Treasury and Federal Reserve Foreign Exchange Operations

November 1988-January 1989

The dollar moved lower in November, continuing the decline against most major currencies that had begun in late September. The dollar then gradually found support at the end of November and recovered through most of December and January to return to levels that had prevailed in the autumn (Chart 1). The U.S. monetary authorities intervened to resist the dollar's decline in November and early December and to resist the dollar's rise in January.

The reversal of the dollar's downward momentum during the period reflected shifts in the market's assessment of the strength of the U.S. economy, of the prospects for exchange rate and monetary policies in the United States and elsewhere, and of the effectiveness of the new U.S. Administration in dealing promptly with pressing economic issues.

The dollar's decline in November

When the three-month period opened in November, market sentiment toward the dollar was decidedly negative. With statistics released in October suggesting that U.S. economic expansion might be moderating, market participants assumed that U.S. monetary policy would not be tightened further. They expected that the interest differentials that had attracted inflows into dollar-denominated assets might not continue to be so favorable. Moreover, concerns about the pace of international adjustment had been aroused by recent trade figures. Not only had the trade surpluses of Germany and Japan showed renewed strength, but also the U.S. trade figures released in mid-October showed that the U.S. trade deficit had widened in August. Market participants began to doubt that the substantial trade improvement the United States had experienced during early 1988 would continue. In addition, market participants expressed growing impatience with the lack of progress being made in reducing the U.S. fiscal deficit and with what seemed to be a lack of urgency given to the issue during the 1988 election campaign.

The dollar's decline through October gained momentum late in the month, especially against the yen. Some Japanese investors sold dollars in order to protect the yen value of their assets against a further drop in the dollar, and many Japanese exporters hedged their dollar receivables well into 1989. The Japanese currency benefited, too, from a favorable market assessment of the ease with which the Japanese economy had shifted from an emphasis on external demand to one on domestic demand, as well as from Japan's ability as a major oil importer to benefit from declining oil prices.

By the beginning of November, the dollar had given up most of its mid-year gain against the yen to trade at ¥125.65. The U.S. monetary authorities continued the intervention operations started at the end of October to counter the downward pressure on the dollar. These operations involved purchases totaling $350 million against yen during the first two days of November.

At the time of the Presidential election in the United States, sentiment toward the dollar became even more negative after comments by foreign officials brought the U.S. budget deficit issue back onto center stage.

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. Christopher Rude was primarily responsible for preparation of the report.

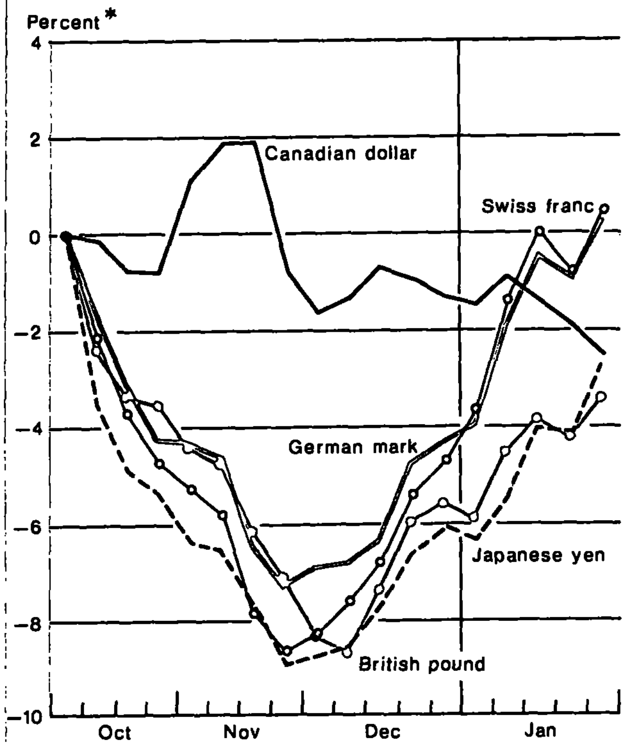
Market participants questioned whether a new Administration could successfully negotiate a budget compromise with a Congress controlled even more than before by the opposition party. Market participants were also skeptical that the Group of Seven (G-7) countries would remain committed to exchange rate stability after additional comments from abroad indicated that other countries' intervention operations to support the dollar might come into conflict with their efforts to keep their own domestic inflation rates under control. The dollar continued to come under selling pressure and, in the period from November 9 through November 16, the U.S. monetary authorities purchased another $625 million against yen in coordination with the Bank of Japan. U.S. and other G-7 officials also made statements expressing continuing official commitment to exchange rate stability.

