TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

January–March 1995

During the first quarter of 1995, the dollar declined 11.3 percent against the German mark, 13.1 percent against the Japanese yen, 0.2 percent against the Canadian dollar, and 7.8 percent on a trade-weighted basis. On March 2, the U.S. monetary authorities intervened in the foreign exchange markets, purchasing $300 million against the Japanese yen and an equal amount against the German mark. The U.S. monetary authorities entered the market again on March 3, purchasing $450 million against the German mark and $370 million against the Japanese yen as part of a concerted operation to support the dollar. In other operations, Mexico drew a net $1 billion on its swap facility with the Federal Reserve and a net $4 billion on the Treasury Department's Exchange Stabilization Fund (ESF), of which a net $1 billion represented drawings from short-term facilities and $3 billion from the ESF's medium-term facility. These drawings were part of the $20 billion financial aid package to Mexico announced by the Clinton Administration on January 31 and signed on February 21.

SHIFTING EXPECTATIONS TAKE THE DOLLAR TO NEW LOWS

At the end of 1994, many market participants expected the dollar to continue to appreciate into 1995. These expectations were based on a belief that short-term U.S. interest rates would continue to rise and, as a result, interest rate differentials would widen in the dollar's favor. German monetary policy was expected to remain steady through the first part of 1995, in turn suggesting that exchange rate movements within Europe would remain subdued. At the same time, market participants anticipated that Japan's current account surplus would contract as Japan's

This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from January 1995 through March 1995. Claudia Corra was primarily responsible for preparation of the report.

economic recovery took hold in 1995, while the U.S. current account deficit would stabilize. During the first quarter of 1995, however, the expectations that had supported the dollar in late 1994 started to unwind, and the dollar declined to historical lows against the mark and the yen.

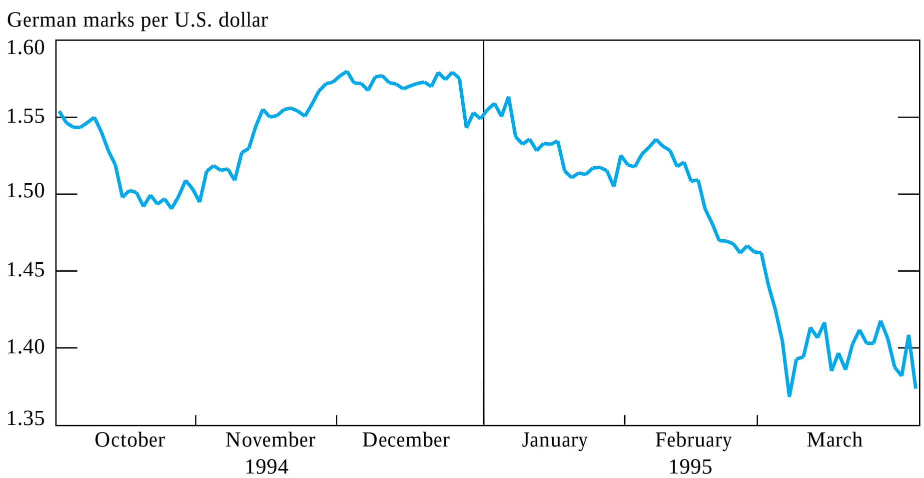
U.S. INTEREST RATE EXPECTATIONS SUBSIDE WHILE THE MARK STRENGTHENS WITHIN EUROPE

Having closed the previous quarter at DM 1.5490 and ¥99.55, the dollar declined in a steady but orderly fashion through mid-February, falling 4.4 percent against the mark to DM 1.4810 and 2.3 percent against the yen to ¥97.27. The decline reflected various factors operating in the economies of the major currencies. In the United States, lower than expected housing, retail sales, and nonfarm payroll data provided initial signs that economic growth was slowing to more sustainable levels. Expectations for additional U.S. interest rate increases faded further after the January 31–February 1 Federal Open Market Committee (FOMC) meeting, at which the Federal Reserve decided to raise both the discount and federal funds rates 50 basis points to 5.25 and 6.00 percent, respectively. Following this hike, market participants came to expect that monetary policy would remain on hold through the March FOMC meeting and possibly through the May meeting as well. This downward revision in expected U.S. interest rates contributed to the dollar's decline. In Europe, the German mark began to appreciate sharply against other European currencies. The prospect of higher than expected wage settlements in Germany and upward trending German producer price data led many market participants to expect an end to the Bundesbank's

Chart 1

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

easing cycle or perhaps even a near-term tightening. Perceived political and fiscal problems in Italy, Sweden, and Spain led to some flight to the German mark from the Italian lira, Swedish krona, and Spanish peseta.

