Treasury and Federal Reserve Foreign Exchange Operations

November 1989 - January 1990

Movements of the dollar against individual currencies diverged widely between November 1989 and January 1990—a period when the rapid opening up of Eastern Europe benefited the German mark and a number of factors continued to weigh against the Japanese yen. The dollar experienced occasional bouts of upward pressure against the yen, and on several of these occasions the U.S. monetary authorities intervened to resist the dollar's rise against that currency, selling a total of $750 million for yen. On balance, the dollar declined against the mark and other European currencies, moving down 8½ percent, 7¼ percent, and 6 percent, respectively, against the mark, Swiss franc, and British pound. The dollar rose, however, about 1 percent against both the yen and the Canadian dollar. On a trade-weighted basis, as measured by the staff of the Federal Reserve Board of Governors, the dollar declined 5¾ percent

November through mid-December

The movement in dollar exchange rates against the European currencies was most marked during the first half of the reporting period. Positive sentiment toward the mark built rapidly following the opening on November 9 of the borders between East and West Germany. Market participants anticipated that an influx of East German immigrants would benefit the German economy by providing a new supply of skilled labor. At the same time, the new immigrants were expected to stimulate domestic demand and thereby spur higher mark interest rates as the Bundesbank sought to contain any potential inflationary pressures. More broadly, international investors focused on the prospects for greatly expanded market opportunities for German enterprises, and the German equity market surged in response to actual and anticipated capital inflows.

Against this background, the mark strengthened against all major currencies, and talk began to circulate, especially around the December 8-9 European Community summit, that exchange market pressures would lead to a revaluation of the mark within the European Monetary System (EMS) Germany has had large sustained trade surpluses against most of its European trading partners. Moreover, the German authorities were presumed to welcome any developments that would foster adjustment of the trade surplus or help dampen inflationary impulses to the economy Market participants believed that a realignment within the EMS would be viewed by Bundesbank officials as consistent with both of these objectives. Accordingly, speculative flows into marks increased, and reports circulated in the market that the Bundesbank's partner central banks were intervening to sell both dollars and marks to support their own currencies.

In the process, the dollar declined steadily against the mark. From DM 1.8415 at the beginning of November, the dollar declined by mid-December to around DM 1.7300, a drop of 6 percent.

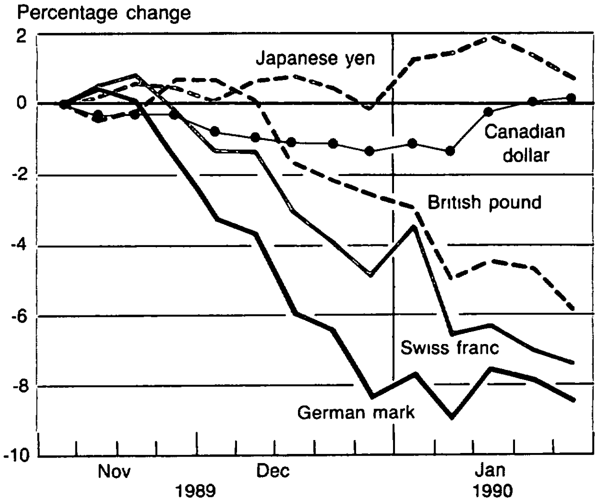
Against the yen, the dollar showed less of a trend, although it experienced upward pressure from time to time when there were reports of strong Japanese

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 George G Bentley was primarily responsible for preparation of the report

