August-October 1982 Interim Report
(This report was released to the Congress and to the press on December 9, 1982.)

Treasury and Federal Reserve Foreign Exchange Operations

By the end of the August-October period under review the dollar had risen to record highs or to levels not seen in many years against several major currencies, strengthening even as U.S. interest rates dropped sharply and as interest differentials favoring dollar-denominated assets narrowed appreciably. Favorable prospects for the U.S. economy relative to other industrial countries, apprehension about the international banking system, and concern about economic and political conditions abroad resulted in an increased global preference for dollar-denominated assets which pushed dollar exchange rates sharply higher.

Concern over international credit exposures and developing financial strains in various markets around the world were sustaining factors behind the dollar's rise throughout the period. During August, market attention focused on Germany where a large multinational company was being forced into receivership and on Mexico where a foreign exchange crisis was unfolding. During September, concern over the international financial situation mounted as developments in Mexico, particularly in light of the unexpected move to nationalize domestic banks, raised doubts in the market about the ability and willingness of the government and other public-sector institutions in that country to meet their external obligations. Meanwhile, the list of countries experiencing payments arrears expanded, and there were well-publicized problems of various commercial banks here and abroad. In this environment, traders did worry about the relatively large exposures of U.S. banks to Mexico and other Latin American countries, and developing pressures on the U.S. banking system were reflected, to an extent, in a widening of yield spreads. between U.S. Government obligations and private credit instruments. But, with so much of the total international credit exposures made up of dollar-denominated claims, dollar-based institutions were thought to be in a better position than others to deal with emerging liquidity strains. Moreover, individual institutions sought to augment their liquidity positions, especially in dollars, against potential funding and cash-flow problems and in advance of important statement dates.

Meanwhile, prospects for economic recovery remained gloomy, and concerns intensified that many of the industrialized countries would tend to rely more on protectionist measures to deal with high and rising levels of unemployment and slack business investment at home and would welcome improvements in international competitiveness in increasingly restricted export markets. These concerns tended to coalesce in Europe when several Scandinavian countries devalued their currencies, at times by more than private and official observers thought necessary to regain competitive equilibrium. Market speculation developed that several European governments would seek to adjust their currencies downward, involving a realignment of the European Monetary System (EMS) joint float. Within that arrangement speculative selling pressures —largely against the French and Belgian francs, the Italian lira, and the Danish krone—intensified around mid-October. But they tended to moderate late in the

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Table 1

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

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

Bank drawing on Federal Reserve System	Outstanding July 31, 1982	August 1 through October 31, 1982	Outstanding October 31, 1982
Bank of Mexico	700 0	{+700 0 {−700 0	700 0

Data are on value-date basis.

Table 2

Drawings and Repayments by the Bank of Mexico under Special Reciprocal Currency Arrangements

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

Drawings on	Outstanding July 31, 1982	August 1 through October 31, 1982	Outstanding October 31, 1982
United States Treasury special temporary facility for $1,000 million	-0-	{+825 0 {−825 0	-0-
Drawings on special combined credit facility			
Federal Reserve special facility for $325 million	-0-	{+236 3 {− 43 8	192 5
United States Treasury special facility for $600 million	-0-	{+438 8 {− 81 3	357 5

Data are on value-date basis

Table 3

Drawings and Repayments by the Bank of Brazil under Special Reciprocal Currency Arrangement with the United States Treasury

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

Drawing on	Outstanding July 31, 1982	August 1 through October 31, 1982	Outstanding October 31, 1982
United States Treasury special facility for $500 million	-0-	+350 0	350 0

Data are on value-date basis

period after official actions were taken by several countries to raise domestic interest rates, to adopt domestic austerity measures, and/or to increase international borrowings. The monetary authorities of the EMS member states intervened heavily as sellers of dollars and, to a lesser extent, of currencies trading at the top of the joint float arrangement. Nonetheless, the EMS currencies as a group declined substantially against the dollar.

In addition, there were other international developments which reinforced the demand for dollars. These included uncertainties over the future political sovereignty of Hong Kong, which reportedly generated flows of capital to North America, and aggravated hostilities in the Middle East, which kept alive fears of a disruption of the flow of internationally traded oil. Certain currencies that had previously offered clear alternatives to investment in dollar-denominated assets also came under sometimes unfavorable exchange market scrutiny, as participants focused on unresolved political divisions over economic, social, and foreign policies in a number of countries. In Germany, Chancellor Schmidt's coalition government collapsed over disputes about economic policy. At first, the prospect of a new government generated expectations that the policy stalemate would be broken. But soon the market concluded that the new coalition government might face serious difficulties in winning a majority at upcoming federal elections next spring and that, in the interim, it had less room to reorient policies than had first been hoped. Also, in Japan, Prime Minister Suzuki unexpectedly announced that he would not seek reelection, and uncertainty over his successor clouded the outlook for the course of Japanese economic policy.