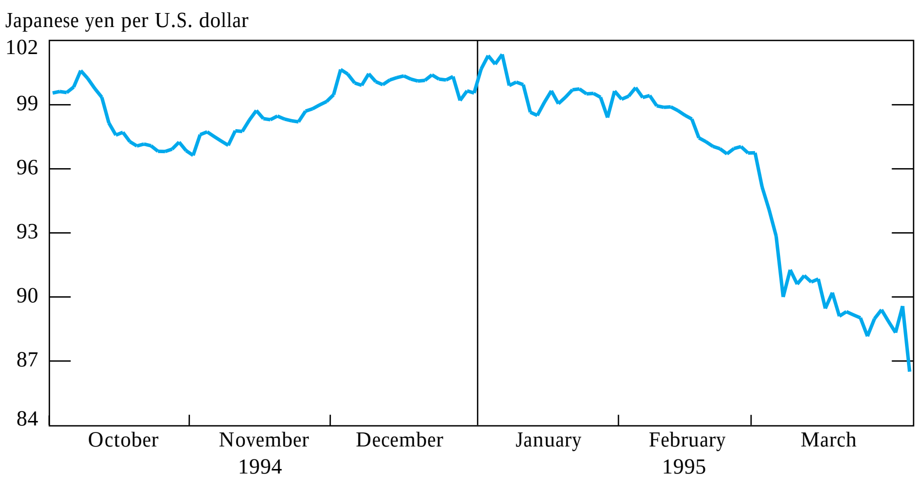
In Japan, analysts began to revise down their near-term forecasts for Japanese growth following the country's severe earthquake on January 17. Moreover, Japanese economic data provided continuing evidence of weak domestic demand. As concerns over another postponement in Japan's economic recovery spread, Japanese stocks came under selling pressure and the Japanese bond market began a sustained rally. The announcement that Barings PLC was being placed in administration, together with the subsequent liquidation of the firm's long positions in Nikkei stock index futures, placed additional short-term pressure on Japanese stocks.

Throughout the early part of the quarter, the Mexican financial crisis also hurt dollar sentiment in at least two ways. First, the U.S. trade deficit was expected to increase as a result of a protracted economic crisis in Mexico, adding pressure to the dollar. Second, the Mexico crisis, coupled with weaker Canadian financial markets, caused many overseas investors to develop an aversion to all North American assets, including dollar-denominated assets. Moreover, that aversion grew as the availability and viability of the first U.S. financial assistance package, which was initially reported on January 11, appeared to be losing congressional support. Sentiment turned more positive with the January 31 announcement of a second package that also included funds from the

Chart 2

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

International Monetary Fund (IMF) and the Bank for International Settlements (BIS). Nonetheless, continued political debate within the United States over the existence and size of the assistance package continued to weigh on market sentiment during much of February.

By February 17, the dollar traded to DM 1.4810, a level last reached in October 1992, and declined to ¥97.27, a level last reached on November 9, 1994.

