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Treasury and Federal Reserve Foreign Exchange Operations

August-October 1986

After declining without interruption for nearly a year and a half, the dollar steadied during the period under review. Although the dollar continued to ease against most of the industrialized countries' currencies through August, it moved up subsequently to close the three-month period mixed on balance (Chart 1). From August to October, it appreciated against some currencies— 6¼ percent against the Japanese yen, 5¾ percent against sterling, and 2½ percent against the Swiss franc. It declined, however, by about 1 percent against the German mark and other currencies of the European Monetary System (EMS). There were dollar purchases by foreign central banks, but no intervention by the U.S. authorities during the period.

As the period opened early in August, the dollar was declining. Market participants had come increasingly to question whether the major industrialized countries would be able to work together to redress their large external imbalances. The huge trade deficit of the United States and the enormous trade surpluses of Japan and Germany had shown little adjustment, notwithstanding the considerable movements in exchange rates between the dollar and both the Japanese yen and German mark. Moreover, there was growing disappointment that the sharp, \$20-per-barrel drop in oil prices that occurred between November 1985 and July 1986 was failing to provide much of a boost to business activity in the oil importing industrialized countries.

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

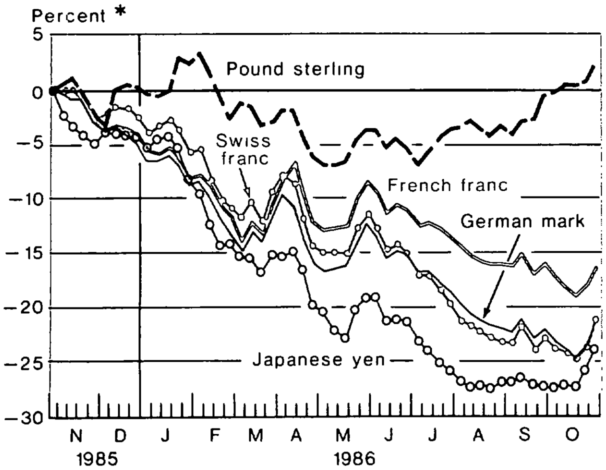
Doubts developed that our major trading partners were likely to expand domestic demand vigorously enough to provide a global environment within which the United States could markedly improve its balance of payments position. Market participants considered seriously the possibility that the U.S. authorities might welcome a continued decline in the dollar on the grounds that central banks abroad might then cut interest rates in their countries more quickly.

Under these circumstances, market participants expected the trend toward lower interest rates to continue, with the United States setting the pace and other industrial countries perhaps following later on. Although there were already a few signs that the U.S. economy was regaining some momentum from the slow first half of the year, market participants still were struck by the areas of weakness in U.S. economic performance. Output and investment remained sluggish, manufacturing employment continued to decline, and retail sales were generally stagnant. At the same time, prospects for price and wage stability appeared to be good for the short term, despite some concern about the longer term inflationary implications of recent rapid monetary growth.

In this environment, expectations resurfaced from time to time throughout the first few weeks of August that the Federal Reserve might again cut its discount rate, perhaps operating unilaterally as it had done in July (Chart 2). As a result, in August interest rates on deposits denominated in U.S. dollars fell, and their decline was sharper than the decline in interest rates in other currencies (Chart 3). The Federal Reserve did cut its discount rate by one-half of one percentage point,

Chart 1

During the period, the dollar paused in its long-term decline against other major currencies.



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

to 5½ percent, effective August 21. The exchange market reaction was muted, partly because many market participants expected the authorities in Germany and Japan to provide some further stimulus to their economies—either with monetary or other measures—before the annual meetings of the International Monetary Fund (IMF) and World Bank at the end of September.

Economic statistics released in mid-August began to paint a contrasting picture between the German and Japanese economies. The German economy, which had contracted sharply early in the year, seemed to be staging a robust recovery; and official German projections of an acceleration in growth began to be given widespread credence in the financial markets. Japan, on the other hand, appeared to be having much more difficulty adjusting to the appreciation of its currency. Although both the mark and the yen had risen by about the same amount against the dollar since early 1985, on a trade-weighted basis the yen's appreciation had been much greater than the appreciation of the mark (Chart 4). Whereas German manufacturers lost little competitiveness in their markets in other EMS countries, Japanese export industries were hit hard. They lost competitiveness not only in the United States but also in important East Asian markets. With business statistics released in August showing continued stagnation in the

Chart 2

The Federal Reserve reduced its discount rate in August. At the end of October, the Bank of Japan announced a reduction in its lending rate.

