Treasury and Federal Reserve Foreign Exchange Operations

August-October 1988

During the early weeks of the period under review, the dollar continued the generally upward trend that had prevailed throughout the summer, moving higher against all major foreign currencies but especially the German mark. At times during August and to a lesser extent during September, there were episodes of upward pressure whereupon the U.S. authorities intervened, selling dollars to restrain the dollar's rise. As the period progressed, shifts in expectations about the U.S. economic outlook, about the prospects for further increases in U.S. short-term interest rates, and about the progress of external adjustment led to a more cautious attitude toward the dollar, and the currency started to ease. During October selling pressures intensified, and late that month the U.S. authorities intervened in the foreign exchange market to support the dollar. On balance, the dollar ended the three-month period about 5½ percent lower against the Japanese yen and 5 percent lower against the German mark from end July levels.

In the opening weeks of the period, the dollar was buttressed by the release of economic statistics indicating continued strength in the U S. economy. The August 5 announcement of preliminary employment data for July, together with an upward revision to June employment data and evidence of increasing capacity utilization, suggested that U.S. economic growth was proceeding at a pace that could give rise to new inflationary pressures. Market participants interpreted these economic statistics as increasing the likelihood that the Federal Reserve would tighten its monetary policy stance. Some observers already claimed to see signs of Federal Reserve tightening and were attracted by the prospects of rising short-term interest rates and the relatively high yields available on dollar-denominated assets. Even so, market participants were somewhat surprised when the Federal Reserve raised the discount rate by ½ percentage point to 6½ percent on August 9. Subsequently, short-term interest rate differentials favoring the dollar against both the German mark and the Japanese yen widened. On August 10, the dollar reached its period high of DM 1.9245 against the mark while trading as high as ¥ 135.20 against the yen. At that time, the dollar was 2½ percent higher against the mark and 1½ percent higher against the yen from the start of the period. From its low point around the turn of the year, the dollar had moved up more than 23 percent against the mark and more than 12 percent against the yen.

For several weeks thereafter the dollar traded firmly as market participants adjusted commercial leads and lags and implemented other hedging strategies to take account of the dollar's renewed strength. Sentiment toward the dollar remained bullish, with traders interpreting even potentially unfavorable news as favorable for the dollar. In these circumstances, market participants questioned the degree of the Administration's concern over the dollar's rise.

Perceptions that external adjustment was proceeding on track encouraged positive sentiment toward the dollar. Market participants noted that the trade deficit had

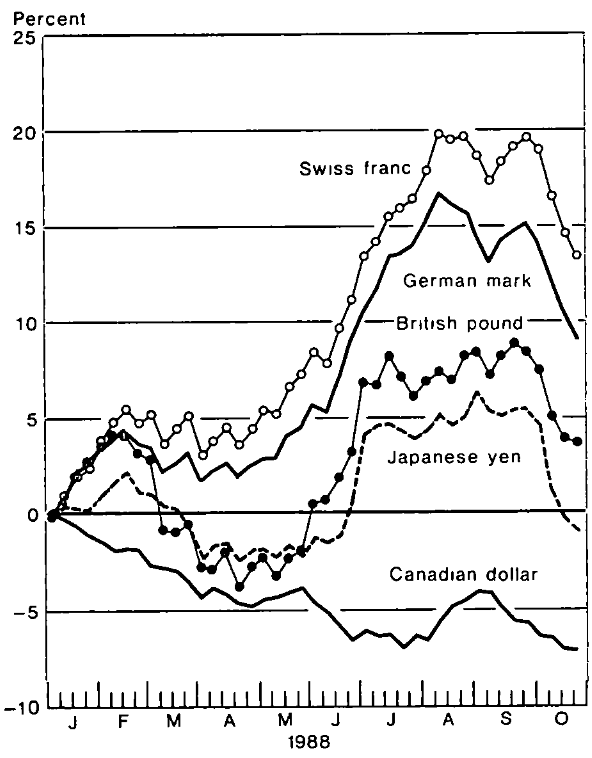
A report presented by Sam Y Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account Cathy McHugh was primarily responsible for preparation of the report narrowed with each of the prior three monthly reports, setting in place a trend of improved performance based on varying combinations of strong export performance and slower growth of imports The August 16 report that the U S trade deficit for June had widened to a seasonally adjusted $12 5 billion from a revised $9.8 billion in May initially disappointed the market, and the dollar briefly declined. But strong upward pressure on the dollar soon reemerged as some market participants seemed to view the widening of the deficit — and in particular the rise in imports — as yet another indication that the Federal Reserve might further tighten its policy stance to counter inflationary pressures Meanwhile, others noted that the substantial rise in imports of capital goods had favorable implications for increasing U.S. industrial capacity

