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The attached report on "Treasury and Federal Reserve Foreign Exchange Operations," by Sam Y. Cross will be published in the January issue of the Federal Reserve Bulletin and in the Quarterly Review of the Federal Reserve Bank of New York. Mr. Cross is Executive Vice President in charge of the Foreign Group of the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account.

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(The text of this article has also been released by the Federal Reserve Bank of New York.)

Treasury and Federal Reserve Foreign Exchange Operations

After rising for a time in August and early September, dollar exchange rates dropped sharply after an announcement on September 22 by the Ministers of Finance and Central Bank Governors of the five major industrial nations. The monetary authorities agreed to pursue additional, specific policies to sustain and accelerate more balanced expansion with low inflation, and to cooperate more closely in furthering an orderly appreciation of non-dollar currencies. For the August-October period as a whole, the dollar extended the decline that had begun in early 1985, against a background of spreading perceptions that U.S. economic growth was slowing while activity abroad was picking up. By end-October, the dollar had fallen nearly 11 percent in terms of the Japanese yen compared with its end-July level, by about 6 percent relative to Continental currencies, and by 2 percent against the pound sterling. On a trade-weighted average basis, the dollar closed about 5½ percent lower than its end-July levels, and 22 percent below its highs of late February 1985.

As the period opened, the dollar continued the irregular decline that had occurred during the previous five months, but the pace of decline was slowing. Economic statistics were still suggesting that growth of U.S. production and employment remained sluggish during the summer months. But market participants doubted that U.S. interest rates would extend the decline that had begun earlier in the spring since they viewed the Federal Reserve as likely to be increasingly cautious in the face of continued rapid monetary growth. Starting in late August, the dollar actually began to rise as it appeared that the outlook for U.S. economic growth might be more favorable than earlier predicted. Better-than-anticipated trade and employment data prompted market participants to change their expectations for the U.S. economy and for interest rates. Under these circumstances, commercial customers as well as professionals acted to cover short positions and reduce hedges against dollar assets established when the dollar had fallen. Moreover, evidence of a renewed flow of private foreign capital into the U.S. securities markets during September, after a temporary slackening in August, helped to dispel concern that the dollar's decline since the spring would cause a major shift of investor preferences toward non-dollar currencies. The dollar reached its highest levels of the three-month period under review during the second week of September, as traders anticipated that upcoming "flash" GNP estimates would reveal strong growth in the third quarter.

By mid-September, however, market participants began to question whether the expected pickup in economic activity would be strong enough to sustain dollar exchange rates

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Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility October 31, 1985
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	
Swiss francs-dollars	600
Other authorized European currency-dollars	1,250
Total	30,100

at the levels they had reached, which were 4 to 9 percent higher than those of early August. As these questions led some professionals to take profits, the dollar fell, dropping further when the "flash" GNP estimate turned out to be lower than most market forecasts.

The dollar's fall then gained momentum after September 22, when the G-5 Finance Ministers and Central Bank Governors made their announcement following a meeting in New York. The statement (see announcement on page 5) drew attention to changes already occurring in fundamental economic conditions around the world, in particular the shift to more moderate growth in the United States, stronger growth in other countries, and the convergence of inflation rates at a lower level. Recognizing that these changes had not yet been fully reflected in exchange rates, the officials affirmed the strong prospects for progress in reducing international economic imbalances and the intentions of the G-5 governments to implement policies to sustain and accelerate these improvements. Each of the countries issued a specific statement of policy intentions to intensify individual and cooperative efforts to achieve sustained noninflationary expansion.

The G-5 announcement had an immediate and strong effect on dollar exchange rates. In part, the exchange market reaction reflected the fact that the announcement was unexpected. More importantly, market participants noted that the initiative had come from the United States and viewed it as a change in the U.S. government's previously perceived attitude of accepting or even welcoming the strong dollar. In addition, the agreement was interpreted as eliminating the likelihood that the Federal Reserve would tighten reserve conditions in response to rapid U.S. monetary growth.

In these circumstances, the dollar dropped sharply on the day following the G-5 announcement even before any official intervention occurred. With Tokyo closed for a holiday, the first central bank operations were in Europe; the dollar had already fallen against major foreign currencies by the time the Bundesbank stepped in to sell dollars at the afternoon fixing in Frankfurt for the first time in more than six months. Later the same day, the U.S. authorities conducted their first operation during the period under review, selling dollars against Japanese yen and German marks in a visible manner to resist a rise of the dollar from the lower levels.

