Authorized for public release by the FOMC Secretariat on 5/10/2021

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

October 3, 1978

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M. A.

Attached is a memorandum from the Manager of the System Open Market Account and the Deputy Manager for Foreign Operations, dated September 29, 1978, and entitled "Dr. Gleske's Proposals to Amend Swap Arrangement."

It is contemplated that this memorandum will be discussed at the meeting of the Committee on October 17.

Attachment

Authorized for public release by the FOMC Secretariat on 5/10/2021

CONFIDENTIAL (F.R.)
CLASS I FOMC

September 29, 1978

TO: Federal Open Market Committee

FROM: Alan R. Holmes and Scott E. Pardee

SUBJECT: Dr. Gleske's Proposals to Amend Swap Arrangement

In a letter dated July 28, Dr. Gleske of the Bundesbank proposed three changes in the text of the swap arrangement to be incorporated in the next renewal in December. As indicated to the FOMC at the August meetings, these included:

-- The elimination of the even sharing of risk between the Federal Reserve and the Bundesbank on swap drawings by the System so that the full risk would be borne by us; this was linked to the proposal that the investment of the Bundesbank's dollar proceeds of our drawings would be at current interest rates in Germany rather than at the U.S. Treasury bill rate as at present.

-- Renewals of swap drawings should be made on the basis of current exchange rates at the time of the renewal, rather than carry over the original exchange rates.

-- The language of the agreement should state more clearly that the amounts we use in repayment are in principle to be obtained in the market.

The first point runs to the heart of how we have operated under floating exchange rates. The even sharing of risk was a key provision of the agreement by the U.S. authorities to resume intervention in July 1973. It currently applies to all swap arrangements

Authorized for public release by the FOMC Secretariat on 5/10/2021

in which the Federal Reserve has drawn since 1973 (with the German, Swiss, French, Dutch and Belgian central banks) and has been accepted in principle by the Bank of Japan should we operate in yen. Therefore, a change in the German arrangement would most likely have to be extended to the others.

From July 1973 through end-1977, the Federal Reserve had repaid $2,508.1 million of swap debt incurred in our various intervention operations, at a cumulative net profit of $26.8 million. Half of this, $13.4 million was for our account. So far this year, on the operations of late 1977-early 1978, we have incurred net losses of $60.7 million, of which $30.3 million was for our account. If the $860.2 million of German-mark and current Swiss-franc swap debt outstanding as of September 28 were to be repaid at prevailing exchange rates, the System would record a further $33.8 million of losses, of which its share would be $16.9 million.

For the moment, therefore, the even sharing of risk provision has meant that out of a total net loss (realized and potential) of $67.7 million since July 1973, the System has stood to take up only $33.8 million. In view of the large swap debt currently outstanding and the possibility that the dollar may rise sufficiently to allow us to repay at a substantially reduced loss or even a profit, these figures give only a temporary picture.

With respect to the switch from U.S. to German interest rates, if we had been operating on that basis since July 1973, the

Authorized for public release by the FOMC Secretariat on 5/10/2021

U.S. would have had interest savings far in excess of the exchange losses just indicated. Moreover, under current circumstances, with a 4 per cent differential between German and U.S. short-term interest rates, the savings would be mounting at a very fast clip. Thus, on the current sequence of drawings extending back to October 1977 the savings would have been on the order of $23 million. If this present level of System drawings were to remain on the books over the next 3 months the additional savings would be some $9 million. Again this provision would have to be extended to other central banks, and it is conceivable that we would have to draw when interest rates are higher in the foreign country than in ours (as, for example, with France or the U.K., where interest rates have been higher than ours virtually throughout the floating rate period).

During the September Basle meeting, Governor Wallich met with Dr. Gleske of the Bundesbank and succeeded in securing tentative agreement to withdraw for the time being this part of the proposal--on exchange risk and interest rate burden--so long as the other two parts are agreable to us.

Even though Dr. Gleske has indicated his willingeness to withdraw this part of the proposal, the question remains whether the Federal Reserve should not accept elimination of the 50-50 profit or loss sharing and the interest rate proposal as being in our own interest, and in the interest of the U.S. Treasury. Aside from the

Authorized for public release by the FOMC Secretariat on 5/10/2021

financial results of the even sharing of risk, which so far have been at best ambiguous, the principle has led to difficulties for the Account Management.

