Treasury and Federal Reserve Foreign Exchange Operations

August-October 1989

During the first half of the August-October reporting period, the dollar came under renewed upward pressure in the face of strong investment inflows In response, the U.S. monetary authorities intervened to sell dollars in keeping with Group of Seven (G-7) policy commitments to foster exchange rate stability. The dollar reached its highs of the period in mid-September. It then moved sharply lower after the G-7 statement of September 23 expressed concern over the dollar's rise and persistent coordinated intervention operations followed Toward the end of the period, the dollar traded in a relatively narrow range. Demand for dollars moderated as a result of a narrowing of interest rate differentials favoring dollar assets and of concerns over volatility in U.S. equity markets. However, investment interest continued to provide some support at lower levels.

The dollar ended the August-October reporting period ½ percent higher on a trade-weighted basis in terms of other Group of Ten (G-10) currencies as measured by the staff of the Federal Reserve Board of Governors. Against individual currencies, however, the dollar's performance varied considerably. On balance, the dollar declined 1¼ percent against the German mark and ½ percent against the Canadian dollar while rising 4¼ percent against the Japanese yen and 5½ percent against the British pound.

During the three-month period, the U.S. monetary authorities sold a total of $5,871 million between August and early October, of which $3,289 million was against Japanese yen and $2,582 million was against German marks These operations were conducted in coordination with foreign central banks.

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 George G Bentley was primarily responsible for preparation of the report

The dollar's rise from early August to mid-September

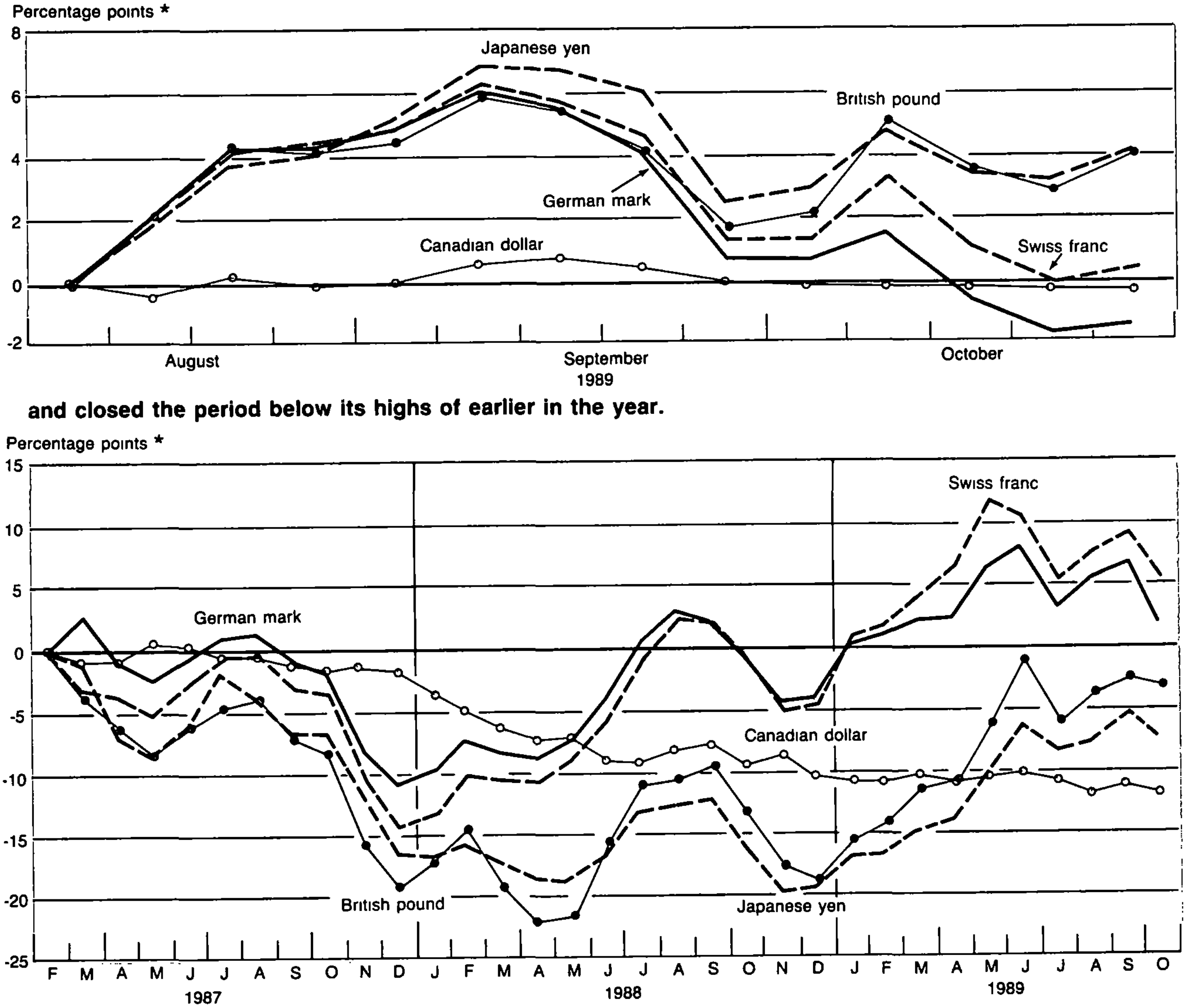
As the period opened, market participants were still apprehensive that the U.S economy might be slipping into recession. In the final days of July, evidence was widespread that the Federal Reserve had responded to a slackening of economic growth and price pressures by easing monetary policy, and the dollar declined. On August 1, Chairman Greenspan confirmed in Senate testimony that the Federal Reserve had modestly eased its stance the previous week. On the same day, several leading banks cut their prime lending rates. The perception thereby strengthened in the market that U.S. interest rates were steadily declining and favorable dollar interest rate differentials would continue to narrow The dollar then moved to its lows for the month of August of DM 1.8430 and ¥ 135.50 on August 2.

