Treasury and Federal Reserve Foreign Exchange Operations

February-April 1992

The dollar advanced against all major foreign currencies during the February to April period as an improved outlook for the U.S. recovery contrasted with evidence of economic and financial fragility abroad. The dollar's rise was most pronounced against the mark and other European currencies early in the period. By late February, however, the dollar had leveled off against the mark, and the focus of market attention shifted to the yen. During late March and April, the dollar largely consolidated its gains, trading in a relatively narrow range against both currencies. On balance, the dollar gained 2¼ percent against the German mark, 6 percent against the Japanese yen, and 2¼ percent on a trade-weighted basis as measured by the staff of the Federal Reserve Board.

Shifts in short-term interest rate differentials reflecting relative economic and financial conditions in the major industrial countries supported the dollar against the yen but weighed on it against the mark. In the United States, most short-term interest rates rose slightly in February and March as U.S. economic reports encouraged a more optimistic view of the strength of the U.S. recovery and then eased modestly during April to end the period 10 to 15 basis points below their opening levels. Meanwhile, short-term interest rates in Japan declined by 50 basis points over the period amid evidence of weakening domestic demand and turbulence in Japanese stock and bond markets. In Germany, short-term interest rates over the period edged up by almost 40 basis points as government borrowing remained strong and market concerns about inflationary pressures failed to diminish. As a result, the interest rate gap favoring foreign short-term investments over their U.S. counterparts tended to narrow with Japan and widen with Germany.

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February to mid-March

The dollar's strong rise during the first half of the reporting period reflected an emerging sense of optimism among market participants about the U.S. economy. At the outset, sentiment toward the economy was far from upbeat. Market participants were concerned about the failure of the recovery to spur significant job growth and about the ongoing weakness in consumer and business confidence. Indeed, the dollar opened the period with a soft tone, touching period lows of DM 1.5570 and ¥124.70 following the release of a much weaker than expected January employment report on February 7.

Anxiety about the U.S. recovery, however, soon gave way to the view that the economy was strengthening. In mid-February, the release of two sets of highly favorable economic reports covering the month of January, one on retail sales and the other on housing starts, led to a rapid run-up of the dollar. Then in early March a series of positive reports, beginning with the February survey of purchasing managers, pushed the dollar up to levels not seen since the fall of 1991.

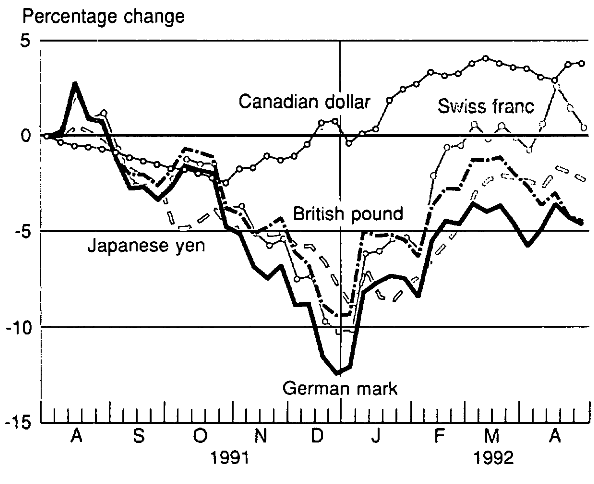
Statements by U.S. officials around this time reinforced the market's more positive outlook towards the U.S. economy and spurred the view that further monetary easing was unlikely in the near term. Market participants paid particular attention to statements by the Federal Reserve Chairman suggesting that monetary easing already in the pipeline was adequate. As the outlook for the U.S. economy improved, short-term interest rates began to back up, and the narrowing of unfavorable interest rate differentials helped underpin the dollar.

The dollar's rise was most pronounced against the mark and other European currencies early in the period, although its advance against the yen continued longer and was ultimately of greater magnitude. The different behavior of the dollar against these two currencies in early to mid-February reflected both special factors affecting Germany and Japan and market expectations that the authorities might intervene in the currency markets to strengthen the yen.

In early February, the market's view that German interest rates had peaked and might begin to decline as early as midyear helped support the dollar against the mark and other European currencies. This view was based on two assumptions. Market operatives believed that the strong reaction both within Germany and throughout Europe to the Bundesbank's move to tighten monetary policy in December 1991 would discourage further tightening for some time. Meanwhile, growing evidence of a German economic downturn appeared to make additional policy action unnecessary.

