(This report was released to Congress and to the press on June 8, 1988.)

Treasury and Federal Reserve Foreign Exchange Operations

February-April 1988

The dollar traded in a narrower range during the three-month period ending in April than in recent reporting periods, remaining above the record lows seen at the beginning of the year against the mark and the yen (Chart 1). On balance, however, from the end of January to the end of April, the dollar declined by 1½ percent on a trade-weighted basis in terms of the other Group of Ten currencies, as measured by the index developed by the staff of the Federal Reserve Board In particular, the dollar declined by ¼ percent against the German mark, 2¼ percent against the Japanese yen, 3¾ percent against the Canadian dollar, and 5¾ percent against the British pound.

Among the main influences on the dollar during the period were: changing expectations about the U S. economic outlook; shifting assessments about the progress of external adjustment, prompted by data on the U.S trade deficit; growing perceptions in the market that official policy actions, including exchange market intervention, would be taken as needed to foster greater stability of exchange rates; and improving interest rate differentials for the dollar.

There were two brief episodes of U S. intervention to support the dollar in the foreign exchange market during the period. The U.S. authorities first intervened toward the end of March when the dollar came under selling pressure as the Japanese fiscal year was coming to a close. The second episode occurred in mid-April when the dollar declined following the release of disappointing U.S trade statistics for February.

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February to early March

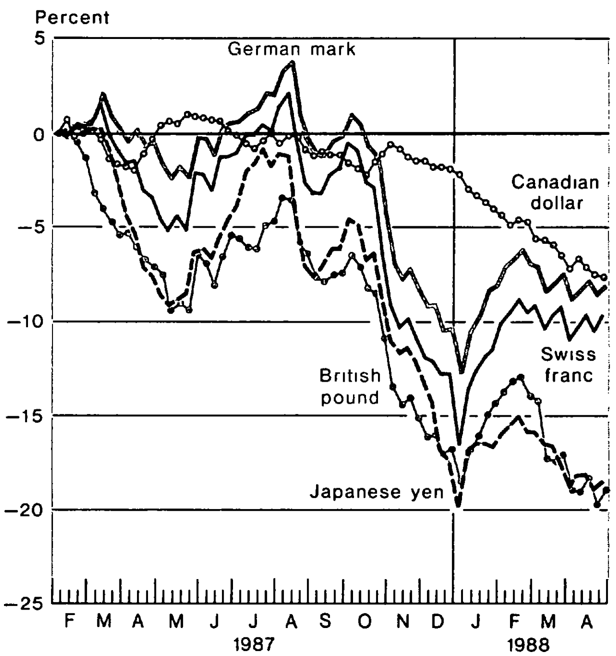
During February and early March, market participants sensed that the exchange markets for the dollar were relatively well-balanced. They saw the extent of foreign participation in the U.S. Treasury's quarterly refunding in early February as an indication that private investors had regained sufficient confidence in dollar-denominated assets to finance the large U.S. current account deficit primarily by private capital inflows. They were also inclined to believe that the monetary authorities of the major industrial nations were firmly committed to fostering exchange rate stability. Traders had been impressed by the coordinated intervention operations conducted by the United States and other authorities at the beginning of the year. Dealers continued to expect that the U.S. and other Group of Seven (G-7) authorities would intervene promptly and forcefully if necessary to counter any renewed sharp decline in the dollar. Market participants also interpreted Chairman Greenspan's testimony to the Congress as indicating that the U.S. monetary authorities would pay attention to exchange rates in administering monetary policy.

More fundamentally, many market participants became more confident that economic conditions warranted the dollar's staying around current levels for the months ahead. Though there were still some lingering concerns about the possibility of recession, traders were impressed with the resilience of U.S. output and employment after the October break in stock prices, and the prospect that interest differentials would move adversely for the dollar began to look increasingly remote. At the same time, some moderation of U.S. domestic demand growth was seen as helping to curb the growth of U.S. imports and thereby sustaining the needed adjustment in the U.S. trade balance. The mid-February report that the U.S. trade deficit had narrowed again in December, this time to $12.2 billion, seemed to provide evidence that the economic adjustment process was on track.

