TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 1995

During the second quarter of 1995, the dollar rose 0.6 percent against the German mark, but declined 2.1 percent against the Japanese yen, 1.9 percent against the Canadian dollar, and 0.3 percent on a trade-weighted basis.[1] The dollar, which had declined sharply during the first quarter of 1995 as expectations of higher U.S. interest rates subsided, remained under pressure through much of April. The dollar subsequently stabilized as diminished expectations of strong economic growth in Japan and Germany prompted market participants to consider the prospect for lower interest rates in these two countries and as market participants began to focus on a G-7 communique released in late April. By June, foreign exchange market activity had declined substantially as the dollar proceeded to settle into fairly narrow trading ranges despite increased volatility in U.S. interest rate markets. By the end of the second quarter, the dollar had risen 2.8 percent and 6.1 percent from its historic lows against the mark and the yen, respectively.

The U.S. monetary authorities intervened in the foreign exchange markets on three occasions during the period—April 3, April 5, and May 31—purchasing a total of $3.6 billion against the German mark and the Japanese yen. On each occasion, the U.S. monetary authorities' purchases of dollars were divided evenly between the Federal Reserve System and the U.S. Treasury Department's Exchange Stabilization Fund (ESF). In other operations, the Mexican authorities drew a total of $5 billion on their medium-term swap facility with the ESF. The Bank of Mexico also renewed its short-term swaps with the Federal Reserve and the ESF, each for $1 billion, for an additional ninety days.

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 April 1995 through June 1995. Claudia Corra was primarily responsible for preparation of the report.

THE DOLLAR ENTERS THE QUARTER UNDER PRESSURE

Toward the end of the first quarter, the dollar continued to reach successive all-time lows against the yen and proceeded to close the quarter at ¥86.50 and DM 1.3735. Several factors weighing on the dollar at that time carried over into the second quarter. First, increasingly strong rhetoric from both sides surrounding the U.S.-Japan trade talks on autos and auto parts, as well as press reports that the United States was considering sanctions, appeared to herald a breakdown in the negotiations. Second, heavy dollar sales against yen by Japanese corporations and financial institutions continued in early April despite the April 1 start of the new Japanese fiscal year. Finally, market rumors of dollar sales by Asian central banks added pressure on the U.S. currency.

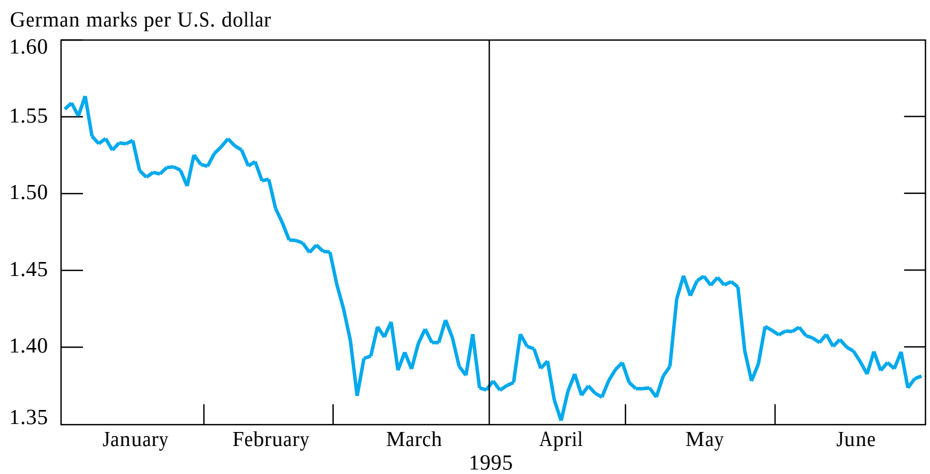
U.S. MONETARY AUTHORITIES PURCHASE DOLLARS AGAINST THE MARK AND THE YEN

On April 3, with the dollar trading at ¥86.50, the Federal Reserve Bank of New York's Foreign Exchange Desk entered the market in Asian trading on behalf of the U.S. monetary authorities, purchasing $500 million against the yen from dealers in Tokyo, Singapore, Hong Kong, and Sydney. The dollar rallied briefly following the intervention, but gave up all of its gains by the New York open. Later that day, at about 11:20 a.m. in New York, the Desk entered the market again, buying $750 million against the mark and $250 million against the yen. The dollar-yen operation was coordinated with the Bank of Japan. Treasury Secretary Rubin confirmed the operation, stating, "This Administration believes a strong dollar is in America's interest, and we remain

Chart 1

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

committed to strengthening the fundamentals that are ultimately important to maintaining a strong and stable currency." Overall, the U.S. monetary authorities purchased $1.5 billion during the course of the global trading day. However, the official purchases met sustained selling on any rally and the dollar ended the day slightly lower, at DM 1.3722 and ¥86.10.

