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

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

DATE: February 10, 1986

FROM: Normand Bernard N.B.

SUBJECT: System investments of foreign currency holdings.

The attached memorandum on the investment facilities for official holdings of foreign currencies was prepared by Mr. Cross in response to a request at the December meeting of the Committee. Mr. Cross notes that the details concerning the investments are quite sensitive and should be treated as strictly confidential.

Attachment

Investment Facilities for Foreign Currency Holdings of the United States

This note describes the investment facilities for foreign currency balances that we manage for the Federal Reserve and the Treasury. It also provides information on the amounts of foreign currencies invested in the various instruments and their rates of return. The choice of investment assets reflects our broad objective of maximizing the rate of return on our foreign currency holdings consistent with negligible credit risk and a very high degree of liquidity. All of our investment accounts are with foreign central banks or with the Bank for International Settlements (BIS).

Our investment facilities include deposit accounts, repurchase agreements against foreign government securities, outright holdings of foreign government securities, and foreign exchange contracts executed for the sole purpose of obtaining a return on our holdings (or "double forwards"). As of January 29, 1986, the Federal Reserve and Treasury held the equivalent of $13.2 billion in foreign currencies. Of the total, $5.3 billion equivalent was placed in foreign exchange contracts, $5.1 billion in repurchase agreements against foreign government securities, $2.7 billion in deposit accounts and $0.1 billion in foreign government securities.

In terms of foreign currencies, the composition of our holdings is as follows:

	In millions of dollars equivalent
German mark	$ 8,380.8
Japanese yen	4,519.2
Swiss franc	297.6
Other*	42.3
TOTAL	$13,239.9

* Consists of small amounts of sterling, Dutch guilder, French franc, Belgian franc and Canadian dollar, all of which are placed in deposit or money employed accounts with respective central banks or the BIS. Because of the relatively small amounts (less than half of 1 percent of total balances), this note does not describe these investments in detail.

I. Type of instrument

A. Deposit accounts

Funds in deposit accounts represent claims on foreign central banks or on the BIS. There are two basic types of account: (1) the two-day notice account, and (2) the time deposit account.

1. Two-day notice accounts: Less than $27 million equivalent is invested in two-day notice accounts, either in deposit accounts (with the BIS) or in money employed accounts (with the Bank of Canada, Bank of England, and Bank of France). Funds in deposit accounts earn a rate of interest related to overnight or call deposits. Funds in the money employed accounts are invested in local money market instruments.

2. Time deposit accounts: Time deposit accounts are maintained with the BIS, with the currencies generally placed in short-dated maturities of three months or less. In the event we wish to withdraw a deposit prior to maturity, the funds are available on two days' notice. While there is no penalty for premature withdrawal, we are obligated to assume the BIS' cost of refinancing if interest rates have risen since the placement of the deposit. The interest yield is 1/4 of a percentage point below Euro-currency interest rates, reflecting the BIS' fee. Currently, Swiss francs and German marks are invested in such accounts.

The amounts invested with the BIS, rather than in facilities with central banks, are placed there at the request of the respective foreign central banks reflecting monetary policy considerations of the respective foreign central banks. After the September G-5 meeting the Bundesbank asked us not to place the marks we acquired with it in order to avoid liquidity impacts on the German banking system.

Thus the German marks we acquired following the September G-5 accord have been placed with the BIS. The Bundesbank has made similar requests of other central banks buying large amounts of marks in the past year or so.

B. Investment facilities involving foreign exchange transactions ("Double forwards")

Because of legal restrictions and the limited availability of suitable investment outlets, the Deutsche Bundesbank has created an investment facility for our holdings of German marks that involves foreign exchange transactions and provides a market-related rate of return. It is our understanding that we are the only monetary authority offered this investment outlet by the Germans.

These so-called "double forward" facilities involve two forward foreign exchange contracts executed simultaneously for the same delivery date. The Federal Reserve sells forward marks to the Bundesbank against dollars at the prevailing market exchange rate. At the same time, the Federal Reserve purchases marks forward at an exchange rate that differs from the one on the sale contract by the amount necessary to provide the Federal Reserve with an agreed return on the mark holdings. Thus, the Federal Reserve has a commitment both to receive and to deliver a stated amount of marks in the future.

The rate of return on the double forwards, as agreed by the Bundesbank and the Federal Reserve, is the German interbank interest rate less 1/4 of a percentage point. At the time this arrangement was negotiated, this formula was thought to approximate the rate that would have applied to a three-month liability of the Federal Republic--comparable to our Treasury bills--if such an instrument had existed in Germany. We believe a rate lower than the interbank rate is appropriate in view of the higher credit standing of the Bundesbank compared with private commercial banks. Double forwards are normally executed for a period of three months but the funds are available on two days' notice without penalty. The United States assumes the risk or benefit of any change in interest rates that occurs between the time a double forward is placed and the time that is prematurely withdrawn--that is, the Bundesbank will adjust the withdrawal exchange rate so as to reflect the change in interest rates.

