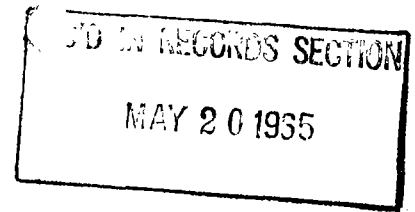




BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON



May 20, 1965

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

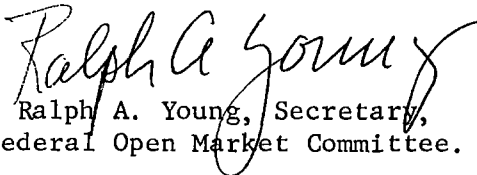
FROM: Mr. Young

Chairman Martin has requested that the following memoranda, copies of which are attached, be circulated to the Committee:

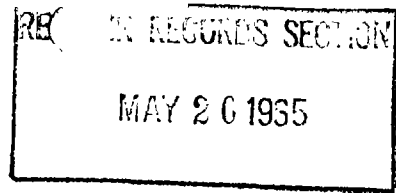
Mr. Coombs: "Action on International Liquidity," dated April 30, 1965.

Messrs. Furth and Young: Commentary on Mr. Coombs' memo, dated May 14, 1965.

It is understood that Mr. Coombs may wish to discuss his memorandum with the Committee at its May 25 meeting.

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

Attachments - 2



Action on International Liquidity

During the past few months, dissatisfaction with the present international financial machinery has become increasingly widespread, but so far has failed to generate anything remotely resembling agreement on a new approach. Triffin, Stamp, Bernstein, and others continue to offer slightly modified variations of their familiar proposals while British, French, German, and other European officials have reiterated their sharply divergent views.

Perhaps the most disquieting feature of the current debate is the increasingly widespread talk of a possible collapse of the present system. Despite the unprecedented display of international financial cooperation in rescuing sterling last November, the lack of any real recovery in the British situation continues to oppress the market with fears that sterling will sooner or later go down and thereby force devaluations of all other major currencies, including the dollar. The highly colored publicity given to French gold conversions and French official attacks on the gold exchange standard has also left the erroneous impression in many quarters of a breakdown in international financial cooperation, and has caused heavy speculative pressure on the London gold market.

A second new feature in the discussion has been the impact of the voluntary credit restraint program on the American business and financial community. So far, cooperation has been good and the favorable effect on our balance of payments is bringing about a major change for the better in market attitudes towards the dollar. At the same time, the very fact of governmental interference, even on a voluntary basis, with the lending and investment decisions of United States banks and industrial corporations has tended to arouse the feeling in business circles that something must indeed be wrong with the machinery if such obviously useful things as foreign lending and investment have to be curtailed.

What has gone wrong, of course, has been the emergence of stubborn deficits in both of the reserve currency countries, the United States and the United Kingdom, which have subjected the gold-exchange standard and the whole Bretton Woods System to excessive strain. But such over-straining of the machinery of international finance has nevertheless left a general impression that the machinery itself is gravely at fault.

With market and public opinion thus sensing a need for reform, I think we should be careful to avoid any impression of standing pat, but should rather seize the opportunity to push through several new measures to reinforce the existing machinery. Unless we do so, there will be the risk of a sudden coalescence of opinion around some proposal which would prove, on closer examination, to be inimical to

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United States interests. More particularly, it seems to me, we should firmly fend off any proposals resembling the Triffin, Bernstein, or CRU approaches. These would involve establishing a new form of international money which, to be acceptable, would necessarily have to embody some characteristic giving it a status and prestige higher than the dollar. Under any such arrangements, we would face the risk of Gresham's Law operating against us, with foreign countries seeking to get rid of their dollars while conserving in their reserves the new unit of account.

In general, I share the view that the best hope of reform lies in the further development and refinement of mutual credit facilities, particularly through the Fund rather than some regional organization. Such an approach would be fully compatible with the alleged need for further increases in owned reserves over the years.

