

*(This report was released to Congress
and to the press on December 3, 1987.)*

Treasury and Federal Reserve Foreign Exchange Operations

August-October 1987

The dollar came under heavy downward pressure in mid-August and again in October to close the three-month period under review down 7 to 8 percent on balance against major foreign currencies (Chart 1). There were three episodes of U.S. intervention in the exchange markets during this period. The U.S. authorities intervened first to restrain the dollar's rise in early August and then to support the dollar in late August-early September and again in late October.

As the period opened, the dollar was extending an advance that had begun in late spring. Market participants had been impressed by official efforts to stabilize dollar rates earlier in the year, both through heavy intervention and through coordination of economic policies among the major nations. The dollar had shown increasing resilience to potentially adverse developments. The U.S. external performance finally appeared to be improving, with U.S. net exports in real terms rising for three consecutive quarters. The U.S. economy was relatively buoyant, with output and employment up significantly, especially in the manufacturing sector. Thus market participants bid for dollar-denominated assets, believing that they offered attractive investment opportunities with limited exchange rate risk.

Meanwhile, the dollar benefited from developments abroad. Doubts persisted that the German economy had shaken off the weakness so apparent early in the year. Disappointing figures for German industrial production

and employment stood in sharp contrast with indicators from the United States and Japan that pointed to a brighter outlook (Chart 2). Against this background, there were substantial long-term capital outflows from Germany during the summer. Also, increasing hostilities in the Persian Gulf raised the possibility of a disruption of oil shipments, which would have greater adverse effects on Europe where oil inventories stood at relatively low levels. When, in addition, reports of a violent riot in Mecca on August 1 revived interest in the dollar as a safe haven, the dollar rose abruptly. As it passed its highs of March against the mark, market participants began to sense that the dollar might advance much further. The demand for dollars became intense, and commercial and other interests began defensively to bid for dollars.

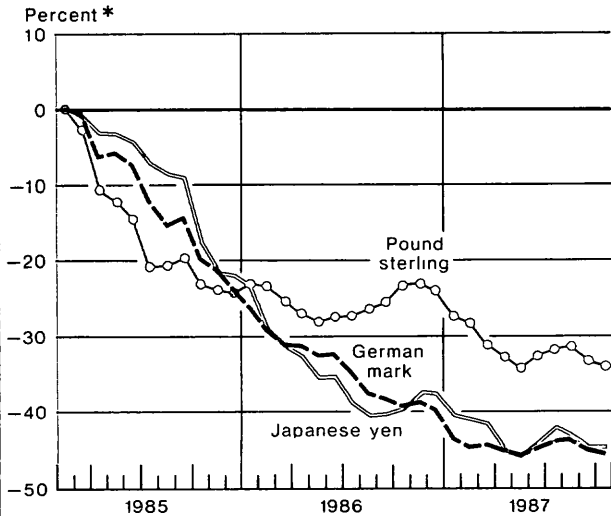
On August 4, with the dollar's rise against the mark accelerating, the Desk intervened on behalf of the U.S. authorities to resist the upward pressure. In keeping with the Louvre accord, the U.S. authorities continued to intervene to foster greater exchange rate stability on subsequent days, selling a total of \$631 million against marks by August 10. The intervention by the U.S. authorities was undertaken in cooperation with the authorities in Germany and other countries. On August 11, the dollar touched a 7-month high of DM 1.9030 against the mark, up 2 $\frac{1}{4}$ percent from the end of July.

On August 14, the report of a \$15.7 billion U.S. trade deficit for June brought into question the view that the U.S. trade performance was on an improving trend. Not only was the deficit larger than any previous month in 1987, but also the deterioration was pervasive, appearing in every regional and commodity group. The

