# Treasury and Federal Reserve Foreign Exchange Operations

## May-July 1989

The dollar was under upward pressure in the first half of the period under review, continuing a tendency that had begun toward the end of the previous reporting period. The dollar was supported by strong investment demand until late May. In early June, after a brief period of relative market calm, the dollar came under renewed upward pressure amid large capital flows precipitated by escalating tensions in China These two waves of upward pressure were met with heavy and sustained intervention.

After mid-June the dollar retreated and, on balance, ended the three-month period 1/4 percent lower on a trade-weighted basis as measured by the staff of the Federal Reserve Board of Governors This reversal in the dollar's direction coincided with changes in the market's assessment of the U.S. economic outlook — in particular, emerging indications of a softening of economic growth and somewhat lessened price pressures led to market expectations of an easier U.S monetary policy stance and lower short-term interest rates Economic and political developments abroad also influenced movements in dollar exchange rates over the course of the three-month period

Against individual currencies, the dollar's net movements varied considerably. The dollar closed the period approximately 3 percent higher against the Japanese yen and 1 1/4 percent higher against the British pound, while it was about 3/4 percent lower against the German mark and 1/4 percent lower against the Canadian dollar.

Intervention sales of dollars by the U.S. authorities between May and the end of July totaled $11,917 million, of which $7,237.5 million was sold against Japanese yen and $4,679 5 million against German marks — the largest U.S. intervention for any three-month reporting period. The bulk of these dollar sales occurred in May and early June when the U S. monetary authorities were intervening vigorously, in keeping with the Group of Seven (G-7) policy commitments to foster exchange rate stability At the same time, a White House statement expressed concern about the dollar's appreciation and indicated that, if sustained or extended, it could undermine international efforts to reduce global trade imbalances. For the balance of the period, intervention sales of dollars were modest as upward pressures on the dollar subsided

### The dollar firms in May

During May, as in earlier months of 1989, the dollar was buoyed by investment and commercial demand At the opening of the three-month period, investors and commercial interests were gaining confidence about increasing the share of dollar assets in their overall portfolios and reducing the hedged proportion of their dollar assets. The relatively stable performance of the dollar during the previous year had led many to conclude that it was no longer necessary to maintain costly hedges to protect their dollar exposures against exchange rate loss. Actions to unwind these hedge positions continued to exert powerful upward pressure on the dollar, while adjustments in commercial leads and lags also contributed to the dollar's upward

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momentum Meanwhile, investors continued to be attracted to the relatively high interest rates available on dollar-denominated instruments, even though interest rate differentials favoring the dollar had already narrowed considerably from levels of last fall and winter Also, market sources reported the widespread view that the prospect for capital gains on long-term fixed income dollar securities seemed attractive given the growing perception that the U S economic expansion was slowing and that interest rates in the United States were likely to continue to decline

With sentiment toward the dollar decidedly positive during early May, the dollar advanced smartly To counter the upward pressure, the U S monetary authorities sold a total of $550 million against marks and $400 million against yen between May 1 and May 8, following through on operations begun at the end of April

The upward pressures intensified after the May 12 report of a smaller than expected rise in U S. producer prices during April buoyed both the U.S bond and exchange markets By May 15 the dollar broke through the significant technical and psychological level of DM 1 9250 against the mark Attitudes toward the dollar became even more bullish following the May 17 release of preliminary U S. trade data for March indicating a sharp improvement in U S external performance On May 22, the dollar pierced the DM 2 00 level against the mark and ¥ 140 against the yen. By May 24, the dollar reached DM 2 0150 and ¥ 142 85, up roughly 7¼ percent against the mark and yen, respectively, from the end of April