The dollar's softer tone was short-lived. Economic data released in early August alleviated the market's earlier concerns regarding the severity of an economic slowdown. The prospects of another imminent easing by the Federal Reserve appeared to fade after employment data released on August 4 showed a sharp upward revision in June nonfarm payrolls and continued employment growth for July The release of figures on August 11 showing buoyant retail sales in July made the possibility of an easing appear even less likely In addition, the monthly U.S. trade reports released in both August and September suggested that the U S trade performance was continuing to improve

In this environment, commercial and investment demand for dollars revived, and the dollar was buoyant through mid-September On September 15, following the announcement that the July U S trade deficit had narrowed unexpectedly to $7 58 billion, the dollar surged briefly to its highs of the three-month period of DM 2 0032 and ¥ 148 98, up roughly 7½ percent and 8¾ percent, respectively, from the closing rates of the previous reporting period At these levels, the dollar was trading near the highs reached earlier in the year. Later that same day, when it appeared that the dollar would not move any higher, dealers began to take profits on long-dollar positions, triggering stop-loss orders, and a sudden decline in the dollar ensued

Chart 1

After rising early in the reporting period, the dollar trended lower after mid-September . . .



* The top chart shows the percent change of weekly average rates for the dollar from August 4, 1989 The bottom chart shows the percent change of monthly average rates for the dollar from February 1987 All figures are calculated from New York noon quotations

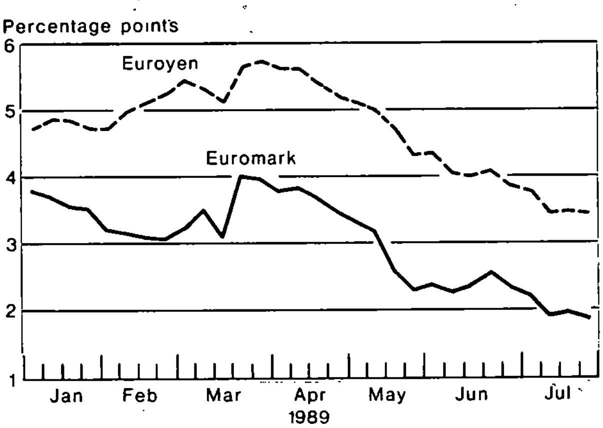
Although sentiment toward the dollar remained positive for quite a while afterwards, the episode revealed a vulnerability for the dollar at these higher levels

During much of September, the U S monetary authorities again intervened in coordination with those of several other countries to resist upward pressure on the dollar After mid-September, moreover, with the approaching G-7 meeting in Washington on September 23, the market became increasingly wary that more aggressive official action might be introduced to curb the dollar's strength, either through intervention or through monetary policy adjustments The dollar then drifted down to close at DM 1 9520 and ¥ 146 00 on September 22, the Friday before the weekend G-7 meeting.

