

*(This report was released to Congress
and to the press on May 29, 1987)*

Treasury and Federal Reserve Foreign Exchange Operations

February—April 1987

The dollar traded rather steadily in February and early March, and then moved lower through the end of April. It closed the period down more than 8 percent against both the Japanese yen and the British pound, down roughly 2 percent against the German mark and most other continental currencies, and unchanged on balance against the Canadian dollar. The U.S. authorities intervened in the market at various times during the three-month period under review.

After declining almost continuously for nearly two years (Chart 1), the dollar steadied as the period opened. Market participants were reassured by a coordinated U.S.-Japanese intervention operation undertaken in late January following a joint statement by Secretary Baker and Finance Minister Miyazawa in which they reaffirmed their willingness to cooperate on exchange rate issues. Talk that the financial authorities of the major industrial countries would soon meet encouraged expectations that multilateral efforts might be forthcoming to prevent the dollar from declining further. In addition, reports of extensive Japanese participation in the February refunding operations of the U.S. Treasury reassured the exchange markets by seeming to suggest that Japanese investors would continue to make substantial investments in dollar-denominated assets.

Meanwhile, economic statistics being released suggested that the underlying economic fundamentals were

clearly moving in directions that would lead to adjustment of external imbalances. To be sure, there were still few signs that the dollar's two-year decline had reduced the nominal U.S. trade deficit. However, GNP data for the fourth quarter of 1986, together with information becoming available on export and import volumes, showed that the nation's trade deficit was declining in volume terms and that the nation's external sector was beginning to contribute to economic growth (Chart 2). Japan's trade surplus, though still high in nominal terms, had been declining in volume terms since the beginning of 1986. As for Germany, weak export volumes and strong import volume gains carried a similar indication that earlier exchange rate movements were working to reduce external imbalances. In these circumstances, the dollar rose from its lows of late January to trade within a narrow range through mid-February against both the yen and the mark, around ¥153 and DM1.82, respectively.

Then on February 22, following meetings held at the Louvre in Paris, finance ministers and central bank governors of six major industrial countries stated that, given the economic policy commitments they were making, their currencies were now "within ranges broadly consistent with underlying economic fundamentals." In the announcement, the authorities of Germany and Japan stated that they would provide greater stimulus to their economies, and the U.S. government said that it would resist protectionism and substantially reduce the budget deficit for the fiscal year 1988. The statement noted that "further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries." The officials

