Sterilized Foreign Exchange Intervention: The Fed Debate in the 1960s

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In early 1962, the Federal Reserve System (the Fed) began to buy and sell foreign currency. The decision to intervene in foreign exchange markets was controversial and generated considerable internal debate. The debate involved the fundamental issue of the Fed's independence from the Treasury. The Treasury has primary responsibility for official foreign exchange operations in the United States. Hence, participation with the Treasury in foreign exchange operations could jeopardize Fed independence. Moreover, the Federal Reserve Act safeguards this independence by requiring that acquisition of Treasury debt by the Fed be done in the open market, that is, at the Fed's discretion rather than at the behest of the Treasury. The practice of acquiring foreign exchange directly from the Treasury in support of the Treasury's operations could erode that safeguard.

Former Secretary of the Treasury George Shultz (Shultz and Dam 1978, p. 9) stated flatly, ". . . the Fed takes direction from the President, through the Treasury Department, on international monetary affairs." Stephen Axilrod (Burk 1992, p. 41), formerly Staff Director for Monetary and Financial Policy at the Board of Governors, noted

> . . . there is a deep distinction in the U.S. (unlike the U.K.) between international and domestic monetary policy: the Fed is totally and utterly independent when making a domestic monetary policy decision; not only is there no clearance with the Treasury—to attempt it would cause a constitutional crisis. The international arena is more complicated: here the Fed's independence is unknown and has not been fully tested, but in practice it is limited. The Treasury controls international finance.

The opinions expressed herein are the author's and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

The debate also dealt with whether the Federal Reserve Act authorized the Fed to transact in foreign exchange. This article reviews the debate and briefly addresses subsequent developments. As background, the article begins with a brief historical overview of the Bretton Woods system and the Treasury's Exchange Stabilization Fund.

1. BRETTON WOODS

In 1962, the United States was part of the Bretton Woods system. That international monetary arrangement attempted to recreate key parts of the gold standard, which had collapsed in the Depression. Member countries other than the United States pegged their currencies to the dollar. The United States agreed to maintain convertibility of the dollar to gold at the rate of $35 per ounce. As required by the Federal Reserve Act, before 1968 Federal Reserve notes were collateralized in part by gold.

If the United States ran a balance of payments deficit and lost enough gold, the Fed would have to contract the money stock. According to the classical view of the gold standard, a reduction in the money stock would reduce the price level and make U.S. goods cheaper to foreigners, who would increase their purchases of U.S. goods. The resulting decline in the external deficit would end the gold outflow. Under the Bretton Woods system, as under the classical gold standard, the price level was supposed to adjust to achieve balance in the country's external accounts.

By early 1959, the currencies of the countries in the European Economic Community had become fully convertible into the dollar (for current account transactions). (This review draws on Coombs [1976], Roosa [1967], and Solomon [1982].) These countries, however, established exchange rates that overvalued the dollar (made U.S. goods too expensive). Consequently, the United States ran a significant, persistent balance of payments deficit. Foreign central banks financed part of the U.S. payments deficit by accumulating dollars, and foreign investors financed part of it by willingly holding dollar assets. However, between 1959 and 1961, the U.S. Treasury had to finance the remainder of the deficit through sales of gold to foreign central banks. Countries relying on the United States for defense (Germany, Japan, and Italy) refrained from gold purchases. Other countries (like Belgium, the Netherlands, and Great Britain) were fearful of being caught with a devalued dollar in their portfolios and enforced the Bretton Woods discipline by asking the U.S. Treasury for gold. By the end of 1960, U.S. gold losses had become front-page news in papers like *The New York Times*.

In the early 1960s, monetary policymakers walked a tightrope requiring them to balance internal and external objectives. The 1960 recession pushed U.S. short-term interest rates below those in Europe. That difference in rates spurred a capital outflow, widened the payments deficit, and aggravated the loss of the Treasury's gold reserve. While in the middle of the 1960 presidential campaign, the country faced both a domestic recession and a balance of payments deficit, each requiring conflicting policy responses.

In 1954, Britain had reopened the London gold market. By 1960, it had acquired a status comparable to the long-term bond market of today. Quotations for the price of gold were a "barometer of confidence in both the gold-dollar parity and the Bretton Woods system generally" (Coombs 1976, p. 14). Through most of the 1950s, sales of gold by South Africa and the Soviet Union had kept the free market price at $35 per ounce. In 1960, however, the concern arose in Europe that a Democrat might win the U.S. presidency and pursue expansionary domestic policies.

On October 20, 1960, the London gold price suddenly shot up from close to $35 an ounce to $40 an ounce. That created an arbitrage opportunity for foreign central banks willing to sell gold in London and replace it by asking the U.S. Treasury for gold. The Treasury decided to maintain the $35 price of gold in the London market with gold sales. On October 31, 1960, candidate John Kennedy promised that if elected he would maintain convertibility at the $35 parity. Later as the President, in his February 6, 1961, message on the balance of payments, he promised that the $35 price of gold was "immutable." The immediate crisis passed, but the drain of gold continued as Kennedy took office in January 1961, and the position of the dollar remained precarious.

The Federal Open Market Committee (FOMC) *Minutes* in 1961 reveal a persistent concern over the U.S. balance of payments deficit, offset by a concern for unemployment. For example, the *Minutes* (Board of Governors 1961, pp. 935–36) paraphrase one governor:

> Mr. Mitchell noted that the Chairman of the Council of Economic Advisers had said recently that if unemployment did not decline, it would be up to the Administration to create jobs. However, he (Mr. Mitchell) felt that it would be better if the private economy could be persuaded to create jobs. Monetary policy should do whatever it could to make this possible. . . . Foreigners wanted to know how this country was going to get its payments position into balance, but he did not feel that anyone in this country knew the answer to this question. As he saw it, the Federal Reserve could do just one thing about the balance-of-payments problem. It could encourage foreigners to leave their money in this country by making interest rates competitive with those in key European countries. In his opinion, however, carrying this policy much farther than it had been carried in recent months would be too high a price to pay at the moment, considering the importance of a somewhat lower level of interest rates to stimulate the domestic economy.

In 1961, the FOMC raised interest rates twice out of a concern for the external deficit. At the October 24, 1961, meeting, the FOMC raised bill rates from about 2¼ to 2½ percent. New York Fed President Hayes, who as vice chairman presided over the meeting in the absence of Chairman Martin, commented (Board of Governors 1961, pp. 897–98)

> That at least a goodly number of those around the table had expressed some concern about the international problem and had recognized that there was perhaps something the System could do to help, in a minor way, to show that it was aware of the problem, without doing danger to the domestic economy.

Governor Mills expressed the general sentiment for an increase in rates at the December 19 meeting (Board of Governors 1961, p. 1079):

> Patently, time is of the essence in reorienting the existing monetary and credit policy in the direction of moderate restraint. . . . What I consider as having been an unpardonable delay in pursuing that objective has permitted distrust in the exchange value of the U.S. dollar to grow and will consequently vitiate counteroffensive interest rate efforts to stem the loss of gold from this country. Reliance on collective central bank and International Monetary Fund actions to protect the U.S. dollar should have been reserved for secondary emergency application and not suggested for continuing use, in that public notice of resort to these media will be regarded by cynical investors as acts of desperation and not as curatives to temporary problems of international currency imbalances.

