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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 17, 1975

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached for your information is a memorandum from Mr. Pardee, dated March 14, 1975, and entitled "Review of Factors Underlying Recent Dollar Decline and Implications for Federal Reserve Intervention Policies."

This memorandum was prepared in response to a suggestion by Governor Bucher at the February meeting of the Committee.

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March 14, 1975

To : Federal Open Market Committee

From: Scott E. Pardee

Subject: Review of Factors Underlying Recent Dollar Decline and Implications for Federal Reserve Intervention Policies.

At the February 18 meeting, Governor Bucher expressed his concern that the System's swap commitments had become quite large and that repayment might be difficult in view of the Board staff's pessimistic forecast for the United States payments balance in 1975. Governor Bucher then questioned whether further substantial intervention would be appropriate in view of the provision in the Foreign Currency Directive that

> "Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise."

He asked for a review of these considerations.

In my view, it would be unfortunate and disruptive to the exchanges to curtail our efforts to maintain orderly market conditions. The pressures against the dollar, which have recently subsided somewhat, mainly reflected temporary and psychological factors that fed on each other and swamped more favorable trends in the fundamentals. The more forceful and concerted intervention undertaken since late January has reassured the market that any further slide in dollar rates will be resisted. Meanwhile, recent economic developments here

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and abroad have forced foreign exchange dealers to reassess whether their extreme pessimism for the dollar is justified.

The economic situation in the United States has been a major factor in the increasingly bearish sentiment toward the dollar in late 1974-early 1975. By October, when the current build-up of swap commitments began, the market was beginning to show signs of nervousness over the onset of a sharp decline in U. S. interest rates. As evidence mounted over subsequent months that the economic recession was more severe for the United States than for other countries, the market came to expect interest rates here to drop off even more rapidly to levels well below those available abroad. Each news item pointing to a weakening of the U. S. economy was taken by the market as a signal to sell dollars. For a time, the market's expectations of a sharp easing in United States interest rates seemed to be confirmed as interest rate incentives shifted to favor placements in an increasing number of other currencies late last year and in early January.

Moreover, the market was concerned that, in the clamor for more stimulative policies, interest rates might be driven so low as to rekindle inflationary pressures in the United States. For the same reason, selling pressure on the dollar erupted each time a gloomy forecast for the United States budget deficit appeared. The very noisiness of the debate in the United States over economic and energy policy generated skepticism in the market that effective or timely policies would emerge.

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In such an atmosphere, the market tended to ignore evidence of the economic slowdown in many other major countries, and of the need by foreign governments also to adopt more expansionary policies, which some already had done. Interest rates were falling abroad, and by late January interest rates in Germany and Switzerland, in particular, were at or below those in the United States. Since then, interest rates have come down in other major countries as well. It is noteworthy that since late August, with the exception of the Bank of Japan, all major foreign central banks have reduced their lending rates, in some cases by more than the Federal Reserve. Many have used other monetary techniques to augment domestic liquidity as well.

Another factor in the dollar's weakness has been the market's concern over possible large-scale diversification of OPEC reserves out of the dollar and into other currencies. The emergence of unfavorable interest incentives contributed to this concern as did heightened tensions in the Middle East. At the same time, however, the decline of the dollar, with widespread expectations that it would continue, provided further incentive for OPEC shifts into currencies considered more likely to rise. Following the easing of controls against short-term capital inflows by Germany and Switzerland, the mark and the Swiss franc were considered prime candidates to receive additional OPEC funds. The amounts of actual diversification seem not to have been massive, but market anxieties have fed on several highly-publicized transactions, particularly into Deutsche marks, and on statements by OPEC spokesmen suggesting that, owing to the dollar's weakness, they are seeking an

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alternative currency or basket of currencies for invoicing their oil exports. In these circumstances, and with the exchange markets generally thin since the Herstatt closure, any sizable dollar offer against those currencies would have a profound effect on dollar exchange rates. In contrast, the substantial dollar purchases by the oil companies' European affiliates, to finance monthly oil payments to OPEC, have been handled quietly and have gone largely unnoticed.

A further source of concern was the possibility that large short positions in Continental currencies remained to be covered in the market, in the backwash of last year's foreign exchange losses by banks in several countries. This concern surfaced in January when the failure of yet another Sindona-related institution left a major Swiss bank short of Swiss francs. That bank's efforts to cover itself in the market generated exaggerated guesses of the amounts needed, and the franc was bid up sharply, pulling other currencies up against the dollar. The National Bank eventually arranged to provide cover for that bank's needs, but the dealers are suspicious that other short positions remain. The National Bank assures us, however, that this source of potential disturbance has passed.

These temporary factors, acting independently or in combination, dominated the exchange markets through late 1974 and early 1975, and overshadowed the evidence of a strong gain in the U.S. competitive position. As a result of the oil price hike, the United States was hit with a $17 billion increase in its oil bill

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in 1974 which led to a string of sizable monthly trade deficits through August. Nevertheless, U.S. exports rose by 40 percent for 1974 as a whole, and the trade deficit clearly narrowed during the last months of the year, when the dollar was declining sharply in the exchanges. The trade figures for January confirm that improvement, as a temporary jump in oil imports masked what otherwise would have been a sizable surplus. Forecasting the U. S. trade balance is particularly hazardous, but my own hunch is that the Board staff's forecast is unduly pessimistic, given that the U.S. has suffered a sharper drop-off of income than generally experienced abroad. Moreover, as our December and January price indices have demonstrated, the inflation rate in the United States has been slackening abruptly, to levels lower than in most other major countries, and this may improve our trade performance in the months ahead.

The greater competitiveness of United States exports has not gone unnoticed abroad. As the dollar depreciated late last year and into early 1975, European exporters became increasingly concerned over an emerging undervaluation of the U. S. dollar that would leave them at a competitive disadvantage in world markets. By late January, this potential problem was also recognized by European government officials, who publicly noted that the dollar had fallen to unrealistically low levels in the exchange markets. By that time, from the September peak levels the dollar had dropped by 27 percent against the Swiss franc and 17 percent against the German mark and by lesser amounts against most other major currencies.

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Up to that point, the Desk had maintained a flexible intervention posture. In October and November, the Desk had operated forcefully on some occasions in conjunction with forceful operations by foreign central banks. In December and January, however, there was a consistent tendency toward lower dollar rates, and the Desk had operated on a modest scale to cushion, but not to resist, the day-to-day declines. By late January, it was clear that a more forceful approach was needed in view of the deteriorating market atmosphere.

On February 1, the Federal Reserve, the Bundesbank and the Swiss National Bank agreed to a program of more forceful intervention. The immediate effects were salutory, but subsequent events--particularly a further decline in U.S. interest rates, a jump in our unemployment rate, and open discussion among OPEC governments over means of protecting themselves against the dollar's depreciation--reinforced the bearish sentiment which had driven the dollar down in the first place. Consequently, the dollar came under renewed pressure and was pushed back to its January lows. The Desk operated flexibly to resist the decline. Moreover, along with further intervention by the Bundesbank and the Swiss National Bank, the central banks of France, the United Kingdom, Belgium, Netherlands, Italy and Japan also bought dollars, in some cases in sizable amounts.

Since late February, the atmosphere has improved, and the dollar has recovered some ground. Recent intervention has been modest. In my judgment the dollar remains heavily oversold in the market, and once a clear turnaround develops we should be able to cover our swap indebtedness, hopefully at a profit.