(This report was released to Congress and to the press on March 9, 1987)

Treasury and Federal Reserve Foreign Exchange Operations

November 1986 – January 1987

After trading fairly steadily throughout November and the first half of December, the dollar moved sharply lower until the end of January. It closed the period down more than 11 percent against the German mark and most other Continental currencies, about 7 percent against the Japanese yen and the British pound, and almost 4 percent against the Canadian dollar. There were large dollar purchases by foreign central banks during the period. The U.S. authorities intervened on one occasion in late January.

As the period opened, the dollar had moved up from the lowest levels reached against the yen and the mark in the third quarter. Many market participants were beginning to believe that the dollar, after a long decline, was entering a stage of greater near-term stability (Chart 1). There were some indications that the favorable side of depreciation was starting to show through in the U.S. economy. The trade deficit seemed to have stabilized at last, though remaining large at $14 billion a month. Output growth in the third quarter also appeared to have been a little stronger than many market participants had previously expected, suggesting some strengthening of export demand.

Meanwhile, the cumulative effects of the dollar's prolonged depreciation were seen in financial markets to be exerting pressures in other countries for more exchange rate stability. Although Japan's trade surplus remained high in nominal terms, the yen's sharp appreciation was eroding competitive positions, resulting in some production cutbacks for overseas markets, and contributing to a rise of unemployment rates. Questions arose whether Japanese domestic demand would remain strong enough to sustain the modest rate of economic growth forecast for the current year. In late October, there had been an announcement of a 1/2 percentage point cut in the Bank of Japan's discount rate and of an economic policy accord between U.S. Treasury Secretary Baker and Japanese Finance Minister Miyazawa. The monetary policy action, together with the accord's assurances with respect to Japanese and U.S. fiscal policies, was seen as supportive of more favorable prospects for the Japanese economy and for a reduction in the two nations' external imbalances. At the same time, understandings reached in the Baker-Miyazawa agreement—that the exchange-rate realignment already accomplished between the two currencies was "now broadly consistent with the present underlying fundamentals" and that the two nations were reaffirming their willingness to cooperate on exchange rate issues—took pressure off the yen in the exchange market. The accord seemed to imply agreement that the yen's appreciation was sufficient, at least for the time being. Many market participants also believed that, henceforth, official intervention—perhaps on a coordinated basis—would be used if necessary to counter a new rise in the yen.

In the case of Germany, the mark's appreciation was seen in the market as increasing pressure on German authorities to take steps to ease currency strains within

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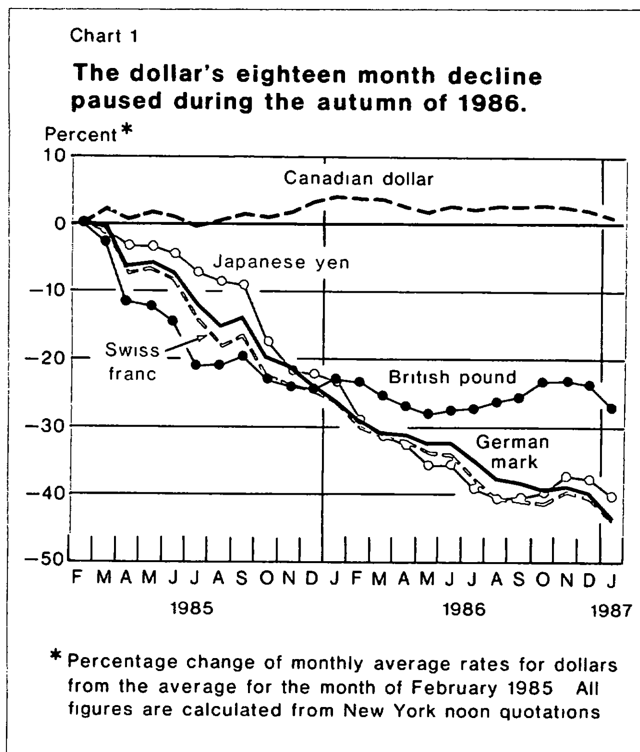


* Percentage change of monthly average rates for dollars from the average for the month of February 1985 All figures are calculated from New York noon quotations

the European Monetary System (EMS). Since the mid-September Economic Community (EC) meeting in Gleneagles, Scotland, central banks participating in the EMS monetary arrangements had used exchange market intervention to try to protect the EMS from tensions associated, in part, with the decline in the dollar. Although there was little evidence that Germany's internal economy was suffering heavily from the effects of the mark's appreciation, many market participants expected the Bundesbank to buy dollars in the exchange market if the dollar resumed a significant downward movement.

