Treasury and Federal Reserve Foreign Exchange Operations

November 1991-January 1992

The dollar declined through the end of the calendar year, approaching historical lows against both the German mark and the Japanese yen as sentiment toward the prospects for U.S. economic recovery turned increasingly negative and large short-dollar positions were built up. Early in the new year, however, the dollar recovered somewhat as expectations about the economy tended to stabilize and short positions were significantly reduced. The dollar's decline was consequently pared back at the end of the period to a net 3½ percent against the mark and 4 percent against the yen. On a trade-weighted basis, the dollar declined 2¾ percent, on balance, over the period.[1] On January 17, the U.S. authorities sold $50 million against yen in their only intervention operation of the period.

November and December

As the period opened, skepticism was deepening about the prospects for a U.S. economic recovery. During the fall, it had become increasingly apparent that the tentative pickup in consumer spending following the Persian Gulf War had served merely to work off inventories and would not lead to a sustained pattern of growth. Then, just prior to the period, any remaining hopes of recovery suffered a severe blow when the Conference Board's index of consumer confidence took an unexpected plunge. Thus, by early November, market participants were beginning to question what mechanism might still be able to spark recovery, noting that up to that point monetary policy had been about the only instrument available to support the economy.

Under these circumstances, the November 6 announcement that the Federal Reserve had cut its discount rate ½ percentage point to 4½ percent was widely anticipated. But market observers noted that the Federal Reserve had now cut the discount rate five times in eleven months, producing a cumulative drop of 2½ percentage points, and they were beginning to doubt whether monetary policy could do much more to facilitate recovery. At the same time, they were sensitive to the political pressures generated by disappointment about the economy and concerned about what alternative measures might be proposed. Operators in the exchange markets, who were mindful that interest rate differentials were already widely unfavorable to the dollar, especially in relation to the German mark, felt a strong incentive to sell the dollar short.

The dollar declined as events in November and early December tended to confirm pessimism about U.S. economic prospects. In mid-November, when financial markets grew nervous about a congressional proposal to spur consumer spending by capping credit card interest rates, a sharp drop in U.S. equity prices dragged the dollar down for a few days. In late November and early December, release of data showing a further drop in consumer confidence and a much sharper than expected drop in payroll employment prompted another sell-off. Meanwhile, statistics for consumer price infla-

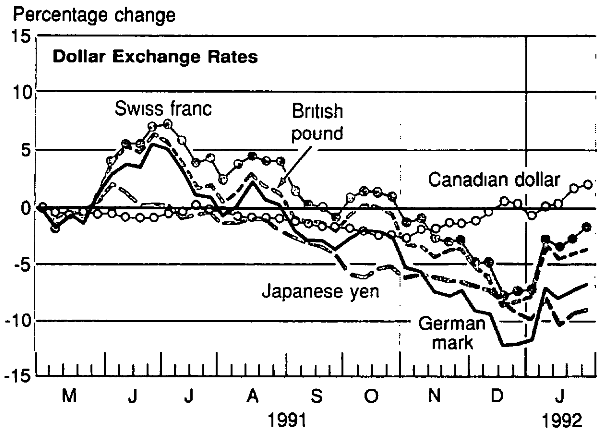
A report presented by William J McDonough, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account Robert Ennis was primarily responsible for preparation of the report.

[1]The trade-weighted value of the dollar is measured by the Federal Reserve Board staff's index

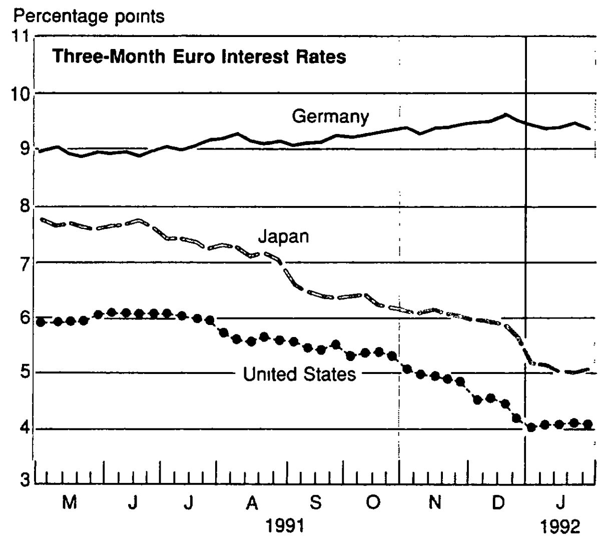
tion suggested to financial markets that the Federal Reserve had further leeway to ease monetary policy. In addition, speculation mounted that an excessively expansionist fiscal package might be forthcoming

