February-April 1986 Report
(This report was released to the Congress and to the press on June 4, 1986)

Treasury and Federal Reserve Foreign Exchange Operations

The dollar moved substantially lower against all major currencies during the three months ended April, declining by more than 8 percent against most European currencies and by almost 12 percent against the Japanese yen. The depreciation was a continuation of the trend that emerged in early 1985 and gained momentum after the September G-5 meeting. The U.S. authorities did not intervene for their own account in the exchange markets during the February-April period, and the dollar's decline proceeded without any new concerted intervention in the exchange markets.

The decline took place against a background of downward-moving interest rates and narrowing interest rate differentials favoring the dollar. The market's attitude also seemed influenced by the implications of continuing large current account imbalances and by assessments of the varying inflation prospects in different countries as a result of oil price changes. Market participants were also influenced by perceptions of official views about the dollar, particularly in light of the January meeting of G-5 Finance Ministers and Central Bank Governors where they expressed satisfaction with the trend of exchange rates since the September meeting.

As the period opened, the foreign exchange markets were in a sensitive phase. The dollar had already declined a substantial amount from its highs of the year before. Yet there was little evidence that the U.S. economy or its trade position had reaped enough benefit to allay concerns among market participants that U.S. authorities would wish to see further dollar depreciation. Indeed, statistics then being released indicated the U.S. deficit on merchandise trade had widened substantially during December, and the external sector continued to exert a significant drag on domestic production. The mid-February estimate of GNP growth for the final quarter of 1985 revealed a disappointing, downward adjustment. Statistics for January's personal income and consumption were also worse than expected, leading many in the market to conclude that the outlook for 1986 was even less optimistic than they had believed earlier. Subsequent data were interpreted as indicating points of weakness, rather than strength, for the U.S. economic outlook.

At the same time, concern faded about potentially adverse effects on prices of any continuing dollar depreciation. Inflationary expectations in the United States were being rapidly scaled back in response to further dramatic drops in prices for oil and some other commodities. Thus, the risk of an accelerating decline in dollar exchange rates was seen by many market observers to be less than before. In addition, through early April, interest rates in the United States continued to ease at a faster pace than those abroad as many market participants expected that the Federal Reserve might ease monetary policy considerably. As a result, interest differentials favoring the dollar continued to narrow. By April 16, interest differentials on long-term government securities fell to within 200 basis points *vis-à-vis* German and Japanese securities.

Beginning in February, a heavy schedule of state-

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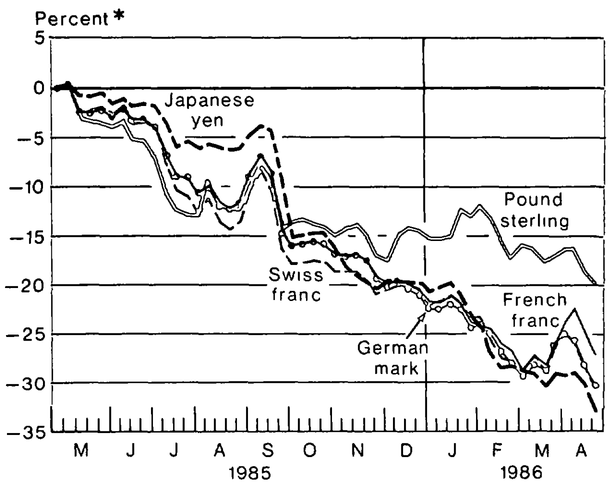
ments and testimonies about U.S. economic policies, together with the approach of a number of important international meetings, provided opportunities for officials here and abroad to be questioned about their attitude toward exchange rate trends. Administration officials generally expressed satisfaction with the decline in dollar rates since the G-5 agreement in September. They noted that the dollar's decline had been orderly and denied that there was any particular level or range of rates at which they expected or desired the dollar to trade. The President, in his annual State of the Union address, noted the problems that previous exchange-rate fluctuations had caused for many Americans and asked Secretary of the Treasury Baker to determine whether it would be useful to hold an international conference to discuss with other countries the role and relationships of currencies. Market participants and journalists tended to conclude from these statements that U.S. authorities would welcome a further depreciation of the dollar, notwithstanding the repeated denials by U S. officials that they had a target for the dollar. In these circumstances, the market's attitude toward the dollar was predominantly bearish.

