February-April 1981 Interim Report
(This report was released to the Congress and to the press on June 3, 1981.)

Treasury and Federal Reserve Foreign Exchange Operations

Coming into the three-month period under review, the United States dollar was in strong demand against most major currencies. The dollar was bolstered by the relatively favorable United States current account position, which has remained in surplus in contrast to the deficits of many other industrial countries, and by the wide interest differentials in favor of dollar placements. The bidding for dollars also reflected bullish sentiment on the part of market participants who responded positively to the determination shown by the Reagan administration to deal with inflation and to revitalize the United States economy. At the same time, as traders focused on political and economic problems facing Western European countries, sentiment toward other currencies became increasingly bearish. The German mark was under particularly heavy selling pressures both against the dollar and against the other European currencies linked formally or informally to the mark. By early February, the markets for dollars had become increasingly one way, with the dollar rising virtually every day. Through mid-February, the dollar advanced by a further 4 percent against the German mark and the other continental European currencies, for a total rise on the order of 20 percent since the previous September. In addition, the dollar rose 3 percent against sterling, ½ percent against the Japanese yen, and ¾ percent against the Canadian dollar over the first half of February.

A report by Scott E. Pardee. Mr. Pardee is Senior Vice President in charge of the Foreign Exchange Function of the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account.

The United States authorities continued to intervene in the exchange markets, buying foreign currencies on days in which the dollar was rising sharply and, on occasion, placing simultaneous bids and offers to settle a volatile market. In all, the Trading Desk operated in the market on nine of the fourteen trading days between February 2 and 23, as a net buyer of marks on each occasion. The total marks thus acquired amounted to $610.0 million equivalent, which was split evenly between the Federal Reserve and the Treasury. An additional $168.4 million equivalent of marks was bought from correspondents. The proceeds of these market and correspondent purchases were added to System and Treasury balances.

After mid-February, the demand for dollars lost steam. By that time, interest rates in the United States were easing somewhat, as the growth rates for the narrow monetary aggregates were coming in below the Federal Reserve's target range. Moreover, the authorities of other countries were acting to raise interest rates or to tighten liquidity conditions in their markets. In particular, on February 19, the Bundesbank took action to defend the mark, suspending the usual Lombard facility to commercial banks and announcing that Lombard credits would be made available at its discretion and at rates that could vary on a day-to-day basis. Interest rates in Germany immediately shot up. As traders scrambled to cover short positions, the mark rebounded against the dollar and rose from the

Table 1

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, 1981	February 1, through April 30, 1981	Outstanding April 30, 1981
Bank of Sweden	200.0	−200.0	-0-

Data are on a value-date basis.

Table 2

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, 1981	− 1.4	− 3.8	-0-
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1981	−271.1	−1,106.9	+958.5

Data are on a value-date basis.

bottom to the top of the European Monetary System (EMS) band. Over late February and early March, dollar rates fell back with wide day-to-day movements. On balance, from late February through mid-March, the dollar dropped off some 8 percent against the German mark and other EMS currencies, while holding fairly steady against the pound sterling and the Japanese yen and declining less than 2 percent against the Canadian dollar.

From late February to late March, the United States authorities did not intervene in the exchange market. On March 30, when the dollar fell sharply following the assassination attempt on President Reagan, the Desk stepped in to settle the market, selling $74.4 million equivalent of marks out of balances, split evenly between the Federal Reserve and the Treasury. Dollar rates quickly rebounded the following day.

In April, the dollar again came into heavy demand. Favorable sentiment toward the Reagan administration remained a generally positive psychological factor. Market participants expressed some concern that the Administration's tax cut proposals might swell rather than reduce the budget deficit, but this concern reinforced expectations that United States interest rates would remain high and that the dollar would stay strong. By early April, indicators were showing that the United States economy was stronger than expected. The expansion in the underlying economy also began to show through more clearly in the demand for money and credit, and even the narrow measures of the monetary aggregates began to grow rapidly. With the Federal Reserve restraining the growth of reserves, the strong demand for money prompted a renewed rise in United States interest rates. Although some central banks abroad continued to raise their own interest rates, or to take other measures to keep a tight rein on liquidity, foreign interest rates did not rise as sharply as rates in the United States so that large interest differentials in favor of dollar placements widened.

In mid-April the Treasury announced that, after study and consultation with officials of the Federal Reserve, the United States authorities had adopted a minimal intervention approach and would now intervene only when necessary to counter conditions of disorder in the exchange market. In the prevailing market atmosphere, many participants interpreted this change in approach as removing a constraint on the dollar's rise. On May 4, in testimony before the Joint Economic Committee of the Congress, Treasury Under Secretary Sprinkel set forth the rationale for this more limited intervention approach.

With the dollar again in demand, dollar rates were bid up sharply, frequently in one-way markets, through the end of April. From the mid-March lows, the dollar rose by a net 8-9 percent against the German mark and other currencies linked directly or indirectly to the mark, 7 percent against the pound sterling, 5 percent against the Japanese yen, and 1½ percent against the Canadian dollar.

The United States authorities did not intervene in the markets in April, although the Desk continued to operate in the market as agent for other central banks. By the month end, several foreign central banks were intervening fairly heavily in support of their currencies either against the dollar or, within the EMS, against the German mark which remained firm among European currencies.

In April, following a heavy reflux of funds into the Swedish krona, the Sveriges Riksbank repaid, prior to maturity, the $200 million drawn in January under the swap arrangement with the Federal Reserve.

In operations during the three-month period, the

Federal Reserve had losses of \$1.4 million on its exchange market operations, while the Exchange Stabilization Fund (ESF) lost \$3.8 million. As of April 30, valuation losses on outstanding balances were \$271.1 million for the System and \$1,106.9 million for the ESF. The Treasury's general account had valuation gains of \$958.5 million, reflecting its foreign currency borrowings.