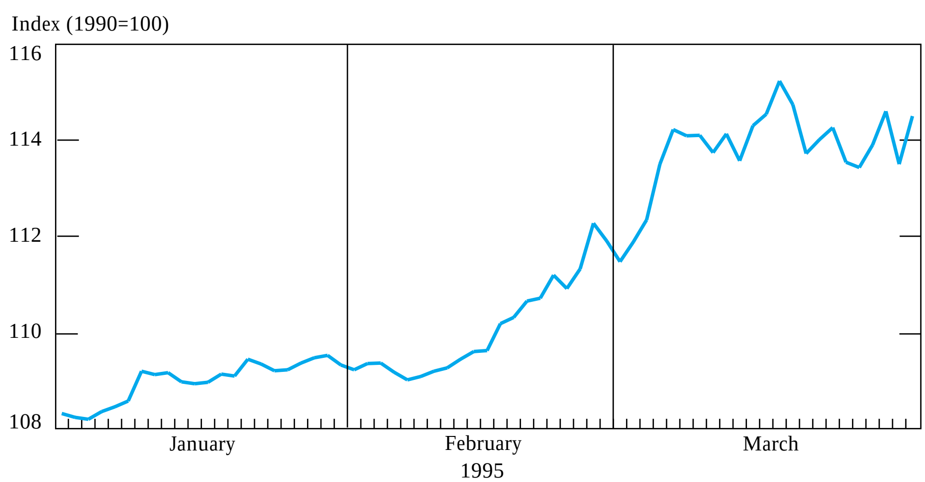
THE DOLLAR'S DECLINE ACCELERATES IN LATE FEBRUARY

Starting in late February, the pace of the dollar's decline accelerated. First, comments by Federal Reserve officials reinforced the perception among market participants that the central bank might be nearing, or might even have reached, the end of its tightening cycle. In particular, market participants interpreted comments by Federal Reserve Chairman Greenspan during his semiannual Humphrey-Hawkins testimony on February 22 as suggesting a significant change in tone. Attention focused almost exclusively on the Chairman's comment that "there may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflationary pressures."

Second, pressure within Europe's Exchange Rate Mechanism (ERM) continued to build, spurring demand for marks and taking the German currency to an all-time high on a trade-weighted basis. In addition to the persistent strains on the Italian lira, the Swedish krona, and the Spanish peseta, the French franc came under pressure amid increased uncertainty ahead of the two-round

Chart 3

THE TRADE-WEIGHTED GERMAN MARK



Source: Bank of England.

presidential election in April and May, while sterling declined because of the perceived weakness of Prime Minister Major's government. Third, expectations that dollar sales by Japanese corporations and financial institutions would accelerate up to the March 31 Japanese fiscal year-end also weighed on the dollar.

Several discrete factors contributed to negative dollar sentiment in late February. First, comments by several Federal Reserve officials between February 28 and March 2 were perceived by market participants as suggesting a lack of official concern over the value of the dollar. Second, the defeat of the Balanced Budget Amendment created the perception—particularly among overseas investors—that the United States lacked the political will to reduce its chronic fiscal deficit. Third, press reports suggesting that the United States would adopt a tougher stance toward Japan in ongoing trade talks also contributed to the dollar's weakness.

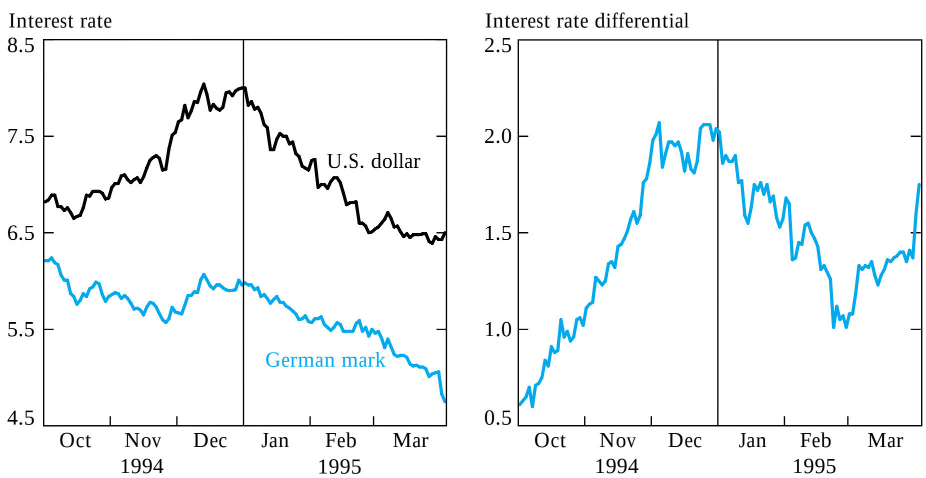
U.S. MONETARY AUTHORITIES BUY DOLLARS AGAINST THE MARK AND YEN

As the dollar's decline accelerated in late February and early March, portfolio managers began to liquidate substantial long-dollar positions. Against a backdrop of reduced liquidity and limited risk appetite, these flows added considerable momentum to the dollar's decline. Moreover, as the dollar breached certain levels, some market participants were knocked out of their options positions, forcing them to sell dollars quickly to reestablish protection against an even weaker dollar.

