Treasury and Federal Reserve Foreign Exchange Operations

May-July 1988

Market sentiment toward the dollar turned strongly positive during the three months ending in July, and the dollar moved higher for most of the period. On balance, the dollar rose 9½ percent in terms of the other Group of Ten currencies on a trade-weighted basis (Federal Reserve Board of Governors staff index). But the increase against individual currencies varied considerably. The dollar rose approximately 12 percent against the German mark and most Continental currencies, returning close to its level against the German mark of a year ago. It advanced a more modest 6½ percent and 9¾ percent, respectively, against the Japanese yen and British pound, remaining well below its levels of a year ago. Against the Canadian dollar, the dollar declined 1½ percent.

In keeping with the Group of Seven (G-7) understandings about fostering exchange rate stability—most recently reiterated in the June Toronto Summit Economic Declaration—the U.S. authorities entered the market at times to counter the dollar's rise, operating in coordination with other central banks. Market sales of dollars by the U.S. authorities between late June and the end of July totaled $2.9 billion, all against German marks.

Throughout the period, the dollar was buoyed by any new signs of strength in the U.S. economy, which were thought likely to lead to a tighter monetary policy and higher interest rates. With statistics measuring U.S. economic growth continuing to point to greater gains than had previously been expected, market participants recognized that the focus of policy attention had shifted from concerns about recession to concerns about inflation. Statements by several Federal Reserve officials had conveyed uneasiness about the potential risks for inflation of relatively tight labor markets and capacity constraints in some industries. As it was, short-term interest rates in the United States had already firmed somewhat between mid-March and the beginning of May, maintaining and in some cases increasing interest differentials favoring investment in dollar-denominated assets.

Until mid-June, the factors supporting a higher dollar were partially counterbalanced by uncertainty about the sustainability of external adjustment and about official reactions to any rise in dollar exchange rates. Thus, the dollar's rise early in the period was relatively modest. The dollar strengthened more decisively after mid-June with market participants increasingly perceiving that international adjustment was indeed proceeding and that major industrial nations might tolerate some further increase in the dollar.

For the period as a whole, the dollar's upward movement against the mark was especially pronounced. There were questions about the longer-term prospects for investment in the German economy, in part stemming from labor costs, and continued concern over the government's intended imposition of withholding taxes on foreign investments in Germany. In these circumstances, there were heavy flows of capital out of Germany, amounting in the first half of 1988 to a record DM 50.6 billion.

The dollar's relative stability against the yen in part

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 H Randi DeWitty was primarily responsible for preparation of the report

reflected favorable assessments of the outlook for the Japanese economy. In particular, market participants were impressed with the extent to which the Japanese economy appeared to be adjusting to its external imbalances and experiencing vigorous increases in domestic demand.

May to mid-June

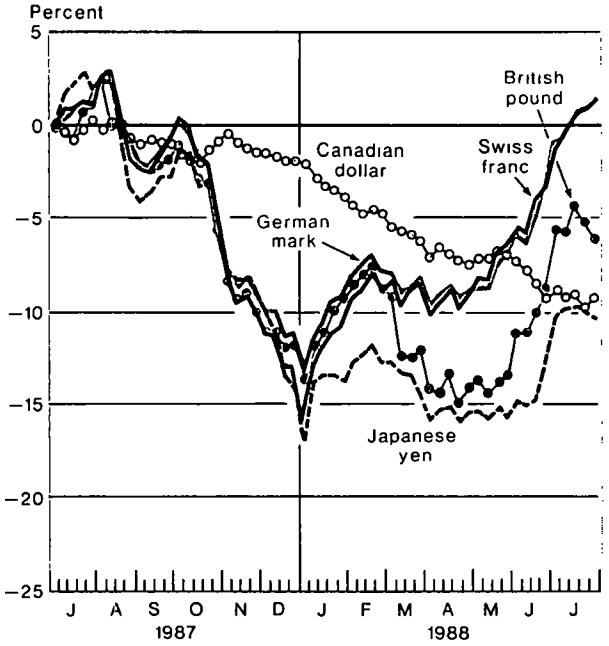
The dollar rose gradually against the mark from May until the middle of June From its opening of DM 1 6775, it moved irregularly higher, breaking through the DM 1 70 level by mid-May and reaching DM 1.7224 by mid-June. It showed little increase on balance against the yen, however

