August-October 1983 Interim Report
(This report was released to the Congress and to the press on December 7, 1983.)

Treasury and Federal Reserve Foreign Exchange Operations

Early in August the dollar moved up sharply, reaching a 9½-year high against the German mark and a record high on a trade-weighted basis. For much of the balance of the period, market participants expected the dollar to retreat substantially from those levels, and the dollar did depreciate gradually through early October. But, buoyed by the effects of greater than expected strength in the domestic economy and political turbulence internationally, the dollar strengthened again during the remainder of October to close the period little changed from its end-July levels against most major foreign currencies.

The decline in the dollar through early October was influenced by widespread predictions of a slowing of the recovery and an easing of money market conditions in the United States. Many forecasters doubted that the domestic economy, which had advanced at a strong 9.7 percent rate in the second quarter largely on the basis of a rebound in consumer expenditures and residential construction, could show sustained growth in the face of the strong dollar and high real interest rates. Moreover, growth of the narrowly defined monetary aggregate, M-1, had decelerated sufficiently to move within its monitoring range for the first time this year, and price data indicated that inflation remained relatively moderate. Consequently, many market participants came to the view that the Federal Reserve would take this opportunity to exert less pressure on bank reserves, and U S. financial markets developed a considerable sense of optimism from late August through early October Short-term interest rates declined by some ¾ percentage point. Yields on longer dated securities also fell, but by smaller margins. Some market participants were concerned that, if interest rates should continue to ease, financing the widening U.S. current account deficits could become more difficult.

However, the U.S. economy continued to grow faster than many observers had anticipated. To be sure, housing starts and retail sales temporarily weakened during the summer, and the release of these statistics kept alive expectations of a significant slowing later in the year. But demand in other sectors, especially business fixed investment and inventories, was strong enough to support major gains in industrial production and employment. During the third quarter, GNP registered a growth rate of some 7.7 percent in real terms, and by October it was clear that the economy retained considerable momentum as it proceeded into the fourth quarter.

As the economy remained buoyant, the scope for further declines in interest rates gradually came to be seen in the market as limited. After mid-October most U.S interest rates edged higher, reinforced somewhat by uncertainties over the credit market implications of the lack of Congressional action to raise the government debt ceiling. In addition, the rapid reemployment of idle

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Table 1

Federal Reserve Reciprocal Currency Arrangements

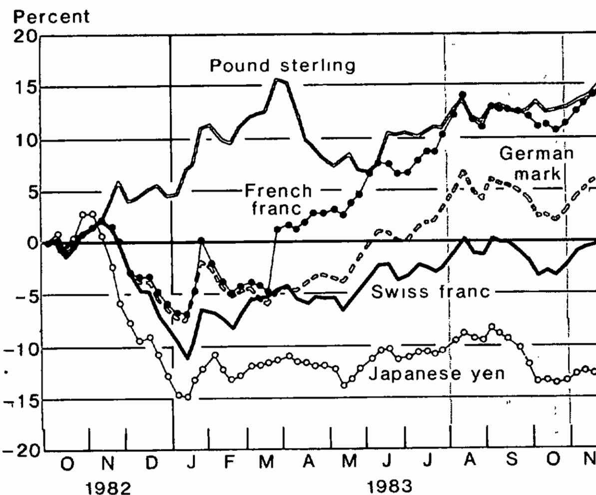
In millions of dollars

Institution	Amount of facility October 31, 1982	Amount of facility October 31, 1983
Austrian National Bank	250	250
National Bank of Belgium	1,000	1,000
Bank of Canada	2,000	2,000
National Bank of Denmark	250	250
Bank of England	3,000	3,000
Bank of France	2,000	2,000
German Federal Bank	6,000	6,000
Bank of Italy	3,000	3,000
Bank of Japan	5,000	5,000
Bank of Mexico		
Regular facility	700	700
Special facility	325	*
Netherlands Bank	500	500
Bank of Norway	250	250
Bank of Sweden	300	300
Swiss National Bank	4,000	4,000
Bank for International Settlements		
Swiss francs-dollars	600	600
Other authorized European currency-dollars	1,250	1,250
Total	30,425	30,100