To some extent, developments in the U.S current account also continued to support the dollar, largely because weaker than expected economic activity tended to limit the deterioration in U S trade performance associated with the eroding price competitiveness of U.S. exports. Thus, although many forecasters projected a modest current account deficit in the third quarter of 1982, few participants anticipated a major shift from equilibrium in the U.S. current account until the domestic economy moved decidedly out of recession. At the same time, Germany's current account had slipped from surplus to near balance, and some analysts, perceiving structural weaknesses in the German economy, predicted only limited further improvement in Germany's balance of payments in the absence of a recovery in world demand and output. At the same time, earlier optimistic forecasts of Japan's current account surplus were scaled back further.

For these various reasons, the United States was viewed relatively favorably on economic and political grounds, and market participants bid up the value of the dollar. On occasion, however, the impact of these concerns on the dollar was offset, as market participants focused on actual and expected declines in U.S interest rates. In late August, for example, a shift in the outlook for U S. interest rates occurred. Whereas at midyear Federal Reserve authorities had indicated that they would tolerate monetary expansion at somewhat higher than the targeted annual rate in view of exceptional economic uncertainty and strong liquidity demands, market participants were skeptical that declines in interest rates would be sustainable so long as they expected an early recovery in economic activity. By late summer, however, evidence suggested a deepening of the U S. recession, a weakening in short-term business credit demands, and a slowing in money supply growth that brought the narrow monetary aggregate—M-1—within the 2½-5½ percent annual growth range. By end-August, therefore, short-term U.S. market rates had dropped some 5 percentage points from end-June peak levels, the Federal Reserve had reduced its discount rate in four steps from 12 to 10 percent, and market participants gained confidence that these declines would stick. In addition, with inflation abating and with the Congress passing a tax increase, bond yields dropped as much as 2 percentage points amid an unusually strong debt-market rally, accompanied by record price increases in the stock market. Abroad, interest rates did not recede by nearly as much, although production and output declines continued and unemployment advanced further with a deepening of the recession in major foreign economies As a result, interest differentials favorable to the dollar narrowed dramatically, for instance, on three-month Eurodeposits from 7½ to 3¼ percentage points *vis-à-vis* the German mark and from 9½ to 4 percentage points against the Japanese yen, and the dollar moved lower in the exchange markets.

Early in October the dollar's strengthening trend was again temporarily interrupted. Following the Federal Open Market Committee meeting early that month, it was announced that less emphasis would be placed in the immediate future on M-1 as an operating target of monetary policy and that somewhat more rapid growth of the broader aggregates would also be tolerated in an environment of extreme economic and financial uncertainty. As explained by Chairman Volcker, financial innovation and institutional change—such as the large volume of all savers certificates about to mature and the new money market deposit accounts to be introduced late in 1982—coupled with the still appreciable strengthening in the desire for liquidity served to distort M-1 as a reliable policy guide. Also, the rigid pursuit of targets in view of these developments would have had the practical effect of a more restrictive policy than intended when the targets were initially set out. Shortly following these statements deemphasizing the role of M-1, the Federal Reserve cut the discount rate another ½ percentage point to 9½ percent. In the market, these actions were widely interpreted as a shift toward greater monetary accommodation by the U.S authorities and generated expectations that declines in U.S. money market and official interest rates, which had stalled during September, would again resume. Once again the dollar came on offer in the exchange market.

But, as in August, the dollar's decline proved temporary and market psychology toward the dollar re-

Table 4

United States Treasury Securities Foreign Currency Denominated

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

Issues	Amount of commitments July 31, 1982	August 1 through October 31, 1982	Amount of commitments October 31, 1982
Public series			
Germany	2,610 6	−671 2	1,939 4
Switzerland	458 5	-0-	458 5
Total	3,069 1	−671 2	2,397 9

Data are on a value-date basis

Table 5

Net Profits (+) or Losses (−) on United States Treasury and Federal Reserve Current Foreign Exchange Operations

In millions of dollars

		United States Treasury	
Period	Federal Reserve	Exchange Stabilization Fund	General account
August 1 through October 31, 1982	-0-	−0 6	+30 6
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1982	−777 9	−1,472 9	+619 3

Data are on a value-date basis.

mained positive. Few market participants regarded the shift in operating procedure as an abandonment of the fight against inflation. Moreover, substantial progress had already been achieved in moving toward greater price stability in this country, with wage, salary, and price increases slowing markedly and unit-labor costs even more dramatically In response, interest rates in longer term markets dropped another 1 percentage point in October alone. Yet, compared with other countries, the decline in U.S. nominal interest rates still lagged behind the reduction of inflationary pressures, so that real U.S. interest rates remained high, both absolutely and relative to other countries Furthermore, foreign monetary authorities were expected to take fuller advantage of what by this time appeared to be sustainable declines in U.S. interest rates to ease credit conditions in their economies. These expectations were confirmed when official and market interest rates in major European countries declined considerably in the last weeks of October. Under these circumstances, financial markets were impressed with anecdotal evidence suggesting that foreign investors sought to benefit from the continuing potential for price appreciation in U.S. domestic capital markets by investing in longer term dollar-denominated securities While foreign purchases of these securities were apparently financed largely out of existing dollar-denominated assets, talk of foreign investment activity nonetheless had a positive psychological effect on the dollar and may have been associated with renewed bidding for dollars in the exchange market.