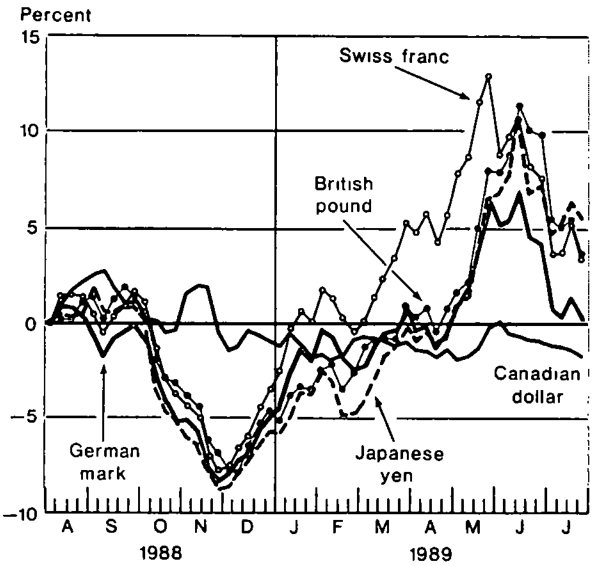
As the dollar moved to levels not seen since the February 1987 Louvre Accord, market participants increasingly came to question the will of the G-7 monetary authorities to halt the dollar's rise Under these circumstances, official warnings about the negative consequences of dollar appreciation went unheeded Instead, market participants gave more credence to statements by some U S and foreign officials that seemed to reinforce the idea that G-7 monetary authorities were prepared to tolerate the recent higher levels for the dollar Upward pressure continued to mount as market participants bid for dollars amid fears that the currency would go even higher

In this environment, the U S authorities intensified their intervention operations to resist the dollar's rise They sold a total of $5,785 million between May 12 and May 31, reflecting sales of $3,000 million against marks and $2,785 million against yen Of these amounts, a total of $2 billion was sold on May 18 and May 19 alone

By late May, upward pressure on the dollar abated and a more cautious atmosphere returned to the for-

Chart 1

**The dollar continued to rise early in the period, then declined after mid-June.**




The chart shows the percent change of weekly average rates for the dollar from August 5, 1988 All figures are calculated from New York noon quotations

Table 1

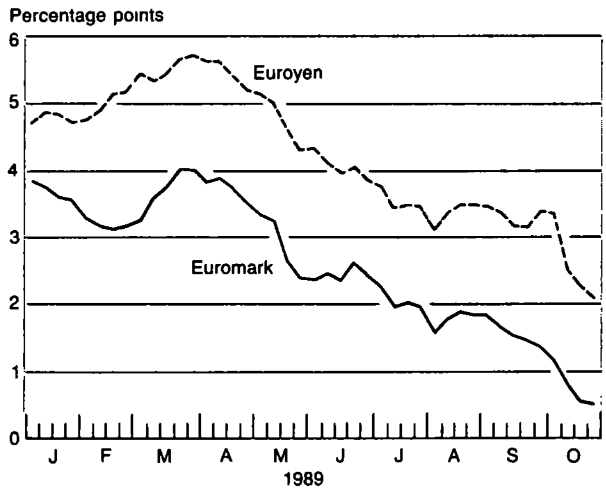
**Federal Reserve Reciprocal Currency Arrangements**
In Millions of Dollars

| 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 |

eign exchange market A confluence of factors contributed to the dollar's retracement at the end of the month The cumulative effect of sizable and persistent central bank intervention operations came to weigh upon the currency and these operations were viewed as a strong signal that U S and foreign officials were seriously committed to fostering exchange rate stability and were determined to resist the dollar's rise Official interest rate increases in Japan, Britain, Switzerland, and elsewhere in Europe late in the month, though prompted by domestic considerations, were also seen as contributing to a more stable exchange rate environment Moreover, indications of a moderation in the pace of U S economic growth began to accumulate, reinforcing expectations that U S monetary policy might soon be eased and, therefore, that favorable interest rate differentials would continue to narrow

Chart 2

**Short-term interest rate differentials favoring the dollar continued to narrow, primarily because of interest rate increases abroad.**




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

The financial markets took special note of the June 2 release of U S nonfarm payroll figures for May that showed slower employment growth than the markets had previously anticipated. These data were seen as increasing the likelihood that the Federal Reserve would soon ease its monetary stance The dollar moved sharply lower, declining about 2 percent against the mark and 1¾ percent against the yen over the course of the day The dollar closed on June 2 at DM 1 9420 and at ¥ 140 45, 3½ percent lower against the mark and 1¾ percent lower against the yen, respectively, from the levels reached on May 24, but 3¼ percent and 5½ percent higher, respectively, from the opening of the reporting period

