February-April 1978 Interim Report
(This report was released to the Congress and to the press on May 31, 1978.)

Treasury and Federal Reserve Foreign Exchange Operations

In late 1977-early 1978, the United States dollar had come under generalized selling pressure in increasingly disorderly exchange market conditions. Among the steps taken by the United States authorities to counter the disorder, the Federal Reserve's foreign exchange Trading Desk had shifted in early January to a more open and forceful intervention approach, utilizing the resources of both the Federal Reserve and the United States Treasury. These operations, in coordination with the intervention by the trading desks of foreign central banks, helped restore a sense of two-way risk to the market and dollar rates settled somewhat above their earlier lows. On January 31, swap drawings in German marks on the Bundesbank had reached $1,251.2 million equivalent by the Federal Reserve and $407.4 million equivalent by the United States Treasury. The Federal Reserve had also drawn $18.9 million equivalent of Swiss francs under the swap arrangement with the Swiss National Bank to finance intervention in that currency.

Despite these actions, market psychology remained extremely bearish toward the dollar. Abroad, economic growth continued to fall short of official expectations, holding out little promise of an early reduction in the United States trade and current account deficits through a demand-induced expansion in our exports. In the United States, the Administration's energy bill, designed to curb the rise in oil imports over time, remained bottled up in the Congress. Moreover, both a prolonged coal strike and the fierce winter weather raised uncertainties over the near-term outlook for the domestic economy and the trade balance. And, of growing concern to the market, the pace of inflation was quickening in the United States even as price increases in other major countries continued to moderate.

These concerns underlay the heavy selling pressure on the dollar, which reemerged toward mid-February. As the markets again became unsettled, the United States authorities together with those of other major countries continued to intervene forcefully. The Federal Reserve Bank of New York operated on ten trading days between February 10 and 28, selling a total of $714.5 million equivalent of marks. These sales were split evenly between the Federal Reserve and the Treasury and were financed by drawings on their respective swap lines with the Bundesbank. The Federal Reserve also sold a further $50.1 million of Swiss francs, financed by drawings on its swap line with the Swiss National Bank.

By late February the dollar had declined generally, falling as much as 5 percent against the German mark and 9 percent against the Swiss franc. The Swiss authorities then imposed harsh new exchange controls

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Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility April 30, 1978
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	4,000*
Bank of Italy	3,000
Bank of Japan	2,000
Bank of Mexico	360
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	1,400
Bank for International Settlements	
Swiss francs-dollars	600
Other authorized European currencies-dollars	1,250
Total	$22,160*

* Increased by $2,000 million effective March 13, 1978

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 January 31, 1978	February through April 30, 1978	System swap commitments April 30, 1978
German Federal Bank	1,251.2	+592 6 −136 1	1,707 8
Swiss National Bank	18 9	+ 50 1	69 0
Total	1,270 1	+642.8 −136 1	1,776 8

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 January 31, 1978	February through April 30, 1978	System swap commitments April 30, 1978
470 1	−88 2	381 9

Data are on a transaction-date basis

Table 4

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 January 31, 1978	February through April 30, 1978	Outstanding April 30, 1978
*Bank for International Settlements (against German marks)	147 0	+148 0 −295 0	-0-
Total	147 0	+148 0 −295 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 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 January 31, 1978	February through April 30, 1978	Amount of commitments April 30, 1978
1,118 0	−123 4	994 6

Data are on a transaction-date basis

which went so far as to induce actual liquidations of nonresident investments in their country. With the exchange rate for the German mark approaching \$0.50 (DM 2.00 to the dollar), some traders feared that a clear breach of that level would lead to the broader use of exchange controls or of protectionist measures to contain the flow out of dollars. To the extent that such measures might trigger a snap back in dollar rates, some dealers were hesitant to take on new short positions at those levels and a few moved to cover short positions taken earlier. Consequently, although the mark rate rose briefly above \$0.50 in early March, it soon settled back without intervention by the Federal Reserve.

