Treasury and Federal Reserve Foreign Exchange Operations

November 1993–January 1994

The dollar appreciated modestly against most major currencies during the November-January period. It rose 2.9 percent against the German mark, 0.1 percent against the Japanese yen, and 0.5 percent on a trade-weighted basis.[1] The U S. monetary authorities did not undertake any intervention operations during the period.

The dollar ends the period virtually unchanged against the yen

After opening at ¥108.64 on November 1, the dollar rose against the yen in thin year-end markets, reaching a high of ¥113 55 before coming down to end the period unchanged Initially, the dollar rose as market participants turned their attention to Japan's lingering recession and to the prospect of interest rate differentials moving in favor of the dollar This shift in focus was prompted by continued weakness in Japanese money supply growth, employment, industrial production, and retail sales. Moreover, Japanese equity prices dropped sharply in November—with the Nikkei stock index falling nearly 17 percent over the course of the month—and remained volatile throughout December. Growing pessimism over the economic outlook for Japan, as well as the uncertain prospects for the Hosokawa government's long-awaited fiscal stimulus package, helped fuel expectations of an additional cut in the Bank of Japan's Official Discount Rate (ODR).

Over the course of December, trading activity in the dollar-yen exchange market started to ebb as first corporate and then interbank participants pulled back from the market ahead of the year-end holidays Japanese exporters, who regularly sell dollars to the market to hedge their foreign currency receivables, were notably absent towards the end of the month. In this environment, market conditions were increasingly characterized by the dominance of technically oriented traders who bought up the U.S currency in anticipation of further dollar gains, and the dollar rose gradually through December from a low of ¥107 37 to a high of ¥112.05.

In late December, Treasury Secretary Bentsen was asked whether he saw a need to intervene in the foreign exchange market to stem the yen's decline He responded that he did not think intervention would be necessary, but rather thought that the foreign exchange market would focus on Japan's substantial trade surplus when determining the relative value of the dollar and the yen. Secretary Bentsen expressed concern that Japan was not meeting its commitment to achieve domestic demand-led growth and a significant reduction in its external surplus He expanded on this view in early January when he said that the proper way for Japan to address its economic imbalances was through a combination of effective fiscal stimulus and market-opening measures, not through a depreciation of the yen.

The dollar reached its period high of ¥113.55 on January 5, but soon drifted lower when expected movements in interest rates failed to materialize. Market participants turned their attention to the shifting fortunes of Japanese political reform and to bilateral trade talks with the United States,

This report, presented by Peter R Fisher, Senior Vice President, Federal Reserve Bank of New York, and Manager for Foreign Operations, 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 November 1993 through January 1994 Nicholas Pifer was primarily responsible for preparation of the report

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

but they were unable to develop a lasting view on how the success or failure of these two initiatives would affect exchange rates Reflecting the market's uncertainty about the near-term direction of the dollar against the yen, the implied one-month option volatility for the dollar-yen exchange rate spiked higher in the second half of January At the same time, foreign investors purchased the equivalent of $10 5 billion in Japanese equities during January; these flows contributed to a sharp rebound in Japanese stock prices and helped support the yen.

The upper house of the Japanese Diet passed Prime Minister Hosokawa's political reform bill on January 29, permitting the government to turn its attention to other policy issues As the period came to a close, U S -Japan trade talks were continuing and the Japanese government was reportedly at work on a record stimulus package for the economy Reflecting the positive implications of such a package for Japanese domestic demand growth, the Nikkei surged nearly 8 percent on the last day of the period and expectations of additional interest rate cuts in Japan receded even further These factors helped strengthen the yen, and the dollar closed at ¥108 65 on January 31