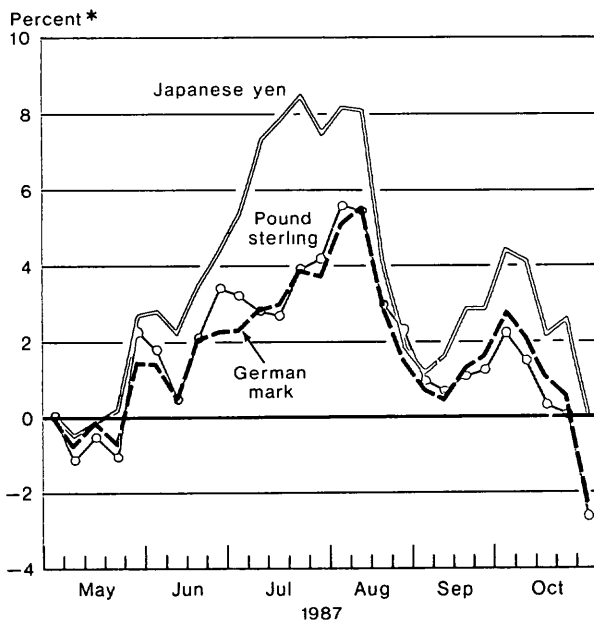
A report presented by Sam Y. Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account. David L. Roberts and Thaddeus D. Russell were primarily responsible for preparation of the report.

Chart 1

The dollar again came under heavy downward pressure during the three-month period under review . . .



declining 7 to 8 percent on balance against major foreign currencies and moving below the lows of late spring.



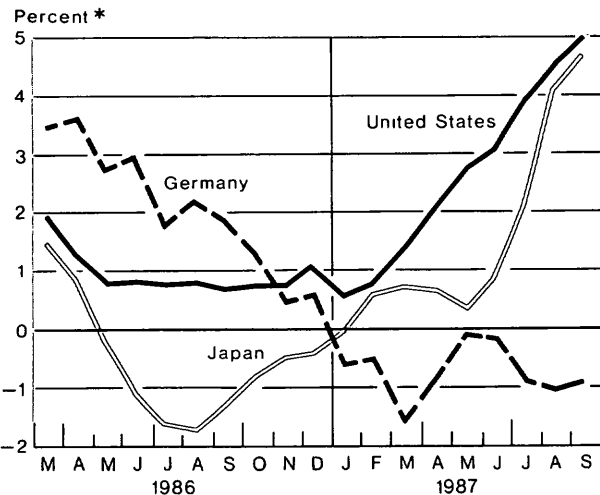
* The top chart shows the percentage change of monthly average rates for dollars from February 1985. The bottom chart shows the percentage change of weekly average rates from the week ending May 1, 1987. All figures are calculated from New York noon quotations.

exchange market response to this disappointing news was initially limited. Many market participants temporarily postponed selling dollars in the expectation that the resilience the dollar had shown to negative news earlier in the summer would reappear, and that they could avoid taking any significant exchange rate loss. But a few days later, when the dollar failed to show signs of renewed buoyancy, heavy selling emerged as many market participants perceived that further postponement of dollar sales could expose them to substantial exchange rate risk. A decline in dollar rates began. By early September the dollar had declined to lows of Y 140.35 against the yen and DM 1.7880 against the mark, levels not seen since late spring.

The dollar's decline was accompanied by a rise in inflation expectations. Although there was little evidence of a generalized increase in inflation, the U.S. economy was operating at relatively high levels of employment and capacity utilization, and there were some signs of upward pressure on materials prices. Against this background, some market participants worried that a further dollar depreciation would quickly be reflected in price increases for a wide range of imports and import-competing products. In these circumstances, U.S. market interest rates, particularly at the long end of the market,

Chart 2

Industrial production continued to rise in the United States and picked up strongly in Japan while remaining sluggish in Germany.



* The chart shows a three-month moving average of the percentage change in industrial production over a year earlier.

moved sharply upward. Some also argued that U.S. interest rates would have to be higher to compensate investors for the risk that the dollar might decline further.

In late August and early September, when dollar rates moved toward levels that had not been tested since the period of dollar weakness of late spring, the U.S. authorities intervened on several occasions. The Desk purchased a total of \$389.5 million against Japanese yen on five occasions between August 24 and September 2. After the dollar moved through DM 1.80 against the mark on September 2, trading conditions deteriorated briefly not only in the foreign exchange market but also in the domestic securities markets, and the Desk purchased \$50 million against marks along with its continuing operations in yen. The Desk's operations in late August and early September were undertaken in coordination with the Bank of Japan, the German Bundesbank, and several other central banks.

