August-October 1979 Interim Report
(This report was released to the Congress and to the press on December 4, 1979.)

Treasury and Federal Reserve Foreign Exchange Operations

Coming into the August-October period under review, exchange market participants were concerned over the outlook for the dollar, as progress toward reducing the United States trade deficit stalled and inflationary pressures in this country intensified further United States exports continued to expand smartly, but import growth also remained strong, reflecting the unexpected rebound in domestic economic activity as well as the upsurge in international oil prices which added massively to our oil import bill The rise in oil prices was also aggravating United States inflation at a time of considerable talk of an impending recession in this country Market participants thus increasingly questioned the credibility of the United States authorities' stated policy emphasis on the need to combat inflation, to curb oil imports, and to foster a strong dollar and stability in the exchange markets

In this regard the markets focused on relative monetary conditions here and abroad Interest rates in other major industrial countries had moved higher through 1979 in response to growing credit demands and accelerating inflation The German economy in particular had built up a head of steam, and the Bundesbank had acted to slow the growth of money and credit As German interest rates rose, the authorities of other European countries whose currencies were linked directly or indirectly to the German mark also moved to increase domestic interest rates For those countries where economic activity remained sluggish, the decision to tighten monetary policies was especially difficult But the authorities stressed the need to raise domestic interest rates at least in line with the increase in domestic inflation rates rather than risk an erosion of the external values of their currencies that would aggravate domestic inflationary pressures In the United States, strong growth of the monetary aggregates had resumed in the late spring and early summer and the Federal Reserve also acted to raise the Federal funds rate Nevertheless, interest rates here did not advance by as much as interest rates in most other industrial countries, and differentials in favor of dollar placements narrowed accordingly Moreover, many market participants had become increasingly concerned that United States interest rates had not risen sufficiently to take account of the surge of inflation and of inflationary expectations in this country.

By early August, heavy intervention by the United States authorities in the early summer had blunted the selling pressures on the dollar and was reflected, in part, by an increase in the Federal Reserve's outstanding swap drawings to $2,053 3 million equivalent of marks and $31 7 million equivalent of Swiss francs as of end-July. Moreover, President Carter's appointment of G William Miller as Secretary of the Treasury and Paul A Volcker as Chairman of the Federal Reserve had been welcomed in the markets as indicating the Government's resolve to deal with inflation and the dollar problem Against this background the exchange markets turned quieter during most of August Even so, confidence in the dollar remained tenuous, and a substantial reflux of funds into dollar-denominated assets

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did not materialize. The United States authorities sharply reduced their intervention, operating in the exchange markets on only three occasions and selling a total of $448.1 million equivalent of marks. At the same time the Federal Reserve was able to purchase through transactions with correspondents enough marks and Swiss francs to make small net repayments on previous swap drawings with the Bundesbank and to liquidate drawings with the Swiss National Bank.

By late summer, market sentiment had deteriorated. Although market interest rates in the United States continued to firm, interest rates elsewhere also advanced further, particularly in Germany. Moreover, even though the dollar had not recovered to earlier levels, some central banks began to support their currencies by selling dollars and other currencies. Many in the market interpreted reports of official dollar sales as indicating an unwillingness to let the dollar rise should it come into demand and, more broadly, as a breakdown in central bank cooperation With the latest price indicators for the United States still rising at double-digit annual rates, the dollar was left vulnerable to selling pressure Thus, by early September, the dollar came on offer once again against the German mark and other European currencies. The demand for marks also swelled on expectations of a near-term revaluation of the mark against other currencies within the European Monetary System (EMS). Intervention to maintain the exchange rate limits within the EMS mounted rapidly, and the participating central banks sold increasingly large amounts of marks Nevertheless, the demand for marks was so strong that it pulled up EMS currencies as a group against the dollar.

Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility October 31, 1979
Austrian National Bank	$ 250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700*
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Swiss francs-dollars	600
Other authorized European currencies-dollars	1,250
Total	$30,100

*Increased by $340 million, effective August 17, 1979

As the decline in the dollar gathered momentum, the United States authorities intervened forcefully once again, selling substantial amounts of marks almost every day during September. In view of the continuing excessive growth of the monetary aggregates, the Federal Reserve raised the Federal funds rate further and hiked the discount rate ½ percentage point to a record 11 percent on September 18 But, in the atmosphere of concern over United States resolve to combat inflation, market participants reacted more to the fact that the discount rate increase was approved by a split 4-3 vote of the Board of Governors than to the tightening in monetary policy Consequently, selling pressure continued as commercial leads and lags shifted against the dollar, corporations intensified efforts to hedge exposures before the quarter end, and some asset holders moved to diversify their portfolios In this environment the formal realignment of EMS currencies over the September 22-23 weekend relieved the tension among the participating currencies but not the broader pressures against the dollar.