Initially, Chairman Martin urged postponement of a rise in rates, but he then relented (Board of Governors 1961, pp. 1089–90 and 1136):

> He questioned whether the situation had really come to the point where a significant change of policy was required. . . . He would hope that the System would not get itself in the position, following the increase in the maximum permissible interest rates on time and savings deposits, of being charged with causing the commercial bank prime rate to be increased at this particular juncture. [The Board of Governors had decided to raise the Reg Q ceiling on deposits held for one year or more from 3 to 4 percent, effective January 1, 1962.]
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> Following additional discussion, Chairman Martin restated his conception of the consensus of the meeting. As he saw it, the consensus was along the lines of concentrating on a bill rate in the upper part of the range of 2½ - 2¾ percent.

The external deficit kept the FOMC from lowering market rates in July 1962 in response to weakness in economic activity. The bill rate, however, only began to rise significantly in June 1963 when it first reached 3 percent.

With monetary policy basically immobilized because of weakness in the domestic economy, the United States was left with only ad hoc measures to deal with the balance of payments deficit. In 1961, it reduced the duty-free allowance on goods purchased abroad by American tourists from $500 to $100. The United States moved to limit the demand for its gold stocks by making it illegal for Americans to buy gold abroad. In 1962, it set up the London Gold Pool among central banks to curb central bank free market purchases of gold. The U.S. government asked Germany to pay more of the expense of maintaining U.S. troops in Germany.

The Treasury issued bonds denominated in foreign currencies, named Roosa bonds after Treasury Under Secretary Robert Roosa, to obtain foreign currency to purchase dollars. The Treasury and the Fed also began Operation Twist, whereby the Fed began to hold longer-term securities, and the Treasury began to issue mainly shorter-term securities. The resulting decrease in the supply of longer-term securities relative to shorter-term securities was supposed to lower longer-term interest rates relative to shorter-term interest rates. The idea was to encourage both domestic investment and short-term capital inflows. Although the balance of payments exercised some influence on monetary policy, the FOMC was unwilling to subordinate domestic to external considerations.

2. THE EXCHANGE STABILIZATION FUND

In 1961, the Exchange Stabilization Fund (ESF) of the U.S. Treasury began to intervene in the foreign exchange markets. Its ability to intervene, however, was limited by its resources. In 1934, Congress had created the ESF with the Gold Reserve Act. Congress capitalized it with $2 billion of the profits created by that Act's revaluation of gold from $20.67 to $35.00 per ounce. It put the ESF under the control of the Treasury and authorized it to intervene in the foreign exchange markets to stabilize the value of the dollar. In 1945, the Bretton Woods Agreements Act transferred $1.8 billion of the ESF's capital to the International Monetary Fund (IMF). The ESF, therefore, was left with $200 million in its capital account and no alternative funding sources apart from money appropriated by Congress (see Todd [1991, 1992]). However, over the years, the ESF had earned profits through its purchases and sales of gold. It invested these profits in domestic and foreign securities. With the income from those securities, by June 30, 1961, it had accumulated about $336 million in assets. (Figures on the balance sheet of the ESF come from U.S. Treasury *Annual Reports*.)

By 1962 the ESF had committed much of its resources through provision of foreign aid, especially to Latin American countries. In 1960, it had acquired Argentine pesos. In May 1961, the ESF agreed to exchange up to $70 million dollars for Brazilian cruzeiros (U.S. Treasury 1961, p. 369). On January 1, 1962, the ESF entered into an exchange agreement with Mexico for $75 million, and in the middle of 1962 it entered into a swap agreement with the Philippines (U.S. Treasury 1963, p. 57).[1]

[1] At times, the ESF obtained the foreign exchange needed to purchase dollars in the foreign exchange market by borrowing from foreign central banks through an arrangement called a "swap." At other times, when the ESF needed dollars, in an arrangement called "warehousing," it would organize a trade with the foreign exchange in the Fed's inventory in return for dollars. The appendix explains the details of these two kinds of transactions.

Because so much of its resources were tied up, the ESF intervened mainly in the forward markets. In that way, it would only need foreign exchange if it had to close out a position at a loss. "Reference was made to the extent of operations of the ESF in the forward market, as opposed to spot transactions, and Mr. Coombs [manager of the New York Fed's foreign exchange desk] said the basic reason was that the ESF was short of money" (Board of Governors 1962, p. 169). The dollar often traded at a large discount in the forward market. The Treasury entered into commitments to furnish foreign currencies in the future in order to reduce this discount. In doing so, it hoped to encourage individuals to hold dollar-denominated assets by reassuring them that the dollar would not depreciate in value.

In March 1961, the British pound weakened while the German mark and Dutch guilder strengthened. Germany and the Netherlands revalued their currencies by 5 percent.[2] Because many in the foreign exchange markets believed that a 10 percent revaluation would be required to eliminate the German balance of payments surplus, capital continued to flow into Germany. In forward markets, the mark commanded a 4 percent premium.

> German exporters . . . hedged by borrowing dollars . . . and converting these dollars into deutsche marks immediately, counting on the future dollar receipts to repay the dollar loans on maturity. Activities of this nature significantly increased the volume of dollars being offered on the exchange market, compelling the German Bundesbank to acquire dollars in huge amounts. . . . U.S. authorities were confronted with the possibility that the Germans would have to purchase gold in order to prevent a further drop in their already low gold/dollar ratio (U.S. Treasury 1962a, p. 3; Foreign 1962).

By the end of June, the ESF had entered into forward contracts agreeing to deliver more than $250 million deutsche marks for dollars in the future. Fortunately, the Treasury was able to unwind these positions without putting pressure on the dollar in the summer because the Berlin Wall crisis produced a weakening of the deutsche mark.

The Berlin crisis, however, produced capital flight to Switzerland, and the Swiss franc commanded a premium of 1½ percent in the forward market. Starting in July, the ESF began to sell Swiss francs forward to Swiss commercial banks, which then became willing to hold the dollars instead of turning them over to the Swiss National Bank. If the Swiss National Bank had been forced to purchase the dollars, it would have been under pressure to use them to buy gold from the Treasury. Toward the end of 1961, the Italian lira became the strongest European currency, and the Italian central bank came under pressure

[2] The following discussion draws on a memo (U.S. Treasury 1962a; Foreign 1962) that "Secretary Dillon promised Chairman Martin we would furnish to the Board of Governors." The memo summarizes a letter from Robert Knight, Treasury General Counsel, to Ralph Young, Adviser to the Board of Governors, February 9, 1962.

to exchange the dollars it was accumulating for gold. In an attempt to encourage Italian commercial banks to hold dollars rather than turn them over to the central bank, the ESF entered into $200 million in forward contracts. The forward commitments of the ESF in lira and Swiss francs amounted to $346.6 million in early 1962.

Forward commitments, however, carried the risk of loss if the dollar did not appreciate. Given the risk exposure due to the size of its forward commitments, the Treasury felt that the ESF had insufficient cash on hand. To provide it with additional cash, the Treasury wanted the Fed to buy the ESF's foreign currencies such as the deutsche mark. The ESF could then acquire the lira and Swiss francs it needed to meet its forward commitments without having to incur the ire of other central banks by dumping their currencies on the market in return for lira and Swiss francs.

