Treasury and Federal Reserve Foreign Exchange Operations Interim Report

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As previously reported, in late 1974-early 1975, the exchange markets had been subject to an almost unremitting diet of bearish news for the dollar, and market forces drove dollar rates persistently lower. The economic downturn and the slide of interest rates in the United States had reinforced expectations of a further widening of interest differentials already adverse to the dollar. Gloomy forecasts emerging in the debates over economic and energy policies in Washington had further depressed the market. With individual oil-producing countries reportedly growing restive over the dollar's depreciation, market fears of an accelerated diversification of oil proceeds to other currencies had intensified. In addition, reports that the market might be left short of some continental European currencies as a result of the failure of several financial institutions last year had triggered further bidding for foreign currencies. In this atmosphere, the market had ignored favorable news for the dollar, such as the underlying improvement in the United States trade balance and the slackening in our rate of inflation.

As the dollar rates fell, the Federal Reserve had intervened in modest amounts on a day-to-day basis to cushion the decline, while other major central banks also intervened to buy dollars in their markets. But, with markets becoming increasingly nervous and unsettled, a more forceful intervention approach was clearly needed to avoid disorderly conditions, and during the last week of January the Federal Reserve and the Bundesbank stiffened their resistance to the further decline in dollar rates. By January 31, the Federal Reserve's swap debt incurred in market operations since October 1974 had accumulated to $412.5 million equivalent, of which $382.7 million was in German marks, $26.6 million in Swiss francs, and $3.2 million in Dutch guilders.

Over the weekend of February 1-2, senior officials of the Federal Reserve, the Bundesbank, and the Swiss National Bank met in London to conclude details of a coordinated, more forceful intervention approach. On Monday, February 3, the Bundesbank and the Swiss National Bank countered renewed selling pressure on the dollar through sizable dollar purchases while several other central banks joined in as buyers of dollars. The Federal Reserve followed up in New York with large offerings of marks, Swiss francs, Dutch guilders, and Belgian francs. Drawing on the respective swap lines, the Federal Reserve sold in two days a total of $139.4 million equivalent of currencies: $74.4 million of marks, $28 million of Swiss francs, $26.9 million of Dutch guilders, and $10 million of Belgian francs. This concerted operation, and its confirmation by Chairman Burns and by officials of the Bundesbank and the Swiss National Bank, prompted a recovery for the dollar of some 4 percent against the mark and Swiss franc.

Subsequent events, however, served to reinforce the bearish sentiment toward the dollar. During the first weeks of February, the cut in Federal Reserve discount rates, subsequent reductions in prime rates, and release of sharply higher unemployment figures seemed to reconfirm market expectations that the decline in United States interest rates would continue to outpace those of other countries. In fact, the easing of most money market rates in the United States was more gradual in February than before and in line with the downturn of rates already emerging in most European centers. Nevertheless, in the absence of

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strong domestic credit demand, United States banks continued substantially to increase their loans and reduce their liabilities to foreigners. Moreover, market concern over the possibility of large-scale diversification into continental European currencies was heightened by repeated statements from OPEC (Organization of Petroleum Exporting Countries) officials that they were seeking ways to protect the value of their oil receipts from a further decline in dollar rates.

Against this background, the dollar came under renewed and occasionally heavy selling pressure which persisted through most of February and drove dollar rates back to the late January lows and beyond. The Federal Reserve, the Bundesbank, and the Swiss National Bank remained prepared to intervene forcefully, as necessary, to avoid the outbreak of disorderly conditions but without holding exchange rates at any particular level. The Federal Reserve intervened on ten of the fourteen business days between February 5 and February 26, selling a total of $278.2 million of German marks and $74.4 million of Swiss francs, all drawn on the swap lines with the respective central banks. Market pessimism was nevertheless so entrenched that, when on February 27 the United States released clearly improved trade figures for January, the dollar failed to rise and the New York market was soon flooded with speculative selling out of Europe. The Federal Reserve quickly countered with offerings of foreign currencies, selling $56.7 million equivalent of marks, $20.9 million equivalent of Swiss francs, $20 million equivalent of guilders, and $6.6 million of Belgian francs, all financed by drawings on the respective swap lines. This operation was followed up with sustaining intervention the next day, amounting to $23.7 million of German marks drawn on the Bundesbank, and helped set the stage for an improved market atmosphere beginning early in March.

By then, interest rate differentials were shifting in favor of the dollar, as the decline in United States interest rates slackened further while interest rates elsewhere continued to fall. In addition, reports of disagreements within OPEC eased some of the immediate concerns in the market that the group would collectively cut production or boost prices further. Moreover, a number of statements by United States officials emphasizing the fundamental strengths in this country's trade and payments position and rejecting a "benign neglect" policy toward the dollar helped to harden the market's view that dollar exchange rates were about to bottom out. The market's pessimism began to lift and dollar rates staged a tentative recovery. Meanwhile, the Federal Reserve had acquired $102.3 million of German marks from the Bank of Italy in connection with an Italian drawing on the International Monetary Fund and repaid $25 million of swap debt with the Bundesbank. Using the remainder of these marks, the Federal Reserve continued to intervene to resist a backsliding in rates that threatened to undermine a more solid recovery, selling in the first four days of March $63.3 million of marks from balances and $9.5 million of Swiss francs financed by further swap drawings.