Under these circumstances, market professionals moved in early November to cover short dollar positions assumed earlier. This bidding for dollars helped push up dollar rates to their highs of the three-month period, around DM 2.08 against the mark and Y 165 against the yen. The dollar continued for a time to be reasonably well bid, especially against the Japanese yen as institutional investors from Japan bought a broad variety of dollar-denominated assets, including equities and real estate investments. The continuing firmness of the dollar vis-à-vis the yen took on a self-reinforcing character; with the dollar standing well above Y 160 after announcement of the Baker-Miyazawa accord, confidence grew that the dollar would stay around these levels. Consequently, Japanese investors not only bought new dollar-denominated securities, they also repaid loans used to finance previous investments. In early December, when dollar interest rates began to rise, largely for seasonal and tax-related reasons, the costs of dollar-borrowings increased and Japanese investors unwound their hedges further.

The dollar was not as strong against the European currencies as it was against the yen. After the dollar reached its high against the mark in early November, market professionals began to build up their mark positions, and many European-based investors who had hedged their dollar assets earlier in the year were content to retain their protection against a renewed dollar decline. In addition, market participants came to the view that the agreement between Secretary Baker and Minister Miyazawa was not relevant for the dollar/mark exchange rate. In these circumstances, the dollar eased back against the mark in November and early December. It subsequently rose against the mark in mid-December, however, when reports of a trip by Secretary Baker to Europe generated expectations that the German authorities would join in an agreement on exchange rate stability similar to the Baker-Miyazawa accord. By the middle of December, the dollar was trading near DM 2.03, down a modest 1½ percent against the mark since the end of October; it was virtually unchanged against the yen at about Y 163.

Table 1

Federal Reserve Reciprocal Currency Arrangements

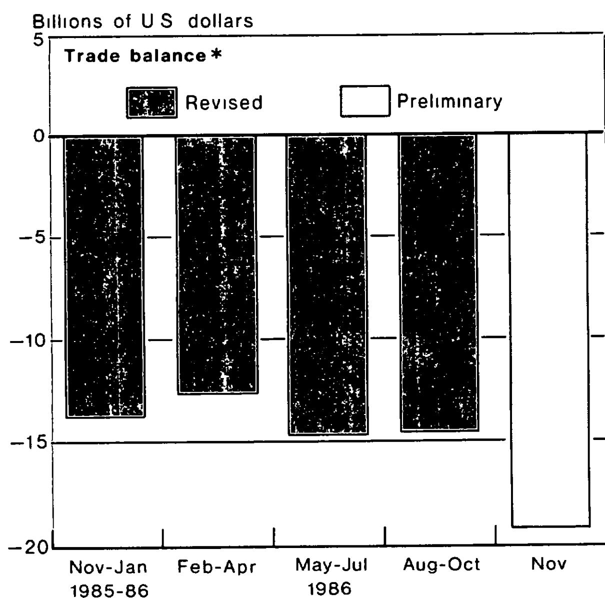
In millions of dollars

Institution	Amount of Facility January 30, 1987
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against other authorized European currencies	1,250
Total	30,100

While the view that the dollar was in a period of stability dominated trading until mid-December, a number of developments were taking place at the same time that gradually undermined the market's confidence in that view. Many market participants were becoming convinced that U.S. domestic demand was slowing and that any signs of strength would prove temporary, reflecting shifts in the timing of transactions before new tax laws took effect at the start of the year. The prospects for 1987 were increasingly seen as dependent on a turnaround in the U.S. trade position.

Chart 2

The release of preliminary trade statistics for November at the end of the year dispelled the view that the U.S. trade deficit had stopped deteriorating.



*Census data Three-month averages for periods indicated, monthly value for November

At the same time, U.S. Congressional elections resulted in a Republican loss of the Senate majority. This outcome was interpreted as complicating the Administration's efforts to maintain control of economic policy, most especially to resist pressure for protectionist legislation or calls for a lower dollar. Political uncertainties intensified following revelations that some U.S. officials had participated in controversial arms sales.

Meanwhile, developments in Germany and Japan indicated that the major industrial countries might be moving away from the economic conditions needed for greater exchange rate stability. In Germany, short-term interest rates rose markedly in November and December. While some of the tightness was attributed to seasonal factors, there was concern in the market that the German central bank might have adopted a more restrictive monetary stance to curb above-target expansion in central bank money. Comments by some German officials seemed to support this view. In Japan, the government adopted a budget late in December for the fiscal year beginning in April 1987 that did not appear to provide the degree of fiscal support to the economy expected after the Baker-Miyazawa accord.