A Treasury memo (Foreign 1962; U.S. Treasury 1962b, p. 2) noted

> Total resources of the Fund at the present time amount to about $340 million. Against these resources there are outstanding $222 million in Exchange Stabilization agreements with Latin American countries, and some additional agreements may be made from time to time. The free resources of the Stabilization Fund are consequently quite small. . . . Spot holdings of foreign exchange now amount to about $100 million . . . . These spot holdings must in general be thought of as providing backing for outstanding forward exchange contracts (currently about $340 million equivalent). The entrance of the Federal Reserve System into foreign exchange operations will therefore provide particularly needed resources.

As Charles Coombs (1976, p. 71) put it later, ". . . the money-creating authority, the Federal [Reserve] could rise to almost any financial emergency, whereas the Treasury was confined, in the absence of new Congressional appropriations, to the existing $330 million resources of its Stabilization Fund."

3. LOOKING TO THE FED

On June 27, 1961, Ralph Young, Adviser to the Board of Governors, distributed to FOMC members a memo proposing that the Fed become involved in the coordinated foreign exchange intervention started by other central banks in response to the March sterling crisis. When the pound sterling had weakened, the Bank of England used its dollar reserves to buy pounds. The resulting outflow of dollars ended up at other European central banks. Although those banks recycled the dollars by lending them to the Bank of England, the U.S. Treasury was concerned that the banks might use the dollars to buy gold from the United States. To safeguard against such an event, Young recommended that the Fed open swap lines with other central banks as a way of acquiring foreign exchange to buy dollars if necessary.[3] He also recommended that the Fed stand ready to replenish the ESF's dollar holdings by purchasing its foreign exchange through a procedure later termed "warehousing."[4]

Young's (1961, p. 8; Foreign 1961) memo stated

> The assets of the Stabilization Fund cannot, without Congressional action, be increased beyond the present amount of about $360 million. Part of this amount is immobilized under present exchange agreements with Latin American countries. The rest is not sufficient to cope with the swings in holdings of foreign exchange . . . in periods of disturbed exchange market conditions.

Chairman Martin first raised the issue of foreign exchange intervention at an FOMC meeting on September 12, 1961. He let William Treiber, first vice president of the New York Fed, take the lead. Treiber (Board of Governors 1961, pp. 798–99) noted the weakness in the dollar and the ESF's lack of resources:

> [The ESF's] present size is about $1/3 billion, of which a large amount is already tied up by stabilization agreements with certain Latin American countries. The scope of acquisition of hard currencies by the Fund is probably not much over $100 million. While the Treasury may eventually ask the Congress to authorize an increase in the resources of the Fund, I understand that in any case the Treasury would welcome Federal Reserve acquisition of foreign exchange as a helpful supplement. . . . Abrupt declines of the dollar to the floor of the foreign exchanges have excited speculation as to possible changes in currency parities . . . an adequate supply of the major foreign currencies . . . [would] restrain a snowballing of speculative anticipations.

Young noted that the Treasury would like the Fed to become involved in foreign exchange intervention so that it could use the ESF's funds for other purposes:

> Mr. Young pointed out . . . that the Treasury has other jobs in connection with the Stabilization Fund. That was one of the reasons why the funds available for the particular kinds of operations under discussion were so limited. He gathered that the Treasury might be happy if it were left free to use the Stabilization Fund for the other things with which it had to deal (p. 815).

Carl Allen (Board of Governors 1961), president of the Chicago Fed, began a discussion of the legality of Fed intervention in foreign exchange markets

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[3] As explained in Appendix A, in a swap the Fed or the ESF places dollar deposits with a foreign central bank, which in return places deposits in its currency with the Fed. Appendix A explains how the foreign exchange acquired through swaps was used to insure foreign central banks against loss of value of their dollar holdings in the event of a devaluation of the dollar. In this way, the United States persuaded foreign central banks not to purchase gold.

[4] As explained in Appendix A, with warehousing the Fed credits the Treasury's deposits with the Fed in exchange for foreign exchange held by the ESF.

and Karl Bopp, president of the Philadelphia Fed, raised the issue of whether the Fed could retain its independence while working with the Treasury:

> Just because a thing was legal, that did not mean that he [Allen] would always want to do it. On the legality of the proposed operations, however, he did have a question . . . whether it seemed clear that it would be legal for the System to undertake such operations (p. 801).
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> . . . The Chairman then turned to Mr. Hackley [Board Counsel], who commented that legal questions had, of course, been raised in the past. Nearly 30 years ago, as indicated in Mr. Young's memorandum, the Board took a position, which it did not publish, that would seem to preclude the implementation of the program such as suggested. However, for reasons that did not need to be gone into today, he felt that the Board could well reinterpret the law in a somewhat different manner, and in his view such a step would be desirable. . . . Chairman Martin then stated that he had mentioned this subject informally—not formally—to the Chairmen of the Senate and House Banking and Currency Committees. . . . It would not be fair to say that the Committee Chairmen had given any clearance of any kind (p. 802).
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> The Chairman went on to comment. . . . There was a very real point . . . that the primary direction must come from the Treasury and that anything done by the Federal Reserve must be coordinated with the Treasury. . . . Everyone . . . ought to keep in mind what the framework was. Also, before entering into any such operations, the System ought to do as the memorandum from Mr. Young suggested; namely, take the matter up formally with the Chairmen of the Banking and Currency Committees (p. 803).
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> Mr. Bopp said that as nearly as he could recall . . . one reason for its [ESF's] creation was dissatisfaction with the idea of the Federal Reserve handling foreign exchange operations. . . . Through the Stabilization Fund . . . the Treasury was to have the authority in case of any conflict. . . . In the longer run, he noted, a possible conflict could develop between Treasury policy and Federal Reserve policy in this area. This was a thing to keep in mind . . . the sense in which the Treasury could direct Federal Reserve operations in this field even though Federal Reserve funds were used (p. 804). . . . Mr. Bopp then commented that he was sympathetic to the approach suggested in Mr. Young's memorandum (p. 805).

Governor Robertson [Board Vice Chairman] was especially skeptical:

> Mr. Robertson said . . . while he would not want to argue that the proposed operations would be illegal, he thought that the point was highly questionable (p. 805). . . . It seemed to him this whole problem was not fundamentally the problem of the Federal Reserve, but rather of the Treasury. If so, Federal Reserve operations of the kind suggested might be construed as bailing out the Treasury. . . . Accordingly, before any operations were undertaken, he felt that the Congress should have a chance to take a look, at least through the Banking and Currency Committees, to see whether it was felt that the Federal Reserve had the power to proceed. . . . In other countries there was a much closer relationship between the central bank and the executive branch of the Government than in this country. . . . While this problem [weakness of

> the dollar] did exist, he would not want to see the Federal Reserve take the position that it could construe the statute [Section 14 of the Federal Reserve Act] in any way it wished (p. 806).

FOMC members then raised a variety of questions:

> Mr. Swan [president of the San Francisco Fed] noticed . . . that the Stabilization Fund had certain amounts committed under existing stabilization agreements with Latin American countries, whereas presumably Federal Reserve operation would not involve such uses of funds (p. 808). . . . Mr. Wayne [president of the Richmond Fed] said . . . he would feel much more comfortable if the Federal Reserve had an official commitment from the Congress that operations of the kind under consideration were clearly within its power (p. 809). . . . Mr. Allen said . . . he had some doubt about the legality of Federal Reserve operations. . . . He was inclined to think that the intent of Congress had been . . . to have the Stabilization Fund do this job (p. 810).