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 31, 1975	Drawings (+) or repayments (—) February 1 through April 30, 1975	System swap commitments, April 30, 1975
National Bank of Belgium	261.8	+16.7 —16.7	261.8
German Federal Bank	382.7	+491.7 —269.6	604.7
Netherlands Bank	3.2	+49.0 -0-	52.2
Swiss National Bank	397.8	+132.8 —159.4	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,645.4	+690.2 —445.7	1,889.9

Note: Discrepancies in totals are due to rounding.

Thereafter, Federal Reserve intervention tapered off sharply and was limited to resisting sudden sharp drops in dollar rates that might rekindle more generalized selling pressure. The System operated on only five of the twelve business days between March 7 and March 24 to sell $55.8 million of marks, of which $47.1 million was financed by new swap drawings and the rest by balances. The Federal Reserve discount rate cut announced on March 7 had little exchange market impact, as it followed official lending rate cuts in several European centers. As time passed, the market became more resistant to unexpectedly adverse developments. The news on March 25 of King Faisal's assassination, for example, only temporarily unsettled the markets; although the Federal Reserve offered several currencies that day to avoid an abrupt decline in dollar rates, it sold only $2.1 million of Dutch guilders before the dollar steadied.

By this time, the Federal Reserve had increased its swap drawings by a net of $653.6 million to finance intervention in February and March, bringing total marketrelated indebtedness to a peak of $1,066.2 million. Of this, $837.8 million was in marks, $159.4 million in Swiss francs, $52.2 million in Dutch guilders, and $16.7 million in Belgian francs. Nevertheless, with market conditions becoming generally more settled, the Federal Reserve had begun to make modest daily purchases of currencies needed to repay that debt.

The dollar's tentative recovery gradually gave way to a more generalized advance that continued through most of April, as market sentiment improved further and outstanding short positions were covered. Underpinning the dollar's rise was mounting evidence of a basic improvement in United States trade and price performance, highlighted by news of successive record monthly trade surpluses in February and March. Moreover, United States interest rates leveled off, in anticipation of the United States Treasury's large borrowing needs in 1975, and the outflow of bank funds slowed.

As the dollar strengthened, the Federal Reserve was able to make progress in repaying swap debt. In late March and April, the System acquired sufficient marks both in the market here and abroad and directly from correspondents to repay $244.6 million of swap drawings. Moreover, the Federal Reserve purchased from the Swiss National Bank the francs needed to repay $159.4 million of swap drawings incurred since December 1974. The System also purchased in the market the Belgian francs needed to liquidate the $16.7 million of swap drawings with the National Bank of Belgium incurred in February. With the Dutch guilder at or near the upper limit of the European "snake" arrangement, however, the Federal Reserve refrained from purchasing guilders in the market.

Despite the dollar's greater buoyancy, the markets remained sensitive to potential diversification of OPEC funds into continental European currencies not only out of dollars but also out of sterling, which came under heavy selling pressure on several occasions during the month. When these concerns surfaced, the dollar occasionally came on offer, but the Federal Reserve intervened only four times—on April 8 and on three days between April 23 and April 29—to cushion sharp declines in dollar rates. These sales, in marks only, amounted to $42.6 million equivalent, of which $31 million was from balances and the remainder drawn on the swap line with the Bundesbank. In each instance, however, the dollar soon resumed its recovery. By the end of April, the dollar had advanced by 4 to 6 percent from its lows against the German mark and Swiss franc and by similar amounts against most major European currencies. On balance, the Federal Reserve reduced its outstanding swap debt incurred since October 1974 by $409.2 million to $657 million on April 30.

In summary, in exchange market intervention during the three-month period, the Federal Reserve sold a total of $793.2 million equivalent of foreign currencies. Of these, $594.7 million equivalent was in German marks, $491.7 million financed by drawings under the swap arrangement with the Bundesbank and the rest from balances. The System acquired in the market and from central bank correspondents sufficient mark balances to repay $269.6 million of swap drawings, leaving $604.7 million equivalent of mark debt outstanding on April 30. Intervention in Swiss francs amounted to $132.8 million equivalent all drawn on the swap line with the National Bank and fully repaid, along with $26.6 million carried over from December-January, by means of direct purchases of francs from the National Bank. In guilders, the System sold a further $49 million equivalent during the period, raising its swap drawings to $52.2 million equivalent. Finally, in Belgian francs, the $16.7 million equivalent of swap drawings on the National Bank of Belgium to finance exchange market intervention during the period was fully repaid through acquisitions in the market. On April 30, in addition to the $657 million equivalent of swap debt remaining from exchange market operations since October 1974, the Federal Reserve had $971.2 million equivalent of Swiss franc and $261.8 million equivalent of Belgian franc swap commitments outstanding since August 1971.

As described in the December 1974 and March 1975 reports, on September 26 of last year the Federal Reserve Bank of New York acquired the $725 million equivalent of forward exchange commitments of the Franklin National Bank. During the three-month period under review, the aggregate of outstanding forward contracts was further reduced by somewhat over $300 million to only $10.5 million on April 30.