Although the dollar started to soften during the second half of December in response to these developments, market forces did not turn decidedly against the dollar until year-end. On December 31, preliminary U.S. trade statistics were released showing a massive deficit for November of $19.2 billion (Chart 2). Several days later, Secretary Baker and other Administration officials commented that special and temporary factors distorted the figures for November and that some of these factors could also influence December trade flows, which might show a similarly large gap.

The preliminary November trade figures were a severe disappointment to the market. They dispelled the belief that a favorable shift in U.S. trade performance had begun and cast an even more pessimistic shadow on

Table 2

Drawings and Repayments by Foreign Central Banks under Regular Reciprocal Currency Arrangements

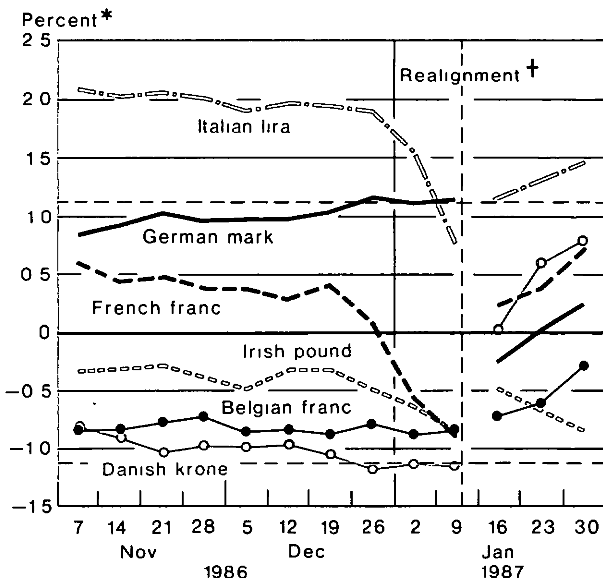
In millions of dollars, drawings (+) or repayments (−)

Central Bank Drawing on the Federal Reserve System	Outstanding as of November 1, 1986	November	December	January	Outstanding as of January 30, 1987
Bank of Mexico	143 4	−66 8	−39 6 +61 8	−37 4	61 4

Data are on a value-date basis

Chart 3

Tensions within the EMS increased in November and December, prompting a realignment over the January 10 weekend.



Weekly averages of 9 a.m. rates in New York for the weeks ending on dates shown

* Percentage deviation of each currency from its ECU central rate. Dotted lines correspond to the System's 2¼ percent limit on movement from bilateral central exchange rates for all participating currencies except the Italian lira. The lira may fluctuate 6 percent from its central rates against other EMS currencies.

† The bilateral central rates of the German mark and Netherlands guilder were revalued by 3 percent and those of the Belgian franc by 2 percent against the other participating currencies.

the outlook for economic growth in the new year. Moreover, the figures enhanced the position of those arguing that the United States needed to take an aggressive approach to improving its trade position. The debate on trade policy gained new attention with the reopening of Congress early in January. Against this background, statements attributed to several U.S. officials were interpreted by market participants as being consistent with the view that the United States now welcomed a lower dollar. By the start of the new year, market sentiment towards the dollar had turned clearly bearish, and dollar rates moved sharply lower—to DM 1.92 and Y 158, down more than 5 percent and 3 percent since mid-December against the mark and the yen, respectively.

In early January, the selling of dollars against the mark subsided temporarily as the market focused its attention on a rapidly changing situation within the EMS (Chart 3). As the mark was rising against the dollar and emerging at its top intervention limit within the EMS arrangement, some other EMS currencies were being weakened by concerns about underlying competitiveness and the sustainability of balance of payments positions. Earlier, market participants had widely assumed that no adjustment of EMS parities would take place before national elections in Germany in late January. But as pressures within the EMS intensified and intervention to preserve existing parities ballooned, the prospect of an earlier realignment developed. During the first weekend in January, press commentary suggested that the German authorities would accept an immediate realignment rather than face several weeks of massive intervention which might undermine the Bundesbank's efforts to maintain control over monetary growth. The next week, the EMS currencies were caught up in a speculative whirlwind as residents of EMS countries other than Germany sought to hedge their mark commitments. The EMS exchange rate structure was maintained by intervention until the January 10 weekend

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangement with the U.S. Treasury

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

Central Bank Drawing on the U.S. Treasury	Amount of Facility	Outstanding as of November 1, 1986	November	December	January	Outstanding as of January 30, 1987
Bank of Mexico	273.0	144.0	−67.0	−39.8 +62.0	−37.6	61.6
Central Bank of Nigeria	37.0	22.2	−7.4	−14.8	*	*

Data are on a value-date basis.