Immediately following the release of these trade statistics, the dollar, after trading within a fairly narrow range in early February, moved up to reach its highs for the three-month period of DM1.7250, Y132.00, and $1.7275 against the pound on February 12. The dollar then drifted lower against these three currencies over the next several weeks and on Friday, March 4, closed in New York at DM1.6895, Y128.75, and $1.7750, respectively, almost unchanged from the levels at the beginning of the period.

Chart 1

After declining sharply against most major foreign currencies toward the end of 1987, the dollar traded within a narrower range during the three-month period ending in April 1988.



The chart shows the percent change of weekly average rates for the dollar from February 6, 1987 All figures are calculated from New York noon quotations

With the dollar trading within a fairly narrow range against these currencies during February and early March, investors shifted funds to currencies that offered high yields. The Canadian dollar was one of the currencies to benefit as investors were attracted by favorable interest rate differentials relative to the U.S. dollar and the Bank of Canada's strong commitment to a further deceleration of Canadian inflation.

Early to mid-March

During early March several developments led market participants to question official resolve to foster stability in exchange rates. On March 7, the British authorities chose not to resist the rise of sterling above the DM3.00 level against the mark, a level the Bank of England had defended with heavy intervention through much of the past year. Some market participants had apparently assumed that Britain's efforts to keep sterling from appreciating against the mark were associated with the G-7's commitments to foster exchange rate stability more generally. Britain's decision was, therefore, seen by those market participants as an indication of a move away from G-7 policy coordination to stabilize exchange rates. A few days later, when the Bank of France temporarily let the franc decline within the European Monetary System in the face of a large order, some market observers saw this action as possible further evidence

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility April 30, 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

that the G-7 authorities might henceforth be prepared to allow more exchange rate movement.

About the same time, some market participants began to worry that the latest economic statistics were pointing to a new threat to the process of economic adjustment. Most notably, the report of a larger-than-expected increase in U.S. nonfarm employment in February, together with data showing increased consumer confidence and a rapid expansion of consumer credit, suggested that U.S. domestic demand was indeed stronger than had been previously expected. Market participants were concerned that, if these developments continued, the U.S. economy could soon reach capacity constraints that would choke off further export growth and provide new impetus to a rise in imports. In this environment, the dollar traded downward in early March, declining sharply against the pound and more gently against other foreign currencies.

The dollar's decline against most major foreign currencies paused in mid-March. Chairman Greenspan reiterated in Congressional testimony the need to be alert to the possibility of a reemergence of inflation and suggested the U.S monetary authorities might adopt a tighter monetary stance, if needed. At the same time, interest rates rose in the United States, and short-term interest rate differentials favoring the dollar began to widen (Chart 2). Market observers were also reassured of the G-7 monetary authorities' intentions to maintain stability in the exchange markets when the Bank of England lowered its money market dealing rates by 1/2 percentage point on March 17 in a move thought to be designed to curb the attractiveness of sterling in the exchange market. Previously, Secretary Baker had indicated in Congressional testimony that sterling's rise above DM3.00 was not inconsistent with the G-7's December 22 statement. Of the major currencies, only the Canadian dollar continued to rise against the U.S. dollar as the former continued to benefit from fairly wide favorable interest rate differentials.

Late March

But in late March, the dollar did not regain the buoyancy it had demonstrated earlier. Although the trade figures for January showed that the U.S. trade deficit had declined again for the third consecutive month, the exchange market reaction to the statistics was subdued. Indeed, several market participants expressed concern that future trade figures would not show much improvement because of the strength of demand in the United States. In this environment, the dollar quickly lost the boost it had received immediately on the publication of the figures.

