Treasury and Federal Reserve Foreign Exchange Operations

February-April 1989

The dollar traded with a firm undertone during most of the three months ending in April, buoyed by persistent investment and commercial demand for the currency. At times, upward pressure intensified and, in keeping with Group of Seven (G-7) undertakings to foster exchange rate stability, the U.S. monetary authorities intervened to resist the dollar's rise. On occasion, the upward pressure subsided and the dollar eased back somewhat. Overall, dollar exchange rates remained more stable than in recent quarterly periods, although throughout the period the currency continued to edge back toward the highs reached in the fall of 1988. On balance, the dollar rose 1/4 percent against the German mark and Canadian dollar, 2 1/4 percent against the Japanese yen, 4 percent against the British pound, and 5 percent against the Swiss franc (Chart 1). The dollar ended the three-month period 1 percent higher on a trade-weighted basis as measured by the staff of the Federal Reserve Board of Governors.

A variety of factors contributed to the investment demand for dollars and dollar assets during this period. The currency's stronger performance in 1988 and early 1989 relative to preceding years prompted investors to feel more confident about increasing the share of dollar assets in their overall portfolios and reducing the hedged proportion of their dollar assets. By such actions, they could benefit more from the relatively wide short-term interest rate differentials favoring the dollar and avoid the increased costs of maintaining hedges.

A report presented by Sam Y Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account Daniel Brotman was primarily responsible for preparation of the report

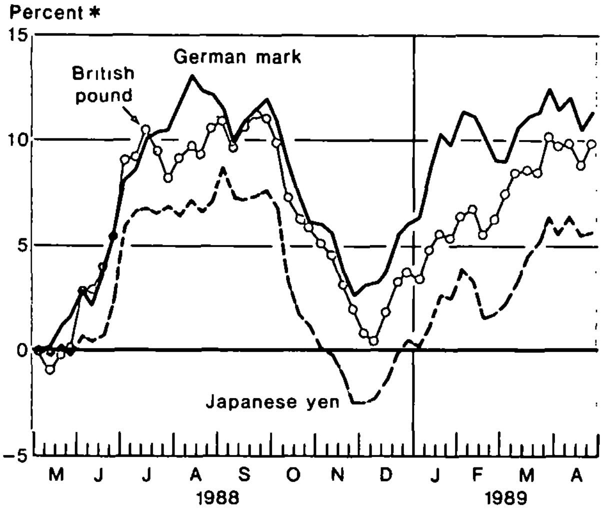
Meanwhile, as positive sentiment toward the dollar mounted, commercial market participants also began to alter their trading strategies Those, such as Japanese exporters, who at times in the past had been heavy forward sellers of dollar receivables scaled back their selling in advance of payment Similarly, those who had dollars to buy in the future began to buy more dollars during the period lest the U.S currency rise further. With the dollar consistently well bid in the market, interbank and speculative position-takers became more willing to take on long-dollar positions.

Underpinning the more positive sentiment toward the dollar were two key factors: interest rate differentials and political developments. Interest differentials continued to favor the dollar, providing a strong incentive for investors to purchase dollar assets so long as they presumed the dollar would remain stable or rise. During the three months ending in April, short-term interest rate differentials against the yen increased from what were already considered high levels, while against the mark they remained sizable but in about the same range as earlier (Chart 2).

