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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date: November 20, 1970.

To: Board of Governors

Subject: Eurodollar Problem.

From: Robert Solomon

CONFIDENTIAL (FR)

Attached are two memoranda dealing with the problem of Eurodollar repayments by U.S. banks.

The first memorandum, under my name, discusses the advantages and disadvantages of permitting the outflow to continue as against taking action to discourage it.

The second memorandum, prepared by Robert Gemmill, discusses alternative methods of discouraging Eurodollar outflows.

RS

Attachments.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONFIDENTIAL (FR) November 17, 1970.

TO: Board of Governors

FROM: Robert Solomon

SUBJECT: Dealing with the Overhang of Eurodollar Liabilities: Laissez-faire vs. Taking Action to Discourage Outflows.

The differential between U.S. and Eurodollar interest rates has led some banks to decide to give up a part of their reserve-free bases and is leading many other banks to think seriously about doing the same.

The reserve-free base has value to a bank insofar as the bank now believes that it may, in the future, wish to have recourse to the Eurodollar market to meet some of its needs for funds in the United States. From the bank's viewpoint this could come about as the result of a future squeeze under Regulation Q ceilings or as the result of higher costs of funds at home than in the Eurodollar market. Thus the banks are willing to pay some cost--in the form of holding Eurodollars at interest rates higher than those on domestic liabilities (Federal funds, CD's, and commercial paper)--as an insurance premium to preserve all or part of the reserve-free base.

But a number of the banks have decided that the current cost is too high and this is leading them to think seriously about reducing the size of the insurance policy.

Consideration of whether or not the Board should do something to discourage the outflow of funds should be preceded by an estimate of the likely magnitude of the outflow in the absence of Board action.

Magnitude of Potential Outflow

The outlook for the U.S. economy is such that one must expect declining short-term interest rates here for some period of time; at the least, short-term rates, after falling further from present levels, are unlikely to rise substantially for quite a while. Meanwhile, short-term yields in Europe are considerably higher than ours. Even if Europe has reached, or passed, the peak of intensity in the use of tight money during this cyclical upswing, the easing of monetary conditions there is likely to lag ours by a substantial margin. Thus European countries (notably but not only Germany and Italy) will be exerting a demand on the Eurodollar market for some time. This is a major reason why the $5 billion of Eurodollar repayments that has already occurred this year has not eliminated the differential between U.S. and Eurodollar yields.

Whether further repayment of Eurodollar liabilities by U.S. banks would be self-arresting, as the result of a decline in Eurodollar rates, thus depends importantly on the strength of demand for Eurodollar in other countries.

While no one can be sure about the duration of tight money in Europe, it is not to be ruled out that a significant differential in short-term interest rates between the United States and Europe would persist for at least a year--and possibly much longer.

A related question is this: assuming a persisting differential in interest costs between the United States and the Eurodollar market, is there a level below which the banks would hesitate to reduce their liabilities to branches and, correspondingly, their reserve-free bases?

One consideration here is that more and more banks are likely to come to the view that Regulation Q will not be used in the future as it was in 1966 and 1968-69. If the Board lifts the remaining ceilings on large CD's, and even if it uses the term "suspension," the view is more than likely to spread that the suspension is permanent. As this happens, banks will reduce what they regard as a minimum desirable reserve-free base.

On the other hand, banks are unlikely to reduce their Eurodollar liabilities to zero. For one thing, they may wish their branches to maintain a balance with the head office. Furthermore, the future is uncertain and banks will hedge their bets regarding the probable reimposition of Regulation Q ceilings.

In 1967, when credit conditions eased here, banks reduced their liabilities to branches--which had grown from $1.7 billion in January 1966 to $4 billion at the end of 1966--only moderately, from a peak of $4 billion to $3 billion. On the other hand, that period of ease was rather short-lived and it is therefore difficult to draw reliable conclusions as to bank behavior from it.

Even if there is an upward trend in the long run in liabilities to branches, banks could temporarily dip below that trend when interest rate differentials make that course profitable, just as they went far above the trend in 1969.

All things considered, it is possible to imagine a potential outflow of as much as $~~500~~ 5 billion from the present level of $9 billion. The term "potential" is used here for more than one reason: (1) to denote a possible outer-limit, (2) to indicate what could happen in the absence of an effect of this very outflow of U.S. funds on European interest rates. It is possible that the outpouring of U.S. funds, by flooding the Eurodollar market and in turn European money markets, would drive down short-term rates abroad before $6 billion flows out. But one of the presumed U.S. objectives, as discussed below, is to avoid flooding European money markets in a way that undermines the efforts of European central banks to combat inflation.

Thus while a $6 billion outflow may not be the most likely estimate, because European rates will decline more than European central banks wish them to decline, it is a possible outflow that U.S. banks might be willing to tolerate if the differential cost of Eurodollars remains relatively high.

Advantages and Disadvantages

Assuming a possible outflow over a period of 6 to 12 months of, say $6 billion--or even $4 billion--what are the disadvantages to the United States of permitting it to happen?

Disadvantages

The official settlements deficit has amounted to $7 billion in the first 9 months of 1970. This is much larger than the official settlements surplus in 1968 and 1969 combined ($4.3 billion). After 5 years--1965-69 inclusive--in which the official settlements deficit averaged out at zero, we have suddenly provided reserves to the rest of the world, in 9 months, at a rate equal to more than three-fourths of the SDR creation agreed to for a three-year period.

If this enormous rate of deficit should go on for a considerable period of time--another six months or a year--several unfortunate consequences can be foreseen.

1. Heavy conversions of foreign dollar accruals into U.S. reserve assets (IMF position, SDR, gold) which could in turn trigger off a burst of speculation against the dollar. If this happened, the reflow of dollars to foreign official reserves from the Eurodollar repayments would be magnified, since forward discounts on the dollar would encourage greater reconversions by Europeans out of Eurodollars into their own currencies and since interest arbitrage reflows would be supplemented by speculative inflows into European currencies.

2. The chances of getting agreement on further creation of SDRs by January 1973 (which requires negotiations in 1972) would become very slim. This in turn would lead to a growing view that the SDR experiment had failed and that an increase in the price of gold is necessary--not only to let the United States pay off its debts but also to put the monetary system on a "sound" basis. The progress that has been made in recent years in de-emphasizing gold and moving the international monetary system toward a managed basis might be lost.

Apart from these dire results, the United States cannot turn its back on a commitment it accepted when it promoted the SDR agreement: we accepted and, in fact, supported the proposition that the international monetary system should not depend heavily on further additions to official dollar reserves. It was agreed that it is neither in the U.S. interest nor in the interest of other countries that our official dollar liabilities should continue to increase rapidly.

3. Europeans already feel resentment at being buffeted in a magnified way by U.S. monetary policy. In 1968-69, we imposed pressures on them when we let our banks drive Euro-

dollar interest rates up to as high as 13 per cent. Now we will be pushing rates down, undermining their tight money policies and adding to their holdings of official dollar reserves.

This resentment has been a catalyst in the drive toward European monetary integration. Whether or not such integration is advantageous to the United States, the anti-American impulses behind it are not.

There are many reasons why the United States should make some effort to maintain cordial and cooperative relations with Europe and Japan. If we sit by and permit a further outflow of $4-6 billion <u>without being seen to have tried to stem it</u>, there will be a growing acceptance of the view, already held in Europe, that the United States has adopted the Friedman-Haberler-Houthakker prescription that our only duty is to try to contain inflation and maintain full employment, while the rest of the world adjusts to whatever volume of dollars flows out of the United States.

One result of a deterioration in the cooperative attitude of the Europeans--which may occur anyway if the Mills' bill gets through Congress and is signed by the President--would be less willingness of European countries to revalue their currencies when in substantial surplus.

The balance, in European minds, would tend to be tipped against such action and toward actions or non-actions that put increasing pressure on the United States.

4. Finally, it can be argued that the medium-term outlook for the U.S. balance of payments is rather favorable (see my submission to the Commission on Trade and Investment).[1/] One can imagine a gradual working down of the Eurodollar overhang over the next 2 or 3 years as the rest of our balance of payments improves. Given this prospect, one can also argue against letting the Eurodollars flow out now in massive volume. Providing an incentive to hold does not saddle us with these liabilities forever.

The very fact that the medium-term outlook is favorable argues for preventing a crisis atmosphere from being created now. After our poor domestic management in 1965-69, we may be on the road back to a sounder domestic economy and a stronger balance of payments. But we can't persuade the Europeans and the markets of this. We can only demonstrate it and that takes time. Between now and when the demonstration becomes evident there is something to be said for temporary measures to hold things (including confidence in the dollar) in place.

1/ Trade, Investment and the Balance of Payments Adjustment Process, August 6, 1970, Washington, D. C.

Advantages

Is there a case in favor of doing nothing and letting the Eurodollar liabilities run off?

1. It can be argued that, having accumulated the overhang, we have to face repayment eventually and we ought to get it behind us. A variant of this argument is that we ought to get a part of the repayment behind us, by standing still for a further outflow of, say $2 billion or so, hoping meanwhile that this will narrow the interest rate differential between U.S. and Eurodollar rates.

2. Another consideration relates to the distribution of foreign official dollar gains resulting from Eurodollar repayments by U.S. banks. A very large proportion of the increase in U.S. liabilities to foreign monetary authorities in 1970 is accounted for by Germany and Canada. For a part of 1970 Germany may have welcomed the additions to its reserves, following the enormous decline in reserves it experienced following the October 1969 revaluation. Even if Germany no longer welcomes additions to its dollar holdings (and ignoring the undermining of the Bundesbank's policy referred to earlier) there is little that Germany can do about it. Apart from buying back the $500 million of gold that it sold to the United States in the fourth

quarter of 1969, Germany is bound by the Blessing letter not to buy gold from the United States. Given the touchiness of the problems regarding U.S. troops in Europe, Germany is unlikely to ask for a revision of the Blessing letter now.

Other European countries would also share in the reserve gains reflecting a further massive outflow of Eurodollars. Belgium, Holland, Italy, Switzerland--even France and possibly Britain--could experience sizable reserve increases if another few billion of Eurodollars were repaid. But we do have reserve assets and should be ready to use them.

Conclusions

A weighing of these arguments can lead to the following judgments:

1. The concern about the undermining of monetary policy abroad is not allayed by the fact that Germany can do little about converting unwanted dollars into gold. In fact, if it became evident that the U.S. was leaning heavily on this constraint on Germany, that fact itself would worsen our cooperative relations with the rest of the world.

Numerous contacts with Bundesbank officials indicate that they would be disturbed by a massive outflow of Eurodollars from the United States, which would provide financing to German companies that find credit unavailable or too expensive in Germany.

2. The argument that the United States should be seen to be trying to moderate the impact that its changing policies have on the rest of the world is hard to challenge. When we finally announced the Eurodollar reserve requirement in mid-1969 we gained some good will and put an end to an acrimonious debate.

3. If a balance of payments crisis should occur--for whatever reason--the United States will be in a better position to deal with Europeans and therefore to see to it that the outcome of the crisis favors our long-run interests if we have a record of taking actions within our power. No one abroad in a responsible position is asking the United States to deflate excessively in order to strengthen our balance of payments. But neither European nor Japanese officials regard restrictions on capital flows as undesirable and in some circumstances they advocate such restrictions. Absence of any action by the United States to shore up a crumbling Eurodollar regulation could lead officials of other countries to believe that we think the world is on a dollar standard and do not concern ourselves with our balance of payments. If they come to this belief, they would be more likely to follow those in Europe who would like to push the continental countries back toward a gold bloc. This would hardly be a congenial environment in which to try to work out of a crisis--or, for that matter, to work on a day-to-day basis even if there is no crisis.

4. The existing attitude toward the dollar is hardly a healthy one. The improvement we see in the underlying balance of payments--and in its prospects--is not evident yet to the rest of the world or to the markets. Since we must expect some deficit next year even if there is no repayment of Eurodollars--and the deficit could be aggravated temporarily if Europe slumps after its current boom--we have a good reason to restrain dollar outflows where and when possible. This need not mean simply a delay in facing the music--if we are right in our optimistic view of the medium-term outlook. And even if we are wrong, the chances of inducing revaluations by surplus countries in Europe will be greater if we are seen to do what we can to hold down our overall deficit.

November 20, 1970

To: Board of Governors

From: Division of International Finance
(Robert F. Gemmill)

Subject: Alternative Methods of Discouraging Euro-dollar Outflows

CONFIDENTIAL (FR)

The Board may seek to induce banks to retain Euro-dollar borrowings by reducing the costs of borrowings up to specified limits, by increasing the benefits to be derived from retention of specified amounts of borrowings, and by use of moral suasion.

This memorandum examines the essential elements of four proposals for reducing costs of or increasing benefits from retention of Euro-dollar borrowings. Any of these proposals (with the possible exception of #4) could be supplemented by moral suasion, and any of them could be supplemented by an announcement that the marginal reserve requirement above reserve-free bases could be raised above 10 percent in the future.

1. The method with the greatest prospect for success in reducing Euro-dollar outflows is the establishment of a special reduced rate of reserve requirement on a part of a bank's demand deposits equal in amount to the bank's Euro-dollar borrowing up to specified limits. This method would reduce the cost of Euro-dollar borrowing, and need not depend for success on banks' expectations of future benefits from use of reserve-free bases. Initially, the rate would be set at 10 per cent for reserve city banks; at the present cost of reserves this

special reduced rate of requirement would save a bank about 40 basis points on the cost of Euro-dollar borrowing. The principal argument against such a measure is the precedent-setting nature of such an amendment to Board regulations.

2. A number of proposals would depend importantly for success on banks' expectations regarding future reserve-free borrowings. One of these proposals would provide the banks with leeway to reduce Euro-dollar borrowings to a specified extent below the level of the reserve-free historical base with no loss of that base. The cost to banks of retaining the full reserve-free historical base would be reduced, and banks that were planning to reduce Euro-dollar borrowings below the new level specifically authorized as leeway might limit their reduction in borrowings in order to preserve the reserve-free base. This proposal would probably sanction some repayments that would otherwise not occur; it might, therefore, have an uncertain balance of payments impact. Moreover, it would tend to perpetuate and strengthen the role of reserve-free bases.

3. Another proposal would increase the benefits to banks from retention of the full amount of their historical bases by establishing a new, higher reserve-free base for banks that retained Euro-dollar borrowings at the historical base level. Reserve-free bases would thus be expanded (e.g. to 120 per cent of current levels). This proposal would be successful only if banks attached a reasonably

high probability to the prospect of using the expanded reserve-free base in the future. Variants of this proposal would involve a combination with #2, above.

4. The Board could attempt to reinforce the lock-in effect by applying the automatic downward adjustment feature to minimum bases (3 per cent of deposits for banks with foreign branches) as well as to historical bases. This might dissuade some banks from relinquishing historical bases and repaying borrowings below the level of minimum bases; it might also induce some banks now using minimum bases to increase their borrowings to preserve these reserve-free bases. A moderate net balance-of-payments gain could be expected. This proposal would tend to reduce the role of reserve-free bases, by eliminating all bases not used. The principal drawback would be the potential inequity involved in withdrawal of reserve-free bases from banks that were planning to expand their foreign branch operations gradually in future years. This proposal could be combined with #1. However, it would not appear equitable to combine a probable reduction in minimum bases with measures (#2 and/or #3 above) that enhance the status of reserve-free historical bases.

5. The Board could make it clear to the banks that the marginal reserve requirement on borrowings above the reserve-free base might be increased above 10 percent in the future. This would presumably increase the present value of retaining reserve-free bases

for those banks that have some expectation of resorting to future Euro-dollar borrowings. This measure could be combined with any of the other proposals.

6. The Board could, in addition, make a direct statement to the banks pointing out the adverse effects of a substantial reduction in outstanding Euro-dollar borrowings, and calling for restraint in reducing these borrowings. The success of such an appeal might be enhanced if it were accompanied by an action that provided the banks with some tangible benefit, which would represent a quid pro quo. Thus, moral suasion might successfully be used to reinforce any of the first three proposals outlined above. (Since #4 provides no benefits to banks, moral suasion would probably have relatively little impact in combination with that proposal.) It might also be combined with Board action to place Regulation Q ceilings completely on a standby basis, if that action were to be taken on domestic grounds. However, it should be noted that such action regarding Regulation Q would probably contribute to readiness of banks to repay Euro-dollar borrowings.

The first four proposals are examined in more detail below. The impact of the various proposals can best be illustrated by indicating the way in which they change a simplified example of the cost-benefit calculation confronting an individual bank under present regulations.

Cost benefit calculation under present regulations.

