November 1985-January 1986 Report
(This report was released to Congress and to the press on March 11, 1986)

Treasury and Federal Reserve Foreign Exchange Operations

The dollar declined substantially against most currencies during the three months ended January, falling by 9 percent against both the German mark and the Japanese yen.

The dollar moved lower with little exchange market intervention by central banks of the five largest industrial countries. While there was less central bank dollar selling than during the six weeks after the G-5 meeting on September 22, market participants remembered the G-5 commitment to adopt additional specific measures to achieve a more balanced economic expansion. They were, therefore, sensitive to the possibility that policy actions might be taken to support the trend of a declining dollar.

Sentiment toward the dollar became decidedly more cautious during the three months. At times during the period, market participants thought that the dollar would stabilize. But by the end of the period they generally believed the authorities either would favor or at least not strongly resist further dollar declines. In this context, they came to view developments that occurred in a negative light for the dollar. Also, figures showing that the trade imbalances of the United States, Germany, and Japan were continuing to widen were seen as maintaining pressure on governments to further the exchange rate movements.

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

At the end of January, the dollar was about 20 percent below the levels at which it had been trading against the Japanese yen and the German mark the week before the September G-5 announcement. It was down around 30 percent from its peaks against those currencies of early 1985 (Chart 1). Given the normal and expected lags to trade flows, the favorable effects of these large changes in exchange rates on the trade position of the United States were not yet showing through in reported trade figures.

During November and December, the exchange markets tended to react to evidence that the U.S. economy was not growing as rapidly as had previously been forecast. Business statistics published at the time showed that the modest acceleration of U.S. growth that occurred in the third quarter was not being sustained in the final quarter of 1985. In Germany, by contrast, output appeared to be expanding more rapidly than before, while official and private forecasts for 1986 were repeatedly revised upward.

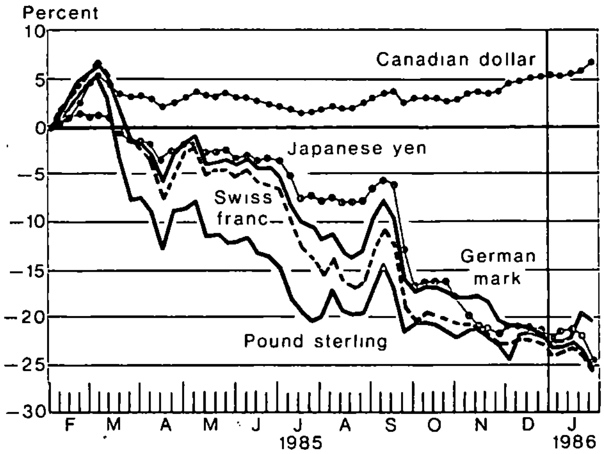
At the same time, U.S. trade and current account deficits continued to mount. Release of monthly trade statistics drew attention to the drag the external sector was exerting on domestic output. These figures served to remind market participants of the magnitude of the adjustment needed to restore more balance to the U.S. expansion and to redress protectionist pressures at home (Chart 2). Meanwhile, the current account surpluses of Germany and Japan were approaching record levels in 1985.

In addition, the fact that the initiative for the September G-5 agreement had come from the United States had a continuing influence on exchange markets throughout the three-month period The G-5 agreement was interpreted by market participants as reducing the likelihood that the Federal Reserve would tighten reserve conditions Many market participants expected the U.S authorities to act to lower U.S interest rates, either in concert with other G-5 countries or alone, in order to reduce the incentive to invest in dollar-denominated assets and thereby encourage an appreciation of nondollar currencies.

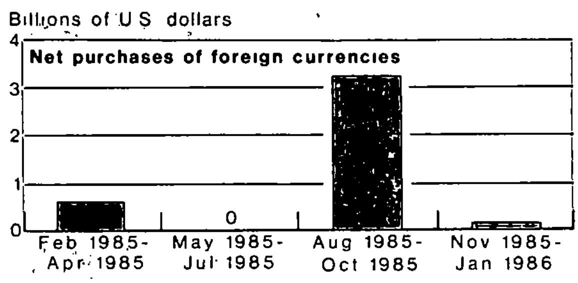
This expectation was particularly strong as the period opened early in November The Bank of Japan had just allowed Japanese money market interest rates to rise sharply

Chart 1

The dollar continued to decline from November through January.