Over time, drawing rights on the Fund, such as the gold tranche, and hopefully an increasing part of the credit tranche, might become so automatic as to deserve inclusion in our own and other countries' international reserves. This, I think, is the most promising path, but I think that the prospects of achieving this goal will be much enhanced if we approach it as a gradual, evolutionary process rather than a full-blown reform designed to deal once and for all with future problems of liquidity.

There has been an increasing tendency of late to put the problem of international liquidity in the setting of a prospective equilibrium or surplus in the United States payments accounts which could exert deflationary pressure on a growing world economy. But even if we should achieve a reasonable balance of payments equilibrium over the next year or two, we should, I think, base our policies on two prudent assumptions: (1) that in the process of swinging around equilibrium from surplus to deficit and back again, there is a risk of losing gold during the deficit periods which will not be offset by recoveries of gold during periods of surplus; and (2) there is also a risk, even if the United States is in surplus, of losing gold as dollars shift from low gold ratio countries to high ratio countries. These are immediate operating problems requiring immediate solutions, whatever may be the longer term approach to international liquidity. I have the strong feeling, however, that a successful solution of these immediate problems will provide much guidance for solution of the longer term problems.

Under the present system, regardless of the United States balance of payments position, if a foreign country moves into surplus and takes in dollars, we are immediately confronted with a potential loss of gold to that country. We have two immediate defenses here. First, the less developed countries urgently need investment income from their dollar holdings and are so dependent upon our foreign aid

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and capital exports that they are reluctant to jeopardize their place in the queue by converting temporary dollar acquisitions into gold. Secondly, so far as the major industrial countries are concerned, we have the Federal Reserve swap line which can be immediately used to mop up dollars taken in by these countries. The one major exception, of course, among the countries included in the swap line network is France which has, in effect, denied us any credit facility by announcing its intention of converting all of its dollar accruals into gold.

A very large percentage of the Federal Reserve drawings on the swap line, which since its inception have amounted to \$2 billion, have been paid off by reversals in payments trends, repayment of government debt, issues of foreign currency bonds, purchases from Britain and Italy of Fund drawings of foreign currencies, and by sales of gold. In general, the philosophy of Federal Reserve drawings on the swap line has been that such drawings saved immediate losses of gold and, even if they had to be paid off six or nine months later by drafts upon the United States gold stock, important breathing space had been gained in the meanwhile.

With the progressive decline in the United States gold stock, however, we have now reached a stage in which it may be inadvisable to rely so heavily upon ultimate settlement in gold, if necessary, of our swap drawings. In this connection, I have detected in recent months increasing concern among certain foreign central banks over the risk that we might get locked into situations in which a Federal Reserve swap drawing would drag on with neither the foreign central bank wanting to buy gold from us, nor the United States Treasury finding it timely to report a reduction in the gold stock. This had led me to the conclusion that the time may have come for us to break the ice in the form of drawings on the International Monetary Fund to settle swap drawings which have proved irreversible within their normal span of six to nine months maturity. In this connection, you will recall our discussions with Governor Carli and other officials of the Bank of Italy in which he indicated that he would welcome such a United States drawing of lire from the Fund if Italy continued to take in dollars. As you will also recall, at the last Basle meeting President Ansiaux of the National Bank of Belgium made a fervent appeal for "casting aside such theoretical nonsense as the CRU, and making use of the institutions we already have available, particularly the IMF". Governors Rasminsky of Canada, Asbrink of Sweden, and Carli of Italy strongly supported the Ansiaux approach, which would also have the support of President Blessing if safeguards could be devised against abuse of Fund drawings by the less developed countries. Recourse to the Fund as a routine procedure has, of course, been urged by the British for many years past.