Chart 1

The dollar continued to rise against most currencies in the early part of the period and subsequently traded in a narrow range.



Notes: The chart shows the percentage change of weekly average rates for the dollar from August 1, 1991. All figures are calculated from New York closing rates.

As February progressed, however, several developments led market participants to reconsider the view that the German authorities would soon move to lower interest rates. These included reports showing a pick-up in money supply growth and inflation in January as well as signs that wage negotiations in Germany in 1992 would result in settlements larger than those anticipated earlier. In this environment, market participants first pushed the date of expected policy easing farther into the future and then began to anticipate the possibility of additional tightening. As a result, the dollar leveled off against the mark at about DM 1.65.

The prospect of continued tight German monetary policy was seen in the market as having implications for other European currencies as well. With respect to the Swiss franc, the Swiss authorities had chosen, in late 1991, not to take part in the German-led tightening of monetary policies in Europe in order to avoid aggravating Switzerland's year-long recession. During January, the franc managed to remain stable against the mark. But in mid-February, when expectations for an early ease in Germany monetary policy waned, the Swiss franc began a sharp decline against the mark, prompting heavy intervention by the Swiss authorities and an eventual rise in Swiss interest rates that exceeded any comparable rise in German rates. The experience of the Swiss franc revealed to market participants the risks facing the authorities in other European countries experiencing weak growth, such as the United Kingdom, if they eased policy without a corresponding move in Germany.

Many of the factors that boosted the dollar against the European currencies were also operative in the market for the yen. Evidence of a pronounced slowdown in the Japanese economy mounted. From early to late February, interest rate differentials against the yen, although adverse to the dollar, narrowed considerably and did so to a greater extent than against the mark. Nevertheless, in February the dollar firmed less strongly against the yen than against the mark.

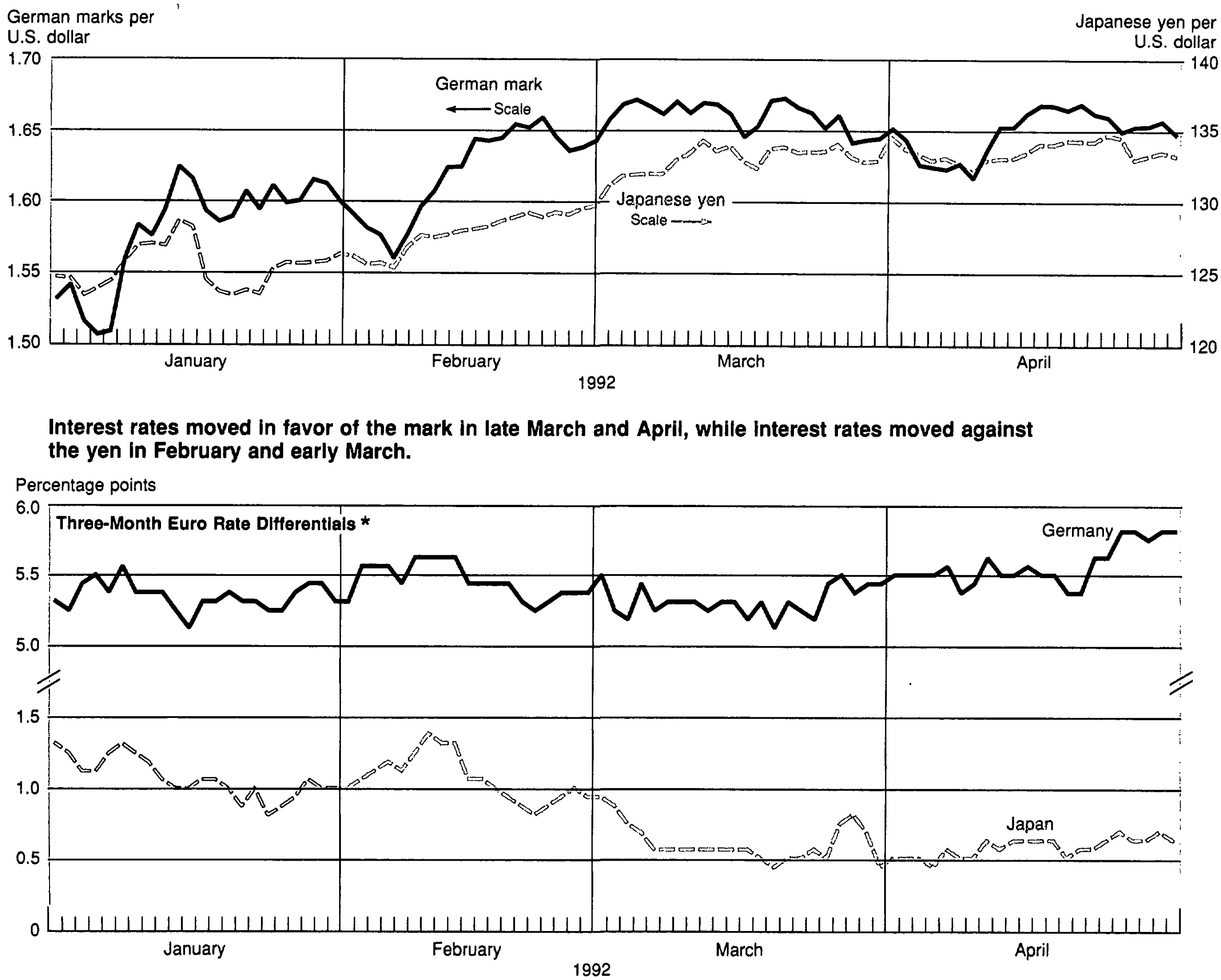
The dollar's tendency in February to appreciate less against the yen than against the mark in part reflected expectations of official intervention to support the yen. At the time, Japanese officials were making increasingly strong and frequent statements indicating that they would not tolerate an excessive yen decline. In the event, the Desk entered the Tokyo market on February 17, in cooperation with the Japanese authorities, to sell a total of $100 million against yen. This operation was followed on February 20 with the sale, again in Tokyo, of an additional $50 million against yen. The February 17 operation was financed by the U.S. Treasury. The February 20 operation was financed equally by the U.S. Treasury and the Federal Reserve.

