BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

January 19, 1962.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

With reference to proposed operations in foreign currencies, there is enclosed for your information a further revision of the combined instructions--guideline memorandum dated January 3, 1962, which was distributed prior to the meeting of the Committee on January 9. This revision incorporates suggestions growing out of technical discussions between the Board's staff and the staff of the Federal Reserve Bank of New York.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

Paper No. 2 (Further Revision)

CONFIDENTIAL (FR) (Draft of proposed FOMC action)

Federal Open Market Committee January 19, 1962.

INSTRUCTIONS REGARDING OPEN MARKET TRANSACTIONS IN FOREIGN CURRENCIES

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 5 of Regulation N of the Board of Governors of the Federal Reserve System, as amended, and the Board's action of ____________, 1962, pursuant to Regulation N, the Federal Open Market Committee issues the following instructions governing open market operations incident to the opening and maintenancy by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to these instructions (hereafter sometimes referred to as transactions in foreign currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

II. Basic Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the United States are:

(1) To help safeguard the value of the dollar in international exchange markets;

(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;

(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;

(4) Together with these banks and institutions, to help moderate such temporary imbalances in international payments as may adversely affect monetary reserve positions and thus to provide a first line of defense against international financial instabilities;

(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy;

(6) To facilitate by these means the balanced growth of international trade and investment and thus to contribute to the promotion and maintenance of high levels of economic activity and employment, and of currency relationships favorable to the most efficient use of capital and credit resources and to the stability of international price levels.

III. Specific Aims of Operations

Within the basic purposes set forth in Section II, the transactions shall be conducted with a view to the following specific aims:

(1) To offset or compensate, when appropriate, the effects on U.S. gold reserves or dollar liabilities of those fluctuations in the international flow of payments to or from the United States that are deemed to reflect temporary disequilibrating forces or transitional market unsettlement;

(2) To temper and smooth out abrupt changes in spot exchange rates and moderate forward premiums and discounts judged to be disequilibrating; and

(3) In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding economy.

In pursuing these aims, care shall be taken that System transactions do not obscure basic changes in the U.S. balance of international payments.

IV. Temporary Fluctuations

Temporary or transitional fluctuations in payment flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) a rise in market rumor of a character likely to stimulate speculative transactions.

V. Reciprocal Holdings of Currencies

System participation in reciprocal holdings of foreign currencies may serve to complement stand-by arrangements negotiated through the facilities of the International Monetary Fund, and in the long run to enlarge the gross reserve strength of the United States without reducing its net reserves.

VI. Arrangements with Foreign Central Banks

In making operating arrangements with foreign central banks on System holdings of foreign currencies the New York Bank shall reserve the freedom to change its balance, subject to the need for minimum working balances.

The Bank shall instruct foreign central banks regarding the investment of such balances in accordance with Section 14 (e) of the Federal Reserve Act and with Section X, para. 4, below.

The Bank shall consult with foreign central banks on coordination of exchange operations, in accordance with Section XI., para. 6, below.

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks of Belgium, France, Germany, Italy, the Netherlands, Switzerland and the United Kingdom are to be referred for review and approval to the members of the Committee designated in Section XVI., below.

VII. Maximum Quota for System Foreign Currency Holdings

Until otherwise directed by the Federal Open Market Committee, the maximum quota for the New York Bank's total holdings of foreign currencies for System Account shall be the equivalent of $500,000,000, computed at cost.

[With the approval of the Committee, this maximum may be increased in the case of System participation in a U.S. drawing on the International Monetary Fund.]

VIII. Currencies Authorized for Purchase

The New York Bank is authorized to purchase from System Account any or all of the following foreign currencies:

Pounds sterling

Belgian francs

French francs

German marks

Italian lire

Netherlands guilders

Swiss francs

IX. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

The Bank is authorized to acquire foreign currencies in exchange for dollar holdings directly from foreign banks for the purposes set forth in Section V, above, and in Section XI., paras. 4 and 5, below.

Unless the Bank is otherwise instructed in accordance with Section XVI., below, all authorized transactions shall be at prevailing market rates within the margins set by Article IV, Section 3 (i) and (ii) of the Articles of Agreement of the International Monetary Fund.

X. Guidelines for Holdings of Foreign Currencies

The guiding principles for System holdings of foreign currencies are, first, that the maximum amount be not too large in relation to System resources considering risks involved, and second, that the amount be not so small as to rob the operations of market influence. The maximum may be realized only when the U.S. balance of international payments attains a large surplus, permitting the ready accumulation of major convertible currencies.

The setting of amounts of individual currencies to be held by the System shall be guided by two considerations: first, the importance of the individual currency in international transactions (measured, for example, by the country's IMF quota or by its contribution to the "borrowing arrangement"); and second, a country's willingness to hold part of its reserves in dollars.