(a) Bank A is assumed to have an historical base of $100 million and borrowings of the same amount. If this bank expects that over the next year Euro-dollar rates will average 1 percentage point higher than the rate on alternative domestic liabilities, and if in the absence of the lock-in effect, the bank would reduce its outstanding Euro-dollar borrowings to $60 million in the coming year, the bank's expected cost of retaining the historical base for the coming year would be $0.4 million (1 per cent of $40 million). If the bank expects to have to resort to Euro-dollar borrowing again in the second year, retention of the historical base would save it roughly 1 percentage point (assuming market rates on alternative sources of funds of roughly 10 per cent) on $40 million of its expected Euro-dollar borrowings--that is, about $0.4 million.

Under these circumstances, the bank would doubtless decide that the investment of $0.4 million to retain the historical base was worthwhile, since the investment required to retain the historical base might well yield returns beyond the second year as well as the return of $0.4 million in that year.

(b) But, if the bank had only a relatively remote expectation of using Euro-dollar borrowing in the second year--perhaps only a 50 per cent chance--then the expected return would be less: if the bank weighted the return by the probability, the return might be estimated at $0.2 million. Under these circumstances, the bank might decide that the immediate cost of retaining the historical base was too high.

This cost calculation will be changed in various ways by the proposals outlined earlier.

Special reduced rate of reserve requirement. Under this proposal, the Board would amend Regulation D to provide that reserve city banks would maintain reserves of 10 per cent against an amount of demand deposits equal to their Euro-dollar borrowings (compared to a regular requirement of 17-1/2 per cent.) The percentage could be raised or lowered if experience indicated that a different rate of requirement would be better suited to Board objectives.

The proposal would, in effect, provide that the Government (through the Federal Reserve) share a part of the cost to banks of retaining Euro-dollar borrowings in order to protect the balance of payments from a massive outflow of short-term funds.

A rate of requirement of 10 per cent would release 7-1/2 cents of reserves for each dollar of Euro-dollar borrowing covered; at the present cost of reserves, a bank would save about 40 basis points on each dollar of such borrowings. At present banks can obtain call Euro-dollars and very short-term maturities at rates very close to those on Federal funds; for maturities of around 3 months, the cost of Euro-dollars exceeds that of CD's with comparable maturities by 3/4 percentage point or more. In relation to these magnitudes, a cost saving of something less than 1/2 percentage point would be a significant one; the excess cost of Euro-dollar borrowings of certain maturities might well be completely eliminated.

In terms of the illustration presented above, the amendment would reduce the present cost to Bank A of retaining Euro-dollar borrowings from about 1 percentage point to about 60 basis points; the net cost of retaining the reserve-free base would thus decline from $0.4 million to $0.24 million. Under these circumstances, a bank that estimated the potential return from a reserve-free base in the second year at $0.2 million (paragraph (b), page 5) might well retain Euro-dollar borrowings to preserve its base.

Adoption of a selective reserve requirement based on Euro-dollar liabilities might make it more difficult for the Board to resist proposals for special reserve requirements based on desirable social purposes--for example, a lower reserve requirement to the extent that banks finance housing. One answer to this is that the present proposal applies only to the composition of bank liabilities and has no effect on the composition of assets. A second point is that the proposed amendment would be designed to benefit the economy generally (rather than to favor any particular sector of the economy) by strengthening the balance of payments.

Leeway for banks to reduce Euro-dollar borrowings with no loss of historical base. An amendment of the lock-in effect to permit banks to reduce Euro-dollar borrowings to a limited extent without loss of reserve-free historical bases would represent sanctioning of some repayments in order to prevent greater repayments. For example, the Board might provide that banks could reduce borrowings to 90 per cent of the current reserve-free historical base level by the end of 1970, and to 80 per cent of the current base by mid-1971, without sustaining any loss of current reserve-free bases. The amount of leeway to be provided would depend upon an assessment of potential repayments in the absence of Board action.

In the illustrative cost-benefit calculations presented on page 5 the amendment of the lock-in effect would reduce the cost of retaining the reserve-free historical base.

> In the earlier example, Bank A would have reduced its borrowings from $100 million to $60 million in the absence of the lock-in effect, and the cost to it of retaining its reserve-free base for one year was calculated at $0.4 million (1 percentage point applied to $40 million of borrowings retained solely to preserve the reserve-free base.) Unless expected future benefits approximated this amount Bank A might well repay $40 million of Euro-dollars.
>
> If the Board were to sanction a reduction in borrowings to 80 per cent of the reserve-free base (a leeway of 20 per cent) Bank A might cut its borrowings to $80 million rather than going all the way to $60 million; the cost of retaining the reserve-free base would then be $0.2 million (1 percentage point applied to the $20 million of borrowings retained for the purpose of holding the historical base.) By permitting a reduction of $20 million, the amendment of the lock-in effect might change the cost-benefit calculation for Bank A sufficiently to avert net repayments of $20 million.

If most banks were in roughly similar positions with roughly similar expectations, the Board might be able to establish a level of leeway that would permit a tolerable volume of repayments, while still protecting the balance of payments. However, Euro-dollar practice has varied substantially among banks, and we have no reason to expect relative uniformity in policies with respect to repayments. The amendment under consideration therefore runs a significant risk of sanctioning repayments by some banks that would otherwise not likely be made. This result occurs in part because a bank would no longer obtain any benefit from retaining borrowings above the minimum level sanctioned in the amendment; repayments would continue so long as Euro-dollars involved even a slightly higher cost than domestic funds.

For each 10 percentage points of leeway provided banks, there would be a reduction in borrowings of about $1 billion. Four banks that earlier indicated plans to relinquish portions of their reserve-free bases planned an average reduction of 30 per cent. It appears probable that leeway of 20-25 percent would have to be provided in order to forestall full repayments according to plan by these banks, if the Board were to resort to the amendment under consideration.

Board sanction of a net repayment of $2-2-1/2 billion of Eurodollar borrowings would not necessarily be regarded by foreign central banks as an adequate measure to stem reflows. Thus, there is no assurance that this type of amendment of the lock-in effect would provide the desired balance of payments benefits.

Moreover, the amendment should be evaluated against a long-term objective of placing all banks on the same footing with respect to reserve-free liabilities--and probably ultimately eliminating all reserve-free bases--as soon as this could be achieved without sacrificing an important policy goal. The Board has no reason to provide large money market banks with "permanent" reserve-free bases, apart from balance-of-payments objectives. Thus a reduction in borrowings of $2 billion that resulted from failure of the Board to take action (and that resulted in a corresponding reduction in reserve-free bases of the banks involved) would clearly be preferable to a reduction of $2 billion under an amended lock-in effect that left the historical bases intact.

Expanded reserve-free bases. Expansion of reserve-free bases (e.g. to 120 per cent of the current historical base) for banks that maintained borrowings at current historical base levels would avoid the sanctioning of net repayments, and thus avoid the potential balance of payments risks involved in the preceding method. But expansion of reserve-free bases would only be successful if banks attached a high probability to the prospect of using the reserve-free base.

By and large, it appears that banks that are now relinquishing portions of their reserve-free historical bases are acting on the expectation that they would have access to other sources of funds on terms no worse than (or not much worse than) those on which they could borrow Euro-dollars. For example, these banks are assuming that there is small likelihood of a squeeze on bank liquidity through operation of Regulation Q ceilings, as occurred in 1969. Such banks would attach a relatively small probability to advantageous future use of Euro-dollars to bolster liquidity.

The proposal would seek to overcome this small probability (in the calculations of an individual bank) by allowing the prospective benefit, if that small probability should be realized, to be obtained on a larger volume of borrowing. By and large it would appear that the small probability would be governing--if a bank has little or no expectation of using its reserve-free historical base, it is unlikely to be influenced significantly by a measure that provides it with a larger reserve-free base.

It might be noted that these banks' desires to preserve reserve-free bases would probably not be significantly strengthened by the Board's giving an indication that the marginal reserve requirement on Euro-dollar borrowings might exceed 10 per cent in the next period of credit stringency. Only banks that attach a significant probability to the future use of Euro-dollars would be affected by that expectation.

Even though expansion of reserve-free bases would probably have a relatively small impact on banks' decisions to repay borrowings, and thus might not avoid some curtailment of historical bases, there would be disadvantages in having Board regulations appear to perpetuate and reinforce the inequities inherent in reserve-free historical bases.

Application of automatic downward adjustment to minimum bases. The Board could reinforce the lock-in effect by applying the automatic downward adjustment feature to minimum bases (currently 3 per cent of deposits for banks with foreign branches and 4 per cent of deposits for banks that borrow directly from foreign banks),[1/] with an appropriate grace period to permit banks to adjust borrowings to the new regulations. The extension of the lock-in effect to minimum bases could not be expected to influence repayments by banks generally; instead, its impact would be to encourage banks currently using minimum bases to raise

1/ In any even the staff would propose that the Board amend Regulation D to establish the same minimum base for borrowings directly from foreign banks as for borrowings through foreign branches.

borrowings to levels equal to 3 per cent of deposits, and to discourage repayments by banks now using historical bases that are so near their minimum bases that they would be able to reduce borrowings substantially without significant loss of future benefits. (Two banks with historical bases only slightly higher than minimum bases have already shifted to minimum bases; their aggregate borrowings in the most recent computation period were $13 million, compared to aggregate historical bases of $38 million.)

The potential balance of payments benefit from the measure might be conservatively at roughly $1/2 billion, representing in approximately equal measure (a) increased borrowing by banks using minimum bases, and (b) retention of existing borrowings by banks using historical bases, which might otherwise shift to minimum bases. This balance of payments gain would represent a partial offset to reductions that would occur in borrowings by banks with Euro-dollar borrowings (and historical bases) well in excess of minimum bases if no other action were taken. The balance of payments gain could be greater if many banks using minimum bases acted to protect their bases; aggregate bases of these banks total almost $1-1/2 billion.

An issue to be weighed is the potential inequity involved in removing minimum bases to the extent that they are not used. The minimum bases were established as a measure of equity for banks that were not large-scale borrowers of Euro-dollars in May 1969. The choice of 3 per cent of deposits represented a purely pragmatic judgment as to a figure which (while not negligible) would not permit an excessive reserve-free inflow at a time when it was Board policy to discourage the inflow. Relatively few banks are now borrowing Euro-dollars under minimum bases to supplement domestic liquidity positions; if it is not Board policy to provide all banks with rělatively permanent access to minimum amounts of Euro-dollar borrowings for liquidity purposes, it would be appropriate to eliminate bases for banks that do not use them. Banks that had not yet established foreign branches might be given a grace period--e.g., 90 days--after establishment of an initial foreign branch in which to establish a minimum base, if required on grounds of equity. Any bank could, of course, borrow directly from foreign banks and thereby preserve a minimum base under Regulation D.

A different issue of equity arises to the extent that branch balances with head offices were required as working balances by the branches. Banks that had not yet developed an extensive foreign branch business would be at a disadvantage compared to those with substantial reserve-free branch balances at head offices. There is some indication, however, that only relatively small branch balances with head offices are essential to effective branch operations. If so, the potential inequity would be relatively small, and it might be judged a cost worth bearing in the interest of (a) achieving some balance of payments gain and (b) reducing the role of reserve-free bases in the banking structure.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 23, 1970.

To Board of Governors

Subject: Coombs' Proposal re Eurodollar Flows.

From Robert Solomon

CONFIDENTIAL (FR)

Attached to this memorandum is a letter, from Mr. Coombs to Chairman Burns, outlining a proposal for dealing with Eurodollar repayments by American banks. The Board will no doubt wish to consider this proposal along with those that are outlined in Mr. Gemmill's memorandum of November 20 (transmitted under cover of a note from me as of the same date).

Attached also is a note outlining the advantages and disadvantages, as I see them, of Mr. Coombs' proposal.

RS

Attachments.

ATTACHMENT I

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045

AREA CODE 212 732-5700

CHARLES A. COOMBS
SENIOR VICE PRESIDENT

November 19, 1970

CONFIDENTIAL (F.R.)

The Honorable Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Chairman:

As you requested, there follows a rough outline of a technical arrangement designed to insulate somewhat the European money markets and central banks against the effects of a continuing repayment of U. S. bank liabilities to their European branches.

As you may know, the BIS has in a number of operations raised Swiss francs on the Zurich money market to provide financing for longer term Swiss franc credits to the U. S. Treasury in the form of Swiss franc denominated securities. It has occurred to me that this technique might be adapted to the Eurodollar market in such a way that the BIS could absorb new dollars flowing onto the market as the U. S. banks repay debt to their branches, mainly in the relatively short-term maturity range. Such Eurodollars with maturities ranging up to, say, 30 days, thus absorbed by the BIS might then be reinvested by the BIS in a U. S. dollar certificate with a maturity of, say, 15 to 24 months with the option, which is present in most foreign currency securities, of a call of two days' notice by either party.

At present, we see a sequence of U. S. bank repayment of Eurodollar debts with the funds thereby released moving on to German industrial borrowers, in turn necessitating Bundesbank purchase of the dollars for subsequent investment in U. S. Treasury bills. This inflates both the German money supply and the dollar reserves of the Bundesbank, but in the end provides a source of dollar financing for the U. S. Treasury.

If other European central banks acquire the dollars, even more difficult operational problems could well occur. If, on the other hand, the BIS could more or less passively absorb the new dollars in the short maturity range coming onto the Eurodollar market, the detour of such funds to the German market and the Bundesbank would be avoided, but the U. S. Treasury would still have an equivalent source of dollar financing.

Two problems immediately come to mind. First, whether an appropriate rate relationship between BIS short-term borrowings on the Eurodollar market and the rate available on subsequent BIS investment in a longer-term U. S. security could be maintained. Secondly, there is the related problem whether the BIS might find itself from time to time unable to fully renew its short-term borrowings on the Eurodollar market.

The answers to these questions would necessarily involve exploration of the possibilities of such an arrangement with the BIS itself, but I would think it likely that continuing payoffs by U. S. banks of Eurodollars should exert more downward pressure on the short than on the longer Eurodollar maturities. Regarding the risk that the BIS might find itself unable to renew fully earlier short-term borrowings in the Eurodollar market, any resultant temporary shortfall in the BIS' cash position could be covered by their drawing on the $1 billion swap line they have with the Federal as an alternative to calling its investment in a U. S. Treasury certificate.

Such BIS absorption of some of the return flows of Eurodollars from U. S. banks would obviously tend to keep the short-term Eurodollar rate somewhat higher than it would otherwise be. The same result would occur, of course, if new regulatory arrangements were introduced which made it profitable for the U. S. banks to maintain their borrowings of Eurodollars at or about their present level.

May I say how pleased all of us were to have the opportunity to welcome you to this Bank today. I thought your comments to our directors were most helpful in many ways.

With best regards.

Sincerely,

Charlie

Charles A. Coombs

ATTACHMENT II

Advantages and Disadvantages of Mr. Coombs' Proposal

The proposal is presented in Mr. Coombs' letter of November 19, 1970 to Chairman Burns (Attachment I).

A thorough analysis of the proposal must await answers to a number of questions that can be raised about it. Among these questions are:

1. Would the BIS be content to hold additional dollar claims--that could amount to several billions of dollars--without an exchange rate guaranty or gold value guaranty? It is difficult to see how the United States could give such a guaranty to the BIS without giving it to foreign central banks on their dollar holdings.

2. Would the BIS insist on a two-day call provision on the 15 to 24 month certificates it would buy from the U.S. Treasury?

3. How would the interest rate on the 15 to 24 month Treasury certificates be determined?

Advantages

1. The proposal would keep dollars out of the hands of foreign central banks by siphoning the funds that U.S. banks were repaying to the Treasury.

2. By standing ready to absorb short-term Eurodollars, the BIS would be keeping interest rates on short maturity Eurodollars from falling. This in turn would help insulate monetary conditions in European money markets; that is, it would lessen the extent to which monetary restraint in Europe was undermined by the Eurodollar repayments by U.S. banks.

3. The proposal would be a first step toward multilateral action to regulate the Eurodollar market--a step that many observers have been calling for. The BIS, representing the central banks of the major countries, would be acting in their behalf, in cooperation with the U.S. Treasury, to shield other countries from the impact of a massive reflow of Eurodollars from U.S. banks.

Disadvantages

1. Under the proposal, banks could repay Eurodollars in volume but the self-arresting mechanism of downward pressure on Eurodollar rates would not be operative. The BIS would provide a floor, or at least a cushion, and thus the banks' incentive to repay might remain undiminished. It is true that a part of the intention of the other proposals before the Board is to limit downward pressure on Eurodollar rates by reducing the incentive banks have to repay their borrowings. The difference between the present proposal and those in Mr. Gemmill's memorandum is that insofar as the latter proposals failed to stem Eurodollar repayments, a self-arresting mechanism would be at work.