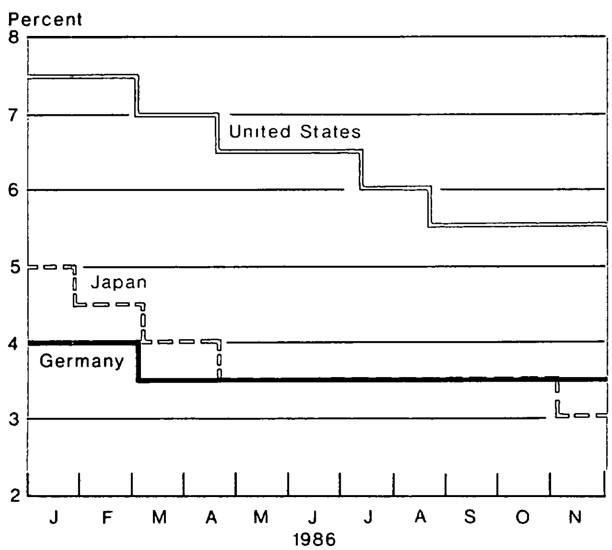
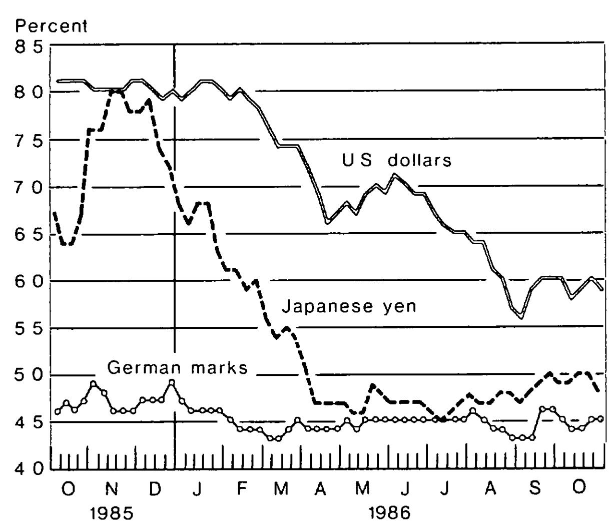


Chart 3

Short-term interest rates closely mirrored expectations of interest rate cuts.



Weekly average of interest rates on three-month Eurocurrency deposits

Japanese manufacturing sector (Chart 5), market participants began to question whether the yen should appreciate much more

In these circumstances, traders began to sense around mid-August that the dollar had more room to decline against the German mark and the other currencies of continental Europe than against the yen When a large U S. trade deficit for July was announced at the end of August, traders sold dollars aggressively against both marks and Swiss francs The dollar continued to decline against the European currencies through the end of August, even though it stabilized against the yen

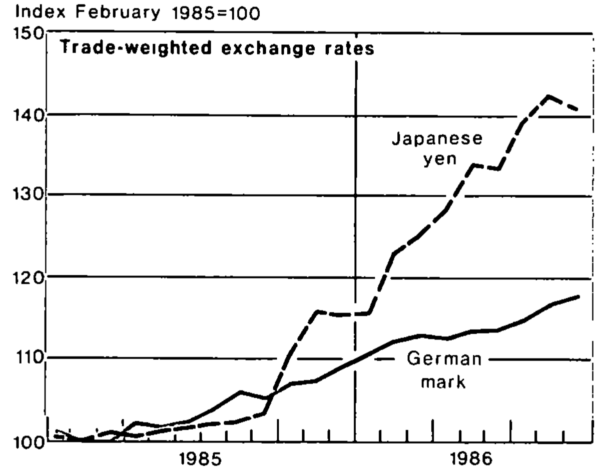
By mid-September, there was further evidence of improvement in the U S economic outlook. Gains in employment during August were more balanced, industrial activity was a little firmer, and retail sales were more buoyant. These developments, together with confirmation of strong growth for the German economy in the second quarter, seemed to suggest that an atmosphere supportive of renewed cooperation would surround the meetings of the Group of Five (G-5) and Group of Seven (G-7) industrial countries in Washington at the end of the month With Japanese production for export declining, German domestic demand replacing exports as the major source of growth, and U S output appearing to grow at a more satisfactory pace, the process of adjustment appeared to be underway at long last

