

**The original documents are located in Box B98, folder “Swap Arrangements - General, 1970-75 (1)” of the Arthur F. Burns Papers at the Gerald R. Ford Presidential Library.**

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What are the swaps?

The Federal Reserve swap network is a system of reciprocal-credit arrangements between the System and 15 other central banking institutions (that is, the central banks of 14 industrialized countries and the Bank for International Settlements). It was first established in 1962.

Foreign central bank needs dollars. The foreign central bank has typically requested a drawing to obtain dollar for intervention in the foreign-exchange market. It would credit the System with X million of dollars-equivalent of local currency on its books and receive, in return, a credit of X million of dollars at the Federal Reserve Bank of New York. The two credits are to be repaid within a specified period. At that time, the foreign central bank pays X millions of dollars to the Federal Reserve Bank of New York and, in return, the New York Reserve Bank pays it X millions of dollars-equivalent of its own currency.

Federal Reserve System needs foreign currency. The Federal Reserve typically makes a drawing when the foreign central bank asks it to do so to cover excess dollar holdings in its hands. The System receives a X millions of dollar-equivalent of foreign currency from the foreign central bank and credits it, in return, with X millions of dollars at the New York Federal Reserve Bank. The System immediately uses the foreign currency to purchase X million of dollars from the foreign central bank. The foreign central bank holds the dollars it has received from the System for the duration of the drawing in special Treasury



Certificates of Indebtedness at an agreed interest rate. When the time for repayment comes, the Federal Reserve is obligated to repay the foreign central bank X millions of dollars-equivalent of the foreign currency and, in return, receives from the foreign central bank the X millions of dollars held at the Federal Reserve Bank of New York.

Purposes of swap network. The Federal Reserve swap network has had the objective of safeguarding the U.S. gold stock as one major purpose. In practice, the Federal Reserve made a drawing of a foreign currency primarily at the request of a foreign central bank which wanted a short-term exchange-value guarantee on dollar receipts it might otherwise have wished to convert into gold. In addition, the network was used to mobilize international official resource to stabilize private markets and, on occasion, even to support major currencies during political or military emergencies. It was also intended to function as a means of offsetting or financing temporary and disturbing international capital flows, especially during speculative crises.



Extracts from Minutes of Federal Open Market Committee

Meeting of January 9, 1962

Mr. Mills seconded the proposal that Chairman Martin be authorized to contact the Chairmen of the House and Senate Banking and Currency Committees to acquaint them with the problem and with the approach that the System might be making to operations in foreign currencies, and to obtain their reaction. (p. 67) FOMC so agreed. (p. 68)

Meeting of January 23, 1962

Chairman Martin reported on his consultations about the subject with the Chairmen of Senate and House Banking and Currency Committees and commented briefly on the general problem of obtaining legislation that would clarify the Committee's authority to conduct foreign currency operations . . .

In the light of the Chairman's report and the roundtable comment, a majority of the Committee were favorably disposed towards operations on an experimental basis. (p. 112)

Meeting of February 13, 1962

He (Chairman Martin) had been authorized to make reference to the subject in his testimony before the Joint Economic Committee on January 30 in connection with hearings on the President's Economic Report. He presumed that the members of the Committee had seen the testimony. Rather surprisingly, the Chairman said, there had been little comment, either favorable or adverse, since that time. (p. 163)



Meeting of March 6, 1962

The Chairman also reported that in response to the request made by members of the Congress at the time of hearings on H. R. 10162, a bill to authorize U.S. contributions in connection with expansion of the stand-by resources of the International Monetary Fund, he had sent to the Chairman of the House Committee on Banking and Currency on March 1, 1962 the following documents for inclusion in the record of the hearings:

(1) A memorandum from the Open Market Committee's General Counsel dated November 22, 1961, expressing the opinion that foreign currency operations by the System were authorized by the Federal Reserve Act;

(2) A summary opinion rendered by the Open Market Committee's General Counsel to the Congressional Joint Economic Committee, upon request, under date of February 19, 1962;

(3) A copy of the letter from the General Counsel of the Treasury dated January 8, 1962, expressing his concurrence and that of the Attorney General in the opinion of the Committee's General Counsel and enclosing a memorandum that he had submitted to the Secretary of the Treasury to the same effect;

(4) A copy of the letter sent by Chairman Martin on February 16, 1962, to the Chairman of the National Advisory Council, along with a copy of the enclosed authorization of the Federal Open Market Committee for System foreign currency operations; and

(5) A copy of an action by the National Advisory Council dated February 28, 1962, indicating that the Council was in accord with the System's decision to undertake foreign currency operations.

Chairman Martin pointed out that this meant that the authorization for foreign currency operations, approved February 13, 1962, was now a public document. (pp. 286-87)



Extracts from Congressional Committee Hearings, Jan-Feb 1962

- I. JEC Hearings "January 1962 Economic Report on the President,"  
January 30, 1962

Martin prepared statement

As one step in such cooperation, the System is now prepared in principle and in accordance with its present statutory authority to consider holding for its own account varying amounts of foreign convertible currencies. Toward this end, we are now exploring, in consultation with the Secretary of the Treasury, methods of conducting foreign exchange operations in convertible currencies with due and full regard for the foreign financial policy of the United States.

These System operations, along with those conducted by the stabilization fund, would have the primary purpose of helping to safeguard the international position of the dollar against speculative flows of funds. (p. 175)

Subsequent Martin statement

I want to make clear, Mr. Bolling, that the Federal Reserve is not anxious to engage in this type of activity. It is only because we feel that we have a responsibility -- with convertible currencies as they are today, currency values -- including that of the dollar -- are more subject than for a long time to speculative movements. (p. 181)

The Committee questioning

Concern was with various economic matters other than proposed operations in foreign currencies.

- II. Hearings, "Bretton Woods Agreements Act Amendment," House Committee on Banking and Currency, February 28, 1962.

Martin prepared statement

. . . The contemplated Federal Reserve operations in convertible foreign currencies would complement the proposed IMF arrangements in two ways.

The Federal Reserve would help to deal with minor pressures before they reach a scale commensurate with IMF action. And it could take prompt action in more serious circumstances while IMF arrangements are being worked out. (p. 91)



With this same object in view, the Federal Reserve has recently decided to reenter the field of foreign-exchange transactions. (p. 90)

. . . While in time it may be desirable to recommend amendment of the Federal Reserve Act to provide greater flexibility than we now have under the act in carrying out these operations, it would be impractical to request such legislation before operating experience under existing authority has provided a clear guide as to the need for it. (p. 92)

Some Committee members challenged authority of System

Reuss: Much of the operation that you are doing under this seems to me to duplicate the foreign exchange stabilization that the Secretary of the Treasury has very properly undertaken pursuant to the Gold Reserve Act of 1934.

To me this is a tremendous power you have taken upon yourself, and I must serve notice on you right now that I consider this an usurpation of the powers of Congress. I don't think you are authorized to do this at all . . . (p. 102).

Widnall: That (Federal Reserve decision) is for the purpose of the stabilization of the dollar; isn't it? (p. 99)

Multer: On page 6 of your statement, Mr. Martin, you refer to the possibility or desirability of recommending an amendment of the Federal Reserve Act at some future time. We should not draw the inference from that that what you have done thus far in these operations are not authorized by the act?

Mr. Martin: They are, in our judgment, Mr. Multer. We studied that very carefully. What I was trying to convey was the fact that there are some things that we might want to do because of changed circumstances, that we would not think we had authority to do, and we would certainly be very careful to hue to our authority. If we wanted to do those things we would come up for legislation.

Mr. Multer: You don't think the time is ripe to ask for such amendments at this time?

Mr. Martin: No, we think we ought to experiment with our existing authority before coming up for more. (pp. 99-100)





Mr. Martin (in reply later to Mr. Barrett): I merely meant in the paragraph that . . . I would see no way in which we could buy foreign Treasury Bills as an investment. I wouldn't think we would have the authority to do that, and we wouldn't do it.

But it might be of value to us to be able to buy foreign Treasury bills at some time. I don't think we have authority to do so at the present time, so we will certainly abide by the letter of the law as it is now drawn. But if we felt that it was desirable for us to do that, we would expect to come up with legislation. (p. 101)

Mr. Patman: Tell me where in the Open Market Committee law you have a right to do this? (Mr. Martin had cited Section 14 of the Federal Reserve Act which specifies that any Federal Reserve Bank can purchase or sell . . . cable transfers, bills of exchange or foreign exchange.) Otherwise the Federal Open Market Committee does not have the power to do it.

Mr. Martin: No, Mr. Patman. I don't think so. We went into that very carefully. This was reviewed carefully by our counsel, by other counsel in the Federal Reserve System. They decided we had this authority under the existing law. It was taken up with the counsel of the Treasury of the United States, and he concurred in that opinion.

It was taken up with the Attorney General of the United States and he also concurred.

You can always get lawyers to disagree, but I don't know how many more we should consult.

Mr. Reuss: I just want to state that I am a lawyer, qualified to practice, and I disagree. I don't think the Fed has the power to do the things that are in here, and I join with the request of Mr. Patman that you file with this committee the opinions not only of your own counsel which I have seen, but of the counsel of the Treasury and of the Attorney General.

Mr. Patman: . . . I think Mr. Reuss is correct . . . Remember, the banks, when they were set up in 1913, your member banks, were given authority, not collectively, but individually, as Federal Reserve banks in 12 regions. They were given this power.

Now you are assuming it for an entirely different agency -- the Open Market Committee. (pp. 127-28)



Resolution of Committee discussion:

Mr. Martin filed with Chairman Spence on March 1 five documents for inclusion in the permanent record of the hearings:

(1) A memorandum from the Open Market Committee's General Counsel dated November 22, 1961, expressing the opinion that foreign currency operations by the System were authorized by the Federal Reserve Act;

(2) A summary opinion rendered by the Open Market Committee's General Counsel to the Congressional Joint Economic Committee, upon request, under date of February 19, 1962;

(3) A copy of the letter from the General Counsel of the Treasury dated January 8, 1962, expressing his concurrence and that of the Attorney General in the opinion of the Committee's General Counsel and enclosing a memorandum that he had submitted to the Secretary of the Treasury to the same effect;

(4) A copy of the letter sent by Chairman Martin on February 16, 1962, to the Chairman of the National Advisory Council, along with a copy of the enclosed authorization of the Federal Open Market Committee for System foreign currency operations; and

(5) A copy of an action by the National Advisory Council dated February 28, 1962, indicating that the Council was in accord with the System's decision to undertake foreign currency operations.









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

*FOMC  
12/15*

December 8, 1970

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

There is enclosed a copy of a memorandum to the Committee from Mr. Bodner dated today and entitled "Proposed modification of procedures to be employed in transactions under certain swap lines." It is contemplated that this memorandum will be discussed at the next meeting of the Committee.

*Arthur L. Broida*

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

Enclosure



STRICTLY CONFIDENTIAL--F.R.