The announcement of a one-half percentage point increase in the Federal Reserve's discount rate to 6 percent on September 4 helped to interrupt the dollar's decline. This action, which was undertaken to signal the intent of the Federal Reserve "to deal effectively and in a timely way with potential inflationary pressures," helped reassure market participants. As the month progressed, the dollar benefited in addition from further increases in U.S. market interest rates. The dollar also firmed in anticipation of, and then following, meetings in Washington late in September, at which the Finance Ministers and Central Bank Governors of the Group of Seven (G-7) reaffirmed their commitment to cooperate closely to foster the stability of exchange rates around current levels. News that President Reagan would sign legislation mandating further reductions in the U.S. fiscal deficit also encouraged the market's sense of progress in the G-7's efforts to coordinate economic policies to promote the adjustment of external imbalances.

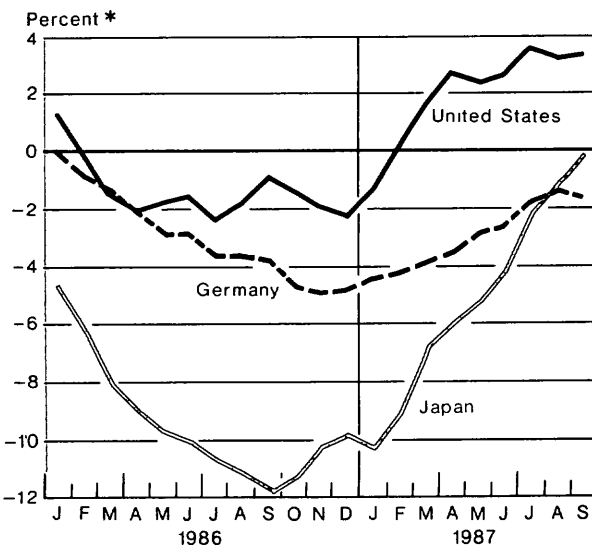
Against this background, demand for dollars increased, particularly on the part of some foreign investors who reportedly bought dollars to remove hedges on their U.S. investments, given the renewed expectation that the dollar would remain reasonably stable. Even the report on September 11 of a \$16.5 billion U.S. trade deficit for July had only a limited effect on exchange rates. By the beginning of October, the dollar recovered to DM 1.8500 against the mark and Y 147.60 against the yen.

At the same time, however, market participants began to feel that, in view of the diminished pressures on exchange rates, foreign monetary authorities would place more emphasis on other policy objectives. Officials of both the German and Japanese central banks had for some time been publicly emphasizing the importance of responding promptly to a possible renewal

of inflationary pressures. In both countries, money supply growth was well above official targets or projections. In Japan, price rises in equity and real estate markets were interpreted as indicating excess liquidity and potential inflationary pressures. Moreover, in both countries the beneficial effects of declining oil prices and currency appreciation on domestic prices were wearing off, so that price indices were beginning to tilt upwards (Chart 3). Notwithstanding the continued disappointment about economic growth in Germany, market participants expected the monetary authorities of both countries to take advantage of any opportunity to absorb liquidity. As operators moved to secure their funding needs, long-term interest rates remained under upward pressure and short-term interest rates started to rise as well (Chart 4). Then, Japanese officials announced new curbs on commercial bank lending for the October-December quarter; rumors began to circulate that the Bank of Japan would soon raise its discount rate, and Japan's long-term credit banks raised their prime lending rate by more than had been expected. In Germany, the key interest rate on the Bundesbank's repurchase agreements moved progressively to moderately higher levels, from 3.60 percent in mid-September to 3.85 percent by

Chart 3

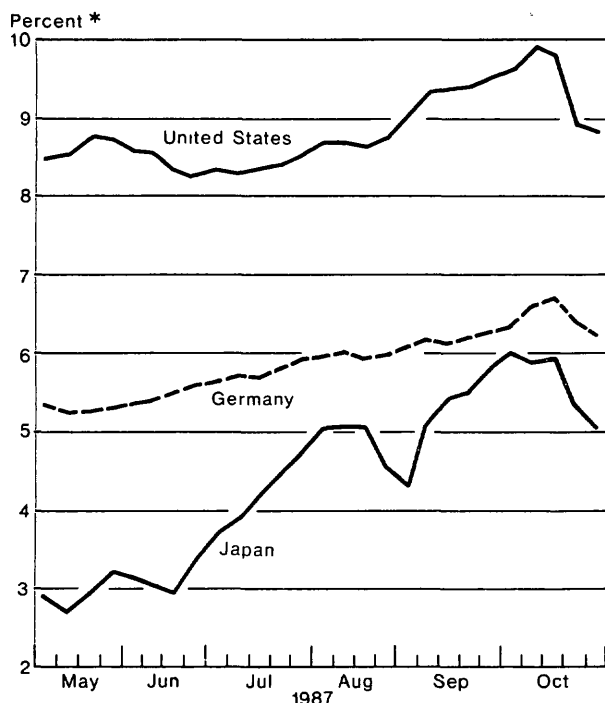
Although inflation remained low in Japan and Germany, price indices had begun to tilt upwards.