Chart 4

DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (June 1995 Contracts)



Source: Bloomberg L.P.

On the morning of Thursday, March 2, in nervous and illiquid market conditions, the dollar fell precipitously, first against the yen and then against the mark. By midday, the dollar had reached lows of ¥94.93 and DM 1.4348, declines of almost two yen and three pfennigs, respectively, from the previous day's closing levels. That afternoon, the Federal Reserve Bank of New York's Foreign Exchange Desk entered the market on behalf of the U.S. monetary authorities, purchasing $300 million against the German mark and $300 million against the Japanese yen in an effort to help stabilize the currency. The purchases were divided evenly between the Federal Reserve and the Department of the Treasury's ESF. The dollar reached highs of DM 1.4463 and ¥95.49 after the Desk entered the market, but closed the day at DM 1.4410 and ¥95.15.

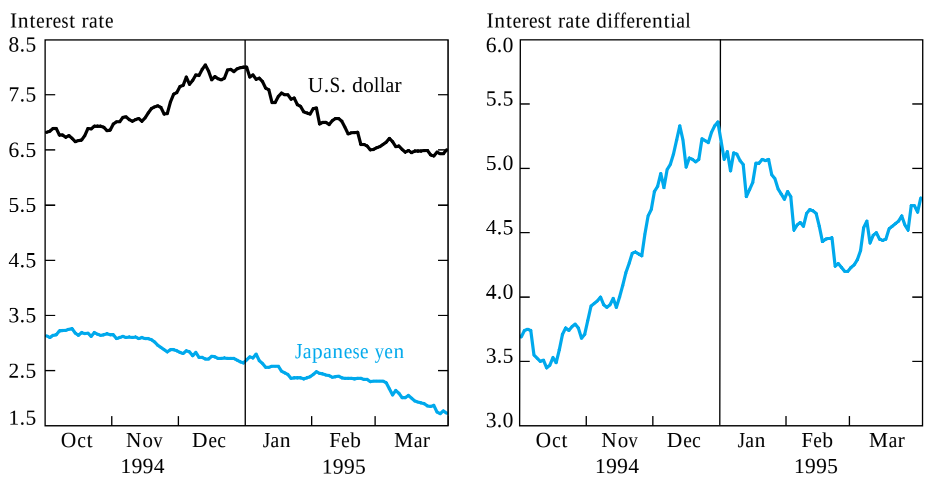
On Friday, March 3, in early European trading, a number of European central banks intervened in concert to support the dollar. Later that day, at about 9:10 a.m., with the dollar trading at DM 1.4490 and ¥94.80, the Desk entered the market to purchase dollars against marks and yen on behalf of the U.S. monetary authorities. The Desk was joined by thirteen other central banks in a concerted effort to support the dollar. Also on March 3, Treasury Secretary Rubin confirmed the U.S. intervention and highlighted official concern over the dollar's recent decline by stating that:

> "A strong dollar is in our national interest. That is why we have acted in the markets in concert with others. The Administration is continuing its work on strengthening economic fundamentals including bringing down the budget deficit further."

Chart 5

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (June 1995 Contracts)



Source: Bloomberg L.P.

During the day, the Desk purchased $450 million against the German mark and $370 million against the Japanese yen. All the dollar purchases were divided equally between the Federal Reserve and the ESF. Throughout the day, the dollar met aggressive selling interest by market participants and proceeded to trade progressively lower, closing at DM 1.4250 and ¥94.08.

