(This report was released to Congress and to the press on September 3, 1987)

Treasury and Federal Reserve Foreign Exchange Operations

May-July 1987

Early in May, the dollar moved down against major foreign currencies, continuing a trend that had prevailed throughout the year. But during the rest of the three-month period ending in July, the dollar first stabilized and then advanced modestly to close up 6½ percent against the Japanese yen and roughly 4 percent against the German mark and other European currencies. The U.S. authorities intervened in the market during three episodes in the period.

As the May-July period opened, many market participants were not yet convinced that the authorities of the major industrialized countries were committed to exchange rate stability. To be sure, statements by both U.S. and Japanese officials during preceding weeks had been interpreted as indicating a genuine concern about the effects of further sharp downward movements in dollar rates and a willingness to cooperate closely to foster exchange rate stability. Nevertheless, traders were disappointed that, after the dollar's 2½-year decline, progress in diminishing the world's external imbalances was so slow. They were mindful of the intense political pressure in the United States over trade issues and wary that there might be new calls for a lower dollar. They were concerned that any further exchange rate decline might add to domestic inflation They noted, as well, that a decline in U.S. final domestic demand was reported in the first quarter GNP data. Consequently, many market participants remained skeptical that the authorities would attach a high enough priority to exchange rate stability to alter domestic economic policies if necessary.

Thus, traders retained their bearish attitude toward the dollar, even though they were aware that the authorities of the Group of Seven (G-7) industrial nations had intervened to purchase dollars in substantial amounts since late March. There was skepticism that private investors, already experiencing substantial exchange rate losses on their dollar portfolios, would continue to place funds in the United States. Although long-term interest rate differentials favoring dollar assets were at their highest levels since the dollar was at its peak in 1985, market participants questioned whether this interest rate advantage would prove sufficient to induce heavy participation by Japanese and other investors in the U.S. Treasury's refunding operation early in May. The dollar, therefore, continued to decline during the first week of May. It moved down to DM 1.7590, its lowest level against the mark in nearly seven years. Against the yen, it eased back to Y 137.95, not far above the 40-year low touched just weeks before.

In these circumstances, the U.S. authorities entered the market in early May, in keeping with the February Paris and April Washington agreements, to contain the intense selling pressure on the dollar. On the first two business days of May, the Desk purchased \$140 million against marks and \$20 million against yen in the first intervention episode of the period under review.

Meanwhile, market participants had taken note of comments made by Chairman Volcker and by Japanese Prime Minister Nakasone in late April, indicating that

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the central banks of the two countries were willing to adjust their monetary policies in a way that would lend support to the dollar. Mr. Nakasone announced that the Bank of Japan would act to ease short-term interest rates. Mr. Volcker stated that the Federal Reserve had "snugged up" monetary policy in light of the exchange rate pressure. Short-term interest rate differentials had already widened in favor of the dollar even before these comments, as U.S. market rates responded to growing inflation concerns. But when U.S. interest rates continued to firm and these differentials continued to expand in May, market participants came increasingly to see the industrialized countries as committed to exchange rate stability.

At the same time, some of the markets' worst fears proved to be unfounded. It soon became clear that Japanese institutions had, in fact, made sizable bond purchases at the May Treasury refunding. Reports that the U.S. unemployment rate had fallen to 6.3 percent in April and that producer prices had increased sharply by 0.7 percent for the same month were seen as giving the U.S. monetary authorities both more room and a greater need to tighten policy. Meanwhile, officials in Japan indicated that they were willing to guide money market rates lower. Also, the Bundesbank lowered the minimum rate on its repurchase agreements and reduced the lower limit for money market rates by cutting the rate at which it stood ready to sell three-day Treasury bills. These actions were interpreted by the markets as indicating that the German authorities were willing to join the Japanese and U.S. central banks in adjusting monetary policies to foster exchange rate stability.