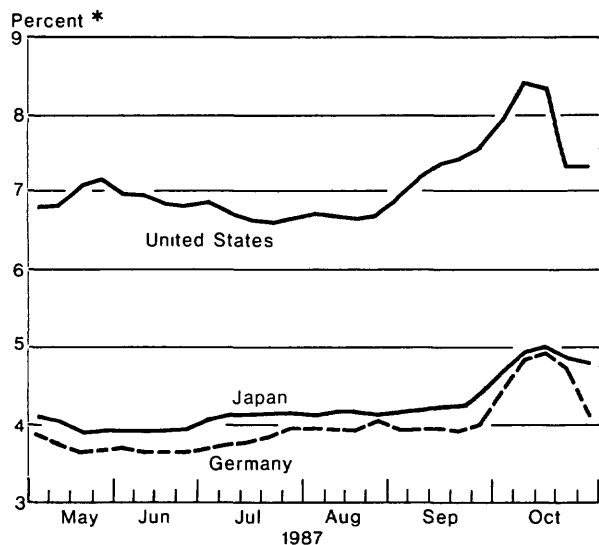
* The chart shows changes in wholesale prices for each month relative to the same month of the previous year.

Chart 4

Through mid-October, long-term interest rates remained under upward pressure in the United States, Germany, and Japan . . .



and short-term rates started to rise as well in all three countries.



*The top chart shows government bond yields and the bottom chart shows domestic three-month interest rates

mid-October, following sharp increases in short-term money market rates

As interest rates moved higher abroad, market participants took the view that, given the commitment to exchange rate stability, interest rates in the United States must move up at least as much to maintain sufficient interest rate differentials. In this context, the announcement on October 14 of another large U.S. trade deficit for August at first had a much more pronounced impact on securities and equities markets than on the exchange markets

But over the following days, the exchange markets grew more concerned about the lack of adjustment in the U.S. trade performance and perceived greater scope for a further downward movement of the dollar. Then, comments by Secretary of the Treasury Baker—to the effect that surplus countries should not raise interest rates in the expectation that U.S. interest rates would surely follow, and that the Louvre framework could accommodate further currency adjustments—imparted new uncertainties to the markets. A press article asserting that Secretary Baker wanted to see the dollar decline was widely assumed to be true, despite his express denial of its accuracy. In these circumstances, some market participants questioned the depth of international cooperation, and others speculated that, in the context of the Louvre accord, the authorities had

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of Facility
	October 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

decided to let the dollar depreciate to a lower level. Consequently, the dollar, which had moved down to around the DM 1.80 level in the days immediately following the release of the trade figures, moved decisively below this level during the weekend of October 17. In the turmoil immediately surrounding the sharp decline in world equity markets on October 19, dollar rates moved without clear direction as market participants positioned themselves defensively. The dollar then gained temporary support from news that Secretary Baker and German officials had met in Frankfurt and had agreed to continue economic cooperation under the Louvre agreement.