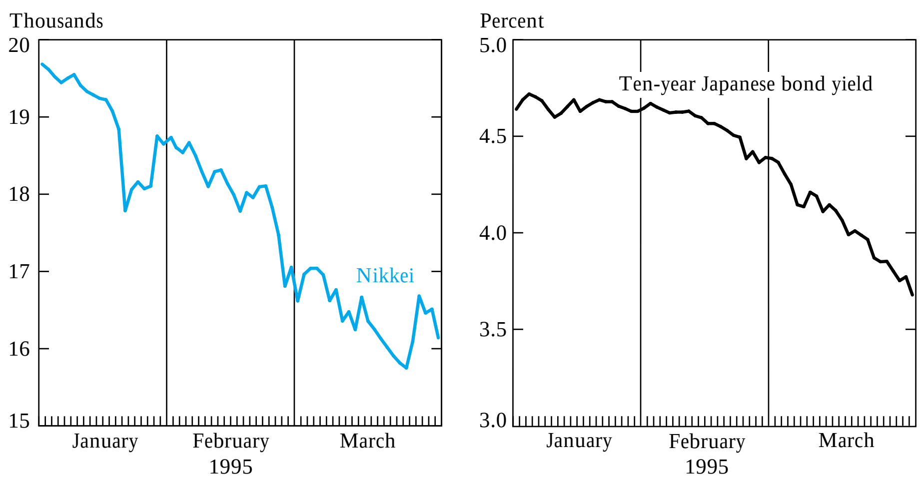
THE DOLLAR EVENTUALLY STABILIZES AGAINST THE MARK BUT REMAINS UNDER PRESSURE AGAINST THE YEN

In the week immediately following the intervention, the dollar continued to decline rapidly against the mark and the yen. Demand for marks increased following the March 5 realignment of the ERM, in which the central parity of the Spanish peseta was effectively devalued by 7 percent and that of the Portuguese escudo by 3.5 percent. On Wednesday, March 8, during Asian trading hours, the dollar reached new historical lows of DM 1.3438 and ¥88.72.

The dollar started to stabilize later that day, following official interest rate increases in several European countries and dollar-supportive statements by senior monetary officials. On March 8, France, Belgium, Denmark, and Portugal increased official short-term interest rates in an attempt to alleviate pressure on their currencies. Soon thereafter, Bundesbank President Tietmeyer stated that the Bundesbank would see if there was "room for a small interest rate cut," but added that the Bundesbank would also consider the possibility of raising interest rates. Market participants noted that this was the first time in several months that President Tietmeyer had mentioned the

Chart 6

THE NIKKEI STOCK MARKET INDEX AND TEN-YEAR JAPANESE GOVERNMENT BOND YIELDS



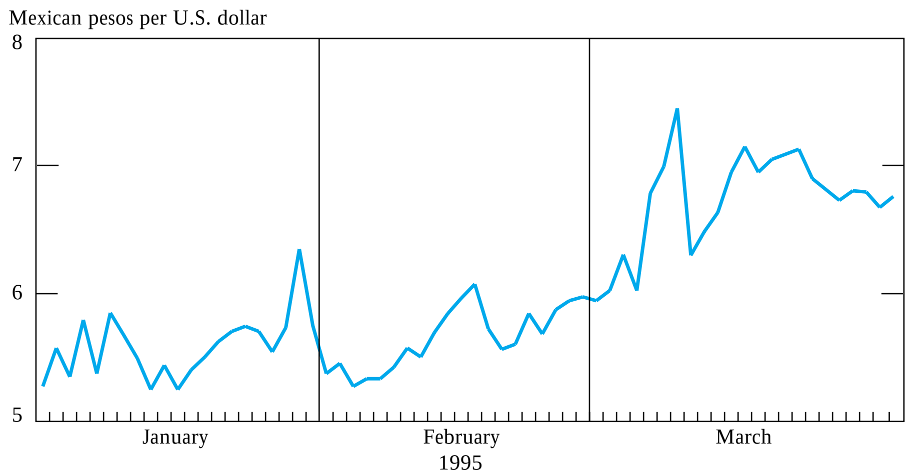
Source: Bloomberg L.P.

possibility of another interest rate cut in Germany. Tietmeyer later added, “In my view, the dollar was, and still is, undervalued. The deutsche mark is valued too high.”