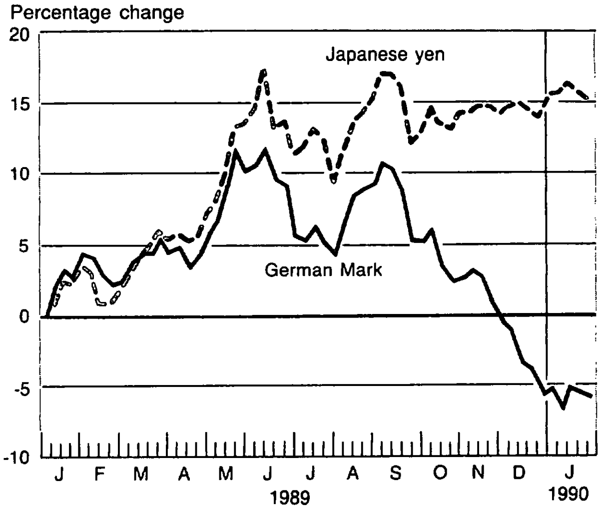
investor demand for portfolio and direct investments in the United States. Market participants were particularly impressed that Japanese interest in investing in dollar-denominated assets appeared to remain strong, even though market commentary about the outlook for U.S. and Japanese monetary policy implied that the interest rate differentials favoring the dollar would continue to narrow. Once in November and again in early December, the U.S. monetary authorities, in keeping with Group of Seven understandings on exchange rate cooperation, intervened to sell a total of $150 million against yen. These operations were coordinated with the Bank of Japan. By mid-December, the dollar was trading around ¥ 144.00, a level 3/4 percent higher than at the start of the reporting period.

Chart 1

Movements of the dollar against individual currencies diverged widely during the period, . . .



with the dollar declining against the German mark while experiencing bouts of upward pressure against the Japanese yen.



The top chart shows the percent change of weekly average rates for the dollar from November 1989. The bottom chart shows the percent change of weekly average rates for the dollar from January 1989. All figures are calculated from New York closing quotations.

Mid-December through January

In mid-December, one focus of market attention was the extent to which monetary policies in the United States and Japan might move in opposite directions. Economic statistics released through mid-December suggested that the U.S. economy was still sluggish and price pressures subdued, keeping alive expectations that U.S. interest rates would continue to move lower. The market's hope that the Federal Reserve had intended to signal a new easing of monetary policy in November had proved unfounded. But market participants were still confident that the Federal Reserve would continue to respond, as it had in preceding months, to evidence of a decelerating economy by allowing short-term interest rates to ease a bit further. Indeed, the Federal Reserve moved on December 20 to supply liquidity under circumstances that led market participants to believe that another such move had

Table 1

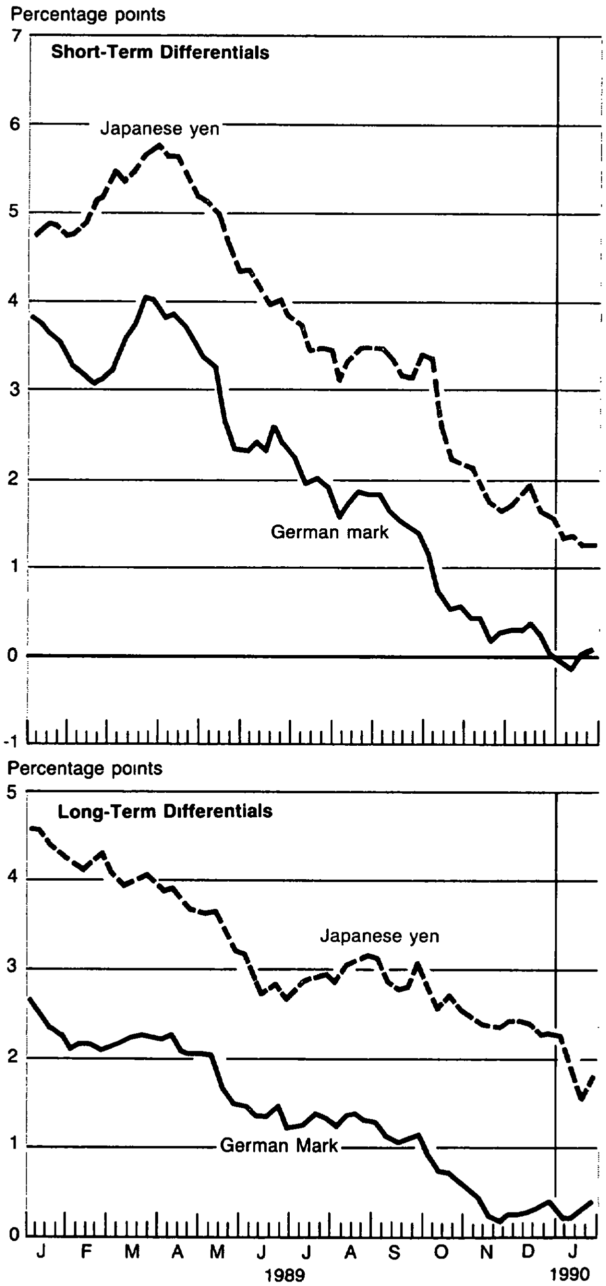
Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility January 31, 1990
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

