The original documents are located in Box B98, folder "Swap Arrangements - General, 1970-75 (2)" of the Arthur F. Burns Papers at the Gerald R. Ford Presidential Library.

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STRICTLY CONFIDENTIAL--F.R.

Date: January 9, 1971

To: Chairman Burns, Vice Chairman Hayes
and Governor Robertson
Federal Open Market Committee

Subject: Mechanics of present and proposed swap procedures

From: David E. Bodner

This memorandum sets forth as simply as possible the comparative mechanics of the present and proposed swap procedures. Examples are presented for each of the two principal ways in which the United States obtains foreign currency to repay swap drawings: through a market reversal (Table 1), and through a United States Treasury International Monetary Fund drawing (Table 2).[1]

System Swap Drawing

(Steps 1-3, and Step 9, Table 1, or Step 8, Table 2)

Both examples begin with the purchase by the Netherlands Bank[2] of dollars from the exchange market when the dollar has reached the Bank's lower intervention point (Step 1). This is followed by a Sytem drawing of guilders, at the same rate, under its swap arrangement with the Netherlands Bank (Step 2), and System use of these guilders to purchase from the Netherlands Bank, again at the same rate, an amount of dollars equal to the initial Netherlands Bank purchase (Step 3). Under the swap arrangements, the United States drawing, unless renewed, is to be repaid in three months using the same rate of exchange at which it was contracted (the final step

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1/ The memorandum is most easily understood if the tables are detached so they can be read in conjunction with the text.

2/ Used as a proxy for any bank in the swap network with which the System might negotiate modification of current procedures.

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in both examples). Note that these steps are identical under both current and proposed procedures. The new proposal makes no change in the fundamental operation of the swap mechanism.

These arrangements protect the dollar swap proceeds of the Netherlands Bank from loss in the event of a devaluation of the dollar, since it has the forward contract to sell dollars to the System in repayment of the swap (Step 9) at the established dollar/guilder rate. These arrangements also provide the Netherlands with an interest return on its dollar proceeds based on the United States Treasury bill rate, or about the same return it would have earned had it held the dollars uncovered.

Should the guilder be revalued during the term of the drawing, the arrangements require the Netherlands to sell the System guilders against dollars at the pre-revaluation rate.

The System may acquire the guilders for swap repayment in two principal ways.

<u>First case: Market Reversal (Table 1)</u>

If the dollar spot rate rises in the Netherlands market, the Netherlands Bank may sell dollars for guilders in the exchange market to moderate the rate movement. As illustrated in Table 1, assume that the dollar strengthens and the Netherlands Bank sells $50 million at a rate of 3.60 guilders to the dollar (Step 4). Under current procedures, the Netherlands Bank may then agree to sell guilders to the System (Step 5) at the same rate and in the same amount as its dollar sale to the market. (Thus the Netherlands Bank repurchases from the System the dollars it sells to the market.) These procedures may be

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repeated if the dollar strengthens further. This is shown in Steps 6 and 7 as another $50 million transaction, this time at a rate of 3.62 guilders/dollar.

At this point the System has acquired $100 million equivalent of guilders, enough to repay the swap drawing, and it does so (Step 9).

As a result of this series of transactions, the Netherlands Bank is left without gain or loss, while the System is left with a profit. The System profit arises because its purchases of guilders from the Netherlands Bank in Steps 5 and 7 (corresponding to that bank's transactions with the market in Steps 4 and 6) were at better rates for the dollar than the original spot sale of the swap proceeds (Step 3).

The proposed procedures (Table 1 B) would modify the scenario outlined above by adding a new forward contract to current swap arrangements as an alternative way for the System to acquire the guilders ultimately required to repay the swap. This new contract, made at the same time as the original swap, would provide for the sale by the Netherlands Bank to the System of the guilders needed for the swap repayment at the same rate as the original swap and spot sale. This new contract (Step 8) could replace the spot transactions shown as Steps 5 and 7. With this change, System transactions with the Netherlands Bank would all be made at the same rate, and neither party would have a net profit or loss from swap associated transactions.[1/] Thus, in essence, instead of acquiring cover

1/ The Netherlands Bank, however, would have a profit in guilders (not shown in the example) on its market transactions, for it sells 359.25 million guilders in Step 1, buys 180 million guilders in Step 4, and buys 181 million guilders in Step 6 for a net gain of 1.75 million guilders and no dollar loss. This is precisely the profit that the System earns under current procedures (see Table 1 A).

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for its swap through a series of spot transactions at various rates, the System would acquire the cover through a single forward transaction.

The addition of this new forward contract, however, would in and of itself remove the protection against possible dollar devaluation given the Netherlands Bank under current procedures. With the new forward contract, the Netherlands Bank must sell the System the guilders needed for repayment at the same rate as that of the swap. If there were a dollar devaluation, the Netherlands Bank would thus find that it had lost the protection of having a zero net dollar position, that is, its dollar holdings equal the amount to be repaid under the swap, because the new forward contract requires that it buy additional dollars from the System at the pre-devaluation rate.[1/] Thus, as indicated in my December memorandum, the whole rationale of the swap would be negated. For this reason, it would be necessary to make the new forward contract conditional upon there being no devaluation of the dollar. In addition, the System has been asked to agree that a formal suspension of gold sales by the United States Treasury, without an official change in the price of gold, would also result in a cancellation of the new forward contract.[2/] The exercise of this cancellation clause would restore the situation to exactly what it is under present arrangements and thus undertakes no new commitments on

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1/ The position changes of the Netherlands Bank given by Steps 1, 2, 3, and 9 in Table 1, column A, sum to zero. If the new forward contract (Step 8) is included, as under the proposed procedures, the sum is +100 (column B).

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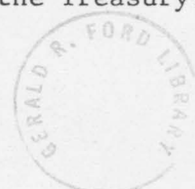
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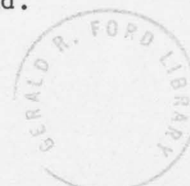
the part of the System. That is, the System would be subject to any loss arising out of having swap drawings outstanding at a time of devaluation of the dollar. Moreover, the existing revaluation clauses in swap agreements would be unaffected by the proposed change and would remain operative in the event of cancellation of the new forward contract.

The new forward contract would be in the form of an option to buy up to the amount of the swap drawing, thus leaving the System the possibility of acquiring through other transactions, at market rates, currencies needed to repay the swap drawing, in line with current procedures. Thus in the case of a market reversal, the System would not be bound to exercise the new forward contract for any particular amount, but could use it to cover only that portion of the outstanding swap that had not been liquidated through normal operations at rates advantageous to the System. This would leave open the possibility of a System profit, while guaranteeing that the System would never have to purchase the needed currency at rates involving it in a loss. It is possible--even likely in the case of some countries--that the proportion of a swap drawing to be covered through market transactions and that through exercise of the new contract would be a subject for ad hoc agreement.

Second case: Drawing from IMF (Table 2)

If the System cannot obtain the foreign currency needed for swap repayment through a market reversal, it normally turns to the United States Treasury to provide the currency for liquidation. Typically, the Treasury has drawn on the International Monetary Fund.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Under current procedures the Treasury draws from the Fund at par (Step 4) and sells the foreign currency to the System at the prevailing market rate (3.5925 guilders/dollar in the example--Step 6). When the swap is repayed, neither the Netherlands Bank nor the System shows a net spot foreign exchange profit or loss on the series of transactions.[1] The Treasury, however, has a profit arising from the fact that it draws at par and sells currency to the System at a rate above par.

The proposed procedures would change this arrangement by providing for the Treasury to sell the currency proceeds of the Fund drawing directly to the foreign central bank at par, rather than to the System at the market rate.[2] The foreign central bank--its dollar holdings having been reduced by the purchase of the currency from the Treasury--would, in turn, then be in a position to sell its currency to the System (purchase dollars from us). If that sale took place under the proposed new forward contract, it would result in the final unwinding of the initial swap drawing with no profit or loss accruing to the Netherlands Bank, the System or the Treasury.