C. Facilities for investments in foreign government securities

Following enactment of the Monetary Control Act of 1980, we negotiated arrangements with selected foreign central banks to provide a mechanism for our investing foreign currency balances in government securities of those countries. Details of the arrangements vary in accordance with differences in market structure and operational requirements of the foreign central bank.

1. Repurchase agreements with foreign central banks

The Federal Reserve purchases government securities for immediate delivery with an agreement to sell the securities back at a specified date. The difference between the purchase and the sale price provides the Federal Reserve a return on its balances. The repurchase agreements are usually negotiated with three-month maturities, but the funds are available on two days' notice without penalty.

The repurchase facility that has been negotiated with the Bank of Japan earns a rate of return based on interest rates in the "Gensaki" market (a repurchase market for Japanese bonds). It is restricted to yen funds acquired by the U.S. authorities in the market as a result of intervention, plus the proceeds earned on such funds. For yen funds withdrawn prior to maturity, we assume no market risk, so long as the premature withdrawal is for intervention purposes.

The rate of return on the repurchase facility with the Bundesbank is the German interbank rate less 1/4 of a percentage point. This facility is not limited to the investment of marks acquired through intervention. For marks withdrawn prior to maturity, we assume the market risk, as in the case of "double forwards."

2. Outright holdings of foreign government securities

Outright holdings of foreign securities are kept on our behalf in custodial accounts with the Bank of Japan, the Bundesbank, and the Swiss National Bank. We have purchased Japanese Treasury bills, outright obligations of the German government and public institutions, such as the Federal Railways and the Post Office, as well as mobilization paper issued by the Bundesbank and money market certificates issued by the Swiss Confederation. All investments are in obligations having a remaining maturity of one year or less. In order to assure the liquidity of our holdings, we have agreements or understandings with the respective central banks that enable us to liquidate the securities on two days' notice. All earn market rates of return, except the Japanese Treasury bills which yield an administrated return below market rates. As a consequence, we seek to limit our holdings of Japanese Treasury bills.

II. Portfolio distribution and yields

The following summarizes the distribution of our foreign currency investments and indicates their rates of return as of January 29, 1986.

A. German mark holdings, by type of instrument and rates of return

	Amount (in millions) German marks	U.S. $ equivalent	Rates of return (percent)	Correspondent
1. Double forwards				
FR	8,805.6	3,684.4	4.54	Deutsche Bundesbank
ESF	3,801.7	1,590.7	4.54	
TOTAL	12,607.3	5,275.1	4.54	
2. Repo-Mobilization paper				
FR	692.0	289.5	4.55	Deutsche Bundesbank
ESF	296.6	124.1	4.55	
TOTAL	988.6	413.6	4.55	
3. Repo-Government bonds				
FR	346.0	144.8	4.55	Deutsche Bundesbank
ESF	148.3	62.0	4.55	
TOTAL	494.3	206.8	4.55	
4. Government bonds				
FR	20.1	8.4	5.38	Deutsche Bundesbank
ESF	--	0.0	--	
TOTAL	20.1	8.4	5.38	
5. Time deposits				
FR	2,971.8	1,243.4	4.40	Bank for International Settlements
ESF	2,948.1	1,233.5	4.40	
TOTAL	5,919.9	2,476.9	4.40	
Total DM's	20,030.2	$8,380.8		

B. Japanese yen holdings, by type of instrument and rates of return

	Amount (in millions) Japanese yen	U.S $ equivalent	Rates of return (percent)	Correspondent
1. Repurchase Agreements				
FR	319,425.3	1,638.0	6.93	Bank of Japan
ESF	561,576.8	2,879.9	6.98	
TOTAL	881,002.1	4,517.9	6.96	
2. Japanese Treasury bills				
FR	42.8	0.2	4.875	Bank of Japan
ESF	206.9	1.1	4.875	
TOTAL	249.7	1.3	4.875	
Total ¥	881,251.8	$4,519.2		

C. Swiss franc holdings, by type of instrument and rate of return

	Amount (in millions) Swiss franc	U.S. $ equivalent	Rates of return (percent)	Correspondent
1. Swiss money market certificates				
FR	197.3	97.192	3.67	Swiss National Bank
ESF	--	0.000	--	
TOTAL	197.3	97.192	3.67	
2. Time deposits				
FR	373.0	183.744	3.88	Bank for International Settlements
ESF	33.5	16.502	4.25	
TOTAL	406.5	200.246	3.92	
3. Two-day notice account				
FR	0.3	0.148	3.50	Bank for International Settlements
ESF	--	0.000	--	
TOTAL	0.3	0.148	3.50	
Total SF's	604.1	$297.586		

Foreign Exchange Function
Federal Reserve Bank of New York
February 6, 1986