The dollar's rise partly reflected a widening perception that U.S. economic growth continued to be buoyant and that the Federal Reserve's policy stance might be tightened if pressures on capacity became troublesome The report, in early May, of a decline in U S. civilian unemployment to its lowest level in 14 years and of strong gains in manufacturing employment, together with a larger-than-expected upward revision in first-quarter GNP figures later that month, provided further evidence that economic activity was expanding rapidly The fact that the country's export sector and manufacturing industries were contributing strongly to the economy's improved performance provided reassurance that adjustment was well underway. Moreover, market participants detected that the Federal Reserve had adopted a firmer policy stance. With financial markets generally reassured by the authorities' concern about inflation, U S. long-term interest rates eased somewhat, and long-term interest rate differentials favoring the dollar generally narrowed, though they remained strongly positive. But as U S short-term interest rates rose, short-term differentials favoring the dollar widened between the beginning of May and mid-June, especially against the European currencies.

In addition, confidence in the efforts of G-7 authorities to foster exchange rate stability had increased as

Chart 1

After trading within a relatively narrow range against most major foreign currencies throughout the spring, . . .

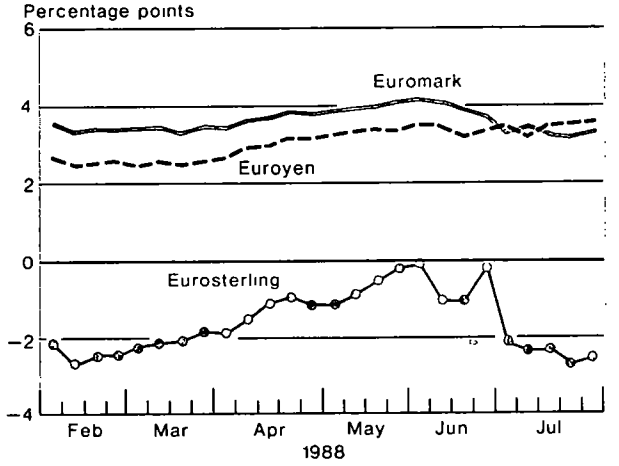


the dollar rose by varying amounts against several major currencies, especially in the second half of the May-July 1988 period.

The chart shows the percent change of weekly average rates for the dollar from July 3, 1987 All figures are calculated from New York noon quotations

Chart 2

Short-term interest rate differentials favoring the dollar widened from May through mid-June, especially against the European currencies.



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

the dollar traded in a relatively narrow range throughout the spring and U S export performance improved. As a consequence, concerns about exchange rate risk diminished, and investors became more confident about investing in dollar-denominated assets to take advantage of the relatively high yields on fixed-income securities available in the United States

Moreover, reports circulated in the market of increased demand for dollars by banks' customers. Many firms had previously established short-dollar positions in the expectation that the dollar's three-and-one-half-year decline would continue well into 1988

Table 1

Federal Reserve Reciprocal Currency Arangements

In Millions of Dollars

Institution	Amount of Facility July 31, 1988
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

When instead the dollar firmed, a number of corporations and financial institutions began to consider that the dollar's long decline had bottomed out These market participants reportedly purchased dollars to avoid losses that might result from having to convert foreign currency receivables at still higher dollar levels. In this environment, market professionals perceived that a large magnitude of dollar buying might come into the exchange market if exchange rate expectations were to shift in favor of the dollar, and a sense of upside risk for the dollar began to emerge

Under these circumstances, the market's longstanding bearish sentiment toward the dollar lessened, but was not eliminated. One concern was that tightening labor markets and capacity constraints in the United States might undermine further adjustment as well as lead to a buildup of inflationary pressures. This concern was reflected in the exchange markets when, on May 17, the dollar gained only modest ground from the announcement of an unexpected improvement in the U.S. trade deficit for March. This muted response occurred, in part, because the data recorded a sharp rise in imports that, if continued, might hinder further improvement in the trade balance.

