February-April 1980 Interim Report
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Treasury and Federal Reserve Foreign Exchange Operations

Coming into the February-April period under review, the exchange markets were caught up in various cross-currents. Market participants were troubled by the persistent rise in OPEC (Organization of Petroleum Exporting Countries) oil prices, the rapidly moving events in Iran and Afghanistan, and the deterioration in United States-Soviet relations. For the United States the higher oil price appeared to add further to the massive oil import bill already expected for this year. Proposals for additional defense expenditures raised the prospect of an enlarged budget deficit. Inflationary expectations showed signs of intensifying. But many of these developments raised difficult problems for other industrial countries as well. The continuing rise in international oil prices threatened to add to uncomfortably large current account deficits in Germany and Japan, among others, and to exacerbate inflation generally. The political tensions both in the Middle East and between the United States and the Soviet Union were thought to be as serious for the economic and military security of Western Europe and Japan as they were for the United States. These various uncertainties made traders especially cautious about taking positions and making markets, thereby adding to exchange rate volatility.

By February, the dollar had firmed somewhat from the lows of early January, but the recovery had been tentative and bouts of selling pressure occasionally emerged. On two occasions when the dollar came on offer during the first two weeks of the month the United States authorities intervened, selling a total of $240.8 million equivalent of marks and $22.5 million equivalent of Swiss francs. Most of these sales were financed out of balances of the Federal Reserve and the Treasury, but the sales of marks also entailed drawings by the Federal Reserve in the amount of $115.4 million equivalent under the swap line with the German Bundesbank. These operations raised the System's total mark swap debt to the Bundesbank to a peak of $2,746.3 million equivalent.

With the economic outlook for the industrial countries obscured by major uncertainties, market participants increasingly focused on interest rate developments here and abroad. The demand for money and credit in the United States increased quite rapidly, as inflationary expectations mounted and as the domestic economy appeared to be strong despite widespread forecasts of recession. Inflationary expectations also gripped the longer term financial markets, and bond yields rose sharply. As part of the efforts of the United States authorities to curb inflation, the Federal Reserve continued to adhere to the monetary policy approach adopted last October 6, placing greater emphasis than before on the supply of bank reserves and less emphasis on the Federal funds rate in seeking to moderate the domestic growth of money and credit. With the Federal Reserve thus restraining the growth of bank

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reserves in the face of the sudden increase in demand for money and credit in the United States, short-term dollar interest rates began to rise sharply The Federal Reserve followed up by raising the discount rate by 1 percentage point to 13 percent in mid-February, but market rates continued to climb

Interest rates abroad were also advancing but not so sharply as in the United States, and funds began to be switched into dollars in response to the increasingly favorable interest rate differentials As the dollar thus came into demand in the exchanges, frequently in the form of large buy orders, foreign central banks were quick to intervene as sellers of dollars out of their own reserves Inasmuch as these pressures occurred during the normal trading hours abroad, the Desk's activities in the New York market for account of the United States authorities were small, with purchases of $60 million equivalent of marks on two occasions through early March. Meanwhile, however, the United States authorities bought substantial amounts of marks from correspondents, mainly from the Bundesbank, and used those marks to reduce swap debt with the Bundesbank

By March, dollar exchange rates had advanced by some 2¼ percent against the German mark and other currencies within the European Monetary System (EMS), ½ percent against the pound sterling, and 5¼ percent against the yen, with trading becoming increasingly one way The Japanese authorities were particularly concerned about the heavy selling pressure on the yen, and on March 2 they announced a package of measures which included agreement by the Federal Reserve, the German Bundesbank, and the Swiss National Bank to cooperate in an effort to avoid an excessive decline of the yen For its part, the Federal Reserve agreed to purchase yen in the New York market for its own account and to provide resources to the Bank of Japan if needed under the existing $5 billion swap arrangement

