August-October 1977 Interim Report
(This report was released to the Congress and to the press on November 30, 1977.)

Treasury and Federal Reserve Foreign Exchange Operations

After the severe tensions in the exchanges of early summer, trading conditions tended to settle down during August and most of September. Nevertheless, market participants remained cautious in anticipation of possible actions to deal with divergent economic performances in several countries

With regard to the United States, concern over the implications of the trade deficit (then running at an annual rate of $30 billion), and how the United States would reduce it, had led to heavy selling pressure on the dollar and a decline in dollar exchange rates in July. But by early August the United States authorities had provided strong reassurances that a generalized decline in dollar rates was not an objective of United States policy Officials stressed that the deficit reflected our increasing dependence on foreign sources of petroleum and the more rapid expansion of the United States economy relative to the growth performances of the other major industrialized countries. The Administration emphasized that its energy proposals then before the Congress, negotiations to liberalize trade in world markets, and economic recovery abroad were appropriate for adjusting imbalances in the international economy Indeed, economic growth was failing to live up to expectations in industrial countries with strong trade surpluses. In response, the governments of Japan and Germany reviewed official policies to consider means of bringing their respective economies closer to their growth targets for the year Under these circumstances, the market expected interest rates abroad to remain steady or even to decline.

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Meanwhile, in view of a sharp rise in the monetary aggregates, interest rates in the United States advanced in early August and, if anything, were expected to rise further over the near term. Thus the dollar firmed against many major currencies. With the dollar advancing, the Federal Reserve was able to buy German marks in the market and from correspondents to repay the full $35 4 million of swap indebtedness to the German Bundesbank incurred in July and to rebuild working balances. Thereafter, dollar rates held fairly steady over the next several weeks. On August 24, when the New York market became briefly unsettled ahead of the release of United States trade figures for July, the Federal Reserve intervened and sold $8 million equivalent of marks out of balances. Otherwise, with the markets generally more settled, the System refrained from intervention through late September.

In some exchange markets, however, the dollar remained on offer. The pound sterling, in particular, was in strong demand as a result of the swing toward surplus in the United Kingdom's current account, an influx of funds into British securities, and the expectation that sooner or later the United Kingdom authorities would allow the pound to rise. The Bank of England continued to buy dollars in volume to keep sterling from rising on an effective trade-weighted basis, and it permitted further declines in British short-term interest rates. Other currencies which a year before had also been under selling pressure, such as the Italian lira and the French franc, remained firm. In addition, the Swiss franc began to be bid up once again, not only against the dollar but against other European currencies as well.

During September, there were signs in the United States of some slowing in the pace of expansion but the growth of the monetary aggregates remained uncomfortably strong. At the same time, the Administration's energy proposals ran into difficulties in the Congress and representatives of several industries stepped up their efforts to obtain protection against foreign competition. Abroad, several governments announced new measures to stimulate their economies But these measures were seen in the market as taking effect only over the medium term and not likely to generate an early trade adjustment. These developments reinforced market pessimism over the outlook for the United States trade account and for the dollar more generally.

Market conditions started to deteriorate during the International Monetary Fund-World Bank meetings in Washington on September 25-30. As financial officials gathered for the meetings, the discussions quickly centered on the slow economic growth of countries with current account surpluses. In the course of these talks, it was generally accepted that there was a need for greater growth in those countries and that the United States trade deficit would remain large until a strong energy program was adopted and as long as the United States economy continued to expand faster than those abroad. The Japanese, in particular, were urged by other governments to find a means of generating more growth at home and reducing their huge trade surplus, which was running at a $17 billion annual rate. Following open discussion of Japanese policy, heavy demand for Japanese yen erupted in late September, driving up the yen rate.