### Renewed upward pressure in early to mid-June

On June 5, however, the dollar moved abruptly higher amid heightened market sensitivity to political instability In particular, market attention shifted to news commentary on the Chinese government's efforts to suppress a student demonstration that reflected growing pressures for democratic reform in China The escalating tensions in China led many market participants to anticipate capital outflows from East Asia for safe-haven considerations stemming from a reassessment of the prospects for economic and political stability in the region A sharp decline in the Hong Kong stock index added to the uncertainty of the time The dollar's rise was particularly pronounced against the yen as the Japanese currency remained vulnerable to selling pressures, in part because of the additional uncertainties associated with Japan's political situation The dollar was bid up strongly, notwithstanding reduc-

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 April 30, 1989 | May | June | July | Outstanding as of July 31, 1989 |
|---|---|---|---|---|---|---|
| Central Bank of Venezuela | 450 0† | 0 | — | — | — | — |
| Central Bank of Bolivia | 100 0‡ | — | — | — | +100 0 | +100 0 |

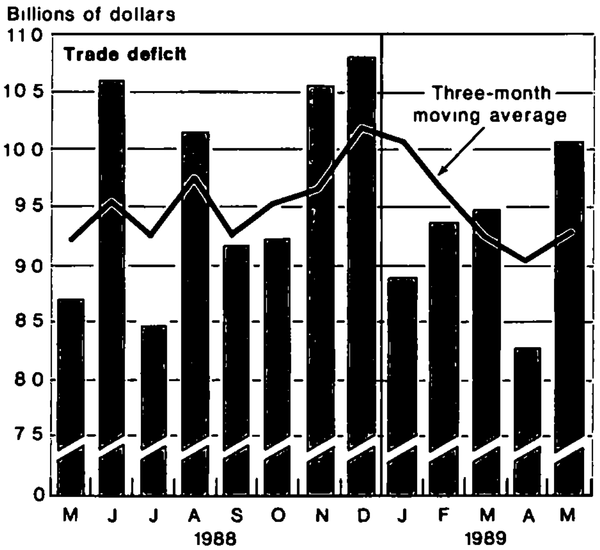
Data are on a value date-basis
†The facility expired on May 15, 1989
‡The facility was established on July 11, 1989

tions in the prime lending rate at several U.S banks on June 5 and an easing of the federal funds rate on the following day.

The bullish sentiment toward the dollar continued to build in advance of the June 15 release of U.S. trade data, which were expected to show a greatly reduced trade gap for April. The dollar moved higher immediately following the preliminary report of a narrowing of the trade deficit to $8 26 billion, from a revised $9 55 billion deficit in March By midmorning in New York trading that day, the dollar was pushed up to DM 2.0470 against the mark and ¥ 151 90 against the yen, its highest levels in more than two years At these levels, the dollar was 8¾ percent higher against the mark and 14¼ percent higher against the yen from end April and was trading roughly 31 percent and 26 percent higher, respectively, from the record lows reached on January 4, 1988.

Chart 3

**The declining trend in the U.S. trade deficit since the beginning of the year provided support to the dollar throughout the three-month period. In mid-June market participants reacted quite favorably to the news of a sharp narrowing in the trade deficit reported for April.**




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 March , April, and May were released on May 17, June 15, and July 18, respectively

## The dollar declined in late June

As impressive as the dollar's upsurge had been, market participants noted that the dollar failed to move above the key technical levels of DM 2 05 against the mark and ¥ 152 against the yen on June 15, and profit taking began to move the dollar lower. Selling momentum quickly built as market participants scrambled to unwind long-dollar positions The dollar plunged in volatile trading, and many participants started to question whether this decline was the beginning of a sea change in the dollar's direction The dollar closed on June 15 at DM 1 9820 against the mark and at ¥ 145 30 against the yen, down 3¼ percent and 4¼ percent, respectively, from the highs reached only hours earlier