2. The proposal would keep dollars out of the hands of foreign central banks but it would put them in the hands of the BIS. If the BIS had a two-day call, as suggested by Mr. Coombs, the U.S. authorities would be presenting the BIS with rather weighty leverage against the United States.

3. The proposal depends on a positive yield-curve in the Eurodollar market, so that the BIS can borrow short at relatively low interest rates and re-lend to the U.S. Treasury at higher rates. Several problems could arise in this connection, depending on the understanding between the Treasury and the BIS on the determination of the interest rate on the certificates. For example, if short-term Eurodollar rates should rise toward or above the rate the Treasury is paying the BIS, the BIS would be likely to exercise its two-day call.

4. Although the arrangement would keep dollars out of the hands of foreign central banks, it would not prevent the Eurodollar repayments from showing up as an official settlements deficit in the balance of payments statistics, since the BIS is regarded as an official reserve holder. Furthermore, BIS holdings of dollars would no doubt be counted as official reserves in the negotiations regarding the next creation of SDRs. An attempt to change the balance of payments accounting practices would invite the charge that, once again, we are window-dressing our statistics.

AGENDA ITEM # ~~4~~ 5

NOV 25 1970

(DATE) 11/27

CHAIRMAN BURNS

#3

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

11/30

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 25, 1970.

To Board of Governors

From Robert Solomon and Robert Gemmill

Subject: Governor Mitchell's Eurodollar Proposal.

CONFIDENTIAL (FR)

Attached is a commentary--hastily prepared--on Governor Mitchell's proposal for dealing with the Eurodollar problem.

Attachment.

CONFIDENTIAL (FR) November 25, 1970.

The purpose of this memorandum is to examine Governor Mitchell's proposal that the Federal Reserve stand ready to offer branches of American banks an asset that would absorb the funds they receive as repayments from their head offices. The asset offered by the Fed would bear a rate of interest attractive enough to induce the branches to continue to maintain their liabilities to Eurodollar depositors.

Under this proposal, U.S. banks would continue to have the option of maintaining their reserve-free bases, or a part of them, but there would be no additional inducement to the banks. As banks decided to let their liabilities to branches run down, the branches would be offered an alternative asset by the Federal Reserve. As a result the Federal Reserve would acquire liabilities to U.S. branches abroad.

Mr. Holland has suggested that the Federal Reserve might implement the proposal by carrying out matched sale-purchase agreements with the banks. Thus the Federal Reserve would regularly offer securities for repurchase in 15 or 30 days, the combined operation providing a yield to the banks sufficient to attract the amount of funds the Federal Reserve wishes to absorb. In order to achieve its objectives, the plan should ensure that the funds so invested represented the proceeds of Eurodollar borrowings, either by a foreign branch of a U.S. bank or by a U.S. bank directly.

In order for the plan to be successful, the asset in which Eurodollars would be invested must not be readily transferable from one investor to another--i.e., it cannot be one that could be readily resold to domestic U.S. investors--and it must be one that cannot readily be acquired by U.S. investors except with Eurodollars. For the transferability to be limited, it would be necessary that U.S. Government securities sold by the Federal Reserve to foreign branches of U.S. banks (or to other banks) be held in custody by the Federal Reserve.

<u>Questions about the Proposal</u>

1. What are the various implications of the Federal Reserve taking a position in the Eurodollar market? The Federal Reserve would become a debtor, perhaps up to some billions of dollars, to the foreign branches of American banks. Would this action highlight the weakness of the dollar? The extent of Federal Reserve liabilities to the Eurodollar market would be a readily measurable quantity that would be identified as overhanging the market and that many observers would add to the measured official settlements deficit. The present level of U.S. bank liabilities is also an overhang but no one knows how much of these liabilities is unwillingly held.

2. How will it be possible to limit the offer by the Federal Reserve so that U.S. resident banks or others do not have access to the preferential arrangement? The scheme could be limited so that

only branches receiving repayment from head offices were eligible. For U.S. banks without branches, presumably the special RP's would be offered up to the extent of their borrowings from the Eurodollar market. It would be necessary to supervise the arrangement so that U.S. banks did in fact retain Eurodollar borrowings up to the amount of the preferential RP's.

<u>Advantages</u>

In addition to the first two advantages that were cited for Mr. Coombs' proposal (in my memorandum of November 23), the following advantages might be realized:

1. One advantage of RP's with frequent roll-overs, is that the Federal Reserve could take advantage of changes in Eurodollar interest rates for different maturities and over time. As compared with a special reduced reserve requirement, the Federal Reserve would have increased flexibility in adjusting the incentive offered to banks.

2. The proposal would help to eliminate <u>historical</u> reserve-free bases. To the extent that banks gave up their bases and permitted their branches to invest in the special RP's, historical bases would decline. Furthermore, at some future point, historical bases might be reduced sufficiently so that a uniform reserve-free base (related to, say, total deposits) could be introduced.

<u>Disadvantages</u>

1. The plan would have an effect on bank reserves. As the Federal Reserve sold securities (with a commitment to repurchase) it would absorb reserves and the Desk would have to offset this effect.

2. This plan would be more costly to the U.S. Government than the proposed reduced reserve requirement against demand deposits. Under the latter scheme, the Federal Reserve would share with the banks the differential between the interest rate on CD's and the interest rate that branches pay on Eurodollar deposits. But the differential would not have to be eliminated, since banks attach some value to the reserve-free base. Under Governor Mitchell's proposal, the Federal Reserve would be trying to attract the funds that become available as banks give up their reserve-free bases. Thus the yield on the matched sale-repurchase deals would have to be at least equal to what branches are paying for Eurodollar deposits. Furthermore, the Federal Reserve would be borrowing at the same interest rate that banks pay for deposits in the Eurodollar market, whereas normally the Government can borrow at lower rates, just as the Treasury bill rate is below the rate on CD's.

3. As indicated earlier, eligibility of purchasers of the RP's would probably have to be limited in order to prevent funds from moving from the United States into the RP's. Thus just as the special reduced reserve requirement would benefit mainly (though not only) the largest banks, so would this proposal. In both proposals,

however, any smaller bank that wished to acquire Eurodollar liabilities could benefit from the incentive offered.

//STRICTLY CONFIDENTIAL (FR) //

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE 12/1/70

TO Chairman Burns

FROM ROBERT SOLOMON

The attached memorandum reports on the latest data on the Eurodollar positions of U.S. banks.

RS

Attachment.

STRICTLY CONFIDENTIAL (FR)

To: Mr. R. Solomon

From: Robert C. Bradshaw and Ralph W. Smith

Subject: Change in Gross Liabilities to Foreign Branches in the week ended November 25, 1970 and in Average Wednesday Gross Liabilities for the Four Weeks Ended 11/25/70 from the Four Weeks Ended 10/28/70.

Gross liabilities of U.S. banks to their own foreign branches declined $332 million in the week ended Wednesday, November 25, 1970, reducing total gross liabilities to foreign branches (including domestic loan participations) to $8.74 billion.

The most recent four-week computation period for calculation of required reserves against Euro-dollar positions ended Wednesday, November 25. The attached table shows the change in (average) gross liabilities to foreign branches for the four Wednesdays through November 25, 1970, compared to the four Wednesdays through October 28, 1970 (the last day of the previous computation period)

The table also shows this change in (four Wednesday average) gross liabilities to foreign branches as a percentage of reported daily average net liabilities to foreign branches plus assets sold to foreign branches in the computation period ended October 28, 1970. It should be noted that the changes calculated from Wednesday gross liabilities data alone have, in our past experience, often not accurately reflected changes in daily average net liabilities.

STRICTLY CONFIDENTIAL (FR)

STRICTLY CONFIDENTIAL (FR)

Change in (Four Wednesday) Average Gross Liabilities to Foreign Branches from the Computation Period Ended October 28, 1970 to the Computation Period Ended November 25, 1970. (Millions of dollars)

Historical Base Banks	Avg. Net Liab. to Foreign Branches 1/ 10/1/70 to 10/28/70	Change in Avg. Gross Liab. to Branches 2/ through 11/25/70	Per cent Change
First Nat. Boston	450	-33	-7
The Bank of New York	81	--	--
Banker's Trust	810	-137	-17
Chase	2,240	-112	-5
Chemical	854	-30	-3
F.N.C.N.Y.	1,182	-244	-21
Irving	558	-142	-25
Mfg. Han.	586	+53	+9
Marine	281	+2	+1
Morgan	1,255	-13	-1
Mellon	126	-8	-6
Union, L.A.	96	+3	+3
Bk. of America	762	+7	+1
F.N. of Chicago	352	-17	-5
Continental Ill.	670	-41	-6
Total	10,304	-712	-7
All other banks	416 3/	-87	-21
All banks	10,706	-799	-8

1/ As reported on a daily average basis for the computation period ended 10/28/70; also includes assets sold to foreign branches.

2/ Change calculated from average Wednesday gross liabilities in the four weeks ending 11/25/70, compared to average Wednesday gross liabilities in the four weeks ended 10/28/70; F.R.B.N.Y. series.

3/ Based on incomplete data for banks using a 3 per cent of deposits base.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE WO4-2041

FOR IMMEDIATE RELEASE December 3, 1970

THIRD QUARTER REPORT ON PURCHASES AND SALES OF GOLD AND OTHER RESERVE ASSETS (JULY-SEPTEMBER 1970)

U. S. reserve assets declined by $801 million in the third quarter to $15.5 billion. The change in the components during the quarter and the amounts held on September 30 were as follows: (In millions of dollars.)

	Change (3rd Qtr.)	Balance Sept.30,1970)
Gold	$ -395	$11,494
SDR	+34	991
Foreign Exchange	-34	1,098
Res. Pos. in IMF	-406	1,944
	$ -801	$15,527

The major changes, as indicated, were reductions in gold holdings and in the U. S. position (drawing rights) in the International Monetary Fund. The U. S. position in the Fund declines as the Fund builds up its holdings of dollars. The Fund accumulated dollars as a number of countries made repayments to the IMF of their earlier drawings and also when the IMF acquired dollars through the sale of gold and SDR to the U. S. Treasury.

Transactions in gold are as set forth in the attached table. The largest transactions were those with the IMF, which were explained in the Treasury Press Release of September 16, involving the distribution to the U. S. of $132 million in gold and SDR and the resale by the Treasury of $400 million in gold to the IMF.

K-542

The gold sales in the third quarter listed in the attached table, other than those to the Netherlands, Switzerland and Muscat, but including the nearly $60 million sale to the Republic of China, were all to countries which had gold payments to make to international institutions.

Attachment

UNITED STATES NET MONETARY GOLD TRANSACTIONS WITH FOREIGN COUNTRIES AND INTERNATIONAL INSTITUTIONS

January 1-September 30, 1970
(In millions of dollars at $35 per fine troy ounce)

Area and Country	First Quarter	Second Quarter	Third Quarter	Total
Europe				
Denmark	-	-	-2.0	-2.0
Greece	-	-0.3	-	-0.3
Iceland	-0.1	-0.1	-0.1	-0.2
Ireland	+2.2	-	-	+2.2
Malta	+2.5	-	-	+2.5
Netherlands	-	-	-20.0	-20.0
Spain	-	-	+50.8	+50.8
Switzerland	-	-	-50.0	-50.0
Turkey	-0.3	-2.1	-5.5	-7.8
Vatican City	-	+1.2	-	+1.2
Yugoslavia	-	-	-0.4	-0.4
Total	+4.4	-1.3	-27.2	-24.1
Latin America				
Argentina	-5.0	-	-	-5.0
Bolivia	*	-	-	*
Chile	-0.8	-0.5	-0.2	-1.5
Colombia	-1.1	-0.1	-	-1.2
Dominican Republic	-0.1	-0.1	-0.1	-0.3
El Salvador	-0.1	-0.1	-0.1	-0.2
Guatemala	-0.1	-0.1	-0.1	-0.3
Haiti	-	-0.1	-	-0.1
Nicaragua	-	-	*	*
Peru	-0.1	-0.2	-3.4	-3.7
Uruguay	-0.1	-8.0	-	-8.1
Total	-7.3	-9.1	-3.9	-20.3
Asia				
Afghanistan	-0.2	-0.2	-	-0.3
Burma	-	*	+20.8	+20.8
Ceylon	-	-	-0.4	-0.4
China	-	-	-59.8	-59.8
Cyprus	-	-	*	*
Indonesia	-	-0.8	-0.9	-1.7
Korea	*	-	-	*
Kuwait	+24.9	-	-	+24.9
Muscat	-	-	-1.1	-1.1
Pakistan	-0.4	-	-	-0.4
Philippines	+1.2	-0.4	+2.7	+3.5
Syria	*	*	*	-0.1
Yemen Arab Republic	-1.5	-	-	-1.5
Total	+24.0	-1.4	-38.7	-16.1
Africa				
Cameroon	-	-0.2	-	-0.2
Central African Republic	-	-0.1	-	-0.1
Gabon	-	-0.1	-	-0.1
Ghana	-	-0.6	-0.2	-0.8
Guinea	*	*	*	*
Liberia	-0.1	-	-	-0.1
Morocco	-0.2	-	-	-0.2
Rwanda	-	-	*	*
Sierra Leone	-	*	*	*
Sudan	-0.4	-0.4	-0.4	-1.2
Tunisia	*	-0.2	-0.2	-0.4
United Arab Republic	-	-0.6	-2.7	-3.3
Total	-0.7	-2.2	-3.5	-6.5
IMF	+23.7	-	-321.7	-298.0
TOTAL	+44.0	-14.0	-395.1	-365.1

*Under $50,000.
Figures may not add to totals because of rounding.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE WO4-2041

December 3, 1970

FOR IMMEDIATE RELEASE

Commendation of Two Top Bank Officials

Acting Secretary of the Treasury Charls E. Walker today sent separate telegrams to Mr. Richard P. Cooley, President of Wells Fargo Bank in San Francisco, and Mr. A. W. Clausen, President of Bank of America in San Francisco, commending them for their reduction in consumer lending rates:

> "Secretary Kennedy, who is abroad, asked me to commend your reduction in consumer lending rates as both consistent with underlying market conditions and very much in the public interest. If emulated by business and labor in general in their price and wage decisions, the road back to high employment and growth, without inflation, would be both shorter and smaller."

/s/Charls E. Walker
Acting Secretary
of the Treasury

K-541

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 7, 1970.

To Board of Governors

Subject: U.S. banks' Euro-dollar positions.

From Ralph W. Smith & Robert C. Bradshaw (through Mr. Hersey)

1. Attached is a table showing the positions of the nine historical-base New York City banks with respect to their reserve-free bases for the computation period ended November 25. Four banks gave up a total of $521 million of their combined reserve-free base in this period. Chemical Bank was the only bank to make an initial cut in its base during that computation period, reducing it by $35 million.

Detail on banks outside New York will not be available for several days.

2. In the three days (December 1-3) following the Board's action raising marginal reserve requirements on Euro-dollars, U.S. banks increased their liabilities to their own foreign branches by $978 million, despite the high cost differential between Euro-dollars and domestic funds during this period. While the daily series is quite volatile, this is nevertheless a very large increase, and perhaps indicative of the effect of the Board's action.

Attachment

STRICTLY CONFIDENTIAL (FR) PRELIMINARY DATA

Net Liabilities of New York City Banks to Foreign Branches Plus Assets Sold to Foreign Branches
(Four Week Computation Period Ending November 25, 1970)
(millions of dollars)

	Reserve-free base 1/			Change from previous computation period	Four weeks ending: November 25, 1970		October 28, 1970
	May 1969	Computation period ending 2/ 10/28/70	11/25/70		Daily average outstanding	Excess over reserve-free base	Excess over reserve-free base
The Bank of New York	84.1	79.2			80.2	1.0	1.6
Bankers Trust Company	998.3	810.3	711.9	-98.4	711.9	--	--
Chase Manhattan	2,239.2				2,251.4	12.2	0.8
Chemical	853.4		818.7	-34.7	818.7	--	0.8
First Nat'l. City, N.Y.	1,453.4	1,182.2	901.3	-280.9	901.3	--	--
Irving Trust Company	838.9	358.1	451.5	-106.6	451.5	--	--
Manufacturers Hanover	583.5				586.5	3.0	2.6
Marine-Midland Grace	280.9	270.3			283.3	13.0	10.4
Morgan Guaranty	1,269.8	1,249.6			1,252.5	2.9	5.7
Total	8,591.5	7,825.8	7,305.2	-520.6	7,337.3	32.1	21.9

1/ Four week daily average of net liabilities to foreign branches plus assets sold to foreign branches.
2/ No entry indicates that the reserve-free base in the previous period shown was still in use.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE December 9, 1970.