During March, some of the market's more basic concerns began to ease. Once the coal strike was settled and the weather improved, the United States economy showed signs of renewed vigor. Following his confirmation as Chairman of the Federal Reserve Board, Mr. Miller argued that in view of the economy's underlying strength the focus of economic policy should be shifted toward curbing inflation. Moreover, both President Carter and Chancellor Schmidt indicated that new consultations on economic and financial policy were under way between the two governments. With this sense of movement on the policy front, some bidding for dollars emerged.

On March 13, following their discussions, the United States and German authorities issued a joint statement. Among the elements of agreement, both sides reaffirmed that continuing forceful action would be taken to counter disorderly conditions in the exchange markets and that close cooperation to that purpose would be maintained. The swap line between the Federal Reserve and the Bundesbank was doubled to \$4 billion. Moreover, the United States Treasury announced that it was prepared to sell \$730 million equivalent of special drawing rights (SDRs) to Germany and, if necessary, to draw on its reserve position at the International Monetary Fund to acquire currencies which might be needed for intervention. Some dealers had anticipated more far-reaching provisions, however, and immediately following release of the statement the dollar came under a heavy burst of selling pressure. On that day and the next, this Bank, in coordination with the Bundesbank, again intervened forcibly selling a further \$372 million equivalent of marks financed through equal swap drawings by the System and the Treasury. Once the initial reaction passed, however, the market came into better balance.

Toward the month end the dollar briefly came under pressure following announcement of a record \$4.5 billion United States trade deficit for February and in the backwash of heavy flows into the Japanese yen. The New York Federal Reserve Bank intervened on two days, selling a total of \$120.2 million of marks. Of that total, \$98 7 million equivalent was financed by equal drawings by the System and the Treasury on swap lines with the Bundesbank and the rest came from balances. The swap drawings raised the combined mark indebtedness of the United States authorities to a peak of \$2,844 million equivalent, of which \$1,844 million equivalent was drawn by the Federal Reserve and \$1,000 million equivalent by the Treasury.

In April, further policy developments in the United States helped generate a better tone for the dollar. President Carter announced a series of proposals against inflation and pressed the Congress to move ahead on energy legislation For its part, the Congress scrapped some legislative items which were considered particularly inflationary and intensified its efforts toward a compromise on the energy bill. Also, as data on the monetary aggregates came in very strong, the Federal Reserve shifted to a less accommodative stance in the domestic money market, leading to a firming of interest rates. Both the exchange market and the United States stock market reacted favorably to these changes The United States Treasury's announcement of its intention to sell gold in a series of monthly public auctions beginning in May was also well received In all, by end-April, the dollar had moved well away from its lows against most major currencies, rising by 4 percent against the German mark.

With the markets generally more orderly and the dollar now more resilient to selling pressures, central bank intervention tapered off. The Federal Reserve Bank of New York intervened on only one further occasion in April, selling \$3.9 million equivalent of marks out of balances on April 27. Otherwise, the Federal Reserve and the Treasury purchased mark balances from correspondents and in the market to begin to liquidate swap debt. By April 30, the Federal Reserve had repaid \$136.1 million of drawings, reducing the amount outstanding to \$1,707.8 million equivalent, and the Treasury had repaid \$88.9 million equivalent, cutting its debt to \$911.1 million of marks.

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 franc-denominated liabilities still outstanding with the Swiss National Bank. The Federal Reserve liquidated \$88.2 million equivalent of special swap debt with the Swiss central bank, leaving \$381.9 million equivalent of indebtedness still outstanding as of April 30. 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 $123.4 million equivalent of franc-denominated securities, leaving $994.6 million equivalent of these obligations still outstanding as of April 30.

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From time to time in public discussions and academic literature reference has been made to foreign exchange profits and losses of the Federal Reserve and the United States Treasury. The Federal Reserve reports its realized net foreign exchange profits each year as part of its annual statement of earnings and expenses. The Exchange Stabilization Fund, which handles the foreign exchange operations of the United States Treasury, reports its net earnings on a quarterly basis, in the *Treasury Bulletin*. Table 6 recapitulates figures on realized gains and losses on an annual basis from 1961, when the United States authorities resumed foreign exchange operations.