Although the dollar benefited temporarily from these actions, it remained under pressure during the rest of November. The release of October U.S. retail sales and industrial production figures indicating that economic growth in the United States continued to be strong, as well as a rise in short-term dollar interest rates (Chart 2), had little positive impact on market sentiment. The U.S. trade report on November 16, showing that the trade deficit had narrowed in September and suggesting that the market's earlier concerns about the pace of international adjustment might have been exaggerated, was also largely ignored.

Near the middle of the month, the selling pressure on the dollar intensified, and the U.S. monetary authorities broadened their intervention operations to include the mark. Between November 17 and December 2, the U.S. authorities purchased a total of $630 million against marks and a further $795 million against yen in a series of intervention operations that were conducted in cooperation with the Bank of Japan, the Bundesbank, and other foreign central banks. The dollar reached its lows of the reporting period on November 25 at ¥120.65 against the yen and DM 1.7085 against the mark. At these levels, the dollar was more than 4 percent lower against the yen and the mark from its level at the beginning of November and roughly 11½ percent lower than its autumn highs. Although the dol-

Chart 1

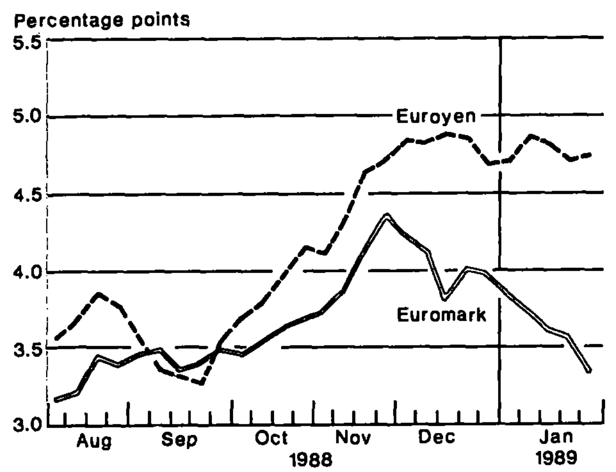
The dollar continued to decline early in the period, then recovered.



*Percent change of weekly average rates for dollars from the week ending October 7, 1988. All figures are calculated from noon New York quotations.

Chart 2

The sharp rise in short-term interest differentials favoring the dollar in November initially had little positive effect on exchange rates.



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

lar had declined by comparable amounts against both currencies, against the yen it was only marginally higher than its record low of ¥120.20, reached on January 4, 1988.

Stabilization and recovery in December

Market participants gradually came to believe that the G-7 monetary authorites were still committed to exchange rate stability. The authorities were seen as showing a consistent presence in the exchange market.

At the same time, market participants sensed from policy decisions taken by foreign central banks—including a one percentage point increase in base lending rates in the United Kingdom on Novemer 25—that containing potential inflationary pressures worldwide was a policy priority. Against this background, U.S. economic statistics that had been released earlier and that revealed unexpected strength in the economy were seen in a different light. Market participants were also impressed by the strong labor market statistics for November released in early December (Chart 3). Noting that short-term dollar interest rates had firmed during November, they came to believe that the Federal Reserve might soon tighten its stance again, either via money market operations or by raising the discount rate.

In addition, market participants were impressed with the extent to which the dollar rallied when a speech by Soviet General Secretary Gorbachev, at the United Nations on December 7, proposing Soviet arms reductions, was temporarily seen as providing scope for the United States to reduce its budget deficit through defense spending cuts. Even though the euphoria of the moment quickly passed, the episode created a renewed sense of two-way market risk.