1/ The $100 million gain shown for the Netherlands Bank is an improvement in the Netherlands' IMF position reflecting its balance of payments surplus which gave rise to the initial dollar inflow.

2/ The Treasury has not yet accepted this proposal.

Table 1

SYSTEM SWAP DRAWINGS WITH
THE NETHERLANDS BANK

First Case: Swap Repayment Through Market Reversal

		Rate G/$	A Current Procedures NB($mn.)	FRS(Gmn.)	B Proposed Procedures NB($mn.)	FRS(Gmn.)
1.	Spot acquisition by the Netherlands Bank	3.5925	100		100	
2.	Swap drawing by System	3.5925	100	359.25	100	359.25
3.	Sale of swap proceeds to Netherlands Bank	3.5925	-100	-359.25	-100	-359.25
4.	Market transaction	3.60	-50		-50	
5.	Sale of G. to System by Netherlands Bank	3.60	50	180		
6.	Market transaction	3.62	-50		-50	
7.	Sale of G. to System by Netherlands Bank	3.62	50	181		
8.	New forward	3.5925			100	359.25
9.	Swap repayment	3.5925	-100	-359.25	-100	-359.25
	Net transactions		0	1.75	0	0

G - Guilders
NB - Netherlands Bank
FRS - Federal Reserve System

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Table 2

SYSTEM SWAP DRAWINGS WITH
THE NETHERLANDS BANK

Second Case : Swap Repayment Through United States IMF Drawing

		Rate G/$	Current Procedures			Proposed Procedures		
			NB ($mn.)	FRS (Gmn.)	U.S.T. (Gmn.)	NB ($mn.)	FRS. (Gmn.)	U.S.T. (Gmn.)
1.	Spot acquisition by the Netherlands Bank	3.5925	100			100		
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3.	Sale of swap proceeds to Netherlands Bank	3.5925	-100	-359.25		-100	-359.25	
4.	IMF drawing by U.S. Treasury	3.62	100 1/		362	100 1/		362
5.	Treasury sale of drawing proceeds to Netherlands Bank	3.62				-100		-362
6.	Treasury sale of drawing proceeds to System	3.5925		359.25	-359.25			
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	Net transactions		100 1/	0	3.75	100 1/	0	0

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1/ Improvement in Netherlands IMF position

STRICTLY CONFIDENTIAL--F.R.

Date: January 9, 1971

To: Chairman Burns, Vice Chairman Hayes
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Both examples begin with the purchase by the Netherlands Bank[2/] of dollars from the exchange market when the dollar has reached the Bank's lower intervention point (Step 1). This is followed by a Sytem drawing of guilders, at the same rate, under its swap arrangement with the Netherlands Bank (Step 2), and System use of these guilders to purchase from the Netherlands Bank, again at the same rate, an amount of dollars equal to the initial Netherlands Bank purchase (Step 3). Under the swap arrangements, the United States drawing, unless renewed, is to be repaid in three months using the same rate of exchange at which it was contracted (the final step

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GERALD R. FORD LIBRARY

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These arrangements protect the dollar swap proceeds of the Netherlands Bank from loss in the event of a devaluation of the dollar, since it has the forward contract to sell dollars to the System in repayment of the swap (Step 9) at the established dollar/guilder rate. These arrangements also provide the Netherlands with an interest return on its dollar proceeds based on the United States Treasury bill rate, or about the same return it would have earned had it held the dollars uncovered.

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The proposed procedures (Table 1 B) would modify the scenario outlined above by adding a new forward contract to current swap arrangements as an alternative way for the System to acquire the guilders ultimately required to repay the swap. This new contract, made at the same time as the original swap, would provide for the sale by the Netherlands Bank to the System of the guilders needed for the swap repayment at the same rate as the original swap and spot sale. This new contract (Step 8) could replace the spot transactions shown as Steps 5 and 7. With this change, System transactions with the Netherlands Bank would all be made at the same rate, and neither party would have a net profit or loss from swap associated transactions.[1/] Thus, in essence, instead of acquiring cover

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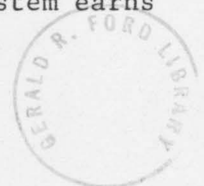
GERALD R. FORD LIBRARY

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GERALD R. FORD LIBRARY

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The proposed procedures would change this arrangement by providing for the Treasury to sell the currency proceeds of the Fund drawing directly to the foreign central bank at par, rather than to the System at the market rate.[2/] The foreign central bank--its dollar holdings having been reduced by the purchase of the currency from the Treasury--would, in turn, then be in a position to sell its currency to the System (purchase dollars from us). If that sale took place under the proposed new forward contract, it would result in the final unwinding of the initial swap drawing with no profit or loss accruing to the Netherlands Bank, the System or the Treasury.

1/ The $100 million gain shown for the Netherlands Bank is an improvement in the Netherlands' IMF position reflecting its balance of payments surplus which gave rise to the initial dollar inflow.

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GERALD R. FORD LIBRARY

Table 1

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	Net transactions		0	1.75	0	0

G - Guilders
NB - Netherlands Bank
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Table 2

SYSTEM SWAP DRAWINGS WITH
THE NETHERLANDS BANK

Second Case : Swap Repayment Through United States IMF Drawing

	Rate G/$	Current Procedures			Proposed Procedures		
		NB ($mn.)	FRS (Gmn.)	U.S.T. (Gmn.)	NB ($mn.)	FRS. (Gmn.)	U.S.T. (Gmn.)
1. Spot acquisition by the Netherlands Bank	3.5925	100			100		
2. Swap drawing by System	3.5925	100	359.25		100	359.25	
3. Sale of swap proceeds to Netherlands Bank	3.5925	-100	-359.25		-100	-359.25	
4. IMF drawing by U.S. Treasury	3.62	100 1/		362	100 1/		362
5. Treasury sale of drawing proceeds to Netherlands Bank	3.62				-100		-362
6. Treasury sale of drawing proceeds to System	3.5925		359.25	-359.25			
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Net transactions		100 1/	0	3.75	100 1/	0	0

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U.S.T.-United States Treasury

1/ Improvement in Netherlands IMF position

[1-71?]

Federal Reserve Bank of New York
New York, New York

Attn: C. A. Coombs, Senior Vice President

Gentlemen:

Under procedures adopted between us for the execution of drawings on the reciprocal currency arrangement, when you make a drawing at our request we will give you a standing order to buy the Belgian francs you will require to cover that drawing in the form of the following cable:

> "We give you a standing order, for value _____ to sell us up to $___ million at a rate of (rate of swap drawing). It is understood and agreed that this order would only be executed by the Federal Reserve Bank of New York at our request pursuant to understandings between us."

We agree that, regardless of other circumstances under which we may or may not make such a request, we will do so if the Belgian franc/dollar spot rate at the time of liquidation of a drawing is below (that is, less francs per dollar) the rate of the drawing when this results from movement of the rate within the present exchange margins or adjustment of the dollar/franc margins. Nothing in these arrangements precludes liquidation of swap drawings by the Federal Reserve through acquisition of Belgian francs in the market or from the U.S. Treasury, or from us when market conditions or other factors result in a reduction in our dollar reserves.

[National Bank of Belgium]

STRICTLY CONFIDENTIAL -- F.R.

