August-October 1981 Interim Report
(This report was released to the Congress and to the press on December 3, 1981.)

Treasury and Federal Reserve Foreign Exchange Operations

In early August the year-long advance of the dollar in the exchange markets reached its peak. Until then, the dollar was in persistently strong demand against most major currencies, bolstered by an improving outlook for United States inflation, positive worldwide sentiment toward the Reagan administration's economic program, a favorable United States current account performance, and large interest differentials favoring dollar investments At the same time, many industrial countries abroad experienced economic and political difficulties which depressed market sentiment toward their currencies By August 10 the dollar had risen some 45 percent from its level a year earlier to reach a five-year high of DM 2.5773 against the German mark, while registering sizable increases against other currencies as well

Subsequently, some of the factors that had spurred bidding for the dollar began to appear less compelling than before. The international enthusiasm which followed Congressional passage of the Administration's tax and expenditure program started to wane. Market participants remained impressed by the Administration's goals of stimulating private savings and investment and reducing the government's role in the economy. But participants in the exchanges, as in the United States domestic financial markets, expressed skepticism that the fiscal package approved by the Congress would in fact succeed adequately in reducing the Federal budget deficit. The prospect of continuing sizable Treasury financing requirements raised serious concerns.

By late summer, also, there was growing evidence of sluggish United States economic activity and market participants expressed concern that the Federal Reserve might be forced to relax its policy of monetary restraint under the weight of growing political criticism of high interest rates at a time of little or no United States economic growth. United States short-term interest rates did in fact begin to ease, even though monetary policy continued tight Between August and early October the Federal funds rate dropped about 500 basis points, the rate on three-month Eurodollar deposits declined about 300 basis points, and the Federal Reserve progressively reduced its surcharge on large banks that frequently borrow at the discount window from 4 percent to 2 percent

Abroad, the domestic economies of major industrial countries were also generally stagnant. Nonetheless, most countries were experiencing accelerating inflation, partly owing to the prolonged weakness of their currencies in the exchanges. The authorities in some nations—notably France, Switzerland, and the United Kingdom—raised their interest rates while others, feeling they had little room to ease monetary policy so as to provide some stimulus to their flagging economies,

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Table 1

United States Treasury Securities Foreign Currency Denominated

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

Issues	Amount of commitment July 31, 1981	August through October 31, 1981	Amount of commitment October 31, 1981
Public series			
Germany	5,233 6	−680.3	4,553 3
Switzerland	458 5	-0-	458 5
Total	5,692 1	−680 3	5,011.8

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
August 1 through October 31, 1981	-0-	-0-	+ 24.3
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1981	−316.5	−1,200 4	+856 0

Data are on a value-date basis.

opted to hold monetary conditions firm As a result, short-term interest differentials favoring the dollar narrowed sharply.

Moreover, a number of balance-of-payments developments here and abroad were interpreted in the market as signaling a reversal in current account positions that in recent years had been favorable to the United States. This country's trade account posted a wide deficit in August, and the current account was expected to move from surplus to deficit sometime during 1982 in view of the sharp appreciation of the dollar and the sluggishness of most foreign economies At the same time, Japan's current account moved strongly into surplus. Germany's net exports had expanded to the point of bringing monthly current account figures close to balance, and German officials as well as private forecasters began to talk of a sharp turnaround in Germany's external position.

Throughout the summer, expectations intensified that divergent policies and economic trends among European Monetary System (EMS) countries, particularly Germany and France, would force a realignment of the joint float. These expectations generated large speculative flows which imposed major strains on the joint float To keep their currencies within the agreed limits, EMS central banks intervened by selling large amounts of dollars in addition to EMS currencies during August and September. Then on October 4 the EMS currencies were realigned, with the German mark and Dutch guilder each revalued 5½ percent and the French franc and Italian lira each devalued 3 percent in relation to the other participating currencies whose central rates remained unchanged. After the realignment the German mark traded near the bottom of the joint float while the French franc rose toward the top, and for a time substantial reflows of capital occurred.

From mid-August through early October these various considerations led to widespread and occasionally substantial selling pressure on the dollar and produced a major decline in dollar rates. From its peak levels the dollar declined by as much as 17 percent against the Swiss franc, 15½ percent against the German mark, 7¾ percent against sterling, 5¾ percent against the Japanese yen, and 4 percent against the Canadian dollar.

After reaching a low point on October 9, however, the dollar came into renewed demand. Commercial buy orders emerged in large amounts in a number of centers to take advantage of what were regarded as favorable dollar rates both for investments and current payments. From time to time there were also substantial purchases of dollars by non-Group of Ten central banks. In addition, recurrent episodes of geopolitical tension, especially in Poland and the Middle East, generated sharp demands for dollars essentially because political and security concerns were seen in the exchanges as potentially less destabilizing to the United States than to most countries abroad. Thus, market participants remained relatively optimistic about the United States overall prospects and continued to regard the United States as an attractive outlet for capital investment.

Also during October, developments suggested that interest rate differentials favorable to the dollar would not erode as rapidly as had been expected. In the United States, short-term interest rates declined further toward the month end as evidence mounted of a softer than expected economy. On October 30 the Federal Reserve responded to the lower level of market interest rates by reducing the discount rate 1 percentage point to 13 percent. But, by this time, recessionary tendencies in many European countries had deepened and market participants came to expect that foreign monetary authorities would take advantage of further declines in United States interest rates to ease their own domestic monetary conditions Moreover, as analysts took account of shifting economic growth prospects here and abroad, many began revising their current account forecasts, predicting less deterioration than previously in the 1982 current account for the United States and less improvement in the current accounts of other countries. Adding to this sense of caution were the widening deficits on invisibles in Germany and Japan, partly reflecting the influence of mounting interest payments on foreign borrowings.

In these circumstances, despite the renewed decline in short-term United States interest rates during the last days of the month, the dollar proved resilient in the exchanges and ended the period up from its lows. On balance, over the three months the dollar declined nearly 16 percent against the Swiss franc, 10½ percent against the German mark, and about 3¼ percent against the Japanese yen. With respect to the Canadian dollar and pound sterling, the dollar ended the period down 2¾ percent and 2¼ percent, respectively.

During the August-October period there were occasions when the market experienced unusually sudden and sharp exchange rate movements mainly related to political events. These episodes occurred largely during the European trading session and were quickly reversed. The United States authorities did not intervene in the market for their own account during the period.

Foreign central banks did intervene during the period in dollars and in sizable amounts. In this connection, the Trading Desk at the New York Federal Reserve intervened on occasion as agent for other central banks in the New York market.

On September 1 the United States Treasury paid off $680.3 million equivalent of its German mark-denominated securities. After this redemption the Treasury had outstanding $5,011 8 million equivalent of foreign currency notes (public series)—$4,553.3 million equivalent denominated in German marks and $458.5 million equivalent denominated in Swiss francs.

In the three-month period from August through October, the Federal Reserve and the Exchange Stabilization Fund realized no profits or losses from exchange transactions, while the Treasury's general account gained $24.3 million, reflecting the profit which occurred upon the redemption of the German mark-denominated securities. As of October 31, valuation losses on outstanding foreign currency balances were $316.5 million for the Federal Reserve and $1,200.4 million for the Exchange Stabilization Fund. The Treasury's general account had valuation gains of $856 million related to outstanding issues of securities denominated in foreign currencies.