August-October 1978 Interim Report
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Treasury and Federal Reserve Foreign Exchange Operations

During the three-month period under review, market pessimism toward the dollar deepened. As selling pressure intensified, dollar rates plunged to record lows against several currencies, exceeding any levels justified by underlying economic conditions. On November 1, the United States authorities reinforced earlier measures to bolster the United States external position and to curb inflation by mounting a major new effort, in coordination with the authorities of several other industrial countries, to correct what President Carter termed "the excessive decline of the dollar". The November 1 package was broadly well received, and good two-way trading was soon restored with the dollar at levels significantly above the end-October lows.

The market's pessimism during the August-October period reflected the persistence of serious economic imbalances among major industrial nations. For some time, market participants and government officials alike had expressed concern over the differential rates of economic growth between the United States, which had posted a solid expansion since 1975, and most other industrial countries, where growth had been disappointingly slow. This difference in growth performance, coupled with special factors such as the earlier jump in the United States oil import bill, had contributed to a massive imbalance in trade and current accounts among the industrial countries, with the United States in substantial deficit and others, such as Japan, Germany, and Switzerland, in substantial surplus.

The dollar exchange rates against the currencies of these countries had already declined substantially over the previous year, but the effects of these changes on trade balances had not yet fully materialized. Moreover, the dollar's decline was contributing to the quickening of inflation in this country. By contrast, in other countries price performance was improving, particularly where the appreciations of currencies lowered import costs.

Many market participants had become skeptical that these disparities in price trends would be reversed in the near term and perceived a considerable downside risk for the dollar. Professional dealers therefore became reluctant to buy and hold dollars whenever the dollar came on offer. Trading in dollars became increasingly one way. Some market participants found that they could profit by selling dollars short, while others sought to protect themselves against further erosion of the value of their assets by shifting into foreign currencies and into commodities such as gold. Beginning in September, the tensions in the dollar market were compounded by a renewed burst of speculation over a possible realignment of currencies within the European Community (EC) "snake" as a prelude to the broader European Monetary System under negotiation by EC members. The German mark was revalued against the other snake currencies on Octo-

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ber 15, but the reversal of the earlier positions had barely begun by the month end.

By late summer-early fall, however, underlying conditions were beginning to improve and there was reason to expect that the improvement would continue. Economic expansion in Germany and Japan was more solidly based, and the governments were introducing additional stimulative measures. For Japan, export and import volumes were beginning to respond to the exchange rate change At the same time, the growth of the United States economy was moderating. Following the bulge in the United States trade deficit early this year, import demand was beginning to slacken while exports were expanding rapidly Moreover, further stabilization measures were being taken by the United States authorities Monetary and fiscal policies were progressively tightened The Congress passed the long-awaited energy bill On October 24, President Carter announced a comprehensive anti-inflation program, including additional budgetary restraints and the introduction of voluntary wage and price guidelines.

Throughout the three-month period, the Treasury and the Federal Reserve continued to intervene to counter disorderly conditions in the New York market in operations conducted by the foreign exchange Trading Desk of the Federal Reserve Bank of New York These operations were mainly in German marks, on behalf of both the Federal Reserve and the Treasury, using balances acquired from correspondents or drawing on the respective swap arrangements with the German Bundesbank. The Desk also intervened in New York in Swiss francs both for the Federal Reserve, drawing on the swap line with the Swiss National Bank, and for the Swiss National Bank In all, the Desk operated on 31 of the 64 business days during the period, selling on behalf of the United States authorities a total of $2,204 4 million equivalent of German marks and $294 2 million equivalent of Swiss francs.

By the end of October, however, the decline of the dollar had clearly been excessive against a number of major currencies From the early-August levels, the dollar had fallen by a net 18 percent against the German mark, 17 percent against the Swiss franc, and 7 percent against the Japanese yen Moreover, the dollar had declined generally *vis-à-vis* other major European currencies against the French franc by 10 percent, the pound sterling by 8 percent, and the Italian lira by 6 percent. And, in view of the prevailing mood and trading conditions in the exchange markets, few expected the dollar's slide to stop on its own or be reversed over the short run

For the United States, the dollar's decline threatened

Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility October 31, 1978	Increases effective November 1, 1978	Amount of facility November 1, 1978
Austrian National Bank	250		250
National Bank of Belgium	1,000		1,000
Bank of Canada	2,000		2,000
National Bank of Denmark	250		250
Bank of England	3,000		3,000
Bank of France	2,000		2,000
German Federal Bank	4,000	2,000	6,000
Bank of Italy	3,000		3,000
Bank of Japan	2,000	3,000	5,000
Bank of Mexico	360		360
Netherlands Bank	500		500
Bank of Norway	250		250
Bank of Sweden	300		300
Swiss National Bank	1,400	2,600	4,000
Bank for International Settlements			
Swiss francs-dollars	600		600
Other authorized European currencies-dollars	1,250		1,250
Total	22,160	7,600	29,760

to undermine the effort to curb inflation, including the newly announced voluntary wage and price control program. It also threatened to undercut the efforts of the Japanese, German, Swiss, and other governments to stimulate domestic growth. Consequently, by late October the United States authorities were in close consultation with their counterparts in other countries, and the essential elements of a coordinated approach to correct the situation were in place by the month end.