January 27, 1971

TO: Chairman Burns,
Vice Chairman Hayes
and Governor Robertson
Federal Open Market Committee

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

FROM: David E. Bodner

This memorandum outlines the basic proposal for modification of swap procedures that was set forth in my memoranda of December 8, 1970 and January 9, 1971. Fundamentally, the question is one of establishing a mechanism for fixing a rate for liquidation of swap drawings that is satisfactory to both parties. As the arrangements now work, the System (or the U. S. Treasury) generally makes a profit on the repayment of outstanding Federal Reserve swap drawings regardless of whether conditions in the market turn around during the period in which the swap is outstanding. Profits made by the System on operations generally have come at the expense of profits foregone by the foreign central bank. In some cases, the other swap partner has actually suffered losses. Moreover, even where the System's profit accrues at the expense of the market (and is thus a profit foregone by the foreign central bank) this takes the form either of an increase in the short-term liabilities to official foreigners of the foreign central bank or of a reduction in its outstanding dollar holdings. (The mechanics of these operations under the swap were described on pages 2 and 3 of my memorandum of January 9.) A number of European central banks have become increasingly unhappy with this situation. As you know, the EEC countries agreed

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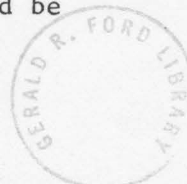
to the latest round of swap line renewals only on condition that the question of the rate for liquidation of swap drawings be resolved promptly. Moreover, the Swiss National Bank has expressed a strong interest in joining in any new arrangements.

The mechanism that we propose to resolve the question, and to which most of the Europeans have already indicated their general agreement in the course of discussions that have taken place to date, is as follows: At the time of the initiation of a swap drawing by the Federal Reserve, we would simultaneously enter into a contract to cover the outstanding commitment through a forward purchase of the amount of the foreign currency needed to liquidate the swap at the exchange rate used for the swap drawing itself. To the extent that this contract was finally executed, no profit or loss would accrue to either party under the swap arrangement.

The cable outlining this contract would read as follows:

> "For value (Date -- 3 months forward)
> we buy from you up to (Amount of foreign
> currency drawn) at rate of (Spot Rate, as
> per swap contract)."

Note that this contract is in the form of an option to buy "up to" the amount of the swap drawing. To the extent that there was a reversal in the market situation, it would still be possible for the System to cover an outstanding swap commitment in the market as it does at present. The new forward contract in that case would be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executed only to cover that portion of the commitment that had not proved reversible. Thus, the System would not be bound to exercise the new forward contract for any particular amount, but could use it to cover only that portion of the outstanding swap that had not been liquidated through normal operations at rates advantageous to the System. This would leave open the possibility of a System profit, while guaranteeing that the System would never have to purchase the needed currency at rates involving it in a loss.

From the point of view of the Federal Reserve, therefore, the proposal has two distinct advantages: 1) it resolves a question which has caused increasing irritation with some of our swap partners and has been an occasional problem with others, while in no way altering the basic mechanics of the swap network and, 2) the new contract would guarantee the System against any risk of loss arising from a swap drawing. The risk of loss generally has not been significant to date (although there have been a few large losses and some difficult negotiations to avoid losses), but is likely to become increasingly important in the future as the EEC countries move to contain their exchange rates in a narrow band moving within the EMA limits.[1/] The cost to the System would be foregoing some profits that have accrued to us in the past as a result of operations.

1/ This question is discussed in some detail on page 5 of my December 8, 1970 memorandum.

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For reasons outlined in my earlier memoranda, the writing of the proposed new forward contract has the effect of short circuiting the protection against a dollar devaluation given to the foreign central bank by a swap drawing. Therefore, we proposed to specify in a background letter (to be referred to in the cable along the lines of the attached draft) that the contract would be considered cancelled in the event of a devaluation of the dollar. It should be noted that in the event this was to happen, the cancellation of the new forward contract would restore the situation to exactly what it is at present when the System has a swap drawing outstanding. The Europeans have asked that this cancellation agreement also be activated by a formal suspension of gold sales by the United States. The letter would also encompass that understanding (see attached draft). This would avoid unduly burdening the cable that would be sent routinely once the new contract was in force and would avoid putting this language in wide circulation on a routine basis. The Treasury has been consulted with respect to the language of the proposed background letter and has no objection.

To achieve the objectives outlined above, the Special Manager recommends that the Committee amend Paragraph 3 of the Authorization for System Foreign Currency Operations to read as follows: "Currencies to be used for liquidation of System swap commitments may be purchased forward from the foreign central bank

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drawn on at the same exchange rate as that employed in the drawing to be liquidated. Otherwise 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."

In the course of discussions, the Belgian National Bank has indicated that, although in basic agreement with the proposed outlined above, it cannot accept the language that appears to be acceptable to the others. The Belgians, uniquely among the central banks, include outstanding forward contracts in their weekly balance sheet and have taken the position that the forward contract described here--which is in effect a one-way option running in favor of the Federal Reserve--would have to be reflected in that balance sheet. The cables received from the National Bank regarding recent swap drawings have included the following paragraph:

> "WE GIVE YOU A STANDING ORDER, VALID DURING THE PERIOD IN WHICH THE PROPOSED DRAWING WILL BE OUTSTANDING, TO SELL US UP TO $_____MILLION AT A RATE OF _____... IT IS UNDERSTOOD AND AGREED THAT THIS ORDER WOULD ONLY BE EXECUTED BY THE FEDERAL RESERVE BANK OF NEW YORK AT OUR REQUEST." 1/

1/ The amount has been the amount of the swap drawing in question and the rate the rate of that drawing.

Because this option runs entirely at their discretion the Belgians apparently would not have to reflect such an order in their balance sheet. From the System's point of view the difficulty with this approach is that it does not guarantee that, in the event the spot rate at the time of liquidation of the contract was disadvantageous to the System, the Belgians would ask us to execute the contract. Thus, the principal benefit that we would obtain from the new arrangement, i.e., protection against loss, conceivably might be foregone. An alternative formulation that would meet the System's objective would be to add an additional sentence to the order as defined by the Belgians so that it would read as follows:

> "IT IS UNDERSTOOD AND AGREED THAT THIS ORDER WOULD ONLY BE EXECUTED BY THE FEDERAL RESERVE BANK OF NEW YORK AT OUR REQUEST. WE AGREE THAT WE WILL MAKE SUCH REQUEST EVEN IF AT THE TIME OF REPAYMENT OF THE SWAP DRAWING THE BELGIAN FRANC RATE HAS APPRECIATED ABOVE THE RATE SPECIFIED IN THIS ORDER."

This would make for a rather complex and perhaps an even overburdened cable, but would meet the System's basic objective under the new procedures. An alternative would be to accept the Belgians' language as given, and have the understanding that is outlined in my proposed additional language covered instead in the background letter that would be exchanged with the Belgian National Bank. In any case, what is at issue with the Belgians is only the form of the proposed

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new contract, not its substance. I request, therefore, that if the Sub-committee approves the amendment to the Authorization proposed above, it authorize the Special Manager to negotiate with the Belgians to reach mutually acceptable language to achieve the same purposes, on the understanding that he would refer back to the Committee if it was not possible to reach agreement without substantive change in the Committee's position.

DRAFT
LETTER

February 1, 1971

De Nederlandsche Bank
Amsterdam
The Netherlands

Attention: Mr. P. C. Timmerman
Deputy Director

Gentlemen:

Pursuant to the understanding between us, we agree that if at any time forward contracts between the Federal Reserve Bank of New York and the Nederlandsche Bank are qualified by the clause:

> "This contract will be governed by the conditions specified in our letter of February 1, 1971"

those conditions are as follows:

> The contract will be considered cancelled in the remote event of a devaluation of the United States dollar or in the event of a formal suspension of gold sales by the United States Treasury.

Sincerely yours,

Charles A. Coombs

GERALD R. FORD LIBRARY

DRAFT
CABLE

DE NEDERLANDSCHE BANK

AMSTERDAM

I. FOR VALUE (DATE - Three Months Forward)

WE BUY FROM YOU AT OUR OPTION UP TO NG (AMOUNT of guilders drawn) AT RATE OF (SPOT Rate, as per Swap Contract).

