(This report was released to Congress and to the press on March 4, 1988.)

Treasury and Federal Reserve Foreign Exchange Operations

November 1987-January 1988

The dollar experienced recurrent periods of downward pressure throughout November and December, then firmed in early January. On balance, the dollar ended the three-month period 7½ percent lower against the Japanese yen and 3 to 4 percent lower against most European currencies and the Canadian dollar. The U S. authorities intervened to support the dollar at various times during the period, most heavily in early November and around the turn of the year

Early November pressure on the dollar

In November, as the period under review opened, the dollar was already under selling pressure stemming from several sources.

Given the sharp decline in stock prices in October and the relatively greater importance of equity holdings in the United States than elsewhere, the U.S economy was seen to be in danger of weakening considerably, and more so than the economies of other countries. Under these circumstances and with the Federal Reserve acting to provide liquidity to the market, U.S. interest rates had declined significantly Meanwhile interest rates in other countries had declined less sharply. As a result, interest rate differentials favoring the dollar had narrowed.

Following the stock market developments in October, market participants looked to the Administration and Congress for decisive action to reduce the U.S. fiscal deficit Progress was not yet visible, even though the Administration and Congress had begun discussions on a two-year deficit reduction program

In light of these factors and the continuing large trade imbalances, many doubts were expressed in the press and in the market that the Group of Seven (G-7) countries would place a high priority on maintaining exchange rate stability and international policy coordination. As a result, market participants were looking for evidence that the economic policy coordinating mechanisms established at the February 1987 Louvre accord were still intact

During the first week of November, the dollar's decline began to accelerate. Some press reports asserted that the U.S authorities' primary concern, at least for the moment, was to prevent a recession, even at the risk of a further decline in the dollar. Other reports tended to reinforce doubts about the strength of the commitment of the G-7 countries to foster stability in exchange rates The dollar's decline continued despite explicit reaffirmation of the U.S. adherence to the Louvre accord.

In fact, the Desk had already begun to intervene in the market on behalf of the U.S. monetary authorities. In concert with other central banks, the Desk purchased $1,095 million from November 2 through November 10, of which $717 million was against marks and $378 million against yen The dollar traded as low as DM1.6485 against the mark and Y133 20 against the yen on November 10

Following these intervention operations and a statement by President Reagan on November 10 that he did not want to see a further decline of the dollar, the selling

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pressures subsided. The report a few days later that the U.S. trade deficit had declined in September and President Reagan's subsequent statement that the budget negotiations could result in $80 billion in deficit reductions over two years seemed to suggest progress toward reducing the U.S. external and internal imbalances. At the same time, the Bundesbank took action to lower German short-term interest rates, which reduced the tendency for the German mark to appreciate against its partner currencies within the European Monetary System (EMS) as well as against the dollar. In that environment, market participants questioned whether the stage was being set for a G-7 meeting that would reaffirm the commitment to exchange rate stability. The dollar firmed to DM1.7170 against the mark and Y137.30 against the yen on November 16.

Reemergence of pressure in late November and December

The dollar came under pressure again as hopes faded for rapid progress in the budget reduction negotiations. Expectations of an early G-7 meeting receded after statements by a number of foreign officials seemed to indicate that a meeting would not occur until a U.S. budget accord had been negotiated and approved by Congress. By November 20, when the Administration and Congressional negotiators agreed upon a plan to reduce the budget deficit by around $75 billion over two years, the dollar was already moving lower as market participants wondered whether the program would be adequate and how long it would take for Congress to enact the measures. With market attention focused almost exclusively on the progress of the budget reduction plan through Congress, news of coordinated interest rate adjustments in Germany and several other European countries on November 24 again helped to ease tensions within the European Monetary System but provided only limited support for the dollar. In the presence of continued doubts about the strength of the G-7 commitment to foster stability in exchange rates, the dollar continued to move lower.

During late November and early December, the U.S. authorities again entered the market to contain the dollar's decline on various occasions when it came under pressure. Between November 27 and December 4, the U.S. authorities purchased $272 million against marks and yen, again in cooperation with other central banks.