By late February, the dollar's relative movements against the mark and the yen reversed. Having stabilized against the mark, the dollar continued to gain against the yen amid increasing signs of fragility in the Japanese economy and financial system and worries over the potential political ramifications of ongoing financial scandals. Concerns about the Japanese economy were reflected in an additional decline in Japanese short-term rates in late February and March, which served to further reduce interest differentials unfavorable to the dollar.

At the same time, market participants concluded that the growing negative sentiment towards the Japanese currency would not be reversed by intervention that was not perceived as concerted and sustained. Thus, they increasingly shrugged off the possibility of intervention. In this environment, the dollar continued the steady advance against the yen that had begun in early Janu-

Chart 2

The dollar rose more sharply against the mark in February but continued to rise against the yen through mid-March.



Note: Values shown in top panel are closing daily rates.

*Foreign rate minus U.S. rate.

ary, rising to levels around ¥134 by mid-March.

Mid-March through April

After mid-March, the dollar traded in relatively narrow ranges against the mark and the yen The absence of clear direction in dollar exchange rates reflected several offsetting trends. On the one hand, reports on the U.S. economy reinforced the view that the recovery would remain weak by historical standards and thus offered little to justify a further dollar appreciation. On the other hand, governments abroad appeared increasingly preoccupied with domestic difficulties, a situation interpreted by market participants as precluding joint official action to bring the dollar lower. With dollar markets relatively lackluster through April, position takers tended to focus on movements of the European currencies against one another, particularly the British pound and Swiss franc relative to the mark.

Market sentiment toward the U.S. economy underwent a subtle shift in March and April. Although data generally reinforced the earlier view that a recovery was under way, market participants tended to focus less on the fact of recovery and more on its strength Many questioned whether the recovery would be vigorous enough to warrant a reversal in the long-term downtrend in U.S. interest rates. Moreover, many of the economic reports that appeared favorable on the surface were attributed to special factors. For instance, the increase in February payrolls, though significantly higher than expected, was largely discounted on the grounds that a big increase in retail jobs may have partially reflected problems in seasonal adjustment. Subsequent favorable data on retail sales, housing starts, and home sales were similarly attributed to onetime factors Thus market participants were generally reluctant to push the dollar up further. Only when tensions mounted between the United Nations inspection team and Iraq over Iraq's nuclear weapons program did the dollar move above DM 1 68, the perceived top of its trading range, to reach its period high against the mark of DM 1 6860 on March 20. The dollar reached its period high against the yen of ¥134.97 on April 2.