Another element of uncertainty about how far the dollar might advance was the presumed reaction of foreign monetary authorities to any significant exchange rate move. For several months, rumors had circulated in the exchange markets that those central banks that had intervened heavily to support the dollar in 1987 were taking advantage of opportunities to sell dollars. Talk of dollar sales by G-7 central banks intensified shortly after the release of the March trade figures in mid-May Throughout late May there was persistent talk in the market that the Bundesbank was regularly selling dollars Gradually, market participants became convinced that foreign officials would act to contain the

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 May 1, 1988	May	June	July	Outstanding as of July 29, 1988
Central Bank of the Argentine Republic	550 0	160 0	−160 0	0	0	*
National Bank of Yugoslavia	50 0	*	0	+50 0	−16 1	+33 9
Central Bank of Brazil	250 0	*	0	0	+232 5	+232 5

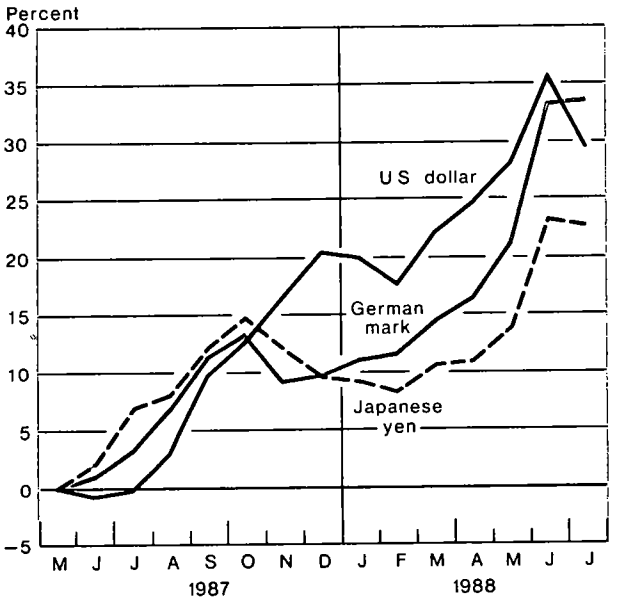
Data are on a value-date basis
*No facility

dollar's rise through intervention At the end of May, the Bundesbank began selling small amounts of dollars openly at the Frankfurt fixing. On June 3, the Bundesbank reported sharp declines in its net monetary reserves, particularly in the foreign currency reserves component. From late May through mid-June, these declines, attributed by the market largely to dollar sales, amounted to DM 7.4 billion Press reports indicated that other G-7 countries might also seek to reduce their dollar holdings.

Market participants also began to anticipate that foreign monetary authorities would take advantage of any increases in U.S interest rates to increase their own interest rates. Monetary aggregates were growing relatively rapidly in a number of countries. Also, during the first week of June, officials of a number of industrial countries openly expressed concerns about a potential rise in inflation worldwide against a background of rising commodity prices German and Japanese officials also noted the inflationary impact of the dollar's rise

Chart 3

Rising world commodity prices . . .



added to concerns about inflationary pressures in a number of industrialized countries.