*No facility.

when a realignment was agreed upon. After the realignment, reflows out of marks back into other EMS currencies were slow to materialize.

Once the EMS realignment was over, traders perceived the Bundesbank as unlikely to intervene in dollars to prevent movements in dollar exchange rates from aggravating EMS strains. Thus, the dollar came under sharp selling pressure when trading resumed following the realignment, pressure that was to continue for most of the rest of the month (Chart 4).

Selling of dollars against yen also built up rapidly. With the dollar below Y 160 against the yen, market participants questioned whether the Baker-Miyazawa accord would indeed assure exchange market stability. Finance Minister Miyazawa and Bank of Japan Governor Sumita were reported to have made it known, in order to reassure the markets, that the Japanese central bank would intervene to prevent the dollar from depreciating further, almost regardless of cost. At the same time, market participants commented that there were no similar statements by U.S. officials. On January 13, after the dollar broke through Y 158, Japanese exporters rushed to sell dollars, and Japanese investment houses and pension funds flooded the market with forward sales to hedge their dollar exposures. The dollar declined by more than 1 percent against the yen that day in heavy trading. The Japanese press reported that the Bank of Japan had bought huge amounts of dollars. Traders interpreted the report as indicating that the pressure on the dollar was so strong that official intervention without the participation of the U.S. authorities would fail.

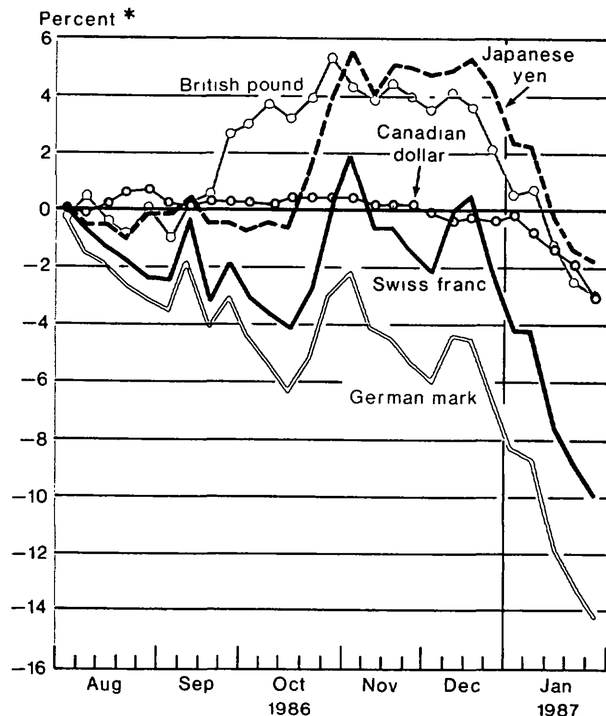
Against this background, a news report on January 14, citing an unidentified U.S. official as stating that the U.S. Administration wanted the dollar to decline further, unleashed new selling of dollars against both the mark and the yen. The dollar fell by more than 3 percent against both currencies in a few hours of extremely nervous trading.

The dollar's decline continued throughout most of January as strong selling pressure mounted on three additional occasions. Each occurred in response to various statements, attributed to Administration officials, that market participants believed reflected a continuing lack of official concern about the dollar's decline. The dollar hit a post-World War II low of Y 149.98 against the yen on January 19, and a seven-year low of DM 1.7675 against the mark on January 28.

On January 21, a consultation between Secretary Baker and Finance Minister Miyazawa resulted in a joint statement that, among other things, reaffirmed their willingness to cooperate on exchange rate issues. When the dollar moved down on the morning of January 28, after the President's State of the Union Message, U.S. authorities intervened in yen, in a manner consistent

Chart 4

During the second half of the period under review, the dollar moved sharply lower.