That same day, speaking before the House Budget Committee, Chairman Greenspan said: “The weakness of the dollar against other major currencies is both unwelcome and troublesome. Dollar weakness, while very likely overdone, is unwelcome because it adds to potential inflation pressures in our economy.” Market participants reacted positively to Chairman Greenspan’s comments, as well as to additional dollar-supportive comments by Treasury Secretary Rubin, because these statements helped assuage concerns that U.S. officials were unconcerned about the dollar. Over the rest of the period, the dollar traded in a range of DM 1.3730 to DM 1.4225 against the mark.

Despite its modest rebound against the mark, the dollar remained under pressure against the yen throughout March. Sentiment toward the dollar continued to be negative as market participants focused on reports of capital repatriation by Japanese financial institutions and of dollar sales by Asian central banks looking to rebalance reserves or cover yen-denominated liabilities. In addition, continued concerns about the Japanese current account surplus caused the yen to appreciate sharply against the dollar. This upward pressure on the yen continued despite rising speculation of an imminent cut in the Bank of Japan’s official discount rate (ODR).

Chart 7
THE DOLLAR AGAINST THE MEXICAN PESO
Spot Exchange Rate



Source: Federal Reserve Bank of New York.

Following the March 28 FOMC meeting, at which no monetary policy announcement was made, the dollar continued to drift lower. Although market participants expected monetary policy to remain steady, weak data on durable goods and home sales provided additional evidence of slower growth, further solidifying market participants' views that the United States was approaching the end of its tightening cycle.

On March 30, the Bundesbank surprised the markets with a 50 basis point cut in its discount rate, to 4 percent, and a 35 basis point cut in its repurchase rate for government securities, which had been fixed at 4.85 percent since July 1994. The announcement supported the dollar for a time, but the rally was short-lived as the dollar failed to break out of its March trading range, prompting fresh dollar sales. The following day, March 31, the Bank of Japan allowed its overnight call rate to fall to a historical low of 1.75 percent. Upward pressure on the yen continued, however, with market participants expressing disappointment that the ODR had not been reduced. The dollar proceeded to fall to a new postwar low of ¥86.30 on March 31 in somewhat illiquid trading conditions. The dollar closed the quarter at DM 1.3735 and ¥86.50.

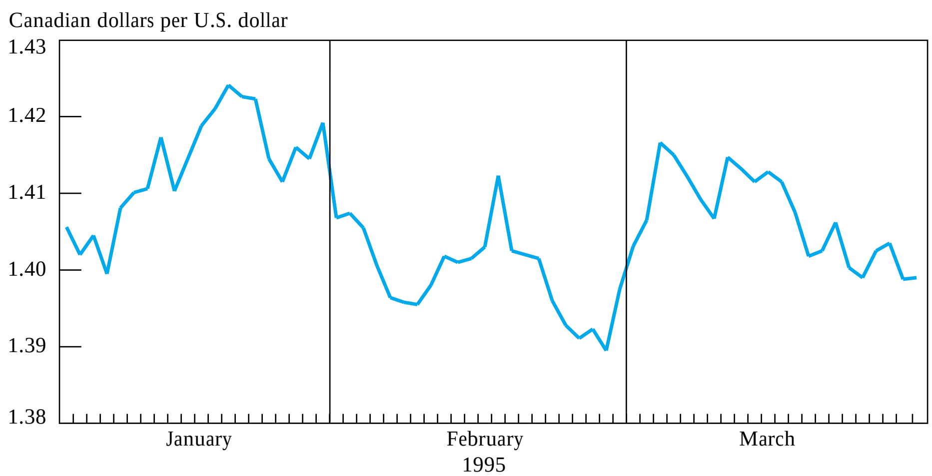
MEXICAN FINANCIAL MARKETS REMAIN VOLATILE

Over the period, the dollar rose 39.4 percent against the peso. The new peso reached a record low of NP 7.65 on March 9 before recovering somewhat during the latter part of the period. As the period opened, uncertainty over the course of Mexican macroeconomic policy and concerns over

Chart 8

THE DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

the impact of the devaluation on Mexico's banking sector led market participants to attach a substantial risk premium to Mexican financial assets, exacerbating already difficult trading conditions in Mexican money and foreign exchange markets.