In response to these developments, foreign exchange dealers concluded that the need for the U S authorities to seek further exchange rate adjustment had lessened, and the immediate pressure on dollar exchange rates subsided At the same time, in the wake of repeated comments by German officials, market participants became reconciled to the view that the Bundesbank was unlikely to ease monetary policy soon As a result, expectations of a further reduction of interest rates faded—not only in Germany, but also in the United States and other countries U S interest rates actually backed up somewhat As dollar exchange rates and interest rates both started to move up, foreign exchange professionals began to cover sizeable short dollar positions Bidding for dollars became intense, at times exaggerated by rumors that unrealistically good U S economic statistics were about to be released By September 12, the dollar was swept up to DM 2 1030 to match its high early in the three-month period

After mid-September, the dollar showed little trend Market participants remained skeptical that, over the longer term, the dollar had declined sufficiently to correct the U S balance of payments deficit But over the shorter term, market participants perceived the dollar to be consolidating its position around mid-September rate levels

Chart 4

In trade-weighted terms, the appreciation of the Japanese yen since September 1985 has been far greater than the appreciation of the German mark . . .

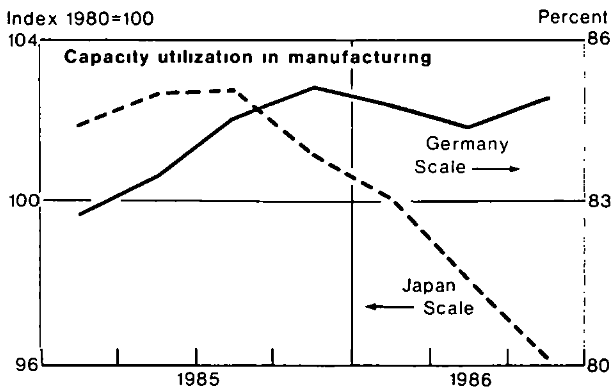


Trade-weighted value of the Japanese yen and the German mark vis-a-vis 17 other industrial countries derived from the International Monetary Fund's Multilateral Exchange Rate Model (MERM), indices rescaled to February 1985=100, the month of the lowest value during the recent period

Source International Financial Statistics

Chart 5

. . . and the impact on the Japanese manufacturing industry was also greater.



Sources Japan, Ministry of Industry and Trade, Germany, Ifo Economic Trends Survey

They were sensitive to any evidence that U S and other monetary authorities would be willing to support such a stabilization of exchange rates. In this environment, they took note of statements such as the one by Chairman Volcker on September 24 that current exchange rate relationships place our industry in a far better competitive position than for some years Accordingly, the dollar fluctuated without clear direction But it was sometimes subject to abrupt movements, especially against the mark between a range of DM 2 00 and DM 2.08. These abrupt shifts came in response to statements, actions, or rumors of actions thought to reflect official attitudes toward exchange rates.

The view that the dollar was entering a period of greater stability was called into question several times between mid-September and mid-October The first such occasion came in response to statements that brought official attitudes about exchange rates into question. Bundesbank President Poehl was reported to have said that the Bundesbank would not cut its interest rates but that Germany would accept a stronger mark as its contribution to international economic adjustment Subsequently, Treasury Secretary Baker said that, although it was preferable not to rely on exchange rate adjustments alone to reduce trade imbalances, there would need to be further exchange rate changes in the absence of additional measures to promote higher growth abroad In response, the dollar moved down decisively, declining on September 19 to DM 1 9845 and ¥ 151 77, its low for the period against the yen But it soon recovered most of this decline after a European Community (EC) meeting of finance ministers and central bank governors at Gleneagles, Scotland, the following day Market participants interpreted statements about that meeting as indicating that the EC countries had agreed to use exchange market intervention, if necessary, to protect the EMS from strains which they felt were associated with the decline in the dollar

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of Facility October 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	
Dollars against Swiss francs	600
Dollars against other authorized European currencies	1,250
Total	30,100

The next point of uncertainty occurred at the end of September The weekend G-5 and G-7 meetings in Washington ended without a specific agreement, which some observers had been looking for, that Germany and Japan would cut interest rates in return for a U S commitment to stabilize the dollar Market participants, sensing that no arrangement was in place to prevent a resumption of the dollar's decline, moved to reestablish short dollar positions As a result, the dollar declined sharply against the continental European currencies throughout the first half of October, hitting its low against the German mark of DM I 9690 on October I7.