The dollar moved as high as DM 1 9230 against the mark on August 22 and ¥ 134.70 against the yen on August 24, almost matching the highs reached earlier in the month. Between August 5 and August 23, the U.S. monetary authorities at times intervened heavily in the foreign exchange market to resist the tendency for the dollar to advance, selling a total of $1,806 million against marks in operations often coordinated with other central banks The intervention operations, reinforced by official commentary both in the United States and abroad expressing concern that any further rise of the dollar against the German unit might impede improvement in the trade balances, were, by the end of August, beginning to be viewed as a forceful demonstration that international agreements to foster exchange market stability remained intact

Then on August 25, in a move prompted by developments in the foreign exchange market as well as domestic conditions in the individual countries, the German Bundesbank and several other European central banks raised their official interest rates As German interest rates edged higher following the Bundesbank's announcement of a ½ percentage point rise in the discount rate, interest rate differentials favoring the dollar against the mark narrowed, diminishing the relative attractiveness of dollar-denominated assets.

Chart 1

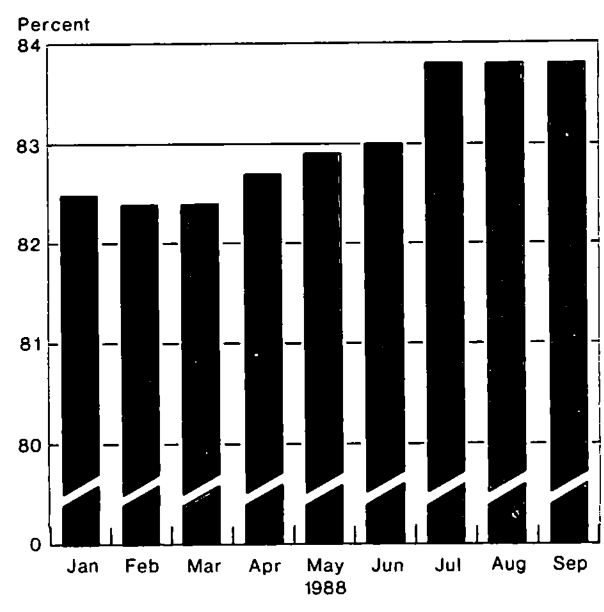
After rising gradually in August, the dollar declined later in the period.



The chart shows the percent change of weekly average rates for the dollar from January 8, 1988 All figures are calculated from New York noon quotations

Chart 2

Data reported in the period showed continuing high levels of capacity utilization.



The chart shows the degree of capacity utilization in U S industry

Table 1

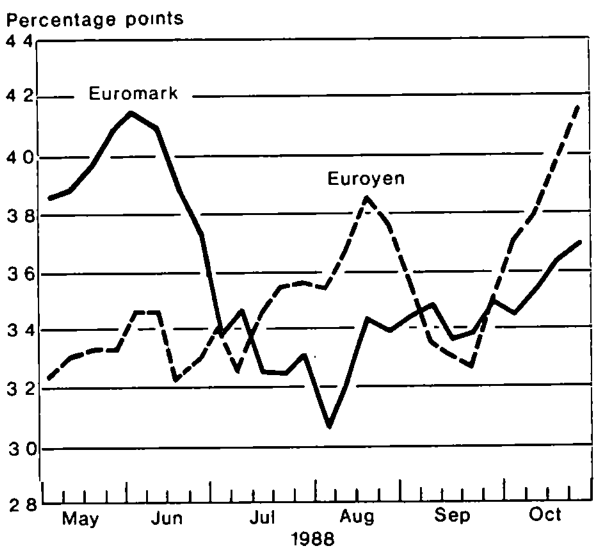
Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility October 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

Chart 3

Short-term interest rate differentials favoring the dollar widened in August and again in October.