The dollar appreciates modestly against the mark

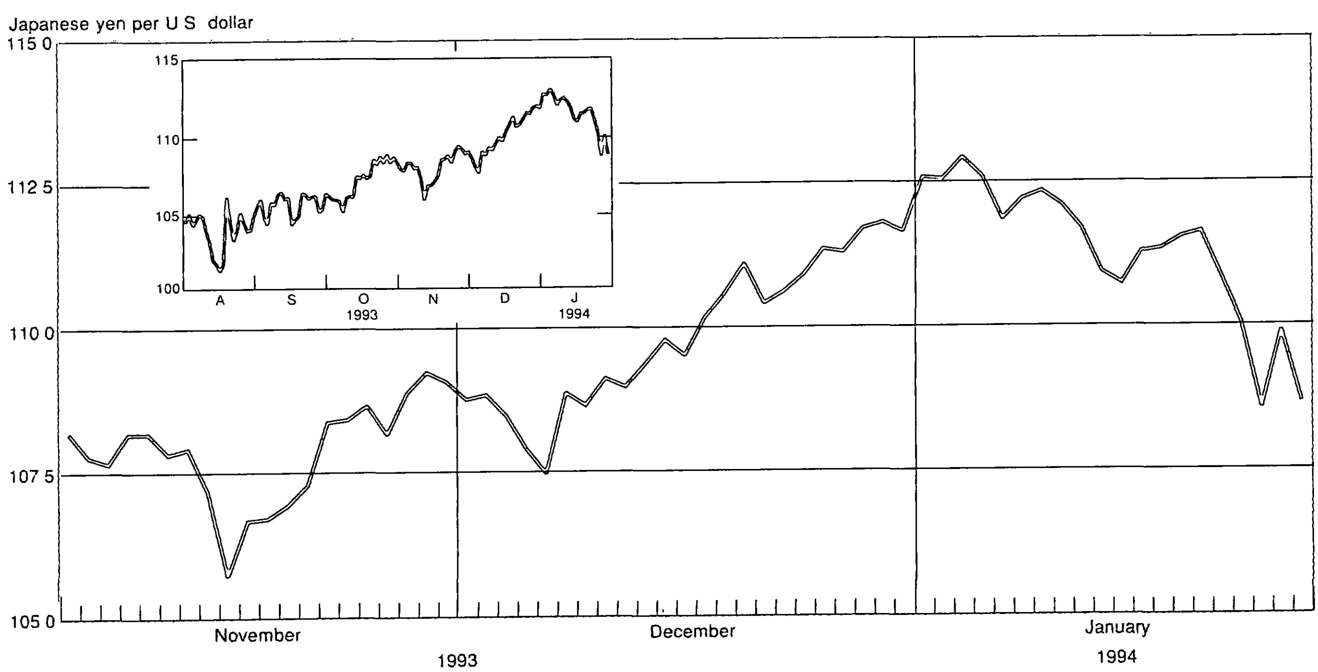
During November and most of December, the dollar was relatively stable against the German mark, trading in a narrow range around the DM 1 70 level Market sentiment towards the dollar was generally positive, however, with dealers taking note of the increasingly divergent paths of the U S. and German economies In this environment, market participants began to anticipate a fairly rapid convergence of short-term German and U S interest rates The Bundesbank, which had surprised the foreign exchange market in late October when it cut its discount and Lombard rates by 50 basis points, trimmed its key money-market repurchase rate from 6 40 percent at the start of the period to 6 25 percent on December 1 At its December 2 council meeting, the Bundesbank announced a prefixed rate of 6 0 percent for the next five-weekly auctions of fourteen-day repurchase agreements Market participants generally interpreted this move as an effort to nudge short-term interest rates lower while also dampening speculation of further monetary easing

The dollar broke out of its trading range in late December, jumping four pfennigs higher in the last three days of

Chart 1

The Dollar against the Japanese Yen

Spot Exchange Rate



Source Federal Reserve Bank of New York

Note Inset panel shows the six-month exchange rate movement the month. Dealers expressed initial skepticism over the rise, which occurred in thin year-end markets. Nonetheless, the dollar subsequently extended its gains to reach a twenty-eight-month high of DM 1.7562 on January 14. As the dollar moved higher, it gained broad support from a series of U.S. and German statistical releases—notably retail sales, factory orders, and the purchasing managers index for the United States, and industrial production, unemployment, and real GDP for Germany—that further contrasted economic conditions in the two countries.

During the latter part of January, the dollar settled into a new trading range against the mark. Expectations of near-term volatility in the dollar-mark exchange rate dropped off sharply, with the implied one-month option volatility falling from nearly 12 percent in early January to less than 9 percent at month-end. While market rumors of central bank sales helped cap the dollar's rise, movements in actual and expected interest rate differentials also weighed on the U.S. currency. At its two January meetings, the Bundesbank Council kept its repurchase rate fixed at 6.0 percent, disappointing the market and further deflating expectations about the pace of German interest rate cuts. Similarly, a perceived lack of inflationary pressures in the United States led dealers to rethink their expectations of a near-term hike in short-term U.S. interest rates. During most of January, therefore, differentials in three-month Eurodeposit rates, as well as those in the expected three-month deposit rates implied by futures prices, moved in the mark's favor. The dollar closed the period on January 31 at DM 1.7338.