TO Chairman Burns

FROM ROBERT SOLOMON

Attached are two tables that you requested:

1. The main elements of the U.S. balance of payments in recent years.

2. The reserve assets and major liabilities of the United States.

RS

Attachments.

Summary of the U.S. Balance of Payments
(millions of dollars; deficit (-))

	1960-65 Average	1966-68 Average	1969	1970 Jan-Sept 1/	1970 Year(est.)
Over-all balances as published					
Liquidity basis	-2,547	-1,577	-7,012	-3,962	-4,300
Official settlements bal.	-2,053	-504	2,700	-7,151	-8,500
before special transactions 2/					
Liquidity basis	-2,855	-3,110	-5,958	-4,110	-4,500
Official Settlements bal.	-2,259	-555	2,758	-7,438	-8,800
Selected items:					
Trade balance	5,346	2,803	638	2,054	
Goods and services	6,098	4,335	1,949	2,957	
U.S. private capital	-4,385	-5,127	-5,233	-4,897	
Foreign private capital	826	5,823	13,199	-296	
(Liabilities to foreign banks)	(438)	(2,452)	(9,217)	(-3,342)	
Military expenditures, net	-2,392	-3,071	-3,335	-2,616	

1/ Seasonally adjusted, before allocation of $867 million of SDR's

2/ Special transactions include sales of "non-liquid" U.S. Government obligations to foreign governments as well as other arrangements designed to reduce the published deficits (primarily the liquidity deficit).

December 7, 1970.

CONFIDENTIAL (FR)

U.S. Reserve Assets and Liabilities

(millions of dollars)

	12/65	12/68	12/69	10/70	11/70
Reserve assets, total	15,450	15,710	16,964	15,120	14,891
Gold	13,806	10,892	11,859	11,495	11,478
IMF gold tranche	863	1,290	2,324	1,823	1,812
Special drawing rights	--	--	--	1/ 991	961
Convertible currencies	781	3,528	2,781	811	640
Liabilities to foreign reserve holders	16,821	18,574	17,162	22,726	
Liquid 2/	16,206	13,511	13,011	18,713	
Non-liquid	615	5,063	4,151	4,013	
Net official reserves	-1,371	-2,864	- 198	-7,606	
Liquid liabilities to foreign commercial banks	7,419	14,472	23,614	20,223	

1/ Initial allocation on Jan. 1, 1970 was $867 million.

2/ Includes IMF gold investment and gold deposits.

December 9, 1970

CHAIRMAN BURNS

For Information Only

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 9, 1970.

To Board of Governors

Subject: Corrected table on New York banks' Euro-dollar positions.

From Ralph W. Smith and Robert C. Bradshaw
(through Mr. R. Solomon)

Please substitute this table for the one circulated on December 7. The original table contained an error on Irving Trust's base in the October 28 reserve computation period.

Attachment

STRICTLY CONFIDENTIAL (FR) PRELIMINARY DATA

Net Liabilities of New York City Banks to Foreign Branches Plus Assets Sold to Foreign Branches
(Four Week Computation Period Ending November 25, 1970)
(millions of dollars)

	Reserve-free base 1/			Change from previous computation period	Four weeks ending: November 25, 1970		October 28, 1970
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Bankers Trust Company	998.3	810.3	711.9	-98.4	711.9	--	--
Chase Manhattan	2,239.2				2,251.4	12.2	0.8
Chemical	853.4		818.7	-34.7	818.7	--	0.8
First Nat'l. City, N.Y.	1,453.4	1,182.2	901.3	-280.9	901.3	--	--
Irving Trust Company	838.9	558.1	451.5	-106.6	451.5	--	--
Manufacturers Hanover	583.5				586.5	3.0	2.6
Marine-Midland Grace	280.9	270.3			283.3	13.0	10.4
Morgan Guaranty	1,269.8	1,249.6			1,252.5	2.9	5.7
Total	8,591.5	7,825.8	7,305.2	-520.6	7,337.3	32.1	21.9

1/ Four week daily average of net liabilities to foreign branches plus assets sold to foreign branches.
2/ No entry indicates that the reserve-free base in the previous period shown was still in use.

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

December 9, 1970

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

There is enclosed a copy of a memorandum to the Board of Governors from Mr. Solomon dated November 17, 1970, and entitled "Dealing with the Overhang of Euro-dollar Liabilities: Laissez-faire vs. Taking Action to Discourage Outflows." This memorandum is being distributed to the Commitee as background for possible discussion at the meeting on December 15.

Arthur L. Broida

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

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONFIDENTIAL (FR) November 17, 1970.

TO: Board of Governors

FROM: Robert Solomon

SUBJECT: Dealing with the Overhang of Eurodollar Liabilities: Laissez-faire vs. Taking Action to Discourage Outflows.

The differential between U.S. and Eurodollar interest rates has led some banks to decide to give up a part of their reserve-free bases and is leading many other banks to think seriously about doing the same.

The reserve-free base has value to a bank insofar as the bank now believes that it may, in the future, wish to have recourse to the Eurodollar market to meet some of its needs for funds in the United States. From the bank's viewpoint this could come about as the result of a future squeeze under Regulation Q ceilings or as the result of higher costs of funds at home than in the Eurodollar market. Thus the banks are willing to pay some cost--in the form of holding Eurodollars at interest rates higher than those on domestic liabilities (Federal funds, CD's, and commercial paper)--as an insurance premium to preserve all or part of the reserve-free base.

But a number of the banks have decided that the current cost is too high and this is leading them to think seriously about reducing the size of the insurance policy.

Consideration of whether or not the Board should do something to discourage the outflow of funds should be preceded by an estimate of the likely magnitude of the outflow in the absence of Board action.

Magnitude of Potential Outflow

The outlook for the U.S. economy is such that one must expect declining short-term interest rates here for some period of time; at the least, short-term rates, after falling further from present levels, are unlikely to rise substantially for quite a while. Meanwhile, short-term yields in Europe are considerably higher than ours. Even if Europe has reached, or passed, the peak of intensity in the use of tight money during this cyclical upswing, the easing of monetary conditions there is likely to lag ours by a substantial margin. Thus European countries (notably but not only Germany and Italy) will be exerting a demand on the Eurodollar market for some time. This is a major reason why the $5 billion of Eurodollar repayments that has already occurred this year has not eliminated the differential between U.S. and Eurodollar yields.

Whether further repayment of Eurodollar liabilities by U.S. banks would be self-arresting, as the result of a decline in Eurodollar rates, thus depends importantly on the strength of demand for Eurodollar in other countries.

While no one can be sure about the duration of tight money in Europe, it is not to be ruled out that a significant differential in short-term interest rates between the United States and Europe would persist for at least a year--and possibly much longer.

A related question is this: assuming a persisting differential in interest costs between the United States and the Eurodollar market, is there a level below which the banks would hesitate to reduce their liabilities to branches and, correspondingly, their reserve-free bases?

One consideration here is that more and more banks are likely to come to the view that Regulation Q will not be used in the future as it was in 1966 and 1968-69. If the Board lifts the remaining ceilings on large CD's, and even if it uses the term "suspension," the view is more than likely to spread that the suspension is permanent. As this happens, banks will reduce what they regard as a minimum desirable reserve-free base.

On the other hand, banks are unlikely to reduce their Eurodollar liabilities to zero. For one thing, they may wish their branches to maintain a balance with the head office. Furthermore, the future is uncertain and banks will hedge their bets regarding the probable reimposition of Regulation Q ceilings.

In 1967, when credit conditions eased here, banks reduced their liabilities to branches--which had grown from $1.7 billion in January 1966 to $4 billion at the end of 1966--only moderately, from a peak of $4 billion to $3 billion. On the other hand, that period of ease was rather short-lived and it is therefore difficult to draw reliable conclusions as to bank behavior from it.

Even if there is an upward trend in the long run in liabilities to branches, banks could temporarily dip below that trend when interest rate differentials make that course profitable, just as they went far above the trend in 1969.

All things considered, it is possible to imagine a potential outflow of as much as $4-6 billion from the present level of $9 billion. The term "potential" is used here for more than one reason: (1) to denote a possible outer-limit, (2) to indicate what could happen in the absence of an effect of this very outflow of U.S. funds on European interest rates. It is possible that the outpouring of U.S. funds, by flooding the Eurodollar market and in turn European money markets, would drive down short-term rates abroad before $6 billion flows out. But one of the presumed U.S. objectives, as discussed below, is to avoid flooding European money markets in a way that undermines the efforts of European central banks to combat inflation.

Thus while a $4-6 billion outflow may not be the most likely estimate, because European rates will decline more than European central banks wish them to decline, it is a possible outflow that U.S. banks might be willing to tolerate if the differential cost of Eurodollars remains relatively high.

Advantages and Disadvantages

Assuming a possible outflow over a period of 6 to 12 months of, say $6 billion--or even $4 billion--what are the disadvantages to the United States of permitting it to happen?

Disadvantages

The official settlements deficit has amounted to $7 billion in the first 9 months of 1970. This is much larger than the official settlements surplus in 1968 and 1969 combined ($4.3 billion). After 5 years--1965-69 inclusive--in which the official settlements deficit averaged out at zero, we have suddenly provided reserves to the rest of the world, in 9 months, at a rate equal to more than three-fourths of the SDR creation agreed to for a three-year period.

If this enormous rate of deficit should go on for a considerable period of time--another six months or a year--several unfortunate consequences can be foreseen.

1. Heavy conversions of foreign dollar accruals into U.S. reserve assets (IMF position, SDR, gold) which could in turn trigger off a burst of speculation against the dollar. If this happened, the reflow of dollars to foreign official reserves from the Eurodollar repayments would be magnified, since forward discounts on the dollar would encourage greater reconversions by Europeans out of Eurodollars into their own currencies and since interest arbitrage reflows would be supplemented by speculative inflows into European currencies.

2. The chances of getting agreement on further creation of SDRs by January 1973 (which requires negotiations in 1972) would become very slim. This in turn would lead to a growing view that the SDR experiment had failed and that an increase in the price of gold is necessary--not only to let the United States pay off its debts but also to put the monetary system on a "sound" basis. The progress that has been made in recent years in de-emphasizing gold and moving the international monetary system toward a managed basis might be lost.

Apart from these dire results, the United States cannot turn its back on a commitment it accepted when it promoted the SDR agreement: we accepted and, in fact, supported the proposition that the international monetary system should not depend heavily on further additions to official dollar reserves. It was agreed that it is neither in the U.S. interest nor in the interest of other countries that our official dollar liabilities should continue to increase rapidly.

3. Europeans already feel resentment at being buffeted in a magnified way by U.S. monetary policy. In 1968-69, we imposed pressures on them when we let our banks drive Euro-

dollar interest rates up to as high as 13 per cent. Now we will be pushing rates down, undermining their tight money policies and adding to their holdings of official dollar reserves.

This resentment has been a catalyst in the drive toward European monetary integration. Whether or not such integration is advantageous to the United States, the anti-American impulses behind it are not.

There are many reasons why the United States should make some effort to maintain cordial and cooperative relations with Europe and Japan. If we sit by and permit a further outflow of $4-6 billion <u>without being seen to have tried to stem it</u>, there will be a growing acceptance of the view, already held in Europe, that the United States has adopted the Friedman-Haberler-Houthakker prescription that our only duty is to try to contain inflation and maintain full employment, while the rest of the world adjusts to whatever volume of dollars flows out of the United States.

One result of a deterioration in the cooperative attitude of the Europeans--which may occur anyway if the Mills' bill gets through Congress and is signed by the President--would be less willingness of European countries to revalue their currencies when in substantial surplus.

The balance, in European minds, would tend to be tipped against such action and toward actions or non-actions that put increasing pressure on the United States.

4. Finally, it can be argued that the medium-term outlook for the U.S. balance of payments is rather favorable (see my submission to the Commission on Trade and Investment).1/ One can imagine a gradual working down of the Eurodollar overhang over the next 2 or 3 years as the rest of our balance of payments improves. Given this prospect, one can also argue against letting the Eurodollars flow out now in massive volume. Providing an incentive to hold does not saddle us with these liabilities forever.

The very fact that the medium-term outlook is favorable argues for preventing a crisis atmosphere from being created now. After our poor domestic management in 1965-69, we may be on the road back to a sounder domestic economy and a stronger balance of payments. But we can't <u>persuade</u> the Europeans and the markets of this. We can only <u>demonstrate</u> it and that takes time. Between now and when the demonstration becomes evident there is something to be said for temporary measures to hold things (including confidence in the dollar) in place.

1/ <u>Trade, Investment and the Balance of Payments Adjustment Process</u>, August 6, 1970, Washington, D. C.

Advantages

Is there a case in favor of doing nothing and letting the Eurodollar liabilities run off?

1. It can be argued that, having accumulated the overhang, we have to face repayment eventually and we ought to get it behind us. A variant of this argument is that we ought to get a part of the repayment behind us, by standing still for a further outflow of, say $2 billion or so, hoping meanwhile that this will narrow the interest rate differential between U.S. and Eurodollar rates.

2. Another consideration relates to the distribution of foreign official dollar gains resulting from Eurodollar repayments by U.S. banks. A very large proportion of the increase in U.S. liabilities to foreign monetary authorities in 1970 is accounted for by Germany and Canada. For a part of 1970 Germany may have welcomed the additions to its reserves, following the enormous decline in reserves it experienced following the October 1969 revaluation. Even if Germany no longer welcomes additions to its dollar holdings (and ignoring the undermining of the Bundesbank's policy referred to earlier) there is little that Germany can do about it. Apart from buying back the $500 million of gold that it sold to the United States in the fourth

quarter of 1969, Germany is bound by the Blessing letter not to buy gold from the United States. Given the touchiness of the problems regarding U.S. troops in Europe, Germany is unlikely to ask for a revision of the Blessing letter now.

Other European countries would also share in the reserve gains reflecting a further massive outflow of Eurodollars. Belgium, Holland, Italy, Switzerland--even France and possibly Britain--could experience sizable reserve increases if another few billion of Eurodollars were repaid. But we do have reserve assets and should be ready to use them.

Conclusions

A weighing of these arguments can lead to the following judgments:

1. The concern about the undermining of monetary policy abroad is not allayed by the fact that Germany can do little about converting unwanted dollars into gold. In fact, if it became evident that the U.S. was leaning heavily on this constraint on Germany, that fact itself would worsen our cooperative relations with the rest of the world.

Numerous contacts with Bundesbank officials indicate that they would be disturbed by a massive outflow of Eurodollars from the United States, which would provide financing to German companies that find credit unavailable or too expensive in Germany.

2. The argument that the United States should be seen to be trying to moderate the impact that its changing policies have on the rest of the world is hard to challenge. When we finally announced the Eurodollar reserve requirement in mid-1969 we gained some good will and put an end to an acrimonious debate.

3. If a balance of payments crisis should occur--for whatever reason--the United States will be in a better position to deal with Europeans and therefore to see to it that the outcome of the crisis favors our long-run interests if we have a record of taking actions within our power. No one abroad in a responsible position is asking the United States to deflate excessively in order to strengthen our balance of payments. But neither European nor Japanese officials regard restrictions on capital flows as undesirable and in some circumstances they advocate such restrictions. Absence of any action by the United States to shore up a crumbling Eurodollar regulation could lead officials of other countries to believe that we think the world is on a dollar standard and do not concern ourselves with our balance of payments. If they come to this belief, they would be more likely to follow those in Europe who would like to push the continental countries back toward a gold bloc. This would hardly be a congenial environment in which to try to work out of a crisis--or, for that matter, to work on a day-to-day basis even if there is no crisis.

4. The existing attitude toward the dollar is hardly a healthy one. The improvement we see in the underlying balance of payments--and in its prospects--is not evident yet to the rest of the world or to the markets. Since we must expect some deficit next year even if there is no repayment of Eurodollars--and the deficit could be aggravated temporarily if Europe slumps after its current boom--we have a good reason to restrain dollar outflows where and when possible. This need not mean simply a delay in facing the music--if we are right in our optimistic view of the medium-term outlook. And even if we are wrong, the chances of inducing revaluations by surplus countries in Europe will be greater if we are seen to do what we can to hold down our overall deficit.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 10, 1970.