Other developments also helped to reduce selling pressures against the dollar. After Japanese authorities urged financial institutions in Japan to refrain from speculative dollar sales and required these institutions to report their foreign exchange positions much more frequently, traders in Tokyo became reluctant to make sizable dollar sales. Later in May, the prospect for greater economic policy convergence improved when Japan's Parliament finally approved the budget for the fiscal year ending March 1988, paving the way for an extraordinary parliamentary session during the summer to draw up a supplementary budget aimed at expanding domestic demand. Then, following reports of an attack on a U.S. naval vessel in the Persian Gulf, the dollar also began to derive some benefit from the view that a disruption in oil supplies would be relatively less detrimental to the United States than to many other developed countries. In response to these developments, the dollar gradually moved up from its early May

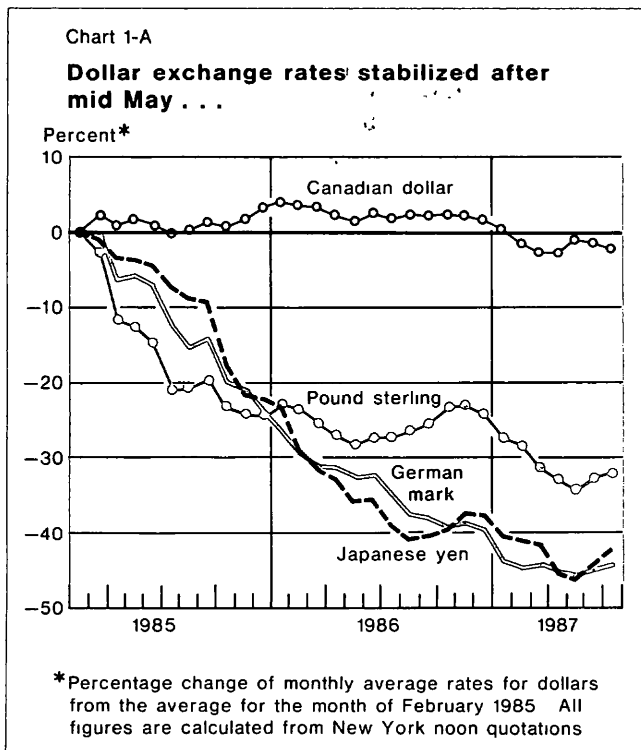


Chart 1-A

Dollar exchange rates stabilized after mid May . . .

*Percentage change of monthly average rates for dollars from the average for the month of February 1985 All figures are calculated from New York noon quotations

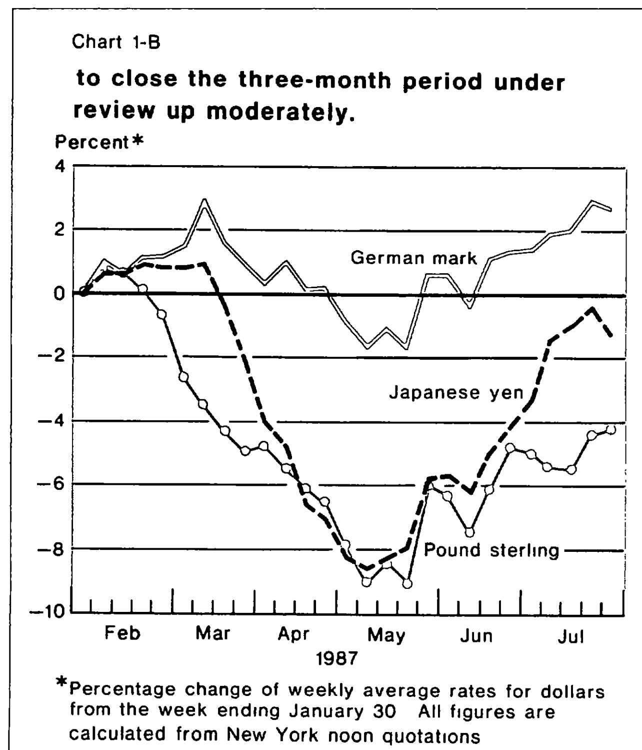


Chart 1-B

to close the three-month period under review up moderately.