On behalf of the U.S. monetary authorities, on April 5 the Desk again entered the market, at about 10:20 a.m., with the dollar trading at DM 1.3737 and ¥86.00. The Desk was joined in this operation by the Bundesbank and the Bank of Japan. Treasury Secretary Rubin confirmed the coordinated intervention, stating, "In effect, what you have is a shared commitment to a strong dollar, because it is in our interest and in the interests of the other economies of the world." During the day, the U.S. monetary authorities purchased $850 million against the mark and $250 million against the yen. The dollar initially rallied on the intervention, reaching intraday highs of DM 1.3860 and ¥86.63, before drifting lower in thin afternoon markets to close essentially unchanged at DM 1.3720 and ¥86.01.

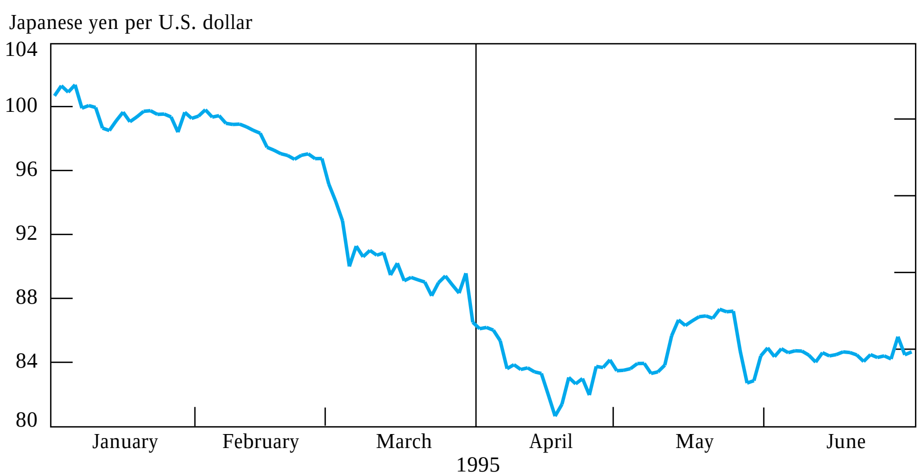
THE DOLLAR REACHES A NEW HISTORICAL LOW AGAINST THE YEN

Following these operations in early April, the dollar continued to decline against the yen. Increasingly, market participants viewed the sustained appreciation of the yen as a symptom of underlying structural problems in the Japanese economy. As a result, they began to focus their

Chart 2

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate

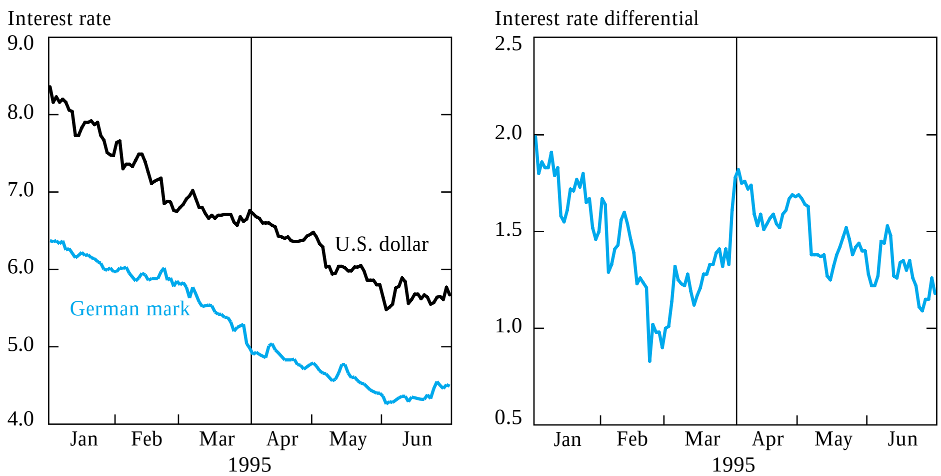


Source: Federal Reserve Bank of New York.

attention on the need for new monetary, fiscal, and deregulatory measures from the Japanese authorities to stimulate domestic demand and spur import growth. To help stem the yen's rise, the Japanese authorities unveiled an emergency economic plan on April 14. That day, the Bank of Japan also cut its official discount rate (ODR) by 75 basis points, to 1 percent. Despite the cut in interest rates, the dollar-yen exchange rate received little support from the package as many dealers viewed the fiscal and deregulatory measures as lacking in specifics. In addition, the absence of progress in the U.S.-Japan auto talks led U.S. officials to raise publicly the possibility of imposing trade sanctions against Japan, adding further downward pressure on the dollar. On Wednesday, April 19, the dollar reached a new low of ¥79.75.