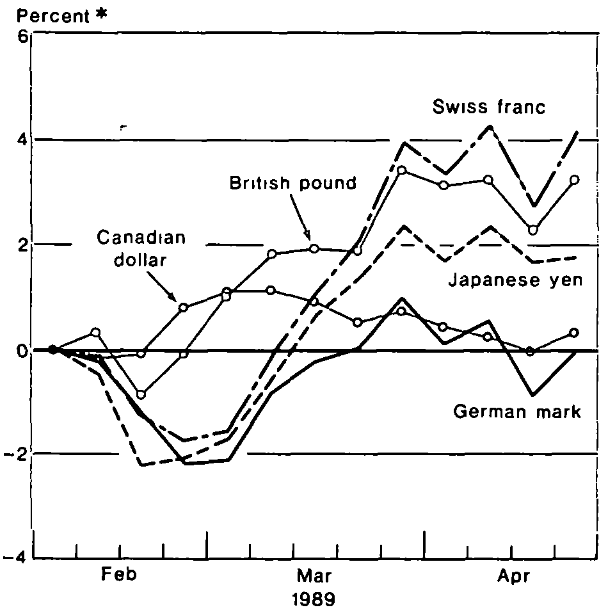
At times during the period, political developments abroad also weighed against several major foreign currencies. In Japan, investigations of an insider trading scandal brought the government of Prime Minister Takeshita under increasing pressure and raised concerns about its viability. In Germany, electoral setbacks to the governing coalition's leading party and other centrist parties gave rise to market uncertainty at a time when there was already considerable confusion in

Chart 1

The dollar traded within a relatively narrow range during the three months ending in April 1989, after recovering from its autumn lows late in the previous period.



Still, the dollar moved higher on balance against a number of currencies, with upward pressure especially noticeable in March and late April.



* The top chart shows the percentage change of weekly average rates for the dollar from May 2, 1988 The bottom chart shows the percentage change of weekly average rates from February 1, 1989 All figures are calculated from New York noon quotations

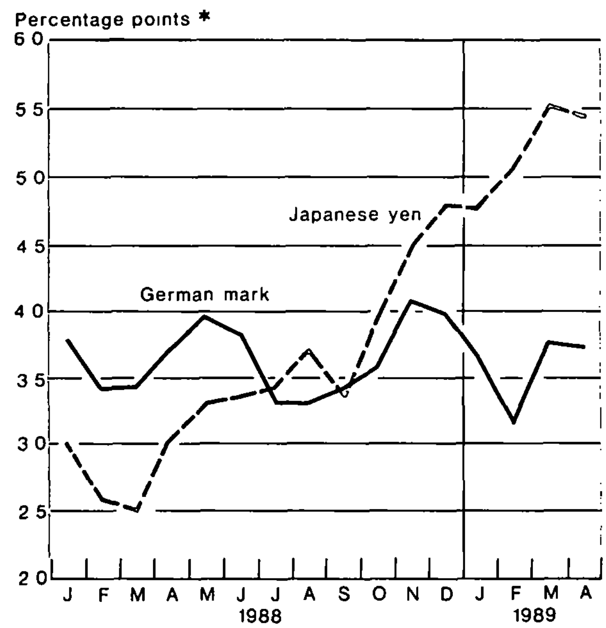
the market surrounding the imposition and subsequent removal of a withholding tax on interest income.

Under these circumstances, market participants appeared increasingly willing to overlook, at least for the time being, developments cited last year as giving rise to concerns about the dollar Trade data released by the United States and other countries during the period suggested that the pace of adjustment of world trade and current account balances might be slowing (Chart 3) Similarly, market observers at times expressed disappointment over the absence of plans for substantial, long-term reduction of the U.S budget deficit

During the period, the degree of upward pressure on the dollar varied in response to shifting market views regarding inflationary pressures and the appropriate tightness of monetary policy in the United States and abroad Changing market assessments of official commitments to exchange rate stability at times also

Chart 2

Short-term interest rate differentials favoring the dollar over the yen continued to widen, while those against the mark remained in their recently observed range.



* The chart shows monthly average differentials at the three-month maturity between Eurodollar deposit rates and Euromarket deposit rates for marks and yen

affected market demand for the U.S. currency. Upward pressure was most pronounced at the opening of the period in February, during March, and toward the end of April. Upward pressure abated and the dollar settled back somewhat in mid-February and mid-April.