The chart shows monthly changes in world commodity prices as reported in the International Monetary Fund's International Financial Statistics and as converted into German marks and Japanese yen

and underscored the importance of maintaining domestic price stability

In these circumstances, the dollar fluctuated irregularly upward, as market participants adjusted their evaluations of official attitudes toward exchange rate movements In the middle of June, the dollar was trading about 2½ percent higher on balance against the mark and other European currencies and was unchanged on balance against the yen from the beginning of the period

Mid-June through July

As time passed, market participants became increasingly impressed with the dollar's resilience They noted that the dollar had shrugged off both intervention and statements by foreign officials aimed at resisting the declines of their own currencies They also watched for reactions to the Bundesbank's June 21 decision to increase the interest rate on its repurchase agreements and looked to the upcoming communiqué from the Summit meeting in Toronto for further indications of policy actions that might affect exchange rates

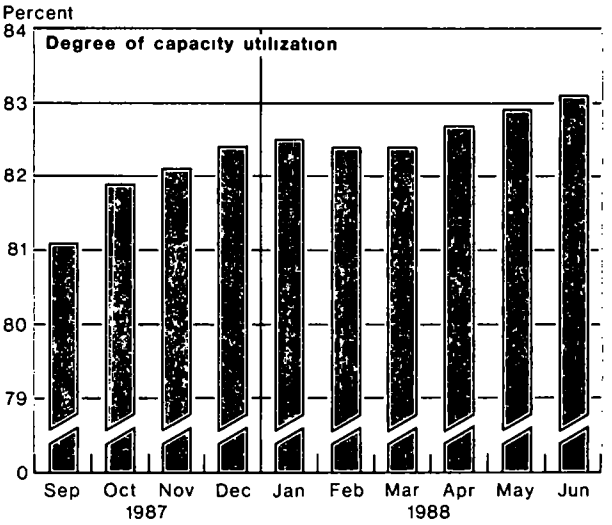
On June 14, the announcement of a much smaller-than-expected U.S trade deficit for April reassured market participants that the correction of global imbalances was continuing, even in the face of a relatively robust U S. economy The market's concerns that strong domestic demand and capacity constraints would limit the scope for further trade adjustment were diminished by the data for April, which showed a decline in imports. The dollar's reaction to this set of trade figures was stronger than that of the previous month, with dollar exchange rates moving up sharply to trade at DM 1 7450 and Y 126 50 soon after the trade figures' release

Later in June, the Economic Declaration issued after the Toronto Summit left the market with the impression that the G-7 monetary authorities would tolerate a further rise of the dollar Although the Declaration repeated the precise words of the December 1987 G-7 statement, the dollar was already 8 percent higher in terms of the mark than at the time of the December statement This different market environment, together with comments by several officials following the Toronto meetings, led to an interpretation that some further rise was acceptable.

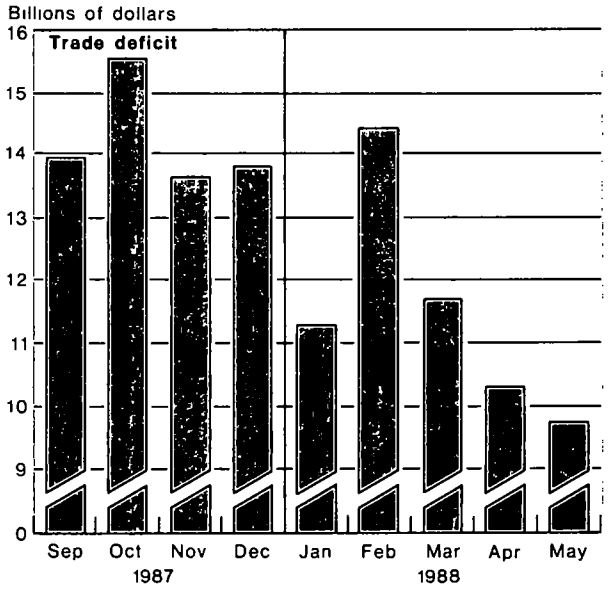
As a result of these developments, the dollar began to rise more quickly in late June As the dollar broke through DM 1 80 and higher levels not previously anticipated, there were reports of corporations and financial institutions moving to reduce their short-dollar positions There were also dollar purchases associated with the covering of options positions that had been established in anticipation of a continued dollar

Chart 4

Rising capacity utilization raised concerns that capacity constraints would limit trade adjustment . . .



but did not keep the U.S. trade deficit from narrowing during the period.