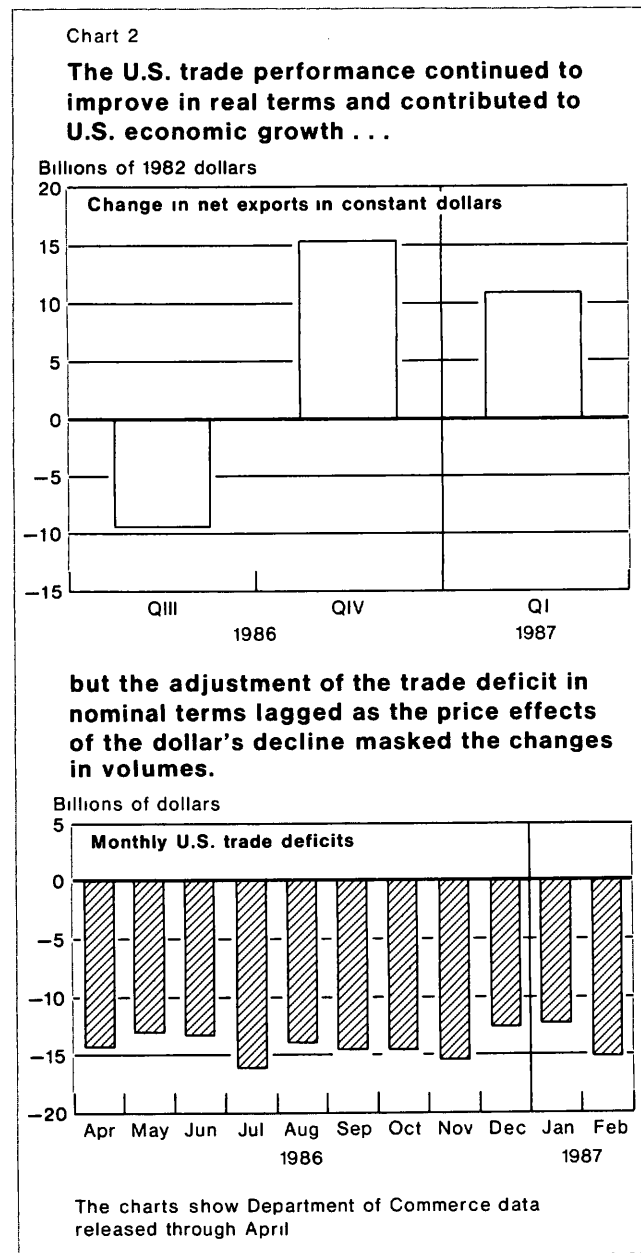
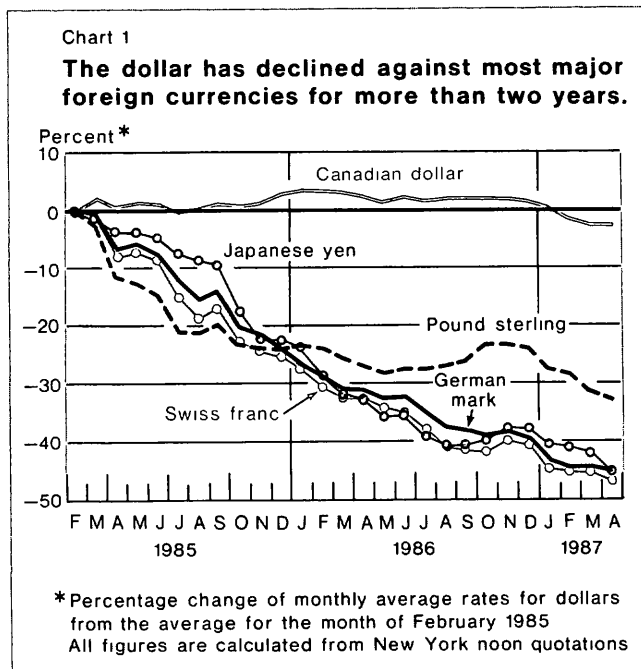
A report by Sam Y Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account. Christopher Rude was primarily responsible for preparation of the report.

of the six major industrial countries also announced that they had agreed "in current circumstances to cooperate closely to foster stability of exchange rates around current levels." Although many market participants regarded previous promises of domestic policy actions by the major industrial nations with skepticism, the prospect of increased cooperation and the more explicit association of the U.S. Treasury with a call for greater exchange rate stability reassured the market about the near-term outlook for the dollar. Remarks by some foreign officials attending the Paris meeting suggested that there had also been an agreement for coordinated intervention in the exchange market.

During the first several weeks following the Paris agreement, the dollar strengthened, especially against the German mark and other continental currencies. Although many market professionals expressed doubt, given the continuing pressures of large international trade imbalances, that further declines in the dollar could be avoided over time, there was less sense of downside risk in holding dollars in the near-term. As a result, some corporations began to unwind costly hedges against their dollar positions. This commercial demand gave the dollar a buoyancy which some market professionals suspected was the result of central bank intervention, an impression which added to the dollar's firmness.

The dollar continued to trade narrowly against the yen around ¥153 after the Paris meeting. Japanese

exporters took advantage of any firming of the dollar against yen to convert export proceeds into yen—an activity that accelerated ahead of Japan's fiscal year-end in March. Japanese investors took advantage of any easing of the dollar against the yen to increase their holdings of U.S. and other foreign assets. They perceived relatively little near-term exchange rate risk in investing abroad, expecting the authorities to prevent any significant further appreciation of the yen against



the dollar.