During the ensuing weeks, Mexican financial markets remained under pressure amid growing doubts about the prospects for congressional passage of the U.S. $40 billion loan guarantee package. On January 31, President Clinton announced a new $47.8 billion aid package that included participation by the IMF and BIS. Mexican markets initially rallied on the announcement but remained volatile amid worries that the second package might be subject to congressional challenge.

Mexican financial markets started to recover in early March following the signing, on February 21, of the $20 billion U.S. portion of the package. Other factors also provided support, including Finance Minister Ortiz's announcement of a strict new economic program, which was well received by the financial community, and the Bank of Mexico's announcement of its intention to follow a tight and more transparent monetary policy. For the rest of the quarter, Mexican markets remained nervous but traded with a somewhat firmer tone. The peso closed the period at NP 6.76 per dollar.

MEXICAN SWAP LINE ACTIVITY

During the period, the U.S. monetary authorities substantially increased their swap lines with Mexico, which had stood at $6 billion at the start of the period. Temporary short-term swap lines were established on January 2 as the Federal Reserve agreed to a $1.5 billion facility with the Bank of Mexico and the ESF agreed to a facility of the same amount with the Mexican central bank and government. The Federal Reserve's temporary facility was later increased to $3 billion on February 1.

In addition, as part of the U.S. financial package signed on February 21, the ESF established a medium-term swap facility with the Mexican government. The facility allows Mexico to draw up to $20 billion, less the amounts outstanding from short-term swaps and securities guarantees.

The Mexican authorities drew on both short- and medium-term facilities during the period. On two separate occasions, January 11 and 13, Mexico drew $250 million from each of its regular short-term facilities with the Federal Reserve and the ESF. Then, for value February 2, Mexico drew $1 billion from each regular short-term facility. Mexico drew $3 billion from the medium-term facility on March 14 and on the same date repaid in full the January drawings.

CANADIAN FINANCIAL MARKETS REMAIN UNDER PRESSURE

During the period, the Canadian dollar reached a nine-year low of C$1.4272 against the U.S. dollar before recovering late in the quarter to close relatively unchanged at C$1.3990. Canadian financial markets remained under pressure because of ongoing fiscal concerns, fears of Quebec separatism, and spillover from developments in Mexico and the United States. Moody's announcement that it was reviewing Canada's foreign and domestic debt rating for a possible downgrade heightened the negative sentiment.

Canada's fiscal year 1995-96 budget, released on February 27, was well received by the market since it met the planned 1996 target of 3 percent of GDP and focused on increased spending cuts. The post-budget rally was short-lived, however, as market participants increasingly began to hold the view that the budget did not adequately address Canada's underlying fiscal trends. During the latter part of the period, Canadian financial markets started to recover once market participants had discounted the possibility of a Moody's downgrade. Canadian markets also benefited toward the end of the period as concerns about Quebec separatism receded.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities intervened twice during the period, buying a total of $1.42 billion against the Japanese yen and German mark. On both occasions, intervention operations were financed equally by the Federal Reserve and the Treasury Department's ESF. The Federal Reserve and the ESF realized total profits of $187.2 million and $164.1 million, respectively, on their intervention operations. Realized profits and losses on sales of foreign currencies are computed as the difference between historic cost-of-acquisition exchange rates and sale exchange rates.

At the end of the period, the current values of the foreign exchange reserve holdings of the Federal Reserve and the ESF were $25.3 billion and $25.4 billion, respectively. The U.S. monetary authorities regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A portion of the balances is invested in foreign government-issued securities. As of March 31, the Federal Reserve and the ESF held, either directly or under repurchase agreement, $9.7 billion and $13.8 billion respectively, in foreign government securities.

