Treasury and Federal Reserve Foreign Exchange Operations Interim Report*

By CHARLES A. COOMBS

Early in January, the dollar continued its strong advance in the exchange markets, spiraling upward against some currencies to levels prevailing before the February 1973 devaluation. The market's bullish appraisal of the dollar mainly derived from the favorable trends in the United States payments balance that had emerged during 1973 and the judgment that this country could better cope with the damaging consequences of the oil crisis than most other industrial countries. Later that month, however, exchange market sentiment abruptly shifted against the dollar and a steady slide in dollar rates developed over the following three months covered by this report. By the end of April, the dollar had fallen from its January peak by as much as 17 percent against the German mark and some other European currencies, while also depreciating considerably against both the Japanese yen and the Canadian dollar. As a result, more than three fourths of the dollar's improvement since October 1973 was eroded.

This adverse shift of market sentiment coincided with the complete elimination of United States capital controls on January 29 and the subsequent easing of European barriers against short-term capital inflows. Moreover, United States interest rates had already begun to fall off sharply while rates abroad held firm, and this swing in interest rate differentials temporarily provided a further strong inducement to outflows of United States funds into foreign markets. Foreign demand for dollar credit mounted as European countries rushed to launch medium-term borrowing programs to meet anticipated balance-of-payments deficits. In response to these pressures, claims on foreigners reported by United States banks, the bulk of which is short term, ballooned by a record increase of well over $6 billion during the three months, February through April. Even more disturbing, the energy crisis threatened to provoke a more rapid and pronounced deterioration in our trade balance than originally expected, while Germany showed a continuing trade surplus of surprising strength.

As this picture unfolded, the dollar came on offer, and dollar rates against most European currencies declined steadily during February to levels nearly 10 percent below the January highs. Such recurrent declines in dollar rates threatened to generate speculative pressures and disorderly trading, and the Federal Reserve accordingly resumed intervention on February 22. By the month end, the Federal Reserve had sold $91.2 million equivalent of marks, financed by drawings on the swap line with the German Bundesbank, of which $3.7 million was repaid with mar-

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 31, 1974	Drawings (+) or repayments (—) February 1 through April 30	System swap commitments, April 30, 1974
National Bank of Belgium	261.8	-0-	261.8
German Federal Bank	-0-	{+368.2 {— 3.7	364.5
Swiss National Bank	371.2	-0-	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,232.9	{+368.2 {— 3.7	1,597.4

Note: Discrepancies in totals are due to rounding.

* This interim report, covering the period February through April 1974, is the third of a series providing information on Treasury and System foreign exchange operations to supplement the regular series of semiannual reports appearing in this *Review*. Mr. Coombs is the Senior Vice President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

ket purchases early in March. In addition, this Bank also sold $6.8 million equivalent of Belgian francs from System balances, as well as some $8.9 million equivalent of German marks and $15.8 million equivalent of French francs from Treasury balances.

Meanwhile, the divergent trend between the United States weakening trade position and the continued strength of Germany's export surplus had kindled renewed debate over German exchange rate policy. During March, speculation over a possible revaluation of the mark became the dominant factor in the market. The mark, now at the top of the EC snake, pulled other European currencies up against the dollar as it posted new gains almost daily. The Federal Reserve intervened intermittently but in sizable amounts to sell a further $225.5 million equivalent of German marks by the end of March, financed by additional drawings on the swap line with the Bundesbank. These operations were conducted in close coordination with the Bundesbank, which also supplied marks on a substantial scale both by buying dollars outright and by intervening in the EC snake arrangement. In other operations during March, this Bank sold $10 million equivalent of Belgian francs from System balances and $17.9 million equivalent of French francs from Treasury balances.

By April, interest rates in the United States had turned around and began to move upward sharply while rates abroad were on an easing trend, thereby progressively reversing earlier interest-arbitrage differentials adverse to the United States. Moreover, trade figures for March showed a more modest United States deficit than generally expected in the market and a slightly reduced surplus for Germany. Nevertheless, the market remained fearful of a possible revaluation of the German mark or disbanding of the EC snake. In addition, publication of first-quarter figures, showing a drop in United States output and a distressing acceleration of domestic inflation, prompted gloomy market reassessments of United States business and foreign trade prospects. Developments in the Watergate affair also exerted a depressing influence on the international value of the dollar from time to time. As the dollar fell still further, the Federal Reserve continued to intervene and sold $51.6 million equivalent of marks in April, financed by further drawings under the swap line with the Bundesbank.

Over the three-month period, February-April, Federal Reserve and Treasury intervention amounted to $427.5 million. Of this total, $368.2 million was financed by Federal Reserve drawings on the swap line with the Bundesbank. As of the end of April 1974, $364.5 million of these drawings remained outstanding. During the period under review, market conditions ruled out any repayments of outstanding System swap debt in Swiss francs and Belgian francs amounting to $971.2 million and $261.8 million, respectively.

Apart from the $1 billion increase in the Federal Reserve swap line with the Bank of Italy on February 1, already reported, the only other change in the swap network during the period was an increase in the Federal Reserve's swap line with the Bank of England from $2 billion to $3 billion, effective March 26. As of April 30, swap lines between the System and other central banks totaled nearly $20 billion.