II. THIS CONTRACT WILL BE GOVERNED BY THE CONDITIONS SPECIFIED IN OUR LETTER OF FEBRUARY 1, 1971.

III. PLEASE CONFIRM.

FEDERAL RESERVE BANK OF NEW YORK

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

January 29, 1971

STRICTLY CONFIDENTIAL (FR)

TO: Chairman Burns
Governor Robertson

FROM: Robert Solomon and A. B. Hersey

SUBJECT: Proposed Modification of Procedures Under Federal Reserve Swap Lines with Central Banks

Mr. Bodner's memorandum of January 27, 1971, transmits a recommendation of the Special Manager that the Subcommittee of the Federal Open Market Committee (authorized at the FOMC meeting of December 15, 1970, to deal with this matter) amend Paragraph 3 of the Authorization for System Foreign Currency Operations to read as follows:

> "Currencies to be used for liquidation of System swap commitments may be purchased forward from the foreign central bank drawn on at the same exchange rate as that employed in the drawing to be liquidated. Otherwise, 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."

Discussion: general background

As explained by Mr. Bodner, the purpose of the recommended amendment is to permit the Special Manager to work out, with foreign central banks on which the System draws under the swap arrangements, certain procedures that would end what some of those banks find a source of irritation under present procedures: namely, the fact that they give up many opportunities of making normal profits through purchases and sales of dollars if they ask us to make a swap drawing (to give them exchange risk cover on the dollars they acquired from the market).

In the absence of a swap drawing such profits arise as follows. A central bank gaining reserves, as the result of a strong balance of payments, makes market purchases of dollars at an exchange rate below par. Subsequently, if there is a reversal in the balance of payments and its currency is less strong on the exchange market, it will sell dollars in the market at a higher rate in terms of its own currency. Or, if there is no reversal, it may use the dollars it had acquired cheaply to buy, at par, gold or SDRs from the U.S. Treasury. Depending on its accounting practices, a central bank may write up the book value of the new reserve asset immediately to par in terms of its own currency, with resultant profit on its books, or it may wait for a future sale of the reserve asset to realize the potential profit.

Under existing procedures for swap drawings by the System the foreign central bank forgoes these normal profits in both cases, as explained in the next four paragraphs.

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(a) In the case of a reversal in the country's balance of payments, the foreign central bank's profits through market transactions are shifted to the System, since (1) its initial acquisitions of dollars cheaply are matched by its sale at the same rate of those dollars to the System in exchange for the foreign currency the System gets by a swap drawing, and (2) its subsequent sales of dollars to the market at a higher rate are offset by the sale of its currency to (purchase of dollars from) the System to provide us with the currency we need to liquidate the swap drawing. The last of these transactions is made, under present rules, at the spot market rate prevailing at the moment. If there is an interval of time between the foreign central bank's sales of dollars to the market and its sale of currency to the System, during which the dollar's value rises further, the foreign central bank may even suffer a loss. (If the System is able to acquire through its own market operations the currency needed to liquidate the swap drawing, the foreign central bank will not have to sell its currency to the System at a rate relatively unfavorable to it, but it will have less occasion to sell dollars in the market at a profit before the cycle is completed.)

GERALD R. FORD LIBRARY

(b) In the case of no reversal in the balance of payments, transactions must be arranged to take place at the maturity of the swap drawing, whereby the System will obtain the foreign currency needed to liquidate the swap drawing and the foreign central bank will obtain (1) dollars to hold uncovered, or (2) dollars with which to buy gold, SDRs, or U.S. Treasury obligations denominated in a foreign currency (Roosa Bonds), or (3) an addition to its reserve position in the International Monetary Fund.

In subcases 1 and 2, the foreign central bank sells the System its currency (and thereby acquires dollars) at the prevailing spot market rate. Its exchange profits for the whole cycle depend on this rate, since its original dollar acquisitions when the dollar was at its floor were passed over to the System in a "mop-up" transaction at the same rate, and since the original swap drawing and its reversal at the end of the cycle are also at the same rate. If the prevailing spot market rate at the time of liquidation is still the floor rate for the dollar, the foreign central bank ends up with a realized or potential profit just equal to what it would have had in the absence of a swap drawing. If, however, the rate for the dollar has improved at all, the foreign central bank finds itself giving up part or all of its profit to the System.

In subcase (3) -- a Fund drawing by the United States -- the System acquires the foreign currency to liquidate the swap drawing at the prevailing spot market rate from the U.S. Treasury. The Treasury, having obtained the foreign currency from the IMF at par, has a profit if that currency is still above par in the exchange market. The foreign central bank has no profit, realized or potential, from the whole cycle, because it acquires the addition to its reserve position in the Fund at par in terms of its own currency.

The proposed amendment of the Authorization would permit a modification of procedures whereby a foreign central bank would in some cases be able to obtain normal exchange market profits, realized

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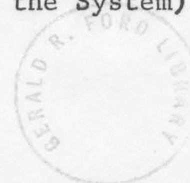
or potential.[1/] The cases in which it would still not be able to make a profit that would have been available in the absence of a swap drawing are the following. (1) In case of a balance of payments reversal, the System would have an option to acquire the currency needed to liquidate a swap drawing through purchases in the market if that were feasible rather than from the foreign central bank at the contract rate. (2) In the case of no reversal in the balance of payments and a U.S. drawing on the Fund, the System would exercise its option not to buy from the foreign central bank, since it would acquire the needed foreign currency from the U.S. Treasury.

Mr. Bodner's memorandum states that in the discussions that have taken place most of the European central banks have indicated their general agreement with the proposed procedures. He also points out that the proposed procedures would ensure that the System would never have losses in its swap drawing operations caused by variations in exchange rates. The System would give up profits that it gets under present procedures in certain cases -- namely, where it acquired foreign currency (needed to liquidate a swap drawing) from the foreign central bank and could no longer use a spot market rate better for the dollar than the original market rate used for the swap.

1/ The statement on page 2 of Mr. Bodner's memorandum of January 27, 1971, that "to the extent this contract was finally executed, no profit or loss would accrue to either party under the swap arrangement" /emphasis added/, does not take account of the foreign central banks' market profits through initial acquisitions in the market at the dollar's floor rate and subsequent resale at a higher rate (the benefit of which would no longer have to be passed over to the System).


GERALD R. FORD LIBRARY

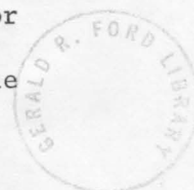
Pros and cons

A case for amending the Authorization as recommended can be made on the following grounds. The underlying purpose of the swap arrangements -- so far as System drawings on foreign central banks are concerned -- is and always has been to prevent hasty purchases of gold or SDRs by the foreign central banks from the United States. Profit considerations have never entered into Federal Reserve policy making regarding the swap arrangements. So long as no Federal Reserve losses are entailed, it is perfectly reasonable that the System should accede to the foreign central banks' desires with regard to normal exchange market profits in order to maintain the friendliest possible relations.

A case against adopting the proposed amendment would have to be based on a view that sacrifice of normal exchange market profits is a proper price for a central bank to pay for the insurance that the swap drawing provides against potentially large losses in certain contingencies -- namely, in the event of devaluation of the dollar or a suspension of gold sales by the United States. This argument is even stronger if at the maturity of the swap the foreign central bank is going to convert its dollar reserve gains into gold, SDRs, or U.S. Treasury securities denominated in foreign currency. We are informed that it is mainly for considerations of this kind that the U.S. Treasury has not agreed to the plan, mentioned in Mr. Bodner's two earlier memoranda, for new procedures in connection with Fund drawings to liquidate swap drawings.