During February and early March, the dollar declined across the board without interruption. The focus of market attention initially was the yen It was supported by mounting monthly trade surpluses and the view that declining oil prices would be particularly beneficial to the Japanese economy. The dollar, which had closed at ¥191.40 at the end of January, declined steadily throughout early February to breach the psychologically important ¥180 level and to reach ¥177.40, a seven and one-half year low, by February 19. The yen's rise then stalled after Japan's Finance Ministry confirmed that it was developing plans to ease regulations on capital outflows which could have the effect of raising the demand for dollars by Japanese institutional investors.

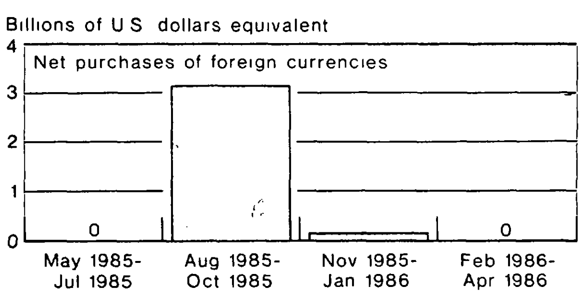
At this point market participants shifted their focus to the dollar/mark exchange rate. Forecasts of German economic growth in 1986 were being revised upward toward 4 percent. Given the relatively lackluster growth performance in the United States during the last quarter of 1985 and the weakness in several U.S. business indicators early in 1986, Germany emerged as a likely

Chart 1

The dollar continued to decline.



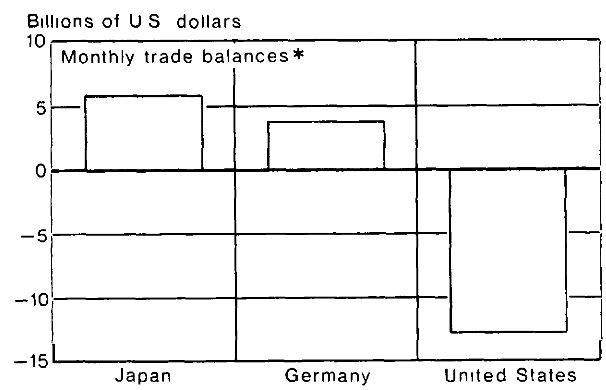
United States monetary authorities did not intervene February through April.



*Percentage change of weekly average rates for dollars from the average rate for the week ending April 25, 1985 Figures calculated from New York noon quotations

Chart 2

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



*Average of the seasonally adjusted trade balances for December 1985 and January and February 1986 candidate for relatively high growth Moreover, the German trade surplus had been increasing during the previous few months The continued drop in oil prices made it appear possible that Germany's trade surplus for 1986 would be double the level of the previous year Traders also anticipated a possible realignment within the European Monetary System (EMS) in which the mark would be revalued With these expectations in the minds of market participants, the dollar declined against the mark until early March as far as DM2.1960.