On the morning of November 1, President Carter, the United States Treasury, and the Federal Reserve announced various actions to be taken. The President emphasized the link between this program and the broader anti-inflation policies of the United States Government as well as the fact that the program had been developed and would be implemented in close cooperation with major governments and central banks abroad. The program featured a further tightening of monetary policy, including a 1 percentage point increase in the Federal Reserve discount rate to a historic high of 9½ percent and a $30 billion package of foreign currency resources to finance United States participation in coordinated intervention in the exchange markets. For the Federal Reserve, this comprised a $7.6 billion increase in the swap network through increases in the swap arrangements with the German Bundesbank by $2 billion to $6 billion, with the Bank of Japan by $3 billion to $5 billion, and with the Swiss National Bank by $2.6 billion to $4 billion. The Federal Reserve also announced the activation of the swap arrangements with the Bank of Japan. For its part, the Treasury announced that it would draw $3 billion from the United States reserve position with the International Monetary Fund (IMF) and sell $2 billion equivalent of special drawing rights (SDR) to mobilize balances of German marks, Japanese yen, and Swiss francs. The Treasury also announced that it would issue foreign-currency-denominated securities up to $10 billion equivalent.

The Desk followed up the announcements with active intervention in the New York market in German marks, Swiss francs, and Japanese yen. These operations were fully coordinated with intervention by other central banks in their own markets and in New York for their own account. The dollar rebounded sharply, and there were similar favorable responses in United States financial markets generally. Over the next days the central banks occasionally found it necessary to respond forcefully. Gradually, however, the market came into better balance, with good two-way trading at levels well above the late-October lows. The technical conditions alone favored a firm dollar, as the covering of previous short positions and unwinding of commercial leads and lags began to bolster the demand for dollars. But the central banks remained prepared to intervene quickly and in size whenever renewed selling pressure on the dollar threatened to erupt. By November 30, the dollar had advanced by 11¾ percent against the German mark, 15½ percent against the Swiss franc, and 11½ percent against the Japanese yen.

As indicated, in intervention operations during the August-October period, the Desk of the Federal Reserve Bank of New York sold German marks and Swiss francs on behalf of the United States authorities. Of the $2,204.4 million equivalent sales of German marks, $1,318.4 million was for the account of the Federal Reserve and $886.0 million for the Treasury. Of the Federal Reserve's sales, $1,157.5 million equivalent was financed by drawings under the swap line with the Bundesbank. The rest was financed by balances acquired from correspondents. However, the Federal Reserve was able to liquidate a total of $551.9 million of swap debt in marks from other acquisitions of marks from correspondents during the three-month period. Consequently, net drawings by the System in marks for the period amounted to $605.6 million equivalent, raising the total to $1,256.1 million equivalent by October 31.

Similarly, the Treasury financed $796.9 million of its intervention in marks by drawings on its swap arrangement with the Bundesbank, with the rest coming from balances. The Treasury's repayment of previous swap debt amounted to $343.5 million equivalent during the three-month period. Total debt under the Treasury's swap line rose by a net of $453.4 million equivalent to $650.4 million equivalent at end-October.

In Swiss francs, the Federal Reserve sales of $294.2 million equivalent were financed by further drawings on the swap arrangement with the Swiss National Bank. The System's swap debt for current operations in Swiss francs rose from $22.9 million of francs in early August to $317.0 million equivalent on October 31.

In addition, the Federal Reserve and the United States Treasury continued with the program agreed to in October 1976 for an orderly repayment of pre-August 1971 Swiss franc-denominated liabilities still outstanding with the Swiss National Bank. The Federal Reserve liquidated $91.9 million equivalent of special swap debt with the Swiss central bank, leaving $186.9 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. The Treasury used Swiss francs purchased directly from the Swiss central bank to repay $137.5 million equivalent of franc-denominated securities, leaving $712.9 million equivalent of these obligations still outstanding as of October 31.

In view of the dollar's depreciation, repayments of

Table 2

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, 1978	August through October 31, 1978	System swap commitments October 31, 1978
German Federal bank .	650 5	{+1,157 5 {− 551 9	1,256 1
Swiss National Bank ..	22 9	+ 294 2	317 0
Total	673 3	{+1,451 7 {− 551 9	1,573 1

Because of rounding, figures may not add to totals
Data are on a transaction-date basis

Table 3

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

In millions of dollars equivalent

System swap commitments July 31, 1978	August through October 31, 1978	System swap commitments October 31, 1978
278 8	−91 9	186 9

Data are on a transaction-date basis

Table 4

United States Treasury Drawings and Repayments under Swap Arrangement with the German Federal Bank

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

Amount of commitments July 31, 1978	August through October 31, 1978	Amount of commitments October 31, 1978
197 0	{+796 9 {−343 5	650 4

Data are on a transaction-date basis

Table 5

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, 1978	August through October 31, 1978	Amount of commitments October 31, 1978
850 4	−137 5	712 9

Data are on a transaction-date basis

Table 6

Net Profits (+) and Losses (−) on United States Treasury and Federal Reserve Foreign Exchange Operations

In millions of dollars

	Net profits (+) and losses (−) related to current operations		**Net profits (+) and losses (−) on liquidations of foreign currency debts outstanding as of August 15, 1971**	
Period	Federal Reserve	Exchange Stabilization Fund	Federal Reserve	Exchange Stabilization Fund
August 1, 1978 through October 31, 1978	−15 3	−3 2	−92 8	−129 7

earlier obligations in German marks and Swiss francs led to realized net losses for the Federal Reserve and the United States Treasury in operations during the August-October period. For the Federal Reserve, these amounted to $15.3 million on current operations and $92.8 million on liquidations of the longer term Swiss-franc indebtedness. For the Treasury, the realized net losses amounted to $3.2 million on current operations and $129.7 million on liquidation of the longer term Swiss-franc indebtedness.