DATE: December 3, 1970

TO: Federal Open Market Committee

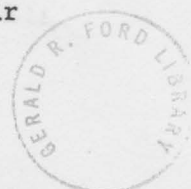
FROM: David E. Bodner

SUBJECT: Proposed modification of procedures to be employed in transactions under certain swap lines

At the time of the November meeting of the B. I. S., representatives of some of the EEC central banks approached Mr. Coombs to discuss the way in which operations under the swap lines have affected their profit and loss positions. It was agreed that representatives of the two central banks most concerned about this question would come to New York to review it in greater detail. On November 13 and 19 Messrs. P. Timmerman of the Nederlandsche Bank and F. Heyvaert of the Banque Nationale de Belgique met with Mr. Coombs and other officers of the Foreign Department at the New York Bank. The two representatives noted that, in the normal course of events, the debtor country in the swap arrangements tends to make a profit on operations. Thus, given the usual cycle of market developments, a country would draw when its currency was weak and repay when it was strong and insofar as it operated in the market at current rates it would make a profit over the cycle. They pointed out, however, that given the small size of the Dutch and Belgian foreign exchange markets, in general it has not proved possible for the System to reconstitute foreign exchange balances it acquired and disbursed under the swap arrangements except through direct transactions with the two central banks. Consequently, profits made by the System on operations have come at the expense of foregone profits by the two central banks. Moreover, in some cases in which System purchases or sales of exchange with the central banks have not been exactly matched by offsetting operations of those central banks with the market, the two central banks have, in fact, suffered some losses. More generally, when it has not proved possible to reverse the swaps through changes in market conditions and we have unwound

our debtor position through IMF drawings by the Treasury, the Treasury has made substantial windfall profits. These arise because the Treasury draws the foreign currency at par from the IMF, while we repay swap drawings made at or close to the ceiling. In the first instance, these windfall profits come at the expense of the foreign central bank through a reduction in its foreign exchange position. The two representatives expressed the view that these costs in foregone profit opportunities and, on occasion, in actual bookkeeping losses, had raised more and more questions within their banks, especially in view of the existence in the swap arrangement of the revaluation clause in a context in which they felt under pressure from the U. S. Government to revalue their currency.

Messrs. Timmerman and Heyaert then proposed a new method of operating under the swap arrangements. They suggested that all transactions be handled at par, including not only drawings and repayments of the swaps themselves, but also the secondary spot sale of the swap proceeds and final reconstitution of System balances to liquidate the swaps. It was explained to them that such a solution would involve the System in extensive dealings in non-market rates which, aside from certain legal problems which might be raised, would constitute a fundamental change in policy on behalf of the Open Market Committee. Mr. Timmerman then proposed that the same effect be achieved by bringing the U. S. Treasury into the transactions: System swaps with the central banks would be made as at present, but the System would then swap the proceeds with the U. S. Treasury and the Treasury would sell the foreign exchange balances to the central bank at par. At the time of liquidation, the central bank would resell the currency to the Treasury at par and the swaps between the Treasury and the System and the System and the central bank would then be unwound. With all the swaps being reversed at the same rates at which





they were made there would be no profit or loss incurred by any party to the swap transaction.

This proposal was put to the Treasury, which did not find it acceptable. Moreover, it clearly had serious drawbacks from the view of the Federal Reserve. An alternative proposal was then considered:

1) In any case in which the swap line has to be repaid through a Treasury drawing on the IMF, the Treasury would resell the foreign currency proceeds of its drawing to the central bank concerned at par, rather than, as at present, selling them to the System at the current market rate. This sale would reduce the central bank's dollar position correspondingly and make room for a direct transaction with the System to unwind the swap. In this manner, the Treasury would forego the windfall profits that now accrue to it on such Fund drawings. This procedure would be exactly analogous to what now occurs when the Treasury sells gold or transfers SDRs to enable the System to repay a swap drawing. The Treasury has this proposal under consideration.

2) Recognizing that, because of the limitations imposed on operations by the small size of the Dutch and Belgian markets, it has proved necessary for us to acquire balances to liquidate the swap through direct transactions with the central banks, and recognizing that when the conditions that gave rise to the swap drawing are not reversed within the normal time span it is necessary to liquidate the swaps through such direct transactions, we might consider fixing the rate for such transactions at the time of the initial activation of the swap. This would be accomplished by entering into a forward contract under which the System would purchase the currency needed to liquidate the swap, the rate on that contract to be the market rate then prevailing, i.e., the same rate used for the swap drawing itself. Thus, no profit or loss would accrue to either party to the extent a swap was unwound in this manner. The execution of such a contract at the time of the initial swap drawing, however, would complete the circle of spot and forward





transactions in such a way that the foreign central bank concerned would lose the protection against a possible devaluation of the dollar that is in many cases the essence of the swap drawing by the System. (That is, the protection is afforded to the central bank by the fact that it has an outstanding contract to sell dollars forward to the System at an established rate. If it then enters into a forward purchase contract for the same value date at the same rate, it effectively washes out its protection.) To deal with this problem it was proposed that the new forward contract include a conditional clause indicating that in the remote event of a devaluation of the dollar this new forward contract would be considered to be canceled.<sup>1/</sup> Furthermore, it was suggested that the System might agree that a formal suspension of gold sales by the U. S. Treasury without an official change in the price of gold would also result in a cancellation of the contract.

3) The new forward purchase by the System would be further qualified to leave open the possibility that the System could acquire, at market rates, currencies needed to prepay the swap to the extent that there was a reversal in the market. That is, the new forward contract to buy currency at the rate of the original swap drawing would cover only that portion of the outstanding swap that it had proved impossible to liquidate through normal operations.

This proposal appears to be acceptable to the Europeans--although it does not meet all their desires--while offering certain distinct advantages to the System. It would eliminate windfall profits made by the Treasury, and to some extent by the System, at the expense of foreign central banks under present arrangements and protect the foreign central bank against the risk of loss in operations under the swap. At the same time, it would preserve the basic structure of operations under the swap lines and guarantee the System against

1/ See sample cable attached.



any risk of loss. At present, the System is exposed to a potential loss any time that it makes a drawing when the spot rate for the foreign currency is below its ceiling. If in such a case no reversal occurs and the System has to liquidate the transaction through direct dealings with the central bank (in association with Treasury sales of reserve assets), there is the possibility that the spot rate could then be higher than it was at the time of the drawing, thereby making the foreign currency more expensive for the System to acquire. Although unusual, there have been such occurrences. Under this proposal such a situation could not arise because the new forward contract would guarantee that the System could acquire the necessary currency at the same rate as the original swap. This may prove to be particularly important in coming years when the EEC countries move to narrow the margin of fluctuation among their currencies within the present dollar band. Under those circumstances, it is entirely possible that the System could be called upon to make a swap drawing in a case in which the central bank was maintaining an interim "ceiling" at a level below the official EMA ceiling. If at the time of liquidation of the drawing, the EEC band had been moved upward so that the currency in question, even if below its formal ceiling, was above the rate at which the System had drawn, a loss would be incurred. Such occurrences may arise, moreover, with greater and greater frequency as the EEC succeeds in narrowing its band. The proposed new arrangement would effectively protect the System against these potentially significant losses. In addition, the new arrangement would protect the System against the risk of loss in the event that a country to which the System was indebted under the swap was to widen the margins against the dollar while a swap drawing was outstanding and the spot rate was then to move above the old ceiling. Although from time to time informal understandings have been reached concerning the activation of the revaluation clause in such an instance, this situation is not



covered in any formal way by the present revaluation clause. Thus, on balance, the proposed change in procedures appears to offer significant advantages to the System as well as eliminating a source of continuing irritation among some of the System's swap partners.



DRAFT CABLE

DE NEDERLANDSCHE BANK

AMSTERDAM

- I    FOR VALUE (Date - Three Months Forward) WE BUY FROM  
YOU UP TO NG (AMOUNT of guilders drawn) AT RATE OF  
(SPOT Rate, as per Swap Contract).
- II    IN THE REMOTE EVENT OF A DEVALUATION OF THE  
U. S. DOLLAR PRIOR TO THE VALUE DATE ABOVE,  
THIS CONTRACT WOULD BE CONSIDERED TO BE CANCELLED.
- III   PLEASE CONFIRM

FEDERAL RESERVE BANK OF NEW YORK





STRICTLY CONFIDENTIAL--F.R.



DATE: December 3, 1970

TO: Federal Open Market Committee

SUBJECT: Proposed modification of procedures to be employed in transactions under certain swap lines

FROM: David E. Bodner

At the time of the November meeting of the B. I. S., representatives of some of the EEC central banks approached Mr. Coombs to discuss the way in which operations under the swap lines have affected their profit and loss positions. It was agreed that representatives of the two central banks most concerned about this question would come to New York to review it in greater detail. On November 18 and 19 Messrs. P. Timmerman of the Nederlandsche Bank and F. Hayvaert of the Banque Nationale de Belgique met with Mr. Coombs and other officers of the Foreign Department at the New York Bank. The two representatives noted that, in the normal course of events, the debtor country in the swap arrangements tends to make a profit on operations. Thus, given the usual cycle of market developments, a country would draw when its currency was weak and repay when it was strong and insofar as it operated in the market at current rates it would make a profit over the cycle. They pointed out, however that given the small size of the Dutch and Belgian foreign exchange markets, in general it has not proved possible for the System to reconstitute foreign exchange balances it acquired and disbursed under the swap arrangements except through direct transactions with the two central banks. Consequently, profits made by the System on operations have come at the expense of foregone profits by the two central banks. Moreover, in some cases in which System purchases or sales of exchange with the central banks have not been exactly matched by offsetting operations of those central banks with the market, the two central banks have, in fact, suffered some losses. More generally, when it has not proved possible to reverse the swaps through changes in market conditions and we have unwound



our debtor position through IMF drawings by the Treasury, the Treasury has made substantial windfall profits. These arise because the Treasury draws the foreign currency at par from the IMF, while we repay swap drawings made at or close to the ceiling. In the first instance, these windfall profits come at the expense of the foreign central bank through a reduction in its foreign exchange position. The two representatives expressed the view that these costs in foregone profit opportunities and, on occasion, in actual bookkeeping losses, had raised more and more questions within their banks, especially in view of the existence in the swap arrangement of the revaluation clause in a context in which they felt under pressure from the U. S. Government to revalue their currency.



Messrs. Timmerman and Heyaert then proposed a new method of operating under the swap arrangements. They suggested that all transactions be handled at par, including not only drawings and repayments of the swaps themselves, but also the secondary spot sale of the swap proceeds and final reconstitution of System balances to liquidate the swaps. It was explained to them that such a solution would involve the System in extensive dealings in non-market rates which, aside from certain legal problems which might be raised, would constitute a fundamental change in policy on behalf of the Open Market Committee. Mr. Timmerman then proposed that the same effect be achieved by bringing the U. S. Treasury into the transactions: System swaps with the central banks would be made as at present, but the System would then swap the proceeds with the U. S. Treasury and the Treasury would sell the foreign exchange balances to the central bank at par. At the time of liquidation, the central bank would resell the currency to the Treasury at par and the swaps between the Treasury and the System and the System and the central bank would then be unwound. With all the swaps being reversed at the same rates at which

they were made there would be no profit or loss incurred by any party to the swap transaction.

This proposal was put to the Treasury, which did not find it acceptable. Moreover, it clearly had serious drawbacks from the view of the Federal Reserve. An alternative proposal was then considered:



1) In any case in which the swap line has to be repaid through a Treasury drawing on the IMF, the Treasury would resell the foreign currency proceeds of its drawing to the central bank concerned at par, rather than, as at present, selling them to the System at the current market rate. This sale would reduce the central bank's dollar position correspondingly and make room for a direct transaction with the System to unwind the swap. In this manner, the Treasury would forego the windfall profits that now accrue to it on such Fund drawings. This procedure would be exactly analogous to what now occurs when the Treasury sells gold or transfers SDRs to enable the System to repay a swap drawing. The Treasury has this proposal under consideration.