The top chart shows the degree of capacity utilization in U S industry Capacity utilization data for April, May, and June were released on May 17, June 16, and July 18, respectively The bottom chart shows the monthly U S merchandise trade balance, seasonally adjusted and reported on a census basis The U S trade figures for March, April, and May were released on May 17, June 14, and July 15, respectively

decline.

In these circumstances, the U.S. authorities entered the market for the first time during the period on June 27 The authorities continued to operate, intervening on 15 of the remaining 23 business days through the end of July and working closely in coordination with other central banks to foster exchange rate stability.

There were several occasions during July when upward pressure on dollar rates was considerable. Some of these occurred when new economic statistics were released confirming the buoyancy of the U.S. economy The dollar was especially well bid, for example, after the July 8 report of a further decline in U.S. civilian unemployment and after the July 27 release of GNP data pointing to a 3 1 percent seasonally adjusted rate of growth for the second quarter. The dollar also came into demand after the report on July 15 of May trade figures that reassured market participants that U.S. trade adjustment remained on track. Meanwhile, press coverage of Chairman Greenspan's congressional testimony reinforced the expectation that the U.S. authorities stood ready to counter inflationary pressures Under these circumstances, the dollar generally moved up during early July, reaching its highs of the period against the mark and the yen at DM 1.8925 on July 18 and Y 135 55 on July 15, respectively. But by the end of July, the dollar was trading off its highs at DM 1 8780 and Y 133 15, respectively

Between June 27 and July 29, the U S. authorities sold a total of $2 9 billion in the market, all against marks. Of the total, $1,317.5 million was sold by the Federal Reserve and $1,612.5 million was sold by the Treasury's Exchange Stabilization Fund (ESF). These operations were conducted in cooperation with other

Table 3

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

In Millions of Dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
May 1, 1988 to July 31, 1988	0	0
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1988	+1,101 2	+856 7

Data are on a value-date basis

central banks.

In other industrialized countries, the authorities also intervened to sell dollars, on occasion in substantial amounts. In addition, interest rates in a number of foreign countries increased as the authorities sought to limit the decline of their currencies against the dollar or otherwise respond to signs of quickening price pressures.

In other operations, the U.S. authorities increased holdings of foreign currencies by $1,282.3 million equivalent through sales of Special Drawing Rights (SDRs) and dollars to other official institutions and through receipt of principal repayments and interest payments due to the United States under the Supplementary Financing Facility of the International Monetary Fund.

As of end July, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,101.2 million for the Federal Reserve and $856.7 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 $1,408.2 million equivalent, and holdings by the Treasury amounted to the equivalent of $1,604.8 million.

During the period under review, the U.S. Treasury, through the ESF, received repayment of its financing facility for Argentina and participated in multilateral financing facilities for Yugoslavia and Brazil.

Argentina. On May 31, the Central Bank of the Argentine Republic fully repaid the $160 million second drawing of a $550 million short-term financing facility provided by the U.S. Treasury through the Exchange Stabilization Fund, thereby fully liquidating the facility.

Yugoslavia. On June 10, the U.S. Treasury, through the ESF, together with the Bank for International Settlements (BIS) acting for a number of central banks, agreed to provide $250 million in short-term financing facilities to the National Bank of Yugoslavia. On June 15, the National Bank of Yugoslavia drew the full $50 million of the ESF facility. On July 1, $16.1 million was repaid.

Brazil. On July 27, the U.S. Treasury, through the ESF, together with the BIS acting for a number of central banks, agreed to provide $500 million in short-term financing facilities to Brazil. The ESF's facility was $250 million. On July 29, the Central Bank of Brazil drew $232.5 million from the ESF facility.