During the next few days, there was some skepticism in the market that the lower dollar levels would be maintained, and a number of commercial customers responded to the apparently attractive rates by buying dollars. This phenomenon was most dramatic in Tokyo where, when the market opened on Tuesday, September 24, after a three-day weekend, dollar demand from corporations and investors spurred the largest turnover on record for spot dollar/yen trading. The Bank of Japan responded with massive dollar sales. Even though these sales were partly offset by sizable normal interest earnings, Japan's published foreign exchange reserves dropped by nearly $1 billion in the month of September. Following these and other operations in subsequent days by the Japanese and other G-5 central banks, market participants came to believe that the authorities were firmly committed to the joint effort and upward pressures on the dollar abated. The U.S. authorities sold a total of $199 million against German marks and $262 million against the Japanese yen during the last week of September and the first week of October, operating repeatedly and visibly at times when the dollar showed a tendency to rise from the lower levels it had reached.

In the two weeks beginning October 7, the dollar came under heavier upward pressure, reflecting strong commercial and investor demand. While impressed with the central bank intervention, market participants still anticipated additional economic policy initiatives. The demand for dollars was spurred when the annual World Bank/IMF meetings in Seoul, Korea, passed without any such announcements. In addition, some statements, attributed to monetary officials at the Seoul meetings, were viewed as expressing satisfaction with the extent of the dollar's decline and suggesting that it would not fall much further. Also contributing to upward pressure on the dollar were growing perceptions that U.S. economic activity was picking up and that new estimates of third quarter GNP growth would show a substantial upward revision.

Table 2

Drawings and Repayments by the Argentine Central Bank under Special Swap Arrangements with the U.S. Treasury

In millions of dollars; drawings (+) or repayments (−)

U.S. drawings on Treasury facilities for	Outstanding September 30, 1984	1984 IV	1985 I	1985 II	1985 III	Outstanding October 31, 1985
500 million	*	+500	−230 −270	*	*	*
150 million	*	*	*	+75 +68	−71.4 −71.4	*

Data are on a value-date basis.

* No facility.

The demand for dollars, especially against the German mark, intensified around mid-October when commercial participants who had held off meeting their dollar needs after the G-5 announcement re-entered the market. But the dollar's rise was largely held in check by coordinated intervention by the United States and other monetary authorities. On October 16, as the dollar staged its strongest rebound since the G-5 announcement, the Desk sold $797 million against German marks and $67 million against Japanese yen, and on the next day it sold additional amounts as the dollar eased back when the upward revision of the U.S. GNP statistics failed to live up to expectations. During the second two weeks following the September 22 communique, the United States sold a total of $1,550.2 million against German marks and $617.6 million against Japanese yen. These operations, some of which were conducted in Far Eastern markets as well as in New York, were closely coordinated with those of the Bank of Japan and European G-5 central banks in their own centers.

During the last two weeks of October, much of the upward pressure on the dollar relative to the European currencies abated in response both to the intervention operations and to a fading of optimism about the U.S. economic outlook. The upward pressure on the dollar *vis-à-vis* the Japanese yen, however, was slower to subside—even though the government of Japan had announced on October 15 a program to increase the rate of growth of domestic demand. Accordingly, the Desk's dollar sales in this two-week period, while more modest in size, were concentrated in yen. In all during these two weeks, the U.S. authorities sold $482.9 million against Japanese yen and $87 million against the German mark.

Late in October the Bank of Japan allowed Japanese money market interest rates to drift higher. It was then that the dollar began to decline particularly sharply against the yen. Many market observers viewed the Japanese actions on interest rates as possibly representing the first of a series of steps to be taken by the G-5 countries to lower interest differentials favorable to the dollar. Despite denials by U.S., German, and Japanese officials that any agreement existed for such coordinated interest rate policy moves, the idea persisted, and the dollar declined across the board to close near its lowest levels of the three-month period under review. It ended October some 13 percent below the level at which it had traded in the week before the G-5 meeting in terms of the Japanese yen, 10½ percent down in terms of the German mark, and 8 percent down *vis-à-vis* sterling. Total intervention sales of dollars by the U.S. authorities, which were split equally between the U.S. Treasury and the Federal Reserve, came to $3,198.7 million during the three months. After September 22, the central banks of France, Germany, Japan, and the United Kingdom sold about $5 billion. The central banks of other G-10 countries sold more than $2 billion.

In other operations, Argentina repaid its drawing on its swap agreement with the United States Treasury established on June 19, 1985. The drawing was repaid as scheduled in two installments of $71.4 million each on August 15 and September 30. The payments coincided with Argentina's drawings from the International Monetary Fund under its new economic stabilization program. Also completed at the same time were the repayments of $460 million outstanding credits to Argentina from twelve foreign central banks, representing their part of the cooperative bridging facility established in June.