2) Recognizing that, because of the limitations imposed on operations by the small size of the Dutch and Belgian markets, it has proved necessary for us to acquire balances to liquidate the swap through direct transactions with the central banks, and recognizing that when the conditions that gave rise to the swap drawing are not reversed within the normal time span it is necessary to liquidate the swaps through such direct transactions, we might consider fixing the rate for such transactions at the time of the initial activation of the swap. This would be accomplished by entering into a forward contract under which the System would purchase the currency needed to liquidate the swap, the rate on that contract to be the market rate then prevailing, i.e., the same rate used for the swap drawing itself. Thus, no profit or loss would accrue to either party to the extent a swap was unwound in this manner. The execution of such a contract at the time of the initial swap drawing, however, would complete the circle of spot and forward

transactions in such a way that the foreign central bank concerned would lose the protection against a possible devaluation of the dollar that is in many cases the essence of the swap drawing by the System. (That is, the protection is afforded to the central bank by the fact that it has an outstanding contract to sell dollars forward to the System at an established rate. If it then enters into a forward purchase contract for the same value date at the same rate, it effectively washes out its protection.) To deal with this problem it was proposed that the new forward contract include a conditional clause indicating that in the remote event of a devaluation of the dollar this new forward contract would be considered to be canceled.<sup>1/</sup> Furthermore, it was suggested that the System might agree that a formal suspension of gold sales by the U. S. Treasury without an official change in the price of gold would also result in a cancellation of the contract.

3). The new forward purchase by the System would be further qualified to leave open the possibility that the System could acquire, at market rates, currencies needed to prepay the swap to the extent that there was a reversal in the market. That is, the new forward contract to buy currency at the rate of the original swap drawing would cover only that portion of the outstanding swap that it had proved impossible to liquidate through normal operations.

This proposal appears to be acceptable to the Europeans--although it does not meet all their desires--while offering certain distinct advantages to the System. It would eliminate windfall profits made by the Treasury, and to some extent by the System, at the expense of foreign central banks under present arrangements and protect the foreign central bank against the risk of loss in operations under the swap. At the same time, it would preserve the basic structure of operations under the swap lines and guarantee the System against

<sup>1/</sup> See sample cable attached.





any risk of loss. At present, the System is exposed to a potential loss any time that it makes a drawing when the spot rate for the foreign currency is below its ceiling. If in such a case no reversal occurs and the System has to liquidate the transaction through direct dealings with the central bank (in association with Treasury sales of reserve assets), there is the possibility that the spot rate could then be higher than it was at the time of the drawing, thereby making the foreign currency more expensive for the System to acquire. Although unusual, there have been such occurrences. Under this proposal such a situation could not arise because the new forward contract would guarantee that the System could acquire the necessary currency at the same rate as the original swap. This may prove to be particularly important in coming years when the EEC countries move to narrow the margin of fluctuation among their currencies within the present dollar band. Under those circumstances, it is entirely possible that the System could be called upon to make a swap drawing in a case in which the central bank was maintaining an interim "ceiling" at a level below the official EMA ceiling. If at the time of liquidation of the drawing, the EEC band had been moved upward so that the currency in question, even if below its formal ceiling, was above the rate at which the System had drawn, a loss would be incurred. Such occurrences may arise, moreover, with greater and greater frequency as the EEC succeeds in narrowing its band. The proposed new arrangement would effectively protect the System against these potentially significant losses. In addition, the new arrangement would protect the System against the risk of loss in the event that a country to which the System was indebted under the swap was to widen the margins against the dollar while a swap drawing was outstanding and the spot rate was then to move above the old ceiling. Although from time to time informal understandings have been reached concerning the activation of the revaluation clause in such an instance, this situation is not



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AMSTERDAM

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U. S. DOLLAR PRIOR TO THE VALUE DATE ABOVE,  
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- III PLEASE CONFIRM

FEDERAL RESERVE BANK OF NEW YORK



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date December 15, 1970

To Mr. R. Solomon

Subject: Comment on Mr. Bodner's

From A. B. Hersey

December 8 Memorandum to FOMC

*ABH*

STRICTLY CONFIDENTIAL (FR)

The gist of Mr. Bodner's memorandum is that the foreign departments of the Dutch and Belgian central banks are beginning to doubt that the sacrifice of normal foreign exchange profits involved in getting an exchange value guaranty on their dollar reserve gains is worth it. On November 18 and 19 a discussion took place in New York between their representatives and Mr. Coombs and other officers of the New York Bank. Proposals were made by the visitors for changes in methods of operating under the swap arrangement to give them profits. The Federal Reserve could not agree to one of the proposals, and the Treasury, which would have been involved in the other, found it unacceptable. Mr. Coombs and his associates made a pair of counter-proposals, complementary rather than alternatives, to achieve the same end by other means. One of these proposals involves Treasury actions and the Treasury has it under consideration. The other "appears to be acceptable to the Europeans."

At the FOMC meeting on November 17, Mr. Coombs had mentioned that some of the Common Market central banks might raise the question of losses they suffered under the present procedure, and he then said that if such questions were raised he would distribute a memorandum to the Committee. Mr. Bodner's memorandum carries out that promise.



To: Mr. R. Solomon

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STRICTLY CONFIDENTIAL (FR)

As I see it, the central question for the Treasury and the Federal Reserve to consider in connection with these proposals is whether the effects of our making exchange value guaranties available to our swap partners are worth enough to the United States to justify our amending long-established procedures in such a way as to provide new financial incentives in order to encourage continued use of exchange value guaranties. A second question -- if the first question is answered, "Yes, but," as I think it should be -- is whether the specific amendments now being negotiated are as satisfactory from the point of view of the United States as this memorandum suggests they are. I have some doubts, but I have nothing better to offer. In this memorandum I shall discuss both these questions. In an appendix I shall try to clarify the matter of how losses may be suffered and profits forgone by our swap partners under present arrangements.

The central question

Others may think the central question is whether or not to maintain the highest possible degree of cooperation with the Common Market central banks in exchange market operations. From what Mr. Coombs said at the last meeting, I take it that his view is that if the Administration places a top priority on maintaining existing exchange rates between the dollar and the European currencies, then everything possible should be done "to defend the dollar on the exchange markets" while domestic policies are producing the necessary adjustments. In Mr. Coombs's view, "if the United States were to drift into a political bargaining encounter over the issue of whether one parity was to be revalued or the other devalued, the very rationale of the central bank swap operations would be called in question."



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The outlook for the balance of payments is not yet so clearly favorable or unfavorable that decisions can be made on the basis of a once-for-ever choice between the two alternative policies Mr. Coombs describes. Therefore, while not completely dismissing "the rationale of central bank swap operations," we are not compelled to go all out "to defend the dollar on the exchange markets." International cooperation and discussion among economic and financial policy makers must aim at more basic objectives like growth, stability, and flexibility of adjustment, rather than just at exchange market stability. "Political bargaining" that will disturb exchange markets may be unavoidable. Still, on both sides there is an interest in avoiding an exchange crisis if possible.

The rationale of central bank swap operations, as I understand it, is to help maintain confidence in international markets that an existing parity will be defended as long as it is useful to do so -- that is, the aim is to prevent a crisis or postpone a crisis as long as possible. Specifically, when we initiate swap drawings at the request of partner central banks it is to make it easier for them to abstain from buying gold from us, so that markets will not take fright at the dwindling of our gold stock. What helps our partner central banks to abstain from buying gold is their ability, when a swap has been made, and their excess uncovered dollars have been "mopped up," to explain to their governments or their public that the increase in their dollar reserves is just as good as an increase in gold reserves -- so long as the swap is outstanding.





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The reason the Dutch and Belgian central banks are beginning to doubt the value of the exchange value guaranty the Federal Reserve swap gives them is, as Mr. Bodner's memorandum suggests, that they feel "under pressure from the U.S. Government to revalue their currency" -- in which case there would be no dollar devaluation to be protected against. (The swap arrangement gives them no protection against the writedown of the domestic-currency value of their dollar holdings in the case of their revaluing their own currency upward.)

I imagine the unspoken part of their argument to run as follows. "Your Government gives us the impression it is determined not to devalue the dollar in terms of gold. If we were to believe this, and if we could convince our domestic critics of this, there would be no point in our getting an exchange value guaranty from you for our dollars in terms of gold. We see, however, that you fear an exchange crisis, and that you think that our abstaining from buying gold helps prevent a crisis; you do not know whether or not we would buy gold without the exchange value guaranty for our excess dollars, but you know that we never do buy gold while a guaranty is outstanding. We are therefore willing to go on with these swap arrangements, if you really want us to, even though we are beginning to doubt their value to us. But you must show us you really want us to go on with them. The best way might be to put an end to all talk of our revaluing our currencies, as well as to do what you need to do if you are to avoid devaluing the dollar. To help kill all talk of our revaluing, it would be useful to change the swap arrangements so as to give us your promise



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that if we did have to revalue you would make good the book loss we would suffer. We are not asking that now. Short of that, however, you should act as cooperatively as possible in our inter-central-bank relationships."

If this is a correct interpretation to put on the Dutch and Belgian approach to Coombs, we have already "drifted" into a political bargaining encounter" of sorts. What, then, would the United States gain if the Dutch and Belgians were to be given a friendly, cooperative reply? First, we would avoid putting them on the spot to carry through with their implied threat to stop using the swap arrangement -- before we have decided whether or not we want them to do so. Second, continued use of the arrangement would certainly prevent their buying gold so long as their excess dollars were guaranteed. But would this be a net gain for the United States? Would they buy gold if their excess dollars were not guaranteed? They might. We cannot take seriously the implication in what they say, that they are sure we will not devalue the dollar in terms of gold; whatever our intentions may be, it is possible that their intentions -- whatever they may be -- will prove irreconcilable with ours. Therefore, we must assume that they still trust gold more than dollars -- or at least will act as if they did -- so that without swap drawings we might lose a good deal of gold, and a crisis in the markets might get stirred up before we were ready.

Perhaps the time is approaching when the United States should turn to other methods of safeguarding the U.S. gold stock. Drawing foreign currencies from the IMF with which to buy back excess dollars



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from countries in balance-of-payments surplus is such a method. One disadvantage is that once our gold tranche position is exhausted we will have to enter into negotiations with the Fund and accept conditions that the Fund may lay down. (That disadvantage might be an advantage if it meant keeping international negotiations about currency parities and the future of gold in a broader forum than either Basle or G-10, but as a practical matter discussion of these matters will not be confined to any one forum.)

Certainly we may feel tempted to tell the Dutch and the Belgians that it is they who should show a more cooperative spirit. There is nothing new about the effects of swaps on their profits. The arrangements have worked for over eight years; why should they be changed now?

Since, however, the prospects for the U.S. balance of payments are uncertain, and since policy positions of the United States, the Europeans, and the Fund regarding future currency parities are in a state of flux, the reaction the New York Bank has given to the Dutch and Belgian approach is probably the right one: to take a magnanimous view, and to see if some suitable way of relieving the irritation that loss of exchange profits is causing them can be found. The answer to the central question, for the present, should then be: "Yes, but is there any suitable way to provide the profits our partners want?"