Meanwhile, greater stability in dollar exchange rates in February, together with the subsequent Paris commitment to foster exchange rate stability, was seen in the market as reducing exchange rate risk more generally and thereby enhancing the relative attractiveness of assets denominated in currencies with relatively high interest rates. Sterling, which also benefited from a number of other economic and political developments, rose strongly against all major currencies in February and early March, amid reports of strong demand by foreign investors. There were also signs of increased investor interest in the Australian and Canadian dollars, the Swedish krone, the French franc, and the Italian lira to take advantage of the high interest rates available in those currencies.

In that environment, investors found that a number of currencies offered more attractive investment opportunities than the German mark. Traders viewed economic activity as somewhat stronger in the United States and somewhat weaker in Germany than previously thought. Also, expectations persisted that short-term interest rate differentials would continue to favor the dollar relative to the mark. Moreover, market participants were aware that there remained outstanding large positions, long of marks and short of dollars; any generalized move to trim these positions was expected to result in considerable bidding for dollars. In these circumstances, the dollar continued to rise gradually against the mark in late February and early March.

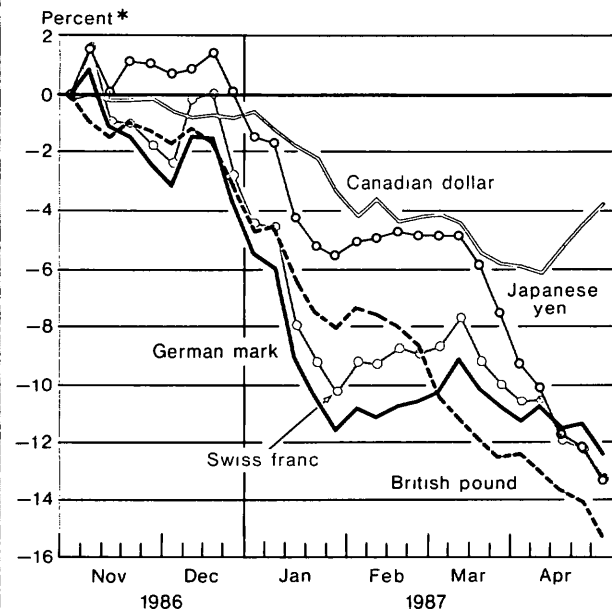
Around mid-March, speculative buying started to push the dollar up more rapidly against the mark. A number of stop-loss orders to buy dollars and sell marks were triggered, and the resulting bidding for dollars in otherwise thin trading propelled the dollar rate up as high as DM1.8745 on March 11 in New York. Under these circumstances, the Desk entered the exchange market, selling \$30 million against marks. The intervention operation, which was undertaken to foster greater exchange rate stability as envisaged in the Paris agreement was quickly talked about in the markets. Dealers imagined that the Desk had sold a much larger amount and interpreted the action as signaling that major countries would seek to limit any significant rise in the dollar, as well as any significant decline. As a result, market participants calculated that there was little need to protect themselves against the possibility that the dollar might continue to advance. In view of their long-standing expectation that the dollar would decline over time, bidding for dollars quickly subsided, and dollar rates started to drift down (Chart 3).

As the dollar started to decline after mid-March, the focus of market attention shifted from the mark to the yen. The expectation that short-term interest rate dif-

ferentials would move in favor of the dollar against the mark and fear of central bank intervention limited the dollar's decline against the mark. But against the yen, the dollar was trading only slightly above the ¥150 level that many market participants, especially in Japan, believed represented at least an important psychological benchmark and perhaps constituted the lower limit of the yen-dollar exchange rate range they thought had been agreed to in conjunction with the Paris agreement. Although Japanese economic growth was weaker than it had been in many years, market participants evidently judged that the Japanese government, embroiled in a debate concerning tax reform, would not take early and significant policy actions to spur domestic demand and reduce its trade surplus as promised in the Paris agreement. Moreover, the announcement that the United States would impose trade sanctions on selected Japanese products following a dispute over semiconductor products fueled fears of protectionism. In Europe, con-

Chart 3

The dollar traded steadily against most major foreign currencies during February and early March but subsequently declined sharply, especially against the Japanese yen.