Under these circumstances, the foreign exchange market slowly shed its negative view of the dollar during the rest of December. Many market participants, who during October and November had postponed purchasing dollars for commercial and investment purposes, began to reenter the market. At the same time, investors who had previously increased their hedging of dollar exposures now lowered their hedge ratios, taking note of the widening of interest rate differentials favoring dollar assets and the increased costs of hedging. The dollar's gradual recovery did not waiver in mid-December when the Bundesbank increased its Lombard rate by one-half percentage point and several

Table 1

Federal Reserve
Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility January 31, 1989
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
Deutsche Bundesbank	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

Table 2

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

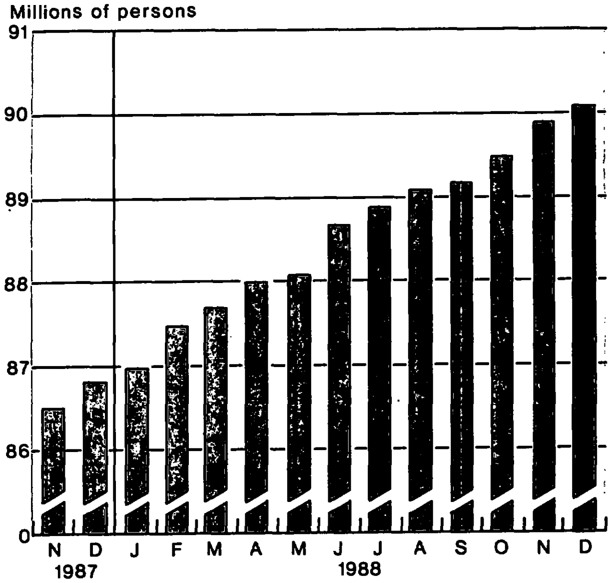
In Millions of Dollars; Drawings (+) or Repayments (−)

Central Bank Drawing on the U.S. Treasury	Amount of Facility	Outstanding as of October 31, 1988	November	December	January	Outstanding as of January 31, 1989
Central Bank of the Argentine Republic	265.0	0	+47.7	0	−46.9	0.8
National Bank of Yugoslavia	50.0	0	*	—	—	—
Central Bank of Brazil	250.0	0	*	—	—	—

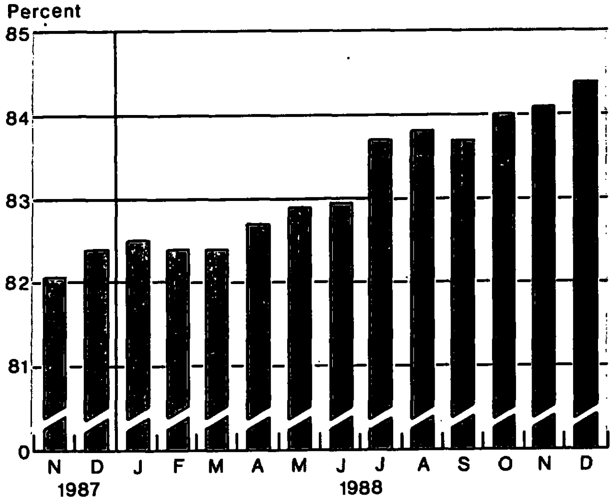
Data are on a value-date basis.
*Facilities expired on November 30, 1988.

Chart 3

Data reported during the period, showing continuing rapid employment gains in the United States . . .



and rising levels of capacity utilization in U.S. industry, . . .

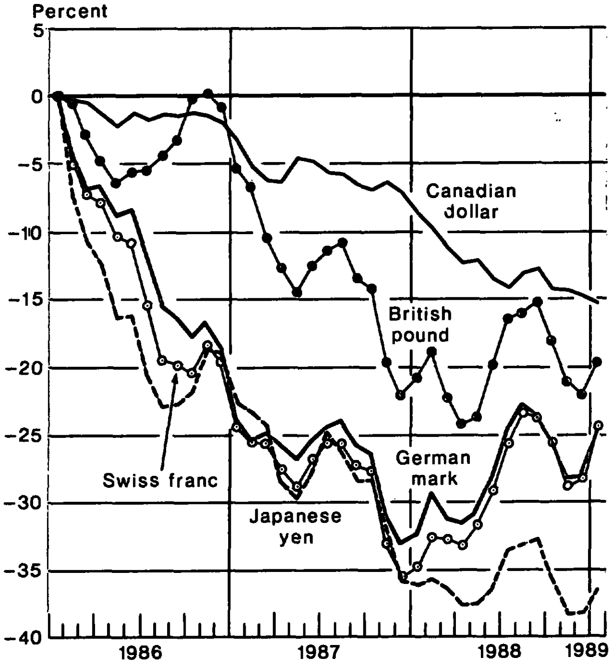


gradually dispelled belief that inflationary pressures were moderating.

The top chart shows monthly total U.S. nonfarm payrolls. The bottom chart shows the degree of capacity utilization in U.S. industry. The figures for October-December 1988 were released during the period.