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The specific counter-proposals

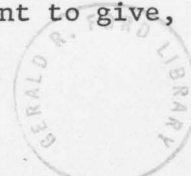
The two counter-proposals now under consideration are complementary: one would be used when an accumulation of reserves by one of our partner central banks proved more than temporary and the United States had to draw on the IMF to unwind the swap, while the other could be used for reversible temporary gains of reserves.

The first needs Treasury action. Sales of a foreign currency by the Treasury to the Federal Reserve would be made in a roundabout way, via the central bank concerned, at rates that would give the foreign central bank a profit. Mr. Bodner's memorandum asserts that the result would be analogous to what happens when the Treasury sells gold or transfers SDRs to enable the System to repay a swap drawing. (I shall try to explain in the appendix in what sense this is so.) He told me this morning that the Treasury is agreeable to this change of procedure.

The second proposal is a complex thing. Starting with present procedures for (1) a "swap" at the current market rate (i.e. a spot transaction, and a forward transaction to reverse it, both at the present spot rate) and (2) a "mop-up" purchase of foreign-held excess dollars also at the current market rate, the proposal piles on top of this (3) another forward contract, at the same current market rate<sup>1/</sup>, to get us the foreign currency with which to meet the first forward contract. Then, since all this has destroyed the exchange value guaranty that the whole arrangement was meant to give,

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<sup>1/</sup> See further comment, page 10 below.





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(4) another agreement is piled on top of the rest, namely to cancel the second contract (and thereby give effect to the exchange value guaranty) if some specified event occurs.

Apart from the obvious objection that this gadgetry would be much harder to explain to citizens and legislators than the present mechanism, the necessity of spelling out precisely what is being insured against might be regarded as a fault in this proposal. At present, our partner central banks holding dollars under swaps get protection against any fall in the value of the dollar in terms of their currency between the time of a swap drawing and the date the swap matures, except one caused by their own action of revaluing their currency. The proposal is that they be protected against two specific contingencies, (a) a devaluation of the dollar (against gold) -- which would of course mean depreciation of the dollar against the other currency if the other currency were not devalued (against gold) or were devalued less than the dollar -- and (b) market depreciation of the dollar in case of "a formal suspension of gold sales by the U.S. Treasury without an official change in the price of gold," if the partner country did not formally revalue against gold but allowed its rate against the dollar to float.

The present arrangements give our swap partners protection against exactly these contingencies, without naming them. In this respect and also with respect to the contingency of a revaluation by a partner country, the proposal involves no substantive change.



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The existing provision for terminating the exchange value guaranty prior to any revaluation by the creditor country would remain in force, taking precedence over all other elements of the swap arrangements. This was not mentioned in Mr. Bodner's memorandum, but this morning he told me that it is so. Whatever the advantages or disadvantages of our promising to reimburse a partner central bank for market depreciation of the dollar on condition that the swap is wound up before -- but not after -- a formal revaluation of the other currency, the proposal leaves these advantages or disadvantages just as they are now -- and this is so whether or not a formal suspension of U.S. Treasury gold sales were to occur.

Mr. Coombs and Mr. Bodner do not regard the necessity of spelling out the contingencies in which the exchange value guaranty is valid as a fault of their proposal. On the contrary, they see reasons to regard this as a virtue. In particular, it would be useful for avoiding losses in the operation of the System account in the future "when the EEC countries move to narrow the margin of fluctuation among their currencies within the present dollar band." At the time of a Federal Reserve drawing the rate for the foreign currency could be at the ceiling of the EEC band, but the whole EEC band might be well below the ceiling of the dollar band; and then at the time of liquidation the EEC band might have moved higher, always within the dollar band. Thus the dollar would have depreciated against the currency drawn. Under present arrangements this could


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prove costly to the System account. Under the proposal, this would not be one of the specified contingencies in which the exchange value guaranty would hold. (The proposal would of course prevent System profits as well as avoid losses, but no one argues that we should be seeking profits in the swap operations.)

One further comment must be made on the third component of the proposed arrangement. The point of the proposal is that the second forward contract, in order to undo the basic swap, would have to be made at the existing spot market rate, not at the existing forward rate in the market. The forward side of the basic swap drawing is of course contracted for at the same (spot market) rate as is applied to the spot side of the drawing. While the FOMC's Authorization for System Foreign Currency Operations and its Foreign Currency Directive do not spell out this feature of the swaps, any other forward exchange contract is governed -- or so it appears to me -- by paragraph 3 of the Authorization, which says in effect that transactions other than drawings "under the reciprocal currency arrangements" "shall be at prevailing market rates," "unless otherwise expressly authorized by the Committee." Presumably this would mean, for a forward contract, the prevailing forward market rate. Use of the spot market rate for a forward transaction would appear to require express authorization.







Rates at which Netherlands Bank buys (B)  
or sells (S) dollars, in terms of NG per \$ as % of par

	No Fed. Res. swap	Swap; reversal with B/P swing, Fed. Res. Buys NG from:- Neth.Bk.			Swap, no B/P swing			
					IMF drawing		Direct trans.	
		market	now	their proposal	now	offer no. 1	now	offer no. 2
	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>
1. Buys \$'s in market	B .994	B .994	B .994	B .994	B .994	B .994	B .994	B .994
2. Initiation of swap	...	B .994	B .994	B1.000	B .994	B .994	B .994	B .994
3. Mop-up sale of \$'s	...	S .994	S .994	S1.000	S .994	S .994	S .994	S .994
4. Sells \$'s in mkt.	\$1.006	...	\$1.006	\$1.006	...	...	...	...
5. F.R. sells in mkt.	...	...	...	...	...	...	...	...
F.R. reconstitutes balances; getting NG from:-								
6. Mkt. (=preceding line)	...	...	... <sup>1/</sup>	...	...	...	... <sup>2/</sup>	... <sup>3/</sup>
7. Direct, Neth. Bk.	...	...	B1.006 <sup>1/</sup>	B1.000	...	...	B1.000 <sup>2/</sup>	B .994 <sup>3/</sup>
8. IMF	...	...	...	...	*1.000	...	...	...
9. IMF via Neth.Bk.	...	...	...	...	...	( *1.000 (S**1.000 (B***.994	...	...
10. Fwd. side of swap	...	S .994	S .994	S1.000	S .994	S .994	S .994	S .994
P&L result	profit	...	... <sup>1/</sup>	profit	...	profit	...	profit <sup>3/</sup>

\* Netherlands Bank acquires reserve position in IMF at par. This is the form the net addition to its reserves takes.

\*\* Treasury sells NG (Neth. Bk. buys NG) drawn from IMF; i.e., Neth. Bk. sells \$'s to Treas.

\*\*\* Fed. Res. buys NG to reconstitute balance and be able to unwind swap (i.e., Neth. Bk. buys \$'s). It is assumed that the NG is still at ceiling (\$ at floor). If the rate has fallen below the ceiling the Netherlands Bank's profit is less.

1/ If the direct purchase of Netherlands guilders by the Federal Reserve from the Netherlands Bank is made at a time when the exchange rate for the dollar has fallen off, there is a profit for the Netherlands Bank. On the other hand, if the market sales (line 4) were made at a lower rate for the dollar than the exchange rate for the direct purchase, the Netherlands Bank has a loss.

2/ In this case it is assumed that balance of payments has not reversed itself, but the guilder has fallen from its ceiling (the dollar has risen from its floor) to par. The Federal Reserve buys guilders at this market rate, par. The Netherlands Bank makes a net addition to its reserves, in the form of dollars at par.

3/ The assumptions are the same as in the preceding case, but the price is the market rate at the time of the initiation of the swap. This gives the Netherlands Bank a potential profit, in the sense that it has acquired dollars at the floor price for dollars and will realize a profit in the future when it sells these dollars.



AppendixHow profits are forgone or losses suffered  
by the Netherlands Bank

The reader of this appendix should start by looking at column 1 of the accompanying table. When a central bank gains dollar reserves and then later has to sell them off because of a reversal in the balance of payments it normally earns a profit, because it buys dollars cheap and sells them dear. Whenever a central bank puts its dollars under a Federal Reserve swap it normally forgoes this profit, and in fact transfers the profit to the Federal Reserve.

Mr. Bodner's memorandum seems to say, on page 1, that a foreign central bank forgoes its normal exchange market profits from buying cheap and selling dear only when the System has to go directly to the partner central bank to reconstitute its holdings of the other currency preparatory to unwinding the swap. Actually, as columns 2 and 3 of the appended table show, the normal profits in absence of a swap are ordinarily forgone whenever there is a swap, whether we reconstitute our balances in that way or in the market. Forgoing profits is the price the other central bank pays for receiving the exchange value guaranty. The underlying principle is that whatever rate the partner pays in the market (line 1) is the rate at which the mop-up sale of dollars to the Federal Reserve is made (line 3), and that, if the partner sells us the foreign currency at the end to

enable us to liquidate the swap, as in column 3, the sale (line 7) is to be at the same rate as that at which the partner acquires its currency (sells dollars) in the market (line 4). Whenever the Federal Reserve reconstitutes its balances in the market, as in column 2, the other central bank is not involved in the two transactions just mentioned (lines 4 and 7).

Federal Reserve profits

The Federal Reserve generally makes a profit when there is a swap that is reversed after a swing in the balance of payments of the partner country. This fact can be appreciated by a close examination of columns 2 and 3 of the table. The four transactions in column 2 and the six transactions in column 3 are transactions of the Netherlands Bank. The Federal Reserve is not involved in the initial market purchase of dollars (line 1). In column 2, however, it has a sale of dollars to the market (a purchase of guilders) on line 5 -- for which the rate is not shown in the table, because the Netherlands Bank is not involved in that transaction. In the remaining transactions that are between the Netherlands Bank and the Federal Reserve, one buys and the other sells. From the point of view of the Federal Reserve, the "B's" on line 2 (initiation of swap) and line 7 (reconstitution of balance by direct transaction) become "S's" (meaning, sale of dollars) and the "S" on line 3 (the mop-up sale of uncovered dollars to us) becomes a "B" (a buying of dollars). It is evident that whereas the Netherlands Bank had pairs of B's and S's at cheap and dear rates for the dollar, we have the following:

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	<u>Column 2</u>	<u>Column 3</u>
Line 2	S cheap	S cheap
Line 3	B cheap	B cheap
Line 5	S dear	...
Line 7	...	S dear
Line 10	B cheap	B cheap



We have a pair of B and S at the cheap rate, and a profit from a cheap B and dear S. Thus, the profit the Netherlands bank forgoes as the price of an exchange value guaranty is passed over to the Federal Reserve.

Later on we shall see what the profit situation is if no swing in the balance of payments of the partner country takes place.

Exceptional losses and profits

In these cases in which the Netherlands Bank generally gives up its normal profit to the Federal Reserve, it may conceivably happen that the market rate at the time the mop-up sale (line 3) occurs is no longer exactly the rate at which the Netherlands Bank originally bought dollars in the market (line 1). Similarly, in column 3, the rate at which the Netherlands Bank sells us guilders to reconstitute our balances (line 7) may conceivably differ from the rate at which it has been buying guilders (selling dollars) in the market (line 4). Whenever there are such differences, the Netherlands Bank may make small losses or profits, and the Federal Reserve's profits may be correspondingly enlarged or diminished. Apparently it is losses of this rather exceptional kind that the Dutch and Belgians have mentioned in their discussions with Mr. Coombs.

