# Treasury and Federal Reserve Foreign Exchange Operations

## May-July 1992

The dollar came under strong downward pressure during the May-July period, declining over 10 percent against the German mark and most other European currencies, nearly 5 percent against the Japanese yen, and over 8 percent on a trade-weighted basis.[1] The dollar's decline was a product of weaker than expected data on U.S. growth and employment and related declines in both short- and long-term dollar interest rates, which contrasted with an upward tendency in European interest rates.

Expectations mounted during the period that the German authorities would engineer a further rise in short-term mark interest rates, thereby adding to the already impressive interest differential in favor of mark investments over their dollar counterparts. At the same time, the defeat of a referendum in Denmark to ratify that country's participation in European monetary and political union triggered large and occasionally destabilizing flows of funds out of the higher-yielding European currencies and into the mark. Although the impact of these flows was felt primarily within Europe, demand for marks reinforced the other pressures weighing on the dollar.

Meanwhile, market participants became convinced during the period that the Japanese authorities were eager to see a further appreciation of the yen. This belief, supported by numerous official statements from Japan, the United States, and Europe and by rumors of central bank intervention to support the yen, added periodically to the market's willingness to sell dollars.

With the dollar rapidly approaching historical lows, a July summit meeting of the leaders of the Group of Seven (G-7) nations heightened the market's focus on official policies toward exchange rates. The absence of any reference to exchange rates in the summit's concluding communiqué, coupled with what appeared to be ambiguous official statements during and following the meetings, led some market participants to conclude that the G-7 was unconcerned about the dollar. Shortly thereafter, the German authorities announced an increase in their discount rate. While the German discount rate increase did not lead to a significant rise in other mark interest rates, market participants saw the move as potentially opening the door to a further widening of interest rate differentials unfavorable to the dollar.

In this environment, market participants began to adopt large short-dollar positions on the premise that the dollar faced little risk of an appreciation but good prospects of a further decline. This perception of the dollar as a one-way bet, coupled with the absence of any source of strong support for the dollar in the marketplace, caused the currency's decline to accelerate. Concerned with developments in the market, the U.S. monetary authorities intervened on July 20 in concert with a number of foreign central banks, purchasing $170 million against the mark. The concerted operation calmed the market, and the dollar traded

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

quietly through the remainder of the period.

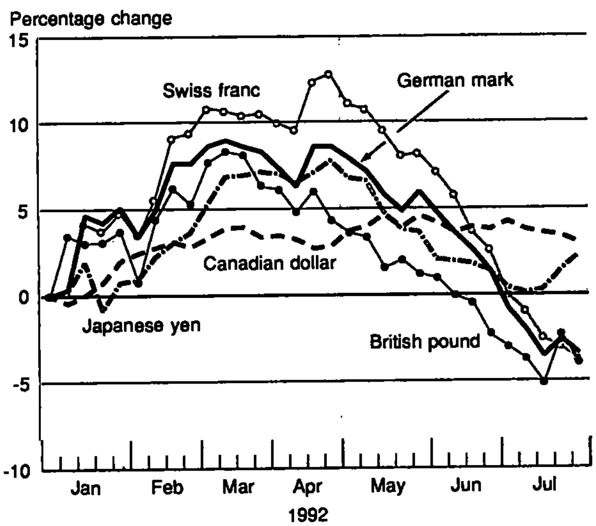
**Dollar trends lower in May amid mixed views on U.S. economy**

Sentiment toward the dollar during the month of May reflected the market's outlook on the U.S. economy—uncertain but hopeful. Earlier in the year, the dollar had risen sharply as market participants grew more confident about the strength and sustainability of the U.S. recovery. From lows of just above DM 1.50 against the mark and ¥122 against the yen in January, the dollar climbed to highs of around DM 1.68 against the mark and ¥135 against the yen in early spring. By April, however, doubts about the durability of the recovery began to reemerge. Indeed, market participants viewed a decline in the U.S. federal funds rate in April as a sign of renewed official concern over weaknesses in the U.S. economy, and the dollar opened the period at just below DM 1.68 and just above ¥133.

Data on U.S. economic activity in May continued to paint a mixed picture of the recovery. The April employment report, released on May 8, showed an unexpected pickup in payrolls and a slight drop in the unemployment rate to 7.2 percent from 7.3 percent in March. But other reports, including those on M2 money supply growth, reinforced the view that growth would be sluggish at best. Meanwhile, press reports and market commentary suggested that the Federal Reserve had shifted its policy from a bias toward easing to a more neutral stance. With these developments proving insufficient to sustain all of the market's hopes for recovery, the dollar edged lower in relatively directionless markets. Having reached highs for the period of DM 1.6510 against the mark and ¥133.75 against the yen in early May, the dollar eased back to end the month around DM 1.60 and ¥128.

