August-October 1980 Interim Report
(This report was released to the Congress and to the press on December 3, 1980.)

Treasury and Federal Reserve Foreign Exchange Operations

Coming into the August-October period under review, exchange market participants remained cautious about the outlook for the dollar. Traders were encouraged by the improving trend in the United States current account, which had swung from deep deficit to near balance and was expected to move into surplus by late 1980 At the same time, however, they were concerned about the outlook for inflation in the United States. Even though our price indexes were no longer rising as rapidly as before, inflation remained uncomfortably high by historical standards and by comparison with inflation rates in many other industrial countries. Moreover, it was feared that the improvements in our current account and price performance might prove transitory to the extent that they stemmed from the sharp recession which had emerged in the United States earlier in 1980. Meanwhile, discussion of possible tax cuts or of an easing of monetary policy had generated concern in the market that heavy stimulus to the economy might undercut the anti-inflation effort. For its part, the Federal Reserve had phased out the special credit restraints imposed in March, but Chairman Volcker had made it clear that the Federal Reserve would continue to adhere to its efforts to slow the growth of money and credit in the United States by placing primary emphasis on bank reserves rather than on interest rates

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By August, United States interest rates were rebounding from their latest lows, and a sudden surge in the growth of the monetary aggregates gave rise to some expectations that United States interest rates might advance even further.

Meanwhile, the market's uncertainties were not limited to the outlook for the dollar. Most other major industrial countries were afflicted with inflation rates which were too high by their own standards and by substantial current account deficits which had been aggravated by the oil price increases of 1979 and early 1980 The authorities had pursued restrictive policies to deal with these problems. By late summer, economic growth was slackening generally, prompting the authorities in several countries to move cautiously toward a less restrictive policy stance. But they were reluctant to move too quickly in the direction of ease in view of the need to fight inflation and their efforts to keep interest rates sufficiently high to attract funds from abroad to finance large current account deficits. As a result, interest rates remained high even as market expectations built up that, in view of domestic economic considerations, an easing of monetary policy was imminent in several countries.

Consequently, an uneasy atmosphere persisted in the exchange markets through August and early September as traders sought to assess the implications of these economic and financial developments here and abroad. In addition, the sense of unease was heightened from time to time by political events, such as general strikes in Poland and continued tensions in the Middle East. In this environment, exchange rates fluctuated widely day to day but few clear trends developed, with the exception that both sterling and the Japanese yen were bid up by force of heavy capital inflows. Among the currencies participating in the joint float arrangement, the French franc remained near the top of the band and the German mark near the bottom.

In the absence of renewed selling pressures on the dollar, the United States authorities took the opportunity to acquire currencies to repay debt arising from earlier intervention and to rebuild balances. Operating on days in which the dollar was firm or rising, the United States authorities bought a total of $426 6 million equivalent of German marks in the market, either in New York or in Frankfurt through the agency of the Bundesbank. Over the same period, the Trading Desk purchased an additional $453 6 million of marks from correspondents. The Federal Reserve used a portion of these marks, along with previously acquired balances, to repay swap debt to the Bundesbank, which was reduced from $879.7 million at end-July to $362.6 million on September 15. The remaining acquisitions were added to Treasury balances which increased by $338.1 million equivalent. The Federal Reserve also bought small amounts of French francs and Swiss francs in the market and from correspondents On occasions when the dollar came under selling pressure in August, the United States authorities intervened on five different days, selling a total of $69.6 million equivalent of marks, including $53.9 million equivalent from Federal Reserve balances and $15.7 million from United States Treasury balances.

By mid-September, economic indications suggested that the United States was moving out of recession Although the upturn was welcomed by the markets, it dimmed the prospects for further inflation relief in the near term. Indeed, partly because of rising food prices, the United States inflation rate was expected to accelerate. Moreover, the money and credit aggregates were growing rapidly. In response to this buildup in the demand for money, the Federal Reserve was acting to constrain the growth of bank reserves. Market interest rates climbed sharply, and on September 26 the Federal Reserve raised the discount rate by 1 percentage point to 11 percent. Strong demand for money and credit persisted through October, putting additional upward pressure on money market rates.

