287	7,447	-385
3/17p/	7,755	-875	6,500	-947

1/ Daily average net liabilities to foreign branches plus assets sold to foreign branches plus branch holdings of Ex-Im securities. Data exclude positions of banks in the Federal Reserve Districts of Atlanta, St. Louis and Kansas City (consisting of relatively small amounts); data for these Districts are not reported on a regular basis.

2/ Average for the four Wednesdays within computation periods of gross liabilities to foreign branches plus branch participation in head office domestic loans plus branch holdings of Ex-Im securities. Among other definitional differences in the two series the Wednesday data exclude liabilities of head offices to branches in U.S. territories and possessions.

p/ Preliminary

March 19, 1971

Table 2

SELECTED EURO-DOLLAR AND U.S. MONEY MARKET RATES

Average in the Computation Period Ended	(1) Call Euro-$ Deposit 1/	(2) Federal Funds 2/	(3) (1)-(2) Differential	(4) 3-mo. Euro-$ Deposit 1/	(5) 60-89 day CD rate (Adj.) 3/	(6)= (4)-(5) Differential
1970 - 9/2	8.08	6.57	1.51	9.08	8.10	0.98
9/30	8.60	6.25	2.35	8.94	7.64	1.30
10/28	6.74	6.22	0.52	7.99	6.97	1.02
11/25	5.97	5.68	0.29	7.25	6.26	0.99
12/23	6.79	5.08	1.71	7.35	5.82	1.53
1971 - 1/20	5.58	4.26	1.32	6.34	5.36	0.98
2/17	4.92	4.01	0.91	5.66	4.48	1.18
3/17	4.43	3.58	0.85	5.15	3.90	1.25
Change from the previous period						
1970 - 9/30	+0.52	-0.32	+0.84	-0.14	-0.46	+0.32
10/28	-1.86	-0.03	-1.83	-0.95	-0.67	-0.28
11/25	-0.77	-0.54	-0.23	-0.74	-0.71	-0.03
12/23	+0.82	-0.60	+1.42	+0.10	-0.44	+0.54
1971 - 1/20	-1.21	-0.82	-0.39	-1.01	-0.46	-0.55
2/17	-0.66	-0.25	-0.41	-0.68	-0.88	+0.20
3/17	-0.49	-0.43	-0.06	-0.51	-0.58	+0.07

1/ All Euro-dollar rates are noon bid rates in the London market; adjusted for the 10 per cent marginal reserve requirement through 9/30/70.

2/ Effective rate.

3/ Offer rates (median, average of Wednesdays) on large denomination CD's by prime banks in New York City; CD rates adjusted for the cost of required reserves.