After a strong opening, the dollar settles back in mid-February

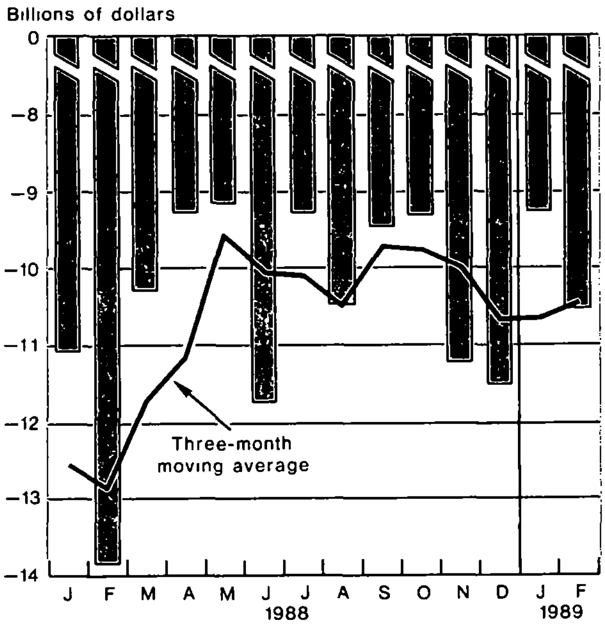
When the three-month period opened in February, market sentiment toward the dollar was distinctly bullish. Market participants, mindful of Chairman Greenspan's earlier indications in Congressional testimony of the Federal Reserve's strong anti-inflationary stance, interpreted evidence of robust U.S. economic growth as a portent of higher dollar interest rates. In particular, the early February report of an unexpectedly large rise in U.S. employment in January reinforced expectations that a buoyant economy would lead to further tightening of U.S. monetary policy. As the dollar firmed above its January highs, the U.S. monetary authorities sold a total of $350 million against marks during the period from February 2 through February 6 in the only intervention operations during the month.

Thereafter, sentiment toward the dollar took on a more cautious tone. This change in sentiment appeared, in part, to reflect concern about central bank intervention. The currency was approaching levels at which central banks had acted forcefully to counter its rise in 1988. Believing the central banks would seek to limit the dollar's rise at these levels again, market participants appeared less aggressive about bidding for dollars in the exchange market. Also, after President Bush's budget address before the Congress on February 9, market participants began to adopt a more realistic view regarding the difficulties the Administration and the Congress would face in negotiating a long-term plan to reduce the U.S. fiscal deficit. After rising in early February to DM 1.8880 and ¥ 130.67, the dollar began to edge lower, and upward pressure abated.

By mid-February, inflation and monetary policy had become the most immediate market concerns. A variety of economic statistics released at that time seemed to indicate a surprising upturn in inflation in several industrialized countries, including the United States and Germany (Chart 4), as well as a worrisome persistence of high inflation in the United Kingdom. There was also considerable uncertainty about the

Chart 3

Data released during the period suggested a slowing in the U.S. trade adjustment process.



The chart shows monthly and three-month moving average U.S. merchandise trade balances, seasonally adjusted and reported on a census basis. The trade figures for December, January, and February were released on February 17, March 15, and April 14, respectively.

Table 1

Federal Reserve Reciprocal Currency Arrangements

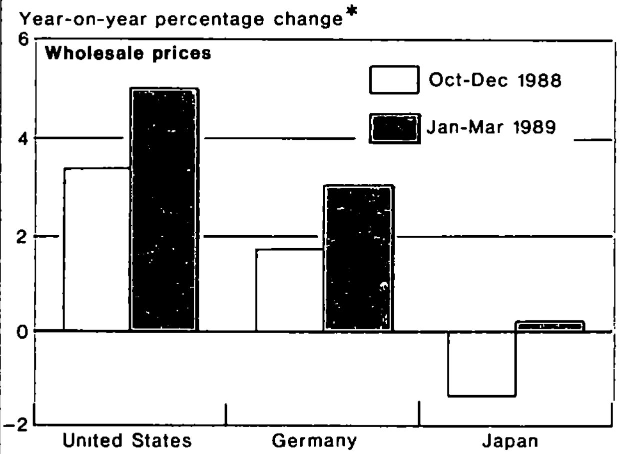
In Millions of Dollars

Institution	Amount of Facility April 28, 1989
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
Deutsche Bundesbank	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

extent to which tax changes in several foreign countries might give rise to inflationary wage demands in the coming months Against this background, market participants began to wonder whether efforts to subdue inflation worldwide might prove more difficult, and require higher interest rates, than had previously been assumed. The management of monetary policy by central banks in various countries tended to come under greater market scrutiny

Chart 4

Data released during the period indicated an upturn in price pressures in several industrialized countries, focusing the market's attention on inflation and monetary policy.