Chart 1

During the first two months of the period, the dollar declined steadily amid evidence of weakness in the U.S. economy. After the new year, the dollar reversed course as market participants bought dollars to cover short positions.



During November and December, German interest rates firmed while U.S. and Japanese interest rates declined.



Notes The top panel shows the percentage change of weekly average rates for the dollar against designated currencies from May 3, 1991 The bottom panel shows weekly average U S, German, and Japanese three-month Euromarket interest rates from May 3, 1991

The dollar declined more against the German mark during this period than against other currencies. This was in part because interest rates in Germany were at, and were expected to stay near, historically high levels The German economy was still going through the transition associated with unification. Although the full force of the unity-related boom had dissipated earlier in the year, credit demands were still significant enough to keep monetary aggregate growth stronger than desired, and inflationary pressures were being kept alive by high wage demands. Accordingly, market participants believed that the German Bundesbank would seek to maintain a tight monetary policy stance. They interpreted the Bundesbank's money market operations as clear evidence of its intention to resist domestic and international pressures to ease. They saw this policy stance as implying that the large interest rate differentials against the dollar would be maintained for the foreseeable future. Market participants also suspected that there might be tension between the monetary policy objectives of Germany and those of other European countries where economic activity was generally decelerating more rapidly And they were wary of the possibility that these tensions might be reflected sooner or later in pressures within the exchange rate relationships of the European Monetary System (EMS), pressures that might spill over into the exchange markets more broadly—especially because final negotiations over eventual monetary union in Europe were scheduled for early December in Maastricht, the Netherlands

In this environment, two announcements by the Finnish authorities in mid-November, first, that the Finnish markka would float and, later, that it would be effectively devalued by about 12 percent, heightened the sense of exchange rate risk and boosted the German mark This episode served as a reminder that market pressures could at times force unwanted changes in exchange rate policy. In response, market participants rushed to reduce their holdings of assets denominated in those European currencies that had previously appeared attractive because of their high yields but that no longer carried a yield sufficient to compensate for their perceived exchange risk. The Swedish krona, for example, came under significant pressure, forcing the Swedish Riksbank to raise its marginal lending rate by a total of 7 percentage points by early December.

As market participants sought to shift funds from higher yielding currencies into the mark, the Exchange Rate Mechanism (ERM) of the EMS became strained. Market participants questioned whether an ERM realignment at the upcoming Maastricht summit could be avoided, raising further uncertainty about the effects such developments might have on the dollar Support for the mark was partly offset, from time to time, by concerns about the rapidly moving political situation in the Soviet Union and its possible negative effects on European countries, including Germany.

In the event, the Maastricht summit proceeded without incident and tensions among European currencies abated somewhat by mid-December. But the growing disparity in economic conditions between the United States and Germany persisted. As wage negotiations in Germany became more tense, the Bundesbank moved to increase interest rates both sooner and by a larger amount than the market had expected, announcing ½ percentage point rises for both its discount and Lombard rates on December 19. To avoid renewed exchange rate pressures, all other EMS central banks except the Bank of England followed this interest rate move, at least in part, over the next several days. By contrast, on December 20, the Federal Reserve reduced its discount rate by more than had been expected. The 1 percentage point cut brought the discount rate to 3½ percent, its lowest level since 1964. The Federal Reserve also appeared to signal that it had relaxed reserve pressures to an extent consistent with about a ½ percentage point decline in the federal funds rate.