Chart 1

**The dollar came under strong downward pressure during the May-July period in response to weaker than expected data on U.S. growth and employment and associated declines in dollar interest rates.**




Notes: The chart shows the percentage change of weekly average rates for the dollar from December 31, 1991. All figures are calculated from New York closing rates.

In May, the dollar traded more softly against the yen than it did against the mark. This divergence occurred against a backdrop of developments that appeared on balance to support the yen and weigh somewhat on the mark. With regard to the yen, official statements and rumors of central bank intervention were seen as indicating general support within the G-7 for Japan's stated preference for a strong yen. Market participants recalled that the G-7, at its April meeting, had stated that "the decline of the yen ... was not contributing to the adjustment process." Although the yen had appreciated somewhat since then, the market read signals from policy makers as evidence that the authorities sought, or would at least tolerate, further gains. For a time, this view provided underlying support for the Japanese currency.

The mark, in contrast, appeared to be falling out of favor among investors amid domestic political uncertainty and labor strife. Although many market participants were wary of the risk of further monetary tightening in Germany, the view that German policies were not having their desired impact weighed on the mark. Indeed, several countries in the European Monetary System (EMS) took advantage of the mark's relative weakness to ease monetary conditions in the hope of stimulating economic activity at home.

**Danish vote on single European currency heightens demand for mark**

Investor sentiment toward the mark shifted abruptly in early June with the defeat of a referendum in Denmark on the Maastricht treaty—a treaty outlining steps toward European union, including economic and monetary union and the creation of a single European currency. Market participants viewed the Danish rejection as a blow to the prospects for a single European currency in the foreseeable future. In their view, abandonment of the agreed timetable for monetary union would loosen the tight discipline that the Maastricht treaty had implied for European inflation rates and budget deficits and thus raise doubts about the likelihood of continued convergence of European fiscal and monetary policies. In this environment, funds that had been invested in higher yielding European currencies such as the Italian lira, French franc, and Spanish peseta were suddenly pulled out and reinvested in the mark. As the mark rose sharply within the Exchange Rate Mechanism of the EMS, talk of an imminent EMS realignment reemerged.

At the same time, expectations regarding German monetary policy began to shift. The conclusion of wage negotiations in Germany in mid-May left market participants wondering what the implications of the wage settlements would be for German monetary policy and whether the Bundesbank would now begin to ease policy. While few observers expected an immediate decline in rates, many believed easier policy would be forthcoming before the end of the year. In late May and in June, however, a series of official statements out of Germany appeared to quash these hopes. Pointing to rapid money supply growth, high wage settlements, and persistently high inflation results, Bundesbank officials cautioned that German interest rates would remain high for the foreseeable future.

**Dollar's decline against mark accelerates in June and July amid weaker outlook for U.S. economy**

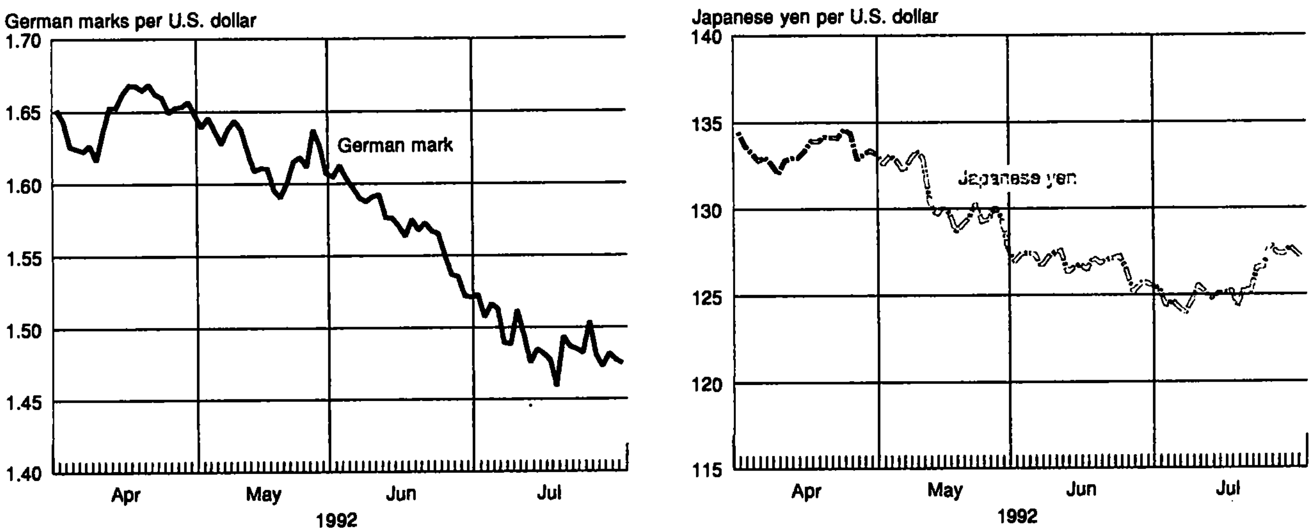
Meanwhile, expectations began to build that monetary policy in the United States would again be eased. Expectations of lower U.S. interest rates grew in tandem with mounting evidence that the U.S. recovery was not gaining strength. In early June, the Labor Department reported a smaller than expected gain in payroll employment and a rise in the unemployment rate to 7.5 percent from 7.2 percent. Subsequent data on both inflation and real economic activity reinforced the view that the authorities had room to guide short-term rates lower. Notwithstanding these reports, market participants continued to believe that the Federal Reserve was reluctant to ease policy without conclusive evidence of renewed weakness in the U.S. economy.