To Chairman Burns

Subject:

From Robert Solomon

STRICTLY CONFIDENTIAL (FR)

The attached memorandum spells out some of the political effects of an international crisis. See especially pages 12-16.

RS

Attachment.

STRICTLY CONFIDENTIAL (FR)

December 8, 1970.

To: Chairman Burns

From: Robert Solomon and Ralph C. Bryant

Subject: Repercussions for the President of an International Financial Crisis.

This note tries to speculate on the political pressures that would face the President if the United States were to find itself in the midst of an international fiancial crisis.

Immediate Cause of Crisis

The crisis could be triggered off in a variety of ways. Most likely it would come as the result of a spreading wave of demands for conversion of dollars by foreign monetary authorities, consequent on a growing belief that the U.S. external position is not viable. This belief in turn, could be generated by a resurgence of inflation, by a dismantling of our restraints on capital outflows, by a massive repayment of Eurodollar liabilities by U.S. banks, or by a U.S. posture that tells the rest of the world that we intend to ignore the balance of payments.

Frame of Reference

In order to start the analysis somewhere, it is assumed that the President has decided to suspend all gold sales and purchases. We do not deal here with the various types of suspension that would be possible, but simply assume complete suspension.[1/] We likewise do not discuss the

1/ It is important to realize that several half-way houses exist. "Complete" suspension may be defined as a situation in which there is no convertibility at all on a systematic basis for official dollar holdings of foreign monetary authorities. Selective redemptions of official dollar balances might be undertaken from time to time by the U.S. Treasury, but only on U.S. terms and conditions. The United States would not itself take measures to maintain present dollar exchange rates with other countries.

many questions that would arise about the timing and the handling of this decision -- even though they are of the utmost importance.

Possible Evolution of the Crisis

What course might events initially take if the President were to suspend gold sales and purchases?

A majority of foreign countries would initially respond by continuing to peg their currencies to the dollar at former exchange rates, in effect becoming members of a "dollar bloc." The Common Market countries, together with a few other countries in Europe, would be likely to work out arrangements so that present fixed parities and exchange relationships within a "Eurobloc" would be maintained. Japan and the sterling area group of countries would face difficult choices; whether they floated independently or pegged to the dollar bloc or the Eurobloc would depend a great deal on their expectations of the manner in which the crisis would eventually be resolved. The exchange rate between the dollar bloc and the Eurobloc group of countries might be maintained by the Europeans at present parities if they foresaw a speedy resolution of the crisis, a return to normal operations of the Fund Agreement, and a return to full convertibility of the dollar. More likely, the dollar-Eurobloc exchange rate would be allowed to float temporarily, with the Eurobloc initially appreciating relative to the dollar bloc. Further developments in the crisis, including especially the evolution of exchange-rate relationships, would depend on the negotiating stances of governments and on the extent of agreement (or disagreement) on the main features of a multilaterally acceptable settlement of the crisis.

Eurobloc countries would be likely to put on some further balance-of-payments controls, particularly on capital transactions. But it would be very difficult to obtain the requisite intra-Eurobloc cooperation in order to make a full-fledged multiple-rate and exchange-control system work. The Eurobloc countries would attempt to establish such a system only if an early and more favorable resolution of the crisis did not seem to be in the cards.

In the period immediately following the U. S. suspension, the price of gold in private markets would rise very sharply.[1/] There would be no agreed "official" price of gold. Expectations that the United States would eventually agree to a policy of buying and selling gold at an official price significantly higher than $35 an ounce would be widespread.

The Eurodollar market and national money markets would at best be highly unsettled and at worst would start to unravel seriously. There would be a general scramble for liquidity in face of all the uncertainty. Irrational behavior would be superimposed on rational

1/ Either or both of the London and Zurich gold markets might be temporarily closed by the U.K. or Swiss authorities, but many other markets would remain open and activity would shift to them.

precautionary behavior. Talk of bank holidays and the failure of financial institutions -- perhaps particularly in the Eurodollar market -- would probably be rampant. Stock and bond prices would fall rapidly at the outset. Action by individual central banks, and the presence or absence of central bank cooperation, would be a critical determinant of what happened after these initial reactions.

Attitudes and Responses of Foreign Governments

There are three important generalizations to be made about the probable behavior of foreign governments. To some extent, these generalizations also describe the likely attitude of the foreign public and foreign press.

First, foreign attitudes and responses will be conditioned by their appraisal of the economic policies of the U. S. Government. If they believe the crisis can be traced in large part to "irresponsible" U. S. demand management, they are likely to react in a much more hostile manner than if they believe the U. S. authorities have been pursuing and intend to pursue "reasonable" demand-management policies.

Second, foreign attitudes and responses will greatly depend on their evaluation of long-run U. S. intentions. Foreign official judgments about the outcome of the crisis preferred by the U. S. authorities necessarily have to be a primary input into their own policy decisions.

Third, foreign attitudes and responses will be conditioned by the timing and the handling of the U. S. decision to suspend. Can the proximate onus for the decision to suspend be laid on the U. S. authorities (were the U. S. authorities too quick to act?), or was the U. S. decision taken only at the eleventh hour when certain foreign central banks forced it on the U.S. authorities? To some extent, this distinction is a chicken-and-egg distinction. Yet there will almost surely be widespread public attempts to allocate the "blame" for a post-suspension crisis. Judgments on this matter are also very likely to influence the policy decisions of foreign governments.

Congressional Reaction

There are a few Senators and Congressmen (e.g., Reuss, Javits) who have formed strong views on how the Administration should react to an international financial crisis of the sort posited here. But they are numerically a small minority. The vast majority do not even have a good grip on the issues that would be at stake in post-suspension negotiations between the United States, the Eurobloc, and other major countries like the United Kingdom and Japan. The mood of Congress in this situation, it seems safe to surmise, would therefore not be dissimilar from the reactions of a beehive split open with the sudden blow of a heavy stick: violently roused from familiar behavior patterns, uncertain where to turn, but worked up and looking for something to sit on and sting.

Public and Press Reaction

Apart from a handful of the more sophisticated papers with able financial staffs, the press in this country will have still less of a grip than Congress on why the crisis has arisen and what should be done about it. Details of the crisis would be steady front-page if not headline news. For at least the first few days balances of payments, exchange markets, gold prices, interest rates, and financial news in general would be thrown at the U. S. public with an intensity never seen in the last three decades. The public will probably be less capable of digesting this unprecedented financial news than it is able to digest other (non-financial) types of shocks to the macrocosm. Wars and riots are a dreary commonplace. But a "collapse of the monetary foundations of the world economy": Ah! There's a really indigestible crisis. "Are things really collapsing? What does it all mean? Why did the President let things get so bad?"

Political Pressures on the President

It seems pretty clear that the President would feel great pressure at home, both from Congress and from all sectors of the public, to do something. At the outset a good deal of this pressure would be unfocused, in the sense that it was more an outburst of concern than a clear lobbying for specific policy responses. Part of the danger of the situation lies in this very fact. Most of the ideas about the "something" to be done would be vague. And most of them would be directed at the very short-run objective of pouring oil on troubled waters, not at the longer-run economic and political interests of the United States.

Another dangerous aspect of the crisis situation is that it would put the President's past economic policies under a much brighter spotlight at home than they would otherwise ever have been. Public opinion would be searching for scapegoats. Alleged "errors" in the President's economic policies would be much more widely recognized and discussed. Even if economic policies in the year or two before the crisis had been financially conservative, it might be difficult for the President and his advisers to avoid the political stigma that they had brought the crisis on. The danger of a political swing against the President might be especially great if it came to be generally believed that the President had fueled up the economy too rapidly in order to increase his chances for re-election in the fall of 1972.

The Issue of the Gold Price

Before the decision on suspension was many days (perhaps many hours) old, the domestic pressure to do "something" would probably begin to crystallize around the dollar price of gold. The most straightforward thing to do, as far as the Congress and the public could see, might seem to be to get the "inevitable" over with, "devalue the dollar" by substantially raising the price of gold, and restore normalcy. We believe this tendency for the domestic pressure to crystallize around the issue of the gold price would occur for two sorts of reasons. First, the majority of the pressure coming from abroad -- including the views of the major governments -- would be pushing for a change in the dollar gold price.1/ Although it is small in numbers, there is also a fairly powerful domestic lobby that would be exerting its efforts. Second, precisely because the great majority of the domestic press and public do not have a good grasp of what the issues and choices are in this area, there unfocused concern is apt to converge on the "simplest" policy option (that step they would have the least trouble comprehending). Even if powerful pressures from abroad and the domestic gold lobby were not trying to push domestic opinion towards an increase in the gold price, therefore, there is a significant danger that domestic opinion would move in this direction of its own accord.

1/ The European (and possibly Japanese) monetary and political authorities, it seems to us, would probably propose a "deal" that would have the United States raise the dollar price of gold by a substantial amount while some or all of them either did not change the price of gold in terms of their currencies or else devalued against gold by a smaller percentage amount than the United States. This deal would result in some changes in relative exchange rates (a good thing) but only at the cost of changing the gold-dollar parity (a bad thing). For a much fuller analysis of this type of deal, the Europeans' reasons for proposing it, and the reasons why it would be undesirable for the United States, see Balance-of-Payments and International Financial Policies for the United States: A Review of the Choices (Strictly Confidential mimeographed book prepared for the Board, June 30, 1969), pp. 114-131.

STRICTLY CONFIDENTIAL (FR)

If the President Holds Out Against a Gold Price Increase and Insists on a Better Policy

There is no doubt in our minds that the types of resolutions to the crisis that ought to be preferred do not involve a change in the dollar price of gold. The economic merits of the situation argue against a revaluation of gold, almost regardless of which country's perspective is taken. The political arguments against a revaluation of gold, seen from the perspective of the United States, are also decisive.

"Better" solutions to the crisis do exist. They would involve a once-for-all realignment of exchange rates that was pretty thoroughgoing, together with a commitment to have somewhat more flexibility in exchange rates in the future. The dollar would be devalued relative to the currencies of Japan and a number of European currencies, but there would be no change in the dollar price of gold. The "better" package would also contain commitments on the future creation of SDR. It might need to contain U.S. commitments of a more formal kind to limit future expansion in the reserve-currency role of the dollar (here is the area in which the United States, on the economic merits of the case, might have to yield to the Europeans). It could even contain some understandings about the consolidation of existing reserve assets into a single reserve claim on the Fund.

A "better" package of this sort is the type of resolution of the crisis which the verdict of history would regard favorably. This is clearly the approach behind which the President ought to throw his own political resources and prestige.

But, it is necessary to point out, the President would have to fight an uphill battle to obtain this more rational resolution of the crisis. It would certainly take longer to get international agreement on a package of this sort. Meanwhile, the uncertainty in exchange markets and financial markets would be continuing. The pressures on the President noted above would probably be growing more intense. "Why doesn't the President do something to end this crisis? Why are negotiations taking so long?" Even with able Administration explanations of the goals and tactics of a "better" approach, it is conceivable that the pressures on the President for a speedier resolution (even if essentially false for the longer run) would build up to a point where they seemed politically intolerable.

If the President Yields to Pressures for an Increased Gold Price

A substantial increase in the dollar price of gold might temporarily calm things down. Exchange markets would move back towards normalcy, with monetary authorities once more pegging rates within narrow bands. Financial markets would get back to a more even keel. If some changes in relative exchange rates had accompanied the revaluation of gold, the period of calm might even last for some time.

Yet ultimately, in our judgment, the world monetary system would be seen to have become more unstable. The President would have followed a seriously wrong policy on the economic merits of the case. He would have bought a temporary easing of the crisis atmosphere at the high price of prejudicing the rational future evolution of world monetary arrangements. The deliberate multilateral creation and regulation of reserve assets via the SDR scheme and the Fund would be seriously undermined. Progress on improving the adjustment of international payments imbalances (e.g., through the introduction of greater flexibility of exchange rates) might have been derailed. Confidence in existing reserve assets and their values in terms of each other would have been dealt a severe blow, from which some of them -- most notably dollar and sterling balances -- would never recover. Not only would central banks be less willing, in the future, to hold dollars; the private use of the dollar abroad might also dwindle, and this would affect the role of New York as a financial center.

Apart from the economic costs, there would be some high political costs to agreeing to a gold price increase. These might come increasingly home to roost as time went on, especially as it became apparent that the problems that produced the crisis in the first place were far from being resolved by the President's consent to a revaluation of gold. As for political opinion at home, there might be a growing undercurrent of resentment at the President "capitulating" to the gold lobby, the gnomes of Zurich, the South Africans, the Russians, and others with a strong vested interest in gold revaluation. Congressional bitterness might grow, in retrospect, that the President had failed to provide better leadership in the crisis. Consent to a gold price increase might, even at home, come to be seen as a symbol of weakness in foreign policy.

It seems almost inevitable that, sooner or later, political awareness will catch up with the economic merits of the President's decisions. If the President does give in and consent to what is a bad policy, he will ultimately get caught out by Congress and the electorate, not to mention future historians. Unfortunately, political awareness will probably catch up only after a significant lag. There is thus a bitter irony in the situation, and great political danger for the President. Congressional and public opinion might push the President into a decision in the heat of the crisis for which, later on in calmer times, they would want to pillory him.

Effects of the Crisis on U. S. Foreign-Policy Objectives

Assume first that the President does give in to pressures for a revaluation of gold. The adverse consequences of this decision for foreign policy, even in the short run, would be great.

An increase in the dollar gold price would inevitably be interpreted as a defeat for the United States and a sharp blow to our prestige. The United States would be seen to be the country initiating the action that would (supposedly) end the crisis. Other governments could thus more easily disassociate themselves from responsibility for the crisis. "The United States was at fault," it would be argued, "and acknowledged this fact publicly by taking draconian action." More seriously, the credibility of all U. S. foreign policies would be undermined. It has been a bipartisan policy of long standing that the U. S. Government would maintain the $35 gold-dollar parity. Unlike the promises of governments never to devalue their exchange rates (promises that are not believable because circumstances can arise in which the only practical thing to do is to change the exchange rate), this U. S. promise is one that could be kept and which ought to be kept. (Changes in the rates at which the dollar exchanges against other currencies, which are necessary, need not and should not involve a change in the dollar gold price.) Most seriously of all, yielding to pressure on the issue of the gold price would almost surely be interpreted by foreign governments -- on both sides of the iron and bamboo curtains -- as a sign of weakness. On which of its other commitments would the United States yield when the going got really rough? What about NATO and other treaties? If governments came to ask this question of themselves, as many would, there could obviously be adverse consequences for nearly all aspects of our foreign policy.

Some foreign governments and other observers would draw an analogy with Britain's situation. Just as poor economic performance led to a secular weakening of sterling and a concomitant erosion of Britain's influence in world affairs, it might be argued, the United States was headed down the same road. Just as the United States had taken over leadership from the United Kingdom, Europe would now have to take over world political and economic leadership from the United States.

It might seem inconsistent for foreign governments to urge an increase in the gold price on the United States as part of a compromise "deal" (see above) and yet, on the hypothesis that the United States yielded to the urging, to think less of the U. S. authorities for showing weakness and failing to honor past commitments. These attitudes are not inconsistent for governments (e.g., France, Soviet bloc countries) wishing to dilute the political power and prestige of the United States. For many other countries these attitudes would be somewhat inconsistent. Such attitudes, however inconsistent, might still be held. Schizophrenia is a disease afflicting national policies as well as individual policymakers.

Countries that had held large proportions of their reserves in dollars -- Japan, Canada, most of the less developed countries -- would feel resentful at a U.S. decision to raise the gold price. The increases in reserves resulting from the gold revaluation would go mainly to the European gold-holding countries. Countries whose arms we have twisted not to purchase gold would feel particularly betrayed. Our relations and bargaining power vis-a-vis these countries could be expected to deteriorate.

The big gain to South Africa from an increase in the price of its major export would be resented by the many countries that feel strongly about apartheid. Some countries would also resent the benefits from gold revaluation that would be reaped by Russia.

Apart from its serious economic disadvantages in undermining the SDR scheme, gold revaluation might also have political costs stemming from its effects on the IMF and SDR creation. Many countries in addition to the United States have invested great amounts of time and prestige in the SDR arrangements. They would tag the United States with the political onus for harmful effects of gold revaluation on these arrangements.

Suppose that the President did not yield to pressures to raise the gold price and held out for the "better" type of resolution of the crisis. What consequences for foreign policy might result?