*The chart shows the change in wholesale prices for the three-month period relative to the same three months in the previous year The figures for January-March were released during the period under review

As for the United States, some market observers questioned whether the successive modest tightening moves by the Federal Reserve over the past year would be sufficient to prevent an acceleration of inflation. At the same time, market participants expressed concern that the potential economic, financial, and political implications of further policy tightening might deter the U S central bank from acting as forcefully as needed

In contrast, market analysts at that time appeared more certain that signs of accelerating inflation in Germany would lead to a quick tightening of the German central bank's policy stance This market view showed through in a significant increase in German money market rates as German banks aggressively bid for funds in anticipation of a near-term increase in the Bundesbank's official interest rates

In this environment, dollar exchange rates eased from their earlier levels By February 20, the dollar had declined to its period low against the yen of ¥ 125 25 Against the mark, the dollar continued to edge lower for another week, reaching its period low of DM 1.8095 on February 27 Even at these levels, however, the dollar remained well above where it had opened the year

The dollar resumes its advance in March

In late February, market assessments of the relative tightness of monetary policy in the United States and abroad underwent an abrupt shift

Questions regarding the U S central bank's counterinflationary stance were put to rest, and U S short-term market interest rates began to edge higher, when the Federal Reserve unexpectedly drained liquidity from the banking system on February 23 and the following day increased its discount rate by one-half percentage point

Table 2

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements 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 January 31, 1989	February	March	April	Outstanding as of April 30, 1989
Central Bank of the Argentine Republic	265 0	0 8	−0 8	*	*	*
Central Bank of Venezuela	450 0	0	0	+450 0	−450 0	0

Data are on a value-date basis
*Facility expired on February 28, 1989

Shortly thereafter, the Bundesbank appeared to send a signal through its public statements and money market operations that it saw no need at that time to tighten its policy stance. Market participants also noted the constraints on Bundesbank monetary policy stemming from currency relationships within the European Monetary System (EMS). With the German mark approaching the upper limit of its bilateral parity with another EMS currency, the Danish krone, further German tightening was viewed as unlikely, and short-term mark interest rates began to decline. Elsewhere, market participants interpreted actions by both the Bank of Japan and the Bank of England as indicating that these monetary authorities were also reluctant to see further increases in short-term interest rates.

Observers concluded that the Federal Reserve's discount rate increase was unlikely to lead to an immediate tightening of policy elsewhere. With U.S. economic statistics released during the month continuing to suggest generally strong economic performance, market participants expected that the recent widening of interest rate differentials favoring the dollar would be maintained. The report that U.S. producer prices had increased by a full percentage point in February in particular fueled expectations that dollar interest rates would remain firm.

Under these circumstances, upward pressure on the dollar reemerged, and by mid-March the dollar had more than fully recouped its February decline. As the dollar moved up against most major currencies, the U.S. monetary authorities resumed selling dollars against marks on March 8, generally operating in coordination with other central banks.

At the same time that sentiment toward the U.S. currency was becoming more positive, sentiment toward other currencies, most notably the Swiss franc and Japanese yen, was worsening. In Switzerland, reports surfaced of heavy selling of the Swiss franc as that currency broke out of the range in which it had traded for several years against the German mark. As the Swiss currency declined, upward pressure on the dollar increased, and the dollar rose against not only the franc but other continental currencies as well.

In Japan, the political atmosphere in March became increasingly tense and uncertain as allegations spread of insider trading and influence-peddling by prominent individuals in business and politics. Reports that foreign investors were looking to liquidate some of their Japanese bond and equity holdings added to the selling pressure on the Japanese yen. Indeed, whereas until mid-month the dollar was advancing most strongly against the mark among the major currencies, by the end of the month upward pressure had shifted to the dollar/yen exchange rate. Thus, at the end of March, U.S. intervention operations were expanded to include dollar sales against yen. In all, the U.S. monetary authorities sold $1,419 million against marks and $100 million against yen between March 8 and March 30.