The chart shows weekly average interest rate differentials between three-month Eurodollar rates and three-month Euromarket deposit rates for German marks and Japanese yen

That day the dollar declined almost 1 percent against the mark, bringing the dollar to about the same level as at the opening of the period. The yen declined even more against the mark on that and subsequent days because the Bank of Japan was not expected to follow actions by the other central banks to raise official interest rates. As the yen weakened, the dollar moved to its period high against the yen of ¥ 137 25 on September 2.

Throughout much of September, the dollar traded within a relatively narrow range. Market participants expressed renewed confidence in the official commitments to promote exchange rate stability and perceived that monetary authorities would not welcome any further rise of the dollar. Many of the factors that had contributed to the upward pressure during late summer also had become much less evident. In particular, a new round of statistics suggested that U.S. economic growth was slowing to a more sustainable pace While that development was viewed as generally favorable for long-run economic prospects, it weakened some of the short-term demand for dollars by contributing to expectations that upward pressure on dollar interest rates was likely to subside The financial markets took special note of the September 2 release of U S nonfarm payroll figures for August that showed slower employment growth than the market had previously anticipated. Inflation concerns were also allayed by the outlook for declining oil prices and the report of unchanged average earnings during August

As the upward pressures on the dollar eased and as market participants perceived prospects for greater exchange rate stability, investors were increasingly attracted to certain relatively high-yielding currencies, such as the Canadian dollar. The Canadian dollar also benefited from early public opinion polls in advance of the Canadian elections showing strong support for the incumbent Conservative party that favored the enactment of the U S -Canadian free trade agreement. The U S dollar declined steadily against the Canadian unit from early September through mid-October.

Although the positive outlook that had prevailed during the summer tended to erode during September, there were episodes of upward pressure on the dollar One occasion followed the September 14 announcement of a smaller-than-expected U S trade deficit for July that provided reassurance to the market that the correction of global imbalances was continuing. Another occurred following the release of a statement by the Group of Seven (G-7) finance ministers and central bank governors attending a meeting in Berlin over the weekend of September 24 Although that statement reaffirmed the basic objectives of previous commitments regarding cooperative efforts, including exchange rate stability, it contained no precise reference to dollar exchange rates. Some market participants, therefore, concluded that the G-7 was prepared to tolerate further dollar appreciation

During these episodes, the dollar moved up smartly, and the U S. authorities intervened to resist these pressures Between September 14 and September 22, the Desk sold $230 million against marks. On September 26, the first business day after the G-7 meeting, the Desk sold an additional $100 million against marks, and a substantial number of other central banks intervened forcefully to sell dollars at the same time The visible, concerted intervention operations provided a clear signal to the market that the G-7 had not changed its exchange market objectives

At the end of September, market participants noted that there was significant concerted intervention to sell dollars against the mark when the dollar, at about DM 1 89, was still well below the levels reached the previous month. Furthermore, subsequent official statements from various sources pointed to the economic risks of a further dollar rise and gave new weight to the September 24 statement

During October, market sentiment toward the dollar turned negative. For one thing, the prospect of upward

Table 2

Drawings and Repayments by Foreign Central Banks under Reciprocal Currency Arrangements with the Federal Reserve System

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

Central Bank Drawing on the Federal Reserve System	Amount of Facility	Outstanding as of July 31, 1988	August	September	October	Outstanding as of October 31, 1988
Bank of Mexico	700 0	0	+700 0	−700 0	0	0