*Percentage change of weekly average rates for dollars from the week ending January 30 All figures are calculated from New York noon quotations

lows to trade at DM 1.7830 and at Y 140.40 on May 18.

The underlying market sentiment toward the dollar remained cautious, however, and the dollar was still vulnerable to potentially adverse news. In fact, two episodes did occur between mid-May and early June that temporarily precipitated renewed bouts of selling pressure against the dollar. The first occurred on May 19 when a major U.S. money-center bank announced a restructuring of its capital and loan-loss reserves that would imply a substantial reported loss for the second quarter. The second episode occurred on June 2 following the announcement that Paul Volcker would not serve a third term as Chairman of the Federal Reserve. In both episodes the U.S. authorities intervened to blunt the selling pressures. In the first, the Desk purchased a total of $133 million against the mark, partly in New York and partly in Pacific markets in coordination with the Bank of Japan. In the second, the Desk purchased a total of $410 million against marks along with $103 million against yen in New York and the Far East. This latter operation was undertaken in cooperation with the Bundesbank, the Bank of France, the Bank of Italy, and the Bank of Japan. In both episodes, the intervention operations helped reassure market participants, and the dollar promptly moved up to levels higher than had prevailed beforehand. Market participants began to feel that the dollar was regaining notable resiliency.

In mid-June, at the time of the Venice summit meeting, the leaders of the G-7 industrial nations reaffirmed the earlier Paris and Washington agreements with respect to exchange rates. Moreover, the communique announced a plan for enhanced multilateral surveillance, including more extensive use of medium-term economic objectives and interim performance indicators. The call for improved surveillance, though seen by some observers as a sign that international economic policy cooperation would increase in the future, left market participants initially disappointed that no concrete initiatives to support the dollar were forthcoming. But the dollar softened only temporarily during the meeting, subsequently reversing the decline without intervention support.

By late June, traders were becoming increasingly impressed with the resilience that the dollar had shown to adverse news in the preceding weeks. In addition, the dollar began to benefit from the release of several economic statistics and other evidence suggesting a better-than-expected performance for the U.S. economy. During the course of the summer, anecdotal reports of rising export volumes gave market participants a basis for seeing the external sector as a growing source of demand. Preliminary estimates of the GNP data for the second quarter released in mid-July, indicating that the

Table 1

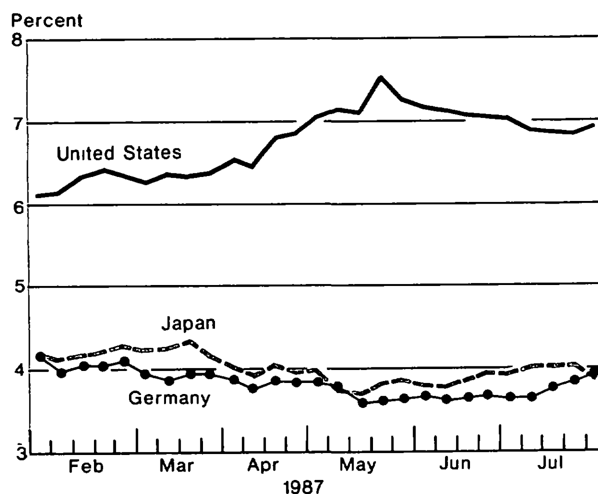
Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility July 31, 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 2

Short-term interest rates moved higher in the United States in May while declining somewhat further abroad.



The chart shows weekly average rates on three-month Euro-deposits denominated in dollars, German marks, and Japanese yen

change in the level of net exports was positive for the third consecutive quarter, seemed to confirm this view. Under these circumstances, the market showed only short-lived disappointment when, in the middle of July, the U.S. trade figures showed a modest widening in the deficit to $14.4 billion in May after having declined in March and April. Indeed, this was yet another occasion when selling pressure against the dollar was quickly shaken off.