By the end of March, the dollar's renewed rise led market participants to question the firmness of official commitments to exchange rate stability. As an early April meeting of the G-7 Finance Ministers and Central Bank Governors approached, some observers speculated that the G-7 might tolerate a further rise in dollar exchange rates as a consequence of the need to deal with inflation. In this atmosphere, the dollar reached its period highs of DM 1.9025 against the mark and ¥ 133.50 against the yen at the end of March. At these levels, the dollar was trading about 5 percent and 6½ percent, respectively, above its late-February lows against these two currencies.

Table 3

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

In Millions of Dollars

February 1, 1989 to April 30, 1989	Federal Reserve	United States Treasury Exchange Stabilization Fund
Realized	0	0
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1989	+941.9	+734.5

Data are on a value-date basis.

Upward pressure on the dollar dissipates in April

Around the time of the April 2 G-7 meeting in Washington, however, market participants began to revise their assessment of official attitudes toward the dollar. A communiqué issued after the meeting stated that "a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive." Market participants interpreted this asymmetrical statement as a sign that the authorities remained committed to resisting the dollar's rise but were prepared to see some decline in the dollar. U.S. intervention sales of dollars against yen during the previous week and market reports of similar operations by the Bank of Japan following the G-7 meeting served to highlight this commitment. So, too, did operations on April 10 and 11 when the U.S. monetary authorities were quick to reenter the market, selling a total of $170 million against marks, as soon as the dollar began to recover from its initial decline after the G-7 meeting.

Around the same time, accumulating, though still ambiguous, evidence that the pace of U.S. economic growth might be easing added to a more cautious sentiment surrounding the dollar. In particular, a number of economic reports on April 14 suggested that earlier fears of a sharp rise in U.S. inflation might have been premature and that capacity pressures in the economy might have peaked (Chart 5).

Meanwhile, market expectations of a possible tightening of monetary policy abroad began to resurface. The announcement on April 13 that the Swiss National Bank would increase its discount and Lombard rates drew market attention once again to the possibility that interest rates abroad might need to be raised. Around the same time, pressures within the EMS eased, and the Bundesbank was thus seen as having more scope to tighten its credit stance if it so chose. In Japan, rumors that the Bank of Japan was making preparations to raise its discount rate also became more widespread. Moreover, reports that the newly appointed German Finance Minister would seek to repeal the recently imposed withholding tax on interest earnings from domestic securities lent some support to the mark against both the dollar and the yen.

When the Bundesbank in fact announced a one-half percentage point increase in its discount and Lombard rates on April 20, and several other continental European central banks joined in by increasing their own official rates, the dollar initially eased further. The dollar moved as low as DM 1.8410 against the mark and ¥ 130.90 against the yen, to trade 3¼ percent and 2 percent, respectively, below its March highs.

The dollar closes the period on a strong note

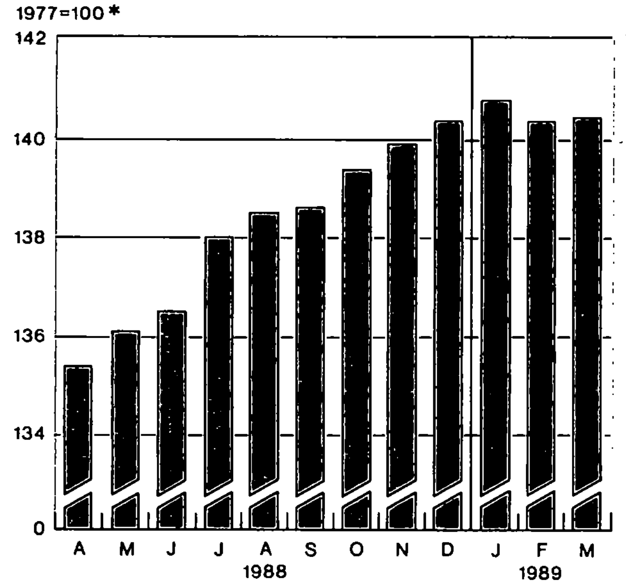
The dollar then quickly began to rebound. Market participants, noting that the Bundesbank's tightening move had had only a limited impact on market interest rates in Germany, reportedly began to take profits on long-mark positions established earlier in the month. By the following day, the dollar was already above the levels at which it had been trading before the German interest rate announcement.