GERALD R. FORD LIBRARY

In rebuttal of the foregoing argument, two things may be said. First, there may be some validity to the thought that benefits to the United States of postponement of foreign gold purchases outweigh the satisfaction foreign central banks may gain from having dollar holdings temporarily covered by a swap drawing. Second, rejection of the recommendation might be regarded by some of the foreign central banks as inviting a termination of friendly cooperative efforts to avoid or at least postpone a serious deterioration of market confidence in the exchange value of the dollar.


GERALD R. FORD LIBRARY

Another disadvantage of the proposal should be pointed out. To explain this, we note first that under the proposed procedures the foreign central bank and the System would be in exactly the same position as under present procedures in the event that certain specific happenings were to occur. If the United States were to reduce the parity of the dollar against gold or were to suspend sales of gold, the System would be obligated exactly as it is under present procedures, by any swap contract that might be outstanding at the time, to pay to the foreign central bank a fixed amount in terms of the foreign currency -- whatever its value then, in terms of gold or dollars -- and would have no assurance of being able to acquire the currency for dollars at any particular rate. The technical feature required to make the proposed arrangements exactly equivalent in this respect to present procedures, is a <u>cancellation</u>, in the event of the specified contingencies, <u>of the forward contract</u> for sale to the System of the needed amount of the foreign currency (this forward contract being the new feature desired for reasons of normal exchange profits).

Under Mr. Bodner's recommendation, a letter would be sent to the foreign central banks stating that the forward contract "will be cancelled in the remote event of a devaluation of the United States dollar or in the event of a formal suspension of gold sales by the United States Treasury."

Under existing procedures such an explicit statement of possible U.S. actions is unnecessary, though it is these contingencies against which the foreign central banks are protected by our swap drawings.

It can be argued, on the one hand, that our swap partners are well aware of the nature of the risks, however small, that swap drawings protect them against, so that no harm is done if these contingencies are made explicit. On the other hand, it can be imagined that receipt and dissemination within foreign central banks of such a letter at this time might strengthen the belief that the United States is giving serious consideration to a basic and far-reaching change in its policies.

Perhaps this danger could be lessened if a sentence were added to the proposed letter as follows: "This letter is provided solely for the purpose of completing technical arrangements under our reciprocal currency agreement. It implies no change in long-standing U.S. policies."

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Postscript

If either of the events specified above seemed likely to cease being only remote contingencies, it would be urgently desirable for the System to reconsider its use of swaps and to reach an understanding with the U.S. Treasury as to how the System might fulfill its obligations under swap contracts. The present proposal reminds us of these questions, but it does not require that immediate answers be given to them.

STRICTLY CONFIDENTIAL (FR) January 29, 1971

To: Chairman Burns,
Vice Chairman Hayes,
and Governor Robertson,
Federal Open Market Committee

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

From: David E. Bodner

During the course of this morning's meeting to review the proposal outlined in my memorandum of January 27, there was extensive discussion of the possibility of handling the problem through the use of a standing order that would avoid the need for a background letter from the Federal Reserve along the lines of my draft letter. During these discussions it was perhaps not fully appreciated that what was being proposed is in fact what has been proposed to us by the Belgian National Bank. The Belgians' version of our proposal, as outlined on pages 5 and 6 of my January 27 memorandum, is for a standing order to cover the amounts needed by the System to liquidate a swap at the rate of that swap. The order runs entirely at the option of the Belgians and, therefore, does not require any background letter from us regarding the possibility of devaluation. As I noted in my memorandum, in the form specified by the Belgians the System would still be exposed to possible losses. This could be resolved either by amending their cable along the lines I indicated or by a background understanding running from them to us.

Therefore, as I interpret the group's discussion this morning, it would recommend that we adopt the Belgian proposal as the general one in place of our original version. Thus we still have only two proposals in front of us.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

January 29, 1971

STRICTLY CONFIDENTIAL (FR)

TO: Chairman Burns
Governor Robertson

FROM: Robert Solomon and A. B. Hersey

SUBJECT: Proposed Modification of Procedures Under Federal Reserve Swap Lines with Central Banks

Mr. Bodner's memorandum of January 27, 1971, transmits a recommendation of the Special Manager that the Subcommittee of the Federal Open Market Committee (authorized at the FOMC meeting of December 15, 1970, to deal with this matter) amend Paragraph 3 of the Authorization for System Foreign Currency Operations to read as follows:

> "Currencies to be used for liquidation of System swap commitments may be purchased forward from the foreign central bank drawn on at the same exchange rate as that employed in the drawing to be liquidated. Otherwise, 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."

GERALD R. FORD LIBRARY

Discussion: general background

As explained by Mr. Bodner, the purpose of the recommended amendment is to permit the Special Manager to work out, with foreign central banks on which the System draws under the swap arrangements, certain procedures that would end what some of those banks find a source of irritation under present procedures: namely, the fact that they give up many opportunities of making normal profits through purchases and sales of dollars if they ask us to make a swap drawing (to give them exchange risk cover on the dollars they acquired from the market).

In the absence of a swap drawing such profits arise as follows. A central bank gaining reserves, as the result of a strong balance of payments, makes market purchases of dollars at an exchange rate below par. Subsequently, if there is a reversal in the balance of payments and its currency is less strong on the exchange market, it will sell dollars in the market at a higher rate in terms of its own currency. Or, if there is no reversal, it may use the dollars it had acquired cheaply to buy, at par, gold or SDRs from the U.S. Treasury. Depending on its accounting practices, a central bank may write up the book value of the new reserve asset immediately to par in terms of its own currency, with resultant profit on its books, or it may wait for a future sale of the reserve asset to realize the potential profit.

Under existing procedures for swap drawings by the System the foreign central bank forgoes these normal profits in both cases, as explained in the next four paragraphs.

GERALD R. FORD LIBRARY

(a) In the case of a reversal in the country's balance of payments, the foreign central bank's profits through market transactions are shifted to the System, since (1) its initial acquisitions of dollars cheaply are matched by its sale at the same rate of those dollars to the System in exchange for the foreign currency the System gets by a swap drawing, and (2) its subsequent sales of dollars to the market at a higher rate are offset by the sale of its currency to (purchase of dollars from) the System to provide us with the currency we need to liquidate the swap drawing. The last of these transactions is made, under present rules, at the spot market rate prevailing at the moment. If there is an interval of time between the foreign central bank's sales of dollars to the market and its sale of currency to the System, during which the dollar's value rises further, the foreign central bank may even suffer a loss. (If the System is able to acquire through its own market operations the currency needed to liquidate the swap drawing, the foreign central bank will not have to sell its currency to the System at a rate relatively unfavorable to it, but it will have less occasion to sell dollars in the market at a profit before the cycle is completed.)

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(b) In the case of no reversal in the balance of payments, transactions must be arranged to take place at the maturity of the swap drawing, whereby the System will obtain the foreign currency needed to liquidate the swap drawing and the foreign central bank will obtain (1) dollars to hold uncovered, or (2) dollars with which to buy gold, SDRs, or U.S. Treasury obligations denominated in a foreign currency (Roosa Bonds), or (3) an addition to its reserve position in the International Monetary Fund.

In subcases 1 and 2, the foreign central bank sells the System its currency (and thereby acquires dollars) at the prevailing spot market rate. Its exchange profits for the whole cycle depend on this rate, since its original dollar acquisitions when the dollar was at its floor were passed over to the System in a "mop-up" transaction at the same rate, and since the original swap drawing and its reversal at the end of the cycle are also at the same rate. If the prevailing spot market rate at the time of liquidation is still the floor rate for the dollar, the foreign central bank ends up with a realized or potential profit just equal to what it would have had in the absence of a swap drawing. If, however, the rate for the dollar has improved at all, the foreign central bank finds itself giving up part or all of its profit to the System.