For the rest of March, market participants remained skeptical about the outlook for the dollar. Throughout this period, the Japanese yen was the currency that gained the greatest attention. Market observers were most impressed with the apparent ability of the Japanese economy to adjust. A boost in domestic demand had spurred the economy to grow at an annual rate of 7 percent during the fourth quarter of 1987, even as the Japanese trade surplus was declining in real terms. Traders also believed that the yen was temporarily being held down ahead of the Japanese fiscal year end on March 31 because of certain tax and bookkeeping considerations. Market participants expected that the underlying strength of the Japanese economy and continuing balance of payments imbalances would cause the yen to move substantially higher once the fiscal year end passed. Moreover, some market participants worried that Japanese financial institutions would sell their dollar assets soon after the year end in order to shift their investments either to currencies with less currency risk or higher yields, or back into yen. As March came to a

Table 2

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

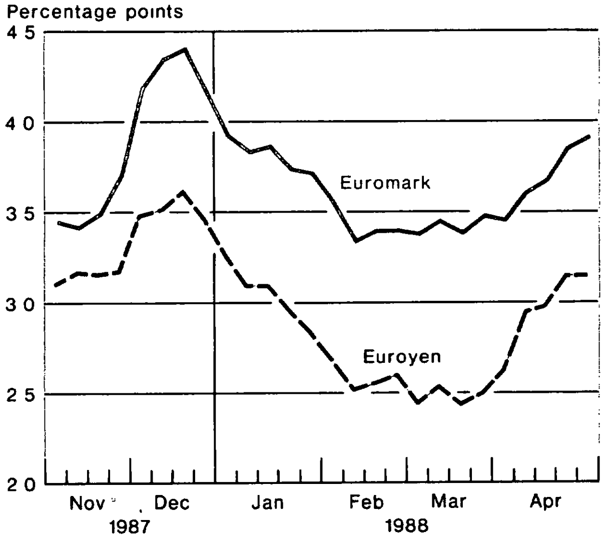
In Millions of Dollars, Drawings (+) or Repayments (−)

Central Bank Drawing on the U S Treasury	Amount of Facility	Outstanding as of February 1, 1988	February	March	April	Outstanding as of April 29, 1988
Central Bank of the Argentine Republic	550 0	*	+390 0	+160 −390	0	+160 0

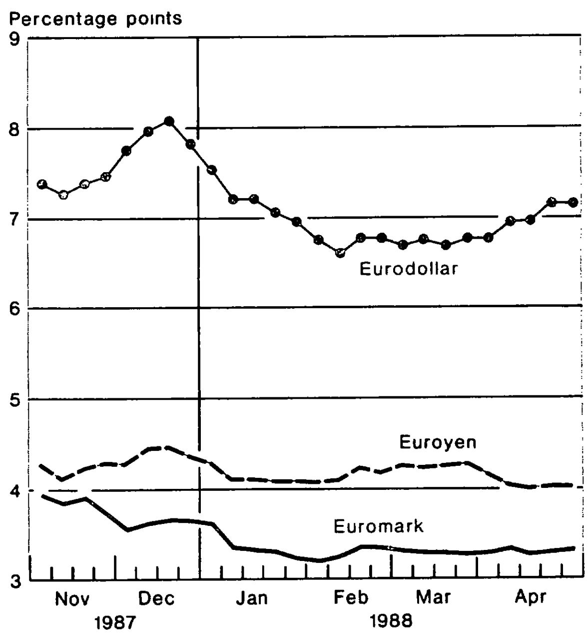
Data are on a value-date basis
*No facility

Chart 2

Short-term interest rate differentials favoring the dollar began to increase in mid-March . . .



as interest rates rose in the United States and declined or were stable abroad.



The top chart shows weekly average interest rate differentials between three-month Eurodollar rates and the three-month Euromarket deposit rates for marks and yen The bottom chart shows weekly average interest rates for three-month Eurodollar, Euromark, and Euroyen deposits

close and it became apparent that the accounting constraints were becoming less binding, traders moved to establish long-yen positions against both the dollar and the mark

Under these circumstances, the dollar resumed its decline in late March, dropping especially against the yen. By Friday, March 25, foreign exchange market conditions had deteriorated significantly, and a sharp decline in U.S. equity prices was interpreted in the market as evidence that Japanese investors had begun to liquidate dollar assets. In these circumstances, the U.S. monetary authorities intervened to limit the dollar's decline and to reassure the market, purchasing dollars against yen that day and again after the weekend on March 28. On March 29, when the dollar was moving higher, the Desk made further dollar purchases against yen to encourage the dollar's rise. Market participants were reassured by the intervention, and the dollar began to firm. The Desk's operations on these three days, totaling $318 million against yen, were undertaken in cooperation with the Bank of Japan.