Data are on a value-date basis

Table 3

Drawings and Repayments by Foreign Central Banks under Reciprocal Currency Arrangements 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 July 31, 1988	August	September	October	Outstanding as of October 31, 1988
Bank of Mexico	300 0	0	+300 0	−300 0	0	0

Data are on a value-date basis

Table 4

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements 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 July 31, 1988	August	September	October	Outstanding as of October 31, 1988
National Bank of Yugoslavia	50 0	33 8	0	−33 8	0	0
Central Bank of Brazil	250 0	232 5	−232 5	0	0	0
Central Bank of the Argentine Republic	265 0*	—	—	—	0	0

Data are on a value-date basis
*Arrangement was in effect as of October 20, 1988

pressure on short-term dollar interest rates appeared to diminish further. Release of a series of economic reports indicated that U S economic activity, while still showing strength, was moderating even more News of smaller-than-forecast increases in U.S. employment during September (later revised upward) and preliminary third-quarter U S GNP figures reinforced the view that a further tightening of U.S monetary policy was less likely in the near term.

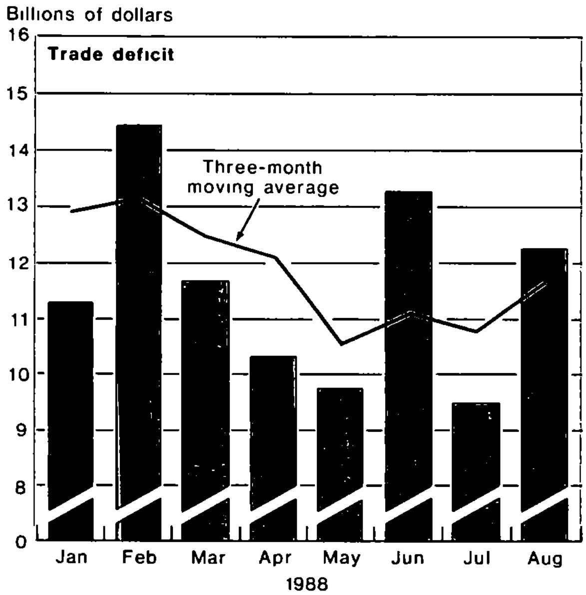
Moreover, market participants, having seen repeated evidence of coordinated central bank sales of dollars during the summer and early autumn, remained convinced that the monetary authorities would firmly resist any further substantial rise of the dollar

In addition, concerns were aroused about the pace of adjustment of global imbalances by the October 13 release of U S. trade data for August showing a widening of the trade deficit to $12 2 billion Despite comments of U S officials cautioning that wide fluctuations in monthly trade data were of little significance and noting the clear trend of improvement in the U.S trade accounts over a longer period, the market continued to focus closely on these monthly trade releases. Participants expressed growing concern about the sustainability of U S. progress in reducing its external deficit.

The dollar's decline against the yen during October was particularly noteworthy. Over the course of the month, the dollar moved approximately 6 percent lower against the Japanese unit. Widespread reports circulated of substantial sales of dollars against yen by

Chart 4

The monthly U.S. trade deficit figures continued to show fluctuations against a background of a declining trend.



The chart shows the monthly and three-month moving average U S merchandise trade deficit, seasonally adjusted and reported on a census basis The trade figures for June, July, and August were released on August 16, September 14, and October 13, respectively

