(This report was released to the Congress and to the press on September 4, 1986)

Treasury and Federal Reserve Foreign Exchange Operations

May-July 1986 Report

The dollar declined against most major currencies during the three months ended July. The dollar's downward movement proceeded against the background of sluggish U.S. economic growth, expectations of continued monetary easing in the United States, and doubts that large payments imbalances among the developed countries were being reduced. There was no intervention by the U.S. authorities during the period but there were sizable dollar purchases by some other central banks. The dollar's depreciation was temporarily interrupted in May only to resume in June and July. By the end of July, the dollar was at its low point of the period, having declined approximately 9 percent against the Japanese yen and Swiss franc, and nearly 5 percent against the German mark and other Continental European currencies.

Coming into the period, the dollar had already declined substantially from its highs of February 1985. Market participants had noted that officials in several foreign industrial countries were expressing concern over the adjustments that their own industries were beginning to experience. In the face of the appreciation of their currencies, foreign exporters increasingly complained of a squeeze on profits as they sought to maintain market shares. Indeed, a number of commentators questioned whether increases in domestic demand in Germany and Japan would be sufficient to offset the decline in export orders and sustain prospects for economic growth in these two 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

Many in the exchange markets anticipated that the governments of the seven major industrial countries might use the occasion of the Economic Summit meeting in Tokyo during early May to outline measures to stabilize dollar exchange rates. The Tokyo Economic Declaration noted that there had been a significant shift in the pattern of exchange rates which better reflected fundamental economic conditions. It stated that the Group of Seven (G-7) countries had agreed to develop a process to review trends for a number of economic variables, including exchange rates, in order to achieve more effective policy coordination. But the declaration did not call for specific measures or concerted actions to prevent the dollar from declining further. Instead, there were reported remarks by some G-7 officials which seemed to imply that there was still room for further appreciation of nondollar currencies, especially the Japanese yen.

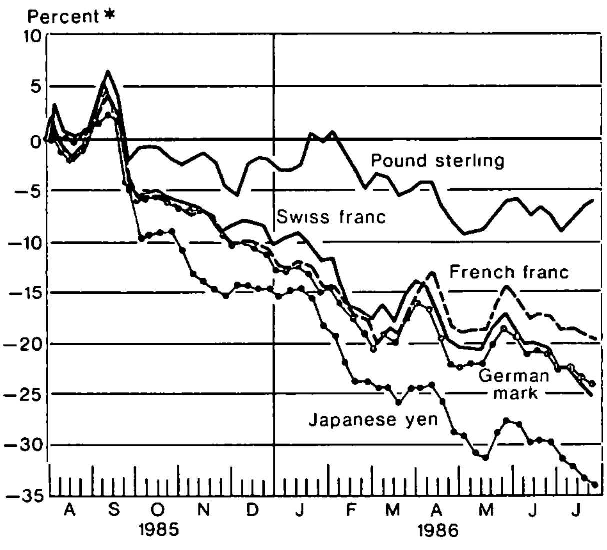
In reaction to the absence of an announcement of specific measures, the dollar resumed its decline after the Tokyo Summit. It depreciated most against the Japanese yen, trading as low as ¥159.99 on May 12, some 38½ percent below its peak of about a year before Contributing to this decline in the dollar was the narrowing of favorable long-term interest differentials. In addition, the dollar was undermined by the persistent current account imbalances manifested by a large U.S. deficit and Japanese surplus. Market participants perceived that the U.S. Administration hoped that a high level of economic activity and rising imports abroad would set the stage for a sizable narrowing of the U.S. trade deficit, given that the dollar had already declined substantially during the past year. But the most recent data were seen by the market as showing little progress in redressing the trade imbalance Strong protectionist sentiments persisted in the U S manufacturing industry, even as the U S authorities sought to reduce restrictive trading practices abroad and resist pressures for protectionist measures at home. Market participants believed that so long as the imbalances were not diminishing, market pressures in favor of the yen would remain strong and that the authorities, at least in the United States, would accept further declines in dollar exchange rates