Accordingly, between August 1 and September 22, the U S. monetary authorities sold a total of $1,452 million against marks and $1,699 million against yen The operations became more frequent as upward pressure on the dollar intensified During the first ten days of August, the U S authorities intervened only once, selling $70 million against yen During the remainder of August, the U S monetary authorities sold dollars on six days for a total of $425 million against marks and $525 million against yen The authorities entered the market more frequently after the beginning of September, intervening on eleven of the fifteen business days leading up to the G-7 meeting to sell a total of $1,027 million against marks and $1,104 million against yen

Chart 2

Short-term interest rate differentials favoring the dollar continued to narrow as interest rates declined in the United States and increased abroad.



The chart shows weekly average interest rate differentials between three-month Eurodollar rates and three-month Euromarket deposit rates for marks and yen

Dollar demand moderates after the late September G-7 meeting

After their meeting on Saturday, September 23, the G-7 finance ministers and governors issued a statement concluding, among other things, that the dollar's rise in recent months was inconsistent with longer run economic fundamentals and that a further rise of the dollar above then current levels or an excessive decline could adversely affect prospects for the world economy The ministers and governors also expressed their intention to cooperate closely in exchange markets

On the strength of the G-7 statement and official intervention to reinforce that statement, the dollar moved lower in Asian trading on Monday, September 25 The fact that the U S monetary authorities, along with others, were selling dollars in the Tokyo market sent a signal of the firmness of the G-7 resolve In the days immediately following the statement, the G-7 monetary authorities persisted with their intervention By October 2, the dollar had declined to DM 1 8650 and ¥ 138.60, about 5 percent lower than its closing levels on September 22 For the next eight business days, the dollar was again well bid, showing a tendency to recover from its October 2 levels Subsequently, as

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility October 31, 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

the authorities continued to intervene to resist the dollar's rise, market participants appeared more reconciled to the possibility that the dollar's uptrend might finally have been broken In total, from September 25 through October 12, the U.S. monetary authorities sold $1,130 million against marks and $1,590 million against yen, operating on most days in that period.

The latter half of October

As mid-October approached, upward pressure on the dollar lessened. For the balance of the three-month period, the dollar remained below the mid-September highs.

One factor contributing to the easing of upward pressure was that interest rate differentials favoring the dollar narrowed further in October as a result of interest rate increases abroad. German market interest rates had begun edging higher in late September as dealers anticipated possible increases in the Bundesbank's official rates. On October 5, the Bundesbank announced a full one percentage point increase in both its discount and Lombard rates, surprising the market with the magnitude of the increase The British, French, Swiss, Belgian, Dutch, Danish, Irish, and Austrian monetary authorities followed by raising their official rates. The following week, the Bank of Japan surprised the market by raising its discount rate by one-half percentage point on October 11, and short-term market interest rates in Japan increased by approximately 75 basis points within the span of a week.

Around this time, market participants also began to expect favorable interest rate differentials to diminish further because of an easing of monetary policy in the United States. Many observers viewed economic reports, particularly the September U S. employment data released on October 6, as a sign that U S economic activity was sluggish enough to warrant a new move to lower U.S interest rates During the second week of October, the federal funds rate moved lower, and by mid-month, market participants concluded that the Federal Reserve had indeed eased.