By end-October the dollar reached record highs against several of the Continental currencies, levels not seen in nearly six years against the pound sterling and the Japanese yen, and a 14½-month high against the German mark. On balance, for the three-month period under review the dollar rose 8¼ percent against the Japanese yen, 6 percent against the Swiss franc, 5 percent against the German mark, and 4 percent against the pound sterling. With respect to the Canadian dollar, however, the dollar declined about 2 percent On a trade-weighted basis the dollar rose 4¾ percent.

The U S. authorities intervened on four trading days during the period when the dollar was bid up sharply to higher levels in unsettled markets. The Federal Reserve and U.S. Treasury intervened early in August and again early in October to purchase $45 0 million equivalent of German marks and $57.0 million equivalent of Japanese yen. The German mark purchases were split evenly between the Federal Reserve and the Treasury. Of the total Japanese yen acquired, $38.5 million equivalent was for the Federal Reserve and $18 5 million equivalent was for the U S. Treasury.

In the August-October period, various short-term financing arrangements were concluded in support of Mexico's efforts to strengthen its economic and financial position. At the beginning of the period, the Bank of Mexico had outstanding a one-day $700 million drawing on its swap line under the Federal Reserve's reciprocal currency arrangements used to finance a short-run liquidity need which was repaid on August 1. Then, with the Mexican authorities proceeding with the implementation of a previously announced stabilization program, the Bank of Mexico again drew $700 million under its reciprocal swap line with the Federal Reserve on August 4, this time for a period of three months The Mexican authorities also arranged a temporary new $1 billion swap facility with the U S. Treasury over the August 14-15 weekend, drew $825 million, and then on August 24 repaid the entire drawing using an advance payment for oil from the U S Department of Energy. Meanwhile, negotiations among Mexico, the U S. Treasury, Federal Reserve, and major foreign central banks resulted in a multilateral package to provide bridge financing to an International Monetary Fund (IMF) standby credit. The credit facility totaling $1 85 billion comprised $325 million with the Federal Reserve, $600 million with the U.S. Treasury, and $925 million with the Bank for International Settlements. During the period under review the Bank of Mexico drew for three months $105 million and $195 million on the Federal Reserve and U.S Treasury swaps, respectively, as part of the first $600 million it took down on the combined facility. The Mexican authorities also made one overnight drawing of $250 million on the combined facility which was repaid. The drawing comprised $43.8 million on the Federal Reserve, $81.2 million on the U.S. Treasury, and $125 million on the Bank for International Settlements Subsequently, the Bank of Mexico also drew for three months $87.5 million on the Federal Reserve and $162.5 million on the U.S. Treasury, leaving $1 billion still available on the entire combined credit facility as of October 31.

In other developments the U.S. Treasury provided $1.23 billion of short-term financing to Brazil by arrangements which were under discussion since October. This additional short-term liquidity was made available in conjunction with economic policies adopted by Brazil at the October meeting of its National Monetary Council. The financing was provided under three swap facilities. One drawing on the first $500 million facility was made on October 28 for $350 million. Other facilities made available in November, when combined with the above-mentioned $500 million, totaled $1.23 billion and were announced by President Reagan during his visit to Brazil in the first week of December. The swap arrangements represent bridging loans to Brazil's drawings under the Compensatory Financing Facility of the IMF as well as on its reserve position with the IMF.

On September 1 the U.S. Treasury redeemed further German mark-denominated securities equivalent to $671.2 million. After this redemption, the Treasury had outstanding $2,397.9 million equivalent of foreign currency notes, public series, which had been issued in the German and Swiss markets with the cooperation of the respective authorities in connection with the dollar-support program of November 1978. Of the notes outstanding as of October 31, 1982, a total of $1,939.4 million equivalent was denominated in German marks and $458.5 million equivalent was denominated in Swiss francs.

In the three-month period from August through October, the Federal Reserve had no profits or losses on its foreign currency transactions. The Exchange Stabilization Fund (ESF) lost $0.6 million in connection with sales of foreign currency to the Treasury general account which the Treasury used to finance interest and principal payments on foreign currency-denominated securities. The Treasury general account gained $30.6 million on the redemption of German mark-denominated securities. As of October 31, 1982, valuation losses on outstanding balances were $777.9 million for the Federal Reserve and $1,472.9 million for the ESF. The Treasury general account had valuation gains of $619.3 million related to outstanding issues of securities denominated in foreign currencies.