The rise of the yen against the dollar had a spillover effect in other markets, and the dollar came on offer against most other currencies as well. As in other periods of exchange market tensions, the Swiss franc was bid up sharply and the German mark also began to rise. In the case of sterling, the Bank of England again intervened to hold the effective exchange rate within narrow limits But the sterling counterpart to the Bank of England's dollar purchases became so great as to threaten to undermine domestic monetary objectives, and the British authorities ultimately permitted the pound to float more freely

With exchange markets increasingly disorderly, central banks intervened more heavily. The Bundesbank

Table 1

Federal Reserve System Drawings and Repayments under Reciprocal Currency Arrangements

In millions of dollars equivalent, drawings (+) or repayments (−)

Transactions with	System swap commitments, July 31, 1977	Drawings or repayments August 1 through October 31, 1977	System swap commitments, October 31, 1977
German Federal Bank .	35 4	+181 1 − 35 4	181 1

Data are on a value-date basis with the exception of the last two columns which include transactions executed in late October for value after the reporting period

Table 2

Federal Reserve System Repayments under Special Swap Arrangement with the Swiss National Bank

In millions of dollars equivalent

System swap commitments July 31, 1977	Repayments August 1 through October 31, 1977	System swap commitments October 31, 1977
705 4	−139 7	565 7

Data are on a transaction-date basis

Table 3

United States Treasury Securities Foreign Currency Series Issued to the Swiss National Bank

In millions of dollars equivalent, issues (+) or redemptions (−)

Amount of commitments July 31, 1977	August 1 through October 31, 1977	Amount of commitments October 31, 1977
1,341 5	−89 7	1,251 8

Data are on a transaction-date basis

bought sizable amounts of dollars to stabilize trading conditions in Frankfurt. In New York, the Federal Reserve intervened on each trading day between September 30 and October 4 and sold $80 7 million equivalent of marks. Of this amount, $35.8 million equivalent was drawn on the swap line with the Bundesbank and the remainder was financed from balances

Although these operations helped to settle trading conditions temporarily, the dollar remained vulnerable, as market sentiment turned increasingly bearish. Traders ignored fundamental factors which would normally favor the dollar These included release of statistics showing that the United States economic expansion remained solidly based, evidence that our inflation rate was still one of the lowest among the major industrialized countries, and a further rise in United States short-term interest rates. In this atmosphere, trading in dollars frequently became one way, and exchange rates moved abruptly To the extent that the dollar suddenly came on offer in other markets, the respective central bank intervened to counter the disorder. When trading conditions became unsettled in New York, the Federal Reserve countered the disorder with occasionally sizable sales of German marks Over the fourteen trading days spanning October 12 through 31, the Federal Reserve intervened on five days, selling a total of $148.0 million equivalent of marks Of this amount, $145.4 million of marks was drawn on the swap line with the Bundesbank and the remainder was financed out of balances. This intervention in marks was accompanied by sales of Swiss francs in New York on behalf of the Swiss National Bank, which also continued to intervene in the Zurich market.

Over the three months August-October, the dollar declined a net 2 percent against the German mark, 6 percent against sterling, 7 percent against the Japanese yen, and 8 percent against the Swiss franc. The only major currencies that declined against the United States dollar were the Canadian dollar, which fell 3¼ percent on balance, and the Swedish krona, which dropped a net 7½ percent following its withdrawal from the European "snake" arrangement in August.

In operations during the period, the Federal Reserve sold $236 8 million equivalent of marks, financing these sales out of balances and with drawings of $181.1 million equivalent under the swap line with the Bundesbank. These drawings remained outstanding at the close of the period. Otherwise during periods of dollar buoyancy, the System bought $79.5 million equivalent of marks in the market and from corrrespondents and repaid $35 4 million of swap drawings incurred in July.

In addition, the Federal Reserve and the United States Treasury continued to make progress in repaying Swiss franc indebtedness to the Swiss National Bank. The Federal Reserve liquidated $139 7 million equivalent of special swap debt with the Swiss central bank, leaving $565 7 million equivalent of indebtedness still outstanding as of October 31 These repayments were financed with francs purchased directly from the Swiss National Bank mainly against dollars, but also against marks and French francs The United States Treasury's Exchange Stabilization Fund used Swiss francs purchased directly from the Swiss central bank to repay $89 7 million equivalent of franc-denominated securities, leaving $1,251.8 million equivalent of these obligations outstanding as of October 31.