April

Foreign exchange markets in Europe and New York quieted with the approach of the long Easter weekend early in April. Nonetheless, market participants continued to express the view that Japanese investors would be unwilling to invest heavily abroad in their new fiscal year. Therefore, they questioned whether Japanese and possibly other foreign investors would have enough confidence in dollar-denominated assets to continue financing the U.S. current account deficit in the future. Thus, the dollar resumed its decline briefly and reached its lows for the three-month period of DM1.6480 and Y123.40 in Far Eastern trading on April 4. With the dollar also declining to $1.8950 against the pound, it was down 2, 3½, and 6¾ percent, respectively, from its opening levels in early February.

In the event, the expected heavy dollar sales did not materialize. Moreover, U.S. interest rates had risen further following the release on April 1 of data indicating an unexpectedly large increase in U.S. nonfarm employment for March. Market participants began to reassess the outlook for the dollar and to reconsider whether their earlier concerns about a lack of investor interest in dollar-denominated assets were overdone. As market participants became more assured that private capital inflows would continue to finance the U.S. current account deficit, the dollar started to move higher.

The dollar continued to move higher in subsequent days As evidence of sustained U.S. economic growth accumulated, market perceptions that the U.S. monetary authorities had greater scope to tighten monetary policy strengthened. The larger-than-expected employment figures for March were followed on April 13 by a report of strong U.S retail sales for the same month. In this context, interest rate differentials favoring the dollar widened further (Chart 3), and market participants interpreted the rise in Federal Funds rates in early April as an indication of a slight tightening in Federal Reserve policy.

Confidence in the firmness of international commitments to foster exchange rate stability was also growing. Traders looked forward to the forthcoming meeting of the G-7 industrial nations for a reaffirmation of official cooperation to stabilize exchange rates. On April 13, the G-7's official communiqué welcomed recent evidence that a correction of the world's external imbalances was underway and, as expected, reaffirmed the G-7's commitment to exchange rate stability

A test of this commitment came the next day. To be sure, the announcement that the U.S. trade deficit had widened in February was a significant disappointment to the market and triggered an abrupt decline in dollar exchange rates (Chart 4). But market participants noted that the monetary authorities of the United States and other countries quickly intervened to stabilize the dollar. The U.S. monetary authorities bought a total of $240 million against marks and $260 million against yen on April 14 and 15 as the dollar briefly tested on April 14 its earlier low against the yen The prompt and concerted response by the U.S. and foreign monetary authorities reassured the market. Consequently, after edging slightly lower to DM1.6555 as well as to a three-month low of $1.9065 against the pound on April 18, the dollar soon stabilized.

For the remainder of April, the dollar was underpinned

Table 3

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

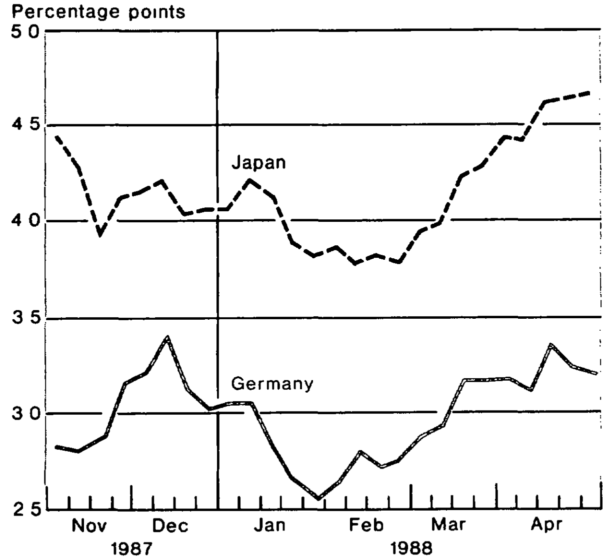
In Millions of Dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
February 1, 1988 - April 30, 1988	+89 9	+50 9
Valuation profits and losses on outstanding assets and liabilities as of April 29, 1988	+1,753 6	+1,318 2