As the foreign exchange market responded to these divergent moves in interest rates, the dollar continued its decline against the German mark. After moving irregularly lower in November and early December, the dollar moved down a further 3½ percent after December 19, hitting its low of the period of DM 1.5025 on December 27. At this level, the dollar had depreciated 10 percent from DM 1.6713 at the period's start and 18½ percent from its 1991 high.

The dollar's decline against the yen during November and December was more tempered than its decline against the mark. Evidence was accumulating that the pace of expansion in Japan was clearly decelerating. Japan's monetary growth was slowing, business confidence and investment intentions were weakening, and flagging domestic demand was being reflected in a widening of Japan's trade surplus. Market participants had therefore come to expect that the Japanese monetary authorities, who had eased official interest rates the previous July, would continue moving to a somewhat more accommodative monetary policy stance, so that U.S.-Japanese interest differentials would remain relatively stable. Indeed, official Japanese interest rates declined during these two months. The Bank of Japan trimmed its official discount rate once in mid-November and again at the end of December. At the same time, persistent weakness in Japan's equity market and political uncertainty caused by recent scandals also weighed on the yen at a time when the dollar was declining generally.

As a result, the dollar eased only moderately against the yen during November. Although the pace of decline quickened during December, the dollar rebounded at the end of the year to close December at ¥124.80, down on balance 4¾ percent from ¥130.75 at the beginning of the period.

January

By early January, the dissolution of the Soviet Union was introducing a new level of uncertainty, especially regarding the outlook for Europe. Although recurring rumors about the Soviet Union's financial condition had been a concern during the earlier months, market participants were now faced with the prospects of greater disarray stemming from changing political structures and moves to liberalize prices in January. Accordingly, the German mark was increasingly susceptible to selling pressures whenever new financial or political difficulties in the former Soviet Union became evident.

Meanwhile, market participants' assessment of the German mark and the German economy weakened considerably after the new year. Press commentary at that time increasingly focused on the sustained slowdown in Germany's expansion. Not only was the pace of domestic demand moderating, but export orders were also sagging under the weight of slowing economies in other industrialized countries. Market participants did not believe that this evidence would lead to any near-term moderation of the Bundesbank's tight monetary policies; indeed, the Bundesbank appeared still to be concerned about wage inflation and credit demands. But the evidence did suggest that the scope for further policy tightening was more limited and the prospects for growth in the coming year more clouded than previously perceived. Under these circumstances, market participants began to question whether interest differentials so unfavorable to the dollar would continue to widen.

Moreover, the financial markets appeared to react positively to the Federal Reserve's policy move of mid-December. The capital markets in the United States had responded favorably, with long-term interest rates easing and the stock market showing sustained strength. Also, the move appeared to have broken the pattern of market expectations concerning U.S. interest rates. Market participants were less certain that a weaker than expected U.S. economic statistic would immediately trigger another monetary policy action, and they were more likely than before to attribute weakness in the data to temporary factors. Moreover, they became mindful once again of the possibility that some statistics might show greater than expected strength.

The dollar's decline against the European currencies therefore lost momentum early in January. Market participants were aware that the dollar had been under virtually continuous selling pressure for almost six months. Many investors as well as foreign exchange market operators had portfolios that were heavily weighted in assets denominated in European currencies. The developments of November and December had led to an even greater concentration in these portfolios of assets denominated in German marks. Under the circumstances, there was a perception of a large risk of loss if market sentiment should switch in favor of the dollar and a perception of diminishing chance of gain if sentiment should remain negative to the dollar.