That day, the dollar also reached a period low of DM 1.3472 against the mark—close to the historical low of DM 1.3438 reached on March 8, 1995. Other factors weighing on the dollar-mark exchange rate included heightened political concerns ahead of the first round of the French presidential election and regional elections in Italy, both scheduled for April 23, which led to renewed appreciation of the mark within Europe. Moreover, in the United States, expectations unwound for any further monetary tightening as a series of weaker-than-expected U.S. economic data releases—particularly declines in retail sales, industrial production, and housing starts—appeared to signal a clear slowdown in the pace of U.S. economic growth.

Chart 3
DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES
Implied by the Three-Month Eurodeposit Futures (September 1995 Contracts)



Source: Bloomberg L.P.

THE DOLLAR BEGINS TO STABILIZE

The dollar began to stabilize against both the mark and the yen in late April and early May. First, the overhang of long-dollar positions against the yen, evident at the start of the period, apparently began to dissipate. Second, anticipation of the April 25 meeting of G-7 finance ministers and central bank governors helped lift the dollar off its lows as dealers began to speculate about the possibility of a coordinated policy response to dollar weakness. Subsequent to the meeting, the G-7 finance ministers and central bank governors released a statement that included the following:

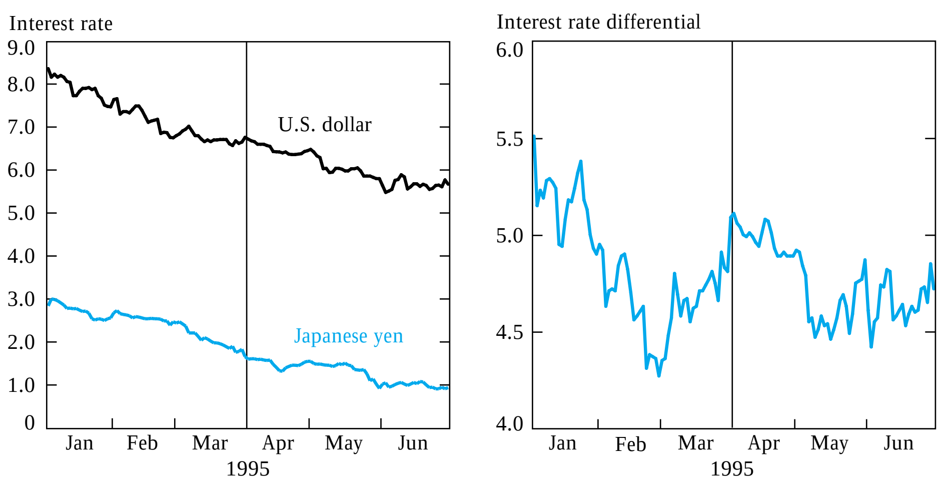
> The Ministers and Governors expressed concern about recent developments in exchange markets. They agreed that recent movements have gone beyond the levels justified by underlying economic conditions in the major countries. They also agreed that orderly reversal of those movements is desirable, would provide a better basis for a continued expansion of international trade and investment, and would contribute to our common objectives of sustained non-inflationary growth. They further agreed to strengthen their efforts in reducing internal and external imbalances and to continue to cooperate closely in exchange markets.

By the end of April, the dollar reached DM 1.3855 and ¥84.15.

Chart 4

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

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



Source: Bloomberg L.P.

In early May, international investors began to unwind their long German mark positions established during the first quarter, when exchange rate volatility had created a rush toward mark-denominated assets. First, investors began to increase their exposure to the higher yielding European markets, particularly after pre-election uncertainties in Italy and France receded, and these flows helped weaken the mark within Europe. Second, portfolio managers, many of whom were underweight U.S. assets, began to underperform their benchmarks when the U.S. bond market rally accelerated. As these investors in turn increased their exposure to the U.S. market, the dollar moved further off its lows.