At the same time, expectations diminished that other countries would soon follow the Bundesbank's move. Market expectations of higher interest rates in Japan lessened following a Japanese price report which suggested that the inflationary effect of Japan's new consumption tax might prove less than initially feared. Similarly, in Switzerland, comments by a senior central bank official countered the view that the Swiss central bank would further tighten its credit stance.

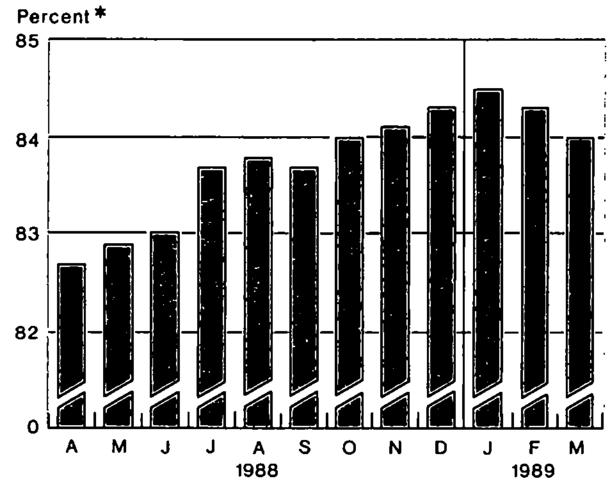
In these circumstances, sentiment toward the dollar

Chart 5

As the period progressed, data indicating a stabilization of U.S. industrial production . . .



and an easing of capacity constraints . . .



suggested to many market participants that the pace of U.S. economic growth may have moderated sufficiently to relieve upward pressure on U.S. interest rates.

*The top chart shows monthly seasonally adjusted index levels of U.S. industrial production. The bottom chart shows monthly seasonally adjusted capacity utilization rates in U.S. industry. The figures for January-March were released during the period under review.

again became bullish, and investment-related purchases of dollars reportedly began to accelerate. With the dollar approaching the levels of its period highs of late March, the U.S. monetary authorities intervened on the last trading day of the period to sell $100 million, half against marks and half against yen. The dollar closed the quarterly period at DM 1.8810 against the mark and ¥133 02 against the yen.

For the period as a whole, the U.S monetary authorities sold a total of $2,139 million, $1,989 million against German marks and $150 million against Japanese yen. The U.S. Treasury, through the Exchange Stabilization Fund (ESF), and the Federal Reserve participated equally in these intervention operations.

The U.S. authorities also acquired $228.2 million equivalent of Japanese yen through nonmarket operations. Of this amount, the authorities sold $99.1 million and $84 8 million equivalent of Special Drawing Rights to official institutions for yen and separately received $44 3 million equivalent of yen in repayments under the Supplementary Financing Facility of the International Monetary Fund.

In other ESF foreign currency transactions during the period·

- The Central Bank of the Argentine Republic repaid the remaining $0.8 million of its swap arrangement with the ESF on February 28. The $265 million facility with the ESF, part of a $500 million short-term financing package arranged in October 1988, expired on February 28.
- The U S. Treasury, through the ESF, agreed to establish a facility to provide up to $450 million in short-term financing to Venezuela on March 13 On March 15, Venezuela drew the entire amount in the facility, and on April 3, repaid the Treasury in full.

As of end April, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $941 9 million for the Federal Reserve and $734.5 million for the 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 regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity A portion of the balances is invested in securities issued by foreign governments. As of end April, holdings of such securities by the Federal Reserve amounted to $1,503 3 million equivalent, and holdings by the Treasury amounted to the equivalent of $1,985.0 million