4. BACKGROUND TO THE DEBATE

The Federal Reserve Act does not explicitly authorize the Fed to influence the value of the dollar by intervening in the foreign exchange market or to acquire foreign exchange for that purpose by swapping deposits with foreign central banks (establish swap lines). It also does not explicitly authorize the Fed to acquire foreign exchange from the Treasury (warehousing). This omission of powers undoubtedly reflected the adherence of the authors of the Federal Reserve Act to the two dominant assumptions of their era: the discipline of the gold standard and the real bills doctrine. Adherence to the gold standard (continued in the Bretton Woods system) required that the Fed raise the discount rate in response to gold outflows. It seems unlikely that the authors of the Federal Reserve Act would have authorized actions designed to avoid this discipline. Also, according to the real bills doctrine, a central bank should extend credit only through discounting commercial bills (bills of exchange), that is, on the basis of debt arising from the financing of real productive activity. Again, it seems unlikely that the authors of the Federal Reserve Act would have authorized deposit creation for U.S. and foreign governments in return for direct asset sales. (Foreign central banks were typically under direct government control.)

Section 14 of the Federal Reserve Act states "Any Federal reserve bank may . . . purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances and bills of exchange." Given the existence of the gold standard and the acceptance of the real bills philosophy at the time of the writing of the Federal Reserve Act, the simplest understanding of the power to buy and sell foreign exchange (cable transfers in the language of the Federal Reserve Act) would be as a power facilitating transaction abroad by the Fed in gold or bankers' acceptances and bills of exchange. H. Parker Willis (1926, p. 488), who drafted the Federal Reserve Act for Carter Glass, discussed the intention of this part of the Federal Reserve Act. He wrote that the power to deal in cable transfers facilitated the ability of Reserve Banks to purchase gold abroad. These foreign gold purchases could be used to supplement the domestic stockpiles of the Reserve Banks. Such purchases could also be used to avoid unnecessary trans-Atlantic movements of gold. For example, a Reserve Bank could use its holdings of gold in London to meet the needs of an individual in London wanting to exchange dollars for gold and thus avoid the need for shipment of gold from New York.

The Federal Reserve Bank of New York had opened swap lines in the 1920s with foreign central banks desiring to make their currencies convertible.[5] In 1932, however, Carter Glass, senator from Virginia and author of the Federal Reserve Act, denounced on the Senate floor those swap lines as inconsistent with the Federal Reserve Act. As a consequence, in the Banking Act of 1933, Congress added language to the Federal Reserve Act giving the Board of Governors the power to prevent the New York Fed from dealing directly with foreign banks. ". . . the Board subsequently (in 1933 and 1934) construed section 14(e) as limiting foreign accounts to the purchase of bills of exchange" (U.S. Congress 1962, p. 147).

5. DEBATING FED FOREIGN EXCHANGE INTERVENTION

At the request of Chairman Martin, Board Counsel Howard Hackley wrote a memorandum outlining a legal basis for Fed participation in foreign exchange operations. The FOMC discussed the memo at its December 5, 1961, meeting. (The full memorandum is reprinted in U.S. Congress [1962]. Appendix B summarizes the legal arguments of the memorandum.)

President Swan had already expressed his doubts in a November 30, 1961, letter to Ralph Young (Foreign 1961). He argued that the memo was a "shaky foundation for proceeding with a full-blown operation" because "the real bills doctrine of the 1914 law" made it doubtful that the Federal Reserve Act would authorize opening foreign accounts for purposes other than buying bills of exchange. Most FOMC members shared the sentiments expressed by George Clay (Board of Governors 1961, p. 1035), president of the Kansas City Fed:

[5] Coombs (1976, p. 75) said of the swap arrangements he was discussing with other central banks in January 1962, "Such swaps of one currency for another, with a forward contract to reverse the transaction, say 90 days hence, had long been a standard trading instrument in the foreign exchange markets. Moreover, back in 1925, the New York Federal [Reserve Bank] under Governor Strong had arranged with the Bank of England a similar swap arrangement of $200 million of United States gold against sterling."

> Mr. Clay went on to say that he had a basic feeling against Government agencies taking unto themselves authorities that had never been specifically granted. . . . He felt that Congress should be given an opportunity, and in fact urged, to assign this authority to the agency that in its wisdom it would choose.

Governor King (Board of Governors 1961, p. 1043) commented:

> He did not think the Federal Reserve was the proper place for these operations if they were to be conducted. Instead, he felt that a political agency or body would be the proper place to lodge the responsibility. As he had heard it said on various occasions, if the System should get into politics at any stage it could founder.

President Bopp (Board of Governors 1961, p. 1046) stated:

> Like others who had spoken, he was concerned about the legal basis for System operations in foreign currencies. The legal authority was not based on specific provisions of the law but rather on a construction of the statutes. . . . In a democratic process it was important . . . to have specific authorization.

President Bryan (Board of Governors 1961, pp. 1048–49) of the Atlanta Fed urged the FOMC to concentrate on maintaining convertibility through the appropriate domestic policies. "Sometimes . . . a great deal more harm can be done, with good intentions, by intervening to save the patient some pain than by letting him realize he is sick."

Governor Robertson (Board of Governors 1961, pp. 1037–42) argued that sterilized foreign exchange intervention by the Fed was bad law, bad politics, and bad economics:

> It does not follow that the power to maintain foreign accounts—basically an incidental power—can be regarded as an authorization to exercise the broad policy functions contemplated by the instant proposal. In other words, even if foreign accounts may be maintained in connection with functions other than dealing in bills of exchange, these must be functions that are authorized by the Federal Reserve Act. *Nowhere in the Act can authority be found for the stabilization function that is the core of this proposal* (italics in original).
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> Even if its legality were to be assumed, I think the proposed action would be highly questionable because it is inconsistent with explicit Congressional authority. . . . Purchasing foreign exchange from the Stabilization Fund whenever that fund has been used up *or* by operating in the same field on its own . . . could be interpreted as circumventing the will of Congress by making available more dollars for the purpose of "stabilizing the exchange value of the dollar" than Congress contemplated. . . . Such a function [selling foreign exchange] . . . involves very sensitive international diplomatic relationships, with which the Federal Reserve is not in the best position to cope. The function would seem to be more appropriately one for the Treasury (which Congress has already designated to handle the problem).
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> Federal Reserve operations in foreign currencies . . . would merely camouflage the difficulty, which is one of dealing with the balance of payments

> problem. . . . If the amount of that fund [the ESF] is insufficient, then the Treasury should request Congress to expand the fund. . . . There are no gimmicks by which the position of the dollar can be maintained in the world. It would be unwise to resort to devices designed to hide the real problems and assuage their symptomatic effects. . . . The United States must practice what it has long preached about the need for monetary and fiscal discipline.

