August-October 1985 Interim Report
(This report was released to the Congress and to the press on December 4, 1985)

Treasury and Federal Reserve Foreign Exchange Operations

After rising for a time in August and early September, dollar exchange rates dropped sharply after an announcement on September 22 by the Ministers of Finance and Central Bank Governors of the five major industrial nations. The monetary authorities agreed to pursue additional, specific policies to sustain and accelerate more balanced expansion with low inflation, and to cooperate more closely in furthering an orderly appreciation of non-dollar currencies. For the August-October period as a whole, the dollar extended the decline that had begun in early 1985, against a background of spreading perceptions that U.S. economic growth was slowing while activity abroad was picking up. By end-October, the dollar had fallen nearly 11 percent in terms of the Japanese yen compared with its end-July level, by about 6 percent relative to Continental currencies, and by 2 percent against the pound sterling. On a trade-weighted average basis, the dollar closed about 5½ percent lower than its end-July levels, and 22 percent below its highs of late February 1985.

As the period opened, the dollar continued the irregular decline that had occurred during the previous five months, but the pace of decline was slowing. Economic statistics were still suggesting that growth of U.S. production and employment remained sluggish during the summer months. But market participants doubted that U.S. interest rates would extend the decline that had begun earlier in the spring, since they viewed the Federal Reserve as likely to be increasingly cautious in the face of continued rapid monetary growth. Starting in late August, the dollar actually began to rise as it appeared that the outlook for U.S. economic growth might be more favorable than earlier predicted. Better-than-anticipated trade and employment data prompted market participants to change their expectations for the U.S. economy and for interest rates. Under these circumstances, commercial customers as well as professionals acted to cover short positions and reduce hedges against dollar assets established when the dollar had fallen. Moreover, evidence of a renewed flow of private foreign capital into the U.S securities markets during September, after a temporary slackening in August, helped to dispel concern that the dollar's decline since the spring would cause a major shift of investor preferences toward non-dollar currencies The dollar reached its highest levels of the three-month period under review during the second week of September, as traders anticipated that upcoming "flash" GNP estimates would reveal strong growth in the third quarter.

By mid-September, however, market participants began to question whether the expected pickup in economic activity would be strong enough to sustain dollar exchange rates

A report 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 Patricia H Kuwayama was primarily responsible for the drafting of this report, assisted by Elisabeth Klebanoff

Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility October 31, 1985
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	
Swiss francs-dollars	600
Other authorized European currency-dollars	1,250
Total	30,100

at the levels they had reached, which were 4 to 9 percent higher than those of early August As these questions led some professionals to take profits, the dollar fell, dropping further when the "flash" GNP estimate turned out to be lower than most market forecasts

The dollar's fall then gained momentum after September 22, when the G-5 Finance Ministers and Central Bank Governors made their announcement following a meeting in New York The statement drew attention to changes already occurring in fundamental economic conditions around the world, in particular the shift to more moderate growth in the United States, stronger growth in other countries, and the convergence of inflation rates at a lower level Recognizing that these changes had not yet been fully reflected in exchange rates, the officials affirmed the strong prospects for progress in reducing international economic imbalances and the intentions of the G-5 governments to implement policies to sustain and accelerate these improvements. Each of the countries issued a specific statement of policy intentions to intensify individual and cooperative efforts to achieve sustained noninflationary expansion.

The G-5 announcement had an immediate and strong effect on dollar exchange rates In part, the exchange market reaction reflected the fact that the announcement was unexpected More importantly, market participants noted that the initiative had come from the United States and viewed it as a change in the U S government's previously perceived attitude of accepting or even welcoming the strong dollar. In addition, the agreement was interpreted as eliminating the likelihood that the Federal Reserve would tighten reserve conditions in response to rapid U.S. monetary growth

In these circumstances, the dollar dropped sharply on the day following the G-5 announcement even before any official intervention occurred. With Tokyo closed for a holiday, the first central bank operations were in Europe, the dollar had already fallen against major foreign currencies by the time the Bundesbank stepped in to sell dollars at the afternoon fixing in Frankfurt for the first time in more than six months. Later the same day, the U.S authorities conducted their first operation during the period under review, selling dollars against Japanese yen and German marks in a visible manner to resist a rise of the dollar from the lower levels.