Chart 2

Both short- and long-term interest rate differentials favorable to the dollar generally continued to narrow during the period.



The top chart shows weekly average interest rate differentials between three-month Eurodollar rates and three-month Euromarket deposit rates for marks and yen The bottom charts shows the weekly average differentials between U S government long-bond yields and German and Japanese government long-bond yields

occurred, and they anticipated that further moves would be forthcoming early in the new year.

In Japan, market participants had noted that short-term market interest rates had drifted progressively higher for several months, and that this trend had continued even after the Bank of Japan raised its discount rate in a surprise move in October Trying to anticipate the authorities' next action, dealers were sensitive to the possibility that the Bank of Japan might again raise its discount rate to follow up on the move in market rates. When such an action did not occur by mid-December, market participants began to suspect that these expectations might not be fulfilled They began to doubt that the authorities would move on interest rates at a time of impending changes in Bank of Japan leadership and so soon before parliamentary elections in early 1990. It surprised market participants, therefore, when Japanese newspapers reported on December 18 that the Bank of Japan would soon raise its discount rate, a move which indeed took place on December 25. When worldwide trading resumed following the Christmas holidays, the dollar declined to its period low against the yen at ¥ 141.70 on December 27 and a twenty-month low against the mark at DM 1.6752 on December 28 — 1 percent and 9 percent lower, respectively, than at the start of November

In early January, the market's assessment of the outlook for dollar interest rates began to change Accumulating signs that the U.S. economy had stopped decelerating began to raise doubts about both the timing and the extent of any further easing of U.S monetary policy Data released around the turn of the year suggested that growth might not be as fragile as had previously been thought and that the slowdown in some manufacturing sectors in late 1989 had not spilled over into other sectors of the economy Unseasonably cold weather led to a sharp run-up in oil prices and heightened concerns about renewed price pressures in the food and energy sectors The January 12 report of an unexpectedly large jump in U S producer prices was then interpreted as justifying concerns that little scope remained for further immediate declines in dollar interest rates. Later in January, the dollar received additional support as market participants focused on interpretive press reports indicating the Federal Reserve's continuing concerns with inflation and its more optimistic assessment of economic growth prospects in 1990. When trading resumed after the new year, this reassessment helped to move the dollar up from its lows of late December and provided continuing support to the dollar throughout the rest of January.

Against the yen, the dollar also benefited early in January from the potential uncertainties surrounding the upcoming parliamentary elections in Japan. Around the start of the new year, rumors of scandals involving members of the ruling Liberal Democratic Party once again unsettled the exchange markets, and the dollar reached its three-month high against the yen at ¥ 146 80 on January 3 With upward pressure on the dollar/yen exchange rate persisting throughout the first half of the month, the U S monetary authorities again intervened, on three days, to sell $600 million against yen These operations, which were coordinated with the Bank of Japan, brought the total of U.S intervention for the November-January period to $750 million, shared equally by the Federal Reserve and the U.S. Treasury. The dollar closed the period at ¥ 144.45, roughly 1 percent higher than at the start of November.