6. THE DECISION TO INTERVENE

The main defenders of Fed involvement in the foreign exchange markets were Governor Balderston, Charles Coombs, and President Hayes of the New York Fed. Balderston (Board of Governors 1961, p. 1058) argued that the Fed should intervene in the foreign exchange market because "it was so close to the function carried on by the Open Market Committee in domestic affairs." Coombs (Board of Governors 1961, p. 1052) argued that "speculative pressures could boil up within a matter of minutes in the exchange market. . . . It would be desirable to have the resources to deal with such periodic emergencies, so that exchange operations could resist speculative trends before they had gone too far." Hayes (Board of Governors 1961, p. 1054) argued that, since the ESF was not in a position to intervene in foreign exchange markets, the Fed should do so.

> As to the roles of the Treasury and Federal Reserve, some of those who commented had suggested that the Stabilization Fund was set up for this kind of purpose. Actually, however, the Fund had been used for a lot of other purposes. It had been used to assist United States foreign policy in relation to various weaker currencies that needed shoring up, as a kind of State Department activity.

In a poll conducted by Chairman Martin, thirteen of the eighteen FOMC participants registered the opinion that "legislation is desirable" before beginning to intervene in the foreign exchange market. (The poll is recorded in the notes of Richmond's President Wayne and are in the Richmond Fed archives for the December 5, 1961, FOMC meeting.) One of the five in favor of intervention, Governor Mills, expressed reservations. "He had no great faith that operations of this kind could be conducted successfully or without serious danger to the independent status of the Federal Reserve System." Another of the five in favor, Delos Johns, president of the St. Louis Fed, believed the FOMC should seek enabling congressional legislation at the same time it proceeded. Chairman Martin ended the meeting by saying that he would explore the matter of legislation with the Treasury and report back to the Committee at its next meeting.

At the December 19, 1961, FOMC meeting, Chairman Martin, supported by President Hayes, asked the Committee's permission to discuss a working relationship with the Treasury for foreign exchange intervention.[6] Most members agreed that Chairman Martin should continue discussions with the Treasury, but agreed with President Deming of the Minneapolis Fed "that he would regard operations in foreign currencies as a proper activity for the central bank if statutory clarification could be obtained" (Board of Governors 1962, p. 1151).

At the January 9, 1962, FOMC meeting, Chairman Martin asked Hackley to report to the FOMC on his discussions with the Treasury's general counsel, Robert Knight. Hackley noted that the Treasury's general counsel and the Attorney General concurred with his opinion. He also noted that the Treasury opposed seeking legislation for three reasons (Board of Governors 1962, p. 61):

> The international situation was very tender. . . . If there were discussions on the Hill, they might be agitating to the markets. Second . . . it might be better to seek such legislation after the Open Market Committee had some experience in order to determine what its problems and limitations were. . . . Third, there was a range of ideas on the Hill with regard to the Federal Reserve System. . . . Legislation, if sought, might become a vehicle for adding various amendments the nature of which could not be foretold.

Chairman Martin said that he had conferred with the Secretary of the Treasury, and they agreed that "regarding the question of seeking legislation . . . there were real problems involved." Martin suggested that he confer with the chairmen of the House and Senate Banking Committees. "If the Committee Chairmen . . . should feel strongly that the introduction of legislation would cause a great deal of stir, it might be better not to embark on that course" (Board of Governors 1962, p. 63). Governor King then commented

> The Federal Reserve was being asked to go a little too far in the name of cooperation. As he understood it, the Treasury was suggesting that it might not favor legislation because of apprehension as to the outcome (p. 63).

The Committee then authorized Chairman Martin to confer with the chairmen of the congressional banking committees.

At the January 23, 1962, meeting Chairman Martin reported to the FOMC "on the general problem of obtaining legislation that would clarify the Committee's authority to conduct foreign currency operations." Although the *Minutes* do not explain why, Chairman Martin no longer considered legislation an option. The *Minutes* note then that the FOMC had a roundtable discussion. They record a reference to the opinions of the Committee's and Treasury's general

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[6] On December 18 the Secretary of the Treasury had sent a letter to Chairman Martin asking for prompt resolution of the issue of FOMC involvement in foreign exchange intervention and offering the advice of the Treasury's legal staff. "I realize that the Committee might be hesitant to embark on operations in which it has not engaged since the establishment of the Stabilization Fund under the Gold Reserve Act of 1934. If the Committee should be interested in the opinion of the Treasury's General Counsel . . . the Treasury's legal staff will be ready to cooperate with yours" (Board of Governors 1961, p. 1146).

counsels that the "System's existing statutory authority, although in some respects limiting, did provide a general sanction for Committee operations," but otherwise state only that "differing viewpoints were expressed." The *Minutes* (Board of Governors 1962, pp. 111–12) then state

> In bringing the discussion to a head, it was moved by Mr. Balderston and seconded by Mr. Hayes that the Committee go on record at this session as favoring in principle the Committee's initiation on an experimental basis of a program of foreign currency operations; that Mr. Young, the Committee's Secretary, and Mr. Coombs, Vice President in charge of foreign operations of the New York Federal Reserve Bank, be authorized to explore for the Committee with the Treasury the needed guidelines for actual operations . . . and further that Chairman Martin be authorized to refer to this development in his statement and testimony before the Joint Economic Committee scheduled for January 30, 1962.

Ten of the twelve voting FOMC members voted in favor and two (Governors Robertson and Mitchell) dissented.

At its February 13, 1962, meeting, the FOMC discussed the issue of "the needed guidelines for actual operation." The exchange was charged because it dealt with the issue of Fed independence. Because foreign exchange intervention involved U.S. relations with foreign governments, many FOMC members were afraid that the Fed would inevitably become a junior member to the Treasury. Earlier, in a November 30, 1961, letter to Ralph Young, President Fulton of the Cleveland Fed (Foreign 1961) had written

> There is a danger that if the System takes on the functions of the executive, it will end up as a captive of the executive branch of the government. . . . It might be safer for the Congress to designate the Treasury Department as the principal locus of responsibility for exchange operations. . . . This approach . . . would not rely on a tenuous Treasury-Federal Reserve "accord," which might not endure with different personalities and under different conditions. For another thing, Congress would retain its traditional control over the purse strings.

At the February 13 meeting, Governor King argued for explicit assurance that the Fed could refuse to finance the activities of the ESF (Board of Governors 1962, pp. 175–77):

> Mr. King raised a question with respect to the comment made earlier by Mr. Young that there would be no specific rules at the outset on relationships between the Treasury and the Federal Reserve, the thought being that these might evolve out of experience. He asked whether it might not be better to have such rules.
>
> In response, Mr. Young expressed the view that no general rule was needed. . . . He did not think that the Treasury would be apt to come to the System with the idea of selling from the Stabilization Fund unless something happened in the development of the over-all program of foreign currency

> operations that would make it seem desirable, from the Treasury's standpoint, to get unloaded. There could always be that development. For example, an underdeveloped country might need temporary help and there would be no way to arrange it except to give a commitment from the Stabilization Fund. In that event, the Treasury might need to convert some of its resources.
>
> Mr. Robertson inquired as to the advantages seen—aside from the Federal Reserve's "unlimited pocketbook"—in having two agencies operating in this field instead of one, and Mr. Coombs replied that he did not think there were any. . . . He [President Swan] asked whether it was not possible that the Federal Reserve would just be in the role of supplying funds to the Treasury rather than conducting foreign currency operations.
>
> [Chairman Martin] considered it difficult to sit down and attempt to draw up such principles while the Federal Reserve was in the process of learning.