* Percentage change of weekly average rates from the week ending August 1, 1986 All figures are calculated from New York noon quotations

Table 4

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
November 1, 1986-January 30, 1987	+8 0	+6 6
Valuation profits and losses on outstanding assets and liabilities as of January 30, 1987	+2,322 8	+1,975 0

Data are on a value-date basis

with the joint statement. Operating in coordination with the Japanese monetary authorities, the Foreign Exchange Trading Desk purchased $50 million against the sale of yen, financed equally by the Federal Reserve and the U.S. Treasury.

During the final days of the month, pressures against the dollar subsided. Reports of the U.S.-Japanese intervention operation and talk of an upcoming meeting of financial authorities of the major industrial countries encouraged expectations for broader cooperation on exchange rate and economic policy matters. Also, release of preliminary U.S. trade data for December, showing a much smaller deficit of $10.7 billion, and a substantial downward adjustment in the revised data for November revived the view that the U.S. trade deficit had stabilized (Chart 5).

Moreover, doubts had developed about the future course of U.S. interest rates. The swift decline in dollar exchange rates raised questions in the market whether the Federal Reserve would let short-term rates ease. Market participants also noted that U.S. market interest rates had not completely fallen back to the levels prevailing before year-end (Chart 6). Interest rates in other countries were, by contrast, below late November levels, especially in Germany after the Bundesbank announced on January 22 cuts of 1/2 percentage point in its discount and Lombard rates to 3 percent and 5 percent, respectively, effective January 23, in conjunction with other monetary policy measures.

Thus, the dollar firmed from its lows against both the mark and the yen to close the period at DM 1.8320 against the mark and Y 153.70 against the yen. As measured by the Federal Reserve Board's trade-weighted index,

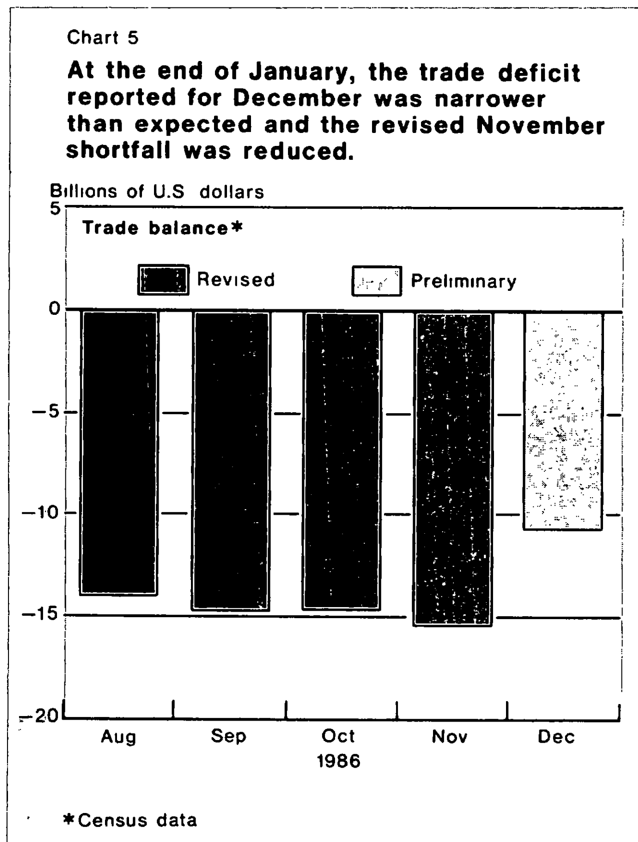


Chart 5

At the end of January, the trade deficit reported for December was narrower than expected and the revised November shortfall was reduced.