Their main concern appears to be not over such losses, but over the forgoing of normal profits when they engage in a swap with the Federal Reserve.<sup>1/</sup>

The first Dutch-Belgian proposal

Column 4 of the table illustrates how the plan the Dutch and Belgians first proposed would have worked. Here, all transactions between the partner central bank and the Federal Reserve are at par, and the Netherlands Bank is left with the normal profit (as in column 1) arising from the difference between buying and selling rates on lines 1 and 4.

Net reserve gains of the foreign central bank

Columns 5-8 treat a few of the various cases that can arise when there is no swing in the balance of payments and the Netherlands Bank ends up with a net gain in its reserves, in the form of an increase in its IMF position (columns 5 and 6) or in the form of dollars, gold, or SDRs. Columns 7 and 8 relate explicitly to the case of a net reserve gain taken in the form of dollars no longer covered by a swap, but those dollars can be converted at par into gold or SDRs, leaving the profit and loss results shown in columns 7 and 8 unchanged.

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<sup>1/</sup>

Perhaps they are also concerned about losses that might occur in the future with changes in EEC exchange rate behavior such as those discussed on page 9 of the memorandum to which this appendix is attached.





In all these cases the Netherlands Bank has an odd number of transactions. All but one form pairs (normally equal under present practices -- as illustrated in columns 5 and 7 -- but exceptionally giving rise to losses or profits as mentioned above), and the unpaired transaction gives the book value of the reserves acquired. If this transaction is at a rate below par, the Netherlands Bank has a potential profit.

A minor point of interpretation of the table

Since the table is set up in terms of rates paid or received by the Netherlands Bank for dollars bought or sold, the calculation of realized or potential profits has to take account of the number of dollars in the various transactions. In each case the amounts in all transactions except those on lines 4 and 7, 8, or 9 are equal to each other. Suppose 100 million of dollars have been bought in the market. We then make a swap drawing of NG 99.4 million -- I am assuming, for convenience, that at par NG 1=\$1 -- for which we give \$100 million (line 2). The Netherlands Bank sells us \$100 million (line 3). At the end (line 10) we will buy back the \$100 million we gave when the swap drawing took place. But in between, to reconstitute our guilder balances, we pay out whatever amount of dollars is required to obtain, at some new rate, the NG 99.4 million that was equivalent to \$100 million at the original rate. Thus, the amounts involved on line 7 are \$98.8 million approximately in column 3, \$100 million in column 4, \$99.4 million in column 7, and \$100 million in column 8. Similarly, in columns 5 and 6, the



amounts of change in the Netherlands reserve position in the Fund (lines 8 or 9) are in each case NG 99.4 million, equivalent to \$99.4 million. As to line 4 (in columns 3 and 4) if we count market sales of dollars exactly equal to the amount that is to be taken from the Federal Reserve in the reconstitution transaction (line 7), at that point the Netherlands Bank will have had exactly no net change in its dollar reserves, and all profit (if any) will have been realized.

Comparison of IMF drawing with gold sale

When the Federal Reserve acquires guilders with which to liquidate a swap drawing by buying from the Treasury guilders that the Treasury has drawn from the IMF, the Netherlands Bank acquires, at par, an addition to its gold tranche or super-gold tranche in the IMF. (This is shown in columns 5 and 6 by the items with a single asterisk. The symbol B is omitted because this is not a purchase of dollars. The U.S. Treasury gives up some of its reserve position in the Fund and gets guilders, the Netherlands Bank gives guilders and gains an addition to its position in the Fund.)

Column 5 represents present practice, and column 6 illustrates the effect of the first of the two counter-proposals given to the Dutch and Belgians. After the U.S. drawing on the Fund (which automatically gives the Netherlands Bank an increase in its reserve position in the Fund), the Netherlands Bank sells the U.S. Treasury dollars for its guilders at par (two asterisks), and then lets the Federal Reserve buy guilders dear -- i.e. it buys dollars



cheap (three asterisks). Thus the Netherlands Bank realizes a profit, while acquiring a net addition to its reserves at par.

Mr. Bodner's memorandum asserts that this result is analogous to what happens when the Treasury sells gold to enable the System to repay a swap drawing. In the latter case the Netherlands Bank sells the U.S. Treasury dollars for gold, and then lets the Federal Reserve buy guilders from it. This gold transaction case is not shown in the table, but it can readily be constructed from column 7 ("direct transaction, now") by adding an interchange of dollars and gold at par. Also, column 7 needs to be modified because it arbitrarily assumes that the Dutch balance of payments has moved into equilibrium so that the exchange rate is now at par (footnote 2 of the table); the Netherlands Bank has decided to hold uncovered dollars rather than ask us to draw on the IMF or sell gold. In that case there is no profit for the Netherlands Bank, either realized or potential. But we now want to consider the gold sale case. If a gold sale had to be made, the more realistic assumption would be that the guilder is still dear and the dollar cheap. When column 7 is modified to conform with that assumption (changing the rate on line 7 from 1.000 to .994), it will show that the Netherlands Bank does have a potential profit. Evidently there is an analogy between such a potential profit in the gold case and the realized profit in column 6, but it is not an exact analogy.



Analogy with other countries' conversions of IMF drawings

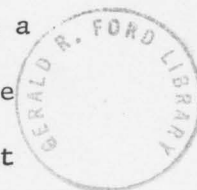
Mr. Bodner pointed out, in our conversation, an analogy between the first counter-proposal (column 6) and the practices followed when other countries draw currencies from the IMF. Again this is not a perfect analogy.

France may draw German marks from the Fund. Needing dollars, it asks the German central bank to convert its marks to dollars. Exactly so, under the counter-proposal we would draw guilders and ask the Netherlands Bank to convert them to dollars. But the analogy is imperfect, because what the United States needs at this point is not dollars but guilders, and the transaction just noted has to be followed by another, in which the Federal Reserve finally gets the guilders it needs.

The Treasury's windfall profits

Mr. Bodner's memorandum puts less emphasis on the profits that would accrue to the Netherlands Bank if the column 6 procedure were adopted than on the fact that the Treasury would be forgoing windfall profits. How do these windfall profits arise?

Under present procedures, the partner central bank normally makes no realized profits or losses in those cases (columns 5 and 7) in which there has been no swing in the balance of payments that would allow it to sell dollars in the market. It may or may not have a potential profit, depending on the rate at which it acquires the uncovered dollars, the addition to IMF position, or the gold that constitute the addition to its reserves. If it has a maximum potential profit, the United States has no profit; but if it has no potential





profit, the United States does have a profit, and in fact a realized profit. Thus, in column 5 or column 7, the U.S. purchases (B) of dollars and sales (S) of dollars are as follows:

Line 2:	S cheap
Line 3:	B cheap
Line 7 or 8:	S at par
Line 10:	B cheap

This profit results from the fact that the mop-up transaction (line 3), like the partner central bank's own purchases of dollars from the market, is made at a rate for the dollar below par, whereas we give up dollars for guilders (line 7 or 8) at par. (The latter rate is always par when we draw on the IMF; the par rate in column 7, however, is an arbitrary assumption; if we had assumed a rate below par on line 7 in column 7 our profit would be smaller, or zero.)

The profit the United States makes (in those cases in which it does have a profit) is realized by the Federal Reserve if it is able to reconstitute its guilder balances at par (as arbitrarily assumed in column 7). But if there is an IMF drawing at a time when the market rate for the dollar is below par, the Federal Reserve realizes no profit (having to buy guilders dear from the Treasury according to our own rules) while the Treasury does make a profit (since it gets guilders at par from the IMF).

#### The second counter-proposal

In column 8, which illustrates the second counter-proposal made to the Dutch and Belgians, the Netherlands Bank is assured a potential profit, because it buys dollars cheap (sells guilders dear) on line 7 regardless of the market rate at the time of liquidation



of a swap drawing. This is the effect of the proposal to make a second forward contract, undoing the exchange value guaranty, at the spot rate prevailing at the time of the swap drawing. At the time of a drawing, the dollar is invariably below par. (In column 8, the spot rate at the time of the drawing, appearing on lines 2, 3, 7, and 10, is assumed to be the same as the rate, on line 1, at which the Netherlands Bank bought dollars in the market.)



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date December 17, 1970

To Chairman Burns

Subject: \_\_\_\_\_

From Mr. Broida

Attached is some background material for the expected discussion concerning swap arrangements with the Common Market countries. The material includes extracts from Committee minutes in 1962 and certain memoranda in 1968 relating to transactions with foreign central banks at rates other than market rates.



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dollar rate against the Swiss franc and the Dutch guilder. Several factors had contributed to a noticeable, although possibly temporary, improvement in foreign confidence in the U. S. dollar. These included President Kennedy's Telestar statement, the announcement of improved balance of payments figures for the second quarter of the year, and the forestalling of potential gold losses through Treasury and System foreign exchange operations. The London gold market had been quieter recently.

Following a discussion of Treasury Stabilization Fund operations during the past three-week period, Mr. Coombs noted that the Federal Reserve System also had been active during that period. On August 2 the System liquidated its \$50 million swap with the Bank of France and replaced it with a standby swap in the same amount. On the same day the System entered into a \$50 million standby swap arrangement with the German Federal Bank. On August 7 the System used \$10.5 million equivalent of Belgian francs to purchase the equivalent amount of dollars from the Belgian National Bank in order to forestall a potential Belgian demand for gold. Also, on August 7 the System drew an additional \$10 million equivalent of Swiss francs from the Bank for International Settlements under its \$100 million standby agreement and used the francs to mop up "excess" dollar holdings of the Swiss National Bank and thus avoid a potential gold loss.

Further, a strengthening of the dollar rate against the Dutch guilder and a decline in the gold holdings of the Netherlands Bank had given the System an opportunity to accumulate Dutch guilders for the purpose of paying off System drawings under the \$50 million swap arrangement with the Netherlands Bank. Arrangements had been made with the





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Netherlands Bank to purchase guilders for System Account at market rates whenever such operations would not place downward pressure on the dollar spot rate vis-a-vis the guilder. Orders executed by the Netherlands Bank under this agreement had totaled more than \$10 million through yesterday. The Account Management would expect to utilize the guilders to pay off \$10 million of the \$50 million drawn under the swap, leaving \$40 million outstanding. It was hoped that the situation had now turned in favor of the dollar and that in the next month or so enough guilders could be bought back to liquidate the swap completely. If this worked out, it would provide another illustration of how official swap operations could be useful in offsetting or cushioning reversible flows of funds.

Mr. Coombs then commented that the Netherlands Bank had shown resistance to making direct deals with the Federal Reserve on a wholesale basis at market rates. As an alternative, it had offered to give the System a special and more or less arbitrary rate under the market. While the System would still make money on the deal if it accepted such an offer this would represent a deviation from the rules set forth in the Committee Authorization and Guidelines pertaining to System foreign currency operations, which called for operating at market rates in the absence of some special circumstances that would cause the Committee to decide to do otherwise. Mr. Coombs had indicated to the Netherlands Bank that he thought the Committee would have serious doubts about deals at a rate other than the market rate. He thought that the System could manage, in any event, to accumulate enough Dutch guilders to pay off the swap before maturity.



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the Netherlands Bank might request a shift in the interest rate basis from an arbitrary 2 per cent rate to one based on the U. S. Treasury bill rate.

Thereupon, upon recommendation of Mr. Coombs, the Committee authorized a renewal for three months of the \$50 million swap arrangement with the Netherlands Bank.

In the case of the \$50 million swap with the National Bank of Belgium, Mr. Coombs noted that this arrangement would not mature until December 20, 1962. The possibility of a standby facility had been suggested by him to the National Bank of Belgium, but the National Bank had preferred to have the original swap agreement executed on an outright basis.