The dollar steadied during the first week of December. The Bundesbank cut its discount rate on December 3

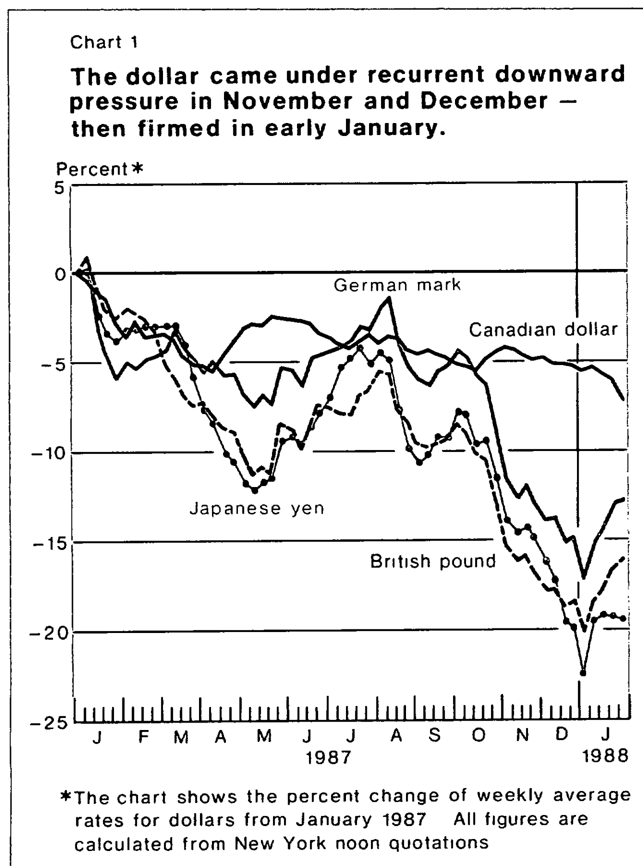


Chart 1

The dollar came under recurrent downward pressure in November and December — then firmed in early January.

*The chart shows the percent change of weekly average rates for dollars from January 1987. All figures are calculated from New York noon quotations.

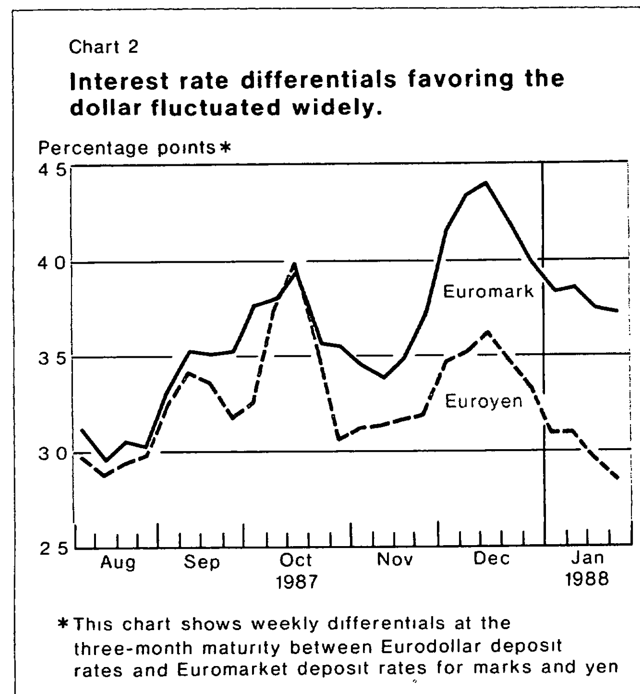


Chart 2

Interest rate differentials favoring the dollar fluctuated widely.

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

to 2½ percent in a move accompanied by official rate cuts in France, the United Kingdom, Switzerland, Belgium, the Netherlands, and Austria. Market participants were encouraged by these signs of renewed international cooperation.

The announcement on December 10 that the U.S. trade deficit had jumped to a record $17 6 billion (not seasonally adjusted) in October underlined the difficulties in reducing the U.S. external imbalance and had a strong market impact. As traders rushed to liquidate their dollar positions, the dollar gapped downward by 1½ to 2 percent within a few minutes of the announcement. The U.S. authorities entered the market, in concert with several European central banks, to restrain the dollar's decline The next day, when market conditions again deteriorated, the Desk reentered the market. Over the two-day period, the U.S authorities purchased $351 million against marks and yen.