In early May, the dollar's decline against the German mark was more muted than its decline against the yen. Political and economic uncertainties following the Chernobyl nuclear accident of late April weighed against the mark for a time There were also heavy reflows of funds into the French franc and Italian lira following an April realignment of the European Monetary System (EMS) and, in the case of the franc, in response to the exchange market's favorable reaction to initial plans for privatization of French public-sector firms Thus, the mark traded at the bottom of the EMS

Before long, however, many in the market came to interpret official views as indicating that a period of consolidation was appropriate Dealers anticipated that

Chart 1

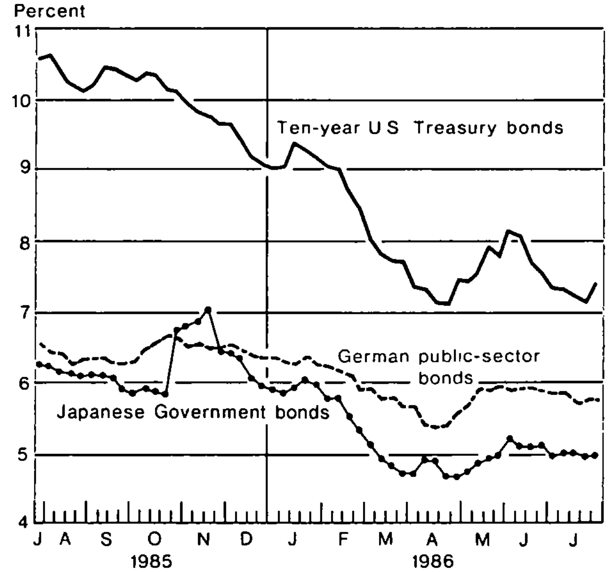
The dollar continued to decline against most major foreign currencies.



*Percentage change of weekly average rates for dollars from the average rate for the week ending August 2, 1985 Figures calculated from New York noon quotations

Chart 2

Interest differentials favorable to the dollar initially widened but then resumed their declining trend.



many of the governments abroad, facing local or national elections, would welcome a period of exchange market tranquility Also, time was needed to evaluate the effects on economic activity and trade flows of the changes in exchange rates and declines in interest rates that had occurred during the preceding year

After mid-May, perceptions about the relative strength of the U S economy temporarily brightened, expectations of further drops in U.S. interest rates faded, and the dollar appreciated more or less steadily for the rest of the month Faster-than-expected growth in U.S. monetary aggregates appeared to lessen the scope for a near-term easing of U S monetary policy Repeated denials of any need to ease monetary policy by officials of the Bundesbank and the Bank of Japan led dealers to believe that there was little chance of a coordinated cut in interest rates For the first time in several months, dollar interest rates increased, with the rate on three-month Eurodollar deposits exceeding 7 percent A strong upward revision in first quarter real GNP and other statistics on U.S. economic activity were interpreted favorably by the exchanges. By June 2, the dollar reached ¥177 05 and DM2 3445, levels which were the highs for the dollar during the period under review