Holdings of a currency should generally be kept sufficient to meet forward contracts in that currency (exclusive of contracts made under parallel arrangements with foreign monetary authorities which provide their own cover) expected to mature in the following three-week period.

Foreign currency holdings above a certain minimum should be invested as far as practicable in conformity with Section 14 (e) of the Federal Reserve Act.

XI. Guidelines for Exchange Transactions

System exchange transactions should mainly be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of volatile funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

The New York Bank should, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

Except under special instructions, the Bank should not purchase or sell more than 15 per cent of the established maximum quota for each currency in any one calendar week.

If market offers to sell or buy intensified as System holdings increased or decline, this would constitute a clear signal for a review of the System's evaluation of international payments flows. This review might suggest direct exchange transactions with the foreign central bank involved to be able to accommodate a larger supply or demand, and a temporary change in the quota for System holdings of a particular convertible currency.

Starting operations at a time when the United States is not experiencing a net inflow of any eligible foreign currency may require that initial System holdings (apart from sums that might be acquired from the Stabilization Fund) be purchased directly from foreign central banks.

It should be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

XII. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange should be that, in general, market movements in exchange rates, within the limits established in the IMF Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the New York Bank reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a re-assessment by the Committee of supply and demand forces.

XIII. Transactions in Forward Exchange

As a beginning for operations in the forward market, the New York Bank may take over from the Stabilization Fund any outstanding contracts for forward sales and purchases of eligible currencies in which the Fund is now dealing. Occasion to engage in further forward transactions will arise mainly when forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to a disequilibrating movement of short-term funds, or when it is deemed appropriate to supplement existing market facilities for forward cover as a means of encouraging the retention or accumulation of dollar holdings abroad.

XIV. Exchange Rates

Insofar as possible, the New York Bank should purchase a currency through spot transactions at or below its par value, and should lower the rate at which it is prepared to purchase a currency as its holdings of that currency approach the established maximum.

If the Bank is unable to build up its holdings of an authorized currency through such purchases at or below par, and if such a build-up seems desirable, the Federal Open Market Committee may authorize the Bank to purchase the currency at prevailing market rates above its par value.

Generally, the Bank should sell a currency through spot transactions at rates at or above its par value, and should raise the rate at which it is prepared to sell a currency as its holdings of that currency approach zero.

XV. Participation of Federal Reserve Banks

All Federal Reserve banks shall participate in the foreign currency operations for System Account in the same proportion as their holdings of U.S. Government securities in the System Account bear to the total amount of such securities in that account.

XVI. Administrative Procedures

The Federal Open Market Committee authorizes the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) to take the following actions within the guidelines issued by the Committee:

(1) To designate maximum amounts of individual authorized foreign currencies to be purchased, sold, and held at any time by the New York Bank;

(2) To establish minimum and maximum rates of exchange for the New York Bank's open market purchases and sales of authorized foreign currencies;

(3) To review and approve all agreements and understandings between the New York Bank and foreign central banks under Section VI., and Section IX., para. 2, above; and

(4) In cases in which it is necessary to reach a decision on operations before the Committee can be consulted, to give instructions to the New York Bank.

The Committee authorizes the Chairman and in his absence the Vice Chairman of the Committee and in the absence of both the Vice Chairman of the Board of Governors:

(1) Under instructions of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

(2) To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities;

(3) To transmit to the National Advisory Council on International Monetary and Financial Problems such reports and information as are required by Section 4 (c) of the Bretton Woods Agreements Act.

All actions authorized under this Section shall be promptly reported to the Committee for ratification and confirmation.

XVII. Special Manager of System Open Market Account

The New York Bank shall select one of its officers, who shall be satisfactory to the Federal Open Market Committee, to serve as Special Manager of the System Open Market Account for foreign currency operations.

The Special Manager shall direct that all transactions in foreign currencies and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee, and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

Proposals of the Special Manager for forward transactions, or for spot transactions at rates other than those outlined in Section XIV. should be referred to the Committee for concurrence before entering into arrangements for their execution.

The Special Manager shall include in his reports to the Committee a statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

XVIII. Transmittal of Information to Treasury Department

The staff officials of the Federal Open Market Committee shall transmit all pertinent information on System foreign currency transactions to designated officials of the Treasury Department.

XIX. Reserve Fund

All profits from System foreign currency transactions shall be set aside in a special reserve against losses from such transactions until the reserve reaches 15 per cent of the established maximum of System holdings of foreign currencies.

XX. Amendment of Action

The Federal Open Market Committee may at any time amend or rescind these instructions.