Buoyed by these flows, the dollar remained steady despite further signs of weakness in the U.S. economy, particularly the April nonfarm payroll report, and associated speculation that the Federal Reserve might need to lower interest rates. Similarly, the dollar had little reaction to the May 10 announcement that, due to a breakdown in U.S.-Japan trade talks on autos and auto parts, the U.S. would initiate sanctions against Japan. The dollar's ability to trade through these ostensibly negative developments suggested to some market participants that, by early May, the dollar's recent problems had become fairly well discounted.

THE DOLLAR RALLIES SUDDENLY

On May 11 and May 12, several factors came together to propel the dollar higher. Early in the morning on May 11, the U.S. House Budget Committee approved a series of deficit reduction measures, causing some shortcovering on increased optimism over the U.S. fiscal outlook. During the European trading session, holders of short-dollar positions were further unnerved by market reports of dollar buying by some large Asian accounts. These factors helped lift the dollar through the technical resistance level of DM 1.3920, bringing the dollar to DM 1.4120 by the time the New York market opened. Later that morning, Bundesbank President Tietmeyer said that both Germany and its partner economies would suffer if the mark remained overvalued and added that, "We are not . . . interested in a sustained currency overvaluation." The dollar subsequently broke through the long-standing technical resistance level of DM 1.4225, causing the dollar to spike higher as dealers scrambled to cover substantial short-dollar positions. Over the two-day period, the dollar rose six pfennigs, to DM 1.4465, and three yen, to ¥86.65. Buoyed by the dollar's sharp rise, sentiment toward the U.S. currency turned quickly positive, a shift that encouraged some fresh dollar buying. On May 18 and May 22, the dollar reached intraquarter highs of DM 1.4618 and ¥87.72, respectively.

However, a lack of follow-through buying disappointed some market participants. The dollar was also adversely affected by weaker-than-expected U.S. durable goods data and existing home sales data, which prompted market participants to speculate on a possible interest rate ease by autumn. With market liquidity reduced due to holidays in Europe, the dollar fell sharply on May 25 and May 26, reaching DM 1.3740 and ¥82.45.

G-10 COUNTRIES INTERVENE TO SUPPORT THE DOLLAR

On the morning of Wednesday, May 31, with the dollar trading at DM 1.3850 and ¥82.70, the Desk entered the market in concert with the central banks of the other G-10 countries, purchasing dollars against marks and yen in an operation initiated by the U.S. monetary authorities. The U.S. monetary authorities' purchases totaled $500 million against the mark and $500 million against the yen.

The operation took the market by surprise, triggering a shortcovering rally. Treasury Secretary Rubin confirmed the intervention as consistent with objectives expressed in the April 25 G-7 communique. Market participants interpreted the operation as a signal of increased coordination by the major central banks and a reflection of their mutual desire for a stronger dollar. The dollar closed the day at DM 1.4135 and ¥84.40.

THE DOLLAR TRADES IN NARROW RANGES AGAINST THE MARK AND THE YEN DURING MOST OF JUNE

During June, the dollar settled in narrow trading ranges of DM 1.3880 to DM 1.4200 and ¥84.00 to ¥85.50. Dealers became increasingly reluctant to take risk, in part due to May's volatile dollar moves but also due to fears of further coordinated intervention ahead of the G-7 summit, held in Halifax, Canada, June 15-17. While the G-7 Halifax communique offered no new initiatives on the dollar, it endorsed the April statement of the G-7 finance ministers and central bank governors, which called for an "orderly reversal" of the dollar's decline.

Increased uncertainty over the near-term outlook for interest rate differentials with Germany and Japan also kept the dollar pinned in narrow trading ranges. The surprisingly weak May nonfarm payroll number released on June 2 reinforced market perceptions of slower U.S. economic growth and increased market participants' expectations of an ease in U.S. monetary policy. At the same time, market participants also began to focus on the prospects for rate cuts in Germany and Japan.

In Germany, weak industrial production data for February and M3 data for the first quarter introduced the idea of a possible Bundesbank ease before the Bundesbank council's mid-summer recess. In Japan, continued signs of stagnant demand and growing concerns over the health of Japan's banking system prompted fears that Japan would slip back into recession.