In view of the continuing buildup of inflationary psychology and of strong credit demands in the United States, reports began to circulate that the United States authorities might impose credit controls as a supplement to the policy of monetary restraint A scramble for funds ensued as businesses attempted to secure lines of credit and as banks sought to fund their commitments, thus pushing up United States domestic and Eurodollar interest rates further As interest differentials favorable to the dollar progressively widened, the dollar came into even greater demand in the exchanges Investors adjusted their portfolios, commercial leads and lags swung heavily in the dollar's favor, and OPEC members increasingly placed surplus funds in dollar-denominated rather than in foreign currency-denominated assets. Professional and corporate borrowers, seeking an alternative to high-cost dollar financing, turned to money and capital markets abroad, where interest rates had risen far less rapidly, and converted their loan proceeds into dollars

This turn of events evoked a vigorous response abroad By then the authorities in other major countries were openly concerned that the sharp deprecia-

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 January 31 1980	February through April 30, 1980	System swap commitments April 30, 1980
Bank of France	-0-	+ 73 9	73 9
German Federal Bank	2,630 9	+ 502 9 −2,838 3*	296 4
Total	2,630 9	+ 576 8 −2,838 3*	370 3

Because of rounding, figures may not add to totals

Data are on a transaction-date basis

* Repayments include revaluation adjustments from swap renewals, which amounted to $0 8 million for drawings on the German Federal Bank renewed during the period

Table 2

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

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

Bank drawing on Federal Reserve System	Outstanding January 31, 1980	February 1, through April 30, 1980	Outstanding April 30, 1980
* Bank for International Settlements (against German marks)	-0-	+143 0 −143 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

tions of their currencies in the exchanges would add to domestic inflationary pressures through higher prices for oil and other imports. Consequently, central banks of several major countries stepped up their intervention in the exchanges. In addition, concern about inflation led many central banks to raise official interest rates, but money market rates for the dollar went up faster. In some cases, the authorities liberalized previous restrictions on capital inflows. The authorities of several countries negotiated actively with foreign official institutions, most notably those from OPEC, to gain investments in their respective currencies For their part the United States authorities continued to acquire marks, purchasing another $35 million equivalent in the market. These marks, together with $2,751.7 million equivalent purchased from correspondents since the beginning of the period, were used to liquidate in full the Federal Reserve's outstanding swap debt with the Bundesbank and to make interest payments on the Treasury's securities issued in the German capital markets.

On March 14, President Carter announced a broad anti-inflation program that included action aimed at balancing the fiscal 1981 budget deficit, a surcharge on imported oil, and authorization for the Federal Reserve under the terms of the Credit Control Act of 1969 to impose special restraints on credit expansion. Accordingly, the Federal Reserve asked the commercial banks to hold their growth of lending to United States residents to 6-9 percent during 1980, required special deposits from nonmember banks and other lending institutions, and raised the marginal reserve requirement on managed liabilities from 8 to 10 percent for large member banks and United States agencies and branches of foreign banks. In addition, the Federal Reserve imposed a 3 percentage point surcharge on large member banks' discount window borrowings. Following these measures, United States short-term interest rates continued to climb through late March and into early April, reaching unprecedented highs.

By late March the bidding for dollars had become so generalized that demand pressures, which had previously been concentrated more heavily in markets abroad, began erupting at any time during the 24-hour trading day. To counter disorderly conditions, the Desk entered the New York market in March and the first week of April as a buyer of German marks on thirteen occasions, of Swiss francs on four occasions, and Japanese yen on ten occasions. In early April the Desk also intervened on one occasion to purchase marks in the Far East. Between mid-March and early April, the Desk purchased an additional $761.6 million equivalent of marks in the market, which—combined with an additional $684.4 million equivalent acquired from correspondents—were added to System and Treasury balances. Between February 1 and early April the Federal Reserve purchased $185.1 million equivalent of Swiss francs, including $140.4 million equivalent in the market, which were added to System balances. Following up on the March 2 agreement with the Japanese authorities, the Federal Reserve bought a total of $216.8 million equivalent for its own account as part of joint operations with the Bank of Japan in the New York market. The Bank of Japan did not draw on the swap line.