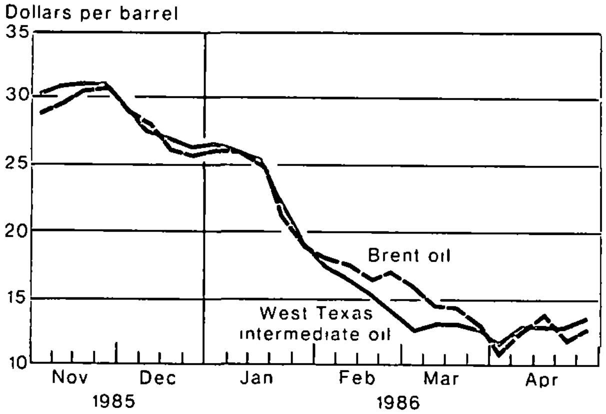
On March 6 and 7, the central banks of Germany, Japan, the United States, France, and the Netherlands lowered their official interest rates The central banks of the United Kingdom, Italy, and Sweden soon followed by cutting their official lending rates. These actions had little immediate impact on exchange rates since the reductions had been widely anticipated and international differentials in market rates were expected to be largely unchanged But the concerted round of interest rate reductions underscored to the market the potential for further coordinated policy actions For some time thereafter, most dollar exchange rates moved narrowly as markets reassessed the near-term outlook for the dollar and the prospects for other coordinated actions

Early in April, the dollar resumed its decline Indications that world oil exporters were failing to agree on a plan to support oil prices kept alive expectations that inflation in the major countries would continue to slow Thus dealers anticipated that the major central banks would act soon to cut interest rates again Some market participants even thought that the Federal Reserve might cut its discount rate more than other central banks In the United States, there was concern about the impact of lower oil prices on U S banks with exposure to the oil-exporting developing countries and to the domestic energy sector In Germany, the central bank had expressed doubts that a further cut in the discount rate would be appropriate given existing conditions in the domestic economy

Selling pressures against the dollar then emerged,

Chart 3

The decline in world oil prices. . .



showed through in lower rates of inflation.

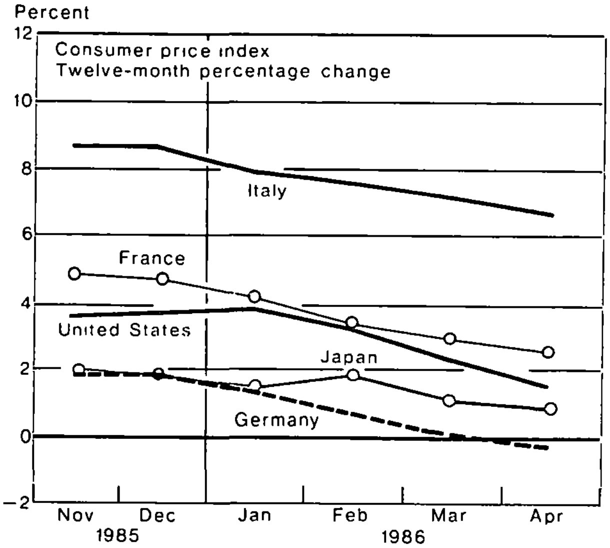
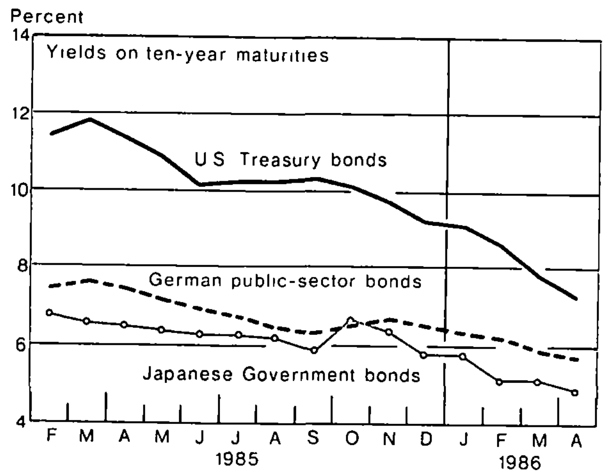


Chart 4

Interest differentials favorable to the dollar narrowed as long-term interest rates declined in the United States more rapidly than abroad



especially against the yen That currency had already appreciated significantly during the past year, and Japanese exporters, particularly small- and medium-size firms, were facing a substantial drop in the demand for their products Under these circumstances, Japanese officials began to voice concern whenever the yen advanced toward the level of ¥175 against the dollar Dealers therefore remained wary that foreign exchange market intervention or some other official action might be taken to curb the exchange rate move But the demand pressures on the yen were becoming so strong as to bring into question the Japanese authorities' ability to resist its appreciation unilaterally, and the yen strengthened relative to all major currencies.