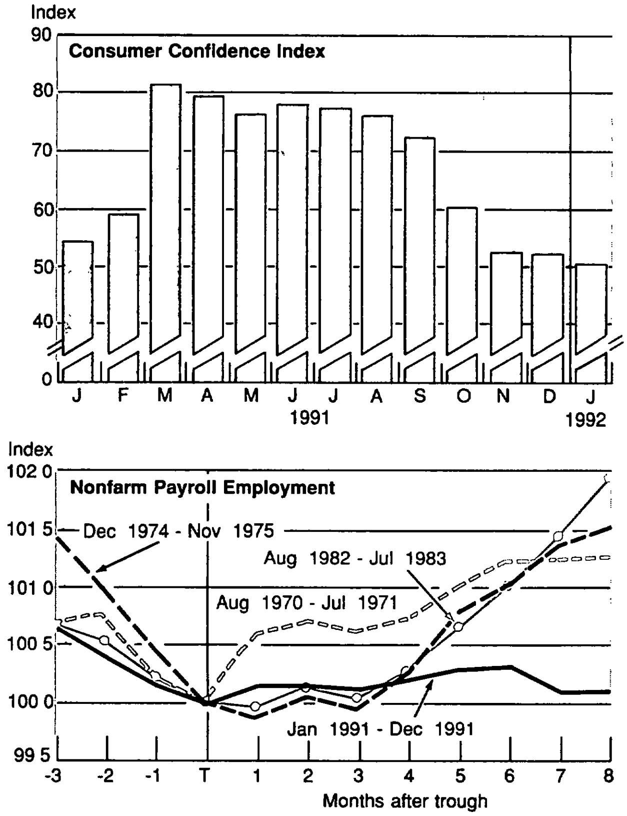
For a short while, however, the focus of market attention was the Japanese yen, a currency against which the dollar continued to decline in early January. Talk had already begun to circulate before the turn of the year that the United States and Japan would agree on some official action to support yen appreciation. Commentary about President Bush's trip to Japan to meet with Prime Minister Miyazawa suggested that the deteriorating condition of the U.S. economy would prompt the President to seek ways to reduce the U.S. trade deficit. There was also speculation that the Japanese government was looking for ways to counter weakness in Japan's stock market. In this context, an upward move in the yen's exchange rate was thought to be acceptable to both governments.

In response to these expectations, the dollar received only a temporary boost from the year-end cut in the Bank of Japan's discount rate. During the first five business days of January, the dollar resumed its downward trend against the yen, declining 1½ percent to a low of ¥122.80 on January 7, the day President Bush arrived in Tokyo. At this level, the dollar was down 6 percent from the start of the period and 13½ percent from its 1991 high.

Thereafter, expectations of official action to support the Japanese yen gradually faded. Market participants became less convinced during President Bush's stay in

Chart 2

Data released early in the period reinforced the negative outlook for U.S. economic recovery. Consumer confidence fell for a second consecutive month in November. Employment remained depressed, failing to show the rebound typical of previous recoveries.



Notes: The top panel shows the Conference Board's consumer confidence index, the shaded portion highlights data released during the period. The bottom panel shows nonfarm payroll employment data during each of the past four recessionary periods. The data are indexed with the trough month set at 100. Data for months six, seven, and eight of the current period were released on November 1 and December 6, 1991, and January 10, 1992, respectively.

Table 1

Federal Reserve Reciprocal Currency Agreements

In Millions of Dollars

Institution	Amount of Facility January 31, 1992
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
Deutsche Bundesbank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against other authorized European currencies	1,250
Total	30,100

Table 2

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

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

Central Bank Drawing on the U.S. Treasury	Amount of Facility	Outstanding as of October 31, 1991	November	December	January	Outstanding as of January 31, 1992
National Bank of Panama	143.0†	—	—	—	+143.0	143.0

Note: Data are on a value-date basis. Components may not add to totals because of rounding.

†Represents a bilateral credit facility with the National Bank of Panama that was established on January 28

Japan that the two countries would take immediate steps to strengthen the yen against the dollar. In keeping with these diminished expectations, the President and the Prime Minister agreed "that recent exchange rate movements were consistent with current economic developments." Nonetheless, market participants continued to focus on the possibility that a more generalized Group of Seven (G-7) policy towards the yen might be considered at an upcoming G-7 meeting on January 25. This possibility seemed credible to market participants because the yen had lagged behind rising European currencies during previous months and because this gap appeared to be generating economic and political concerns in a number of countries other than the United States. But in time, even this proposition lost standing in the marketplace.

When the G-7 meeting occurred in New York, the finance ministers and central bank governors issued a communiqué in which they agreed to intensify their cooperative efforts to strengthen world economic growth. With reference to exchange markets, the G-7 "agreed to continue to monitor market developments and reaffirmed their commitment to cooperate closely in exchange markets, thus contributing to favorable conditions for stable exchange markets and economic recovery." Market participants, however, were somewhat disappointed by the absence of any specific mention of the yen exchange rate.