But soon strong downward pressure on the dollar resumed. Press commentary about the U.S.-German discussions in Frankfurt suggested that an agreement had been reached on a lower range for the dollar. In addition, all interest rates in the United States fell sharply after the stock market decline, as investors shifted back into fixed interest rate securities, particularly Treasury bills and bonds. While interest rates abroad also declined, they declined by less than U.S. interest rates, so that interest rate differentials favoring the dollar contracted sharply (Chart 5). Later on, pessimism about efforts to reduce the U.S. fiscal deficit

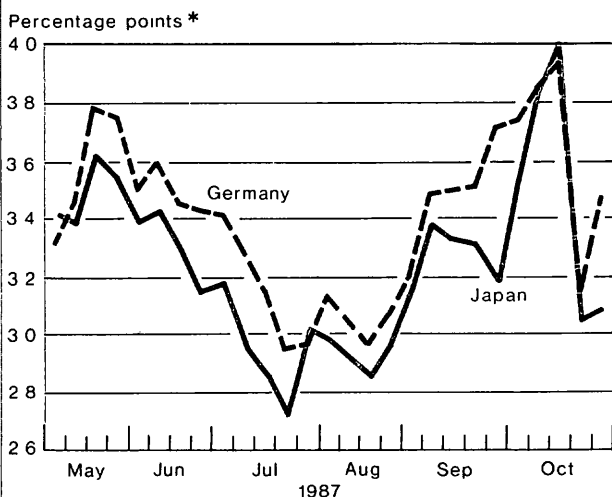
weighed on the dollar. Also, there was widespread commentary in the press questioning the priority for the United States of stabilizing exchange rates in view of concerns that the stock market decline might seriously weaken U.S. economic activity.

Selling pressure on the dollar became intense on October 27 when the dollar declined below its lows of last May against the mark. In order to resist a further decline in the dollar/mark rate, the Desk entered the market on behalf of the U.S. authorities. While these operations for a time stabilized the rate, the dollar again moved sharply lower following commentary that the U.S. authorities were prepared to allow the dollar to decline considerably further. Although the U.S. Treasury denied that the remarks reflected U.S. government policies, strong selling pressure persisted and the Desk continued to intervene, operating in yen as well as in marks. Over the three days, the U.S. authorities bought a total of \$395 million against marks and \$65 million against yen. These operations were conducted in cooperation with the Bank of Japan, the German Bundesbank, and other central banks. On October 29, the dollar traded as low as DM 1.7220 against the mark, close to its previous all-time low of eight years earlier, and Y 137.15 against the yen, its lowest level in 40 years. The dollar closed the period only slightly higher at DM 1.7275 and Y 138.30, down 7 percent and 7³/₄ percent, respectively, from end-July levels.

In summary, over the three months the United States monetary authorities intervened both to sell and to buy foreign currencies. They sold a total of \$899.5 million equivalent of German marks and Japanese yen. The Treasury and Federal Reserve intervened in equal amounts. The Treasury sold \$284.75 million equivalent

Chart 5

After widening progressively, interest differentials favoring the dollar contracted sharply in late October in the aftermath of the worldwide drop in stock market prices.



* This chart shows weekly average differentials at the three-month maturity between Eurodollar deposit rates and Euromarket deposit rates for marks and yen

Table 2

Net Profit (+) or Losses (-) on United States Treasury and Federal Reserve Currency Foreign Exchange Operations

In millions of dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
August 1, 1987 - October 31, 1987	+\$92.6	+\$117.2
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1987	+\$2,099.9	+\$1,790.7

Data are on a value-date basis

of yen and \$165.0 million equivalent of marks. The Federal Reserve sold \$169.75 million equivalent of yen and \$280.0 million equivalent of German marks. In the intervention activity early in the period, the Federal Reserve and Treasury each bought \$315.5 million equivalent of German marks. The Federal Reserve also bought from customers \$85.3 million equivalent of Japanese yen during the period.

In the period from August 1 through October 31, the Federal Reserve and the Treasury's Exchange Stabilization Fund (ESF) realized profits of \$92.6 million and \$117.2 million, respectively. Valued at end-October exchange rates, the valuation gains on outstanding foreign currency balances were \$2,099.9 million for the Federal Reserve and \$1,790.7 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 currencies 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 Monetary Control Act of 1980, the Federal Reserve is authorized to invest in securities issued by foreign governments, and as of October 31, 1987, \$980.1 million equivalent of its foreign currency holdings were invested in such securities. In addition, the Treasury held the equivalent of \$2,473.5 million of its foreign currency holdings in such securities as of the end of October.

On October 30, the Treasury Department through the ESF joined with several central banks to provide a multilateral near-term credit facility totaling \$500 million for the Central Bank of the Argentine Republic. The ESF's portion of the facility was \$200 million. No drawing was made during the period under review.