February-April 1982 Interim Report
(This report was released to the Congress and to the press on June 4, 1982.)

Treasury and Federal Reserve Foreign Exchange Operations

A combination of wide interest rate differentials favorable to dollar-denominated assets and a relatively more positive attitude toward economic and political prospects for the United States than for other countries moved the dollar higher in the exchange markets through mid-April. Thereafter, though the dollar weakened substantially, it nonetheless ended the February-April period under review higher on balance against all major currencies except the German mark, which benefited from a positive shift in market sentiment and strengthened across the board.

The dollar's advance through mid-April partly reflected a reassessment of the U.S. interest rate outlook. With the drop in economic activity in the United States, market participants had expected some decline in U.S. short-term interest rates and an erosion of the impressive interest rate advantage on dollar-denominated assets. Instead, money growth surged early in 1982 while economic activity was contracting. Although part of the bulge in money growth was thought to be short term and reversible in nature, part also reflected less technical factors such as increased precautionary demands by individuals. With the Federal Reserve restraining the supply of bank reserves to prevent the narrow monetary aggregate (M-1) from staying persistently above the 2½-5½ percent 1982 annual growth target, short-term interest rates moved higher. The rise was interrupted in late February when the demand for money and credit declined. But then, in March, expectations of another spurt in money growth during April exerted renewed upward pressures on short-term rates. Meanwhile, long-term interest rates did not move lower in the face of declining economic activity essentially because of concerns that Federal Government deficits would burgeon in the years ahead to the point of exerting major strains on the financial markets, particularly once the economy begins to expand again.

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Abroad, interest rates in most countries did not show increases and in many cases even declined. Monetary authorities faced persistent stagnation in their domestic economies and record unemployment. The widespread lowering of European interest rates in January left market participants with the impression that economic policy priorities were shifting somewhat in favor of providing economic stimulus as opposed to concentrating as heavily as before on the anti-inflation fight. Talk spread in the market that some foreign authorities might even impose capital or foreign exchange controls so as to permit a cut in their interest rates without incurring depreciations of their currencies against the dollar. Such measures were not undertaken but, during March, many foreign central banks did reduce their official lending rates or otherwise facilitated an easing in domestic monetary conditions. As a result, interest differentials in favor of the dollar remained large, continuing to attract funds into dollar-denominated assets.

Meanwhile, exchange market sentiment toward the dollar was bolstered by the rapid ebbing of U.S. inflation. As measured by the consumer price index, the inflation rate dropped several percentage points in the early months of 1982 to about 3 percent at an annual rate, while inflation abroad either declined by less or in some cases even accelerated. To be sure, part of the improvement reflected recession-induced (and therefore more readily reversible) price declines in food, in energy, and in other raw materials, while the dollar's appreciation in the exchange market also played a role by tempering import costs. But a decided moderation in wage settlements was also taking place in the United States, and many in the exchange market saw reason to hope for more lasting changes in attitudes and in behavior on the part of both business and labor, with the prospect of further progress on inflation ahead.

Further supporting the dollar was the perception that the worldwide recession was harming the U.S. trade balance and investment activity less than that of many other countries. While the weakness in the U.S. economy had previously led analysts to scale back the forecast deterioration in the U.S. current account, a swing into deficit was nonetheless widely expected. However, the current account remained in surplus early in 1982, as sharply lower oil prices, a fall in import volumes, and large net services earnings more than offset the deterioration in manufactured exports.

At the same time, international investors felt that political stability and the long-term business climate in the United States provided a strong inducement to continue investing in U.S. assets despite the higher level of the dollar in the exchanges. Already in 1981, reversing a long-standing pattern, foreign direct investment in this country actually exceeded U.S. direct investment abroad by some $12 billion. Tax incentives, regulatory reforms, and the prospect of policy continuity in support of market mechanisms continued to underpin foreign direct investment while also encouraging sizable flows into U.S. stocks and bonds. Moreover, geopolitical tensions from time to time brought the dollar into demand as a "safe haven" for more liquid forms of capital as well.

The downturn in world economic activity seemed to weigh especially heavily on economies abroad and served to heighten competitive tensions. To be sure, the sharp decline of the Organization of Petroleum Exporting Countries (OPEC) surplus had its counterpart in lower current account deficits among the industrial countries, but the distribution of the benefits was proving highly uneven. Moreover, even those countries with improving balance-of-payments trends, such as Germany and Japan, were not expected to sustain a rapid growth of their exports. Constraints on expanded trade with Eastern Europe developed in the wake of the Polish payments crisis, while previously rapid growth markets in Asia had slowed. The growth of import demand by OPEC dwindled as oil-producing countries grappled with lower oil revenues. In addition, the threat of major protectionist measures clouded industrial country relations, particularly those affecting Japan. At the same time, however, in nearly all countries overseas (more dependent on trade than the United States for a large portion of gross national

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	Commitments January 31, 1982	February 1 through April 30, 1982	Commitments April 30, 1982
Bank of Mexico	-0-	+600.0	600.0

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, 1982	-0-	+0.7	-0-
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1982	−410.8	−1,159.3	+840.3

Data are on a value-date basis.

product), the anemic state of domestic demand triggered greater efforts by domestic enterprise to sell in external markets and consequently competitive pressures were strong.