This advance of United States interest rates was not matched abroad, where, if anything, the authorities were becoming increasingly concerned about slower economic growth and the prospect of recession. Consequently, interest differentials swung increasingly in favor of the dollar against most major currencies,

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 July 31, 1980	August through October 31, 1980	System swap commitments October 31, 1980
Bank of France	166 3	− 165 2*	-0-
German Federal Bank . .	879 7	− 873 0*	-0-
Total	1,046 0	−1,038 2*	-0-

Because of rounding, figures may not add to totals
Data are on a transaction-date basis
* Repayments include revaluation adjustments from swap renewals, amounting to $1 1 million for drawings on the Bank of France and $6 7 million for drawings on the German Federal Bank which were renewed during the period

Table 2

United States Treasury Securities, Foreign Currency Denominated

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

Issues	Amount of commitments July 31, 1980	August through October 31, 1980	Amount of commitments October 31, 1980
Public Series			
Germany	5,233 6	-0-	5,233 6
Switzerland	1,203 0	-0-	1,203 0
Total	6,436 6	-0-	6,436 6

Data are on a value-date basis

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	General account
August 1, through October 31, 1980	+14.0	+ 0 1	-0-
Valuation profits and losses on outstanding assets and liabilities as of October 31,1980 ...	+12 7	−372 8	+138 8

Data are on a value-date basis

prompting flows of funds into dollar-denominated assets Much of this pressure fell on the German mark, in view of Germany's low nominal interest rates relative to rates abroad and Germany's sizable current account deficit. Funds were shifted out of marks not only into dollars but into sterling and French francs as well. Within the European Monetary System (EMS), the German mark and the French franc were pushed to their respective intervention points, and the Bundesbank and the Bank of France were obliged to absorb substantial amounts of marks against francs. At the same time, the EMS currencies as a group declined against the dollar

As a result of the flow of funds into dollar assets, the dollar rose in October to end the three-month period up a net 7 percent against the German mark and other currencies in the EMS, 3½ percent against the Swiss franc, and 1⅜ percent against the Canadian dollar Over this same period, sterling rose a net 4⅜ percent against the dollar and the yen moved up by 7⅜ percent

With the dollar in demand, the United States authorities stepped up their acquisitions of currencies to repay debt and rebuild balances Operations were conducted in New York, Frankfurt, and on occasion in the Far East. When strong one-way pressures emerged late in October, the Desk intervened, sometimes forcefully, in the market as a buyer of German marks Purchases of marks in the spot market totaled $1,770 7 million equivalent between mid-September and end-October. Moreover, as part of the effort to repay debt and rebuild balances, the United States authorities purchased a total of $346 6 million of marks from correspondents, divided about equally between the Federal Reserve System and the Treasury, and $132 9 million of outright forward marks on behalf of the Treasury As a result, the Federal Reserve was able to complete liquidation of its swap debt with the Bundesbank by the end of the period

In addition to its mark purchases, the United States authorities bought over the three-month period $87 5 million equivalent of Swiss francs, including $25 million equivalent in the market and $62 5 million equivalent from correspondents. Of this amount, $62 6 million equivalent was added to System balances and $24 9 million equivalent went into Treasury balances The Federal Reserve also took advantage of opportunities to buy $158 6 million of French francs to complete repayment of its swap debt with the Bank of France

During the August-October period, the Federal Reserve realized $14 million in profits on its foreign exchange operations and the Exchange Stabilization Fund (ESF) realized $0 1 million As of the end of the period, the Federal Reserve showed valuation profits of $12 7 million on its foreign exchange assets while the ESF showed valuation losses of $372 8 million on its foreign exchange assets The Treasury's general account showed valuation profits, related to the outstanding issues of securities denominated in foreign currencies, of $138 8 million