*Facility, which became effective August 30, 1982, expired on August 23, 1983

Chart 1

The Dollar against Selected Foreign Currencies



Percentage change of weekly average bid rates for dollars from the average rate for the week of September 27-October 1, 1982 Figures calculated from New York noon quotations

Table 2

Drawings and Repayments by the Bank of Mexico under Special Combined Credit Facility

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

Drawings on	Outstanding October 1, 1982	1982 IV	1983 I	1983 II	1983 III	Outstanding October 31, 1983
Federal Reserve special facility for $325 million	46 0	+211 2	+ 67.8	− 56.0	−269 0	*
United States Treasury special facility for $600 million	85 5	+392 2	+122 3	−104 0	−496 0	*
Total	131 5	+603 5	+190 0	−160 0	−765 0	*

Data are on a value-date basis. Because of rounding, figures may not add to totals.

*Facility expired and outstanding drawings were repaid on August 23, 1983

capacity began to raise some questions among market participants over the medium-term outlook for monetary policy, particularly in view of the continuing fiscal stimulus provided by a large government deficit. As the outlook for U.S. interest rates and the economy shifted during October, market professionals moved to cover large short-dollar positions that they had built up earlier.

With the outlook for the U.S. economy remaining stronger than for those abroad, capital continued to flow into U.S. stock and bond markets. Also adding support for the dollar were "safe-haven" considerations prompting capital flows into the United States in response to events that heightened international tensions during the period. Market participants were mindful that such episodes had generated significant capital inflows at times during the past year, and talk of safe-haven influences resurfaced on September 1 following report that the Soviet Union had downed a Korean airliner. But that particular incident did not elicit a strong exchange rate reaction. Later in the period, however, intensified fighting in Lebanon, escalation of threats in the Iran-Iraq war, and a U.S. landing in Grenada were among the events that did have a more noticeable impact on the dollar and thereby enhanced the perceived risk of positioning against the U.S. currency.

Exchange market reaction to announcement of record U.S. trade and current account deficits was subdued, as the deficits were being easily offset by the continuing capital inflows. Although the statistics confirmed the existence of deficits of unprecedented size—with one monthly trade deficit over $7 billion—the current account issue faded into the background as a market factor, especially when the September trade deficit showed a reassuring narrowing.

The only currency to advance significantly against the dollar over the three-month period as a whole was the Japanese yen, buoyed by Japan's outstanding trade and price performance. The yen also benefited from the market's perception that the Japanese authorities were committed to supporting the yen. Bank of Japan Governor Mayekawa made clear that the exchange rate was an important consideration in the timing of the ½ percentage point discount rate cut which finally took place on October 21 in conjunction with announcement of a six-point economic stimulus package. The Japanese authorities stated that they remained ready to intervene in the exchanges when necessary to defend the yen, and in fact they did sell dollars in the market on several occasions during the period. Following close consultation with the Bank of Japan as the yen weakened late in the period, the U.S. authorities also purchased a modest amount of yen in a joint operation with the Japanese central bank. These operations began on October 31 and continued the next day. In total, the U.S. authorities purchased $29.6 million equivalent of yen, an amount that was split evenly between the Treasury and the Federal Reserve.

As detailed in the previous report covering the period through end-July, the U.S. authorities also intervened in the exchanges on four occasions during six business days, buying both Japanese yen and German marks, in coordinated operations that began on July 29 and lasted through August 5. These operations together brought the total of U.S. authorities' intervention in the exchange market from July 29 through November 1 to $283.6 million equivalent, split equally between the Treasury and the Federal Reserve. Of this amount, $101.0 million equivalent was in Japanese yen and $182.6 million equivalent was in German marks.