Other central banks have pointed out that it has introduced two asymmetries into the swap arrangements. First, the other central banks share in the risk when we draw but the System does not share in the risk when they draw. Second, they take full risk on any intervention they do in their market and half the risk of intervention in our market (or in practice, 3/4 of the risk or more) in what are often called "joint" or "coordinated" operations.

In some cases haggling over this issue has delayed the initiation of a new sequence of operations as the other central bank held out in an effort to induce us to provide symmetry, either by dropping the even sharing or by extending it to potential drawings on their part. Moreover, on many occasions when we have been operating, the other central bank, that is, the Bundesbank, has constrained our use of the swap line on the argument that since it bears part of the risk it should agree fully in what we do. In contrast, the Bundesbank has given us a free hand when we operate out of our own balances.

The reason for our asking for even sharing of risk boils down to an appearance of having struck a somewhat better deal for ourselves in situations in which the U.S. has had to be coaxed into

Authorized for public release by the FOMC Secretariat on 5/10/2021

an intervention operation and that we can present this as such to the Congress and the public. This has had a certain public relations appeal in the U.S., but it has been a source of irritation to other central banks that the "reciprocal credit facilities", the term we often use to describe the swaps, are not so reciprocal after all.

The proposal by Dr. Gleske links the elimination of risk sharing to the adoption of a mechanism by which the U.S. could obtain a substantial interest saving on swap debt. Although it is rash to predict the future of either interest rates or exchange rates, the most likely expectation for the foreseeable future is that U.S. interest rates would remain above those in Germany. A higher inflation rate here than there would tend to lead to a roughly offsetting decline in the dollar over the long run, and thus give us exchange losses which offset the interest savings. But the decline in the dollar need not be at time in which we are actually indebted to the Bundesbank under the swap line. Our biggest interventions are usually when the mark rate has already been bid up substantially and has reached levels which are out of line with underlying conditions at the time. On balance, the U.S. is likely to gain from the proposal.

The Treasury has informed us that it would be politically costly to drop the risk sharing at this time, since we are in the midst of a large operation which so far has led to losses, and, therefore, has objected to our changing this provision now. The Treasury has indicated, however, that it might be sympathetic to the proposal once present pressures have let up.

Authorized for public release by the FOMC Secretariat on 5/10/2021

This position is understandable. In view of Dr. Gleske's willingness to defer the issue, there is no need for formal action by the FOMC at present. We would suggest that we simply inform Dr. Gleske that the Federal Reserve would prefer to retain the present risk-sharing and interest rate provisions for now, but would be prepared to review the matter as soon as circumstances permit.

The second part of the proposal, applying current exchange rates to swap renewals, is easier to accept. We would be booking profits and losses on a more current basis, which is consistent with generally accepted market practices and accounting standards as they have evolved in recent years. Now that we are publishing our foreign exchange profits and losses each quarter, there is something to be said for having our earnings figures more nearly reflect the swings in exchange rates during the quarter.*/ This change would also have to be made in all other agreements, but raises no problems of symmetry. In fact, when the Bank of Italy had drawn on us in 1976, we considered shifting to this approach for "maintenance of value" reasons. The lira had fallen sharply between that drawing and the first renewal, and some members of the FOMC expressed the view that the Bank of Italy should in effect put up more lire as collateral for the credit we had extended.

---

*/ Revaluing the swap contract at renewal not only would alter the time profile of realized profits and losses but also would affect the dollar amounts on which the United States is paying interest. If the dollar has declined, then the dollar amount on which interest is paid would be increased.

Authorized for public release by the FOMC Secretariat on 5/10/2021

We therefore recommend also that the second part of Gleske's proposal be accepted by the FOMC, on the understanding that we would explore with all central bank partners the possibility of extending this amendment to their arrangements as well.

Dr. Gleske's third proposal is to clarify the language of the existing agreement to the effect that the marks needed for repayment of swap debt should be obtained in the market if possible. We believe that we should also obtain clarification from the Bundesbank to the effect that it will sell us marks directly against dollars if necessary. Such changes in language would be cleared with the Foreign Currency Subcommittee.