In subcase (3) -- a Fund drawing by the United States -- the System acquires the foreign currency to liquidate the swap drawing at the prevailing spot market rate from the U.S. Treasury. The Treasury, having obtained the foreign currency from the IMF at par, has a profit if that currency is still above par in the exchange market. The foreign central bank has no profit, realized or potential, from the whole cycle, because it acquires the addition to its reserve position in the Fund at par in terms of its own currency.

The proposed amendment of the Authorization would permit a modification of procedures whereby a foreign central bank would in some cases be able to obtain normal exchange market profits, realized

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or potential.[1/] The cases in which it would still not be able to make a profit that would have been available in the absence of a swap drawing are the following. (1) In case of a balance of payments reversal, the System would have an option to acquire the currency needed to liquidate a swap drawing through purchases in the market if that were feasible rather than from the foreign central bank at the contract rate. (2) In the case of no reversal in the balance of payments and a U.S. drawing on the Fund, the System would exercise its option not to buy from the foreign central bank, since it would acquire the needed foreign currency from the U.S. Treasury.

Mr. Bodner's memorandum states that in the discussions that have taken place most of the European central banks have indicated their general agreement with the proposed procedures. He also points out that the proposed procedures would ensure that the System would never have losses in its swap drawing operations caused by variations in exchange rates. The System would give up profits that it gets under present procedures in certain cases -- namely, where it acquired foreign currency (needed to liquidate a swap drawing) from the foreign central bank and could no longer use a spot market rate better for the dollar than the original market rate used for the swap.

1/ The statement on page 2 of Mr. Bodner's memorandum of January 27, 1971, that "to the extent this contract was finally executed, no profit or loss would accrue to either party under the swap arrangement" /emphasis added/, does not take account of the foreign central banks' market profits through initial acquisitions in the market at the dollar's floor rate and subsequent resale at a higher rate (the benefit of which would no longer have to be passed over to the System).

GERALD R. FORD LIBRARY

Pros and cons

A case for amending the Authorization as recommended can be made on the following grounds. The underlying purpose of the swap arrangements -- so far as System drawings on foreign central banks are concerned -- is and always has been to prevent hasty purchases of gold or SDRs by the foreign central banks from the United States. Profit considerations have never entered into Federal Reserve policy making regarding the swap arrangements. So long as no Federal Reserve losses are entailed, it is perfectly reasonable that the System should accede to the foreign central banks' desires with regard to normal exchange market profits in order to maintain the friendliest possible relations.

A case against adopting the proposed amendment would have to be based on a view that sacrifice of normal exchange market profits is a proper price for a central bank to pay for the insurance that the swap drawing provides against potentially large losses in certain contingencies -- namely, in the event of devaluation of the dollar or a suspension of gold sales by the United States. This argument is even stronger if at the maturity of the swap the foreign central bank is going to convert its dollar reserve gains into gold, SDRs, or U.S. Treasury securities denominated in foreign currency. We are informed that it is mainly for considerations of this kind that the U.S. Treasury has not agreed to the plan, mentioned in Mr. Bodner's two earlier memoranda, for new procedures in connection with Fund drawings to liquidate swap drawings.

GERALD R. FORD LIBRARY

In rebuttal of the foregoing argument, two things may be said. First, there may be some validity to the thought that benefits to the United States of postponement of foreign gold purchases outweigh the satisfaction foreign central banks may gain from having dollar holdings temporarily covered by a swap drawing. Second, rejection of the recommendation might be regarded by some of the foreign central banks as inviting a termination of friendly cooperative efforts to avoid or at least postpone a serious deterioration of market confidence in the exchange value of the dollar.

Another disadvantage of the proposal should be pointed out. To explain this, we note first that under the proposed procedures the foreign central bank and the System would be in exactly the same position as under present procedures in the event that certain specific happenings were to occur. If the United States were to reduce the parity of the dollar against gold or were to suspend sales of gold, the System would be obligated exactly as it is under present procedures, by any swap contract that might be outstanding at the time, to pay to the foreign central bank a fixed amount in terms of the foreign currency -- whatever its value then, in terms of gold or dollars -- and would have no assurance of being able to acquire the currency for dollars at any particular rate. The technical feature required to make the proposed arrangements exactly equivalent in this respect to present procedures, is a cancellation, in the event of the specified contingencies, of the forward contract for sale to the System of the needed amount of the foreign currency (this forward contract being the new feature desired for reasons of normal exchange profits).

GERALD R. FORD LIBRARY

Under Mr. Bodner's recommendation, a letter would be sent to the foreign central banks stating that the forward contract "will be cancelled in the remote event of a devaluation of the United States dollar or in the event of a formal suspension of gold sales by the United States Treasury."

Under existing procedures such an explicit statement of possible U.S. actions is unnecessary, though it is these contingencies against which the foreign central banks are protected by our swap drawings.

It can be argued, on the one hand, that our swap partners are well aware of the nature of the risks, however small, that swap drawings protect them against, so that no harm is done if these contingencies are made explicit. On the other hand, it can be imagined that receipt and dissemination within foreign central banks of such a letter at this time might strengthen the belief that the United States is giving serious consideration to a basic and far-reaching change in its policies.

Perhaps this danger could be lessened if a sentence were added to the proposed letter as follows: "This letter is provided solely for the purpose of completing technical arrangements under our reciprocal currency agreement. It implies no change in long-standing U.S. policies."

GERALD R. FORD LIBRARY

<u>Postscript</u>

If either of the events specified above seemed likely to cease being only remote contingencies, it would be urgently desirable for the System to reconsider its use of swaps and to reach an understanding with the U.S. Treasury as to how the System might fulfill its obligations under swap contracts. The present proposal reminds us of these questions, but it does not require that immediate answers be given to them.

Gov. Robertson
will hand

February 12, 1971

To: Chairman Burns and Governor Robertson

From: A. B. Hersey, A. L. Broida, and D. B. Hexter

Attached for your consideration is a draft memorandum to the FOMC concerning the problem relating to System swap arrangements on which Mr. Bodner reported at the December meeting, from the subcommittee that was authorized to deal with this matter.

In our judgment distribution of a memorandum along the lines of the draft would be helpful not only in giving the full Committee information on the current status of the matter but also in providing the members with the kind of background material they might want to have before they are asked to vote on an enabling amendment to the foreign currency authorization.

We will be available to discuss the proposed memorandum with you, if you so desire. Mr. Bodner has a copy of the draft and will be discussing it with President Hayes early next week.

Attachment

DRAFT
2/12/71

To: Federal Open Market Committee

From: Chairman Burns, Vice Chairman Hayes and Governor Robertson

Procedure for liquidation of drawings under reciprocal currency arrangements

GERALD R. FORD LIBRARY

STRICTLY CONFIDENTIAL (FR)

Acting under authority delegated by the Committee at its meeting on December 15, 1970 to us as a subcommittee, we have authorized the Special Manager to negotiate with central banks on which the System draws under its reciprocal currency (swap) arrangements, regarding certain new procedures in connection with liquidation of swap drawings. These negotiations were started last week and are still in process.

Under the present terms of paragraph 3 of the Authorization for System Foreign Currency Operations, express authorization by the Committee would be required on each occasion the new procedures were to be used, as is explained below. To avoid the need for repeated Committee actions, we plan to recommend an appropriate amendment to that paragraph as soon as the current negotiations reach a stage at which such an amendment appears desirable.