At the same time, the dollar was perceived as vulnerable to central bank intervention operations Consistent and heavy intervention sales of dollars by the U S authorities, undertaken in coordination with other central banks, continued after the dollar moved down from its peak and helped convince market participants that the G-7 monetary authorities were firmly committed to resisting the dollar's rise and maintaining exchange rate stability By mid-June, market participants had become more aware of the scale of intervention Intervention sales of dollars by the U S authorities between June 6 and June 30 totaled $4,952 million, including $3,822 5 million sold against yen and $1,129.5 million sold against marks.

By late June, market attention had shifted back to the outlook for the U S economy and monetary policy Indications of a softening in economic activity continued to appear, highlighted by the June 23 report of a sharp drop in durable goods orders in May Further, emerging signs pointed to some lessening of price

Table 3

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

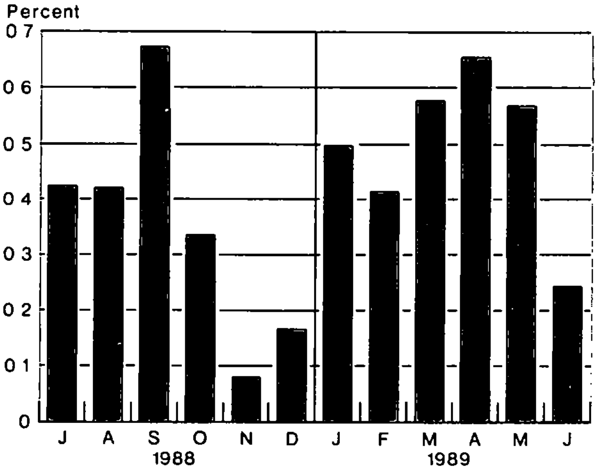
In Millions of Dollars

| May 1, 1989 to July 31, 1989 | Federal Reserve | United States Treasury Exchange Stabilization Fund |
|---|---|---|
| Realized | 0 | + 77 3 |
| Valuation profits and losses on outstanding assets and liabilities as of July 31, 1989 | +1,045 5 | +502 8 |

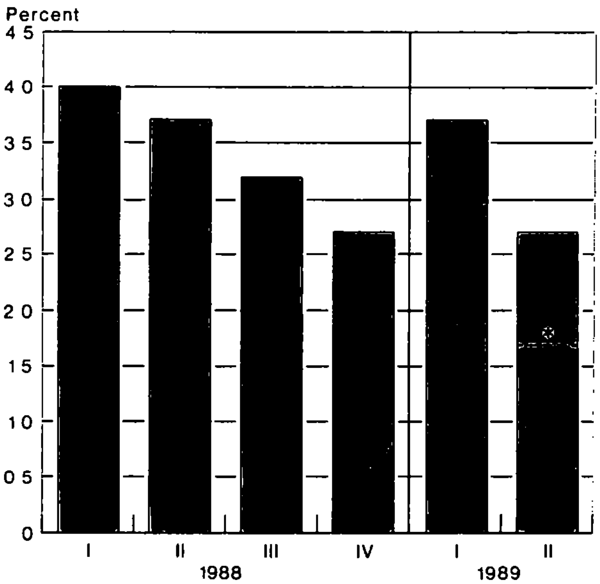
Data are on a value-date basis

Chart 4

**Data released during the period indicating some decline in the monthly rate of price increases . . .**




**and a slowdown in the pace of economic growth . . .**




**suggested that the balance of risks in the U.S. economy may have shifted away from greater inflation.**

The top chart shows the month-to-month change in the U.S. consumer price index. The bottom chart shows the annualized change in U.S. real gross national product.

*The change in real gross national product for second quarter 1989, originally reported at +1.7 percent on July 27, was later revised to +2.7 percent after the close of the reporting period.

pressures and to an underlying trend in inflation that was less severe than markets had previously feared. Market participants noted the easing in the federal funds rate that had already taken place earlier in the month and expected further declines. The dollar moved lower as market participants anticipated that favorable interest rate differentials would narrow further, thereby diminishing the relative attractiveness of dollar-denominated instruments.