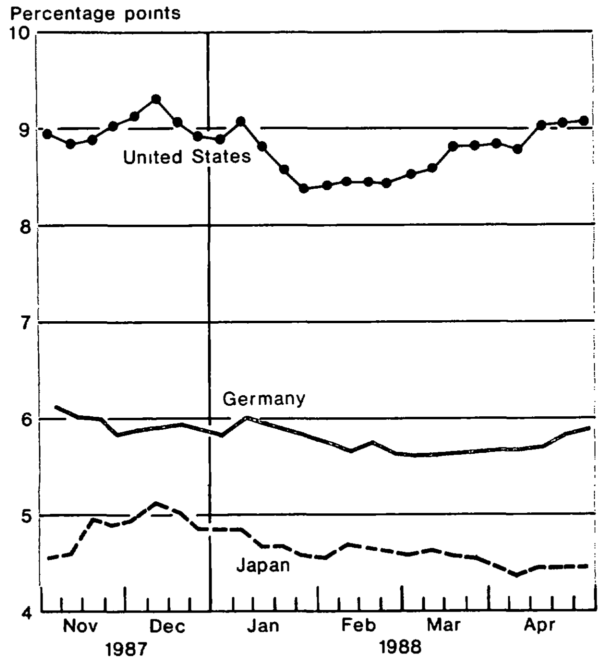
Data are on a value-date basis

Chart 3

Long-term interest rate differentials favoring the dollar also increased during the three-month period . . .



as interest rates rose in the United States.

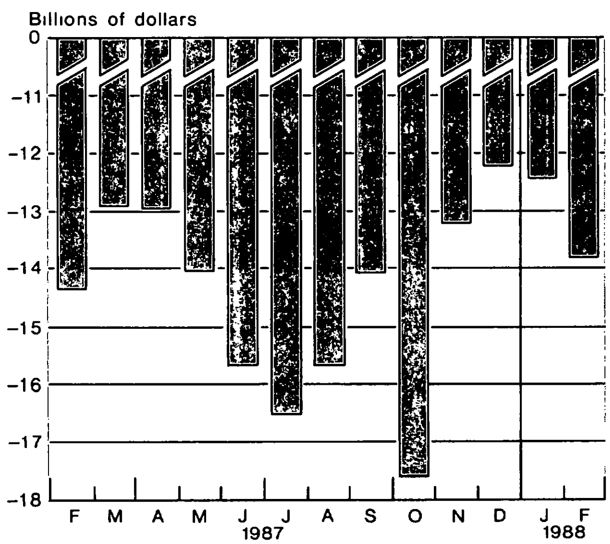


The top chart shows weekly average differentials between U S government long-bond yields and German and Japanese government long-bond yields The bottom panel shows the weekly average U S , German, and Japanese government long-bond yields by expectations that U.S interest rates might continue to rise. Market participants perceived an increasing convergence of the monetary policy stance needed for domestic stability and that needed for external adjustment. News of a sharp rise in U.S. consumer prices during March, followed by evidence of strong demand in the preliminary first-quarter U.S. GNP figures, increased market expectations that the Federal Reserve might tighten monetary policy Statements by several Federal Reserve officials, expressing concerns about the potential risks for inflationary pressures of relatively tight labor markets and capacity constraints in some industries (Chart 5), reinforced these expectations. In these circumstances, the dollar moved gradually higher in late April. It also began to recover against the Canadian dollar from the low of CAN$1.2213 reached on April 20 to close the period at CAN$1.2285. The dollar closed the period at DM1.6775, Y125.10, and $1.8765 against the pound.