United States monetary authorities' dollar sales were small after October.



Percentage change of weekly average bid rates for dollars from the average rate for the week ending February 1, 1985 Figures calculated from New York noon quotations

In response, the yen rose strongly against both the dollar and European currencies in the first days of November Market participants were impressed with what they saw as evidence of the willingness of the Japanese authorities to boost the yen. But they questioned whether the rise in Japanese interest rates was consistent with the overall objective of achieving a more balanced global expansion. Domestic demand in Japan had been subdued Some small- and medium-sized exporters were already expressing concern about the adverse effects of the yen's appreciation on the profitability of their sales abroad Any slowdown in export sales was seen as having a potentially significant and negative effect on future production gains. Under these circumstances, many market participants believed that the rise in Japanese interest rates would have to be quickly reversed lest the internal Japanese economy be weakened any more. They thought this reversal was most likely to occur in the context of joint action to lower interest rates in the United States and other countries

When several days passed without any evidence of an easing in the Federal Reserve's monetary policy, market participants began to question whether the monetary authorities wished to see the dollar fall further. As a result, bidding for dollars reappeared and the dollar rose markedly against the yen and European currencies The Trading Desk conducted its only intervention operation of the period on November 7, selling $77 2 million against Japanese yen and $25 million against German marks The purchases were split equally between the U S Treasury and the Federal Reserve.

For the balance of November, the dollar fell rather steadily, especially against the German mark The improving outlook for Germany's growth and its near-record trade surplus contrasted with the lackluster pace of business activity and the growing trade deficit of the United States. The mark gained support from press and market attention to comments by officials that gave the impression the U S Administration remained dissatisfied with the extent of the mark's rise.

During the first half of December, the dollar's depreciation stalled as market participants again questioned the willingness of the monetary authorities in other countries to accept a further rise of their currencies As November reserve figures were published, they indicated that the G-5 countries were again increasing their foreign exchange holdings (Chart 3). The dollar steadied first against the yen—then trading near ¥200, some 17½ percent above the levels prevailing before the G-5 agreement Market participants noted Japanese interest rates were easing back again and interpreted a Japanese official's comments supporting a managed float of major currencies as indicating a desire for the yen to stabilize The dollar then steadied against the German mark With the mark then at DM2.50, some 14 percent above mid-September levels, market participants were sensitive to any indication of the German authorities' views about the scope for further appreciation of their currency. Accordingly, when rumors circulated that the German central bank had purchased dollars in the exchange market, professionals temporarily became wary of selling dollars

But the dollar shortly resumed its decline in December. The report of an upward revision of GNP for the final quarter of 1985 failed to alter perceptions that economic growth in the United States had slowed toward the end of the year. The passage of legislation aimed at reducing the U S fiscal deficit over coming years was seen as at least beginning to address a fundamental problem facing the United States Yet, in the near term, the prospect of declining fiscal deficits contributed to an easing of long-term U S interest rates, narrowing differentials in favor of the dollar. Thus, the dollar moved below DM2 50 after mid-month as the mark again led the rise of currencies against the dollar.

As the mark rose against the dollar during November and December, it also moved up against its partner currencies in the European Monetary System (EMS) Although inflation had slowed in all EMS countries, the rise in prices in Germany had remained consistently smaller than in the others. The cumulative effects of the inflation differentials since the last major realignment of EMS parities in 1983 were seen as having implications for the competitiveness of industry in individual member countries Thus, as EMS currencies as a group strengthened, questions arose about the sustainability of the system's parity rates

The renewed rise of the mark against the dollar starting late in December intensified pressures within the EMS (Chart 4). Market participants were sensitive to the possibility that many EMS countries would seek early adjustments to their currencies—similar to that already made for the lira in July 1985—in order to avoid a protracted period of speculation over EMS currency relationships Regularly scheduled meetings of European Community officials were viewed by some as providing a forum for negotiating a realignment of joint float parity rates These pressures were mirrored in a sharp widening in the forward market discounts of the currencies of Italy, France, and Belgium relative to the German mark (bottom panel, Chart 4) In the spot market, selling of these currencies typically built up before weekends when the opportunity for a currency realignment was viewed as the greatest and then eased when no realignment occurred.