With the precedent of United States "technical" drawings on the International Monetary Fund to help finance repayments by other

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countries having been well accepted, I cannot visualize any adverse market reactions to United States drawings to finance temporary balance of payments difficulties or shifts of dollars between foreign countries. I would rather assume that the market would welcome such a move as new evidence of flexibility in the United States approach by so activating a potentially major source of financing. By June, if any of our swap drawings in Dutch guilders, Italian lire, and Belgian francs are still outstanding, they will have been on the books for six months or more, and I would recommend we borrow these currencies from the International Monetary Fund in whatever amounts are required to settle the score.

It might be that the Fund would have on hand sufficient amounts of these currencies to meet our needs without recourse to the GAB. But if not, I think that we should press for a simplification of the terms and conditions under which the United States may exercise its legal drawing rights from the Fund under the gold tranche. As I understand it, drawings under the GAB arrangement seem generally to be limited to situations involving a threat to the international financial machinery and require a sizeable majority vote of the participating members. There is, however, a very important distinguishing feature of a United States drawing on the Fund. From the United States point of view, foreign currencies are not in effect convertible one into the other since foreign countries do not accept each others' currencies as part of their exchange reserves. Consequently, if the United States needed to borrow \$100 million in lire and \$50 million in Belgian francs from the International Monetary Fund, it would do no good for the Fund to offer us marks, French francs or Dutch guilders as a substitute. We should need specified foreign currencies in specified amounts and could accept no substitutes. Essentially, therefore, the problem boils down to a bilateral relationship between the United States and the foreign countries whose currencies we need. If we want to borrow lire and Belgian francs from the International Monetary Fund, and if both the Italians and Belgians are prepared to lend their currencies to the Fund, I would think it feasible to arrange such a transaction either by stretching the GAB agreement to fit or by activating the underlying authority of the International Monetary Fund to borrow individual member currencies with the consent of the lending country, as and when needed.

While thus turning to the Fund as a new source of financing for the United States, I think we should also proceed to negotiate as soon as possible certain revisions in our Federal Reserve swap arrangements. As you know, the sizes of our credit lines with foreign central banks are based upon rough estimates, guided by actual experience, of prospective short-term swings in the reserve positions of our central bank partners. Federal Reserve drawing rights upon foreign central banks are thus designed to enable us to mop up dollars taken in by such central banks regardless of source, whether from a United States deficit or from third countries which have also slipped into deficit.

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In many cases, of course, it would be difficult, if not impossible, to determine the relative degree of responsibility of the United States and of other deficit countries for the dollar intake of a surplus country. On the other hand, there occur from time to time special situations in which the surpluses of certain foreign countries may be clearly related to the deficits of other foreign countries. This was true of the sterling crises of 1961 and 1964 and also true of the Italian crisis of 1963-64.

In the latter case, much of the Italian deficit was reflected in surpluses registered by Germany and Switzerland. As dollars flowed out of Italy, the Federal Reserve and Treasury supplied dollar assistance both through Italian drawings on the swap line, and by Treasury prepayment of outstanding lira bonds. Meanwhile, the Bundesbank and the Swiss National Bank were on the receiving end of much of the dollar outflow from Italy and so the Federal Reserve drew on its swap lines in both German marks and Swiss francs to mop up these surplus dollars, while the Treasury also issued German mark and Swiss franc bonds to these institutions. In effect, therefore, the Federal Reserve and the Treasury were in a position of borrowing money from one central bank to lend to another. This role of intermediary was a natural reflection of the central role of the dollar in international finance as the only generally accepted reserve currency. By the spring of 1964, both the lending and the borrowing transactions of the Federal Reserve had been largely liquidated by an Italian drawing on the International Monetary Fund.