On July 2, with the release of yet another month's figures for employment, the market became convinced that conclusive evidence of weakness was at hand. A report of an unexpected decline in payroll employment and large rise in the unemployment rate to 7.8 percent triggered a sharp decline in dollar exchange rates as dealers anticipated a policy response by the Federal Reserve. Within the hour, the Federal Reserve cut its discount rate ½ percentage point to 3 percent and relaxed reserve pressures to an extent consistent with about a ½ percentage point reduction in the federal funds rate. In response, dollar interest rates began to soften, and interest rate differentials between the dollar and most major foreign currencies moved further against the U.S. currency.

Uncertainty surrounding the U.S. presidential campaign reinforced, for a time, the market's negative sentiment toward the dollar. In June and early July, foreign investors expressed confusion and concern over the potential implications of a three-way presidential race. The possibility that elections in November would not

Chart 2

**By July, the dollar was trading within five percent of its historical lows against the German mark and Japanese yen.**



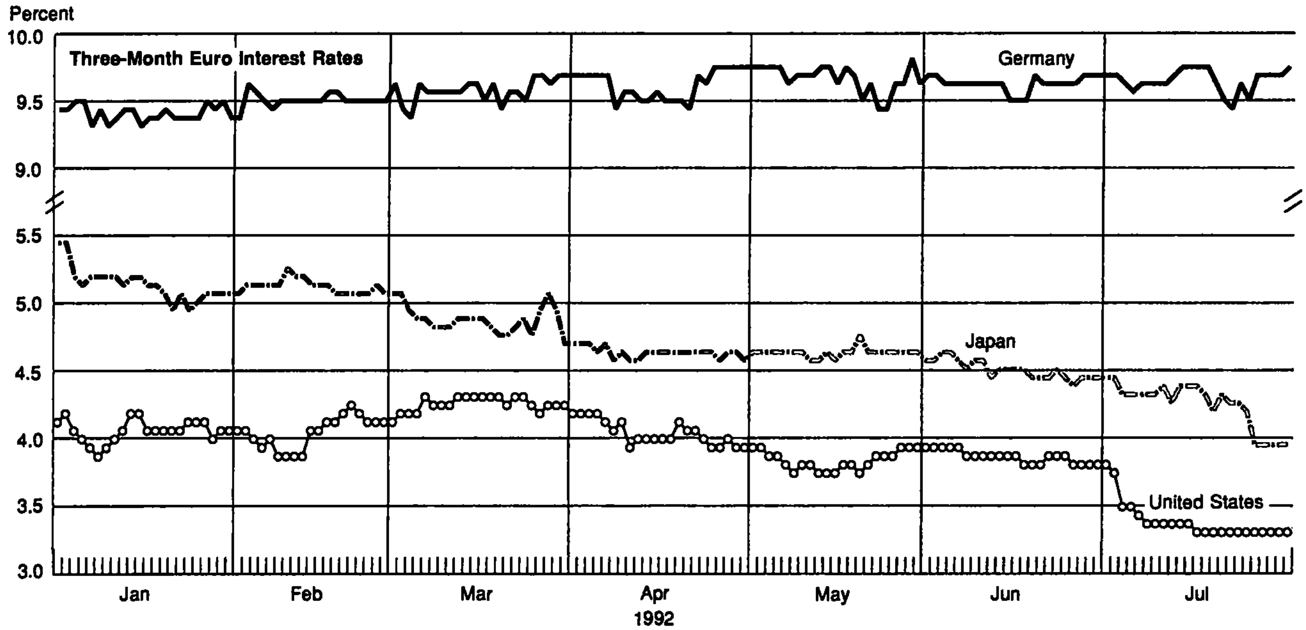
result in a clear victory for any candidate was enough, when combined with other factors weighing on the dollar, to discourage inflows into U.S. stock and bond markets.