Chairman Martin then advanced a proposal that the Board of Governors, not the full FOMC, have responsibility for foreign exchange intervention. Hackley explained the proposal, which he had advanced in a memo dated February 8, 1962: "He [Hackley] did feel that in at least some respects this approach might be more defensible from a legal standpoint" (Board of Governors 1962, p. 177). The New York Fed and many other regional banks, however, objected to being excluded. Most FOMC members felt that exclusion of the regional banks would weaken the federal character of the System:

> [Governor] Shepardson said that . . . either approach involved an interpretation of the law that was rather nebulous. . . . On the assumption that the original proposal would be legally supportable . . . participation of the entire Open Market Committee would be desirable from the standpoint of System unity (Board of Governors 1962, p. 186).

As part of this discussion, Chairman Martin recommended that decisions about foreign exchange intervention be made by a subcommittee consisting of the Chairman and Vice Chairman of the FOMC and the Vice Chairman of the Board of Governors. Earlier, Delos Johns (Board of Governors 1961, p. 1051), president of the St. Louis Fed, had opposed such a delegation of authority:

> He had real doubt about the power of the Committee to delegate its responsibilities. That was an old question. . . . He was not quite satisfied by the argument that a subcommittee that supervised the operations was not making policy. The executive committee was abolished because the Committee became convinced that it was not confining its activities to administration and instead was actually making policy. This is almost inevitably the result, he suggested, when delegations of authority are made to a small group.[7]

[7] Prior to 1955, only the Executive Committee (consisting of the Fed chairman, two governors, the president of the New York Fed, and one other regional Bank president) met regularly to make monetary policy. The full FOMC met only four times a year, with two of those meetings separated by only a weekend.

There was, however, no real opposition to delegating to a small subcommittee authority over operations in the foreign exchange markets. Any other arrangement appeared impractical.

Chairman Martin then asked for approval of guidelines for initiating foreign currency purchases. Although the Board staff had circulated on December 12, 1961 (Foreign 1961), a draft of congressional legislation that would give the Federal Reserve explicit authority to transact in foreign exchange, Martin (Board of Governors 1962, p. 193) argued

> There were those . . . who felt that the law was not sufficiently clear. It might be desirable to seek legislation in this area at some time, but at the moment he doubted whether it would be feasible, with so little experience, to determine what kind of legislation was needed. . . . The availability of those decisions [Hackley's memorandum and the opinions of the Treasury's general counsel and the Attorney General], along with a lack of System experience in foreign currency operations, would handicap the System if it tried to get legislation. The System would be asked what kind of additional legislation it needed, and the Congress probably would not want to put itself in the position of approving something if the Federal Reserve was not clear about its wishes in the matter.

In the words of Coombs (1976, p. 72), the FOMC then "somewhat apprehensively approved on February 13, 1962, the undertaking of market operations in foreign currencies."

At the March 6, 1962, FOMC meeting, discussion again centered around the issue of whether the Fed, by participating in foreign exchange operations, would be taking orders from the Treasury. The Treasury had two immediate problems. First, a number of foreign governments, especially France, wanted gold for their dollars. The problem was acute:

> Mr. Coombs reiterated that a number of European central banks holding large amounts of dollars had been deliberately refraining from taking gold. If any bank should come in for a large amount of gold, an "every man for himself" proposition could possibly develop (Board of Governors 1962, p. 273).

On February 28, in a telephone poll, the FOMC had approved entering into a swap arrangement with France.[8] Among the seven governors, King and Robertson had dissented and Mitchell had abstained.

The Treasury's second problem was that the ESF needed dollars so it could buy Swiss francs to meet its forward commitments:

> Mr. Mitchell inquired of Mr. Coombs whether a purchase by the System of marks from the Stabilization Fund might not be the kind of operation that would leave the System open to the charge of bailing out the Stabilization Fund. . . . At times . . . the Federal Reserve had been dominated by the

[8] See the discussion in the appendix in the memo of Ralph Young, dated October 17, 1963, on using swaps to offer foreign central banks protection against dollar devaluation.

> Treasury, so there was always a problem of maintaining a kind of arms-length relationship. On the present occasion, the objectives of the Treasury and the Federal Reserve tended to coincide, but a different situation could possibly develop (Board of Governors 1962, pp. 277 and 280).
>
> Reference was made by Mr. Thomas [Board economist] to the fact that the Federal Reserve could not purchase U.S. government securities directly from the Treasury. . . . Mr. Hackley [said] that the law clearly indicates that direct purchases of U.S. government securities from the Treasury are not open market transactions. As to foreign currency operations, he had come to the conclusion, however, that in this sense the Stabilization Fund was a part of the open market (Board of Governors 1962, pp. 279 and 283).

After Coombs noted that "the Stabilization Fund was strained to the utmost at this moment" (Board of Governors 1962, p. 285), the Committee voted to buy marks from the ESF.

7. CONGRESSIONAL ANNOUNCEMENT

On February 27 and 28, 1962, the House Committee on Banking and Currency held hearings on legislation (U.S. Congress 1962) to increase the resources of the IMF. Chairman Martin (U.S. Congress 1962, pp. 91–92) used these hearings to announce that the Federal Reserve had become involved in foreign exchange intervention:

> The Federal Reserve has recently acquired small amounts of several convertible currencies widely used in international transactions from the Treasury Stabilization Fund and has opened accounts with several European reserve banks. . . . While in time it may be desirable to recommend amendment of the Federal Reserve Act to provide greater flexibility than we now have under the act in carrying out these operations, it would be impractical to request such legislation before operating experience under existing authority has provided a clear guide as to the need for it.

Rep. Reuss (U.S. Congress 1962, pp. 102 and 140) criticized the use of the "nearly unlimited money creative powers of the system" to intervene in the foreign exchange markets:

> Much of the operation that you are doing . . . seems to me to duplicate the foreign exchange stabilization operation that the Secretary of the Treasury has very properly undertaken pursuant to the Gold Reserve Act of 1934. To me this is a tremendous power you have taken upon yourself, and I must serve notice on you right now that I consider this an usurpation of the powers of Congress. . . . You come in here and tell us that you propose to go off on, if I may say so, a frolic of your own, involving unspecified sums without the slightest statutory guidance.