By contrast, market participants were becoming disappointed about the economic outlook for many of the United States' trading partners. Although there were some indications that the Japanese economy was beginning to recover from the depressing effects of the yen's earlier rise, news in Germany that manufacturing orders and retail sales had declined in May and that unemployment remained high underscored market views about the underlying weakness of the economy there. Even in the United Kingdom, the European country with the most optimistic outlook just a few months before, a series of disappointing statistics tended to suggest that the economy was beginning to overheat and raised questions in the market about the near-term outlook for sterling-denominated bonds and stocks.

Against this background, market participants began to buy back dollars previously sold. Reports of increased corporate demand ahead of the quarter end, buying by Japanese investors to reduce hedges on U.S. investments, and renewed investor interest in U.S. securities circulated in the market. Meanwhile, rising tensions in the Persian Gulf and talk of large dollar purchases from the Middle East tended to strengthen the dollar's role as a store of value and currency of choice for flight capital at times of political uncertainty.

Thus, the dollar moved up steadily for several weeks after mid-June and then firmed within a fairly narrow range for the rest of the period under review. The more stable dollar, together with the receding of inflationary fears following a report of a slowdown in producer price inflation for May, gave a lift to U.S. bond prices and led to an easing of market interest rates generally. At the same time, some of the bullish sentiment that had prevailed in the Japanese and German bond markets faded, so that interest rate differentials favoring the dollar narrowed somewhat.

As the dollar firmed, market participants came increasingly to expect the G-7 central banks to intervene at some point to sell dollars in an effort to restrain the dollar's rise. Traders assumed that the U.S. authorities would try to retain the favorable trade effects of the dollar's depreciation of the past two years and noted that the U.S. authorities had sold dollars in early March

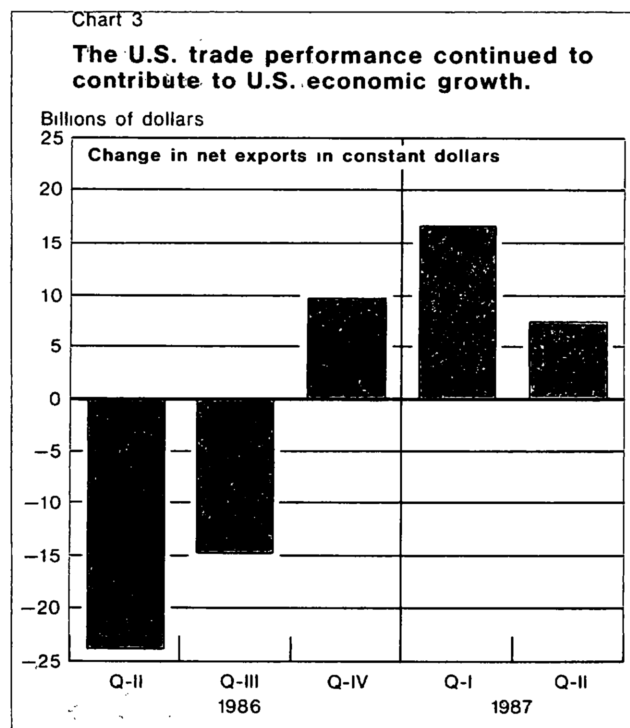


Table 2

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangement with the U.S. Treasury

In Millions of Dollars, Drawings (+) or Repayments (−)