**Concerns over fragility of Japanese economy and stock market weigh on yen**

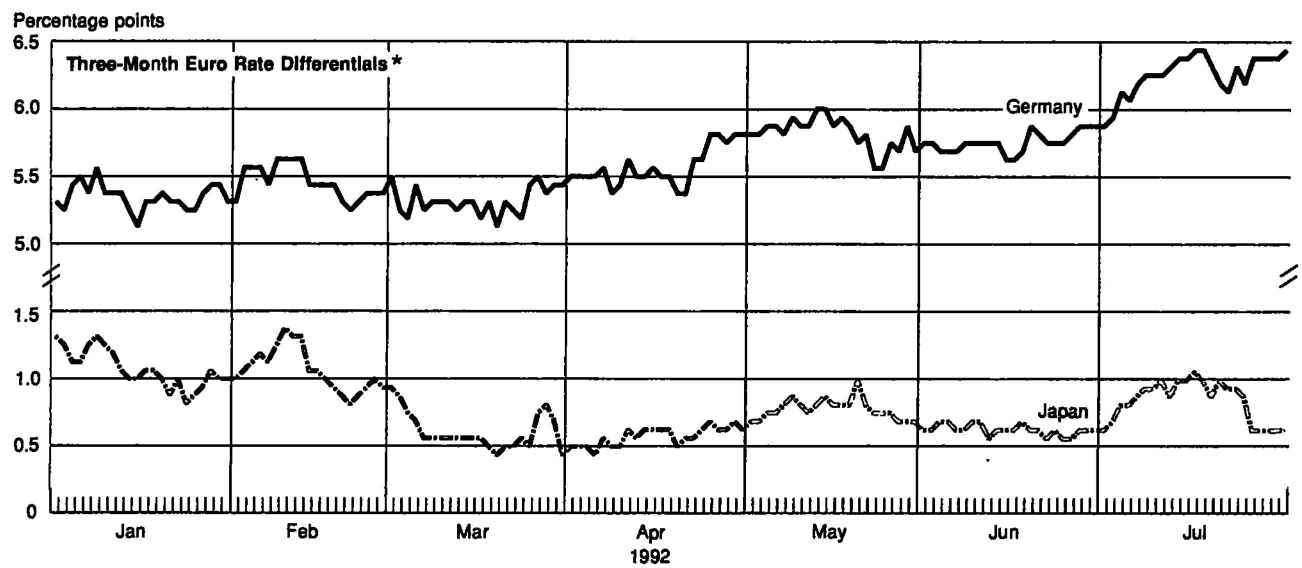
As the dollar began declining more rapidly against the mark and other European currencies, its decline against

Chart 3

**Short-term interest rates declined in the United States and Japan.**




**As a result, the interest rate differentials unfavorable to the dollar widened against the German mark while holding steady against the Japanese yen.**




* Foreign rate minus U.S. rate.

the yen moderated somewhat. The dollar's relative resilience against the yen occurred as Japanese interest rates softened in response to evidence of increasing weakness in the Japanese economy and worries over the fragility of the Japanese equity market. In mid-June, release of the Japanese central bank's quarterly survey of business conditions reinforced these concerns. The report, long regarded as an important indicator of future growth, showed an unexpectedly large decline in business sentiment. While the Japanese authorities described the report as reflecting the economy's downward adjustment at its most severe point, the Japanese stock market responded by tumbling to a new five-and-a-half-year low, and short-term Japanese interest rates declined as market participants anticipated easier Japanese monetary policy.

### G-7 summit sharpens focus on official policy toward exchange rates

By early July, the dollar was trading below its level at the beginning of the year and within 5 percent of its historical lows against the major currencies. Official comments on exchange rates, when they occurred, appeared to express satisfaction with the movement in exchange rates. Against this background, the July 7-8 meeting of G-7 heads of state took on added importance in the market's view as participants sought clarification of the authorities' attitude toward the dollar.