By early April, doubts about the strength of the U.S. recovery intensified. The March employment report released on April 3 showed a small decline in private nonfarm payrolls. Meanwhile, the M2 measure of money supply, having risen sharply earlier in the year, fell toward the lower end of its target range, a decline that elicited expressions of concern by several U S. officials On April 9, the Federal Reserve relaxed reserve pres-

Chart 3

Japanese interest rates declined throughout the period, while German interest rates rose towards the end. U.S. rates firmed in early March but then reversed course.

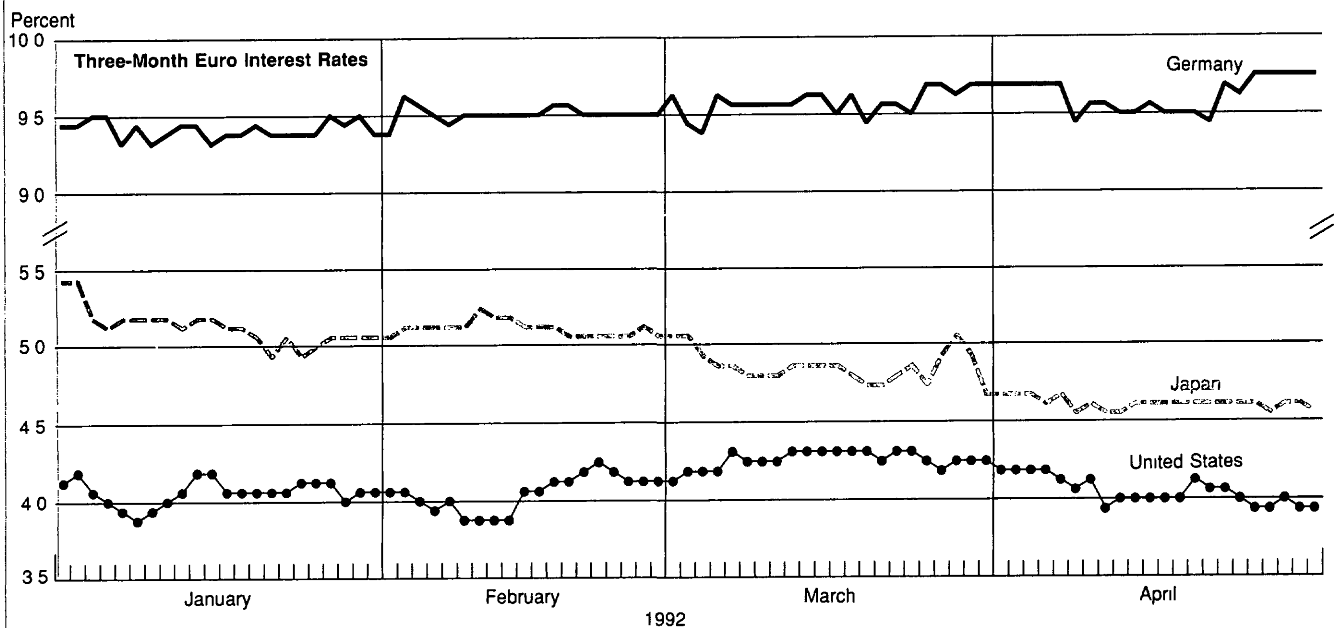
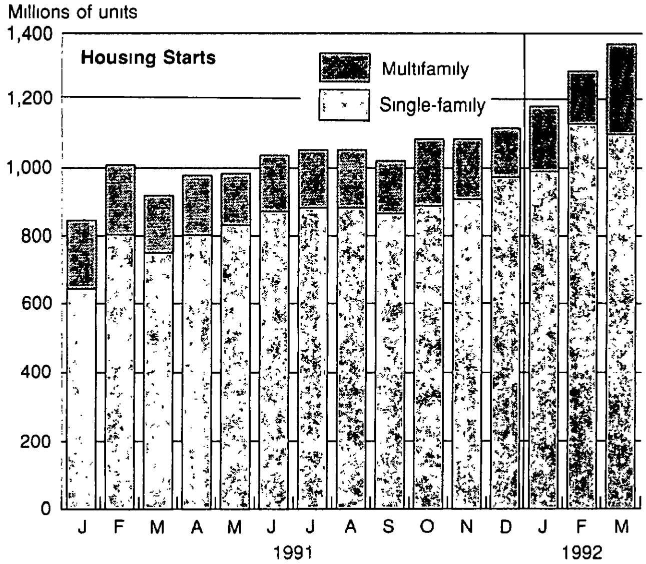
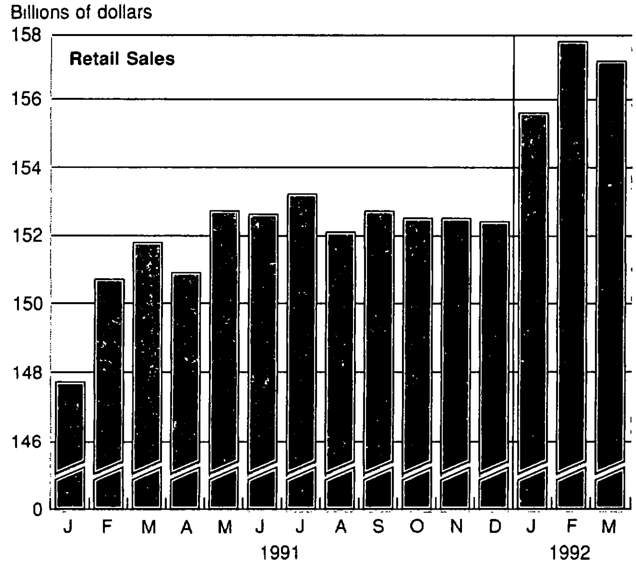