I continue to think that it is entirely appropriate for the United States to fulfill this role of intermediary between the surplus and deficit countries. But I also think that we should try to avoid carrying the entire burden as an intermediary when a foreign country slips into heavy deficit. We have in fact made quite a bit of progress in helping to arrange a partial substitution of direct financing between the surplus and deficit countries abroad for United States borrowing from the surplus country and lending to the debtor country. Thus, in the case of the Italian crisis in March 1964, we helped to round up Bank of England and Deutsche Bundesbank financing for the Bank of Italy, thus relieving the potential drain on the Federal Reserve. Next, in June 1964, after lengthy negotiations, we helped to arrange a swap credit of \$100 million from the Swiss National Bank to the Bank of Italy which enabled us to pay off an earlier equivalent drawing by the Federal Reserve on our Swiss franc swap line. In September of 1964, as pressure developed on sterling, the Bank of England supplemented its \$500 million swap line with the Federal Reserve by securing short-term credits of \$500 million from European central banks and the Bank of Canada. Finally, in November 1964, an increase of the Federal Reserve swap line from \$500 million to \$750 million and provision of a \$250 million Export-Import Bank credit was accompanied by extensions of short-term credits by the central banks of Western Europe, Canada and Japan in the amount of nearly \$2 billion.

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In all cases so far, however, direct lending by the surplus to the deficit central bank has been arranged on an ad hoc and, generally, last minute basis. What I should now like to explore is the possibility of reaching advance understandings, however informally, that in the event of speculative pressure on the currency of any member of the swap network, those central banks receiving inflows of funds would give sympathetic consideration to joining immediately with the Federal Reserve in short-term credit assistance to the central bank under attack.

At the present moment, one can visualize two major possibilities of new speculative pressures during 1965; first, sterling and second, the Japanese yen. In the case of sterling, the prospective International Monetary Fund drawing of \$1.4 billion by the British government will not only exhaust British credit facilities at the International Monetary Fund, but also, unless the Bank of England should take in a good many dollars over the next few weeks, will be utilized to the extent of more than \$1 billion to pay off previous Bank of England drawings upon the central bank credits. Moreover, on May 25 the European, Canadian and Japanese lines of credit to the Bank of England will expire. To cope with the distinct possibility of renewed speculative pressures on sterling during the summer and autumn months, the Bank of England will thus have to fall back upon three main sources of funds: (1) British gold and dollar reserves; (2) the \$750 million Federal Reserve swap line and the \$250 million Export-Import Bank credit; and (3) the British government's dollar stock and bond portfolio amounting to roughly \$1 1/4 billion. We thus face the distinct possibility that new speculative attacks on sterling will force the Bank of England to have heavy recourse to United States funds. Meanwhile, the dollar outflows from the United Kingdom may predominantly end up in the Continental European central banks from which the Federal Reserve will be in turn forced to borrow. A similar pattern might readily develop, although probably on a smaller scale, in the event of a run on the Japanese yen. To guard against either or both eventualities, it would be in the interest of the Federal Reserve to try to line up in advance some informal undertakings by the Continental central banks and the Bank of Canada to share with us part of the burden of new rescue operations.

The Bundesbank has backed away from an earlier offer of a new short-term credit facility to the Bank of England to replace part of the credit provided by the Bundesbank under the \$3 billion package. More generally, I think we shall encounter a basic reluctance on the part of most European central banks to commit themselves, however informally, to sizeable short-term credit facilities which would be superimposed upon the already sizeable credit facilities extended to the Federal Reserve. For example, I seriously doubt whether it would be possible for the Bank of England to develop a formal swap network sizeable enough to afford adequate protection against speculative attack, and the feasibility of the Bank of Japan working out similar arrangements on a broad scale is even less likely.

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There is, however, one possibility of reconciling the Federal Reserve's natural desire for foreign central bank participation in new rescue operations and the natural reluctance on the part of foreign central banks to pile one swap arrangement on top of another. This is the possibility of considering the Federal Reserve's drawing rights of \$2,650 million of foreign currencies as a pool, which could be partially diverted to other central banks in time of need. Specifically, if a new speculative attack on sterling should result in sizeable outflows from London to Rome, it would be advantageous to the Federal Reserve if the Bank of Italy were to extend a direct line of credit to the Bank of England in the amount of, say, \$150 million. To the extent that the Bank of England drew upon such a swap line with the Bank of Italy, the need for Federal Reserve swap drawings of lire would be correspondingly reduced. Yet the Bank of Italy might very well feel that such an overall commitment of \$450 million to the Federal Reserve plus another \$150 million to the Bank of England would represent an undue exposure. But if the Federal Reserve were to offer to relinquish, temporarily and on an informal basis, \$150 million of its drawing rights on the Bank of Italy on condition that the Bank of Italy would extend a corresponding credit to the Bank of England, the overall commitment of the Bank of Italy to provide short-term credit would remain unchanged. By so relinquishing part of its drawing rights on the Bank of Italy, the Federal Reserve would simply be substituting direct borrowing by the Bank of England with the Bank of Italy for indirect financing through the Federal Reserve.