For the rest of the month, market sentiment remained bearish as the dollar came under recurrent strong selling pressure in an atmosphere of pessimism and uncertainty. Market participants remained skeptical that the budget reductions being considered by Congress would be sufficient to deal effectively with the U.S. fiscal deficit problem. Erroneous press reports, though quickly denied, raised doubts about the commitment of the Administration to exchange rate stability and added to the uncertainty.

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility January 31, 1988
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

Meanwhile, market participants were reassessing the economic outlook generally and found the performance abroad to be mixed. The Japanese economy remained buoyant, driven by accelerating domestic demand, while in Germany the mark's continuing rise was seen as possibly leading to a decline in both German net exports and investment spending. The view that the Japanese economy was fairly strong and that the Japanese authorities had less scope than others to lower interest rates added to the selling pressure on the dollar against the yen. In these circumstances, the dollar fell more rapidly against the yen than against other major foreign currencies during the second half of December The strength of the yen relative to European currencies also was consistent with a view that, since Japan's trade surplus with Europe had widened in previous months, the yen had considerable scope to appreciate vis-a-vis the European currencies.

At the same time, market participants were no longer quite so pessimistic about the effects of the October stock market decline on the U.S. economy. Evidence that consumer confidence may have fallen sharply in October and remained weak in November kept alive concerns about the possible effect of the stock market decline on U. S. economic growth. But the release of other statistics, including better-than-expected employment and industrial production figures for November, suggested that the market's initial worries that the decline might seriously weaken U.S. economic activity were exaggerated.

On December 22, officials of the G-7 nations issued a statement reaffirming the basic objectives and policy directions set forth in the Louvre accord, agreeing that a further decline of the dollar could be counterproduc-

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
November 1, 1987-January 31, 1988	+612 4	+749 7
Valuation profits and losses on outstanding assets and liabilities as of January 29, 1988	+1,846 8	+1,350 5

Data are on a value-date basis

tive. However, traders were disappointed that the statement offered no explicit new economic policy moves aimed at stabilizing exchange rates and redressing trade imbalances.

Against this background, the dollar again came under strong downward pressure as the year drew to a close. U.S. corporations and Japanese banks sold dollars in thin holiday markets, at a time when most banks in Europe and the United States were unwilling to adjust their positions ahead of year end, and the market became one-sided. The U.S monetary authorities intervened heavily in concerted intervention operations. During the period December 16 through December 31, the Desk purchased a total of $1,707 million, approximately half of which was against marks and half against yen. By early morning January 4 the dollar had declined to record lows of DM1.5615 against the mark and Y120.20 against the yen in the Asian/Pacific markets At that point, the dollar was almost 10 percent lower against the mark and more than 13 percent lower against the yen from the start of the period.

Recovery of the dollar in January

Market sentiment changed dramatically beginning later that day, when active trading resumed in New York after the New Year, in response to unmistakable evidence of concerted, visible, and aggressive intervention operations These operations provided a clear signal that U.S. and foreign officials were seriously committed to fostering exchange rate stability and gave new weight to the December G-7 statement. Reported comments by foreign officials also reinforced the view that new initiatives to halt the dollar's decline might be underway. The dollar advanced by 1¾ percent against the mark and 2¼ percent against the yen by the close of New York trading from its lows earlier that day and continued to strengthen during the remainder of the first week of January.

In this context, the announcement of reductions in official interest rates in three European countries on January 5 was interpreted as a further sign that officials were willing to take steps to adjust their monetary stance and coordinate policy to support the dollar. The release on January 8 of better-than-expected U.S. employment statistics for December helped to strengthen the view that a sharp slowdown in domestic economic activity was not imminent and, accordingly, that there might be less downward pressure on U.S. interest rates On January 13, Japanese Prime Minister Takeshita and President Reagan met in Washington and reaffirmed the December G-7 statement. They indicated that arrangements had been made to assure the ade-