In the period August through October the Federal Reserve and the Exchange Stabilization Fund (ESF) realized

Table 3

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

In millions of dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
August 1, 1985—October 31, 1985	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1985	−451.0	−202.7

Data are on a value-date basis.

no profits or losses from exchange transactions. As of October 31, cumulative bookkeeping or valuation losses on outstanding foreign currency balances were $451 million for the Federal Reserve and $203 million for the Treasury's ESF. These valuation losses represent the decrease 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 currency balances 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 authority provided by the Monetary Control Act of 1980, the Federal Reserve had invested $1,796.6 million equivalent of its foreign currency holdings in securities issued by foreign governments as of October 31. In addition, the Treasury held the equivalent of $2,672.1 million in such securities as of the end of October.

Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States

Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States met today, September 22, 1985, in the context of their agreement to conduct mutual surveillance and as part of their preparations for wider international discussions at the forthcoming meetings in Seoul, Korea. They reviewed economic developments and policies in each of their countries and assessed their implications for economic prospects, external balances, and exchange rates.

At the Bonn Economic Summit in May 1985 the Heads of State or Government of seven major industrial countries and the President of the Commission of the European Communities issued an Economic Declaration Toward Sustained Growth and Higher Employment. In that Declaration the participants agreed that:

> The best contribution we can make to a lasting new prosperity in which all nations can share is unremittingly to pursue, individually in our own countries and cooperatively together, policies conducive to sustained growth and higher employment.

The Ministers and Governors were of the view that significant progress has been made in their efforts to promote a convergence of favorable economic performance among their countries on a path of steady noninflationary growth. Furthermore, they concluded that their countries are restoring the vitality and responsiveness of their economies. As a result of these developments, they are confident that a firm basis has been established for a sustained, more balanced expansion among their countries. This sustained growth will benefit other industrial countries and will help ensure expanding export markets for developing countries, thereby contributing importantly to the resolution of problems of heavily indebted developing countries.

They believe that this convergence of favorable economic performance has been influenced increasingly by policy initiatives undertaken by their countries. Moreover, each of their countries is committed to the implementation of further policy measures which will reinforce favorable convergence and strengthen the sustainability of the current expansion.

Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets.

Recent economic developments and policy changes

Ministers and Governors expect that real growth in aggregate for their countries will be about 3 percent this year, compared with negative growth of −0.7 percent in 1982. Although this figure is down slightly from 1984, growth will be more balanced than at any time in the last four years. After the particularly rapid U.S. growth of 1983-84, there is now increased evidence of internal growth in other countries. In particular, private investment has picked up strength. The current expansion is occurring in a context of fiscal consolidation; it is not dependent on short-lived fiscal stimulus. As a result of the changes in the components of growth, real growth in their countries can be expected to remain strong as U.S. growth moderates.

The current sustained expansion is occurring within a framework of declining inflation, a phenomenon that is unprecedented in the past three decades. Inflation rates are at their lowest in nearly 20 years, and they show no signs of reviving.

There has been a significant fall in interest rates in recent years. Apart from welcome domestic effects, this has been particularly helpful in easing the burden of debt repayments for developing countries.

This successful performance is the direct result of the importance given to macroeconomic policies which have reduced inflation and inflationary expectations, to continued vigilance over government spending, to greater emphasis on market forces and competition, and to prudent monetary policies.

These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the United States experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors—relative growth rates, the debt problems of developing countries, and exchange rate developments—has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

The U.S. current account deficit, together with other factors, is now contributing to protectionist pressures which, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise still higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.

Policy intentions

The Finance Ministers and Governors affirmed that each of their countries remains firmly committed to its international responsibilities and obligations as a leading industrial nation. They also share special responsibilities to ensure the mutual consistency of the individual policies. The Ministers agreed that establishing more widely strong, noninflationary domestic growth and open markets will be a key factor in ensuring that the current expansion continues in a more balanced fashion, and they committed themselves to policies toward that end. In countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required.

Ministers and Governors agreed that it was essential that protectionist pressures be resisted.

Ministers recognized the importance of providing access to their markets for LDC exports as those countries continue their essential adjustment efforts, and saw this as an important additional reason to avoid protectionist policies. They welcomed the GATT preparatory meeting scheduled for late September and expressed their hope that it will reach a broad consensus on subject matter and modalities for a new GATT round.

In this context, they recalled and reaffirmed the statement in the Bonn Economic Declaration on the debt situation:

> Sustained growth in world trade, lower interest rates, open markets, and continued financing in amounts and on terms appropriate to each individual case are essential to enable developing countries to achieve sound growth and to overcome their economic and financial difficulties.

The Ministers agreed that they would monitor progress in achieving a sustained noninflationary expansion and intensify their individual and cooperative efforts to accomplish this objective. To that end, they affirmed the statements of policy intentions by each of their countries.

Conclusions

The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in each country's statement, provide a sound basis for a continued and more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market-opening measures will be important to resisting protectionism.