Although interest rate differentials favoring the dollar had been narrowing throughout most of 1989 without any apparent negative effect on dollar exchange rates, the moves that occurred in October were sufficient to induce a moderation in capital inflows to the United States. By this time, interest rates in Germany had risen to levels that were almost as high as those in the United States. At the same time, as asset prices both in the United States and in foreign markets continued to adjust to the changing interest rate and economic assessments, questions arose about the continued

Table 2

Drawings and Repayments by Foreign Central Banks under Reciprocal Currency Arrangements with the Federal Reserve System

In Millions of Dollars, Drawings (+) or Repayments (−)

Central Bank Drawing on the Federal Reserve System	Amount of Facility	Outstanding as of July 31, 1989	August	September	October	Outstanding as of October 31, 1989
Bank of Mexico†	700 0	0	—	+700 0	—	+700 0

Data are on a value-date basis

†Drawn as a part of the $2,000 million near-term credit facility established on September 21, 1989

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements with the Federal Reserve System

In Millions of Dollars, Drawings (+) or Repayments (−)

Central Bank Drawing on the U S Treasury	Amount of Facility	Outstanding as of July 31, 1989	August	September	October	Outstanding as of October 31, 1989
Bank of Mexico†	125 0	0	—	+84 1	—	+84 1

Data are on a value-date basis

†Drawn as a part of the $2,000 million near-term credit facility established on September 21, 1989

strength of certain capital markets—markets that had attracted investors either because of high yields or the prospect of sharp capital gains. Against this background, the sharp decline in U.S. equity prices on October 13 revived concerns that heavy foreign investment in the United States might be discouraged and that the Federal Reserve might ease even more quickly or aggressively than previously supposed.

The October 17 release of data showing a sharp deterioration in the U.S. trade position in August also served to reduce upward pressure on the dollar, as it highlighted the dangers of a further rise in the U.S. currency and reminded the market of the continuing need to correct the current account imbalances.

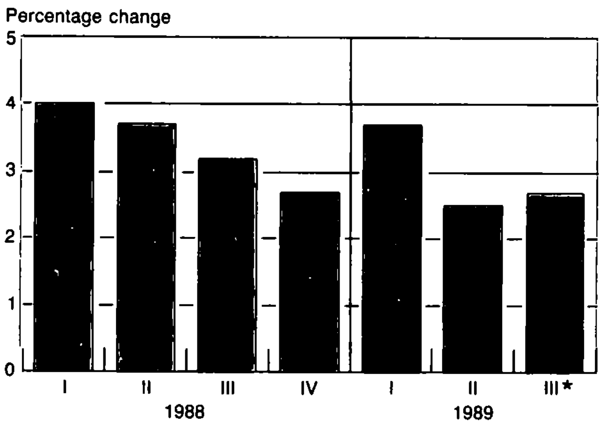
Although the dollar's overall tone remained considerably softer late in the period, the dollar continued to receive some support from investment demand, particularly by Japanese entities, through the end of the three-month period. The dollar closed the quarterly period at DM 1.8415 against the mark and ¥ 142.85 against the yen.

With the dollar generally trading more narrowly in the latter part of the reporting period, markets tended to focus more on developments abroad, and the dollar's performance against individual currencies varied considerably. The dollar's decline against the mark was particularly pronounced, as the German currency benefited not only from the rise in German interest rates but more broadly from a growing sense of confidence in Germany's economic performance and prospects. Buoyant demand, high levels of capacity utilization, and reports of high wage demands from German labor unions seemed to indicate that interest rates would remain firm and economic growth strong. The process of reform just beginning to unfold in Eastern Europe and the inflow of East German immigrants were seen to promise longer term benefits for the West German economy, although there was considerable uncertainty about the short run.

Against the yen, conversely, the dollar showed a somewhat greater tendency to rise as actual and anticipated Japanese capital outflows kept the yen under downward pressure against most other major currencies. Japanese investor demand for dollars, which had helped support the dollar throughout 1989, reflected a high Japanese domestic savings rate, ample domestic liquidity, and a perception that domestic assets were relatively expensive. The United States was seen as having a good long-term investment environment and

Chart 3

Real GNP growth figures for the third quarter of 1989 indicated a continued moderation in the pace of economic growth.



The chart shows the annualized change in U.S. real gross national product.

*The change in real gross national product for third-quarter 1989, originally reported at 2.5 percent on October 26, was later revised to 2.7 percent after the close of the reporting period.

Table 4

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 July 31, 1989	August	September	October	Outstanding as of October 31, 1989
Bank of Mexico†	425.0	0	—	+384.1	—	+384.1
Central Bank of Bolivia‡	100.0	100.0	—	−100.0	—	—
				+ 75.0	—	+ 75.0

Data are on a value-date basis.

†Represents the ESF portion of $2,000 million near-term credit facility.