Mr. Coombs next referred to the problem he had mentioned at the August 21 Committee meeting relative to acquiring guilders through direct transactions with the Netherlands Bank. He had recommended, and the Open Market Committee had concurred, that guilders should continue to be acquired at the market rate rather than to accept a proposal from the Netherlands Bank that System purchases be arranged at a special arbitrary rate at such times as the System wished to purchase guilders in substantial quantity. The problem was that on some days guilders were available in the market in only limited amounts. In the circumstances, he had endeavored to think of some compromise solution that would enable the purchase of larger quantities of guilders



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while continuing the market rate principle. It had occurred to him that the System might pay a stipulated commission or fee to the Netherlands Bank for the convenience of obtaining sizable lots of guilders through direct transactions with the Netherlands Bank. He had mentioned this possibility to the Netherlands Bank, and yesterday he had received word that the Bank would be agreeable in principle to such an arrangement. The Bank had suggested that the commission might be fixed at the rate of 1/8 per cent. Such a rate, Mr. Coombs pointed out, would result in roughly an equal sharing between the Federal Reserve and the Netherlands Bank of the profits accruing from System drawings of guilders when the dollar was weak and purchases of guilders after the dollar had strengthened. The Treasury also was involved because it had \$20 million of guilder drawings outstanding that it was anxious to liquidate quickly. Accordingly, he had inquired whether such an arrangement would be acceptable to the Treasury, and had found that the Treasury would be agreeable. If the Open Market Committee concurred in such an arrangement, it should be possible to clean up the guilder operation completely in the course of the next week through purchases of \$15 million of guilders for System account and \$20 million for Treasury account. If the arrangement was not favored, he feared that the guilder operation would drag on, with relatively meager possibilities of acquiring guilders through the market.





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In reply to questions, Mr. Coombs confirmed that the Federal Reserve Bank of New York made no charge when it executed foreign exchange transactions on behalf of foreign central banks. The commission would be unusual in interbank relationships, but the use of an arbitrary rate that deviated from the market rate concerned him even more. He felt that the System would be on better ground if it continued to adhere to the concept of executing foreign exchange transactions only at the market rate, but paid a fee to the Netherlands Bank for the convenience to the Federal Reserve of the execution of wholesale transactions direct with the Netherlands Bank.

Mr. Coombs recalled that the current swap arrangement was initiated with a view to mopping up dollar holdings of the Netherlands Bank in excess of the traditional \$200 million limit of that Bank. The Netherlands had subsequently experienced an outflow of funds. At present its total holdings of dollars were down to around \$135 million, and another prospective out-payment appeared likely to reduce the holdings close to the \$100 million level. Thus, repayment of the System's drawings would build up the dollar holdings of the Netherlands Bank only to a point well below the traditional dollar conversion point.

In reply to additional questions, Mr. Coombs reiterated that the effect of the payment of the proposed commission would be to reduce a windfall profit to the Federal Reserve from its guilder operations. While no parallel question had arisen under swap arrangements with other foreign





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central banks, conceivably a question of the same nature might arise elsewhere; the System was just getting into this field. A similar problem, incidentally, had arisen in connection with the repayment of drawings from the International Monetary Fund.

Mr. Coombs further pointed out that the question whether commissions or fees should be paid on other occasions remained at the initiative of the Federal Reserve. In markets the size of the Swiss franc, German mark, or pound sterling markets, there should not be too much difficulty in buying in sufficient quantity at market rates. Hence the question of the size and depth of the various currency markets was involved. He had not been able to think of any absolutely satisfactory solution to the guilder problem, but he had a feeling that the commission plan was the least disadvantageous.

In reply to a question regarding the possibility of waiting until the terminal date of the drawings, Mr. Coombs commented that this would focus the present point of difficulty more sharply. He would prefer to pay off the drawings in advance.

In reply to another question, Mr. Coombs repeated that he saw a substantial advantage in liquidating the swap with the Netherlands Bank as fast as possible in order to demonstrate that the System's operations were designed to deal with reversible flows of funds and that the operations were effective. One never knew when the tide might move the other way, and he would like to have this credit facility completely restored



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if possible. The System had to feel its way on this sort of thing. He did not think that the arrangement he proposed would necessarily create a precedent, even in the case of guilders.

Mr. Hayes agreed, noting that the System could always say, even to the Dutch, that it would not be able to operate the same way again. In view of factors such as the differences in the size of the various foreign exchange markets, the System could distinguish among its arrangements more or less on an ad hoc basis.

After further discussion, Chairman Martin commented that the Federal Reserve was engaged in experimental operations. The Committee might want later to establish some principles that would apply to swap arrangements generally. However, if it seemed desirable for the Federal Reserve to liquidate the current guilder drawings and the arrangement proposed by Mr. Coombs seemed to provide the best available mechanism, agreement on a small fee probably was not too much of a price to pay.

Mr. Mitchell commented that in his view the payment of the fee was not too important in itself. The important thing was the principle of parallel treatment. So far as he could see, the payment of a fee had no basis from the standpoint of principles that the System ought to be following.

Mr. Deming inquired whether there might not be more justification for paying a premium if the swap arrangement was being unwound at the last minute than if this were done in advance. Mr. Coombs replied that the



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United States would be saving interest. Also, by waiting it might forego the opportunity to make a sizable profit. Mr. Deming then commented that he was not too concerned about the making of a profit or the sharing thereof. It was the principle of paying a fee that was of more concern to him.

Mr. Furth noted that if the System endeavored to buy 15 million dollars of guilders through the market, the market price probably would go up by an amount at least equal to the 1/8 per cent commission. It was quite customary, in the case of Fund drawings, to pay a rate close to the market, taking into consideration the effect of a market transaction on the rate. Therefore, he was not particularly apprehensive about the establishment of a precedent. On a market broader than the guilder market, this simply would not happen. Further, if it became known that a swap operation always was to be reversed on the last day, it would be relatively simple for a central bank to have the market on that day less favorable to the System than the rate involved in the payment of a small commission.

Question was raised of Mr. Coombs whether payment of a commission was actually more desirable than departing from the market rate. If some kind of agreement was in effect whereby the market rate was made subject to a certain adjustment, would this not be better than paying a commission?

Mr. Coombs replied that a rather nebulous area was involved when one tried to ascertain the effect of a large transaction on the market rate. The effect of such a transaction on the market rate might be more or less than 1/8 per cent. As he had indicated previously, the payment





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of a commission of 1/8 per cent would come close to splitting between the Netherlands Bank and the Federal Reserve the benefit of this particular operation. This seemed to him better than getting into the question of what would happen to the market rate if an attempt was made to execute a large transaction in the market.

Chairman Martin then suggested that the Open Market Committee approve the plan proposed in this instance by Mr. Coombs, with the understanding that this was clearly not to be regarded as establishing a precedent.

Thereupon, the plan proposed by Mr. Coombs was approved on the basis stated by the Chairman.

Mr. Coombs then commented that over the next few months, a period of the year when there was usually some pressure on the pound sterling, there might be opportunities to pick up sterling at rates of par or below. He thought it might be well, as and when such opportunities arose, to acquire sterling up to a total of not more than \$25 million equivalent. Such holdings might be useful in pilot operations after the turn of the year, when the seasonal flow of funds to London might be expected to begin.

Without objection, purchases of sterling along the lines recommended by Mr. Coombs were authorized.

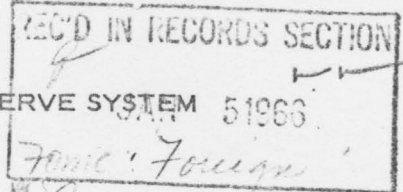
Mr. Coombs also noted that last week in London he had mentioned to British officials that the Federal Reserve System might be prepared to





TELEGRAM  
LEASED WIRE SERVICE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 51966  
WASHINGTON



CONFIDENTIAL (FR)

ELLIS - BOSTON  
HAYES - NEW YORK  
PATTERSON - ATLANTA  
SCANLON - CHICAGO  
GALUSHA - MINNEAPOLIS

Following request received from Committee's Special Manager  
concerning liquidation of System's guilder indebtedness.

"An opportunity has unexpectedly arisen to liquidate completely the System's guilder commitments before year-end. During the past few days there has been a sizable commercial demand for dollars in the Netherlands apparently attributable to a rush for imports prior to the imposition of new domestic taxes at the first of the year. The Netherlands Bank has been selling dollars in its market as the guilder eased, and now is in a position to purchase from the United States \$50 million against guilders, the guilder proceeds to be used half to repay the System's August 1965 drawing of \$25 million equivalent under the swap arrangement and half to liquidate the remaining guilder/mark swaps with the BIS, \$12.5 million equivalent each for System and for Treasury, that have been on the books since the fall of 1964.

*revised 9/28/62  
plus FOMC minutes  
9/11/62*

"The Netherlands Bank has requested that we agree to pay a commission of 1/8-per cent on the transactions as was done once before in September 1962. See FOMC minutes for the meeting of ~~the~~ September 11, 1962, pages 48-54 for a discussion of the earlier proposal. I believe it is in the interests of the System to agree to the commission in this case, as was done in 1962, in order to liquidate on a wholesale basis commitments that otherwise could be met through market acquisitions only in small amounts over a protracted period. A transaction of this size could not in any case be effected in the guilder market in a short period of time without moving the rate against us. Some of these guilder commitments under the third-currency swaps have been outstanding for more than a year, and in the case of the drawing under the System swap arrangement we now have an opportunity to repay our obligations well before the second renewal. While the payment of a commission will somewhat reduce System profits by passing on part of the potential profit to the Netherlands Bank, it will not involve the System in losses.

"This transaction would again be considered an exception to the rule that the System deal at market rates; the payment of the commission



*Copy filed*

*FOMC: Foreign*

*General*

FILE COPY

*Tom Gallo*

TELEGRAM  
LEASED WIRE SERVICE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
CONFIDENTIAL (FR) WASHINGTON -2- December 27, 1965

in 1962 did not become a precedent for subsequent transactions, as indicated by the fact that since October 1962 we have liquidated some \$260 million in System drawings under the arrangement with the Netherlands Bank without payment of commission. The Treasury has already agreed to payment of a commission of 1/8 per cent on this transaction. I request the Committee's approval to do likewise for the System's portion."

Please wire whether you would approve this transaction, if  
EST  
possible before 11:00 a.m./Tuesday.

YOUNG

ALB:me

ALB

*Copy sent  
to Sam Rabinowitz  
and Sheppard  
for Daane contacted  
by telephone, voted for.*



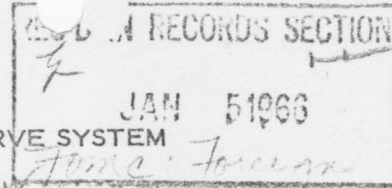
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TELEGRAM  
LEASED WIRE SERVICE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
WASHINGTON

CONFIDENTIAL (FR)

HAYES - NEW YORK



Re Special Manager's request for approval of transaction  
involving liquidation of System's guilder indebtedness, as described  
in my wire of yesterday, <sup>12/27/65</sup> available members of Committee have advised  
that they approve.

YOUNG

ALB:me

*Ray*



FILE COPY

*Car*  
*Se*





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

CONFIDENTIAL (FR)

March 27, 1968

To: Federal Open Market Committee

From: Mr. Holland

Attached is a memorandum from the Special Manager, dated today and entitled "Recent purchase of Swiss francs at rate other than market rate." This is the memorandum referred to under item 4 of the agenda for the Committee meeting to be held on April 2, 1968.