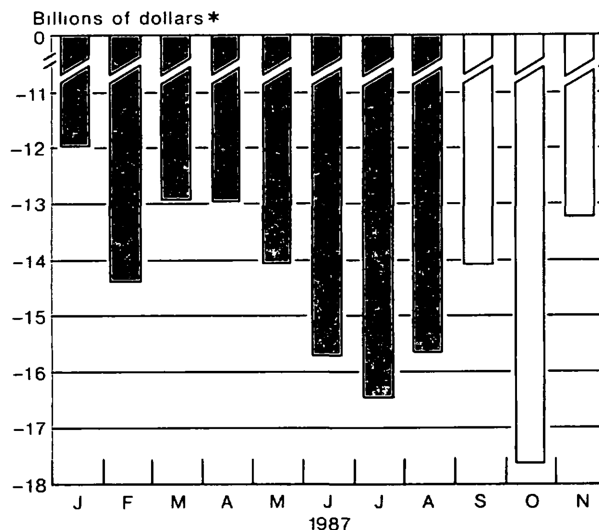
Statement of the Group of Seven on December 22

Paragraph 8

The Ministers and Governors agreed that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process could be counterproductive by damaging growth prospects in the world economy They re-emphasized their common interest in more stable exchange rates among their currencies and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster stability of exchange rates In addition, they agreed to cooperate closely on exchange markets. The Ministers and Governors stressed the need for consistent and mutually supportive policies and believe that the measures being taken will accelerate progress toward the increased, more balanced economic growth and sustainable external positions necessary for greater exchange rate stability.

Chart 3

The wide swing in trade figures released during the period was an important factor affecting exchange rates.



*Monthly U S merchandise trade balance, not seasonally adjusted, census basis Shaded bars indicate trade figures released in November - January

quacy of resources needed for their cooperative efforts.

On January 15, the report that the U.S. trade deficit for November had narrowed to $13.2 billion (not seasonally adjusted) pushed the dollar sharply higher. Market participants were encouraged that the deficit, which had declined with virtually all geographic regions and across all commodity groups, was finally narrowing, albeit slowly and erratically. Stronger-than-expected U.S. retail sales figures for December, released at about the same time, reinforced earlier evidence that a recession was not likely in the immediate future. The dollar closed on January 15 at Y130.85 against the yen and at DM1.6865 against the mark, 9 percent and 8 percent higher, respectively, from its period lows on the morning of January 4. Although profit taking brought the dollar back from its highs, market participants had gained confidence in the view that the dollar had stabilized, at least for the time being.

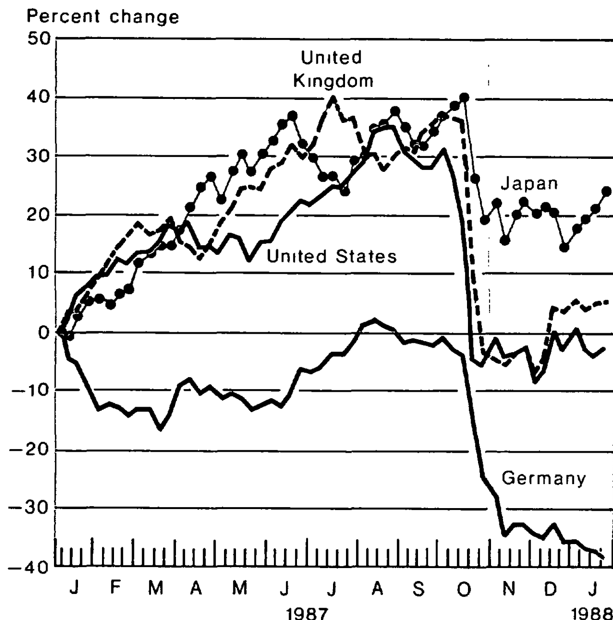
Between January 4 and January 15, intervention dollar purchases by the U.S. monetary authorities totaled $685 million against marks and yen. The bulk was purchased during the first two business days of the new year.

The dollar traded within a narrow range from the release of the U.S. trade figures through the remainder of the month. Market participants were impressed by the early January intervention operations and expected the U.S. authorities to act forcefully to counter any renewed sharp decline of the dollar. As it happened, the U.S. authorities intervened on only one other occasion, purchasing $30 million against yen on January 21 when the dollar came under some downward pressure. At the same time, events abroad reinforced the sense that policies were being directed toward lessening exchange market pressures. In Germany, the Bundesbank changed its monetary target to a broader aggregate (M3) from the narrower aggregate central bank money. The Bundesbank issued a statement that the new target would allow the German authorities to pursue the twin goals of providing monetary stability and stimulating domestic demand. Although the change was technical, observers felt that it might imply a reduced likelihood of a tightening of monetary policy.