An undertone of caution set in as the perceptions of downside risk associated with holding dollar assets increased. By late June, portfolio adjustments to reduce hedging ratios appeared to taper off. Capital flows from East Asia also appeared to diminish. Furthermore, corporations reportedly refrained from buying dollars as the currency continued to decline. Under these circumstances, the dollar experienced only a brief bout of upward pressure in the aftermath of a June 25 upper house by-election in Japan.

The dollar subsequently resumed its decline as market attention again centered on the prospects for further narrowing of favorable interest rate differentials. Accumulating signs of slowing U.S. economic growth were seen by market participants as increasing the likelihood that the Federal Reserve would again ease its monetary stance. At the same time, economic statistics were suggesting buoyant growth and increasing inflationary pressures abroad. In these circumstances, the monetary authorities in Germany and several other continental countries announced increases of one-half

During the three-month period, the Federal Reserve warehoused foreign currencies for the Exchange Stabilization Fund (ESF) of the Treasury. Such warehousing operations have been carried out from time to time since 1963. In carrying out such an operation, the Federal Reserve buys the foreign currency in a spot purchase from the Treasury and simultaneously sells it back to the Treasury at the same exchange rate for a future maturity date. A key aspect of this type of transaction is that, since both the Federal Reserve and the Treasury agree to pay and to receive the same amount of foreign currency, as specified by the use of the same exchange rate, neither party incurs any foreign exchange rate risk by virtue of this transaction. The ESF may realize a profit or loss at the time the warehousing transaction is undertaken and remains exposed to valuation gains or losses on the foreign currencies being warehoused (see Table 3). A warehousing transaction is reversed when the Treasury repays dollars and the Federal Reserve repays the foreign currency it has acquired from the Treasury.

to one full percentage point in their official interest rates on June 29. On July 6, the dollar traded as low as ¥ 137.85 against the yen, down $5^3/_4$ percent from the June 9 close.

During the second week in July, however, sentiment toward the dollar turned temporarily more positive. A series of economic reports released on July 14 was viewed in the exchange market as favoring the dollar These reports confirmed economic activity was settling into a sustainable rate, while price data suggested the Federal Reserve might not have as much leeway to lower interest rates as previously supposed. But then, in his congressional testimony on July 20, Chairman Greenspan stated that the balance of risks in the U.S. economy had shifted away from greater inflation and that monetary policy had been adjusted accordingly. The testimony temporarily revived expectations that U.S interest rates would continue to move lower, and dollar rates subsequently drifted irregularly lower through the balance of the month.

During July, at times when there appeared to be upward pressure building toward the dollar, the U.S. authorities entered the market to contain the pressure. These operations, however, were modest and intermittent. In fact, the Desk operated on only three days during July, selling a total of $230 million dollars against yen between July 11 and July 21. On July 31, the dollar closed the three-month reporting period at DM 1.8648 against the mark and at ¥ 136.90 against the yen.

The total intervention sales of $11,917 million during the three-month reporting period were shared equally by the U.S. Treasury, through the Exchange Stabilization Fund (ESF), and the Federal Reserve System. To finance a portion of these operations, the ESF "warehoused" $4,000 million equivalent of foreign currencies with the Federal Reserve (see Box).

In other operations, the ESF acquired $198.0 million equivalent of Japanese yen through sales of Special Drawing Rights and repayments under the Supplementary Financing Facility of the International Monetary Fund. Also during the period, Bolivia drew the full $100 million from a short-term financing facility established on July 11 by the U.S. Treasury through the ESF. The ESF short-term facility with Venezuela, established on March 10, expired in May. There was no activity in the facility during the period.

As of end July, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,045.5 million for the Federal Reserve and $502.8 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 July, holdings of such securities by the Federal Reserve amounted to $5,113.6 million equivalent, and holdings by the Treasury amounted to the equivalent of $5,856.9 million.