Meanwhile, the dollar had continued to trade in a relatively narrow range against the Japanese yen In early September, news of a meeting between Secretary of the Treasury Baker and Japan's Finance Minister Miyazawa generated some anticipation that an agreement on exchange rates might be forthcoming Later in September, foreign investors, discouraged by the worsening business climate in Japan, began to sell holdings of shares on the Tokyo stock market. This outflow, combined with a growing pessimism about the likelihood of a reduction in the Bank of Japan's discount rate, contributed to a sharp drop in the Tokyo stock market in the middle of October Japanese institutional investors, attempting to offset the resulting losses on their yen equity portfolios prior to the end-October reporting date, realized profits on their dollar-denominated assets by unwinding hedges that had been put in place when the dollar was much higher. These various factors generated a demand for dollars throughout most of October and reinforced sentiment that the dollar had reached a near-term bottom against the Japanese currency

Late in October evidence was accumulating that the U S economy had strengthened significantly during the third quarter and that the U S trade position had at least begun to stabilize A preliminary estimate showing that real GNP increased by 2 4 percent in the third quarter was followed by a report that U S durable goods orders had increased 4.9 percent in September. Moreover, preliminary trade statistics for September indicated a second month of decline in the U S trade deficit

At the same time, market participants became increasingly impressed with European officials' apparent intention to buy dollars to resist depreciation of the U.S. currency and associated strains on the EMS. There were several reports of Bundesbank and other European central bank intervention to buy dollars during October. In addition, reported statements from German officials that any further decline of the dollar threatened economic growth in Europe contributed to the perception that there might also be a limit to the dollar's depreciation against the continental currencies. Accordingly, when the demand for dollars against the yen strengthened late in October, and the dollar began to firm against that currency, it also firmed somewhat against the European currencies.

As the period drew to a close, the dollar received a final boost of support from the announcement of a one-half percentage point cut in the Bank of Japan's discount rate and an economic policy accord between U.S. Treasury Secretary Baker and Japanese Finance Minister Miyazawa. The accord outlined fiscal policy initiatives, including tax reform plans in Japan, and underscored the U.S. commitment to reducing the budget deficit. The two countries judged the exchange rate realignment achieved between their currencies since September 1985 to be broadly consistent with present underlying economic fundamentals, and they reaffirmed a willingness to cooperate on exchange market issues. Notwithstanding statements by Treasury officials that U.S. intervention policy had not changed, some market participants interpreted the accord to be a pact for concerted intervention to support the dollar.

Thus the dollar continued to rise through end-October. This rise in dollar exchange rates was led by an increase against the yen but was accompanied by increases against other major currencies. The increase in the dollar at the end of the period left it higher on balance against some currencies and limited its decline against the German mark. On the trade-weighted basis of the Federal Reserve Board dollar exchange rate index, the dollar closed the period 1$^3/_8$ percent higher than at the end of July.

The pound sterling was the only currency against which the dollar rose consistently during the period under review. Some of sterling's decline was seen in foreign exchange markets as reflecting the impact of weak oil prices on British export revenues and government income. But market participants were also concerned about the direction of the government's overall monetary and fiscal policies, as well as about pre-election political uncertainties. With the authorities deciding formally to abandon monetary targets as a

Table 2

Drawings and Repayments by Foreign Central Banks under Regular Reciprocal Currency Arrangements

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

Central Bank Drawing on the Federal Reserve System	Outstanding as of August 1, 1986	August	September	October	Outstanding as of October 31, 1986
Bank of Mexico	0	+210.2	−66.8	0	143.4

Data are on a value-date basis.

Table 3

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 August 1, 1986	August	September	October	Outstanding as of October 31, 1986
Central Bank of Bolivia	100.0	*	*	0	0	0
Central Bank of Ecuador	75.0	75.0	−75.0	*	*	*
Bank of Mexico	273.0	*	+211.0	−67.0	0	144.0
Central Bank of Nigeria	37.0	*	*	*	+22.2	22.2

Data are on a value-date basis.
*No facility.