Against the major European currencies, the dollar was influenced early in April by strains emanating from a realignment of exchange rates within the joint intervention arrangement of the EMS Market participants had long expected that some adjustment in exchange rates might occur soon after the March elections in France to adjust for inflation differentials that had existed between the participating countries since the general realignment in 1983. As such an event was thought to become more imminent, the dollar's decline against the mark slowed Some dealers were anticipating that the dollar might benefit from speculative reflows out of the mark after the realignment But the realignment that occurred over the first weekend in April unleashed a strong demand for French francs against all currencies French residents unwound long-standing commercial leads and lags and nonresidents sought quickly to build up investment positions in francs and to benefit from the relatively high interest rates in France As a result, the dollar again came on offer against the European currencies after the realignment

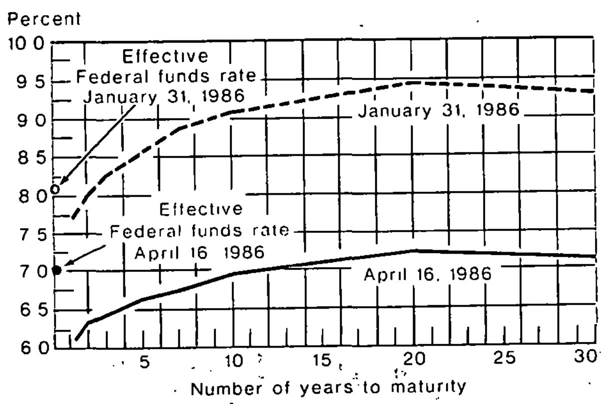
By late April, the dollar had declined 10 percent against the Continental currencies and 13 percent against the yen from end-January levels It touched ¥166 10 against the yen, a record low for the postwar period, and DM2 1520 against the mark, the lowest level against the German currency since April 1981. At this point the dollar was more than 37 percent below its highs *vis-à-vis* those currencies of about a year before

Meanwhile, the financial markets around the world were astir with talk of a renewed drop in interest rates in many major countries The plunge in oil prices was beginning to show through in reduced inflation rates for a number of countries Partly in sympathy, interest rates on U S long-term securities had declined almost to the level of the Federal funds rate, indicating strong market expectations that a further cut in the Federal Reserve's discount rate was in the offing Japanese bond yields fell to postwar lows And in Europe, a number of countries that had not participated fully in the easing of interest rates prior to the EMS realignment were seen as having increased scope to cut rates

In fact, the moderation of global inflationary expectations did provide the impetus for a lowering of official interest rates in a number of countries The Federal

Chart 5

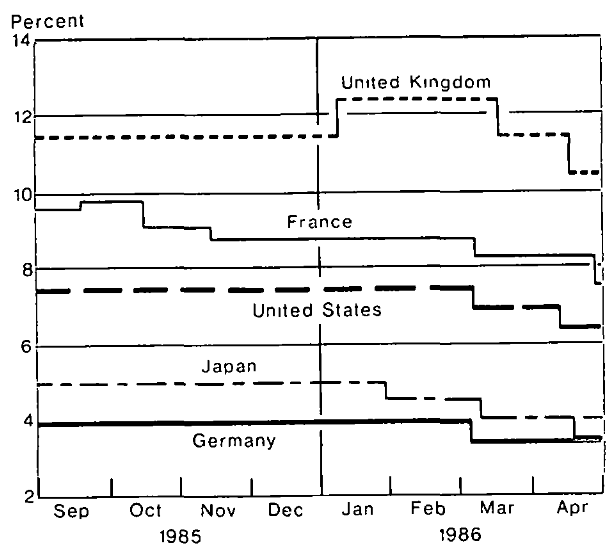
In the United States, long-term yields fell more rapidly than short-term yields.