In response to these pressures within the EMS, the authorities in both Belgium and Italy acted to stem speculative capital outflows by raising money market interest rates The central banks whose currencies were under pressure intervened regularly, and at times in substantial size, to sell dollars and marks out of official reserves Belgium, along with several other countries, stepped up its borrowings in the Eurocurrency markets in order to replenish international reserves Then in mid-January, the Italian authorities acted to protect the lira against speculation by raising interest rates

Chart 2

Exchange market participants focused on the policy implications of growing trade imbalances.

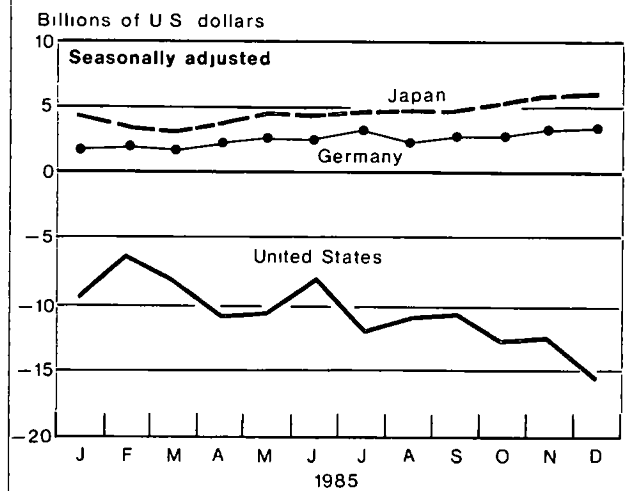
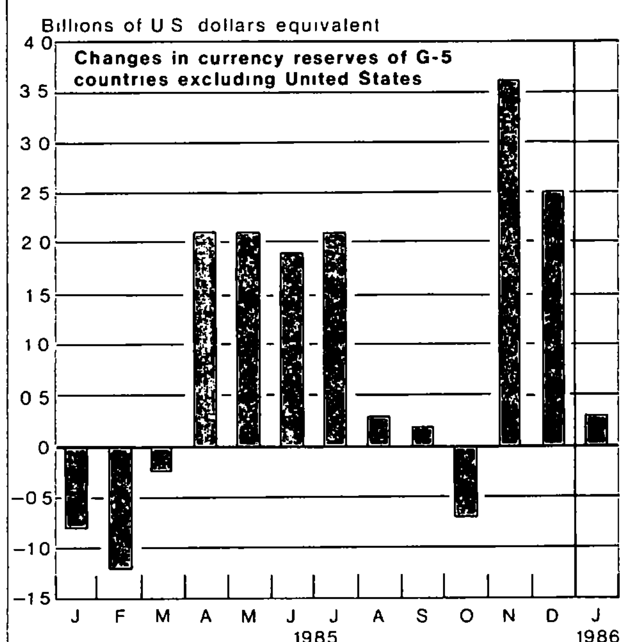


Chart 3

G-5 foreign central banks gained reserves as their dollar sales declined.



Data are drawn from IMF data published in International Financial Statistics more, imposing a ceiling on the growth of bank credit, and tightening or reintroducing exchange controls affecting commercial leads and lags.

Meanwhile, during January, the bearish sentiment toward the U.S. economy began to lift following a series of U.S. economic statistics—starting with an unexpectedly strong gain in December employment—that caused analysts to revise upward their growth estimates for the coming year. In response, U.S. interest rates moved up briefly, causing interest differentials in favor of the dollar to widen again. But, unlike previous occasions during this economic expansion when evidence of a stronger-than-expected U.S. economy

Table 1

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
November 1, 1985—January 31, 1986	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1986*	+152.2	+296.7

