Treasury and Federal Reserve Foreign Exchange Operations Interim Report: February-April 1976

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In early 1976, the dollar was largely shielded from the variety of tensions which developed in markets for other currencies. By that time the latest economic indicators suggested that the United States recovery was regaining momentum and was more solidly based than the more recent upturns in other industrial countries. Moreover, with the United States already having one of the lowest rates of inflation among industrial countries, the further moderation in the uptrend of prices here bolstered sentiment toward the dollar.

Elsewhere, divergent price and productivity performances among European countries had led many market participants to expect that exchange rate adjustments might again be necessary, both by those within the Economic Community (EC) "snake" arrangement and by other European countries whose trade is closely linked to that group. During January, concern over political and economic developments in Europe generated speculative pressures in markets for several European currencies. The Italian lira declined after the Bank of Italy withdrew temporarily from the market to conserve its reserves during a prolonged Cabinet crisis. In several other markets, central banks intervened sometimes heavily to moderate fluctuations in their currencies. The dollar occasionally came on offer against the German mark, Dutch guilder, and Swiss franc in late January, but Federal Reserve intervention was limited to modest sales of marks out of existing balances without renewed recourse to the System's swap arrangements with foreign central banks.

By early February, intense two-way speculation had developed within the EC snake arrangement. With the French franc heavily on offer and the German mark in demand, the two currencies were pushed toward the opposite extremes of the EC band. Strains also developed within the 1½ percent Benelux band, driving the Belgian franc to the bottom and the Dutch guilder to the top. Since the dollar figured heavily in these various dealings—both as a vehicle currency for many market participants and as an intervention currency for central banks—the dollar was soon caught up in the cross fire. With several central banks defending their own currencies through dollar sales, the potential for even larger accumulations of dollar balances in traders' positions began to weigh on market psychology. Dealers, therefore, sought to shift into currencies they believed more likely to rise in the very near future. In the process, the German mark began to rise more sharply, exerting an upward pull on other European currencies including those still under generalized selling pressure. Consequently, the dollar, which by February 2 had already slipped by 2½ percent against the mark from the late 1975 highs, declined a further 1½ percent by February 11.

As speculative pressures mounted, the French and German central banks stepped up their intervention to defend the limits of the snake, not only in dollars but in each other's currencies as well. At the same time, with the New York market also becoming unsettled, the Federal Reserve intervened on four days between February 2 and 11. The System sold a total of $137.4 million equivalent of marks, financed by $80.9 million of drawings under the swap arrangement with the Bundesbank and by use of existing balances. In addition, the System sold $19.6 mil-

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lion equivalent of Dutch guilders, drawn on the swap line with the Netherlands Bank.

The immediate strains on the snake then eased, as the concerted intervention by the member central banks was reinforced by strong statements by their respective governments denying the need or advisability of rate adjustment. Trading conditions gradually improved during late February, and the Federal Reserve intervened on only two occasions when the dollar dropped abruptly against the mark, selling a total of $15.8 million equivalent from balances. Otherwise, the dollar gradually rose against the main Continental currencies to above the levels of early February, providing the opportunity for the System to acquire $54.1 million of marks in the market and from correspondents. Part of these acquisitions was used in early March to repay $26.4 million of the recently incurred swap indebtedness with the Bundesbank.

This temporary calm in the European exchange markets was again broken early in March, when sterling suddenly came under selling pressure and fell below the $2.00 level. Market fears of widespread readjustments in European currency relationships quickly resurfaced. By March 5, the EC snake was again stretched to its limits and required substantial intervention to maintain the prescribed margins. As market concern over the durability of existing parities in the European snake progressively deepened, intervention in EC currencies swelled to massive proportions. With markets increasingly nervous and unsettled, the Federal Reserve entered the New York market on March 5 and March 12 with offerings of marks, selling $52.8 million equivalent of which $23.2 million was financed under the swap line with the Bundesbank and the rest from balances.