The prevailing view in the weeks leading up to the meeting was that the authorities would call for a further appreciation of the yen to help resolve global trade imbalances. But with the dollar near all-time lows, some believed that the resulting communiqué might in fact contain language supportive of the dollar. In the event, the communiqué contained no direct reference to exchange rates. Comments by individual officials after the meeting, including a statement by Secretary Brady that the United States "is not seeking to depreciate the dollar," did not entirely dispel the overall impression that the G-7 authorities were unconcerned with the decline in the dollar. In this environment, the dollar began to decline sharply.

Within days of the G-7 summit, market attention shifted to a meeting of the Bundesbank Council in Frankfurt on July 16. Expectations that the German authorities would announce a tightening of monetary policy escalated in the days leading up to the meeting. But the announcement of a ¾ percentage point increase in the German discount rate—and subsequent increases in official rates in Italy, the Netherlands, Austria, Belgium, and Spain—nonetheless jolted the markets. Although the discount rate hike did not spur significant gains in money market rates and the Bundesbank denied that a Lombard rate increase would necessarily follow, market participants believed that the move paved the way for a subsequent rise in short-term mark rates. As a result, downward pressure built against the dollar and against the currencies of some EMS members.

In these circumstances, the U.S. monetary authorities intervened on July 20 in concert with a number of foreign central banks to support the U.S. currency. In several rounds of dollar buying, the Foreign Desk of the Federal Reserve Bank of New York purchased $170 million against marks. The intervention was fi-

Table 1
**Federal Reserve Reciprocal Currency Agreements**
In Millions of Dollars

| Institution | Amount of Facility July 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
**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 April 30, 1992 | +2,653.1 | +1,039.5 |
| Realized April 30–July 31, 1992 | +336.2 | +114.4 |
| Valuation profits and losses on outstanding assets and liabilities as of July 31, 1992 | +4,536.7 | +2,503.9 |

Note: Data are on a value-date basis.

nanced equally by the Federal Reserve and the U.S. Treasury. Market participants responded strongly to the evidence of close cooperation among U.S. and foreign monetary authorities, and the dollar rose from its period low of DM 1.4470 against the mark in the morning of July 20 to over DM 1.48 later that day and to DM 1.50 by the end of that week. Pressures within the Exchange Rate Mechanism of the EMS also eased somewhat following the concerted central bank initiative.

The dollar held steady against the mark during the remainder of the period and rose slightly against the yen. Statements by German officials that the discount rate hike was not the first step of a broader tightening of monetary policy, and evidence that the German authorities were operating in their domestic markets to resist a rise in short-term mark interest rates, gradually dampened the market's expectation of higher German interest rates. Meanwhile, continued sharp declines in Japanese stock prices fueled expectations of monetary easing in Japan, and these expectations were realized on July 27 with the announcement of a ½ percentage point cut in the Japanese discount rate. In this environment of steady to lower interest rates abroad, pressures on the dollar subsided. The dollar closed the three-month reporting period at DM 1.4745 against the mark and ¥127.10 against the yen.

* * * *

In other operations during the period, the U.S. monetary authorities purchased a total of $6,176.6 million against marks in a series of off-market spot and forward transactions with the Bundesbank. The arrangement with the Bundesbank was similar to a transaction conducted last year. It followed an agreement between the U.S. and German authorities that their respective holdings of German marks and dollars were in excess of current needs and that it was to their mutual advantage to reduce those holdings. Sixty percent of the marks were sold for the account of the Federal Reserve, with the remainder sold for the account of the U.S. Treasury. A spot transaction of $2,503.9 million settled on May 22 and a forward transaction of $743.7 million settled on July 21. The remaining forward transactions are to be settled later in the 1992 calendar year.

During the May-July period, the Federal Reserve realized profits of $336.2 million, of which $316.5 million resulted from settlement of portions of the aforementioned off-market currency transaction. The U.S. Treasury realized profits of $114.4 million, including $101.2 million resulting from settlements under that transaction. Cumulative bookkeeping or valuation gains on outstanding foreign currency balances at the end of July were $4,536.7 million for the Federal Reserve and $2,503.9 million for the Exchange Stabilization Fund (ESF). These valuation gains represent the increase in the dollar value of outstanding currency assets valued at end-of-period exchange rates, compared with 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 that have a high degree of quality and liquidity. A portion of the balances are invested in securities issued by foreign governments. As of the end of July, holdings of such securities by the Federal Reserve amounted to the equivalent of $9,315.9 million, and holdings by the Treasury amounted to the equivalent of $9,213.6 million, both valued at end-of-period exchange rates.