Perhaps the main point to make is that, regardless of the President's decisions, world monetary relationships would never again be the same. The fall-out from the crisis would go on for several years. Especially if the President were to consent to an increase in the gold price, but even if he did not, foreign governments would press still harder for some limitation on the future expansion of the dollar's role as a reserve currency. The flexibility the United States is alleged to have to engage in foreign activities without worrying about the balance of payments (we can "print" reserve liabilities instead of running down reserve assets) has in any case been declining in the last decade. However the crisis assumed here were resolved, it would clearly accelerate this trend.

If a "better" resolution of the crisis were to be negotiated, difficult multilateral compromises would have to be taken on par value changes, on greater flexibility of exchange rates in the future, and on the proper role of the dollar as a reserve currency. These compromises would also have political costs. There would certainly be some resentment at a strong U. S. position that was unyielding on the gold price. To some extent, foreign governments would damn us if we don't agree to a gold price increase ("Why is the United States trying to dictate its own solution and force it down our throats?") and damn us if we do ("A sign of political weakness").

The most unfavorable impacts on our foreign policies stemming from a refusal of the President to consent to an increase in the price of gold would come in the short run. At the time of the crisis and immediately after, relations with some governments (e.g., France) would be strained. In the longer run, given the superiority of the "better" resolution of the crisis,[1/] these strains would gradually fade into the background.

1/ The "better" solution would be superior in the long run both from the point of view of the United States and all other countries except those with vested interests in gold revaluation (South Africa) or those who believe they would benefit from a diminution in U. S. prestige and influence.

STRICTLY CONFIDENTIAL (FR)

The Probability of a Crisis Occurring

It seems appropriate after trying to peer into the witches' cauldron to draw back and to ask how likely such a crisis is and how the probability of a crisis depends on the current stance of economic policy.

If foreign governments believe that U.S. economic policy has been irresponsible prior to the crisis, as noted above, they will be much more hostile than otherwise. The chances of getting them to agree quickly to a "better" package for resolving the crisis would be markedly smaller. For the Europeans, "irresponsible" demand management would mean trying too blatantly to manipulate the economy for the purposes of the 1972 elections. The Europeans and the Japanese would also probably condemn us if we make no attempt at a serious incomes policy. A further symptom of "irresponsible" behavior, as seen by our major trading partners, would be any sign that the President and his advisers were taking a blasé, let-it-rip attitude towards the U.S. balance of payments. An aggresive relaxation of the capital controls would no doubt exacerbate the situation.

Even if economic policy is as "responsible" as it can in good faith be made to be, there is a significant possibility of a crisis occurring. The short-run outlook for the balance of payments is for continued weakness, even without a deliberate move to more expansionary fiscal policies. This uncomfortable fact makes it still more critical than usual to get demand-management policies right and to keep in close, cordial touch with foreign governments who are on the other end of our balance-of-payments deficit.

Whatever he does about a crisis, should one occur, the President will be in an extremely hot situation. It is difficult, if not impossible, to imagine him emerging from a crisis unaffected. It follows from this judgment that the President, as he formulates the new budget and charts the course of economic policy, should do all he reasonably can to minimize the possibility of a crisis occurring. Deflating the domestic economy significantly below the growth path that would otherwise be warranted (if it were not for the balance of payments) would be a mistake. That would not help our relations with any foreign government and would only produce a domestic economic crisis with all of its unfavorable political impacts. But it would also be a great mistake to disregard the tenuous state of the balance of payments and go for broke.

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045

AREA CODE 212 RE2-5700

December 11, 1970

ALFRED HAYES
PRESIDENT

CONFIDENTIAL (F.R.)

The Honorable Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Arthur:

You may be interested in the enclosed memorandum written by Charlie Coombs on the possible use by the Treasury of the BIS to absorb Euro-dollars.

As you know, the substantial spread between Euro-dollar rates and domestic rates has been a matter of concern to our banks as they consider whether or not to maintain their Euro-dollar base. As we look ahead to next year there is the disturbing possibility of a massive flow of Euro-dollars into European central banks. Charlie's memorandum is a timely proposal for dealing with what may possibly become a very worrisome situation.

I am taking the liberty of sending copies of this letter to the other members of the Board of Governors.

Sincerely,

Al

Alfred Hayes

Enc.

cc: Members of the Board of Governors

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

CONFIDENTIAL (F.R.)

DATE December 10, 1970

TO Mr. Hayes

SUBJECT: Eurodollar Debt Problem.

FROM C. A. Coombs

As you may recall, in a letter to Chairman Burns on November 19, 1970, I hastily and briefly outlined one possible way of dealing with the effects of continuing repayment of U. S. bank liabilities to their European branches. Since then, I have given the question more thought and have become persuaded that such an approach would be not only technically feasible, but also useful in a number of ways.

The essence of the scheme, as you will recall, would be to make an arrangement with the BIS which would undertake to absorb in a more or less passive way part of the return flow of dollars to the Eurodollar market as U. S. banks repay debt to their branches. The dollars thus absorbed would probably fall primarily in the overnight to 30-day maturity range, reflecting the pronounced shortening of the maturity range of Eurodollar debt on the books of the U. S. banks. The BIS would then channel the dollars so acquired to the U. S. Treasury against issuance of a special dollar certificate. In my letter to the Chairman, I mentioned the technique already employed by the U. S. Treasury in borrowing Swiss francs via the BIS, in which the BIS took relatively short-term deposits from the Swiss banks and channeled them into a U. S. Treasury certificate in the 15-month range. In this operation a two-day call feature was introduced; first, in order to permit the BIS to stay within its legal limitations regarding the liquidity of its assets, and secondly, to permit renegotiation if a big change in market rates required alteration of the interest rate applicable to the security. In effect, the main purpose of the call feature was not to anticipate a possibly complete liquidation of the operation before maturity, but rather to facilitate its being rolled over on a different interest rate basis if events so required. In actual fact, the call feature was never exercised.

Specifically I could conceive an arrangement whereby the BIS would channel short-term Eurodollar money into a 15-month Treasury security and would similarly require a two-day call option in order to satisfy its statutes and permit renegotiation of the interest rate on the certificate. By and large, however, I would think that the U. S. Treasury could count on taking and holding on to whatever dollars it might have acquired from the BIS, although it might from time to time have to put a higher rate on the certificate. There is also, of course, the risk of a sudden drying up of the Eurodollar money in the short-term range, or an exorbitant rate jump over brief periods, but as I indicated in my letter, such emergencies could readily be dealt with by a BIS drawing on the $1 billion swap line with the Federal.

An alternative technique would be for the BIS to borrow Eurodollar funds in the overnight up to 30-day range, and channel them as it went along into new Treasury certificates (or into special deposits at the Treasury) with matched maturities or an average of maturities originally borrowed by the BIS. In effect, under this proposal the U. S. Treasury would be paying the Eurodollar rate for short-term money. I think that this procedure would provide a cleaner operation and one in which occasional, if not frequent, payment of Eurodollar rates above New York rates might be justified on the grounds that the U. S. Treasury is not borrowing in that range in the U. S. market, although, of course, maturing issues are constantly passing through the very short-term maturity range. Such an operation, I think, could be designed in such a way as to ensure the U. S. Treasury of a reliable and stable flow of dollar financing from the Eurodollar market, safeguarded again by the possibility, in an emergency, of a BIS drawing on the Federal Reserve swap line.

You probably have seen Mr. Solomon's commentary on my letter to Chairman Burns, which noted several advantages of the proposal. On the other hand, Mr. Solomon apparently misunderstood certain aspects of the proposal as indicated by his suggestion that the BIS might require an exchange rate or gold guaranty. Since the BIS would be borrowing Eurodollars against a dollar placement, exchange rates or gold fall completely outside the picutre, and we can be confident that no problem would arise on this score. Secondly, Mr. Solomon suggested that the BIS might acquire "rather weighty leverage against the United States" if such an operation were undertaken. This suggests a misinterpretation of the role of the BIS as an operational bank as distinct from its role as a gathering place for central bank governors. There is virtually no influence on policy matters which the BIS, as an operational bank, can exert, and they have over the years been most assiduous in avoiding using their operational facilities as a platform for policy discussions. So far as the BIS governors are concerned, their attitudes, I think, would be governed by their national responsibilities and would, I should think, be sympathetic to any proposal designed to keep additional dollars out of their markets and the reserves of their central banks.

The basic issue involved, I think, in appraising this proposal, is whether the Treasury would find it preferable to borrow dollars from the Eurodollar market rather than subsequently having to buy back the same dollars from European central banks through sales of gold, SDRs or drawings on the International Monetary Fund. The responsibility here in this area is primarily that of the Treasury and they should assume an adequate share of the burden. If anyone is to pay rates above U. S. rates for Eurodollars in order to keep them out of the hands of foreign central banks, it would seem to me it should be borne by the general public via the U. S. Treasury, rather than a small group of banks who can go only so far in subordinating the interests of their stockholders to those of the U. S. balance of payments.

U. S. TREASURY DEPARTMENT

Date 12/14

TO Dr. Burns

H. I. Liebling
Office of Financial Analysis
Room 4409 Ext. 5781

FOR OFFICIAL USE ONLY

REVIEW OF
ECONOMIC AND FINANCIAL DEVELOPMENTS
(December 11, 1970)

PRICES AND THE FULL EMPLOYMENT GAP

Addressing the National Association of Manufacturers, President Nixon outlined a new economic policy to be directed towards crossing onto the road of higher real economic growth in 1971, while continuing to reduce inflation.

> As last week's Review on "The Price-Unemployment Dilemma" indicated, important gains towards disinflation have been in progress, as reflected in a decline in growth of the private GNP deflator to an annual rate of 4.7% in the third quarter from the recent peak of 5.3% in the first quarter of this year. But -- this was accompanied over this period by increases in the unemployment rate to 5.2% from 4.2% two quarters earlier. By the end of the year, the unemployment rate, apart from strikes, had continued to ascend; whereas the plan in early 1970 had contemplated it to have entered a descending phase by this time.

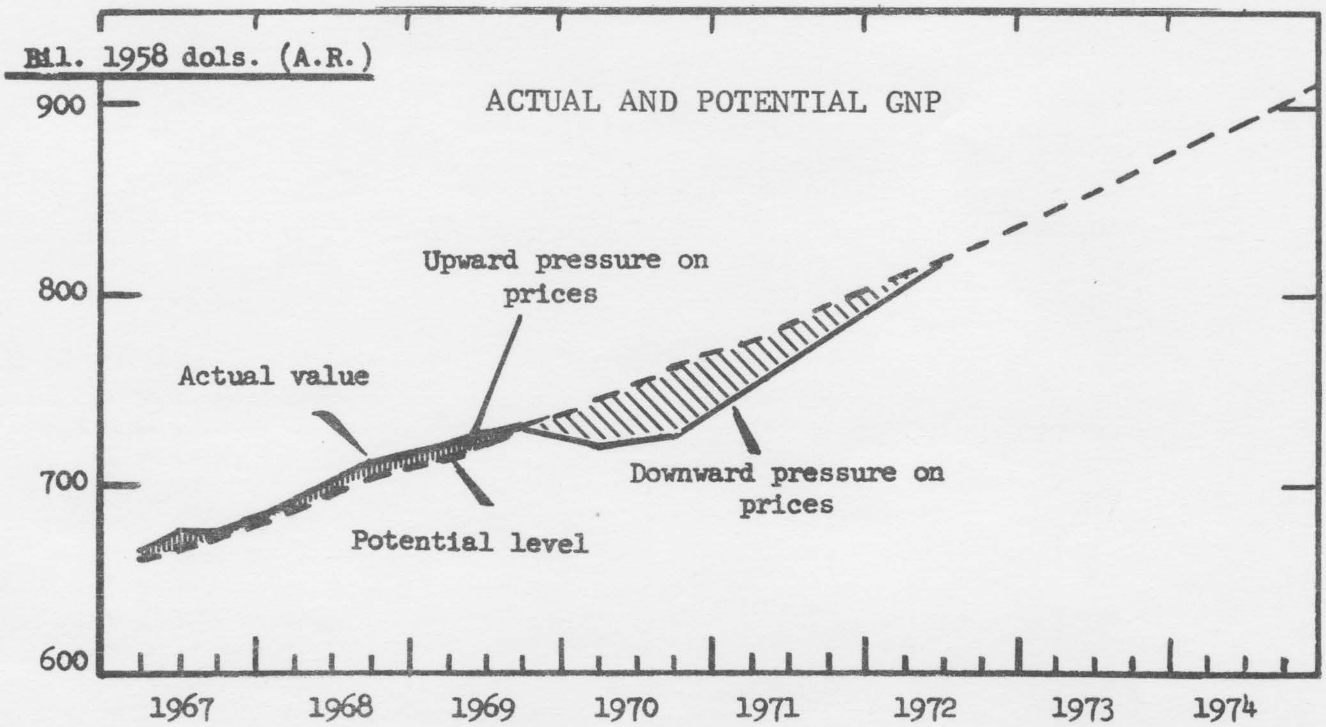
With current rates of unemployment so much above expectations, the President announced a new plan to move the economy as rapidly as possible towards the "full potential of growth and employment while continuing to reduce inflation." Still in the midst of this season of economic policy-making, the exact time and rate of growth required to achieve these goals were not stated but they surely will be specified subsequently in the Economic Report.

These important parameters: (a) how much acceleration in real growth and reduction in unemployment, and (b) the time period in which these goals were to be accomplished, remain to be considered by policy-makers during the weeks ahead.

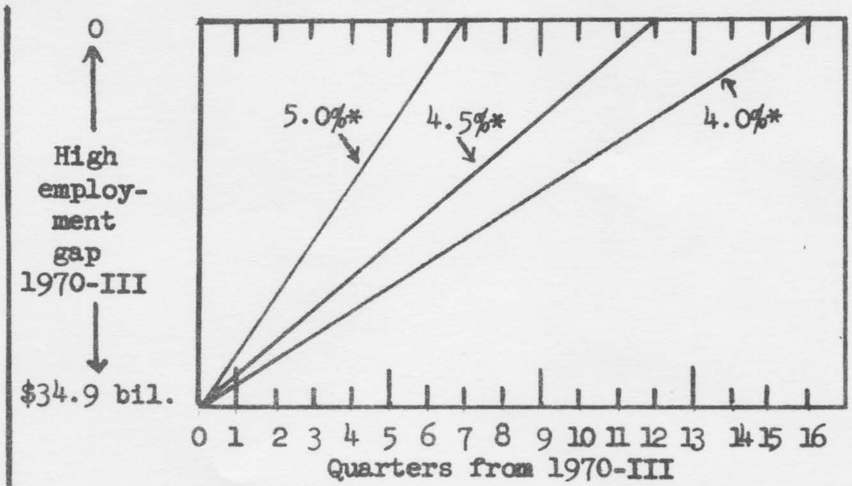
> It is these parameters which influence the degree of progress towards disinflation. Unfortunately, there exist considerable uncertainties in economic knowledge concerning the interrelationships between them.

At least two -- there are many more -- of these uncertainties are illustrated in the chart on the following page. Therein two different theories of price change are depicted. The numbers used in the chart are hypothetical.

TWO THEORIES OF PRICE BEHAVIOR



In the lower panel, the "speed of adjustment" of prices to rates of economic growth is shown. The duration of time in which the "full employment gap" is closed is directly related to the rate of inflation. A seven-quarter sequence in closing the "gap" -- which requires a 7% economic growth -- is associated at the end of a sequence with a 5% inflation rate; longer sequences are associated with lower rates of inflation.



* Hypothetical inflation rates at period of gap close.