A handwritten signature in cursive script, appearing to read "Robert C. Holland", is written over a horizontal line.

Robert C. Holland, Secretary,  
Federal Open Market Committee.

Attachment





CONFIDENTIAL (FR)

March 27, 1968

TO: Federal Open Market Committee  
FROM: Charles A. Coombs

Subject: Recent purchase of  
Swiss francs at rate other  
than market rate

On March 6, under paragraph 3 of the authorization for System foreign currency operations, I secured the approval of the Subcommittee of the FOMC provided for in paragraph 6 of the authorization to purchase from the Swiss National Bank (BNS) \$50 million equivalent of Swiss francs at a rate other than the prevailing market rate. This memorandum sets forth the reasons for this operation.

The System's Swiss franc swap lines with the BNS and the BIS have been in continuous use since June 1967. The System drew heavily on these lines in June - July 1967 in order to compensate for large flows to Switzerland following the Middle-East hostilities, and again in December in order to offset flows resulting from the sterling devaluation and year-end window dressing. By year-end, combined commitments to the BNS and the BIS amounted to \$650 million equivalent. Beginning in mid-January, the Swiss franc came on offer as a result of a better market atmosphere surrounding the dollar and the pound, reversal of year-end flows, and intermittent foreign exchange requirements of the Swiss Confederation. Under the circumstances, the Swiss National Bank began selling dollars on January 6, replenishing its losses by purchasing from the System a total of \$288 million against Swiss francs. By March 4,



the System had used these francs, together with francs acquired from other sources, to reduce its swap commitments in that currency by \$333 million equivalent to \$317 million.

In early March, the U. S. Treasury agreed to make a drawing on the IMF and also to enter into a funding operation with the Swiss National Bank to help reduce System swap debt. In discussions with the Swiss authorities, a figure of \$175 million was agreed upon as a reasonable target for a Swiss-franc funding package. One hundred-twenty-five million dollars equivalent was to be repaid to the BIS with francs made available by the Swiss National Bank against issuance of a Swiss franc-denominated U. S. Treasury note (\$100 million equivalent) and a \$25 million Treasury sale of gold. The remaining \$50 million equivalent repayment was to be made through a System sale of dollars against Swiss francs to the Swiss National Bank which undertook to hold such dollars on an outright basis, pending eventual sale for Swiss Confederation requirements.

On March 6, Mr. MacLaury called Dr. Ikle of the Swiss National Bank to settle the final terms of the package. Dr. Ikle, while still ready to take \$50 million into his position, pointed out that if he bought dollars from the Federal Reserve at that day's market rate of SF 4.3450 per dollar, the Swiss National Bank would incur a loss of SF 1,500,000 (somewhat more than \$345,000) since the swap contract obligated the Swiss National



Bank to sell dollars against Swiss francs at 4.1350, the rate of the drawing (i.e., the transaction would involve a purchase of \$50 million at 4.3450 at a cost to the Swiss National Bank of SF 217,250,000; the Swiss National Bank would receive on the swap repayment only SF 215,750,000). Moreover, the loss to the BNS would be exactly matched by a profit accruing to the Federal Reserve.

Ordinarily, the System would expect to make a profit on repayments of drawings since it draws and sells a foreign currency when the currency is expensive in terms of dollars (i.e., at its ceiling) and reacquires the currency and pays off the drawing when the currency is inexpensive in terms of the dollar.<sup>1/</sup> However, System profits are normally at the expense of the "market", not the foreign central bank. The System usually buys the needed currency in the market or, if the foreign central bank is selling dollars in the market, directly from it at the same rate. The problem in this case stemmed from the fact that the System was buying the needed foreign currency directly from the foreign central bank, not from the market, at a time when the central bank was not selling dollars to the market.

<sup>1/</sup> Between January 19 and March 4, System repayments of Swiss franc drawings had resulted in profits of nearly \$2.6 million.





In my judgment, it seemed inappropriate that the Swiss National Bank should incur a loss on a transaction involving a temporary (and possibly permanent) increase in its holdings of uncovered dollars. On March 6, 1968, I therefore recommended to the Subcommittee of the FOMC that I be authorized to purchase \$50 million equivalent of Swiss francs at 4.3150, the rate on the swap drawing, rather than at 4.3450, the market rate at the time. The Subcommittee gave its unanimous approval for this transaction.





CONFIDENTIAL (F.R.)



April 25, 1968

TO: Federal Open Market Committee  
FROM: Charles A. Coombs

SUBJECT: Recent purchase of  
Dutch guilders from the Netherlands  
Bank at market rate plus commission

On April 11, I secured from the Subcommittee of the FOMC approval to purchase from the Netherlands Bank some 46 million Dutch guilders at the prevailing spot rate in Amsterdam plus a commission of 1/8 per cent. This memorandum sets forth the reason for this operation.

When conditions in the gold market were reaching crisis proportions in March, it was deemed desirable that the impact of large dollar flows across the exchanges be moderated, whenever appropriate, through official U. S. sales of foreign exchange in the forward markets. Accordingly, on March 11, the Federal Reserve Bank of New York, acting for System and Treasury accounts combined, authorized the Netherlands Bank to sell forward up to \$50 million of Dutch guilders for delivery up to three months; commitments were immediately incurred for April, May and June deliveries (a total of \$20.855 million each for System and Treasury accounts).

As I pointed out to the Committee in my memorandum of March 27 on "Recent Purchase of Swiss francs at Rate other than Market Rate", the System usually makes a profit on repayments of its foreign exchange obligations inasmuch as it tends to incur such obligations when foreign currencies are expensive in terms of the dollar and to acquire the currencies needed to discharge its obligations after such currencies have become relatively inexpensive in terms of the dollar. This profit is realized at the expense of the market even when the exchange is being purchased from the central bank, provided, of course, that the central



bank sells dollars to the market at the same rate at which it sells its currency to the System and in the same amounts.

On April 11, Mr. Sillem of the Netherlands Bank called Mr. Bodner to say that the Netherlands Bank was ready to sell to us the 46 million guilders needed to liquidate official U. S. commitments falling due April 17, 1968 (\$12.84 million equivalent for System account and an identical sum for Treasury account). However, in proposing to accommodate the System (and Treasury) the Netherlands Bank found itself in a position similar to that of the Swiss National Bank last month. In effect, the Netherlands Bank had bought guilders forward from the System and was now selling guilders spot to the System to enable the System to meet the original sale contract. The original forward sale was done at 3.596975. The market spot rate that would have been applicable to the System purchase to cover the sale was 3.619375. To the extent that both the forward purchase and spot sale were matched by transactions between the Netherlands Bank and the market, the latter would suffer the "loss"-- i.e., the cost of forward cover. But to the extent that the Netherlands Bank had to sell the spot dollars at rates lower than that at which it bought dollars from the System, it had to take a loss.

In fact, the Netherlands Bank had been selling dollars gradually in the market in the preceding few weeks to make room in its dollar position to absorb these dollars from the System; those sales had been made at rates for the dollar lower than that prevailing on the 11th and, consequently, the purchase from the System would result in a loss to the Netherlands Bank (which would not normally buy dollars at the then prevailing rate). In order to offset this loss the Netherlands Bank felt it necessary to charge a commission of 1/8% over the prevailing

spot rate, i.e., \$32,000 on the full amount.

It seemed inappropriate that the Netherlands Bank should suffer a loss in an operation undertaken in cooperation with the System-- especially since under the terms proposed by that bank the System and Treasury would still be left with a net profit of some \$63,000 each. On April 11, I therefore recommended to the Subcommittee of the FOMC that I be authorized to pay a commission of  $1/8$  per cent to the Netherlands Bank to purchase for System account the Dutch guilders necessary to pay off System forward commitments to the market maturing April 17. The Subcommittee gave its unanimous approval for this transaction.



December 10, 1968

To: Federal Open Market Committee      Subject: Legality of special  
From: Mr. Hackley                              arrangement with German  
Federal Bank.

At the November 26, 1968, meeting of the Federal Open Market Committee, Mr. Coombs reported regarding a proposed arrangement between the New York Reserve Bank and the German Federal Bank. The Committee raised no objection to the proposed arrangement, but Counsel was asked to consider its legality.

That afternoon, Mr. Robert Crowley of the New York Bank informed me by telephone of the general nature of the proposed arrangement and indicated that, since the arrangement was to be executed the following morning, he hoped the requested legal opinion could be given that afternoon or at least by 8 a.m. the following morning. He stated that Mr. Guy and Mr. Sloane, General Counsel and Assistant General Counsel of the Reserve Bank, had been consulted and that they saw no legal problems. At my request, Mr. Crowley wired the following description of the proposed arrangement:

"We are selling marks on an outright basis to the market for delivery in 3 months at a premium of 3 per cent per annum based on the spot rate. We obtain the marks to meet our forward commitment by drawing now on our swap line with the Federal Bank at the spot rate. In order to give the Federal Bank 50 per cent of the profit arising out of our sales at a premium from the spot rate, we propose to sell the marks back to the Federal Bank in 3 months at a differential rate. To state this in actual terms: Yesterday we sold 252,900,000 marks forward at a rate of 25.31 for a dollar amount of approximately \$64 million. We will draw value tomorrow on our swap line the marks to cover the sale at 25.125, a dollar amount of approximately \$63 million 600 thousand. This leaves a profit of approximately \$400,000 which we would split with the Federal Bank by selling them 3 months forward the same amount of marks we had drawn, but at a rate of about 25.045 for a dollar value of \$63 million 400 thousand. This results in the System and the Federal Bank each getting a profit of \$200,000."

Following receipt of the above wire, I discussed the matter with Mr. O'Connell, Deputy General Counsel to the Board, who had been present at the Open Market Committee meeting. At 8 a.m. on November 27, 1968, Mr. O'Connell talked by telephone with Messrs. Arnold and Bodner of the New York Bank and advised them that he and I concurred in the opinion expressed by Messrs. Guy and Sloane that there appeared to be no legal impediment to the proposed arrangement. However, he also advised that we felt it possible that some question might be raised





as to the justification for seeming to "give up" a \$200,000 profit on the transaction involved. In this connection, Mr. O'Connell suggested that a "background" memorandum would be helpful.

It is understood that transactions with the German Federal Bank were executed on November 27 and on following days in general accordance with the description set forth above in Mr. Crowley's wire.

My understanding of the transaction is as follows: Apparently with the purpose of implementing the decisions reached at Bonn during the latter part of the week of November 18, the New York Reserve Bank in New York and the German Federal Bank in Frankfurt sold marks to the market in order to stimulate an outflow of funds from Germany. The New York Bank on November 25 sold such marks in New York forward for delivery in three months at a premium of 3 per cent per annum based on the spot rate, i.e., at a forward exchange rate of 25.31 cents as compared with the then market spot rate of 25.125 cents. The New York Bank will receive at maturity approximately \$64 million for the marks thus sold. In order to be in a position to deliver the marks, the New York Bank on November 27 drew the same amount of marks under its swap line with the German Federal Bank at the spot rate of 25.125 cents, paying therefor about \$63.6 million. At this point, therefore, the New York Bank had a potential profit of about \$400,000. However, the New York Bank agreed with the German Federal Bank to sell the same amount of marks back to the latter after three months at a rate of 25.045 cents for approximately \$63.4 million. Thus, the transaction would result in a profit of about \$200,000 for the German Federal Bank and a reduction in the New York Bank's potential profit from \$400,000 to \$200,000.