Throughout June, market participants increasingly took the view that the United States would impose trade sanctions on Japan on June 28, as announced in early May. Despite this possibility, the dollar-yen exchange rate traded with a steady tone, in part because market participants were unable to reach a consensus on the ultimate impact of sanctions. Some viewed the likely imposition of sanctions as negative for the dollar, while others held the opposite view, expecting that sanctions would effect a faster reduction in the Japanese trade surplus. The dollar briefly rallied following the June 28 agreement between the United States and Japan on autos and auto parts, but soon gave up its gains as dealers came to view the commitments involved as insufficient to reduce materially Japan's trade surplus. The dollar closed the quarter at DM 1.3812 and ¥84.65.

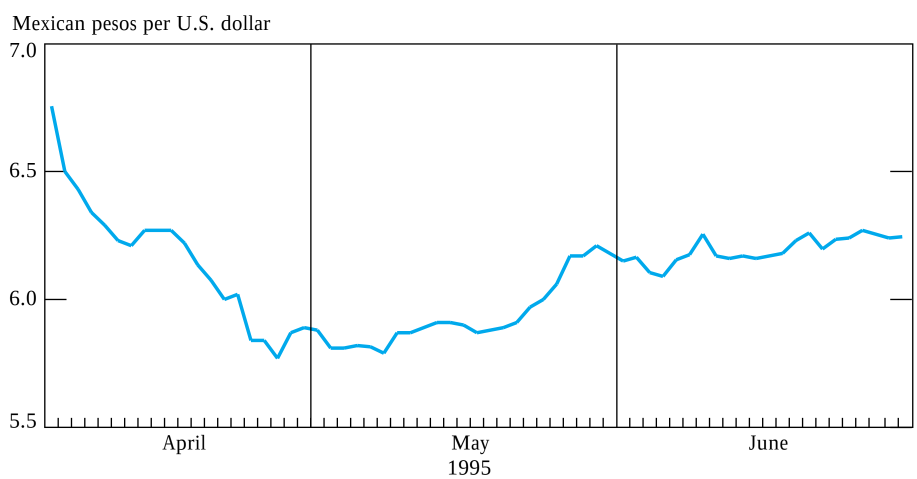
MEXICAN FINANCIAL MARKETS FIND A RANGE OF STABILITY

Over the period, Mexican financial markets recovered substantially as the economy began to show the effects of tough monetary and fiscal policies, and as some foreign investors cautiously returned to the Mexican markets. The Mexican peso steadied for the first time since the December 1994 devaluation, appreciating approximately 7.5 percent against the dollar during the quarter. Mexico's IPC stock market index recovered as well, rising 19.8 percent in local currency terms. Nominal interest rates fell dramatically, reflecting diminished inflation expectations. Mexico's inflation rate peaked in April and then started to decline, prompting most market analysts to anticipate further declines later this year.

Chart 5

THE DOLLAR AGAINST THE MEXICAN PESO

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

MEXICAN SWAP ACTIVITY

The Mexican authorities drew $3 billion on April 19 and $2 billion on May 19 on their medium-term facility with the ESF, bringing the total amount drawn by Mexico under the Medium-Term Stabilization Agreement to $8 billion. In addition, on May 3, the Bank of Mexico renewed its short-term swaps with the ESF and the Federal Reserve System for an additional ninety days, each for $1 billion.

CANADIAN MONETARY POLICY EASES

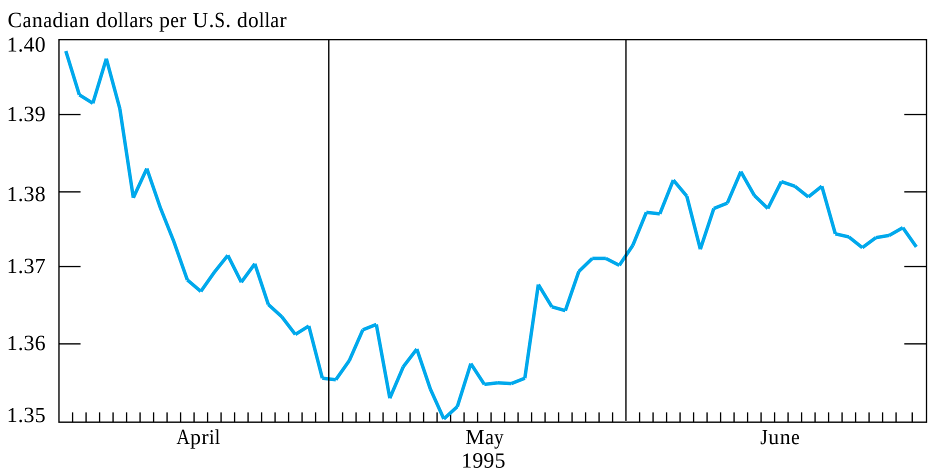
Canadian financial markets performed positively over the period as concerns over the federal budget deficit and fears of Quebec independence receded. The April 12 decision by Moody's to downgrade the federal government's foreign currency debt to Aa2 from Aa1, and its domestic debt to Aa1 from Aaa, was largely anticipated and had little market impact. The Canadian dollar, having opened the quarter at C$1.3990, reached a period high of C$1.3475 on May 15.