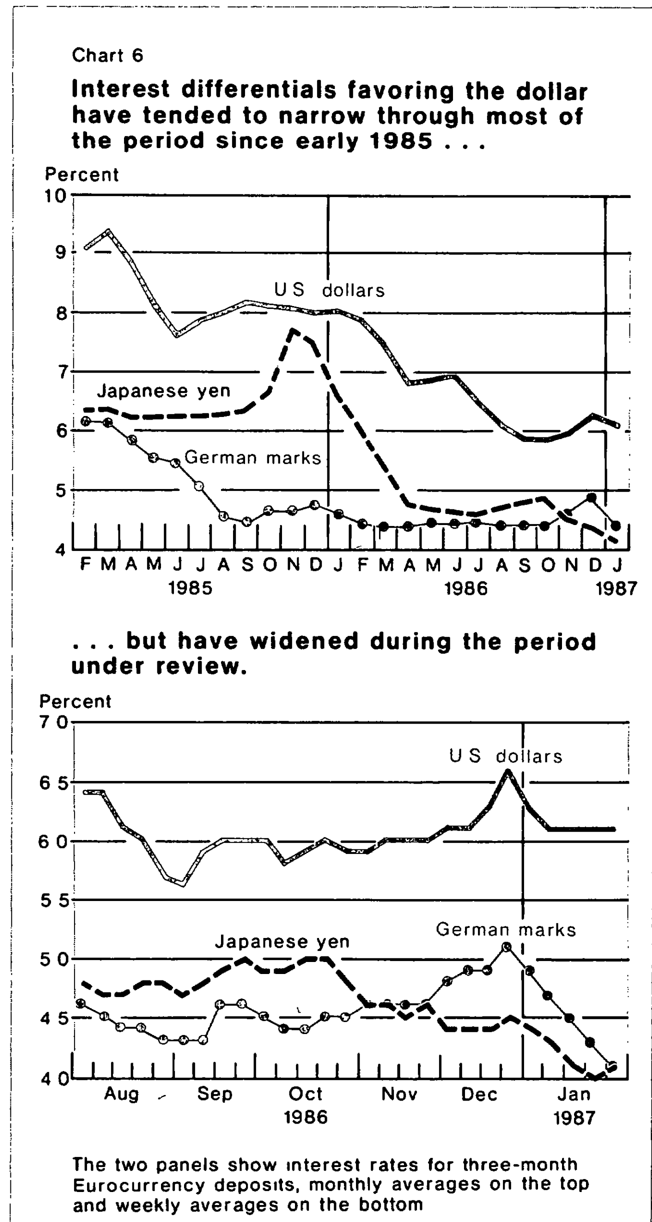


Chart 6

Interest differentials favoring the dollar have tended to narrow through most of the period since early 1985 . . .

. . . but have widened during the period under review.

The two panels show interest rates for three-month Eurocurrency deposits, monthly averages on the top and weekly averages on the bottom

it had declined 9 percent since the beginning of the three-month period.

* * * *

At the beginning of the three-month period, Mexico and Nigeria had drawings outstanding on short-term financing facilities of the U.S. Monetary Authorities.

Mexico. As noted in the previous report, $850 million of a $1.1 billion multilateral near-term contingency support facility for Mexico's international reserves was made available jointly by the U.S. Monetary Authorities, the Bank for International Settlements (acting for certain central banks), and the central banks of Argentina, Brazil, Colombia, and Uruguay on August 29. On that date, the Central Bank of Mexico drew $211 million from the U.S. Treasury through the Exchange Stabilization Fund (ESF) and $210.2 million from the Federal Reserve through its regular swap facility with the Bank of Mexico. As of November 1, $144 million was outstanding from the drawings on the ESF and $143.4 million was outstanding from the drawings on the Federal Reserve. The Central Bank of Mexico repaid its August 29 drawings from the ESF and the Federal Reserve in three installments starting on November 26, liquidating them by January 5.

On December 8, after Mexico received disbursements under loans from the International Bank for Reconstruction and Development, the Central Bank of Mexico became eligible to draw the remaining $250 million under the multilateral facility. On this date, Mexico drew $62 million from the ESF and $61.8 million from the Federal Reserve. On January 5, the Central Bank of Mexico repaid the ESF and the Federal Reserve each $0.4 million in connection with its other repayments, leaving $61.6 million outstanding on its December drawing from the ESF and $61.4 million outstanding on its drawing from the Federal Reserve at the end of the period. After the period closed, Mexico fully liquidated these outstanding commitments.

Nigeria. At the beginning of the period, Nigeria had a $22.2 million swap drawing outstanding from a $37 million short-term facility provided by the ESF. This facility was part of a $250 million short-term credit facility organized under the leadership of the Bank of England. The Central Bank of Nigeria repaid $7.4 million on November 28 and the remaining $14.8 million on December 10.

* * * *

In the period from November 1 through January 30, the Federal Reserve and ESF realized profits of $8 million and $6.6 million, respectively. As of January 30, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $2,322.8 million for the Federal Reserve and $1,975 million for the Treasury's ESF. These valuation gains represent the increase in the dollar value of outstanding currency assets valued at end-of-period exchange rates, compared with the rates prevailing at the time the foreign currencies were acquired.

The Federal Reserve and the ESF invest foreign currency balances acquired in the market as a result of their foreign 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, as of January 30, the Federal Reserve held $3,103.6 million equivalent in securities issued by foreign governments. As of the same date, the Treasury held the equivalent of $4,265.5 million in such securities.