* Percentage change of weekly average rates from the week ending October 31, 1986. All figures are calculated from New York noon quotations.

cern was growing that the Japanese were diverting their exports from other markets to Europe. With the weakness of the German economy seemingly confirmed by figures then becoming available, market participants were sensitive to the possibility that trade friction between Japan and Europe was also intensifying. Market concerns increased that there might be renewed calls for a lower dollar as a response to these trade problems. A clear bearish sentiment reemerged towards the dollar against the yen.

On March 23, the dollar moved below ¥150. Japanese investment houses, insurance companies, and corporations sold dollars aggressively, stop-loss orders were activated, and the dollar began to move down sharply. To restrain the dollar's decline, the Desk made daily purchases of dollars against yen in a series of operations between March 23 and April 6, purchasing a total of \$3,007.7 million. The operations by the U.S. authorities were coordinated with operations by the Bank of Japan and several European central banks.

By the end of March, the dollar appeared to be settling in a range around ¥147. But concern over the stability of the dollar had spread from the foreign exchange to other financial markets. The dollar's depreciation precipitated sharp declines in prices of U.S. bonds and equities. It contributed to sharp increases in the prices of gold and silver. And as investors sought alternatives to dollar-denominated assets, the prices of

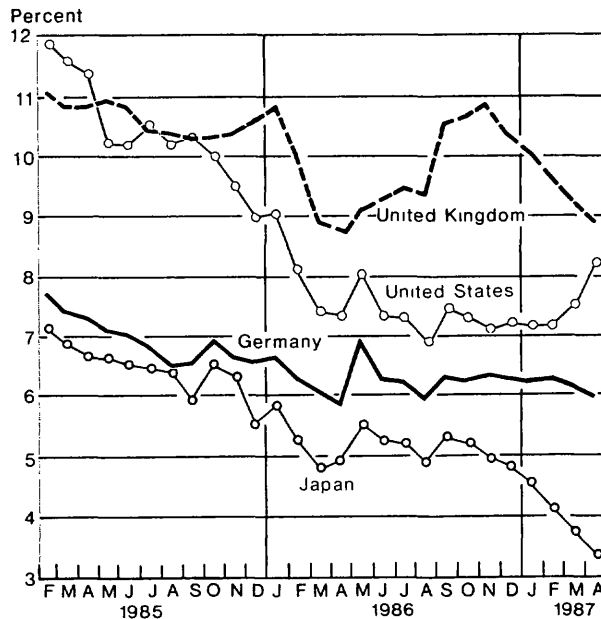
Table 1

**Federal Reserve
Reciprocal Currency Arrangements**
In millions of dollars

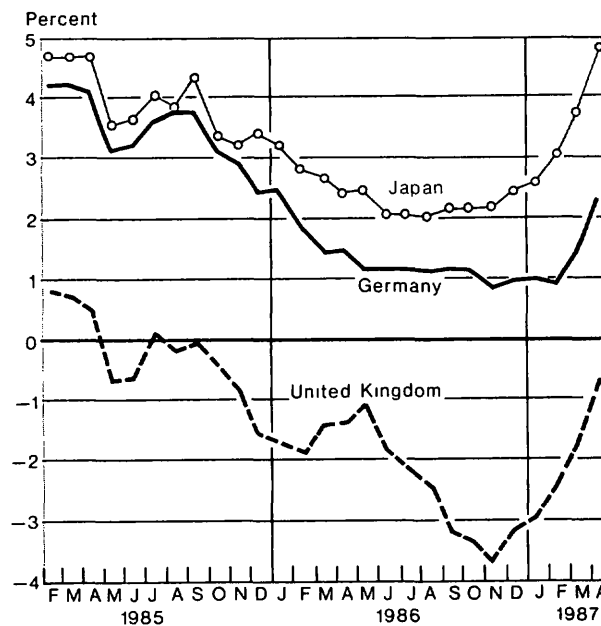
Institution	Amount of Facility April 30, 1987
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
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

Chart 4

**Interest rates rose in the United States
and declined abroad . . .**



so that interest differentials moved sharply in favor of the dollar.