Chairman Martin (U.S. Congress 1962, p. 140) challenged Rep. Reuss' representation. "Now, you may disagree as a lawyer with the lawyers for the

Federal Reserve Board as to our existing authority on this, Mr. Reuss. But as I reiterate, our lawyers said we had the authority, the Treasury counsel concurred, and the Attorney General concurred with them.” Copies of the Hackley Memorandum, the opinion of the Treasury’s general counsel and the concurrence of the Attorney General were provided to the Committee at its request and published in the hearing record.[9]

8. CONCLUDING COMMENTS

From the time of the first swap arrangement with France for $50 million in 1962 to the closing of the gold window in August 1971, Fed swap lines grew to $11.7 billion. The entrance of the Fed into the foreign exchange markets initially produced considerable internal debate. On the one hand, Coombs (1962, p. 469) considered foreign exchange intervention to be integral to maintaining the international monetary order. “[W]hen the exchange markets become seriously unsettled by political or other economic uncertainties, normally beneficial speculation may quickly become transformed into a perverse, and sometimes even sinister, force.” On the other hand, Governor Robertson (Board of Governors 1962, p. 185) was critical:

[9] The Fed’s conduct of foreign exchange operations has continued to be the subject of much discussion in the years since the internal FOMC debate chronicled in this article. In commenting on an earlier draft of this article, members of the Board of Governors’ staff suggested that the following additional information be included for completeness:

Since 1962, Congress has reviewed the foreign currency operations of the Federal Reserve in hearings on related issues. The Hackley Memorandum was published a second time in a 1973 hearing record of the House Banking Committee on the Par Value Modification Act of 1972. In addition, the *Annual Reports* of the Board have described and provided data on the Federal Reserve’s foreign currency operations, and the Federal Reserve Bank of New York has submitted quarterly reports to Congress on Treasury and Federal Reserve foreign currency operations. Although Congress can properly be considered to have been fully aware of these published materials, it has not acted to restrict the authority of the Federal Reserve to engage in these operations.

In fact, Congress has recognized and facilitated the Federal Reserve’s foreign currency operations by amending a related provision of the Federal Reserve Act to permit the investment of foreign exchange obtained through those operations. In 1980, Congress amended Section 14(b)(1) of the Act to grant Reserve Banks the authority to invest foreign exchange in “short-term foreign government securities.” The provision was enacted as part of the Monetary Control Act of 1980 in response to a long-standing request from the Board. Its enactment demonstrated congressional awareness and suggested tacit acceptance of the Federal Reserve’s foreign currency operations.

Finally, in 1989 and 1990 the Federal Reserve conducted a comprehensive study and review of System foreign exchange operations. This material was discussed and reviewed by the FOMC at its meeting on March 27, 1990. All aspects of the operations, including the policy and legal basis of such operations, were thoroughly examined. After consideration of the material, the FOMC voted in favor of increasing the limits on the System’s holding of foreign currencies and on the amount of eligible foreign currencies the System was willing to warehouse for the Treasury and the ESF. The discussion and the votes were reported in the published FOMC minutes. Three members dissented from these decisions. Two of the dissenters cited concerns about the absence of definitive congressional intent in this area but only in reference to the warehousing increase.

> Mr. Robertson recalled that he had opposed the whole program of operations in foreign currencies on legal, practical, and policy grounds because it had seemed to him that the only basis for the entrance of the Federal Reserve into this field would be to supplement the resources of the Stabilization Fund and because the program was being undertaken without specific congressional approval.

The place of the Federal Reserve System within the U.S. government is different from the place of central banks in other countries because the U.S. government is different. The U.S. government is characterized by a division of powers, with fiscal policy assigned to Congress. As discussed in Appendix A and Broaddus and Goodfriend (1995), the sterilized foreign exchange intervention and warehousing practiced by the Fed since the early 1960s constitute fiscal policy, not monetary policy. That fact raises fundamental issues about the Fed's operations in the foreign exchange markets. Policymakers vigorously debated many of these issues when the Fed first became involved in the foreign exchange markets in the early 1960s. Those debates remain helpful today in assessing the proper role of the Federal Reserve System.

APPENDIX A: SWAPS AND WAREHOUSING

The Fed can obtain the foreign exchange it requires to buy dollars in the foreign exchange market through a swap of currencies with another central bank. In a swap, the Fed agrees to establish dollar deposits on its books for the German Bundesbank in exchange for the Bundesbank establishing mark deposits for the Fed. At the same time, the Fed agrees via a forward transaction to reexchange the same amount of marks for the Bundesbank's dollars at a given date in the future. Before the breakdown of the Bretton Woods system of fixed exchange rates, the United States used swaps to provide cover for the dollar holdings of foreign central banks. That is, as a consequence of maintaining the fixed exchange rate with the dollar, the Bundesbank might have to buy dollars it did not want to hold. It would have liked to exchange them for gold at the U.S. Treasury, but the Treasury did not want to deplete its stockpile of gold.

The U.S. Treasury could persuade the Bundesbank to hold the unwanted dollars by guaranteeing the Bundesbank against loss in case of a devaluation of the dollar. The Treasury did so by having the Fed take marks acquired by the latter in a swap transaction and use them to buy dollars from the Bundesbank. Counting the dollars in its swap account, the Bundesbank ended up with the same amount of dollars as before the swap, but more of the dollars it did hold were protected against devaluation. The reason is that if the Bundesbank decided not to renew the swap agreement, it could just exchange at the old exchange rate its dollars at the Fed for the marks in the Fed's deposit at the Bundesbank. The Fed, however, since it had used its marks to buy the Bundesbank's dollars, would have to go into the market to buy the marks. (In practice, the Treasury always protected the Fed from loss in buying the necessary foreign exchange.)

Ralph Young (1963; Swap), Director of the Board's Division of International Finance, provided the following explanation:

> Foreign monetary authorities were increasingly unwilling to hold additional dollar claims on an uncovered basis. . . . When the System draws foreign currencies for temporary use under a swap arrangement, the foreign central bank comes into additional dollar holdings that are covered against exchange risk in an amount corresponding to the System's drawing. As the System uses the currencies that it has drawn . . . through a direct sale against dollars with the foreign monetary authority, the *uncovered* dollar holdings of the foreign monetary authority are reduced . . . by a corresponding amount. In this way, although the foreign central bank in question ends up holding the same amount of total liquid dollar assets that it would have held in the absence of the swap drawing . . . its *uncovered* dollar holdings can be held down to the amount that . . . it is content to hold. And in this way, gold sales by the U.S. Treasury are avoided (italics in original).

After the breakdown of the fixed parities of the Bretton Woods system in the early 1970s, the Fed began using the foreign exchange acquired in swap transactions to intervene directly in the foreign exchange markets in response to weakness in the external value of the dollar. At that time, swaps assumed their more modern function of attempting to influence market psychology. Charles Coombs (Board of Governors 1971), Manager of the System foreign exchange account, and Fed Chairman Arthur Burns (Board of Governors 1972), respectively, expressed the change:

> Mr. Coombs remarked that the rationale of the swap network rested on two main considerations. First, the network enabled the System to shield the Treasury gold stock and other reserve assets by providing the alternative of an exchange guarantee to foreign central banks having dollars they wished to convert. . . . That part of the rationale had now fallen away, since the decision of August 15 [1971, closing the gold window] had made the dollar inconvertible into gold or other reserve assets (p. 1101). . . . More generally, the swap network had come to be regarded in the market as the very symbol of central bank cooperation (p. 1102).
>
> By demonstrating that the United States was prepared to cooperate with other nations . . . such operations [in the foreign exchange markets] could have a major impact on market psychology (pp. 734–35).