The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.

The French Government intends to pursue its policy aimed at reducing inflation, moderating income growth, and achieving continued improvements in external accounts. It will further intensify its efforts to speed up structural adjustment and modernization and thus lay the basis for job-creating growth.

Therefore, it is determined:

- To pursue vigorously disinflation.
- To secure the attainment of monetary aggregates growth targets, consistent with decelerating inflation.
- To curb public expenditures progressively so as to low-

er the tax burden while reducing the government borrowing requirement.

- To foster the investment recovery allowed for by the improved financial situation in the business sector.

- To take further steps toward liberalization and modernization of financial markets, to increase competition in the financial sector so as to reduce financial intermediation costs and give a greater role to interest rates in monetary control.

- To foster job creation through the implementation of an innovative and active policy in the field of education and training and by promoting constructive discussions between social partners on work organization.

- To resist protectionism.

The Government of the Federal Republic of Germany, noting that the German economy is already embarked on a course of steady economic recovery based increasingly on internally generated growth, will continue to implement policies to sustain and extend the progress achieved in strengthening the underlying conditions for continuing, vigorous, job-creating growth in the context of stable prices and low interest rates.

In particular, the Government of the Federal Republic of Germany will implement policies with the following explicit intentions:

- The priority objective of fiscal policy is to encourage private initiative, productive investments, and maintain price stability.

- Toward this end, the Federal Government will continue to reduce progressively the share of the public sector in the economy through maintaining firm expenditure control. The tax cuts due to take effect in 1986 and 1988 form part of the ongoing process of tax reform and reduction which the Federal Government will continue in a medium-term framework.

- The Federal Government will continue to remove rigidities inhibiting the efficient functioning of markets. It will keep under review policies, regulations, and practices affecting labor markets in order to enhance the positive impact of economic growth on employment. The Federal Government and the Deutsche Bundesbank will provide the framework for the continuing evolution of deep, efficient money and capital markets.

- The fiscal policy of the Federal Government and the monetary policy of the Deutsche Bundesbank will continue to ensure a stable environment conducive to the expansion of domestic demand on a durable basis.

- The Federal Government will continue to resist protectionism.

The Government of Japan, noting that the Japanese economy is in an autonomous expansion phase mainly supported by domestic private demand increase, will continue to institute policies intended to ensure sustainable noninflationary growth, provide full access to domestic markets for foreign goods, internationalize the yen, and liberalize domestic capital markets.

In particular, the Government of Japan will implement policies with the following explicit intentions:

- Resistance of protectionism and steady implementation of the Action Program announced on July 30 for the further opening up of Japan's domestic market to foreign goods and services.

- Full utilization of private sector vitality through the implementation of vigorous deregulation measures.

- Flexible management of monetary policy with due attention to the yen rate.

- Intensified implementation of financial market liberalization and internationalization of the yen, so that the yen fully reflects the underlying strength of the Japanese economy.

- Fiscal policy will continue to focus on the twin goals of reducing the central government deficit and providing a pro-growth environment for the private sector. Within that framework, local governments may be favorably allowed to make additional investments in this fiscal year 1985, taking into account the individual circumstances of the region.

- Efforts to stimulate domestic demand will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets.

The United Kingdom Government, noting that the British economy has been experiencing steady growth of output and domestic demand over the past four years, will continue to pursue policies designed to reduce inflation; to promote sustained growth of output and employment; to reduce the size of the public sector; to encourage a more competitive, innovative, market-orientated private sector; to reduce regulation and increase incentives throughout the economy; and to maintain open trading and capital markets free of foreign exchange controls.

In particular, the United Kingdom Government intends:

- To operate monetary policy to achieve further progress toward price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.

- To continue to reduce public expenditure as a share of GDP and to transfer further substantial parts of public sector industry to private ownership.

- To reduce the burden of taxation in order to improve incentives and to increase the efficient use of resources in the economy.

- To take additional measures to improve the effective working of the labor market, including the reform of Wages Councils and improvements in youth training; and implement proposals to liberalize and strengthen competition within financial markets.

- To resist protectionism.

The United States Government is firmly committed to policies designed to ensure steady noninflationary growth; maximize the role of markets and private sector participation in the economy; reduce the size and role of the government sector; and maintain open markets.

In order to achieve these objectives, the United States Government will:

- Continue efforts to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector.

- Implement fully the deficit reduction package for fiscal year 1986. This package passed by Congress and approved by the President will not only reduce by over 1 percent of GNP the budget deficit for fiscal year 1986, but lay the basis for further significant reductions of the deficit in subsequent years.

- Implement revenue-neutral tax reform which will encourage savings, create new work incentives, and increase the efficiency of the economy, thereby fostering noninflationary growth.

- Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.

- Resist protectionist measures.