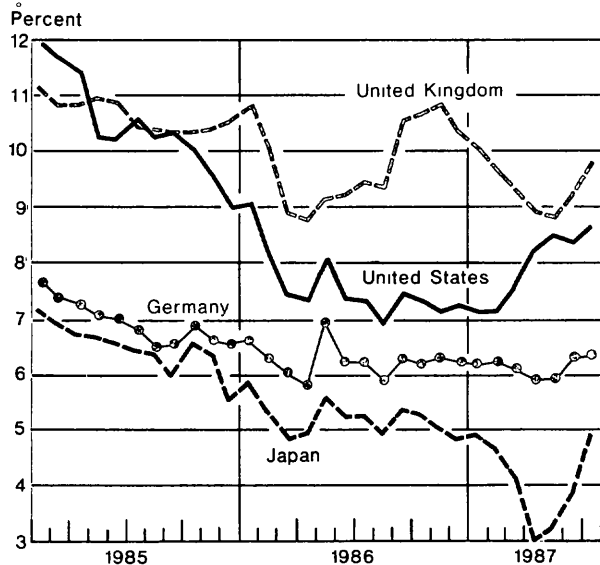
Central Bank Drawing on the U.S. Treasury	Amount of Facility	Outstanding as of May 1, 1987	May	June	July	Outstanding as of July 31, 1987
Central Bank of the Argentine Republic	225.0	225.0	0	0	−225.0	*

Data are on a value-date basis

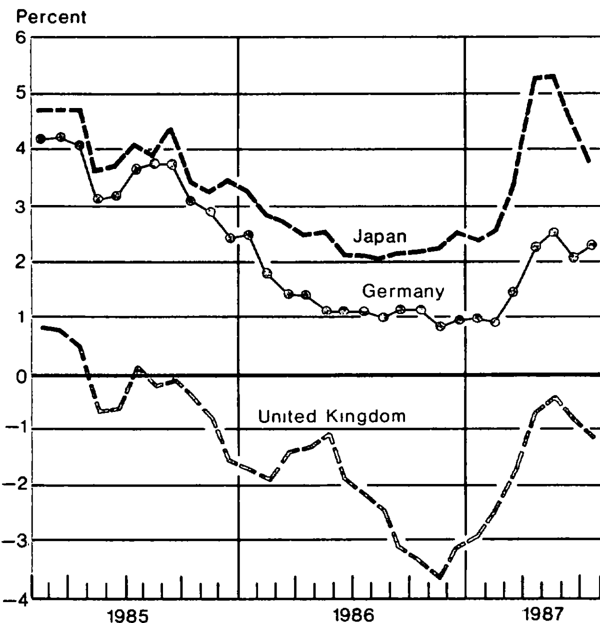
*No facility

Chart 4

The upward trend in long-term U.S. interest rates slowed while rates abroad rebounded . . .



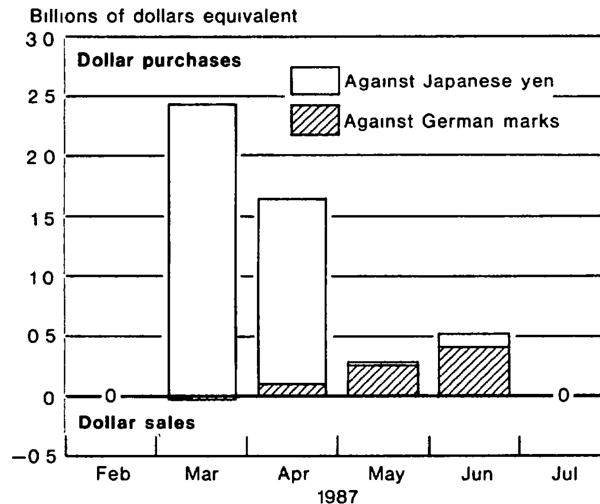
so that interest differentials favorable to dollar assets narrowed.