For the period 1961-70, a single figure is given for each institution, reflecting profits or losses arising from operations undertaken at the time. For 1971 to date,

Table 6

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

In millions of dollars

Year	Net profits (+) and losses (−): Federal Reserve	Net profits (+) and losses (−): Exchange Stabilization Fund
1961		+0.2
1962	+0.3	+1.5
1963	+0.3	+0.9
1964	+0.1	−0.1
1965	+1.0	+3.5
1966	+1.4	+3.2
1967	+1.3	+1.5
1968	+8.1	+2.2
1969	+6.4	−1.0
1970	+3.0	−20.7
Total 1961-70	+21.9	−8.8

Year	Net profits (+) and losses (−) related to current operations: Federal Reserve	Net profits (+) and losses (−) related to current operations: Exchange Stabilization Fund	Net profits (+) and losses (−) on liquidations of foreign currency debts outstanding as of August 15, 1971: Federal Reserve	Net profits (+) and losses (−) on liquidations of foreign currency debts outstanding as of August 15, 1971: Exchange Stabilization Fund
1971	+3.7	+3.7	−11.9	+14.1
1972	+1.4		−54.5	−160.3*
1973	+1.3		−47.5	−231.5*
1974	+4.1		−37.7	−11.6*
1975	+8.0		−250.2†	−0.1*
1976	+6.2		−34.0	−13.8
1977	+4.6		−148.2	−113.0
Total 1971-77	+29.3	+3.7	−583.9	−516.2
January-April 1978	−8.1	−2.8	−77.5	−107.5

Because of rounding, figures may not add to totals The net profits and losses for the Federal Reserve are on a calendar-year basis. These figures may differ slightly from data reported in the Federal Reserve Board annual reports, in which net profits and losses realized in the last days of some years were reflected in the Income Statement for the following year

* Indicated net losses reflect revaluations of foreign currency liabilities to take account of the two dollar devaluations, except for $84.5 million in 1972 and $61.6 million in 1973 which were realized on repayments of debts.

† Of which $250.0 million reflects revaluations of foreign currency liabilities to take account of the two devaluations of the dollar.

the figures on current operations are shown separately from those on liquidations of foreign currency debts outstanding as of August 15, 1971, when the United States suspended convertibility of the United States dollar into gold. Although current exchange market operations in recent years have continued to yield net profits, intervention by the United States authorities has been conducted with the objective of countering disorderly conditions in the exchange market, not of aiming for profits. Indeed, the experience has been that in the first instance, when the dollar is declining in a one-way market, swap debt mounts and the United States authorities face possible losses on outstanding swap contracts. But once the market settles down and positions in the market are unwound, the dollar rates rise, providing the opportunity for the United States authorities to cover their debt at a reduced loss or even a profit. As a matter of policy, however, the United States authorities have chosen to repay debt as quickly as market conditions permit so as to maintain the short-term nature of the swap facilities rather than to wait for profits. The swap repayments in late April were at a loss, which is reflected in the figures for January-April 1978.

With respect to the net losses on foreign currency debt outstanding as of August 15, 1971, it must be remembered that the debt was incurred under a regime in which officially held dollars were convertible into gold, held by the United States Treasury. These financing techniques were among the many adopted by major countries to reduce the use of gold while providing the holder of the debt with protection against exchange risk. After the suspension of dollar convertibility in 1971, the dollar was formally devalued twice, in 1972 and 1973, and was floated in 1973. As recounted in this series of reports on Treasury and Federal Reserve operations, the debt has been repaid by a variety of means, but in fulfilling the contractual responsibility on exchange risk the United States authorities have absorbed the losses set forth in the table. To the extent that the United States gold stock was in fact conserved by the original operations, the increase in value of that gold at current market prices would be well in excess of the losses actually taken.