This action is designed to meet a problem that was raised by the central banks of Belgium and the Netherlands, among others, as described in a memorandum from Mr. Bodner to the Committee dated December 8, 1970, entitled "Proposed Modification of Procedures to be Employed in Transactions under Certain Swap Lines," a copy of which is attached. Copies are also attached of memoranda to us from Mr. Bodner dated January 9 and 27, 1971 and a memorandum to us from Mr. Robert Solomon and Mr. Hersey

dated January 29, 1971. The problem is to establish a mechanism for fixing a rate satisfactory to both parties at which -- if there had been no change in the parity rate -- the System would purchase from a central bank the foreign exchange needed for liquidation of a System swap drawing on that bank, in case there had not been a market reversal or a U.S. drawing on the IMF. It is contemplated that the rate for such purchases would be fixed at the time of the swap drawing and would be the same as the rate of the swap, rather than either the spot market rate at the time the currency would be needed or the forward market rate at the time of the swap. Fixing of the rate in this manner requires either express authorization or an amendment of paragraph 3 of the Authorization, which at present allows (in the absence of express authorization) only transactions "at prevailing market rates."

The particular procedures that we approved are a modification of the procedures proposed by the Belgians, discussed on pp. 5-7 of Mr. Bodner's memorandum of January 27. These procedures avoid the disadvantage, pointed out in the January 29 memorandum, of the New York Reserve Bank's having to mention explicitly in correspondence with foreign central banks certain contingencies (devaluation, and suspension of gold sales) in which a forward contract for the System's acquisition of the other currency would not be used. The procedures that we approved would (1) enable the foreign central bank to avoid any loss (in terms of its own currency) attributable to use of the swap arrangement, (2) allow it to retain normal exchange rate profits in certain circumstances, (3) protect the System from any loss arising from exchange rate changes within the present margins or within adjusted margins

GERALD R. FORD LIBRARY

(as well as from a parity revaluation by the foreign country, as under existing arrangements -- which would be unchanged in this respect), and (4) not preclude the System's acquisition of the needed foreign currency in other ways. The final attachment to this memorandum is a copy of the draft letter reflecting these understandings, as submitted to the foreign central banks concerned in the course of the current negotiations. These procedures would be authorized for use, if desired by the other party, in connection with System swap drawings on any of the central banks in the swap network.

Attachments

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 18 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

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

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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.[1/] 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.

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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

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 12, 1971

To Chairman Burns

Subject: Renewal of swap agreements by FOMC

From Samuel Katz and Robert Solomon

CONFIDENTIAL (FR)

The maturity of the various System reciprocal-currency agreements during the month of December[1/] provides the opportunity for a review of the swap network in the light of the U.S. suspension of gold convertibility. This memorandum attempts to review the alternative decisions the FOMC might consider under four headings:

a. Should the swap agreements be renewed?

b. Should the purposes, uses, and over-all magnitude of the swap network be reviewed at this time?

c. How should outstanding liabilities be settled? and

d. Should any individual swap lines be altered at this time?

The staff's recommendations are:

1. That the agreements be renewed; but Federal Reserve officials should either wait for our swap-partners to take the initiative or should raise the renewal question in a low-key manner. In either event they should avoid any implication that the System is prepared to provide exchange-value guarantees on any additional dollar holdings at this time;

2. That the broad lines of policy governing repayment of outstanding balances seem to be set and no further action of the FOMC is required at this time;

1/ These agreements mature as follows: on December 2 (U.K.; Switzerland; Austria; Sweden; Japan; Denmark; Mexico; Norway; and the B.I.S.); on December 16 (Germany); on December 22 (Belgium); on December 28 (France); and on December 30 (Italy; Netherlands; and Canada). The details of Federal Reserve swap arrangements and the amounts and dates of system drawings are shown in detail in Annex I.

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3. That the members of the FOMC might consider whether on the basis of the pro and con arguments (which the staff regard as evenly-balanced) they should undertake a cutback in the credit line with the Bank of England; and

4. That the members of the FOMC postpone for the time being discussion of two major issues with regard to the future role of the swap network:

   a. Changes in the purposes and uses; and

   b. The desirability of a major cutback in the network credit aggregates.

We will consider each of these recommendations in turn.

Renewal of swap agreements

The staff find the arguments substantially in favor of a renewal of swap agreements at this time. The shock of a termination of the swap network would:

1. Cloud the atmosphere for current international financial negotiations;
2. Create additional uncertainties about the direction of U.S. international policies;
3. Adversely affect prospects for international cooperation; and
4. Disturb confidence and stability in private financial markets in the leading countries.

At this time, it is important that our swap-partners not regard an automatic renewal of these agreements as a precedent as to future U.S. willingness to provide exchange-value guarantees on dollar balances. The Treasury is particularly concerned that our posture on renewal of the swaps not prejudice in any way our negotiating position regarding future convertibility. At the moment, the only dollar-balances protected against an upward drift in the exchange rates of other countries are those covered under the Federal Reserve network or by means of Treasury foreign-currency issue of bonds. As part of the August 15 program, the Secretary of the Treasury "requested the Federal Reserve to suspend the virtually automatic use of its swap network for the purpose of converting dollars into other currencies; the future operation of these and other mutual credit facilities with foreign countries will be determined in the light of emerging developments."

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The danger of a misinterpretation of the attitude of U.S. agencies about future commitments on dollar holdings arises from the history of the swap facilities as an instrumentality for providing an exchange-value guarantee to foreign official dollar holders. At this time there is uncertainty about when the United States will again be prepared to assume a convertibility obligation, but there is every reason to expect it to be much more limited than our pre-August commitment to provide gold for dollars. Our swap-partners ought not to be led to expect that they will be able to obtain the same exchange-value guarantees in the future that they have obtained from the System in the past until the form of U.S. convertibility has been decided upon.

Accordingly, the staff would stress that, while System officials should avoid any threat from our side to the continuity of the swap network, they should also take a low key posture on the question of renewals of reciprocal-currency agreements and of Federal Reserve drawings currently outstanding. It is important that, in the discussions about the renewal of swap lines or of outstanding drawings, System personnel avoid giving foreign officials any implication about when, and to what degree, the United States is likely to resume convertibility or be willing to grant through the network exchange-value guarantees on additional foreign official dollar accruals.

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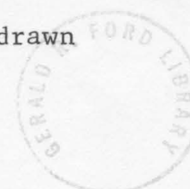
Changing purposes and uses of swap facilities

The staff would expect that major changes will have to be made in the years ahead in the purposes and uses of swap facilities. It is regarded as unlikely that the network would ever again have as a major purpose the granting of exchange-value guarantees on foreign official dollar holdings. Instead, we would expect the swap network to be conceived of as a mechanism for international cooperation through which (i) capital flows could be offset or financed and (ii) official resources could be used to stabilize private markets and even to support major currencies during political emergencies. Furthermore, it is likely that there remains the need for some international arrangements to ensure that speculative factors not overwhelm private financial markets during periods of uncertainty merely because there is no machinery for supportive official intervention in them.

The staff also regard it as likely that there will be major adaptations in the uses to which swap facilities would be put in the years ahead. On the historical record, it is evident that the overriding objective of swap operations between 1964 and 1967 was to avoid the devaluation of the U.K. pound. To this end, Federal Reserve officials made System resources available to the Bank of England and they also took a leadership role in assembling seven different packages of international credits between 1962 and 1967 to help the United Kingdom authorities avoid devaluation. As a result, credits to the Bank of England accounted for nearly two-thirds of the dollar credits drawn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by swap-partners from the System since 1962. In turn, protracted U.K. use of these credits raised major concern in the post-devaluation period among FOMC officials about the liquidity of these System claims in sterling. The Committee was forced in 1968 to make the particularly difficult decision to extend outstanding credits beyond 12 months in order to avoid an additional threat to the post-devaluation stability of sterling.

But the United States is not likely to assume such broad responsibilities to aid the United Kingdom in the years ahead. As a member of the Common Market, the Bank of England will undoubtedly participate in the short- and medium-term credit facilities which will be created among the European countries. These arrangements, to which the United States does not now adhere, would presumably serve as the first-line defense of the pound.

Secondly, even if the United States were concerned about the stability of the pound, it is by no means clear that we could afford substantial dollar credits to Britain. On the contrary, about the last thing System officials are likely to encourage would be substantial additional dollar flows from the Bank of England to other G-10 central banks.