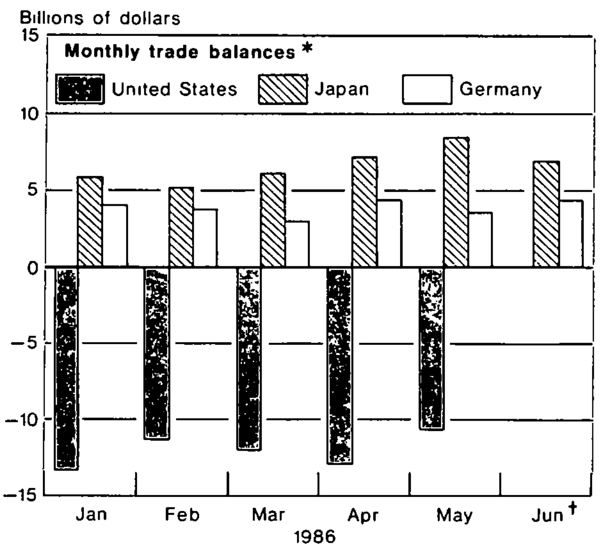
But the dollar began to edge down again in early June as new evidence suggested that the anticipated boost to U S exports and growth was not being sustained and expectations of another downward adjustment in U S interest rates were revived After the statistics of late May, an increase in U S unemployment came as a disappointment and was the start of a series of figures pointing to only lackluster U S economic activity Statements by Chairman Volcker were interpreted as running counter to the idea that the Federal Reserve needed to wait to cut its discount rate again until central banks in other countries eased monetary policy Market participants started to consider the possibility that the U S authorities might welcome a renewed decline in the dollar on the grounds that central banks abroad might cut their interest rates more quickly in such an environment In the meantime, there were concerns that some of the heavily indebted Latin American countries were considering imposing a debt service moratorium or limiting debt payment to a percentage of export earnings Thus, for domestic and international reasons, market participants thought that a further easing of U S monetary policy might be imminent With the possibility that such a U S move might not be matched elsewhere, the dollar came under downward pressure

For several weeks in June, pressures to sell the dollar were well contained Dealers perceived that authorities abroad were prepared to intervene to prevent a further decline in dollar rates for a while In particular, there were numerous reports of dollar purchases by the Bank of Japan, and market participants seemed to believe that the Japanese central bank would strenuously attempt to limit the yen's rise before Japanese parliamentary elections on July 6 Dealers also thought that the Bundesbank might intervene if the mark threatened to rise too strongly

In July, the dollar began to move down quickly, especially against the Japanese yen and the Swiss franc Market participants doubted the Japanese authorities would be able to contain for long the yen's rise in the face of mounting trade surpluses (Because of the substantial depreciation of the dollar since February 1985 and the decline in world oil prices, Japan's trade surplus continued to grow in dollar terms, even though Japanese exports in 1986 were actually lower in volume terms than in the previous year) As a result, traders started to establish large long positions in yen and commercial leads and lags swung in favor of Japan The Swiss franc also began to be viewed as a particularly attractive alternative to the dollar It was not as

Chart 3

Attention in the foreign exchange market continued to focus on the persistent large trade imbalances of the United States, Germany, and Japan.

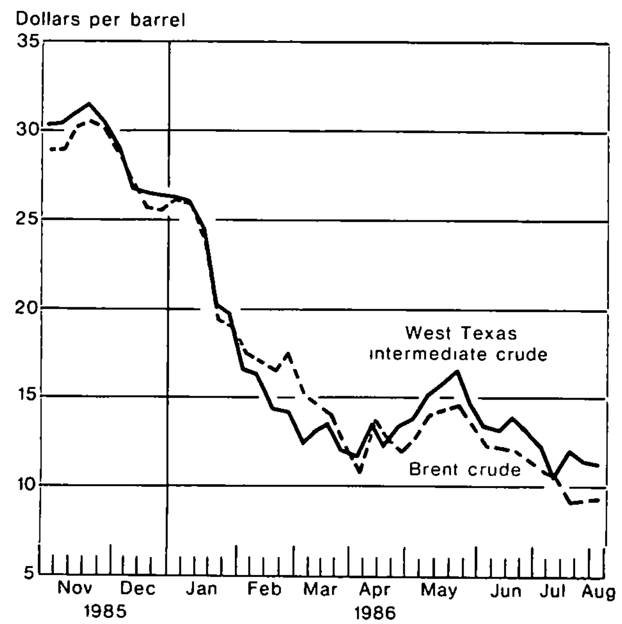


* Balance of payments basis for the United States Census data for Japan and Germany

† U S data for June on a balance of payments basis were unavailable at the time of publication

Chart 4

Oil prices again moved lower.



