Treasury and Federal Reserve Foreign Exchange Operations Interim Report: August-October 1975

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Coming into August, the exchange markets were bullish for the dollar. By that time, the United States trade account had moved decisively into surplus. Growing signs of a United States economic recovery also helped bolster confidence in the dollar, while a firming of United States interest rates beginning in late June had added to interest differentials favoring short-term dollar placements. By contrast, economic recovery abroad was still lagging, and the market had come to expect additional stimulative measures, including lower interest rates, in several foreign countries. These considerations had gradually erased the market's previous extreme pessimism toward the dollar and had prompted a ground swell of demand for dollars in June and July, as earlier speculative positions against the dollar were unwound, adverse leads and lags were reversed, and arbitrage and investment funds were drawn into New York and the Euro-dollar market. By end-July, the dollar had climbed against the German mark by some 9¾ percent from mid-May and by almost 11½ percent from the lows of last February. As previously reported, the Federal Reserve had taken advantage of this recovery to acquire sufficient currencies to repay in full all remaining swap debt incurred in market operations in late 1974-early 1975.

During August the immediate optimism for the dollar waned somewhat, particularly after release of discouraging consumer and wholesale price figures for the United States. Following the previous sharp run-up, profit taking shaved some 1-2 percent from dollar exchange rates early in the month. The undertone was nevertheless firm, and over subsequent weeks the dollar continued to be bolstered by the sizable United States trade surplus and by favorable interest arbitrage differentials. In fact, the exchange markets remained in rough balance through the rest of August and early September.

Toward mid-September, bullish exchange market sentiment for the dollar resurfaced. While the economic picture remained little changed abroad, the United States recovery was, in the initial stages at least, progressing much more strongly than previously expected. Consequently, a renewed rise in some United States money market rates prompted expectations of even further increases in dollar interest rates. In response, traders resumed heavy bidding for dollars in the exchanges and dollar rates advanced across the board. To moderate the day-to-day rise, foreign central banks sold sizable amounts of dollars in their respective markets. The Federal Reserve bought modest amounts of German marks to add to working balances, accumulating \$59.3 million equivalent since early August. Moreover, when the Belgian franc dropped particularly sharply, the System took the opportunity to purchase \$6 million equivalent of francs to hold in balances. Demand for the dollar crested on September 22-23, when dollar rates reached some 4 to 5 percent above their late-July highs.

The mood of the market shifted abruptly in late September, however, as the long-brewing controversy over how to resolve New York City's fiscal difficulties began to influence the exchanges. By then, each new development was receiving widespread attention in the world press and, although very little of New York City debt is held abroad, an increasing number of foreign businessmen and officials were expressing concern over the broader implications of

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a possible default by the city. These concerns at first prompted precautionary selling of dollars by some traders, leading to a slippage of dollar rates. Then, in early October, United States interest rates turned down once again and, amidst scattered indications that the pace of the United States economic recovery might have slowed, some dealers shifted to expect further declines. Meanwhile, new forecasts of a near-term pickup of some European economies raised the prospect of a hardening of interest rates abroad. In this atmosphere of uncertainty, the dollar lost buoyancy and dollar rates were pushed sharply lower in sporadic bouts of selling pressure. In an effort to maintain order and resist the decline, foreign central banks entered the market as buyers of dollars, on some days in sizable amounts. The New York market also turned unsettled on several occasions in early October, and the Federal Reserve, operating on four days between October 1 through 15, sold a total of $50.1 million equivalent of marks from balances. Thereafter, the dollar leveled off around 4-5 percent below late-September highs. Exchange rates still fluctuated widely, however, as the market reacted to each new twist and turn in the New York City fiscal situation. On balance, foreign central banks continued to buy dollars through the month end. In New York, although the Federal Reserve remained prepared to intervene, the market was generally quiet and there was no further need for sales of foreign currencies. During periods of dollar buoyancy in October, the System purchased $36 million equivalent of marks for future contingencies.

In sum, during the period August-October the Federal Reserve purchased in the market and from correspondents a total of $95.3 million of German marks and $6 million of Belgian francs. Sales of currencies in the market which occurred in early October amounted to $50.1 million equivalent of marks. There were no new swap drawings by the Federal Reserve.

On August 29 the swap line between the Federal Reserve and the Bank of Mexico was increased by $180 million to $360 million. The full amount was subsequently drawn by the Bank of Mexico, in late September-early October, to meet temporary needs, and these drawings remained outstanding at the end of the period.

Table I

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, July 31, 1975	Drawings (+) or repayments (—) August 1 through October 31, 1975	System swap commitments, October 31, 1975
National Bank of Belgium	261.8	-0-	261.8
Swiss National Bank	371.2	-0-	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,232.9	-0-	1,232.9

Note: Discrepancies in totals are due to rounding.

Table II

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS AND THE BANK FOR INTERNATIONAL SETTLEMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding July 31, 1975	Drawings (+) or repayments (—) August 1 through October 31, 1975	Drawings on Federal Reserve System outstanding October 31, 1975
Bank of Mexico	-0-	+360.0	360.0
Bank for International Settlements (against German marks)	-0-	+ 58.0 — 58.0	-0-
Total	-0-	+418.0 — 58.0	360.0