In these circumstances the realignment of the European Monetary System (EMS) in February raised questions in private and official circles about the relative competitiveness of member economies, about the durability of the new parities, and about the cohesion of participating states in the joint float arrangement. Indeed, almost immediately after the February 20-21 weekend when the central rates of the Belgian franc and Danish krone were adjusted downward by 8½ and 3 percent, respectively, speculation developed that the EMS would again be realigned. Selling pressures focused on currencies of countries where the policy design or the economic-social setting was thought by the market to impede the fight against inflation and the efforts to regain equilibrium in the balance of payments or to put public-sector finances on a sounder basis. The speculative selling pressures—most intense against the French franc, the Belgian franc, and the Italian lira—tended to moderate by early April following official actions to raise interest rates and restrict capital outflows. In addition, foreign monetary authorities intervened heavily as sellers of dollars and, to a lesser extent, of currencies that traded at the top of the joint float. Even so, the EMS currencies declined substantially against the dollar.

In response to these various factors, therefore, from end-January to mid-April the dollar gained as much as 8 percent against the Japanese yen, 6¾ percent against sterling and the Swiss franc, about 3½ percent against the German mark, and nearly 3 percent against the Canadian dollar to approach levels close to the peaks registered in August 1981.

In the latter half of April, however, traders and investors began to assess the dollar's prospects less favorably and dollar exchange rates declined. The latest economic statistics gave virtually no sign of an end to recession, eroding hopes that a perceptible recovery in U.S. business activity was likely in the near term. With production, employment, and incomes proving weaker than once anticipated, grounds developed for expecting the April bulge in M-1 to unwind quickly, thereby lessening the need in the view of market participants for an immediate squeezing of the availability of bank reserves under the Federal Reserve's monetary policy approach. For a brief period, also, optimism developed in the exchange markets of an early compromise on measures to bring projected Federal deficits in fiscal year 1983 and beyond under better control. Consequently, though market participants remained sensitive to the many forces underpinning the high level of U.S. interest rates, the balance of exchange market opinion swung toward the view that interest rates in this country could drop, perhaps substantially, in the ensuing months. And, in fact, U.S. interest rates did decline toward the month end.

At the same time, market participants were disappointed that U.S. mediation efforts were unable to avert a military conflict between Argentina and the United Kingdom and expressed concern that U.S. relations with Latin America might deteriorate in view of the U.S. alliance with Britain. Paralleling the sense of disappointment over U.S. leadership in the foreign arena was a lessening of confidence in U.S. economic management on the domestic front, as hope for an early and satisfactory solution to the budget deficit faded amid drawn-out and inconclusive discussion and negotiations.

The market's more cautious assessment of the dollar coincided with a favorable shift in sentiment toward the German mark. In Germany, progress toward curbing inflation was underscored by moderate wage settlements negotiated with the pace-setting metalworkers union. Publication of a record postwar monthly trade surplus for March appeared to confirm the considerable improvement under way in Germany's balance-of-payments position both in relation to earlier trends and in relation to other industrial countries. Within the EMS the mark had already been strong for more than a year, and with these developments the German currency strengthened against the dollar as well.

In these circumstances the dollar fell back against all major currencies in late April. It closed the three-month period under review, down about ½ percent against the German mark. In relation to other currencies, however, the dollar remained more resilient and ended the period higher, on balance, by about 2 percent against the Canadian dollar, 2½ percent against the Japanese yen, 3 percent against sterling, and 4½ percent against the Swiss franc.

During the period, the Trading Desk did not intervene for the account of the U.S. Treasury or the Federal Reserve. The Desk continued its long-standing practice of intervening as agent for other central banks from time to time in the New York market.

In other developments, the Mexican government devalued the peso in February and for a time the peso benefited in the exchanges from a reflux of funds. However, selling pressures again built up, and in late April the government announced a stabilization program to improve the policy framework for dealing with the country's inflation and balance-of-payments problems. Mexico's international reserve position was under strain during the period and, to help meet a temporary reserve need, the Bank of Mexico requested and was granted a $600 million drawing on its $700 million swap line with the Federal Reserve. The funds were drawn on April 30 and repaid shortly after the close of the period under review.

In the three-month period from February through April, the Federal Reserve and the Treasury general account realized no profits or losses from exchange transactions. The Exchange Stabilization Fund gained $0.7 million in connection with the sale of foreign currency to the Treasury general account to finance interest payments on foreign currency-denominated securities. As of April 30, valuation losses on outstanding foreign currency balances were $410.8 million for the Federal Reserve and $1,159.3 million for the Exchange Stabilization Fund. The Treasury general account had valuation gains of $840.3 million related to outstanding issues of securities denominated in foreign currencies.