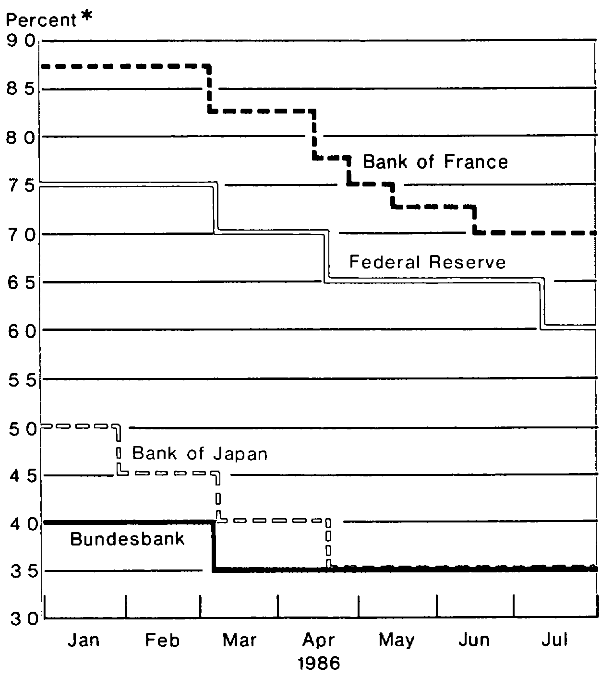
affected as the German mark by political uncertainties, and by June had developed an interest rate advantage over the mark Moreover, market participants felt that the Swiss National Bank would maintain relatively tight monetary conditions whatever the international environment and was not likely to intervene in the exchanges to limit the appreciation of its currency

The German mark, too, began to gain more strength as the dollar declined during July After the Federal Reserve cut its discount rate a half of one percentage point, effective July 11, a number of German officials commented that a further decline in German interest rates would be inappropriate inasmuch as their domestic economy had picked up in the second quarter and the growth of central bank money remained above target In addition, the German government indicated it would not depart from its earlier fiscal targets The mark also strengthened against other European currencies around this time Flows into France that had occurred after the April EMS realignment and had weighed on the mark began to subside as French residents reportedly took advantage of an easing of exchange controls The mark also benefited from shifts in investor preference away from sterling-denominated assets, previously viewed as a principal alternative to dollar investments. As Britain's economic outlook dimmed with oil prices reaching new lows and the government of Prime Minister Thatcher facing considerable political criticism, investors and traders both shifted funds increasingly out of sterling and into marks During July, the German mark moved from near the bottom to near the top of the EMS to emerge as the third strongest currency in that arrangement, it also gained $7^{1}/_{2}$ percent against sterling

In late July, the dollar's decline accelerated There was press commentary to the effect that, for other industrialized countries, the boost to real income resulting from the oil price decline was not yet showing through, these countries were going to have to expand more quickly and import more vigorously for the United States to achieve a substantial balance of payments

Chart 5

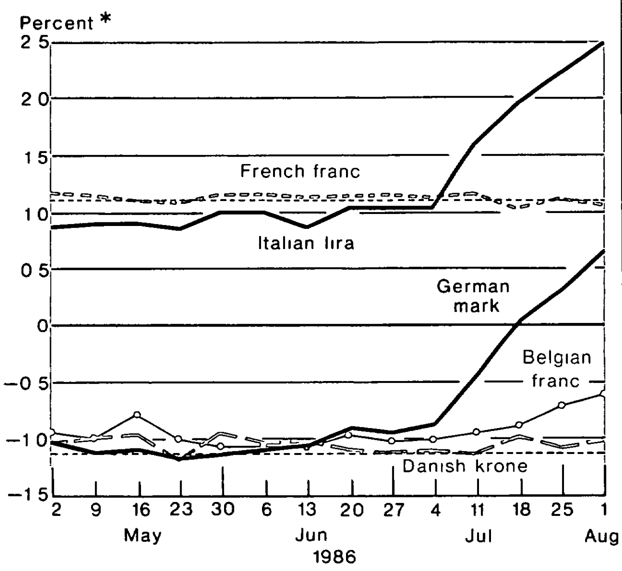
In July, the Federal Reserve lowered its discount rate but was not joined by some other central banks.



