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

March 23, 1981

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M. A.

Attached is a memorandum from Mr. Pardee entitled, New German Mark Investment Facility, dated March 19, 1981.

Attachment

Date: March 19, 1981

To: Federal Open Market Committee

Subject: New German Mark Investment Facility

From: Scott E. Pardee

The purpose of this memorandum is to report to the Committee the nature of new facilities at the Bundesbank for investment of System and Treasury deutschemark balances. The new facilities provide for a market-related yield, compared to the earlier arrangement with the Bundesbank which generated a return tied to the Bundesbank discount rate,which is generally below market rates. The method for establishing interest rates to be paid on most of the investments parallels that negotiated in December for determining interest cost on our swap drawings from the Bundesbank: 25 basis points less than the rate for comparable maturity in the Frankfurt interbank market on the day of transaction. At our request, the investments are liquid, providing for withdrawal of funds on two-days notice. The new facilities are with the Bundesbank, thereby permitting us to maintain complete confidentiality of our mark operations and to preserve the spirit of the existing agreement among G-10 central banks to limit investment of reserves in the euro-currency markets. Our new mark investment facilities entail market risk, making them symmetrical with Germany's holdings of their dollar reserves, which are invested in U.S. government securities at market risk.

The Bundesbank has offered investment facilities at a market-related yield only to the Federal Reserve, and the investments of all other central banks still yield a rate tied to the Bundesbank discount rate. These special arrangements reflect the close working relationship we have with the Bundesbank, as is embodied in our swap arrangements. The Bundesbank has requested we not make public the nature of the new facilities.

When the new facilities were proposed by the Bundesbank in late February, we reviewed them with members of the FOMC Foreign Currency Subcommittee and with the Treasury, and were able to agree in principle to the proposal at that time. Implementation of the specific provisions of the facilities has proceeded since early March. A more detailed description follows of the separate components of the new investment facilities and our transfers of balances into them.

1. Bond Purchases.

The Bundesbank will invest System and Treasury mark balances in long-term bonds with remaining maturity of less than one year of the Federal Republic of Germany, the Federal Railways and the Post Office. The sales will be priced at official market prices, and are to be from the Bundesbank portfolio of such issues. It is agreed that the bonds will be repurchased by the Bundesbank or sold in the market at prevailing market prices at our request on two days notice. This facility involves market risk if bonds are sold prior to maturity. Because the Bundesbank holds only modest amounts of such securities, this facility initially is limited to DM 65 million.

2. Repurchase Agreements.

The Bundesbank will invest mark balances in repurchase agreements at market-related rates for periods of three months. The underlying assets include mobilization and liquidity paper issued by the Bundesbank, Treasury bills of the Federal Republic of Germany, and the same list of long-term bonds mentioned in the preceeding paragraph. The bonds involved in this facility will have more than one year remaining maturity. The interest rate on the repurchase agreements is to be 25 basis points less than the Frankfurt interbank market rate. Balances may be disinvested from this facility on two-days notice. Owing to portfolio considerations at the Bundesbank, this facility is limited to a total of DM 2 billion, DM 1 billion against long-term bonds and DM 1 billion against the various types of short-term paper.

3. Double Forwards.

The previously existing double forward transactions were modified under the new facility, with the Bundesbank agreeing to pay a market-related interest rate as defined above. Double forward transactions will normally be executed for three months maturity, but shorter maturities are possible by mutual agreement.

The disposition of FOMC and Treasury mark investments before and after implementation of the new facilities is described in Table 1. The main objective has been to invest in the outright bond holdings and repurchase agreement facilities up to limits imposed by the Bundesbank. To the extent possible, investment in these facilities use FOMC and Treasury marks in equal proportions, considering Treasury marks warehoused with the Federal Reserve as part of the Treasury contribution. After a separate negotiation between the German Finance Ministry and the U.S. Treasury, DM 1.3 billion of short-term Federal Republic debt obligations (Schuldscheine) were purchased by the FOMC using warehoused Treasury marks, the maturity of the Schuldscheine matched to the upcoming maturity of Carter bonds. About DM 1.5 billion was moved from the BIS to the Bundesbank and placed in the new double-forward facility. Of the remaining FOMC balances at the BIS, DM 400 million is to be invested in euro-mark time deposits, and the remainder is to be transferred to the Bundesbank and invested in the double-forward facility, the arrangements to be worked out in a fashion agreeable to all three institutions. The new double-forward investments were split between one, two and three-month maturities, in order to provide regularly spaced contract renewals in the future.

These new Bundesbank investment facilities allow concentration of mark balances at the Bundesbank at a substantially higher yield. Of our total holdings of DM 17.2 billion, about DM 8.8 billion were previously invested in the Bundesbank double-forward facility at a yield of 7 1/2 percent. All of these funds have been invested in the new facility at an average yield of about 14 percent, earning the FOMC and the Treasury an additional DM 146.3 million, approximately, over the life of the contracts already in place.

CML:MLG:SEP/gh

Attachment

DEUTSCHEMARK INVESTMENTS
(MILLIONS OF MARKS)
FACE AMOUNTS

	AS OF MARCH 4, 1981	AS OF MARCH 17, 1981
BIS ACCOUNTS		
2-day notice - FOMC	2081.5	1081.5
- TREAS	335.9	0.9
Euro-mark time deposits - TREAS	500.0	400.0
	2917.4	1482.4
BUNDESBANK		
Old Double Forward - FOMC	2909.4	- 0 -
- TREAS DIRECT	89.1	- 0 -
- TREAS WAREHOUSED WITH FR	5956.2	
New Double Forward - FOMC	-	2844.4
- TREAS DIRECT	-	324.1
- TREAS WAREHOUSED WITH FR	-	3856.2
New Repurchase Agreements		
Against S-T Assets - FOMC	-	500.0
- TREAS DIRECT	-	100.0
- TREAS WAREHOUSED WITH FR	-	400.0
Against L-T Bonds - FOMC	-	500.0
- TREAS DIRECT	-	100.0
- TREAS WAREHOUSED WITH FR	-	400.0
New Outright Long-Term Bond Facility - FOMC	-	65.0
GERMAN TREASURY		
Schuldscheine - TREAS DIRECT	5520.2	5520.2
- TREAS WAREHOUSED WITH FR	-0-	1300.0
	14,479.9	15,909.9
TOTALS	17,392.3	17,392.3