Swaps constitute a fiscal policy, not a monetary policy, action. (See Goodfriend and King [1988] on monetary and fiscal policy.) Consider a swap line with Mexico that involves the acquisition of peso deposits by the Fed in return for dollar deposits at the Mexican central bank. If the Mexican central bank tries to prop up the value of its currency by using its dollar deposits to buy pesos on the foreign exchanges, the U.S. monetary base increases. The Fed will sterilize this increase in the base by selling U.S. Treasury securities out of its portfolio. As a result, the Fed's portfolio will come to include fewer U.S. assets and more peso assets. Because the monetary base ends up unchanged, the Fed has not undertaken a monetary policy action. Neither the U.S. money stock nor interest rates changes. However, when the Fed sells Treasury securities, the supply of U.S. Treasury securities in the hands of the public increases. The effect is the same as though the Treasury had lent money to Mexico by selling Treasury securities to the general public. The Fed has undertaken a fiscal policy action.

Warehousing is one way the Treasury obtains funds for either intervening in the foreign exchange market or lending to a foreign government. It also involves a fiscal policy action by the Fed (Goodfriend 1994). With warehousing, the Fed puts dollars into a deposit account of the U.S. Treasury in return for assets denominated in foreign currencies from the Treasury. At the same time, the Fed and the Treasury agree to reverse the transaction at a future date. Warehousing is equivalent to a repurchase agreement in which the Fed makes a loan to the Treasury using the foreign assets as collateral. When the Treasury uses the dollars it has gained to intervene in the foreign exchange market, the Fed offsets the resulting increase in the monetary base by selling a Treasury security. As above, government debt in the hands of the public increases. It is as if the Treasury issued debt to obtain dollars with which to buy foreign exchange.

If the Fed provides a loan to Mexico via a swap or to the Treasury via warehousing, the measured federal government deficit does not rise because for accounting purposes the Fed is assumed to be part of the private sector. What is relevant for fiscal policy, however, is government debt in the hands of the taxpaying public. If the Fed acquires an additional government security, it will return the interest it receives to the Treasury. Interest paid on the debt is a wash. In contrast, if the private sector acquires an additional government security, the U.S. government must come up with additional funds to pay the interest. Swap lines and warehousing that finance sterilized foreign exchange intervention are fiscal policy actions because they increase the debt that taxpayers must fund.[10]

Because of the separation of powers at the federal level that characterizes the U.S. framework of government, the involvement by the Fed in fiscal policy raises a number of issues. The U.S. Constitution assigns the major decisions

[10] The additional interest the Treasury owes because of the increase in its debt outstanding can be offset by the interest gained on the acquisition of a foreign asset. The redistribution of assets, however, is still fiscal policy. With warehousing or a swap, the Fed has extended credit to the Treasury or a foreign government, but has not changed the monetary base.

about fiscal policy to Congress. When the Fed undertakes a fiscal policy action, it is off-budget; that is, it is not subject to the regular congressional budget process. For further discussion, see Broaddus and Goodfriend (1995).

APPENDIX B: THE HACKLEY MEMORANDUM

The Hackley Memorandum outlining a legal basis for transactions by the Fed in the foreign exchange market dealt with the three ways the Fed acquires foreign exchange: (1) directly from the Treasury in return for crediting the dollar deposits of the Treasury at the Federal Reserve; (2) directly from foreign central banks in exchange for dollar deposits placed with those banks; and (3) in the open market in exchange for dollar deposits at private banks.

In his memo, Hackley pointed to the language of Section 14 of the Federal Reserve Act, which lists transacting in foreign exchange (cable transfers) as an express power.[11] ("Any Federal reserve bank may . . . purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and banker's acceptances and bills of exchange.") He argued that not only does this language allow the Fed to intervene in the foreign exchange market but also to acquire foreign exchange directly from the Treasury. In taking this position, Hackley made two assertions: "Within the meaning of . . . Section 14," the United States (the Treasury) is a "corporation" and Federal Reserve purchases of foreign exchange "from the Stabilization Fund may reasonably be regarded as 'open market' purchases." He defended the first assertion by reference to Chief Justice Marshall's definition of a "corporation" in the *Dartmouth College* case as "an artificial being, invisible, intangible and existing only in contemplation of law" (U.S. Congress 1962, p. 149).

He defended the second assertion by arguing that the Treasury is part of "the open market" for purposes of transacting in foreign exchange, but not for transacting in government debt because the Treasury does not issue the foreign exchange, but it does issue debt (U.S. Congress 1962, p. 149):

> By the Banking Act of 1935, Congress prohibited such purchases of Government obligations except in the "open market." . . . It seems clear, however, that this limitation on direct purchases of Government obligations was intended to prevent the Federal Reserve System from lending its resources to the Treasury in a manner that might be inconsistent with the System's monetary and credit

[11] The discussion of Section 14 in the section of this article entitled "Background to the Debate" dealt with intent or purpose. Hackley's discussion deals exclusively with powers. The purpose of granting someone a license to drive a car may be to allow him to drive to the store. The power to drive the car, however, is different from the motivation for granting the power.

> responsibilities. These considerations, of course, are not applicable to purchases of cable transfers from the Treasury. In other words, an "open market" in cable transfers may be regarded as embracing any person with whom a Reserve bank may feel free to deal, including the United States Treasury, which is a part of that market; whereas an "open market" in Government obligations may be regarded as excluding the United States Treasury, which issues such obligations and consequently is *not* part of that market. . . . On balance, it is my opinion that a Reserve bank's purchases of cable transfers from the Stabilization Fund may be regarded as "open market" purchases from a "domestic corporation."

In outlining a legal basis for swap transactions with foreign central banks, Hackley (U.S. Congress 1962, p. 149) turned to paragraph (e) of Section 14, "Foreign Correspondents and Agencies:"

> Every Federal reserve bank shall have power . . . with the consent or upon the order and direction of the Board of Governors . . . to open and maintain accounts in foreign countries, appoint correspondents, and establish agencies in such countries wheresoever it may be deemed best for the purpose of purchasing, selling, and collecting bills of exchange . . . (or acceptances) arising out of actual commercial transactions which have not more than ninety days to run.

Interpretation of this language turns on the qualifying language "wheresoever it may be deemed best." An interpretation consistent with the real bills doctrine is that this language allows the Fed only "to open and maintain accounts in foreign countries . . . for the purpose of purchasing, selling, and collecting bills of exchange."

Hackley, however, argued that the wheresoever clause does not limit the Fed's authority to open accounts in foreign countries as a way of engaging in swaps.[12] In defending this position, Hackley (U.S. Congress 1962, p. 146) first argued that the language does not unambiguously limit the opening of accounts just to dealing in bills of exchange:

> . . . perhaps the strongest argument for the more liberal construction of the statute may be based upon the ambiguous nature of the phrase "wheresoever it may be deemed best." . . . It does not expressly require such accounts . . . to be utilized *only* for the purpose of buying and selling bills of exchange. It is susceptible of the construction that such accounts may be opened wherever geographically it may be reasonably contemplated that they *might* be used at some time for such purpose but that they need not be limited to that purpose (italics in original).

[12] Hackley said later in commenting on the legality of swap arrangements with the Bank of England, "There was no express authority in the [Federal Reserve] Act for the Federal Reserve to extend credits to foreign banks, although such an action might be justified under the authority for the Federal Reserve Banks to open accounts with foreign banks" (Board of Governors 1967, p. 1244).

Hackley then notes that Section 14(e) concludes by stating that once "any such account has been opened . . . by a Federal reserve bank . . . any other Federal reserve bank may . . . carry on . . . any transaction authorized in this section." That is, foreign deposit accounts can be used for any purpose, not just transacting in bills of exchange.

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