Chart 4

Housing starts and retail sales data released during February suggested that the recovery was proceeding apace.

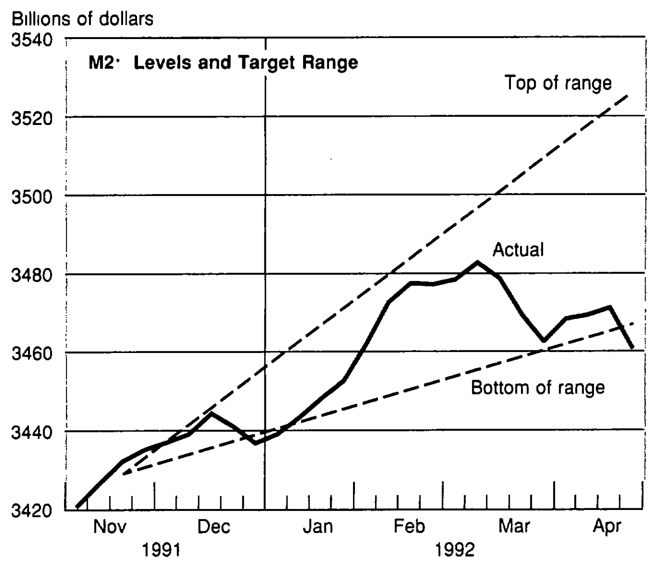


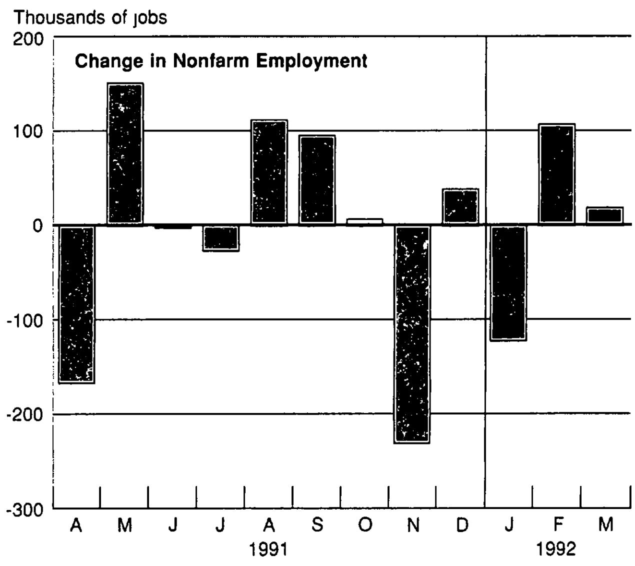


Note Data are as of end-April The retail sales figures were released on February 13, March 12, and April 14, while the housing starts data were released on February 19, March 17, and April 17, respectively

Chart 5

Data released during April indicated substantial weakness in money supply and employment.