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of Dollars

	Balances as of December 31, 1994	Quarterly Changes in Balances by Source: Net Purchases and Sales[a]	Impact of Sales[b]	Investment Income	Currency Valuation Adjustments[c]	Balances as of March 31, 1995
Federal Reserve						
Deutsche marks	13,405.2	(375.0)	3.4	188.7	1,655.0	14,877.3
Japanese yen	8,510.0	(335.2)	5.3	23.1	1,213.7	9,416.9
Mexican pesos[d]	0.0	995.1	0.0	4.9	(134.9)[e]	865.1
Subtotal	21,915.2	284.9	8.6	216.7	2,733.8	25,159.2
Interest receivables[f]	116.3					127.3
Total	22,031.5					25,286.5
U.S. Treasury Exchange Stabilization Fund						
Deutsche marks	7,500.6	(375.0)	3.4	103.2	916.6	8,148.8
Japanese yen	11,801.0	(335.2)	5.3	29.1	1,696.1	13,196.3
Mexican pesos[d]	0.0	3,983.6	0.0	16.4	0.0[e]	4,000.0
Subtotal	19,301.6	3,273.5	8.6	148.7	2,612.8	25,345.2
Interest receivables[f]	64.9					88.0
Total	19,366.5					25,433.2

Note: Figures might not sum because of rounding.

[a] Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

[b] This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

[c] Foreign currency balances are marked-to-market monthly at month-end exchange rates.

[d] See Table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to the Bank of Mexico.

[e] Valuation adjustments on peso balances do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark-to-market its peso holdings, but the Federal Reserve System does.

[f] Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked-to-market until interest is paid.

Table 2

NET PROFITS (+) OR LOSSES (-) ON U. S. TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON HISTORIC COST-OF-ACQUISITION EXCHANGE RATES

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of December 31, 1994		
Deutsche marks	2,170.4	708.1
Japanese yen	2,407.2	3,344.4
Total	4,577.6	4,052.4
Realized profits and losses from foreign currency sales[a] December 31, 1994 - March 31, 1995		
Deutsche marks	81.6	58.2
Japanese yen	105.6	105.9
Total	187.2	164.1
Valuation profits and losses on outstanding assets and liabilities as of March 31, 1995[b]		
Deutsche marks	3,747.2	1,569.8
Japanese yen	3,520.5	4,939.9
Total	7,267.7	6,509.8

[a] As indicated in Table 1, foreign currency sales totaled $750.0 million against German marks and $670.4 million against Japanese yen.

[b] Valuation profits or losses are not impacted by peso holdings, which are canceled by forward contracts.

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 1995
Austrian National Bank	250	0
National Bank of Belgium	1,000	0
Bank of Canada	2,000	0
National Bank of Denmark	250	0
Bank of England	3,000	0
Bank of France	2,000	0
Deutsche Bundesbank	6,000	0
Bank of Italy	3,000	0
Bank of Japan	5,000	0
Bank of Mexico[a]		
Regular swaps	3,000	1,000
Temporary swaps	3,000	0
Netherlands Bank	500	0
Bank of Norway	250	0
Bank of Sweden	300	0
Swiss National Bank	4,000	0
Bank for International Settlements		
Dollars against Swiss francs	600	0
Dollars against other authorized European currencies	1,250	0
Total	35,400	1,000

U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 1995
Deutsche Bundesbank	1,000	0
Bank of Mexico[a]		
Regular Swaps	3,000	1,000
Temporary Swaps	1,500	0
United Mexican States[a]		
Medium-Term Swaps		3,000
Total[a]		4,000

[a] Facilities available to Mexico comprise regular and temporary short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the Government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is $20 billion, less any outstanding drawings on the short-term facilities.

Table 4

DRAWINGS (+) AND REPAYMENTS (-) BY MEXICAN MONETARY AUTHORITIES

Millions of Dollars

	Outstanding as of December 31, 1994	January	February	March	Outstanding as of March 31, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	0.0	+500.0	+1,000.0	-500.0	1,000.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	0.0	+500.0	+1,000.0	-500.0	1,000.0
Medium term	0.0	0.0	0.0	+3,000.0	3,000.0

Data are on a value-date basis.