In the five weeks through April 8, the dollar had advanced a further 11¼ percent against the German mark, 5¾ percent against the pound sterling, and 4¾ percent against the Japanese yen to reach the highest levels recorded in some two and a half years. Nevertheless, the scramble for funds in the United States had about run its course, and an increasing number of economic indicators were suggesting that overall economic activity in the United States was slowing rapidly. Under these circumstances, market participants began to sense that domestic interest rates would soon turn down. Meanwhile, foreign money markets had tightened up considerably, in part as a result of the recent heavy exchange market intervention

Against this background, once United States interest rates showed clear signs of declining in early April, the dollar came under immediate and heavy selling pressure. At this time also, dwindling prospects for a solution to the hostage situation seriously heightened political tensions between the United States and Iran, adding to the market's concerns about the dollar. On April 8-10 the dollar dropped sharply across the board, declining about 5 percent against the major European currencies in only twenty-four hours To cushion the decline, the Trading Desk intervened in size, operating in German marks and Swiss francs. The Desk also sold French francs, in consultation with the Bank of France, to avoid aggravating the weakness of the mark relative to the franc within the EMS.

Nevertheless, as interest rates continued to decline in the United States, and the sequence of weekly indicators showed that the key monetary aggregates were contracting, the dollar came under periodic selling pressure. Traders generally recognized that the Federal Reserve's policy of restraint on money supply growth was consistent with some easing in financial market conditions, particularly as demands for money and credit weakened and evidence of recession mounted. There were expectations that the momentum of inflation would slow in the months ahead, but traders remained concerned that interest rates were dropping more rapidly than anticipated. Abroad, interest rates generally held firm so that favorable interest

Table 3

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
February 1 through April 30, 1980	+34 9	+ 11 7	+ 3 7
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1980	−21 8	−360 8	−137 9

Data are on a value-date basis

differentials for the dollar were rapidly eroding The United States authorities stepped in fairly quickly to cushion the decline whenever the dollar came on offer in late April. These operations were closely coordinated with similar intervention by the Bundesbank and other foreign central banks and helped restore two-way trading in the exchanges

Gradually over the month, market participants focused somewhat less on interest rate considerations and more on broader economic developments Monthly data showed that the United States trade position was improving, while some evidence suggested a slowing in United States inflation As a result, dollar rates in the exchange market steadied By the end of April, although the dollar had declined as much as 9 to 11½ percent from its peaks against the major Continental currencies, it was still 2 to 3½ percent higher on balance for the three-month period under review Against the Japanese yen and the pound sterling, the dollar ended the period about ½ percent higher on balance

During April the United States authorities intervened on nine occasions in marks, selling a total of $1,183 million equivalent shared between the Federal Reserve and the Treasury. Most of these operations were financed out of balances, but System sales of $387 6 million equivalent were financed by drawings under the swap line with the Bundesbank At the same time the Federal Reserve was able to buy $50 4 million equivalent of marks in the market on two occasions and $91 1 million equivalent from correspondents, thereby adding to System balances and reducing System swap debt to $296 4 million equivalent by the month end During April, the System also operated in Swiss francs on three occasions, selling $80.2 million equivalent financed out of balances In addition, the Federal Reserve intervened in French francs on three occasions, selling a total of $73 9 million equivalent financed by drawings on the swap line with the Bank of France

During the period under review the Federal Reserve and the Treasury both realized profits on foreign exchange operations Table 3 shows that the System realized $34 9 million, the Exchange Stabilization Fund realized $11 7 million, and the Treasury's general account realized $3 7 million in profits. On a valuation basis, however, as of April 30 the System showed $21 8 million in losses on outstanding foreign exchange holdings and commitments The Exchange Stabilization Fund and the Treasury's general account, respectively, showed $360.8 million and $137 9 million in losses on outstanding assets and liabilities