In effect, such an arrangement, if further generalized, would convert the bilateral swap lines between the Federal Reserve and foreign central banks into swap lines which could be made, to some extent, multilaterally available. In effect the swap lines extended to the Federal Reserve by foreign central banks could in times of need be "swiveled" so as to provide a flow of credit directly to foreign central banks whose currencies were being subjected to speculative attack. Such an arrangement could vastly increase the efficiency and flexibility of the present swap network, would convert it to a more multilateral type of operation, and, finally, would relieve the United States and Federal Reserve of part of the financing burden which falls upon us because of the central role of the dollar in international finance. I doubt that it is in the interest of the United States to abdicate from the central role which was assigned to the dollar by the Bretton Woods Agreement and the subsequent evolution of the gold-dollar exchange standard. The more prudent course of action, it would seem to me, would be to gear our policies to enabling the dollar to continue to perform this role by protecting the present arrangements against over-strain.

C. A. Coombs  
April 30, 1965



MAY 14 1965  
MAY 14 1965

Chairman Martin

Coombs' memo on "Action on

Messrs. Furth and Young

International Liquidity."

Mr. Coombs' idea of multilateralizing the Federal Reserve swap network, as set forth in his memo of April 30, 1965, is an imaginative and thoughtful but ambitious approach to the problem of strengthening and expanding the existing system of mutual currency arrangements.

Some general problems

Execution of the proposal would encounter two general problems:

- (1) enlistment of foreign central bank cooperation; and
- (2) complication of System swap administration--including the relationship of System swap operations to over-all U. S. foreign financial policy administration.

Problem of cooperation:- It might be a difficult task to persuade the foreign banks to extend to all other participants the facilities they have thus far been willing to extend to the Federal Reserve. And to persuade the governments of the foreign countries involved to agree in advance to a quasi-automatic invocation of the General Arrangements to Borrow to permit IMF refunding of any intractable swap drawing would be even more difficult.

Complication of swap administration:- Before authorizing the New York Bank to enter into serious negotiation on so ambitious

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an effort, the FOMC should carefully examine any wider implications. For instance, the proposed elaboration would risk converting the swap network from an inter-central bank operation based on purely financial criteria to one involving inter-governmental relationships with political overtones, in particular, via the GAB and the IMF. This change might well subordinate System swap administration to the execution of the Treasury's foreign financial policy, involve it in an uneasy relationship with the State Department, and put it under the direct supervision of such inter-agency bodies as the NAC, the LRIPC, and the Cabinet Balance of Payments Committee. Since the project would directly affect the U. S. position in the IMF, it could probably not be realized without formal NAC authorization.

More specific problems

Aside from the foregoing general considerations, an FOMC decision on whether or not to authorize negotiations on the Coombs proposal would hinge on the answers to three specific questions:

- (1) Are the prospective advantages of the proposed change substantial enough to warrant the risk of a rebuff?
- (2) Would the proposed change in the character of the swap network require the availability of IMF resources for refunding swap drawings? And,
- (3) Would the proposed swap network entail any special risks for the United States?