It should be noted here that at some time in the future the New York Bank will have to buy the necessary marks in the market in order to pay back the marks drawn by it under its swap line with the German Federal Bank. If the price it will have to pay should be less than the spot rate on November 27, when it drew under its swap line, its profit from the transaction will be increased; if the price it will have to pay should be higher, its profit will be reduced. This is why the preceding paragraph refers to the "potential" profit of the New York Bank. It is understood that in either event the German Federal Bank's profit of \$200,000 would not be affected.

It should be noted also that, if the mark should be revalued upward in the next three months, the New York Bank would be protected against loss by a standard clause in its swap agreement with the German Federal Bank. This was the primary reason for the form of the arrangement in question.

Turning now to the legality of the arrangement, it appears that in essence the question is whether the New York Bank may properly agree to sell forward to the German Federal Bank the amount of marks



drawn under the swap line at an exchange rate that will have the effect of reducing the profit that would otherwise inure to the New York Bank.

Since 1961, it has been settled (with the concurrence of the U. S. Attorney General) that the New York Reserve Bank, under provisions of the first paragraph of section 14 of the Federal Reserve Act, may buy and sell foreign currencies in the open market, and that it may enter into reciprocal deposit agreements with foreign banks under section 14(e) of the Act. There is nothing in the law that restricts the exchange rate at which foreign currencies may be bought and sold or that limits the terms of agreements with foreign banks for reciprocal deposits or drawings thereunder. Consequently, the law in no way limits the rate at which the New York Bank may agree to sell marks forward to the German Federal Bank.

The FOMC's Authorization for Foreign Currency Operations contains the following provision:

"3. Unless otherwise expressly authorized by the Committee, all transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces."

Since this provision is applicable only to open market transactions under paragraph 1(A), it does not apply to the rates at which transactions are made under swap agreements. Thus, it appears that, at least as far as the Committee's Authorization is concerned, there is no inhibition against the setting of exchange rates on transactions under swap agreements that may be different from prevailing market rates.

Obviously, the making of profit is not the objective of any Reserve Bank operations. Any profit that may result from the System's foreign currency operations is only incidental. In the present instance, it is assumed that any loss of potential profit to the System is regarded as offset by the protection afforded the System under the swap agreement with the German Federal Bank against possible revaluation of the mark and particularly by the importance, in the interests of the United States, of achieving the objectives of foreign currency operations as set forth in the Foreign Currency Directive of the FOMC. Especially relevant to the transactions in question is the objective stated in paragraph 2.C of "avoiding disorderly conditions in exchange markets" that may result from "responses to short-run increases in international political tension" or from "market rumors of a character likely to stimulate speculative transactions". Also relevant are the objectives set forth in paragraph 4 of preventing "forward premiums or discounts



from giving rise to disequilibrating movements of short-term funds" and of minimizing "speculative disturbances".

To summarize, it is my opinion, as previously indicated, that there is nothing in the law that prohibits the New York Reserve Bank from agreeing to exchange rates on transactions under a swap agreement that may have the effect of reducing potential profits that would otherwise inure to the New York Bank. The major consideration is one of policy, i.e., achieving the objectives of foreign currency operations as described in the Committee's Foreign Currency Directive.





December 17, 1970.

Chairman Burns:

The attached draft of memorandum reflects my present views regarding the legal implications of the proposed change in swap procedures discussed in Mr. Bodner's memorandum of December 8.

Howard H. Hackley

Attachment



DRAFT  
HHH:vcd  
12/17/70

To: Federal Open Market Committee      Subject: Legal implications of  
From: Mr. Hackley                      Mr. Bodner's proposed modification  
   of procedures under certain swap  
   arrangements.

In his memorandum to the Federal Open Market Committee of December 8, 1970, Mr. David E. Bodner indicated that, in the course of recent discussions with representatives of the Nederlandsche Bank and the Banque Nationale de Belgique, they in effect complained of the fact that the Federal Reserve has made profits on operations under their swap arrangements at the expense of foregone profits on the part of their central banks. As one means of meeting these complaints, Mr. Bodner's memorandum proposes that, when it is necessary to liquidate swaps with those banks through direct transactions with those banks, the System might fix the rates of such transactions at the time of the initial activation of the swap drawing. This would be accomplished "by entering into a forward contract under which the System would purchase the currency needed to liquidate the swap, the rate on that contract to be the market rate then prevailing, i.e., the same rate used for the swap drawing itself."

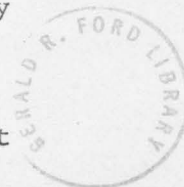
The foreign currency operations of the Federal Reserve System have been premised upon the authority of the Reserve Banks to "purchase and sell in the open market, at home or abroad, . . . cable transfers" (§ 14, ¶ 1) and, with the consent of the Board, to establish accounts for and with foreign banks (§ 14(e)). A legal question that might be raised with respect to Mr. Bodner's proposal is whether the proposed forward purchase of foreign currencies from the central banks involved at a rate other than the prevailing forward market rate would constitute



a bona fide "open market" operation. The law itself does not expressly limit the rates at which foreign currencies may be bought and sold; but an "open market" transaction ordinarily means one in which commodities are purchased and sold at a price determined by a free and competitive market.

It might be argued that, even if the proposed forward purchase of foreign currencies at a non-market rate may not be regarded as an open market transaction, it may be legally supported on the ground that it is an incidental step in the reconstitution of the System's foreign currency balance with a foreign central bank and is therefore implicitly embraced within the Reserve Banks' authority to establish accounts with foreign banks. This argument, however, is not persuasive, since the proposed forward purchase of the foreign currency directly from the foreign bank obviously is intended only to enable the Reserve Bank to acquire the amount of such foreign currency needed to fulfill its commitment under another forward contract to sell the currency to the foreign bank at the maturity of the drawing.

It appears that, since the inauguration of the System's foreign currency operations in 1962, sales of foreign currency to foreign banks on a forward basis have consistently been made at non-market rates and that purchases of foreign currencies on a spot basis have occasionally been made from foreign banks at non-market rates. Moreover, the Committee's Authorization for System Foreign Currency Operations has always recognized that "open market" purchases and sales of foreign currencies need not always be at prevailing market





rates. Paragraph 3 of the Authorization provides:

"Unless otherwise expressly authorized by the Committee, all transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces."

It is understood that, since inauguration of Federal Reserve foreign currency operations, it has been the practice, when the New York Reserve Bank draws on a foreign central bank under a swap arrangement, to sell at that time to the foreign bank for forward delivery on the maturity date of the drawing such amount of the foreign currency as will be needed to reconstitute the Reserve Bank's balance with that bank at the maturity of the drawing. Such forward sales of foreign currency are made at the same rate as the market spot rate at the time of the drawing rather than the prevailing market forward rate at that time. In addition, it is understood that, when a foreign central bank draws on the New York Reserve Bank under an outstanding swap arrangement, the foreign bank similarly enters into a forward contract to sell to the Reserve Bank at a non-market rate the amount of dollars necessary to liquidate the swap drawing at maturity. Thus, in such instances the Reserve Bank has followed the practice of pur-  
chasing dollars on a forward basis at a rate other than the prevailing market forward rate.

In 1968, question was specifically raised as to the legality of an arrangement with the German Federal Bank under which the Reserve Bank would sell marks forward to that Bank at a rate that would result in an even sharing with the German Bank of the profits made by the



Reserve Bank through the forward sale of marks in the market at a premium over the spot rate. In a memorandum of December 10, 1968, I expressed the opinion that, since the law does not restrict the exchange rate at which foreign currencies may be bought and sold or limit the terms of reciprocal deposit agreements with foreign banks, there was no legal impediment to the proposal for a forward sale of marks to the German Bank at a non-market rate.

In 1962, it appears that, because Dutch guilders were available in the market in only limited amounts, the New York Reserve Bank, with the Committee's approval, in order to repay a swap drawing bought guilders on a spot basis directly from the Netherlands Bank and paid that Bank a fee or commission at a rate of one-eighth per cent, the result being a sharing of Federal Reserve profits with the Netherlands Bank. Although this transaction was approved by the Committee with the understanding that it was not to be regarded as a precedent, it appears that in December 1965 the Committee approved a similar transaction with the Netherlands Bank, recognizing that it was an exception to the rule that the System deals at market rates. In April 1968, another such transaction with the Netherlands Bank was approved by the Subcommittee of the FOMC. In March 1968, the Subcommittee of the FOMC approved a spot purchase of Swiss francs from the Swiss National Bank at a rate other than the prevailing market rate.

Obviously the present proposal for the forward purchase of a foreign currency from a foreign central bank at a non-market rate would



constitute an innovation in procedures and presumably involves policy considerations. As a legal matter, however, it appears to be no different in principle from transactions in which the System has engaged since 1962 under which forward contracts, as well as spot purchases, have been entered into at non-market rates. The practices followed in the past have not been subjected to legal attack; and, even though question might be raised as to whether such transactions are true "open market" transactions, it seems doubtful, in view of the history of the matter, that the proposal now under consideration would be subject to such attack, particularly if, as Mr. Bodner states, one of the consequences would be to guarantee the System against "any risk of loss".

There is a question whether forward purchases of foreign currency at non-market rates as proposed by Mr. Bodner would require the authorization of the Committee. As previously indicated, paragraph 3 of the Foreign Currency Authorization clearly states that any transaction in foreign currencies undertaken under paragraph 1A of the Authorization must be at prevailing market rates unless "expressly" authorized by the Committee. Paragraph 1A authorizes the New York Reserve Bank to purchase and sell foreign currencies "through spot or forward transactions on the open market at home and abroad, including transactions . . . with foreign monetary authorities . . . ."

Paragraph 1D of the Authorization authorizes the Reserve Bank to draw foreign currencies and to permit foreign banks to draw dollars under reciprocal currency arrangements, without mention of rates of





exchange; and it might be argued that purchase and sale transactions with a foreign bank in connection with a drawing and repayment of a drawing by the System under a swap arrangement are not subject to paragraph 3 of the Authorization. In my memorandum of December 10, 1968, with respect to the proposed forward sale of marks to the German Federal Bank at a non-market rate, I expressed the view that paragraph 1A, and therefore 1D, does not apply to transactions made under swap agreements. At the present time, I am not so clear that this is the case. A better view might be that paragraph 1D merely authorizes reciprocal deposit arrangements with foreign banks and is not intended to exempt transactions under such arrangements from paragraph 3. As has been noted, it appears that the Committee itself in 1962 and 1965 felt that direct purchases of Dutch guilders from the Netherlands Bank at a non-market rate required the authorization of the Committee; and in 1968 the Subcommittee of the Committee approved purchases of foreign currencies at non-market rates.

Even if a forward sale of a foreign currency to a foreign bank in repayment of a swap drawing, made at a non-market rate, might be regarded as an incident to the reciprocal swap of deposits and as not subject to paragraph 3 of the Authorization, such an immediate relationship to the foreign currency deposit does not exist where the System purchases the foreign currency directly from the foreign bank in order to be in a position to liquidate the drawing.

For the reasons here indicated, it is my opinion that a forward purchase of foreign currency at a non-market rate, as contemplated by Mr. Bodner's proposal, should be expressly authorized by the Committee.