Notes Data for the left panel are as of May 15, 1992 In this panel, the target range for 1992 starts in the middle of November 1991 Data for the right panel are as of April 3, 1992 sures to an extent consistent with about a ¼ percentage point reduction in the federal funds rate. In this environment, other U.S short-term interest rates declined, interest rate differentials moved against the dollar to varying degrees, and the dollar eased Although the dollar received temporary support from favorable data in mid-April, most notably a sharp reduction in the February merchandise trade deficit, on balance the dollar was unchanged against the mark during April

During the latter half of April, the mark received support from a rise in German short-term interest rates, a rise that helped further widen the already substantial advantage accruing to short-term mark investments The rise in German rates occurred as the Bundesbank issued warnings about the inflationary threat of rapid money supply growth and high wage settlements and as its operations served to lift rates on domestic securities repurchase agreements. Indeed, inflationary concerns were reinforced during April by German public sector employees' call to strike and by an unexpected acceleration of M3 money supply growth from 8.6 percent in February to 9 4 percent in March—a rate well above the upper end of the Bundesbank's target range for M3 growth of 5 5 percent

Meanwhile, the British pound came under pressure within the Exchange Rate Mechanism (ERM) of the European Monetary System in response both to concerns over elections in the United Kingdom scheduled for April 9 and to the rise in German interest rates. Market participants expressed concern that the British election would not result in a clear mandate for any party or that a new government might not be committed to sterling's current parity within the ERM Despite the protracted weakness of the U K economy in the months leading up to the election, the strong downward pressure, coupled with sterling's position near its lower intervention limit in the ERM, precluded any easing of monetary policy. In the end, sterling rose strongly following news of the Conservative party's April 9 election victory. Financial markets also rallied, with a key stock market index gaining about 6 percent after the results were announced

The dollar remained remarkably stable against the yen during mid-March and April despite evidence of continuing weakness in the Japanese economy and mounting financial woes. This stability occurred against a backdrop of relatively steady short-term interest rate differentials, with short-term rates in both the United States and Japan declining by roughly the same amount The decline in Japanese rates occurred throughout the period, both in anticipation of and in further reaction to the 75 basis point Japanese discount rate cut on April 1.

The decline in Japanese stock prices appeared to have largely offsetting influences on the dollar-yen exchange rate. On the one hand, weakness in the stock market was seen both as increasing the prospects for

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility April 30, 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 January 31, 1992	February	March	April	Outstanding as of April 30, 1992
National Bank of Panama	143 0†	143 0	−85 0	−58 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 and repaid in full on March 11

Table 3

Net Profits and Losses on United States Treasury and Federal Reserve Foreign Exchange Operations

In Millions of Dollars, Profits (+) or Losses (−)

	Federal Reserve	U S Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1992	+3,615 2	+1,941 6
Realized February 1-April 30, 1992	0 0	0 0
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1992	+2,653 1	+1,039 5

Note Data are on a value-date basis

further easing in Japan and as discouraging continued investment from abroad On the other hand, market participants believed that Japanese institutions were repatriating funds from abroad to bolster bank capital ratios and that these capital inflows were providing support for Japanese currency Subsequently released data indicated that Japanese residents were indeed large net sellers of foreign securities in March, resulting in an increase in net inflows to Japan

Toward the end of the month, the possibility of official action to support the yen again became a focus of market attention with the approach of the Group of Seven (G-7) meeting in Washington in the last week of April G-7 finance ministers and central bank governors issued a statement on April 26 noting that "the decline of the yen since their last meeting was not contributing to the adjustment process." Against the backdrop of this statement and subsequent comments by both U S and Japanese officials, the dollar declined from the higher end to the lower end of the ¥132 to ¥135 range in which it had traded for most of April

* * *

In other operations, the U S Treasury Exchange Stabilization Fund (ESF) repurchased the remaining $2 billion equivalent of foreign currencies that it had warehoused with the Federal Reserve. The ESF also received repayment in full from Panama on a $143 million special swap facility initiated in late January As of end-April, the U S monetary authorities had no forward transactions outstanding.

As of the end of April, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $2,653 1 million for the Federal Reserve and $1,039.5 million for the ESF. There were no realized profits or losses during the period 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 April, the Federal Reserve's holdings of these securities totaled $8,776.8 million equivalent and the Treasury's holdings totaled $8,852 7 million equivalent, valued at end-of-period exchange rates