As expectations of a yen appreciation subsided, market participants began to worry that there was an overhang of short-dollar positions against the yen as well as against the European currencies. Concerns about the technical position of the market came to the surface when the dollar did not fall off sharply on news that President Bush had become ill and had had to leave a state dinner during his Tokyo trip. The dollar's unusual lack of sensitivity to potentially disturbing news about an American president's health was interpreted as indicating how unwilling market professionals were to extend their short-dollar positions further and how great the risks were that the dollar might rise abruptly if a general effort to cover some of these short-dollar positions were to develop.

Table 3

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

In Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1991	+2,764.8	+1,132.6
Realized November 1, 1991-January 31, 1992	+75 0	+3.9
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1992	+3,615.2	+1,941 6

Note. Data are on a value-date basis.

Under these circumstances, the dollar drifted higher and staged an uneven recovery during most of January. In some instances, particular events triggered dollar buying: the announcement in January of a stronger than expected report for U.S. employment, testimony by Chairman Greenspan that further dampened expectations of an early easing of Federal Reserve monetary policy, and rumors out of the former Soviet Union of violence and political upheaval. In other instances, however, the dollar's rise was precipitated by the bidding of market professionals and their customers that reflected pent-up demand from previous months.

These pressures were particularly intense around mid-month. The dollar rose sharply to trade at levels that had not been expected just weeks before and that therefore threatened to unleash yet further rounds of bidding as market participants continued to cover their short positions. Under these circumstances, the U.S. monetary authorities entered the market on January 17, in an operation coordinated with the Japanese monetary authorities, selling $50 million against yen. The intervention sale was shared equally by the Federal Reserve and the Treasury's Exchange Stabilization Fund (ESF). After this operation, the dollar declined sharply. While subsequently finding support, it remained below the highs of DM 1.6355 and ¥129.37 reached on January 15. The dollar closed the period at DM 1.6125 and ¥125.75, down on balance over the three months by nearly 4 percent against the two currencies. At these levels, the dollar was about 12 percent below its 1991 highs against both the mark and the yen.

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In other operations, a total of $1,301 million in off-market spot and forward foreign currency sales, executed by the U.S. monetary authorities with foreign monetary authorities, settled during the period.

- The two remaining forward purchases of $551.1 million and $549.9 million against marks settled on November 27 and December 27, respectively, completing the $5,548.5 million of spot and forward dollar purchases from the Bundesbank. As previously reported, the operation was initiated in June 1991 to adjust the foreign currency reserves of the Federal Reserve and the ESF. For each transaction, 60 percent was executed for the account of the Federal Reserve and 40 percent for the ESF account.
- On November 22, the Federal Reserve agreed to purchase $200 million against German marks from a foreign monetary authority.

The ESF continued to purchase SDRs against marks in transactions by agreement with the International Monetary Fund (IMF). During the period, a total of $341.7 million equivalent of such SDR purchases settled, of which $41 million equivalent was transacted in the previous report period. The ESF also purchased a total of $443.4 million against sales of SDRs in transactions by agreement with foreign monetary authorities needing SDRs to pay IMF charges or for repurchases. An additional $50.6 million, which was transacted in October, settled in the period.

The Treasury agreed to participate in a special financing facility for the first time since March 1991. On January 28, the Treasury, through the ESF, established a $143 million bilateral credit facility to assist Panama in repaying its arrears to international creditors. Panama drew the full amount on January 31. The facility is scheduled to expire on March 20, 1992.

During the November–January period, the Federal Reserve and the ESF realized profits of $75 million and $3.9 million, respectively, from the sales of foreign currencies. As of the end of January, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $3,615.2 million for the Federal Reserve and $1,941.6 million for the ESF. The Federal Reserve and the ESF regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity. A portion of the balances is invested in securities issued by foreign governments. As of the end of January, the Federal Reserve holdings in these securities amounted to $8,938.8 million equivalent and the Treasury holdings amounted to $9,203.5 million equivalent, valued at end-of-period exchange rates.