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

March 14, 1979

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M. A.

Attached is a memorandum from Messrs. Axilrod and Holmes, dated March 13, 1979, and entitled "Limits on foreign currency operations."

It is contemplated that this memorandum will be discussed at the meeting of the Committee on March 20, in connection with the review of procedural instructions with respect to foreign currency operations under agenda item 14.

Attachment

STRICTLY C[illegible]
CLASS I - FOMC

TO: Federal Open Market Committee DATE: March 13, 1979

FROM: Messrs. Axilrod and Holmes SUBJECT: Limits on foreign currency operations.

When the November 1 program to help support the dollar was instituted, the Committee--to facilitate implementation of the program--suspended inter-meeting limits on the Manager's foreign currency operations contained in the Procedural Instructions, and left only a limit on the outstanding open position in foreign currencies (currently this limit is $8 billion). The most active part of the dollar support program may now be behind us. Since the turn of the year, the dollar has been generally stable, and the System has repaid about $2 billion in outstanding swap debt. The DM debt has been reduced to $3.4 billion from a peak of $4.6 billion, the Swiss Franc debt incurred earlier in the support operation has been repaid entirely, and the Desk now holds foreign currency balances of about $185 million in yen and $20 million in Swiss francs.

One cannot be certain that further large support operations will not be needed again in the months ahead as a result of either internal or external disturbances. However, it appears to us that enough time has passed since the support program was put in place--and enough progress has been made in stabilizing the dollar--for the Committee to consider reinstating inter-meeting limits on foreign currency operations under the Procedural Instructions.

Two alternatives might be usefully considered--(1) the limits in effect before the November 1 program, and (2) a less confining alternative.

(1) Previous procedural limits:

(a) Operations leading to a change in the over-all open position[1/] exceeding $100 million on any day, or in the net position in a single currency of the same amount, required approval of the Foreign Currency Subcommittee.

(b) Operations leading to a change exceeding $300 million between FOMC meetings in either the over-all open position or the net position in a single currency also required subcommittee approval.

(c) A change in the over-all open position exceeding $500 million required clearance with the FOMC (or with the subcommittee if consultation with the FOMC was not feasible in the time available).

(d) Swap drawings proposed by a foreign bank not in excess of the larger of $200 million or 15 per cent of the size of the swap line were to be cleared with the subcommittee and above that amount with the full FOMC.

In addition, it should be noted that the FOMC has recently indicated an informal limit of $500 million for holding balances in foreign currencies.

These limits clearly would have been too small during the active period of the recent dollar support operations, in the sense that the Desk would not have been able to act in a timely fashion to affect markets in line with the Committee's objectives. Exchange markets are greatly affected by participants' perceptions of official attitudes, and prompt, fairly sizable operations in a period of market uncertainty

1/ Defined as the absolute sum of net positions in individual currencies.

can often forestall the need for operations that turn out to be cumulatively even larger over an extended period.

In a "normal" period, these earlier limits would not appear to represent an undue constraint on the Desk's ability to carry out the Committee's objectives. However, they are likely to require rather more frequent inter-meeting contact with the subcommittee and probably also the FOMC in the future than they had in the past. In part, this is because the foreign exchange markets continue to expand with the expansion of world trade and inflation of prices. But also, it is by no means clear that the coming months will in fact be a period of "normality" in markets. Thus, remaining efforts to work toward a relatively stable dollar--one that neither rises nor falls excessively rapidly or changes unduly in response to unrealistic market expectations--would probably require some of the same capacity for the Desk to act promptly and in volume that has been available in recent months.

Alternative procedural instructions that provide more leeway for day-to-day Desk operations without formal consultation are described below. The changes that would be required in the existing (currently suspended) Procedural Instructions to implement this alternative are shown in capital letters and with strike-throughs in attachment A.

(2) <u>Alternative procedural limits:</u>

(a) Establish an inter-meeting limit for changes in the overall open position of \$1 billion without the need for formal approval by the Foreign Currency Subcommittee and of \$1½ billion without further FOMC consideration.

(b) Require approval of the subcommittee for a daily change of more than $300 million in the over-all open position, or of more than $150 million in the net position in a single currency. However, a daily change of $300 million in the net position in a single currency could be undertaken without formal subcommittee approval when it was associated with repayment of swap drawings.

(c) Reconfirm the earlier understanding with respect to swap drawings proposed by a foreign bank.

It would be understood, of course, that the Manager would continue to co-ordinate closely with the Chairman, and subcommittee members, even on operations within these limits, particularly those operations that are not routine in nature.

The limits would encompass changes in position caused by incurrence of debt under swap lines, repayment of debt, and additions to or liquidation of foreign currency balances. The larger daily limit proposed for repayment of debt in a single currency, as compared with additions to debt, would provide the Desk with leeway to take advantage of favorable market conditions to repay the System's still large DM swap debt. A lower limit may be unduly confining, for example, in case large individual blocks of DM become available through off-market transactions with the foreign central bank.

With inter-meeting limits re-established, the Committee may also wish to consider discontinuing its informal additional limit of $500 million on total holdings of foreign currency balances. However, we do not believe the matter need be considered at this time since the Committee is planning a more extended discussion of policy with respect to holding balances at a later point.

ATTACHMENT A

Procedural Instructions with Respect to
Foreign Currency Operations
(Amended June 20, 1978)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager of the System Open Market Account, shall be guided by the following procedural understandings with respect to consultations and clearance with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation which would result in a change in the System's over-all open position in foreign currencies exceeding ~~$100~~ $300 million on any day or ~~$300 million~~ $1 BILLION since the most recent regular meeting of the Committee.

B. Any operation which would result in a change ON ANY DAY in the System's net position in a single foreign currency exceeding ~~$100 million on any day or $300 million since the most recent regular meeting of the Committee~~ $150 MILLION, OR $300 MILLION WHEN THE OPERATION IS ASSOCIATED WITH REPAYMENT OF SWAP DRAWINGS.

C. Any operation which might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 per cent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation which would result in a change in the System's over-all open position in foreign currencies exceeding ~~$500 million~~ $1.5 BILLION since the most recent regular meeting of the Committee.

B. Any swap drawing prpposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 per cent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System, and about any operations that are not of a routine character.