The top chart shows long-term government bond yields and the bottom chart shows the differentials between U.S. Treasury bonds and foreign government securities

bonds denominated in other currencies rose. As a result of the divergent forces in the world's bond markets, long-term interest rate differentials moved strongly in favor of the dollar (Chart 4).

Meanwhile, market participants came to believe that new incentives would be needed to maintain the credibility of official efforts to stabilize exchange rates and halt the dollar's decline. As a result, they looked forward to a scheduled meeting of the G-7 finance ministers and central bank governors in Washington on April 8 for evidence that the authorities were firmly committed to exchange rate stability.

The G-7 ministers and governors welcomed the proposals announced by the governing party in Japan for substantial measures to stimulate Japan's economy. But market participants were disappointed that additional new initiatives were not announced. Also, U.S. trade statistics for February, released on April 14, left the impression that the adjustment in the world's trade imbalances, at least in nominal terms, was still disappointingly small. Under these circumstances, sentiment towards the dollar remained bearish. Market participants questioned whether interest differentials favoring the dollar were sufficient to maintain foreign investors' appetite for dollar-denominated assets. As a result, the dollar was again heavily offered in early April, especially against the yen but also against other currencies that provided attractive capital market outlets for foreign investors. The U.S. authorities continued to intervene

on occasion, buying dollars at times to foster exchange rate stability. They operated on three of the nine business days between April 7 and April 17, buying \$532 million against yen. As before, these operations in yen were closely coordinated with those undertaken by the Bank of Japan and several European central banks.

Statements by U.S. and Japanese officials in mid-April were interpreted as indicating that the officials were genuinely concerned about the risks of further sharp downward movements in dollar rates and that other action might be forthcoming to enhance efforts to stabilize exchange rates. Comments by Bank of Japan Governor Sumita and other Japanese officials suggested that new arrangements were under consideration to finance concerted intervention operations. In a speech before the Japan Society in New York, Treasury Secretary Baker, making specific reference to the dollar-yen rate, said that U.S. and other authorities intended to cooperate closely to foster exchange rate stability despite trade difficulties and that a further decline of the dollar against other major currencies could be counter-productive. Also around mid-April, U.S. short-term interest rates firmed, and this was taken by some market participants as an indication that U.S. monetary policy might be tightening somewhat to ease the pressures on the dollar.

Even so, many in the market continued to doubt that the authorities were sufficiently committed to exchange rate stability to make major adjustments to domestic

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 February 1, 1987	February	March	April	Outstanding as of April 30, 1987
Bank of Mexico	61.4	-61.4	0	0	0

Data are on a value-date basis

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangement 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 February 1, 1987	February	March	April	Outstanding as of April 30, 1987
Bank of Mexico	273.0	61.6	-61.6	*	*	*
Central Bank of Argentina	225.0	0	0	+225.0	0	225.0

Data are on a value-date basis

*No facility

economic policies. Thus, the dollar again came under strong selling pressure during the last full week of April as hopes of more economic policy convergence faded. In Japan, official comments suggested that there would be no further easing of credit policy, and there seemed to be little evidence of movement toward a more expansionary budget. Doubts developed that the Federal Reserve had much scope to tighten monetary policy, given the decline in U.S. final domestic demand as reported in the first quarter GNP data. Moreover, reports emerged from U.S.-Japanese trade negotiations indicating little progress, and, towards the end of the month, the U.S. House of Representatives added to its trade bill a provision calling for mandatory restrictions on U.S. imports from countries with large trade surpluses.

Thus, the dollar was again subject to episodes of intense selling pressure in the third week of April. Against the yen it declined below ¥140, reaching a 40-year low of ¥137.25 on April 27. The dollar also declined against the European currencies, easing below DM1.80 to trade as low as DM1.7710 against the German mark. The Desk intervened on three more occasions in late April, both in yen and marks, purchasing \$424.9 million against yen and \$99 million against marks.