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Question of advantages:- Under present arrangements, a participating central bank (say, the Bank of England) needing the currency of another participant (say, Germany) may draw dollars under its swap with the Federal Reserve, then sell these dollars to the third country, and thereby possibly cause that third country to use those dollars for purchasing gold from the U. S. Treasury. The United States could avert a loss of gold if the Federal Reserve in turn drew on its swap with the third country. But this swap would solve the problem only for the moment. When the drawings mature, the Bank of England may have earned dollars that enable the Bank to liquidate its swap with the Federal Reserve, while the United States might have failed to earn marks that would enable the Federal Reserve to liquidate its swap with the Bundesbank. Hence, the mark swap might need to be liquidated through the sale of gold by the U. S. Treasury-- unless the Treasury preferred to draw marks from the IMF.

Under the proposed arrangement, the Bank of England would draw directly on the Bundesbank and it would be its own business to earn the marks to liquidate its swap with the Bundesbank, or to sell gold or to draw on the IMF for that purpose. Thus, it would seem that the dilemma that could confront the Federal Reserve under present arrangements would be avoided.

Actually, however, as long as the dollar is used as a "vehicle" currency for exchange transactions of central banks, the Bank of England would be able--if it had earned dollars in the

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meantime--to buy the marks needed for liquidation of its swap with the Bundesbank by selling dollars in the Frankfurt market. If it were to do so, the Bundesbank could then use these dollars for the purchase of gold from the U. S. Treasury, thereby bringing about exactly the same situation that would have obtained under the present arrangements. Of course, the new swap agreements could provide that no central bank should use dollars to repay a drawing in a non-dollar currency. But if such an agreement were feasible, it would be equally practicable to insert a clause in the existing swap agreements providing that no central bank should draw dollars under its Federal Reserve swap for the purpose of buying non-dollar currencies.

Thus, it would not appear that the substitution of the proposed "multilateral" swaps for the present system of Federal Reserve swaps would materially reduce the danger that swap drawings of third countries might result in a gold drain on the United States, as thought by Mr. Coombs.

Question of IMF refundings:- Any short-term swap drawing can bring lasting relief to a currency under attack only if there is room for quasi-automatic refunding of a drawing. Such refunding would need to take the form of a drawing on the IMF as long as there is no provision for bilateral long-term credit facilities. The more frequently swap drawings should be used--and if the proposed multilateralization were successful, such use would certainly become more frequent--the more important would be the need to rely on a quasi-automatic refunding mechanism.

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Experience with the recent British IMF drawing has shown, first, that the IMF can provide substantial amounts of Continental European currencies only by invoking the GAB; and second, that such invocation tends to lead to lengthy and painful negotiations which may extend to issues only loosely connected with the financial problems of the drawing itself. Hence, it would seem worth while to work toward multilateralization of the swap arrangements only if the countries that might participate would be willing to tighten their obligations under the GAB, and in this way ensure the ready availability of resources for a refunding by means of drawings on the IMF.

Question of risk to the System and the U. S.:- But even if the proposed multilateralization were to be considered sufficiently advantageous to justify System initiative, it should be remembered that the multilateralization would entail some risks for the United States.

It is quite possible that some peripheral countries might make use of the arrangements for purposes for which they would not have drawn on the Federal Reserve--say, for window-dressing or for payments for which the Federal Reserve would have been reluctant to permit the use of its resources. In that case, a substantial part of the aggregate swap resources might be pre-empted by third countries, leaving a serious gap once the Federal Reserve might wish to draw on the arrangements for its own account. If the Bundesbank were to give a large swap accommodation to, say, the Bank of Japan, it might then

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become impossible for the Federal Reserve to acquire German marks at a time when the United States had to make payments in marks; thus, the United States would be compelled either to deplete its gold reserves or to draw on the IMF. Hence, the multilateralization could have potential drawbacks--even though the probability of such adverse effects might be small.

Conclusion

This memo raises some preliminary questions and doubts about the implications of Mr. Coombs' suggestion for the multilateralization of the swap network. But the Coombs suggestion is indeed challenging; it deserves serious study and further critical evaluation.

(Initialed) R.A.Y. J.H.F.

JHF:RAY:cbd