‡The facility, which was established on July 11, 1989, was renewed on September 15, 1989.

as providing sufficient opportunities to absorb a large pool of Japanese savings

Against sterling, the dollar traded relatively firmly throughout most of the three-month period as market participants became increasingly concerned about the outlook for the U K. economy Despite the fact that high British interest rates were raising worries about a recession, many analysts felt that the progress in curbing inflation and redressing external imbalances had been too slow Market uncertainty regarding the future direction of U.K. economic policy was compounded by the perception that the U.K authorities were divided on basic issues

For the three months as a whole, the U S monetary authorities sold $5,871 million The U.S Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve System participated equally in these operations. To finance a portion of its share, the ESF "warehoused" $3,000 million equivalent of foreign currencies with the Federal Reserve, bringing the total of warehoused funds to $7,000 million equivalent.

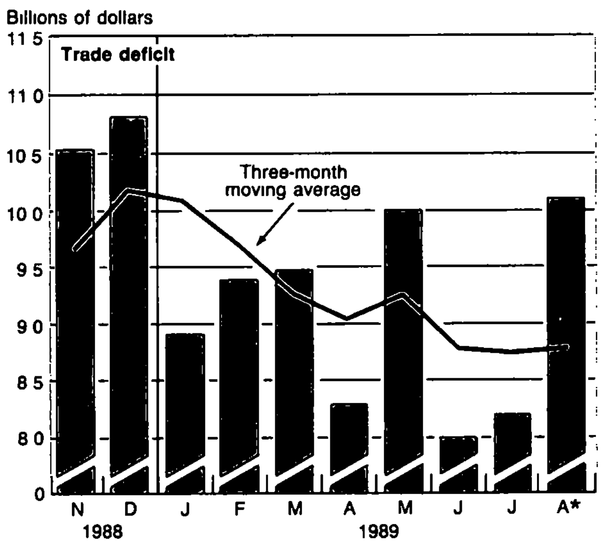
In other operations, on September 21, the Federal Reserve System and the ESF, together with the Bank for International Settlements (acting for certain central banks) and the Bank of Spain, agreed to provide a short-term credit facility totaling $2,000 million to the Bank of Mexico. The Federal Reserve's share in the facility was $825 million, of which the first $700 million was to be provided under the existing reciprocal swap line with Mexico and the remaining $125 million under a separate swap agreement The ESF's share was $425 million, provided under a special swap arrangement On September 25, Mexico drew $784 1 million from the Federal Reserve's portion and $384.1 million from the ESF's portion of the facility

Also during the period, Bolivia repaid in full on September 15 its $100 million outstanding commitment on the short-term financing facility established with the ESF Subsequently, the Treasury agreed to provide a new $100 million facility, and on September 22, Bolivia drew $75 million.

As of end October, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,366 5 million for the Federal Reserve and $870 3 million for the ESF (the second figure includes valuation gains on warehoused funds) These valuation

Chart 4

After narrowing in June and July, the U.S. trade deficit widened sharply in August.



The chart shows the monthly and three-month moving average U S merchandise trade deficit, seasonally adjusted and reported on a customs basis The trade figures for June, July, and August were released on August 17, September 15, and October 17, respectively

* The deficit for August, originally reported at $10 8 billion, was later revised to $10 1 billion

Table 5

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

In Millions of Dollars

	Federal Reserve	U S Treasury Exchange Stabilization Fund
May 1, 1989 to July 31, 1989		
Realized	0 0	+ 77 3
Valuation profits and losses on outstanding assets and liabilities, July 31, 1989	+1,045 5	+724 2†
August 1, 1989 to October 31, 1989		
Realized	0 0	+119 6
Valuation profits and losses on outstanding assets and liabilities, October 31, 1989	+1,366 5	+870 3

Data are on a value-date basis

†This figure takes into account warehoused funds as of July 31, 1989 Data as originally reported in Table 3 of the foreign exchange report in the summer 1989 issue of the *Quarterly Review* excluded valuation profit on warehoused funds The amount of valuation profits including warehoused funds as of July 31, 1989, was $724 2 million

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 October, holdings of such securities by the Federal Reserve amounted to $6,746.5 million equivalent, and holdings by the Treasury amounted to the equivalent of $7,475.7 million