Chart 4

In January 1989 market participants were impressed by the dollar's relatively good performance in the previous year.



The chart shows the percent change of monthly average dollar exchange rates from January 1986. All figures are calculated from noon New York quotations.

Table 3

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

In Millions of Dollars

November 1, 1988 to January 31, 1989	Federal Reserve	United States Treasury Exchange Stabilization Fund
Realized	+155.3	+155.4
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1989	+1,004.8	+789.4

Data are on value-date basis.

other European central banks also announced increases in their key lending rates. Instead, with the year-end approaching, demand for dollars from bank customers, and by bank dealers themselves who moved to square positions in increasingly thin markets, kept the dollar relatively well bid. Although dealers were skeptical that the dollar's firmer tone would carry over into the new year, the dollar closed the year at DM 1.7725 against the mark and ¥124.85 against the yen, 3½ percent higher than its lows of late November.

The dollar's rise in January

In January, sentiment toward the dollar grew bullish. Actions and statements in the political sphere contributed to a sense of optimism about the new Administration. Signs of Federal Reserve tightening early in the month added to the dollar's upward momentum. As January progressed, several reports showing continued strength in the U.S. economy, together with Chairman Greenspan's reiteration in congressional testimony of the Federal Reserve's concern about the dangers of inflation, supported expectations that dollar interest rates would continue to firm. Also, the market interpreted certain statements by foreign officials as implying a readiness of the G-7 industrial nations to tolerate a further appreciation of the dollar. In this atmosphere, market participants shrugged off the report on January 18 of a sharp rise in the U.S trade deficit in November.

As the dollar moved up through levels not seen for several months, market participants continued to reduce their dollar hedges and reverse commercial leads and lags. Moreover, investors noted the relatively good performance of the dollar throughout 1988 (Chart 4), and reports circulated of widespread Japanese and European interest in buying dollar-denominated securities. In the process, bidding for dollars became at times quite strong. The force of the dollar's rise was directed particularly against the German mark and other European currencies.

By mid-January the dollar had moved up to DM 1.8713 against the mark and ¥128.52 against the yen. On January 19, the Bundesbank announced a further one-half percentage point increase in its Lombard rate and a similar increase in its discount rate. Several other European central banks also raised key lending rates. The rate increases, supported by coordinated intervention, injected a note of caution to the market, and, for a time, the dollar's upward momentum stalled. But the dollar soon resumed its rise to reach its period highs of DM 1.8795 against the mark and ¥130.55 against the yen on January 31. It thus closed the three-month reporting period 5 percent higher against the mark and 3½ percent higher against the yen relative to its levels at the start of November. On a trade-weighted basis, as measured by the staff of the Federal Reserve Board, it was 4 percent higher on balance.

As the dollar moved up in January, the U.S. monetary authorities intervened to counter the rise. From January 6 to January 27, the U.S. authorities intervened on 12 days to sell a total of $1,880 million against marks in coordination with the Bundesbank and other foreign central banks.

In summary, for the period as a whole, the U.S. monetary authorities purchased a total of $2,400 million during November and December—$1,770 million against Japanese yen and $630 million against German marks—and sold $1,880 million against German marks during January. The U.S. Treasury, through the Exchange Stabilization Fund (ESF), and Federal Reserve participated equally in the financing of all intervention operations.

The ESF also received $62.2 million equivalent of Japanese yen in principal repayments and interest payments under the Supplementary Financing Facility of the International Monetary Fund.

For the November-January period, the Federal Reserve and Treasury realized profits of $155.3 million and $155.4 million, respectively. As of the end of January 1989, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,004.8 million for the Federal Reserve and $789.4 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 the end of January 1989, holdings of such securities by the Federal Reserve amounted to $1,457.9 million equivalent, and holdings by the ESF amounted to the equivalent of $1,821.3 million.

In other operations, on November 22, 1988, the Central Bank of the Argentine Republic drew $79.5 million from a $265 million swap facility with the ESF. This facility was provided as part of a $500 million short-term financing package arranged in October 1988 by a number of monetary institutions. Argentina repaid $31.8 million on November 23, 1988, and $46.9 million on January 26, 1989.

ESF short-term facilities with the Central Bank of Brazil and the National Bank of Yugoslavia expired in November 1988. There was no activity in either facility during the period.