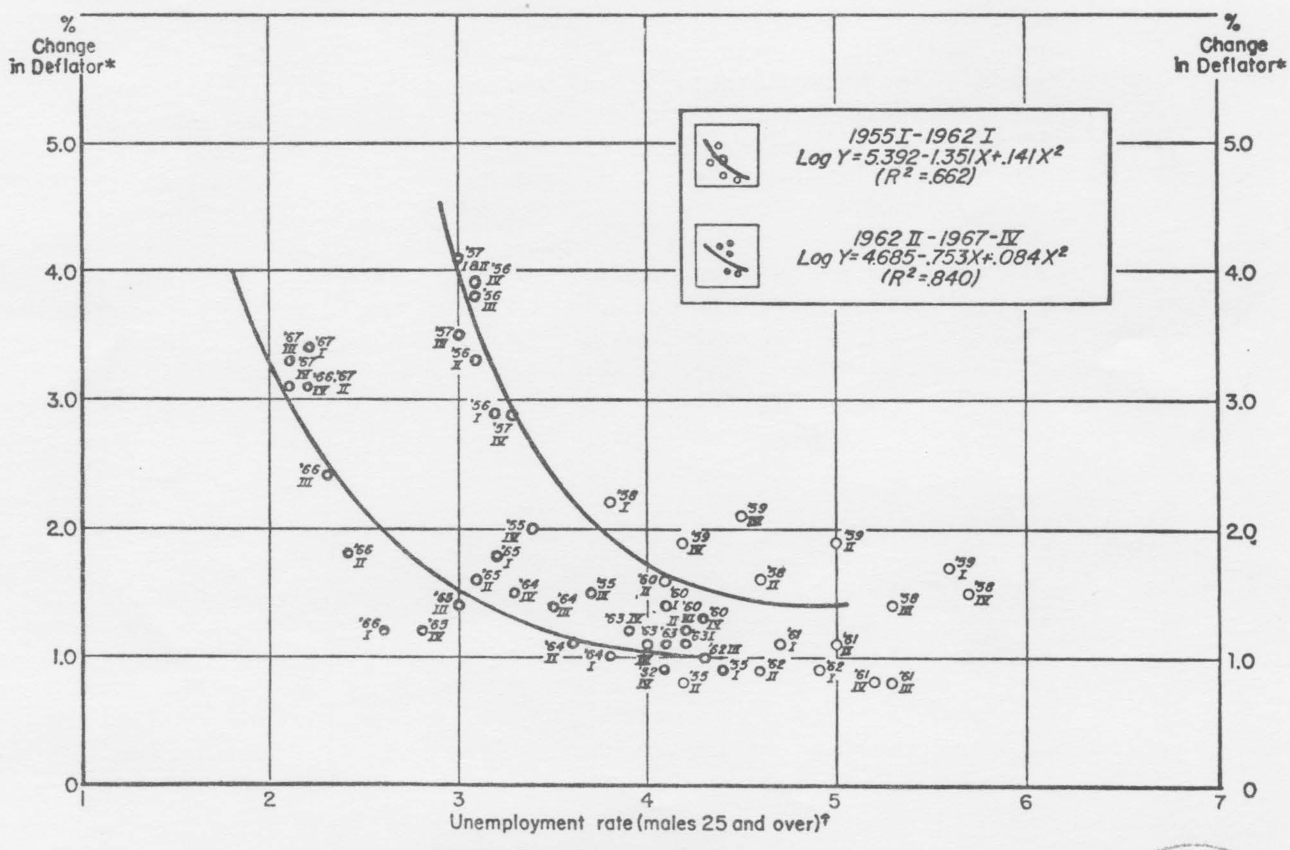
A contrasting theory of price behavior is portrayed in the upper panel. Therein, the very existence of a "gap" is influential in restraining the forces of inflation. The theory presupposes that the "gap" by its very existence assumes that supply capabilities are not fully utilized; and that the forces of increased demand on prices become neutralized by increased supplies or other factors.

Whether one or the other theories in fact will apply to the period ahead will not be determined until the record for 1971-72 is made. The record of other industrialized countries is not reassuring on this score.

Still, these theories of inflation, each in its turn, could be modified by improved functioning of markets -- a matter noted by the President, and by such students of inflation as Chairman Burns. Among these are the inflation-prone structure of collective bargaining in the construction industry and elsewhere, barriers to entry in the skilled trades, adequate job training and job bank programs, etc.

These could have influential effects over the longer run. They appear to bear the promise of fulfillment of lower inflation and higher rates of employment. At least, this appears to have been the experience of the 1960s, as compared with the 1950s.

Change in Private Nonfarm GNP Price Deflator and Unemployment Rate for Males 25 and over, 1955–67



*Percent change from one year earlier.
†Four quarter moving average, ending in current quarter.

This is illustrated in the above chart, which shows two so-called Phillips curves for these periods of time.

The leftward shift in this curve in the 1960s reflected a structural change in the economy, such that for a given level of unemployment the rate of price increase was less than that expressed in earlier years. Hopefully, a further leftward shift in the Phillips curve would be in prospect for the 1970s under the proposals noted earlier.

FINANCIAL MARKETS

Following two months of relatively slow growth, the money supply (M_1) rose $800 million in November. This advance was four times as much as that in October and may have developed to average up the slow rates of September and October to conform more closely with the recent rate of 5% or more established by the FOMC as a target.

Through the four-week average ending December 2, the annual growth rate from December 1969 was 5.7%.

ANNUAL RATES OF GROWTH IN M_1 DURING QUARTER
(Percent)

	I	II	III	IV
1969	5.6	4.7	0.8	1.6
1970	6.0	5.9	6.2	n.a.

This expansion in the money supply (M_1) during 1970 has developed coincidentally with a relative weakness in the demand for money.

As a result, interest rates have been declining in 1970, especially in short maturities. Though temporarily stiffening during the week ending December 2, 3-month Treasury Bill rates for the week ending December 9 eased again, reaching 4.94%, which compares with 7.81% a year earlier, and the lowest since 4.92% in the week ending December 6, 1967.

Long-term rates also have begun to decline somewhat. Yesterday, an Aa-rated utility bond was offered at 7.75%, 10 basis points lower than on a similar offering a week earlier, and the lowest in $1\frac{1}{2}$ years.

The slack demand for short-term funds, which had been accounting for lower short-term yields, is shown in the table below:

CHANGES IN SHORT-TERM CORPORATE DEBT
(Bils. of dols.)

Period		Commercial Paper	Commercial and Industrial Loans	Total
1969:	June 30 - Sept. 30	2.3	1.2	3.5
	Sept. 30 - Nov. 30	2.4	1.0	3.4
1970:	June 30 - Sept. 30	-0.9	-1.3	-2.2
	Sept. 30 - Nov. 30	1.9	-2.4	-0.5

As the table indicates, during the past five months ending November 30, commercial paper outstanding rose by only $1 billion, which compares with a rise of $4.7 billion during the comparable period of last year. Commercial and industrial loans declined by $3.7 billion since June 1970, as contrasted with a rise of $2.2 billion in this period of last year.

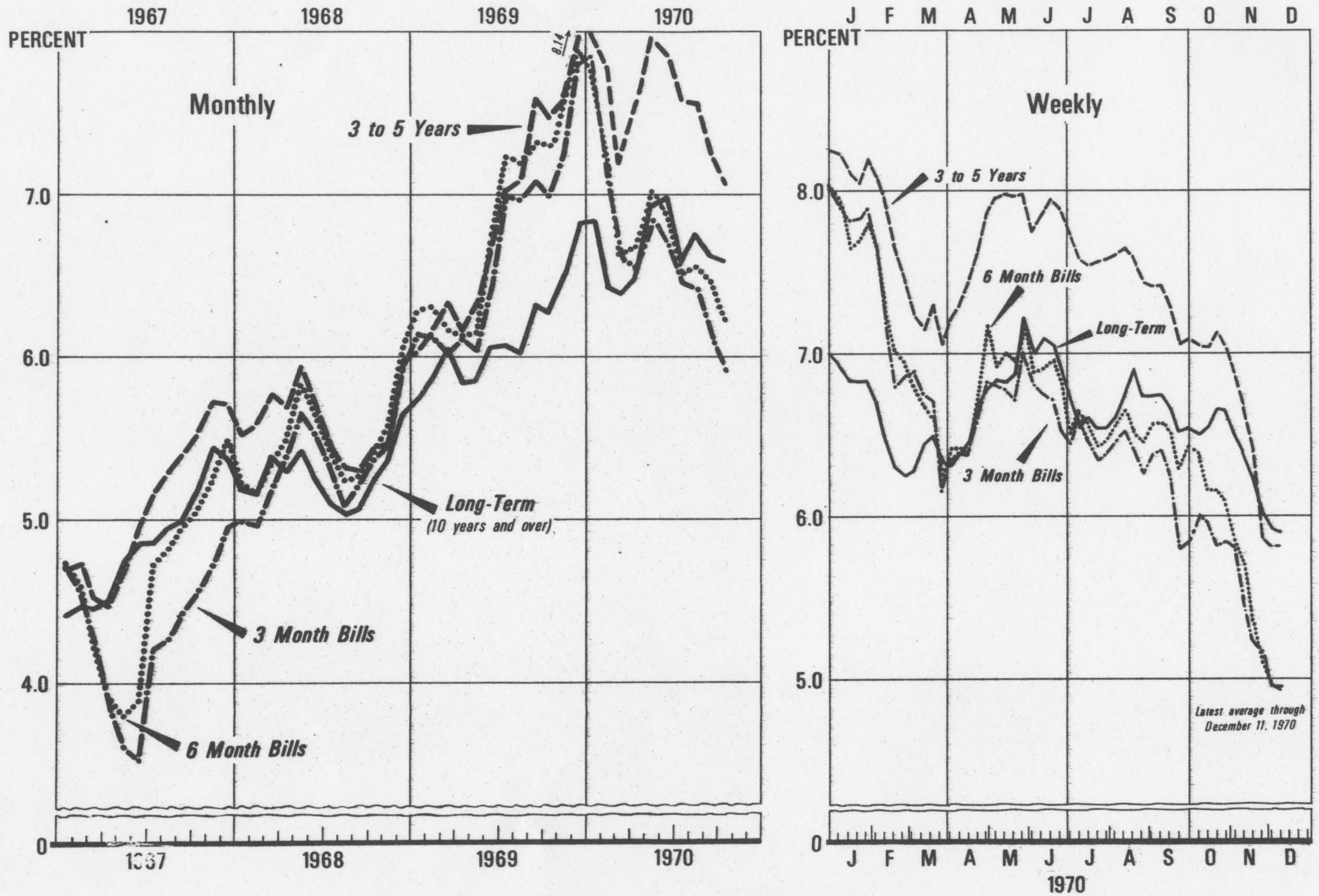
Initiators: Droitsch
Liebling

Reviewer: Liebling

OFFICE OF THE SECRETARY OF THE TREASURY
OFFICE OF FINANCIAL ANALYSIS

MARKET YIELDS ON U.S. GOVERNMENT SECURITIES*

(Fully Taxable Issues)



*Averages computed from daily closing bid prices.

ECONOMIC AND FINANCIAL REFERENCE DATA

	1. Seasonally adjusted	Latest Period		Previous Period	Year Ago
Production, income, and sales	Gross national product ($bil.) 1/	3rd Q.	985.5r	971.1	942.6
	Personal income ($bil.) 1/	Oct.	809.5p	811.9r	766.7
	Wage and salary payments ($bil.) 1/	Oct.	541.3p	546.6r	522.7
	Corporate profits before taxes ($bil.) 1/	3rd Q.	85.0p	82.0r	89.9
	Industrial production, FRB 2/	Oct.	162.3p	166.1	173.1
	New orders, durable goods mfrs. ($bil.)	Oct.	28.7p	29.9r	31.2
	Shipments, durable goods mfrs. ($bil.)	Oct.	29.4p	30.7r	30.9
	Retail sales, total ($bil.)	Nov.	30.3u	30.5r	29.8
Employment	Civilian employment (mil.)	Nov.	78.6	78.7	78.5
	Unemployment rate (%)	Nov.	5.8	5.6	3.5
Construction	Total new construction ($bil.) 1/	Oct.	93.1	93.3	90.7
	Private housing starts, total (thous.) 1/	Oct.	1,550p	1,504r	1,390
International transactions	Exports ($mil.) 3/	Oct.	3,707	3,535	3,365
	General imports ($mil.)	Oct.	3,528	3,398	3,212
	Merchandise trade balance ($mil.)	Oct.	+179	+137	+154
	"Overall" payments balance ($mil.)	3rd Q.	-680p9/	-1,204r9/	-2,279
	"Official" settlements balance ($mil.)	3rd Q.	-1,847p9/	-1,761r9/	-582
Commercial bank statistics	Loans and investments ($bil.) 4/	Oct.	424.0	423.7	397.6
	Loans ($bil.) 4/	Oct.	286.9	287.3	273.8
	Money supply ($bil.) 5/ 6/	Nov.	213.8	213.0	203.5
	Time deposits ($bil.) 5/	Nov.	225.0	222.2	194.0

	2. Not seasonally adjusted	Latest Week or Month		Previous Period	Year Ago
Production	Raw steel production (thous. tons)	12/5	2,379	2,289	2,777
	Auto production excl. trucks (thous.)	12/12	171.9	143.2	183.6
	Electric power, seasonally adjusted 2/	12/5	228	243	227
Price indexes	BLS raw industrials 2/	12/8	107.7	108.4	116.4
	Wholesale prices 2/	Nov.	117.7	117.8	114.7
Banking	Loans, large reporting banks ($mil.)	12/2	174,475	173,309	169,048
	Fed. Res. govt. sec. holdings ($mil.)	12/9	59,937	62,499	57,153
	"Free" reserves ($mil.)	12/9	-153	-41	-983
	Treasury gold stock ($mil.) 7/	12/9	11,117	11,117	10,367
Securities, average yields	Treasury 13-week new bill rate (%)	12/7	4.882	5.094	7.803
	Treasury long-term bond (%)	12/11	5.89	5.93	6.73
	Moody's seasoned Aa corporates (%)	12/11	8.23	8.27	7.85
	New Aa corporates, Treasury est. (%)	12/11	8.15	8.39	9.12
	Moody's seasoned Aaa municipals (%)	12/11	5.15	5.15	6.48
	Bond Buyer's new munic. bond index (%) 8/	12/11	5.33	5.41	6.88

1/ Seasonally adjusted annual rate. 2/ 1957-59=100. 3/ Excluding military aid shipments.
4/ Last Wednesday of month. 5/ Daily average. 6/ Demand deposits adjusted and currency outside banks. 7/ Excludes gold in Exchange Stabilization Fund. 8/ 20-bond index.
9/ Including allocations of Special Drawing Rights.
u - unofficial adv. estimate. p - preliminary. r - revised.

MISC. 3B
Misc. 3B.2-30M-3-64

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

admin marking ~~CONFIDENTIAL~~ (F.R.)

DATE December 14, 1970

TO Mr. Hayes

SUBJECT: Euro-dollar policies of New York banks

FROM A. R. Holmes

In response to Chairman Burns' request the following summarizes briefly the results of a survey conducted late last week of the Euro-dollar plans of the major New York banks.

Generally speaking the Board's December 1 amendment to Regulation M is viewed by the banks as sending out a clear message to them not to repay Euro-dollar borrowings. This message, rather than the technical details of the amendment, has been influential in inducing them to stand pat on their current holdings for the time being. There seems to be little evidence that banks which in the current period are running below their most recently established base are trying to rebuild that base before the current period expires on December 23. All the banks are very much concerned about the costs involved in maintaining Euro-dollar positions, with varying degrees of resentment over the fact that the Federal Reserve apparently expects them to shoulder these costs. The banks generally feel caught in a dilemma between acting in what they believe the Federal Reserve thinks is the public interest, and the economics of the rate spread between Euro-dollar and domestic interest rates. They are keeping their Euro-dollar policies under close review, and unless the spread between Euro-dollar and domestic rates narrows will be under great pressure to reduce their takings because of the impact of the extra costs on profits. Banks generally believe that there should be some incentive for them to hold on to Euro-dollars, and have come up with virtually all the suggestions that the Board has under consideration that would reduce the costs to the banks. One added starter is the suggestion that the Treasury should make additional deposits in Tax and Loan Accounts in those banks who agree to hold on to their Euro-dollar positions.

A brief review of comments by individual banks follows. It should be recognized that there are differences of opinion within individual banks, and that the situation is being kept under constant review by top management in all the banks.

ARH:fm

Att.

Irving Trust Company

Had been repaying Euro-dollars but now willing to take on a spread of a point to a point and a half in order to avoid going lower. Banks cannot be expected, however, to incur such extra costs for any length of time. Some means of reducing costs necessary to avoid further repayments, such as special Treasury deposits in Tax and Loan Accounts for cooperating banks or reduction in reserve requirements linked to banks' willingness to hold Euro-dollars and to rate spread. Also believes greater flexibility should be introduced in base by permitting banks to go to, say, 75 per cent of base, without losing the original base.

Manufacturers Hanover Trust

Have been maintaining base but in view of cost may have to decide to cut back. Believes Board is asking too much of banks in terms of cost.

Morgan Guaranty

Took Board regulations as asking the banks to hold on to Euro-dollars for awhile. Have decided to hold base for another month and will review position after year-end in light of spread between Euro-dollar and domestic rates. Maintaining base now provides opportunity to see if some sort of inducement to hold Euro-dollars will be forthcoming from the Board. Greatly concerned about cost of maintaining position and effect on bank earnings. Would be content to hold base if spread were only 1/4 per cent but current 1 1/2 per cent entirely too high to hold on very long.