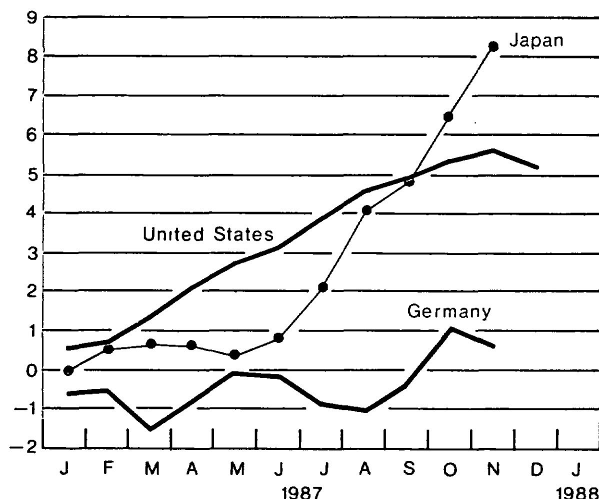
As the period came to a close, the exchange market was quiet and the dollar was trading in a narrow range. However, the dollar was perceived as still vulnerable to disappointing trade figures. Market participants, therefore, awaited further evidence that a bottom for the dollar had been reached and that the underlying economic conditions were in place for a more sustained period of exchange rate stability. The dollar closed the three-month period at DM1.68 against the mark and at Y128 against the yen, down on balance almost 3 percent and $7\frac{1}{2}$ percent, respectively, from levels at the

Chart 4

The sharp fall in stock prices . . .



led to concerns about the economic outlook, but data released during the period indicated that the initial worries were exaggerated.



The top chart shows the percent change of weekly averages for the Dow Jones Industrial, Commerzbank, FT 30, and Nikkei Dow stock market price indices from January 1987 The bottom chart shows a three-month moving average of the percent change in industrial production over a year earlier

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 November 1, 1987	November	December	January	Outstanding as of January 29, 1988
Central Bank of Argentina	200	0	+190	−190	0	*
Central Bank of Ecuador	31	0	*	+31	−31	*

Data are on a value-date basis
*No facility

end of October.

During the three-month period, the U.S. monetary authorities purchased a total of $4,140 million dollars, of which $2,388 5 million was against German marks and $1,751.5 million against Japanese yen. The U.S. Treasury and the Federal Reserve intervened in nearly equal dollar amounts, though the currency composition differed. The Federal Reserve sold $2,030 million equivalent of German marks and no yen; the Treasury's Exchange Stabilization Fund (ESF) sold $358.5 million equivalent of marks and the entire $1,751.5 million equivalent of yen.

Over the same period, the U.S. authorities acquired yen in a variety of ways. In particular, $30.9 million equivalent was received representing interest payments under the Supplemental Financing Facility of the International Monetary Fund (IMF), $184.5 million equivalent resulted from the exchange of SDRs with other monetary authorities, and $1.4 million equivalent was purchased from customers.

In the November-January period, the Federal Reserve and the ESF realized profits of $612.4 million and $749.7 million, respectively, from foreign currency operations. As of the end of January, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,846.8 million for the Federal Reserve and $1,350.5 million for the 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 regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity. A portion of the balances is invested in securities issued by foreign governments. As of end January, holdings of such securities by the Federal Reserve amounted to $1,051.7 million equivalent, and holdings by the Treasury amounted to the equivalent of $996.1 million.

During the period under review, the U.S. Treasury through the ESF provided short-term financing facilities to Argentina and Ecuador.

Argentina. As noted in the previous report, on October 30, 1987, a $500 million near-term credit facility was made available jointly by the ESF, the Bank for International Settlements (acting for certain central banks), and the central banks of Mexico, Uruguay, and Colombia to the Central Bank of the Argentine Republic. On November 12, the Argentine central bank drew $190 million from the ESF's portion of $200 million. The central bank of Argentina repaid $90.1 million on December 7, $84.3 million on December 21, $10.3 million on December 23, and the remaining $5.3 million on December 30.

Ecuador. On December 3, 1987, the ESF agreed to provide a $31 million short-term credit facility for the Central Bank of Ecuador. On the next day, the Central Bank of Ecuador drew the full amount, which was subsequently repaid on January 26, 1988.