Following a meeting of EC Finance Ministers over the weekend of March 13-14, the French government announced that it would withdraw the franc from the snake. At the same time, the Dutch and Belgian authorities announced the suspension of the separate 1½ percent Benelux band. Over subsequent days, however, speculation persisted over the possibility of further adjustments in rates for other European currencies and bidding for marks remained strong, pushing the dollar down a further 1 percent. These pressures spilled into the New York market on March 16-17, and the Federal Reserve again intervened in marks, selling $34.9 million equivalent of which $29.8 million was drawn under the swap line and the remainder from balances. Thereafter, further sizable intervention in European currencies, supported by restrictive monetary measures by those countries whose currencies were pinned to the bottom of the snake, and firm denials by German and other EC government officials of any intention of altering existing parities led to a gradual relaxation of these speculative tensions.

Meanwhile, evidence of additional improvement in production and employment levels in the United States, coupled with further encouraging price developments, reinforced the generally favorable market sentiment toward the dollar. Market expectations of an early firming of United States short-term interest rates also had a steady-

Table I

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 31, 1976	Drawings (+) or repayments (—) February 1 through April 30, 1976	System swap commitments, April 30, 1976
National Bank of Belgium	252.9	— 81.3	171.7
German Federal Bank	-0-	{+133.9 {— 53.9	80.0
Netherlands Bank	-0-	{+ 19.6 {— 19.6	-0-
Swiss National Bank	567.2	{+600.0* {— 20.0	1,147.2
Bank for International Settlements	600.0	—600.0*	-0-
Total	1,420.1	{+753.5 {—774.8	1,398.8

Note: Discrepancies in totals are due to rounding.
* Consolidation of Swiss franc swap debt.

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 January 31, 1976	Drawings (+) or repayments (—) February 1 through April 30, 1976	Drawings on Federal Reserve System outstanding April 30, 1976
Bank of Italy	250.0	+250.0	500.0
Bank of Mexico	-0-	+360.0	360.0
Total	250.0	+610.0	860.0

ing influence. Consequently, although the dollar was at times caught up in the backwash of further flows out of sterling and the Italian lira in late March and April, it traded fairly narrowly against the mark and other currencies in the EC snake. The Federal Reserve therefore intervened only once in late March, selling $9.9 million of marks from balances. Otherwise, taking advantage of the dollar's basic buoyancy on quiet days, the Federal Reserve acquired currencies needed to repay swap debt. The System thus purchased $119.6 million of marks in the market and from correspondents, liquidating a further $27.5 million of commitments in that currency, and bought sufficient guilders in the market to liquidate in full the $19.6 million swap on the Netherlands Bank incurred in February.

In summarizing operations over February-April, the Federal Reserve sold in the market a total of $270.4 million equivalent of foreign currencies. In marks, System sales amounted to $250.8 million, with $133.9 million financed by drawings under the swap arrangement with the Bundesbank and $116.9 million from balances. Mark purchases totaled $173.7 million equivalent of which $53.9 million was used to liquidate swap drawings on the Bundesbank, leaving $80 million equivalent outstanding at the end of the period. The System also sold $19.6 million equivalent of Netherlands guilders financed by a swap drawing, which was subsequently repaid with balances acquired in the market.

In addition, the Federal Reserve made further progress in repaying swap debt outstanding since August 1971. Throughout the period the System continued to buy Belgian francs in the market and from correspondents, purchasing $74.9 million equivalent. These acquisitions, together with existing balances, were used to repay $81.3 million equivalent of the drawings on the National Bank of Belgium, leaving $171.7 million outstanding at end-April. The Federal Reserve in February transferred its $600 million of Swiss franc swap debt from the Bank for International Settlements to the Swiss National Bank. During the period, the System purchased $33.2 million equivalent of Swiss francs from correspondents and liquidated $20 million of its debt with the Swiss central bank. Swiss franc commitments outstanding at end-April totaled $1,147.2 million.

Also during the period, the Bank of Italy, after resuming market operations in early March, drew $250 million on its swap line with the Federal Reserve, raising total drawings to $500 million. In addition, in early April, the Bank of Mexico drew the full $360 million available under its swap line with the Federal Reserve.