On May 8, the Bank of Canada began to ease monetary policy following a succession of weaker-than-expected Canadian economic data releases. Over the period, the call money target range declined a cumulative 75 basis points, to 7.00-7.50 percent. Initially pressured by the easier monetary policy stance, the Canadian dollar withstood the successive declines in interest rates and proceeded to consolidate in a range of C$1.3720-C$1.3820.

Chart 6

THE U.S. DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities intervened three times during the period, buying a total of $1.5 billion against yen and $2.1 billion against marks. On all three occasions, intervention operations were divided evenly by the Federal Reserve System and the ESF.

At the end of the period, the current values of the foreign exchange reserve holdings of the Federal Reserve System and the ESF were $24 billion and $29.1 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 June 30, the Federal Reserve System and the ESF held, either directly or under repurchase agreement, $9.8 billion and $13.5 billion, respectively, in foreign-government securities.

ENDNOTE

1. The dollar's movements on a trade-weighted basis against ten major currencies are measured using an index developed by staff at the Board of Governors of the Federal Reserve System.

Table 1

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

Millions of Dollars

	Balances as of March 31, 1995	Quarterly Changes in Balances by Source: Net Purchases and Sales[a]	Impact of Sales[b]	Investment Income	Currency Valuation Adjustments[c]	Balances as of June 30, 1995
Federal Reserve						
Deutsche marks	14,877.3	(1,050.0)	(0.1)	163.4	(54.6)	13,936.0
Japanese yen	9,416.9	(750.0)	1.1	45.5	217.9	8,931.4
Mexican pesos[d]	865.1	(14.3)	0.0	14.3	102.4[e]	967.5
Subtotal	25,159.2	(1,814.3)	1.0	223.2	265.7	23,834.8
Interest receivables[f]	127.3					126.0
Total	25,286.5					23,960.8
U.S. Treasury Exchange Stabilization Fund						
Deutsche marks	8,148.8	(1,050.0)	(0.1)	85.6	(31.1)	7,153.2
Japanese yen	13,196.3	(750.0)	1.1	85.9	310.5	12,843.9
Mexican pesos[d]	4,000.0	4,842.0	0.0	158.0	0.0[e]	9,000.0
Subtotal	25,345.2	3,042.0	1.0	329.5	279.4	28,997.1
Interest receivables[f]	88.0					72.8
Total	25,433.2					29,069.9

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 using 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. However, Mexico is obligated to maintain in dollar terms the value of ESF peso holdings resulting from Mexican drawings under the Medium-Term Stabilization Agreement.

[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 March 31, 1995		
Deutsche marks	3,747.2	1,569.8
Japanese yen	3,520.5	4,939.9
Total	7,267.7	6,509.8
Realized profits and losses from foreign currency sales[a] March 31, 1995 - June 30, 1995		
Deutsche marks	259.0	196.6
Japanese yen	284.7	285.1
Total	543.7	481.7
Valuation profits and losses on outstanding assets and liabilities as of June 30, 1995[b]		
Deutsche marks	3,433.5	1,342.0
Japanese yen	3,454.8	4,966.4
Total	6,888.3	6,308.5

Note: Figures might not sum because of rounding.

[a] As indicated in Table 1, foreign currency sales totaled $2,100.0 million against Deutsche marks and $1,500.0 million against Japanese yen.

[b] Valuation profits or losses are not affected 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 June 30, 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 June 30, 1995
Deutsche Bundesbank	1,000	0
Bank of Mexico[a]		
Regular swaps	3,000	1,000
United Mexican States[a]		
Medium-term swaps		8,000
Total[a]		9,000

[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 March 31, 1995	April	May	June	Outstanding as of June 30, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0[a] -1,000.0[a]	0.0	1,000.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0[a] -1,000.0[a]	0.0	1,000.0
Medium-term	3,000.0	+3,000.0	+2,000.0	0.0	8,000.0

Note: Data are on a value-date basis.

[a] Drawing of February 2 was renewed on May 3 for an additional ninety days.