Data are on a value-date basis

* 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

Table 2

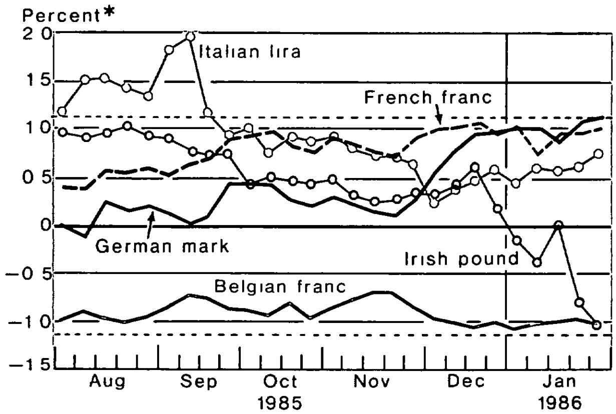
Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

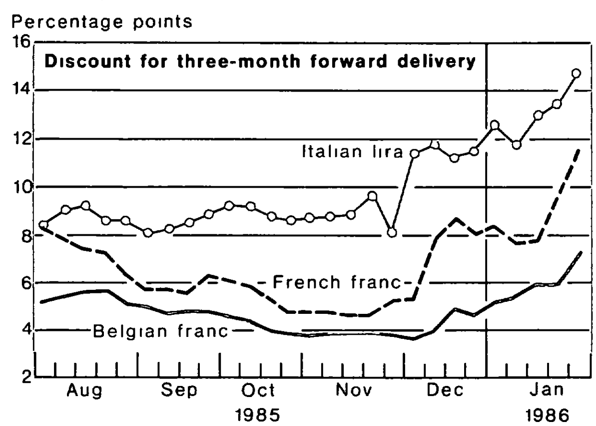
Institution	Amount of facility January 31, 1986
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	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 currencies-dollars	1,250
Total	30,100

Chart 4

The mark rose and strains intensified within the EMS.



Forward discounts widened against the mark, reflecting speculation of an EMS realignment.



*Percentage deviation of each currency from its ECU central rate. Dotted lines correspond to the System's 2¼ percent limit on movement from bilateral central exchange rates for all participating currencies except the Italian lira. The lira may fluctuate 6 percent from its central rates against other EMS currencies.

Weekly averages of daily 9 a.m. rates

and rising interest rates boosted the dollar, the exchange market reaction was muted. Prior to a January 18 meeting of G-5 monetary officials in London, anticipations persisted that some joint action to lower the dollar by interest rate changes or other means would be taken. When no policy statements were issued from that meeting, these expectations subsided.

At the same time, an unexpectedly sharp drop in oil prices had become the dominant factor in the exchange markets. Oil prices had started to plunge after members of OPEC, faced with a growing abundance of oil supplies, chose to defend their market share rather than to support oil prices by curtailing production. With the supply of oil outstripping demand, spot oil prices dropped, closing January nearly 40 percent below the levels recorded three months earlier (Chart 5).

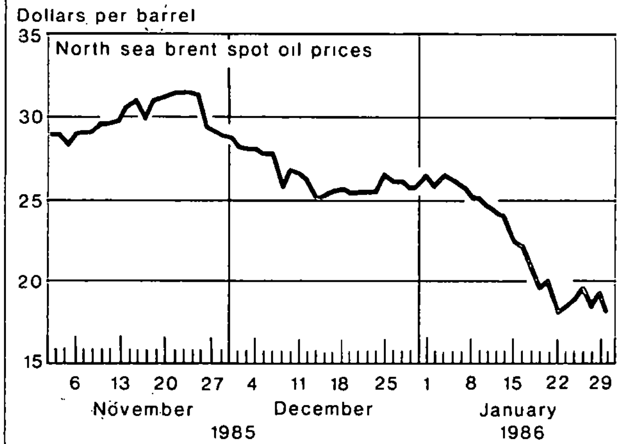
The decline in world oil prices greatly enhanced the likelihood that the world's economic expansion would continue without reaccelerating inflation soon. To be sure, the United States was expected to benefit from the slowing of inflation and a reduction of imports. But market participants saw the possibility that relatively greater benefits would accrue to major competitors and trading partners of the United States, because they are more dependent on imported sources of energy. Moreover, the sharp fall in oil prices raised questions about the exposure of U.S. banks to borrowers in the energy sector and the major oil producing developing countries. Thus, each successive report of lower oil prices tended to cause the dollar to weaken relative to the yen and some continental European currencies. These pressures were not limited to the dollar; the pound sterling and the Canadian dollar also were vulnerable to developments in the oil market.