*Percentage change in the discount rates of the central banks of the United States, Germany, and Japan and the money market intervention rate of the Bank of France

Chart 6

The German mark strengthened within the EMS joint float.



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

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility July 31, 1986	Amount of facility July 31, 1985
Austrian National Bank	250	250
National Bank of Belgium	1,000	1,000
Bank of Canada	2,000	2,000
National Bank of Denmark	250	250
Bank of England	3,000	3,000
Bank of France	2,000	2,000
German Federal Bank	6,000	6,000
Bank of Italy	3,000	3,000
Bank of Japan	5,000	5,000
Bank of Mexico	700	700
Netherlands Bank	500	500
Bank of Norway	250	250
Bank of Sweden	300	300
Swiss National Bank	4,000	4,000
Bank for International Settlements		
Swiss francs-dollars	600	600
Other authorized European currencies-dollars	1,250	1,250
Total	30,100	30,100

adjustment. Yet a U.S. official's call for stronger growth abroad had elicited replies from German and Japanese officials indicating that stimulative policies would not be forthcoming in the near term. As for the United States, rapid growth in the U.S. monetary aggregates and a sustained decline in U.S. interest rates indicated that monetary policy was not a constraint on U.S. growth. But long-term U.S. interest rates had actually firmed as short-term rates eased during the last half of July Under these circumstances, market observers wondered whether foreign demand for U.S. securities was being sustained sufficiently to finance the U.S. deficits and thereby avoid another sharp decline in dollar rates or a further rise in interest rates. Simultaneously, release of U.S. trade statistics suggesting the deficit had widened in June reinforced the view that the desired adjustments were slow in materializing. As market participants increasingly questioned whether the major industrialized countries would be able to work together to redress their large economic imbalances, the dollar declined to close the period at DM2.0890 and ¥153 65.

At the end of July, the dollar had declined 9 percent against the Japanese yen and Swiss franc, as well as almost 5 percent against the German mark and other EMS currencies. It had remained stable, however, against the Canadian dollar and had risen against the pound sterling. Therefore, on a trade-weighted basis against the currencies of the major industrial countries, as calculated by the Federal Reserve Board, the dollar closed the period 3 percent below its level of end-April.

On May 14, the U S Treasury, through the Exchange Stabilization Fund (ESF), agreed to provide short-term financing to the Central Bank of Ecuador totaling $150 million until Ecuador could finalize negotiations for a new financing facility from commercial banks and additional loans from international financial institutions. On May 16, the Central Bank of Ecuador made a drawing of $75 million.

The Federal Reserve and the ESF invest foreign currency balances acquired in the market as a result of their foreign exchange market 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, as of July 31 the Federal Reserve had invested $2,941 2 million equivalent of its foreign currency holdings in securities issued by foreign governments. In addition, the Treasury held the equivalent of $4,083.6 million in such securities as of the end of July.

Table 2

Net Profits (+) or Losses (−) on U.S. Treasury and Federal Reserve Current Foreign Exchange Operations

In millions of dollars

Period	**Federal Reserve**	**U.S. Treasury** Exchange Stabilization Fund
May 1, 1986-July 31, 1986	0	0
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1986*	+1,398 6	+1,470 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

Table 3

Drawings under Special Swap Arrangements with the U.S. Treasury

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

Drawings on U S Treasury facilities for	Total facility	May 16, 1986	Outstanding July 31, 1986
Central Bank of Ecuador	150	+75	+75

Data are on value-date basis