The dollar recovered little against the mark in early January At this time, talk revived of a revaluation

Table 2

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

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

Central Bank Drawing on the Federal Reserve System	Amount of Facility	Outstanding as of October 31, 1989	November	December	January	Outstanding as of January 31, 1990
Bank of Mexico†	700 0	700 0	—	—	—	700 0

Data are on a value-date basis
†Drawn as a part of the $2,000 million near-term credit facility established on September 21, 1989

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements with the Federal Reserve System

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

Central Bank Drawing on the Federal Reserve System	Amount of Facility	Outstanding as of October 31, 1989	November	December	January	Outstanding as of January 31, 1990
Bank of Mexico†	125 0	84 1	−6 5	−35 8	−7 7	34 1

Data are on a value-date basis
†Drawn as a part of the $2,000 million near-term credit facility established on September 21, 1989

Table 4

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

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

Central Bank Drawing on the U S Treasury	Amount of Facility	Outstanding as of October 31, 1989	November	December	January	Outstanding as of January 31, 1990
Bank of Mexico†	425 0	384 1	−6 5	−35 8	− 7 7	334 1
Central Bank of Bolivia‡	100 0	75 0	—	−75.0	—	0
Central Bank of Bolivia§	75 0	—	—	+75 0	−75 0	0
National Bank of Poland‖	200 0	—	—	+86 0	—	86 0

Data are on a value-date basis
†Represents the ESF portion of $2,000 million near-term credit facility
‡The facility, which was established for $100 million on July 11, 1989, was renewed on September 15, 1989
§The latest facility was established on December 29, 1989, and expired upon repayment on January 12, 1990
‖Represents the ESF portion of a $500 million short-term credit facility established on December 27, 1989

of the German mark within the EMS. In fact, an adjustment of the EMS was announced on January 5 to accommodate a request from the Italian government to bring the Italian lira within the narrow band of the exchange rate mechanism of the EMS. When this relatively modest adjustment occurred smoothly and without a generalized realignment, expectations of further near-term adjustments of exchange rates diminished. The dollar's low for the period was DM 1.6630 on January 8.

For the remainder of January, movements in the dollar/mark exchange rate were dominated by events in Eastern Europe. Although indications of heavy investor demand for the mark continued to support that currency, reports in mid-January began to reveal the fragility of the government structure in East Germany and elsewhere in Eastern Europe. Doubts also were voiced about political stability in the Soviet Union, especially in light of mounting separatist movements in several Soviet republics. These fears somewhat dampened the near-term enthusiasm for the mark, which traded with little clear direction for the rest of the month. The dollar closed the period against the mark at DM 1.6850.

Uncertainty about the implications of the widespread political and economic changes taking place was reflected in increased volatility in the world equity and