The prospect of declining commodity prices, together with reduced fiscal deficits, fostered renewed rallies in the U.S. stock and bond markets in January. As a consequence, long-term U.S. interest rates fell late in the month. Thus, long-term interest rates differentials became progressively less favorable to the dollar, contributing to uncertainties whether capital inflows would continue to support the dollar as they had in recent years.

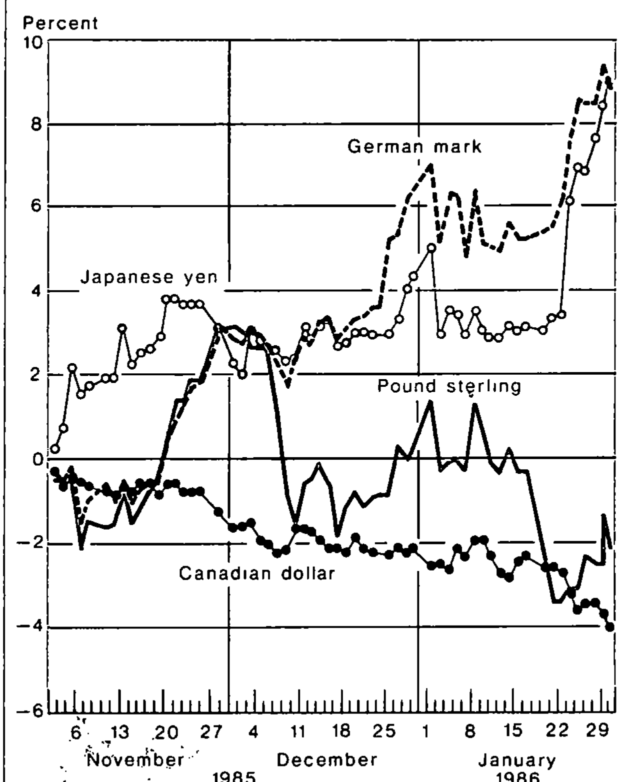
Against this background, market participants scrutinized statements by U.S. and foreign officials for any indication of changes in their views or intentions about dollar exchange rates. At the time the yen was holding around the key ¥200 level. Market participants noted that Japanese interest rates were being allowed to ease back toward levels prevailing before the run-up of late-October to early-November and talk spread of a cut in the Bank of Japan's discount rate. They wondered, therefore, if the Japanese authorities would resist a renewed rise in their currency. But some private forecasters were suggesting that the fall in oil prices might permit more scope for a higher yen. When a Japanese official was quoted late in January as agreeing that a further

Chart 5

World oil prices plummeted . . .



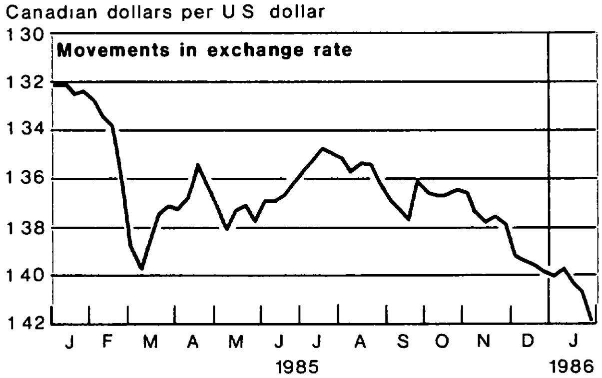
contributing to the rise of some currencies and the decline of others against the dollar.



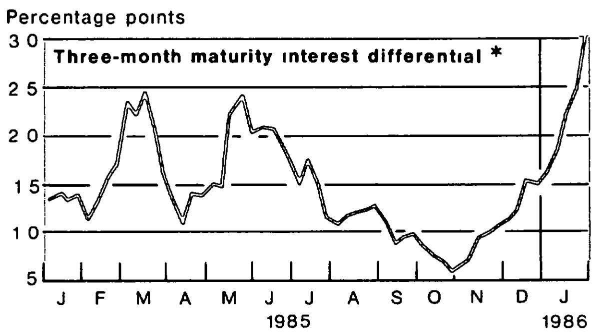
Percentage change of daily average bid rates for selected foreign currencies from the noon rates on November 1, 1985. Figures calculated from New York noon quotations.