During the next few days, there was some skepticism in the market that the lower dollar levels would be maintained, and a number of commercial customers responded to the apparently attractive rates by buying dollars. This phenomenon was most dramatic in Tokyo where, when the market opened on Tuesday, September 24, after a three-day weekend, dollar demand from corporations and investors spurred the largest turnover on record for spot dollar/yen trading The Bank of Japan responded with massive dollar sales Even though these sales were partly offset by sizable normal interest earnings, Japan's published foreign exchange reserves dropped by nearly $1 billion in the month of September Following these and other operations in subsequent days by the Japanese and other G-5 central banks, market participants came to believe that the authorities were firmly committed to the joint effort and upward pressures on the dollar abated The U S authorities sold a total of $199 million against German marks and $262 million against the Japanese yen during the last week of September and the first week of October, operating repeatedly and visibly at times when the dollar showed a tendency to rise from the lower levels it had reached

In the two weeks beginning October 7, the dollar came under heavier upward pressure, reflecting strong commercial and investor demand While impressed with the central bank intervention, market participants still anticipated additional economic policy initiatives The demand for dollars was spurred when the annual World Bank/IMF meetings in Seoul, Korea, passed without any such announcements. In addition, some statements, attributed to monetary officials at the Seoul meetings, were viewed as expressing satisfaction with the extent of the dollar's decline and suggesting that it would not fall much further Also contributing to upward pressure on the dollar were growing perceptions that U S economic activity was picking up and that new estimates of third quarter GNP growth would show a substantial upward revision

Table 2

Drawings and Repayments by the Argentine Central Bank under Special Swap Arrangements with the U.S. Treasury

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

U S drawings on Treasury facilities for	Outstanding September 30, 1984	1984-IV	1985-I	1985-II	1985-III	Outstanding October 31, 1985
$500 million .	*	+500	−230 −270	*	*	*
$150 million	*	*	*	+75 +68	−71 4 −71 4	*

Data are on a value-date basis
* No facility

The demand for dollars, especially against the German mark, intensified around mid-October when commercial participants who had held off meeting their dollar needs after the G-5 announcement re-entered the market But the dollar's rise was largely held in check by coordinated intervention by the United States and other monetary authorities On October 16, as the dollar staged its strongest rebound since the G-5 announcement, the Desk sold $797 million against German marks and $67 million against Japanese yen, and on the next day it sold additional amounts as the dollar eased back when the upward revision of the U.S. GNP statistics failed to live up to expectations During the second two weeks following the September 22 communique, the United States sold a total of $1,550 2 million against German marks and $617 6 million against Japanese yen These operations, some of which were conducted in Far Eastern markets as well as in New York, were closely coordinated with those of the Bank of Japan and European G-5 central banks in their own centers

During the last two weeks of October, much of the upward pressure on the dollar relative to the European currencies abated in response both to the intervention operations and to a fading of optimism about the U S economic outlook The upward pressure on the dollar *vis-à-vis* the Japanese yen, however, was slower to subside—even though the government of Japan had announced on October 15 a program to increase the rate of growth of domestic demand Accordingly, the Desk's dollar sales in this two-week period, while more modest in size, were concentrated in yen In all during these two weeks, the U S authorities sold $482 9 million against Japanese yen and $87 million against the German mark

Late in October the Bank of Japan allowed Japanese money market interest rates to drift higher It was then that the dollar began to decline particularly sharply against the yen Many market observers viewed the Japanese actions on interest rates as possibly representing the first of a series of steps to be taken by the G-5 countries to lower interest differentials favorable to the dollar Despite denials by U S , German, and Japanese officials that any agreement existed for such coordinated interest rate policy moves, the idea persisted, and the dollar declined across the board to close near its lowest levels of the three-month period under review It ended October some 13 percent below the level at which it had traded in the week before the G-5 meeting in terms of the Japanese yen, 10½ percent down in terms of the German mark, and 8 percent down *vis-à-vis* sterling Total intervention sales of dollars by the U S authorities, which were split equally between the U S Treasury and the Federal Reserve, came to $3,198 7 million during the three months After September 22, the central banks of France, Germany, Japan, and the United Kingdom sold about $5 billion The central banks of other G-10 countries sold more than $2 billion

In other operations, Argentina repaid its drawing on its swap agreement with the United States Treasury established on June 19, 1985 The drawing was repaid as scheduled in two installments of $71 4 million each on August 15 and September 30 The payments coincided with Argentina's drawings from the International Monetary Fund under its new economic stabilization program Also completed at the same time were the repayments of $460 million outstanding credits to Argentina from twelve foreign central banks, representing their part of the cooperative bridging facility established in June

In the period August through October the Federal Reserve and the Exchange Stabilization Fund (ESF) realized

Table 3

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
August 1, 1985— October 31, 1985 . . .	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1985	−451 0	−202 7

Data are on a value-date basis

no profits or losses from exchange transactions As of October 31, cumulative bookkeeping or valuation losses on outstanding foreign currency balances were $451 million for the Federal Reserve and $203 million for the Treasury's ESF These valuation losses represent the decrease 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, the Federal Reserve had invested $1,796.6 million equivalent of its foreign currency holdings in securities issued by foreign governments as of October 31 In addition, the Treasury held the equivalent of $2,672 1 million in such securities as of the end of October