Yields on actively-traded issues adjusted to constant maturities

Chart 6

Official interest rates were lowered.



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
February 2, 1986-April 30, 1986	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1986*	+962 9	+1,031 4

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

Reserve and the Bank of Japan both lowered their discount rates by one-half of a percentage point, effective April 21. Central banks in the United Kingdom, France, and Italy lowered their official rates in one or two steps by one-half of a percentage point or more at about the same time The German central bank, feeling more constrained by the weakness of the mark within the EMS, did not join in this second round of reductions of official lending rates.

At the end of April, the dollar's decline paused. Some foreign exchange and bond dealers had expressed concern that investors might be reluctant to acquire the additional dollar-denominated assets needed to finance the continuing U.S. current account and fiscal deficits. Market participants were also well aware of pressures on foreign governments to ease the pain for their own industries of too-rapid a fall of the dollar. Accordingly, they considered the possibility that some agreement to support the dollar might emerge from the discussions at the Economic Summit in Tokyo early in May. In addition, by late April, there was evidence that foreign participation in U.S securities markets continued to be strong. The dollar therefore moved up somewhat from its lows by the close of the period under review.

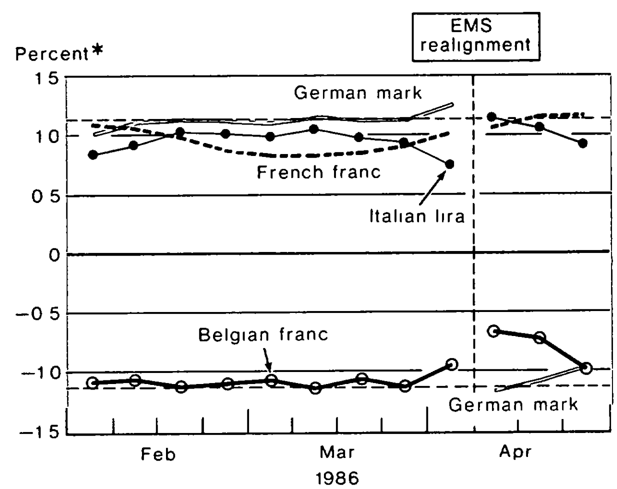
The EMS Realignment

On April 6, the European Community announced a realignment of the central rates within the EMS This was the first overall realignment of EMS central rates in more than three years. The realignment was initiated by the new French government as part of its program to restore competitiveness in the French economy and dismantle exchange and other financial controls It involved in effect a devaluation of almost 6 percent for the French franc's bilateral central rates against the German mark and the Dutch guilder. Other adjustments against the mark and the guilder were much smaller, including 3 percent effective devaluations in the central rates of the Italian lira and the Irish pound and 2 percent for the Danish krone and the Belgian franc

Movements of the market exchange rates for the EMS currencies after the realignment were relatively small. The French franc depreciated 3½ percent against the mark, substantially less than the 6 percent devaluation of its bilateral rate with the German currency. In other respects the configuration of exchange rates within the EMS also showed only modest change—except for the German mark, together with the Dutch guilder, which moved from the top to the bottom of the narrow band. Heavy reflows of funds following the realignment were reflected in substantial changes in the foreign exchange reserves of several countries. German reserves declined by almost $4 billion equivalent during the two weeks following the realignment, although much of this decline was recouped later in the month At the same time, there were large increases in the foreign-currency reserves of France and Italy during April. These two countries, as well as the other countries whose EMS central rates were effectively lowered against the guilder and the mark, took advantage of the relief from exchange market pressure late in April to add reserves, ease exchange controls, and lower interest rates

Chart 7

The German mark moved to the bottom of the EMS after the realignment.



Weekly averages of daily 9 a m rates

*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