Table 5

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

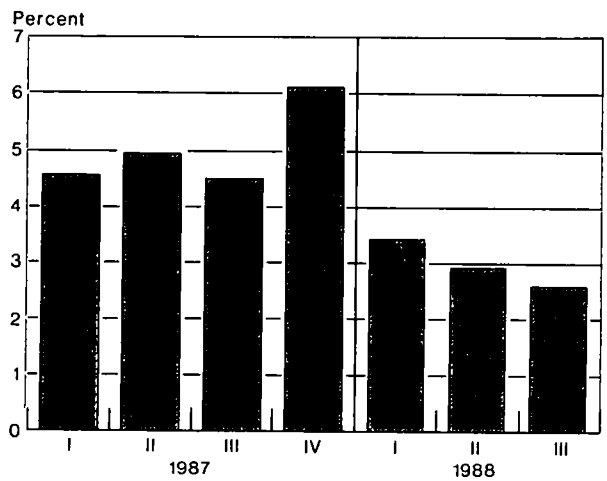
In Millions of Dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
August 1, 1988 to October 31, 1988	0	0
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1988	+1,536 9	+1,258 9

Data are on a value-date basis

Chart 5

During the period, the U.S. economy grew at a slightly less vigorous pace.



The chart shows the annualized change in U S Gross National Product

Japanese institutional investors and U.S. investment banks seeking to hedge an increasing proportion of their dollar portfolios in anticipation of further dollar declines. Furthermore, the yen's strength seemed to reflect a relatively favorable market assessment of Japan's progress in adapting to the rise in its currency since 1985. Selling pressure intensified as the dollar moved below important technical and psychological levels, reaching the period lows of about ¥ 124.50 against the yen and DM 1.76 against the mark at one point on October 31. Under these circumstances, the U.S. authorities entered the market to buy dollars for the first and only time in the period, purchasing that day $200 million against yen to support the dollar.

As the period ended, the dollar was underpinned by a widely held market view that the authorities would act to prevent any sharp fall in the dollar at least through early November in advance of the U.S. presidential election. In addition, interest rate differentials favoring the dollar widened slightly as Japanese money market rates eased by a modest amount. However, market sentiment toward the dollar remained distinctly negative as skepticism deepened that the policy initiatives needed to keep the international adjustment process intact, both here and abroad, would be undertaken promptly enough.

The dollar closed the three-month period at ¥ 125.50 against the yen, barely 4½ percent above its record low of ¥ 120.20 recorded on January 4, 1988. Against the mark, the dollar closed the reporting period at around DM 1.79, more than 14½ percent above its record low of DM 1.5615 in January. On a trade-weighted basis, as measured by the index of the Federal Reserve Board staff, the dollar declined by 4½ percent in terms of the other Group of Ten currencies during the period.

The U.S. monetary authorities sold a total of $2,136 million against German marks and purchased a total of $200 million against Japanese yen during the three-month period. The Federal Reserve and the Treasury's Exchange Stabilization Fund (ESF) participated equally in the financing of all intervention operations.

During the period, there were several other foreign currency transactions of the ESF and the Federal Reserve:

- On August 1, the Bank of Mexico activated its reciprocal arrangements with the Federal Reserve and the U.S. Treasury, drawing $700 million and $300 million, respectively. On September 15, both amounts were fully repaid.
- On August 26, the Central Bank of Brazil repaid an outstanding $232.5 million drawing on a $250 million short-term ESF financing facility. The remaining $17.5 million was not drawn during the period.
- The National Bank of Yugoslavia repaid $17.2 million to the U.S. Treasury on September 26 and $16.6 million on September 30, thereby liquidating the $50 million ESF facility. This facility was provided to Yugoslavia in June along with a $200 million facility by the Bank for International Settlements, acting for a number of central banks.
- On October 20, the U.S. Treasury through the ESF, together with a number of other monetary institutions, agreed to establish a facility to provide up to $500 million in short-term financing to Argentina. The ESF's share was $265 million. No drawings were made as of October 31.

As in previous periods, the U.S. authorities acquired foreign currencies through sales of dollars to other official institutions and through receipt of principal repayments and interest payments received under the Supplementary Financing Facility of the International Monetary Fund. Such foreign currency acquisition totaled $2,103.4 million equivalent.

As of end October, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,536.9 million for the Federal Reserve and $1,258.9 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 October, holdings of such securities by the Federal Reserve amounted to $2,540.1 million equivalent, and holdings by the Treasury amounted to the equivalent of $2,816.9 million.