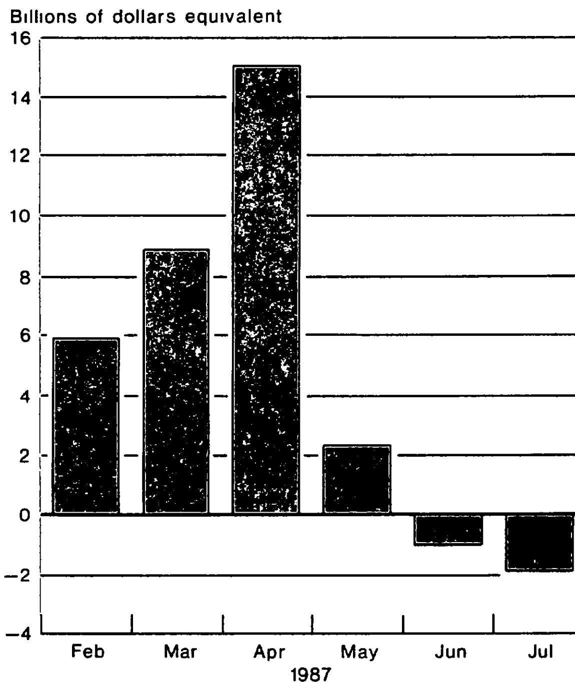
The top chart shows long-term government bond yields and the bottom chart shows the differentials between U S Treasury bonds and foreign government securities

Chart 5

Dollar purchases by the U.S. authorities were far smaller during the current three-month period . . .



and the foreign exchange reserves of other G-7 countries stopped rising.



The bottom chart shows monthly changes in foreign exchange reserves of the G-7 industrial countries, excluding the United States, as reported in the International Monetary Fund's International Financial Statistics, various issues

Table 3

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
May 1, 1987 – July 31, 1987	+103 2	+109 7
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1987	+1,580 2	+1,422 8

Data are on a value-date basis

at around DM 1.87 against the mark. They were also aware that, with central bank money in Germany growing more rapidly than targeted by the Bundesbank for the year, the German central bank might try to absorb liquidity once the dollar strengthened—either through domestic monetary operations or by selling dollars in the exchange market. As the rate approached DM 1.87, rumors circulated in the market at various times that the Federal Reserve or the Bundesbank were selling dollars. As long as some market participants believed the central banks would effectively contain any significant upward pressure against the dollar, there was little incentive for them to build up speculative long positions in the dollar.

Consequently, the dollar fluctuated generally in a narrow range through the end of July. It closed the three-month reporting period at DM 1.8600, up 5¾ percent against the mark, and at Y 150.05, up 8¾ percent against the yen, from its lows in early May. On a trade-weighted basis in terms of the other G-10 currencies, as measured by the index developed by the staff of the Federal Reserve Board, the dollar had risen by nearly 4 percent during the three-month period. During the period, the U.S. authorities sold a total of $806 million equivalent of foreign exchange—$683 million equivalent of marks and $123 million equivalent of yen. These operations were financed equally from Federal Reserve and U.S. Treasury balances.

* * * *

On July 15, the Central Bank of the Argentine Republic fully repaid a $500 million multilateral short-term credit facility provided by the U.S. Treasury through the Exchange Stabilization Fund (ESF) and the central banks of a number of other countries. As noted in the previous report, the full amount was drawn on March 9. The ESF's portion of the facility was $225 million.

In the period from May 1 through July 31, the Federal Reserve and ESF realized profits of $103.2 million and $109.7 million, respectively, on sales of foreign currency. As of July 31, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,580.2 million for the Federal Reserve and $1,422.8 million for Treasury's ESF. These valuation gains represent the increase in the dollar value of outstanding foreign currency assets valued at end-of-period exchange rates, compared with the rates prevailing at the time the currencies were acquired.

The Federal Reserve and the ESF regularly invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market rates of return and that have a high degree of quality and liquidity. A portion of the Federal Reserve's invested balances—$953.6 million equivalent as of July 31, 1987—were held in securities issued by foreign governments under the authority provided by the Monetary Control Act of 1980. The Treasury also held some of its invested balances—$2,537.2 million equivalent as of the same date—in such securities.