Bankers Trust Company

Board should provide incentive to retain Euro-dollars rather than ask banks to shoulder cost of rate spread. Not much influenced by increase of reserve requirements on above base borrowings from 10 to 20 per cent. Sense of patriotism only factor causing them to hold line at current levels, and in light of earnings outlook for 1971, there are limits beyond which economics must win out over patriotism. Some inducement through lower reserve requiements--or other means--would be more effective.

Chase Manhattan Bank

Believes Board's message very clear that it wants banks--in public interest--to maintain Euro-dollar base. Raising reserve requirements on over-base borrowing raises some questions about Board's intent with respect to Regulation Q. Are maintaining base but keeping under close review in view of the heavy cost. Hard to make case for maintaining base on purely economic grounds, believes some incentive should be given banks but not enamored of most suggestions for relief. The real problem is the unusual spread between Euro-dollar rates and domestic rates and failure of Euro-dollar rates to decline in recent weeks.

Chemical Bank

Have stopped running down base and will review after year-end in light of what happens to Euro-dollar rates. View Board action as very costly to banks, but as temporarily effective in restraining Euro-dollar outflow. Expressed concern over shift of base on foreign branch loans to U. S. residents from May 1969 to November 1969, particularly since this was not made clear in Board press release.

First National City Bank

Feels that they were singled out as "bad boys" because went below base. Had made public announcement of their position and had not been put on notice by Federal Reserve that it did not want paydowns. Are currently standing pat about $200-$300 million below their latest established base. Had considered restoring earlier base but rejected as too costly. Much concerned about cost to bank of maintaining current position and will keep position under review. Would like to see some sort of inducement to banks to keep Euro-dollars, such as issue of special Treasury notes to their foreign branches at concession rates.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE 12/16

TO Mr. Robert C. Holland

FROM ROBERT SOLOMON

Any reaction?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 10, 1970

To Mr. Robert Solomon

From Robert F. Gemmill

Subject: Reserve requirements and Euro-dollar borrowings

One of the principal objections to the proposed special reduced rate of reserve requirement on demand deposits as a technique for discouraging reductions in Euro-dollar borrowings is the fact that much and perhaps all of the release of reserves would accrue to the largest banks that have been the major borrowers of Euro-dollars. The proposal might well be open to political criticism on this ground.

As noted in the Division's memorandum of November 28 to the Board, one way to counter some part of this criticism might be to increase reserve requirements on reserve city banks by an amount that would offset the potential release of reserves expected to result from the special reduced reserve requirement applicable to Euro-dollar borrowings.

Such a general increase in reserve requirements for reserve city banks (e.g. from 17-1/2 per cent to 18-1/2 per cent) would create inequities of two sorts:

(1) Banks that have not borrowed Euro-dollars would have increased reserve requirements, but would not readily (if at all) be able to offset these increased requirements by Euro-dollar borrowings which would entitle them to a reduced rate of reserve requirement on an equal amount of demand deposits. (Most reserve city banks would have much smaller reserve-free bases for Euro-dollar borrowings than do the largest banks.) Roughly half of any general increase in reserve requirement on reserve city banks would fall on banks that have not borrowed significant amounts of Euro-dollars.

(2) Among banks that are major borrowers of Euro-dollars, the distribution of benefits (reduced rate of requirement equal to amount of Euro-dollar borrowings) and burdens (increased requirement on demand deposits) would be inequitable. Euro-dollar borrowings of a number of major banks exceed 20 per cent of deposits (subject to reserve requirements) and range as high as 30 per cent; on the other hand, borrowings are equal to only about 5 per cent of deposits for one bank, and are less than 10 per cent of deposits for a few others.

The Board could largely avoid the first sort of inequity, and limit the increased reserve requirement to large Euro-dollar borrowers, if the requirement were a graduated one, applied only to the amount of a bank's net demand deposits in excess of $1 billion. As shown in the attached table, a cut-off at this deposit level includes virtually all the major Euro-dollar borrowers, and only a very few banks that are (or were) not major borrowers. However, a graduated reserve requirement, based on deposit size, cannot avoid creating inequities among major Euro-dollar borrowers, since borrowings represent widely differing proportions of deposits.

The table attached to this memorandum includes all banks with net demand deposits of $1 billion or more (week of October 21, 1970). It excludes only three banks using historical bases for Euro-dollar borrowings, with aggregate borrowings of $450 million. The table is calculated on the assumption that the special reduced rate of reserve requirement applicable to an amount of deposits equal to Euro-dollar borrowings is set at 7-1/2 per cent -- providing the banks with a reserve saving of 10 cents on each dollar of Euro-dollar borrowing (equivalent at present interest rates to about 50 basis points saving on the cost of borrowings.) This reduced rate of requirement would involve a release of reserves for 17 banks of about $930 million, based on recent levels of Euro-dollar borrowing; if banks that are not making full use of their 3 per cent minimum bases were to do so, the reserve release would be close to $1 billion for these billion dollar banks (based on net demand deposits.)

A rate of reserve requirement of 21-1/2 per cent on a bank's net demand deposits in excess of $1 billion would yield a total reserve absorption of almost $1 billion (based on daily average data for the week ended October 21.) As noted in the table, eight banks would obtain a reserve release larger than the reserve absorption, and nine would obtain a reserve release less than the absorption. Use of several steps of graduated requirement to obtain the same total reserve absorption would increase the burden on the largest banks -- notably Bank of America (which would have relatively low benefits from the special reduced rate of requirement because of a low historical base) and First National City (which would have relatively low benefits because of repayments of Euro-dollars.)

The net reserve absorption would be reduced if lower graduated requirements were imposed. A supplementary table indicates the way in which the positions of individual banks would be affected by rates of requirement of 19-1/2 per cent and 20-1/2 per cent on net demand deposits in excess of $1 billion. As noted in the supplementary table, a requirement of 19-1/2 per cent on deposits in excess of $1 billion would produce a net reserve release for all banks of about $433 million, and only a few banks (notably Security Pacific) would experience a significant reserve absorption. A requirement of 20-1/2 per cent would result in a net reserve release for all banks of about $188 million; seven banks would experience reserve absorption, including net increases of more than $20 million for Bank of America, Security Pacific and First National City.

Apart from the inevitable differential impact among Euro-dollar banks, use of a graduated reserve requirement in conjunction with a special reduced requirement on Euro-dollar borrowing poses several policy issues:

1. Is the Board prepared to adopt graduated requirements as a relatively permanent feature of the banking structure?

2. Is this the time to introduce graduated requirements?

3. Is the rate structure appropriate for use in connection with Euro-dollar borrowing consistent with longer-term Board objectives regarding a graduated requirement.

Banks with Net Demand Deposits in Excess of $1 billion

Bank	Column 1 Reserve release (with special reduced requirement of 7-1/2 per cent on net DD equal to Euro-dollar borrowings) (millions of dollars)	Column 2 Reserve absorption (with reserve requirement of 21-1/2 per cent on net DD in excess of $1 billion (millions of dollars)	Column 3 Column 1 - Column 2
First Nat'l. Boston	40	5	+35
Bankers	71	56	+15
Chase	225	181	+44
Irving	45	13	+32
Morgan	125	62	+63
Mellon	12	4	+8
Cont. Illinois	62	41	+21
First Nat'l. Chicago	35	28	+7
Subtotal	615	390	+225
Chemical	82	91	-9
First Nat'l. City	90	153	-63
Manufacturers	59	96	-37
Nat'l. Bank of Detroit*	--	12	-12
Bank of America	76	162	-86
United California*	--	17	-17
Crocker Citizens*	3	13	-10
Wells Fargo*	5	16	-11
Security Pacific*	--	42	-42
Subtotal	315	602	-287
Total	930	992	

* Note: The reserve release would be about $60 million greater, and the differences in Column 3 $60 million less, if the banks marked with an asterisk borrowed Euro-dollars in amounts equal to their minimum (3 per cent) bases.

Supplementary Table

Bank	Graduated Requirement of 19-1/2 per cent: Column (1) reserve release	Column (2) reserve absorption	(2) - (1)	Graduated Requirement of 20-1/2 per cent: Column (2)	(2) - (1)
First National Boston	40	2	+38	3	+37
Bankers Trust	71	28	+43	42	+29
Chase Manhattan	225	90	+135	135	+90
Chemical	82	46	+36	68	+14
Irving Trust	45	7	+38	10	+35
Morgan Guaranty	125	31	+94	46	+79
Mellon	12	2	+10	3	+9
Continental Illinois	62	21	+41	31	+31
First National Chicago	35	14	+21	21	+14
			Subtotal	359	+338
First National City	90	77	+13	115	-25
Manufacturers Hanover	59	48	+11	72	-13
Subtotal		366	+480		
Crocker Citizens*	3	6	-3	9	-6
National Bank of Detroit*	--	6	-6	9	-9
Bank of America	76	81	-5	122	-46
United California*	--	9	-9	13	-13
Wells Fargo*	5	8	-3	12	-7
Security Pacific*	--	21	-21	31	-31
Subtotal		131	-47	383	-150
TOTAL	930	497	+433	742	+188

Note: If banks marked with an asterisk borrowed Euro-dollars in amounts equal to their minimum (3 per cent) bases, the aggregate reserve release would be about $60 million greater.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE 12/31/70

TO Chairman Burns

FROM ROBERT SOLOMON

Phil Coldwell comes out just about where your staff does: give the banks an incentive--via reduced reserve requirements--to retain their Eurodollar liabilities.

RS

Attachment.

From the desk of

ARTHUR F. BURNS

12/19/70

Mr. R. Solomon

Caldwell
12-15-70

BRIEF ON OVERHANG OF EURODOLLAR LIABILITIES

Basic Position

Since we permitted the banks to enlarge their Eurodollar holdings and accepted the benefit therefrom, theoretically we should accept the repayment and the detriment therefrom. One must recognize, however, that there is an element of face-saving in trying to slow the outflow as well as a real risk that the foreign central banks may decide that enough is enough and begin trading their dollars for gold. We are in no position to stand such a gold run nor is the international financial mechanism.

Secondary Position

Given the practicality of the problem and the need to slow the outflow of Eurodollars, it seems to me that disincentives and negative incentives of the type tried by the Board in its recent increase of reserve requirements are not the answer. Instead, it seems to me that we must try some positive incentive in the form of cost improvement to encourage the banks to hold their base amounts of Eurodollars. This could be done by either of the following methods:

1. Redefine "deposits" so as to give a positive credit of a given percentage (perhaps 2 percent) of reserve requirements in an amount equal to the Eurodollar base of the particular bank. Alternatively in the same vein, a certain proportion of Eurodollar base (perhaps 10 to 25 percent) might be counted the same way as cash items in the process

of collection. Either of these two methods would provide a positive cost advantage of holding Eurodollars. The percentages or dollar credits would have to be worked out so that the advantage is not overwhelming but marginal enough to make up for the cost differential.

2. Another alternative might be to differentiate the reserve requirement on certificates of deposit by the amount of Eurodollar deposits. Under this arrangement a bank with its base amount of Eurodollars fully drawn would get a credit on its reserve requirement against certificates of deposit. Again, the percentages would have to be worked out with sufficient care that there would not be too great a margin of advantage.

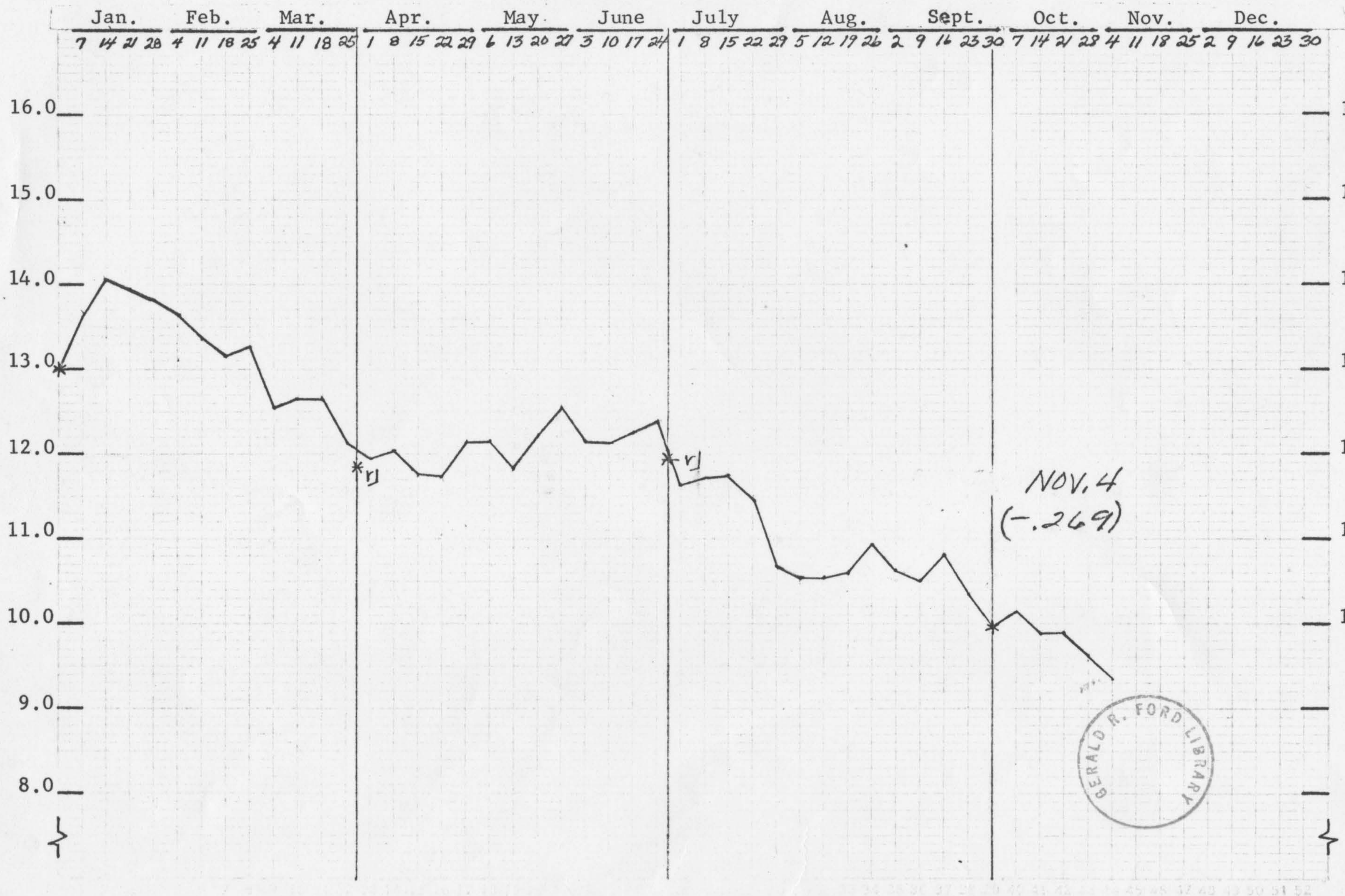
These proposals are based on the idea that there must be some slowing of the Eurodollar outflow, at least for a temporary period of time until, hopefully, we make more fundamental corrections in both our foreign policy, which is causing the large outflow, or our balance of trade, which presently provides too little offset against the other forms of outflow.

P. E. Coldwell
December 11, 1970

CONFIDENTIAL (FR)

1970

Gross Liabilities of U.S. Banks to Their Foreign Branches
and Branch Participations in Head Office Domestic Loans
(billions of dollars)



r/ revised

Figures for Wednesdays

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

Average for month or week ending Wednesday	(1) Call Euro-$ Deposit 1/	(2) Federal Funds 2/	(3)= (1)-(2) Differential	(4) 3-month Euro-$ Deposit 1/	(5) 60-89 day CD Rate (Adj.) 3/	(6)= (4)-(5) Differential
August	7.26	6.61	0.65	8.19	8.17	0.02
September	7.68	6.29	1.39	8.03	7.64	0.39
Oct. 7	7.73	6.36	1.37	8.35	7.24	1.11
14	7.13	6.21	0.92	8.18	6.97	1.21
21	6.08	6.18	-0.10	7.76	6.84	0.92
28	6.00	6.07	-0.07	7.66	6.84	0.82
Nov. 4	6.10	6.07	0.03	7.58	6.65	0.93
Daily						
Nov. 5	6.13	6.13	0.00	7.56	6.72	0.84
6	6.25	6.00	0.25	7.56	6.72	0.84
9	6.63	n.a.	n.a.	7.50	n.a.	n.a.

1/ Noon bid rates in the London market.
2/ Effective rate.
3/ Offering rates (median, as of Wednesdays) on large denomination certificates of deposit by prime banks in New York City; adjusted for reserve requirements. Daily rates from New York Times.