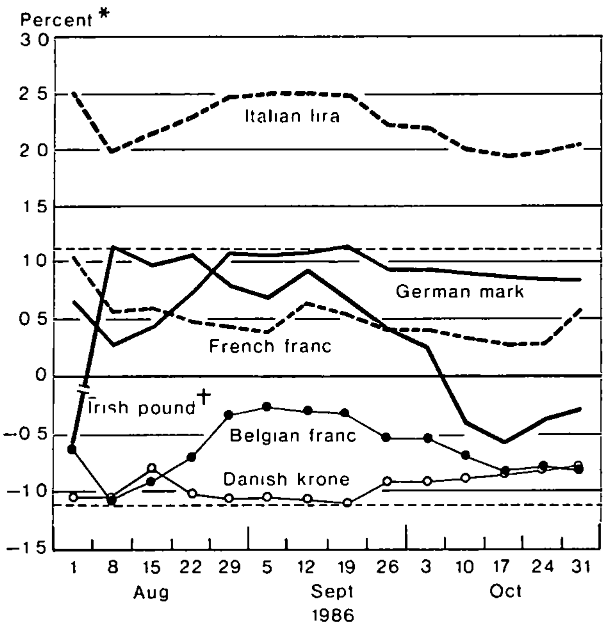
policy tool, expectations strengthened that the government might adopt an exchange-rate guide for policy instead As a result, discussion of sterling's joining the intervention arrangements of the EMS became even more widespread than before, both in the press and in financial markets But no new policy initiatives along these lines emerged during the period under review By the end of October, sterling had depreciated by almost 6 percent against the dollar and by even more against the continental European currencies.

During the period, the exchange rate mechanism of the EMS was at times subject to strain The Irish pound was caught between the decline of sterling on the one hand and the rise of continental currencies on the other With Irish exporters experiencing a loss of competitiveness in the United Kingdom, Ireland's primary export market, the Irish authorities devalued the Irish pound on August 2 by 8 percent against the bilateral central rates of the other EMS currencies

Later on, as the German mark appreciated against the dollar, it also moved up against other currencies By late August the mark reached the top of the narrow band, a position it held throughout the remainder of the period At times during September and to a lesser extent during October, the narrow band was fully stretched to the $2^1/_4$ percent intervention limit as the mark benefitted more than the others from the dollar's decline In response to these pressures, EC finance minister and central bank governors, at their Gleneagles meeting, agreed to try to stem the rise of the member currencies against the dollar, largely in an effort to preserve stability within the EMS. By late October, tensions within the EMS joint float had subsided substantially

Chart 6

In August, the German mark moved to the top of the narrow EMS band.



Weekly averages of 9 a m rates in New York for the weeks ending on dates shown

* 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

+ On August 2, the Irish pound was devalued by 8 percent against the bilateral central rates of the other EMS currencies

* * * *

At the beginning of the three-month period, the only drawing outstanding on the credit arrangements of the U S Monetary Authorities was $75.0 million drawn on May 16, 1986 by the Central Bank of Ecuador against a $150 0 million U S Treasury Exchange Stabilization Fund (ESF) short-term swap facility On August 14, the swap arrangement was terminated pursuant to the agreement

In the period from July through October, the U S Monetary Authorities provided short-term bridging facilities to Bolivia, Nigeria, and Mexico.

Bolivia The U S. Treasury through the ESF on September 17 extended a $100 0 million financing facility to the Central Bank of Bolivia. There were no drawings made against this facility during the period under review

Table 4

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, 1986— October 31, 1986	0	0
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1986	+1,341 3	+1,290 1

Data are on a value-date basis

Nigeria. The U.S. Treasury, through the ESF, agreed on October 24 to provide a $37.0 million short-term facility to the Central Bank of Nigeria as part of a $250.0 million multilateral facility organized under the leadership of the Bank of England. On October 31, a drawing of $22.2 million was made on the U.S. portion.

Mexico. On August 27, the U.S. Monetary Authorities agreed jointly to a multilateral arrangement in the amount of $1.1 billion with the Bank for International Settlements (acting for certain central banks) and the central banks of Argentina, Brazil, Colombia, and Uruguay to provide a near-term contingency support facility for Mexico's international reserves. Drawings on the facility were made available in light of agreement between Mexico and the IMF concerning a proposed stand-by arrangement, the expected receipt by Mexico of disbursements under loans from the International Bank for Reconstruction and Development (IBRD), and the agreement by Mexico to apply drawings from the IMF and disbursements from the IBRD to the balances on outstanding drawings on the facility. On August 29, $850.0 million was made available to Mexico. On this date Mexico drew $211.0 million from the Treasury through the ESF and $210.2 million from the Federal Reserve through its regular swap facility with the Bank of Mexico. On September 30, Mexico repaid $67.0 million to the ESF and $66.8 million to the Federal Reserve.

During this period the Federal Reserve and the ESF realized no profits or losses from exchange transactions. As of October 31, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,341.3 million for the Federal Reserve and $1,290.1 for the Treasury's 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 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 invested $2,868.0 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 $3,980.1 million in such securities as of the end of October.