Meanwhile, speculative excesses began to show up in a number of other financial and commodity markets in the United States and abroad Concern over international price stability heightened, as spot oil prices advanced once again and as OPEC (Organization of Petroleum Exporting Countries) members began to raise their contract prices above the range agreed last June. The price of gold soared to as high as $447 per ounce in early October This explosion in commodity prices was widely interpreted not just as a shift out of the dollar but as a shift out of currencies generally into tangible assets In the exchange markets, the Japanese yen in particular declined in response to the oil situation and to Japan's sudden shift into current account deficit. Otherwise the brunt of the speculative pressures fell on the dollar as the world's major trading and reserve currency In this atmosphere, market participants, the financial press, and politicians here and abroad were calling generally for improved monetary policy coordination among major industrial countries and, in particular, for the United States to take more effective action to bring United States inflation under control

By Tuesday, October 2, the dollar had declined by 4 percent against the German mark and by 1 to 5 per-

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, 1979	August through October 31, 1979	System swap commitments October 31, 1979
German Federal Bank ..	2,053 3	+1,844 1 − 492 1*	3,443 9
Swiss National Bank	31 7	+ 44 2 − 76 0	-0-
Total . . .	2,085 1	+1,888 3 − 568 0*	3,443 9

Because of rounding, figures may not add to totals

Data are on a transaction-date basis

* Repayments exclude revaluation adjustments from swap renewals, which amounted to $38 6 million for drawings on the German Federal Bank renewed during the period

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, 1979	August 1 through October 31, 1979	Amount of commitments October 31, 1979
-0-	+337 7 −337 7	-0-

Data are on a value-date basis

Table 3

Drawings and Repayments by Foreign Central Banks and the Bank for International Settlements under Reciprocal Currency Arrangements

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

Banks drawing on Federal Reserve System	Outstanding July 31, 1979	August 1 through October 31, 1979	Outstanding October 31, 1979
*Bank for International Settlements (against German marks) ..	-0-	+39 0 −39 0	-0-

Data are on a value-date basis

* BIS drawings and repayments of dollars against European currencies other than Swiss francs to meet temporary cash requirements

Table 6

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

In millions of dollars

Period	Federal Reserve	United States Treasury: Exchange Stabilization Fund	United States Treasury: General Account
August 1 through October 31, 1979 . . .	−12 6	+ 56 5	+ 16 2
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1979	+ 1 2	−358 8	−123 9

Data are on a value-date basis

Table 5

United States Treasury Securities, Foreign Currency Denominated

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

Issues	Amount of commitments July 31, 1979	August through October 31, 1979	Amount of commitments October 31, 1979
Public series:			
Switzerland	1,203 0	-0-	1,203 0
Germany	2,946 7	-0-	2,946 7
Total	4,149 7	-0-	4,149 7

Data are on a value-date basis

cent against other European currencies, compared with early-August levels. In their intervention during September and early October, the United States authorities sold a further $3,720.9 million equivalent of marks shared about evenly between the Federal Reserve and the Treasury. The Federal Reserve financed most of its mark intervention by drawing an additional $1,762 2 million equivalent under the swap line with the Bundesbank, bringing total drawings to $3,746.0 million after allowing for further repayments and revaluation adjustments from swap renewals. The remainder of the System's mark sales and all the Treasury's intervention was financed out of balances. The Treasury's $337.7 million equivalent drawing and repayment on the swap line with the Bundesbank reflected temporary financing, while Treasury holdings of German government securities were being liquidated. The Federal Reserve also resumed intervention in Swiss francs, selling $44 2 million equivalent drawn on the swap line with the Swiss National Bank.

By that time, however, the exchange markets were alive with rumors of a new support package for the dollar Market participants followed closely the news reports surrounding the Hamburg meeting between United States and German officials and the annual meetings of the International Monetary Fund and World Bank in Belgrade, Yugoslavia, in the first week of October. When it was learned in the market that Chairman Volcker had left Belgrade early to return to Washington, dollar rates rallied on expectations of dramatic new policy action, and the Trading Desk had no further need to intervene. On Saturday, October 6, the Federal Reserve announced a series of complementary actions to assure better control over the expansion of money and credit, to help curb speculation in financial, foreign exchange, and commodity markets, and thereby to dampen inflationary forces. The actions included a 1 percentage point increase in the discount rate to 12 percent and the imposition of an 8 percent marginal reserve requirement on increases in managed liabilities. In addition, the System announced that it would place greater emphasis on the supply of bank reserves in its open market procedures and less emphasis on the Federal funds rate in seeking to reach its monetary aggregates objective.

In the days following these measures, interest rates in the Eurodollar and domestic markets moved up sharply. Although there was considerable uncertainty at first, the exchange markets reacted positively on balance both to the announced Federal Reserve actions and to the subsequent rise in dollar interest rates. Through the remainder of October the dollar traded more firmly despite the continued advance of interest rates abroad, the lack of improvement in the latest United States trade and inflation figures, the escalation in international oil prices, and growing uncertainties over the political situation in Iran Compared with early-October lows, the dollar was up 2 percent to 5 percent on balance against the European currencies by the month end. Against the Japanese yen and Canadian dollar the dollar rose 5 percent and 2 percent, respectively, during the period under review.

With the dollar on much better footing following the October 6 measures, the United States authorities did not intervene as a seller of foreign currencies through the rest of the month Rather, the improvement in the dollar enabled the Federal Reserve to step up repayment of swap debt through purchases of foreign currencies from correspondents. As a result, by the month end the Federal Reserve had repaid $314.3 million equivalent of swap drawings on the Bundesbank, reducing the total to $3,443 9 million, and had arranged acquisition of a sufficient amount of Swiss francs to liquidate outstanding drawings in that currency.

During the period under review, the System realized net losses of $12.6 million on its exchange market operations. The Exchange Stabilization Fund (ESF) realized net profits of $56 5 million, while the Treasury's General Account realized net profits of $16.2 million. Valuation losses were $358 8 million for the ESF and $123.9 million for the General Account, while the System had valuation profits of $1.2 million. Also in August the Federal Reserve's reciprocal swap arrangement with the Bank of Mexico was increased by $340 million to $700 million