Chart 6

The Canadian dollar fell to new lows...



...despite widening interest differentials.



*Canadian finance paper minus Eurodollars
Weekly average of daily rates

rise might be acceptable, the yen broke through ¥200 and led other foreign currencies sharply higher against the dollar. It continued to strengthen even after the Bank of Japan announced a cut in its discount rate of one-half of a percentage point, to 4½ percent, on January 29 to be effective the following day.

Meanwhile, protectionist pressures in the United States, which had subsided somewhat following the September G-5 meeting, resurfaced. An unexpected jump in the December U.S. trade deficit to a record level contrasted with Japan's record trade surplus for the same month. Market participants noted that some U.S. government officials were still talking about the need for a stronger yen. Press reports in advance of the President's annual State of the Union address, saying that the Administration would propose to discuss with other countries the role and relationship of currencies, contributed to the sense that the United States would welcome a further depreciation of the dollar.

In response, the dollar was falling at the end of January. It dropped to a seven-year low of ¥191.35 and to a three-year low of DM2.3645 and closed near those lows on the last day of January.

The only major currencies against which the dollar rose during the period under review were pound sterling and the Canadian dollar. Early in November, the pound was still benefiting from its role as a principal investment alternative to the dollar. As the dollar declined, investors moving out of dollar assets showed a preference for placing funds in the liquid sterling markets. But after touching a two-year high of $1.5025 against the dollar at the beginning of December, sterling came under intense selling pressure as the market weighed the implications of falling oil prices. The drop was expected to lower British oil export revenues, thereby exacerbating a negative trend in the country's balance of payments. An associated decline in oil royalty payments to the government was expected to undermine progress in reducing Britain's fiscal deficit. As a result, the government's strategy of using tax cuts in the coming year to support economic growth came into question In these circumstances, the pound declined despite continuing favorable interest differentials. It reached record lows against the German mark and gave up its earlier gains against the dollar to close the period at $1.4115, down 2¼ percent on balance.

The fall of sterling contributed to the decline of the Irish pound within the EMS alignment toward the end of the period under review (Chart 4). Speculation against the Irish currency mounted as traders anticipated it would be devalued in any EMS realignment, given the fall of the British pound and Ireland's close economic ties with the United Kingdom. As a result, the Irish currency fell to join the Belgian franc at the bottom of the EMS band by the end of January while money market interest rates firmed in Ireland.

The Canadian dollar also weakened substantially during the period, falling to record lows against the U.S. dollar. After the September G-5 meeting the Canadian dollar, alone among the currencies of the major trading partners of the United States, had not appreciated against the U.S. dollar. The policy issues surrounding the problems of some small Canadian banks last fall were seen as unsettling by market participants. News of a current account deficit in the third quarter, the first deficit recorded in Canada since 1983, added to market participants' disquiet. In addition, the fall in oil prices, while having little net effect on Canada's external position, was expected to result in sharply lower government revenues and create dislocations in some sectors and some regions of the economy. Market observers also expressed disappointment in the degree to which the government had been able to cut Canada's fiscal deficit Under these circumstances, the currency came on offer in the face of speculative selling and recurring rumors that foreign investors were liquidating investments in Canadian securities.

In response to these pressures, the Bank of Canada intervened forcefully late in the period and for a time afterward, replenishing foreign currency reserves by drawing nearly \$1.5 billion from its two standby credit facilities with commercial banks. During the last four weeks of January the Central Bank also acted to tighten money market conditions. Interest rates in Canada rose markedly and, with comparable rates in the United States either steady or declining, the interest differentials favoring the Canadian dollar widened to three percentage points, the highest level in more than three years (Chart 6). On balance, the Canadian dollar declined 4¼ percent against the dollar during the three-month period under review.

In the period November through January, the Federal Reserve and the Exchange Stabilization Fund (ESF) realized no profits or losses from foreign exchange transactions. As of January 31, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were \$152 million for the Federal Reserve and \$297 million for the Treasury's ESF. This is the first reported valuation gain for the Federal Reserve since October 31, 1980.