In other operations during the three-month period, Mexico fully repaid the remaining portion of its special combined credit facility. On August 15, Mexico prepaid outstanding swaps of $100.8 million to the Treasury and $54.3 million to the Federal Reserve. Drawings of $395.3 million and $214.8 million were repaid to the Treasury and the Federal Reserve, respectively, upon maturity on August 23, and the facility then expired. This

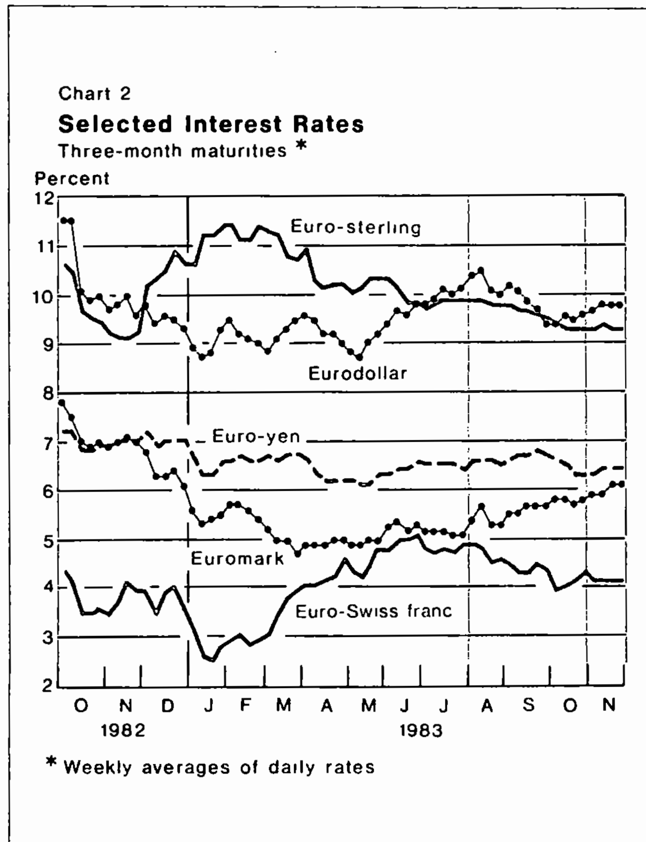


Table 3

Net Profits (+) or 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, 1983	-0-	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1983	−771 9	−786 2	-0-

Data are on a value-date basis

facility had originally consisted of $600 million from the Treasury and $325 million from the Federal Reserve It was provided in cooperation with other central banks, which together extended credit to the Bank of Mexico totaling $1 85 billion

During the past year, the Treasury had participated, along with other nations, in providing liquidity support to the Bank for International Settlements for credit facilities that the BIS provided to the Central Bank of Brazil and to the National Bank of Yugoslavia This support took the form of the Treasury, through the Exchange Stabilization Fund (ESF), agreeing to be substituted for the BIS in the event of delayed repayments By the end of the period, contingent commitments on behalf of Brazil remained at $500 million and on behalf of Yugoslavia were reduced to $16 million Both commitments expired as the credits were repaid after the close of the reporting period

In the period from August through October, the Federal Reserve, the ESF, and the Treasury general account realized no profits or losses from exchange transactions As of October 31, cumulative bookkeeping, or valuation, losses on outstanding foreign currency balances were $771 9 million for the Federal Reserve and $786 2 million for the ESF (Valuation gains and losses represent the increase or decrease in the dollar value of outstanding currency assets and liabilities, using end-of-period exchange rates as compared with rates of acquisition) These losses reflect the fact that the dollar strengthened since the foreign currencies were purchased

The Federal Reserve and the Treasury invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve invested some of its foreign currency resources in securities issued by foreign governments As of October 31, the Federal Reserve's holdings of these securities were equivalent to $1,618 6 million In addition, the Treasury held the equivalent of $2,318 8 million in these securities as of end-October