Finally, the staff regard it as unlikely that the U.S. government will return to as rigid an exchange-rate policy as was enforced -- largely through the facilities of the swap network and of the Fund -- between 1962 and mid-1967. There is now general agreement among Fund

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members that a limited (but significant) increase in exchange-rate flexibility is unavoidable. Mechanisms to achieve this additional flexibility are likely to be an essential precondition before the United States again accepts a convertibility commitment even in a limited form.

Although modifications in the purposes, uses and magnitude of the swap network will have to be discussed by the FOMC in the future, a formal discussion at this time would be premature. Until the outlines of the new world monetary structure are clarified, in fact, such a discussion would lack focus and would probably be of only limited utility.

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Policies governing settlements of outstanding balances

Federal Reserve officials are in the process of working out settlement arrangements on outstanding System indebtedness to swap-partners. These obligations as of November 3 (in millions of U.S. dollar equivalent) were:

Belgium	$ 535 m.
Bank of England	750 m.
Germany	60 m.
Switzerland	1000 m.
B.I.S. (Swiss francs)	600 m.
(Belgian francs)	35 m.
Total (dollar equivalent)	$2980

The general lines of policy which have thus far emerged have two elements:

1. The System has not accepted responsibility to compensate swap-partners on dollars covered by the swap lines held when they upvalued their parities (Switzerland, May 10, 1971);

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2. The System has recognized the responsibility to compensate them against loss (i.e. providing unchanged amounts of foreign currencies) on dollar balances covered by swap drawings (or on liabilities incurred) to the extent that their currencies were freed to float upward after August 15.

Form of Belgian repayments - Thus far, the only post-August repayments made have been in Belgian francs. The Belgian authorities have renewed drawings as they have matured (See Annex I) and have encouraged System officials to make moderate and steady purchases of Belgian francs in the exchange market to reduce these obligations. To date some $75 million of the drawings have been repaid out of balances

acquired in the market. Last week the New York Reserve Bank postponed further purchases at the request of the Belgian authorities because of advances in the franc's market quotation. The Belgian officials had told us prior to this time that they did not regard Federal Reserve market purchases as important in the recent rise in the Belgian franc rate.

Experience with drawings in other currencies - The Swiss authorities have agreed to renew each of the three System drawings shown in Annex I. (See Annex I.) The DM obligations have been renewed until December 30 and $10 million was repaid on November 12 out of System balances. The drawing on the Bank of England which matures on November 17 has also been renewed until February 1972.

FOMC has no apparent policy options - As the staff views the situation, U.S. officials could leave the initiative about repaying maturing System liabilities to our swap-partners. The System can make repayment now only (with the agreement by the swap-partner) by buying their currency in the market. This our partners may be reluctant to encourage where they do not wish to have their currencies pushed up in the market. Should they wish to be paid off with reserve-assets, settlement would then become a matter between them and the U.S. Treasury and not with the System.

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Should any credit lines be cut back?

Regardless of what decision might be made in the future about the aggregate size of the swap network, it is evident at this time that the Bank of England's credit line is disproportionately large. At least four arguments can be advanced in favor of reducing this line at this time:

1. The U.S. balance of payments cannot finance substantial credits to the United Kingdom and we would find it embarrassing if the U.K. payments position deteriorated (as some expect) after Britain joined the Common Market in 1973 and asked to draw on the swap lines;
2. The avoidance of a U.K. devaluation is not likely again to become a priority objective of U.S. policy;
3. The vote of the U.K. Parliament to join the Common Market provides a heaven-sent occasion to announce a reduction in this line; and
4. The U.K. balance of payments is presently strong enough to remove any need for the full line.

Case against action - By contrast, a U.S. decision at this time to reduce the swap-line would create an additional uncertainty in world financial markets. This consideration would appear to be the main argument against FOMC action at this time.

Staff recommendation - In our view, the weighing of the arguments on both sides does not create a compelling case either to act or to postpone action at this time. A decision to act at this time could be easily justified; but a postponement decision could as easily be defended. At the least System officials could be requested to raise the matter informally with Bank of England officials.

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On the other hand, the Committee should anticipate the need to face the question of cutting back the U.K. line at an appropriate time. Accession to the Treaty of Rome provides a convenient occasion to take this decision. Thus, it could be made at any time up to the end of 1972.

SCHEDULE III

ANNEX I

November 5, 1971

SYSTEM SWAP ARRANGEMENTS AND DRAWINGS
(In millions)

Central Bank of	ARRANGEMENTS IN EFFECT Original Date	Amount	Term (in mos.)	Maturity Date	Line in continuous use since	DRAWINGS OUTSTANDING Total Out.	Original Date	Amount	Maturity Date	Rate of Drawing
Austria	10/25/62	$ 200.0	12	12/ 2/71						
Belgium	6/20/62	600.0	12	12/22/71	6/30/70		2/10/71	45.0	11/10/71	49.62 5/8
							5/10/71	65.0	11/10/71	49.62 1/2
							8/10/71	40.0	11/10/71	49.62 1/2
							8/12/71	70.0	11/12/71	49.62 1/2
							8/16/71	20.0	11/16/71	49.62 1/2
							8/17/71	10.0	11/17/71	49.62 1/2
							2/24/71	35.0	11/24/71	49.62 1/2
							5/26/71	30.0	11/26/71	49.62 1/2
							2/ 3/71	70.0	1/ 3/72	49.62 1/2
							4/ 7/71	30.0	1/ 7/72	49.62 1/2
							7/21/71	40.0	1/21/72	49.62 1/2
							7/28/71	25.0	1/28/72	49.62 1/2
						535.0	8/ 4/71	55.0	2/ 4/72	49.62 1/2
Canada	6/26/62	1,000.0	12	12/30/71						
Denmark	5/17/67	200.0	12	12/ 2/71						
England	5/31/62	2,000.0	12	12/ 2/71	8/17/71	750.0	8/17/71	750.0	11/17/71	2.4197
France	3/ 1/62	1,000.0	12	12/28/71						
Germany	8/ 2/62	1,000.0	12	12/16/71	4/13/71		5/ 7/71	30.0	12/30/71	3.63
							5/ 7/71	15.0	12/30/71	0.27545
						60.0	5/ 7/71	15.0	12/30/71	0.27545

Handwritten notes (Belgium): "BNB has agreed to renew to: 1/3/72 [illegible]; 2/10/72; 2/10/72"

SCHEDULE II

ANNEX I

November 5, 1971

SYSTEM SWAP ARRANGEMENTS AND DRAWINGS
(In millions)

	ARRANGEMENTS IN EFFECT				Line in	DRAWINGS OUTSTANDING				
Central Bank of	Original Date	Amount	Term (in mos.)	Maturity Date	continuous use since	Total Out.	Original Date	Amount	Maturity Date	Rate of Drawing
Japan	10/29/63	1,000.0	12	12/ 2/71						
Mexico	5/17/67	130.0	12	12/ 2/71						
Netherlands	6/13/62	300.0	12	12/30/71						
Norway	5/17/67	200.0	12	12/ 2/71						
Sweden	1/17/63	250.0	12	12/ 2/71						
Switzerland	7/16/62	1,000.0	12	12/ 2/71	5/19/71	BNS has agreed to renew to 2/10/72 →	8/10/71	350.0	11/10/71	4.06
							8/17/71	400.0	11/17/71	4.06
						1,000.0	5/19/71	250.0	11/19/71	4.09
B.I.S.	7/16/62	600.0	12	12/ 2/71	8/12/71	600.0	8/12/71	600.0	11/12/71	4.06
B.I.S.	8/ 2/65	1,000.0A/	12	12/ 2/71	8/18/71	35.0	8/18/71	35.0	11/18/71	BF 49.62
		11,730.0						$2,980.0		