In the final days of April, comments by Chairman Volcker and by Prime Minister Nakasone during his visit to Washington indicated that the central banks of the two countries were making more adjustments in their monetary policies. Mr. Nakasone announced that the Bank of Japan would act to ease short-term market rates, and Mr. Volcker stated that the Federal Reserve had "snugged up" monetary policy in light of the exchange rate pressure. With the market perceiving that

monetary authorities were acting to widen interest rate differentials in favor of the dollar, the currency recovered from its lows against the yen and the mark to close the period at ¥140.85 and DM1.7925, respectively. At these levels, the dollar was down 8 3/8 percent against the yen from both its opening in February and its level in mid-March. Against the mark, the dollar closed the period down 2 1/8 percent from its opening in February and down 4 3/8 percent from its highs in mid-March. On a trade-weighted basis as measured by the Federal Reserve Board index, the dollar declined 3 7/8 percent against all G-10 currencies between the opening in February and the end of April.

For the three month period as a whole, intervention dollar purchases by the U.S. monetary authorities totalled \$4,063.6 million, while dollar sales totalled \$30 million. All intervention was financed out of foreign currency balances. The bulk of the authorities' dollar purchases, or \$3,964.6 million, was against sales of yen, of which \$1,962.3 million equivalent was drawn from the Treasury's balances and \$2,002.3 million equivalent was drawn from the Federal Reserve. In addition, the Federal Reserve and the Treasury each sold \$49.5 million equivalent of German marks. On one occasion in the period, as indicated above, the Federal Reserve and the Treasury each sold dollars by purchasing \$15 million equivalent of German marks.

During the three-month period, foreign central banks also bought dollars in extraordinary amounts in the exchange markets. In part, these purchases reflected operations of the Bank of Japan, the Bundesbank, and several other European central banks which purchased dollars against yen and other currencies in accordance with the understandings of the Paris Accord and the April G-7 statement to foster exchange rate stability. But in part, these reflected the purchases of a number of European central banks that took advantage of the relative firmness of their currencies against the mark, the dollar, or both, to replenish official reserves by purchasing dollars.

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During the three-month period, the Treasury Department through the Exchange Stabilization Fund (ESF) joined with other central banks to provide a multilateral short-term credit facility totalling \$500 million for the Central Bank of the Argentine Republic in support of Argentina's economic program to achieve sustainable growth and a viable balance of payments position. The ESF's portion of the facility was \$225 million. The facility was established on March 5, and the full amount was drawn by the Central Bank of the Argentine Republic on March 9.

Table 4

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

In millions of dollars

Period	United States	
	Federal Reserve	Treasury Exchange Stabilization Fund
February 1, 1987 - April 30, 1987	+ 688 1	+ 571 9
Valuation profits and losses on out- standing assets and liabilities as of April 30, 1987	+ 1,981 3	+ 1,809 8

Data are on a value-date basis

Meanwhile, Mexico fully repaid on February 13 the \$61.6 million drawing on the ESF and \$61.4 million drawing on the Federal Reserve that were outstanding under a two-tranche \$1.1 billion multilateral near-term contingency support facility provided jointly by the U.S. monetary authorities, the Bank for International Settlements (acting for certain central banks), and the central banks of Argentina, Brazil, Colombia, and Uruguay. The facility has now lapsed. As noted in previous reports, the first tranche of \$850 million had been made available to Mexico on August 29, 1986, with the Federal Reserve providing \$210.2 million and the ESF providing \$211.0 million. On December 8, after Mexico had become eligible to draw the second tranche of \$250.0 million, Mexico had drawn \$61.8 million from the Federal Reserve and \$62.0 million from the ESF. Drawings on the first tranche were fully repaid in the previous reporting period.

In the period from February 1 through April 30, the Federal Reserve and ESF realized profits of \$688.1 million and \$571.9 million, respectively, on sales of

foreign currency balances. As of April 30, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were \$1,981.3 million for the Federal Reserve and \$1,809.8 million 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. As of April 30, 1987, under the authority provided by the Monetary Control Act of 1980, the Federal Reserve held investments totalling \$1,091.1 million equivalent of its foreign currency holdings in securities issued by foreign governments. In addition, as of the same date, the Treasury held the equivalent of \$2,566.1 million in such securities.