Table 5

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

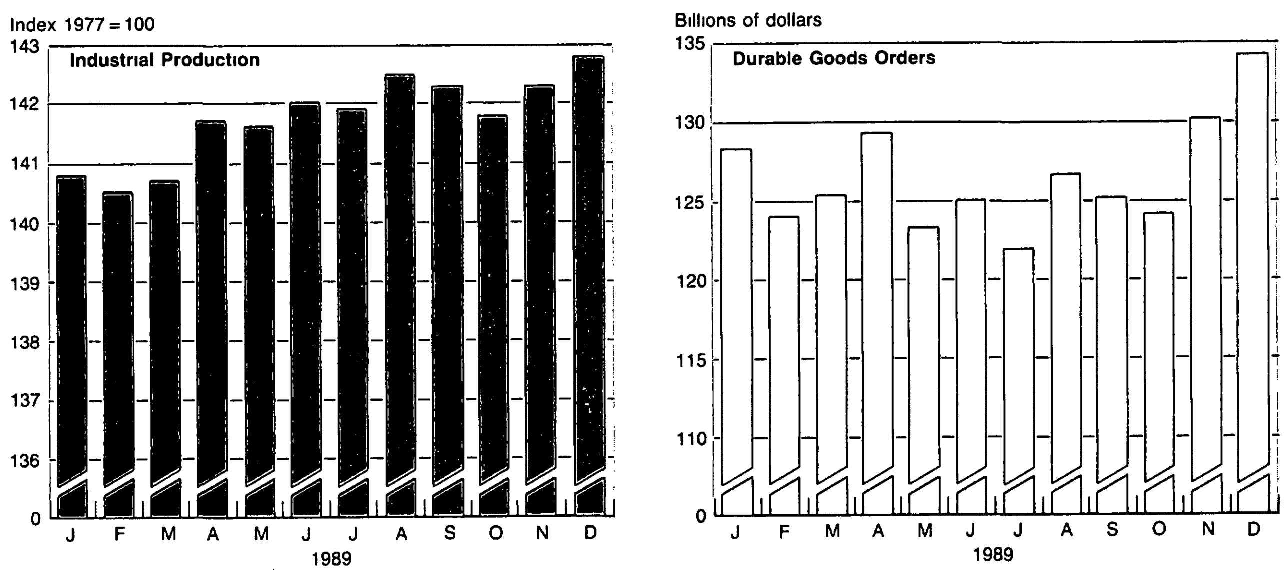
In Millions of Dollars

October 31, 1989 to January 31, 1990	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Realized	0	0
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1990	+2,709.6	+2,011.0

Data are on a value-date basis

Chart 3

In the latter half of the period, evidence about the performance of the U.S. economy began to raise doubts about both the timing and the extent of a further easing of U.S. monetary policy.



The left chart shows the monthly index of total U.S. industrial production, seasonally adjusted. The industrial production figures for October, November, and December were released on November 14, December 15, and January 17, respectively. The right chart shows monthly U.S. manufacturers' total new orders for durable goods, seasonally adjusted. The new orders figures for October, November, and December were released on November 22, December 22, and January 26, respectively.

bond markets during January. This volatility, together with convergence of long-term interest rates in the United States, Germany, and Japan and the attraction of new investment opportunities in Europe, revived concerns about the continued smooth financing of the U.S current account deficit. In this context, dollar rates from day to day were sometimes influenced by sharp movements in other financial markets. But for the month as a whole, these developments appeared to have little lasting effect on dollar exchange rates.

Against the Canadian dollar, the dollar trended lower throughout the three-month period until mid-January The dollar reversed its course at that time, when a move by the Bank of Canada to ease interest rates precipitated a sell-off of the Canadian currency

In other operations, the U.S. Treasury through the Exchange Stabilization Fund (ESF), together with the Bank for International Settlements (BIS) (acting for certain participating central banks), agreed to provide short-term support of $500 million to the National Bank of Poland for its economic stabilization and reform efforts, effective December 27. The ESF's share in the facility was $200 million. On December 28, Poland drew $86 million of the ESF's portion.

Also during the period, Bolivia on December 29 repaid in full its $75 million outstanding drawing of a $100 million facility established with the ESF On the same day, Bolivia drew the full amount of a newly established $75 million facility. The drawing was fully repaid upon maturity on January 12.

On four separate occasions, Mexico repaid portions of its outstanding swap commitments under the $2,000 million facility established with the U.S. monetary authorities, the BIS (acting for certain participating central banks), and the Bank of Spain. The Federal Reserve and ESF each received a total of $50 million

As of end January, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $2,709.6 million for the Federal Reserve and $2,011.0 million for the ESF (Valuation gains on holdings warehoused by the ESF with the Federal Reserve are excluded in the first figure and, correspondingly, included in the second figure.) These valuation gains represent the increase in 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 have a high degree of quality and liquidity A portion of the balances is invested in securities issued by foreign governments. As of end January, holdings of such securities by the Federal Reserve amounted to $7,180.4 million equivalent, and holdings by the ESF amounted to the equivalent of $7,477.6 million.