During the three-month period, the U.S. monetary authorities purchased a total of $818.0 million dollars, of which $240.0 million was against German marks and

Chart 4

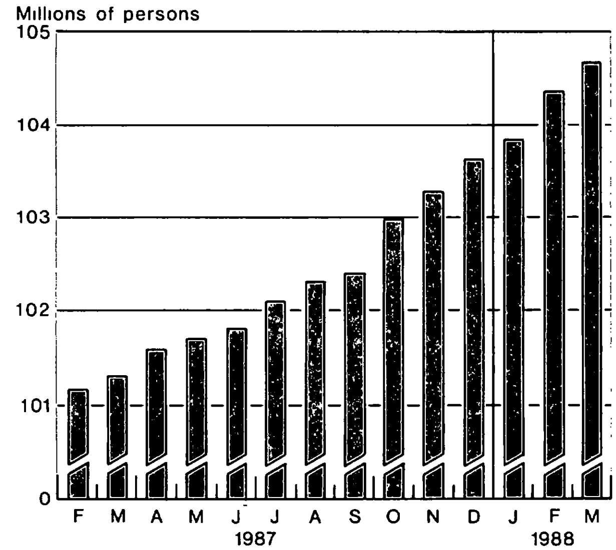
Sharply reduced U.S. trade deficits for December and January benefited the dollar early in the period, but the markets were disappointed by the deficit for February.



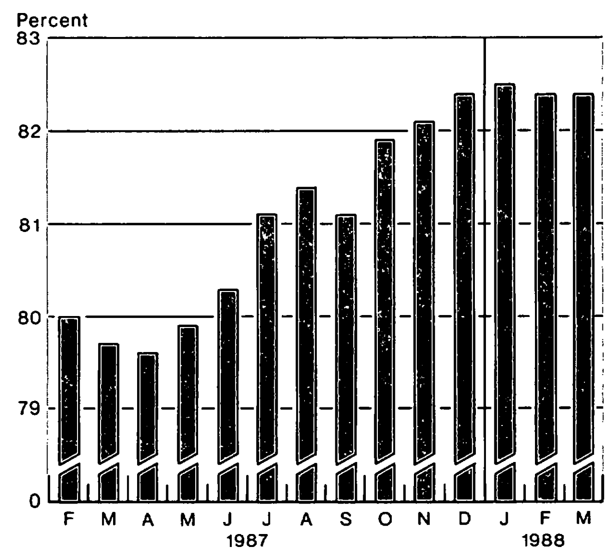
The chart shows the monthly U S merchandise trade balance, not seasonally adjusted, census basis
The U S trade figures for December, January, and February were released on February 12, March 17, and April 14, respectively

Chart 5

During the three-month period, rising employment in the United States . . .



and signs of capacity utilization constraints in some industries . . .



reinforced concerns about both the persistence of the nation's external imbalance and inflationary bottlenecks in the economy.

The top chart shows monthly U S nonfarm payrolls The bottom chart shows the degree of capacity utilization in U S industry The figures for January-March were released during the three-month period under review

$578.0 million was against Japanese yen. The Federal Reserve provided the $240 million equivalent of German marks as well as $60 million equivalent of Japanese yen. The Treasury's Exchange Stabilization Fund (ESF) provided the remaining $518 million equivalent of Japanese yen.

As in the previous period, the U.S. authorities acquired yen in various ways, including $425.2 million equivalent of yen received through the sale of SDRs to other monetary authorities and $2.5 million equivalent of yen received as repayment of borrowings from the United States under the Supplemental Financing Facility of the International Monetary Fund.

In the February-April period, the Federal Reserve and ESF realized profits of $89.9 million and $50.9 million, respectively, from foreign currency operations As of end-April, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,753.6 million for the Federal Reserve and $1,318.2 million for the ESF. These valuation gains represented 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-April, holdings of such securities by the Federal Reserve amounted to $1,024.9 million equivalent, and holdings by the Treasury amounted to the equivalent of $945.8 million.

On February 23, 1988, the U.S. Treasury through the ESF provided a $550 million short-term financing facility to Argentina. This facility provided for two separate drawings: the first for an amount of up to $390 million and the second for an amount of up to $160 million. The Central Bank of the Argentine Republic drew $390 million on February 24 and the additional $160 million on March 11. The first drawing of $390 million was repaid on March 24.