Other operations

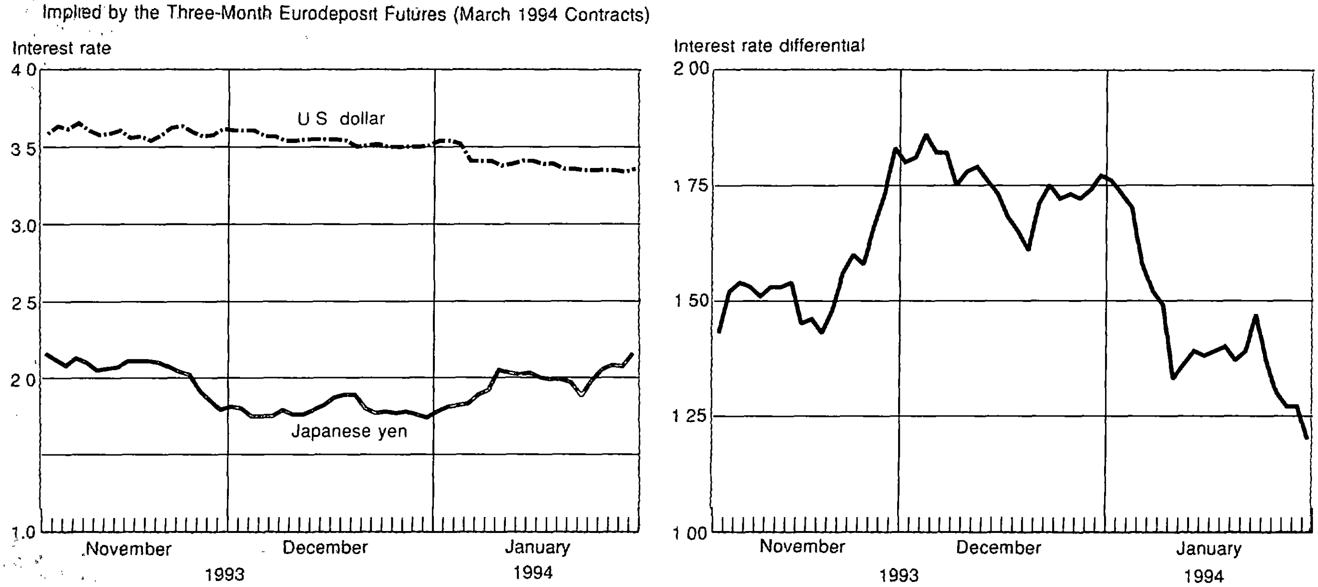
As of the end of January, cumulative valuation gains on outstanding foreign currency balances were $2,868.4 million for the Federal Reserve and $2,513.0 million for the Treasury's Exchange Stabilization Fund (ESF). There were no realized profits or losses for the quarter.

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 liquidity and credit quality. A portion of the balances is invested in securities issued by foreign governments. As of the end of January, the Federal Reserve and the ESF held either directly or under repurchase agreements $10,740.5 million and $10,436.2 million, respectively, in foreign government securities valued at end-of-period exchange rates.

Chart 2

Differential between Dollar and Yen Interest Rates

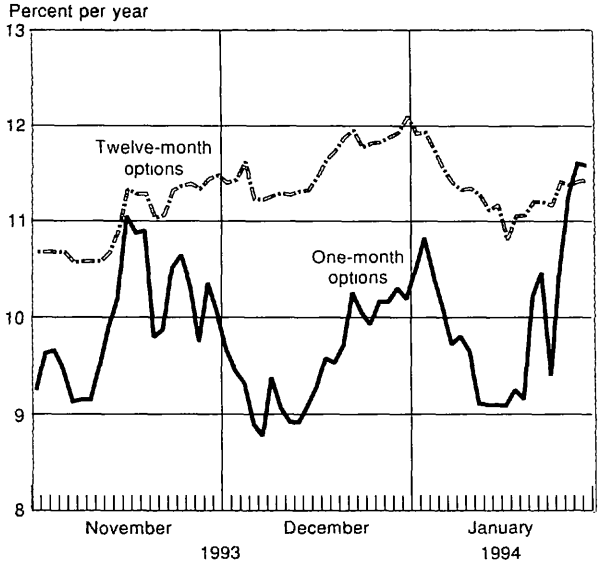
Implied by the Three-Month Eurodeposit Futures (March 1994 Contracts)



Source: Bloomberg L.P.

Chart 3

Dollar-Yen Exchange Rate Volatility Implied by Option Prices



Source Reuters

Table 1

Federal Reserve
Reciprocal Currency Arrangements

Millions of Dollars

Institution	Amount of Facility January 31, 1994
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
Swis 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 Profit (+) or Losses (–) on United States Treasury and Federal Reserve Foreign Exchange Operations

Millions of Dollars

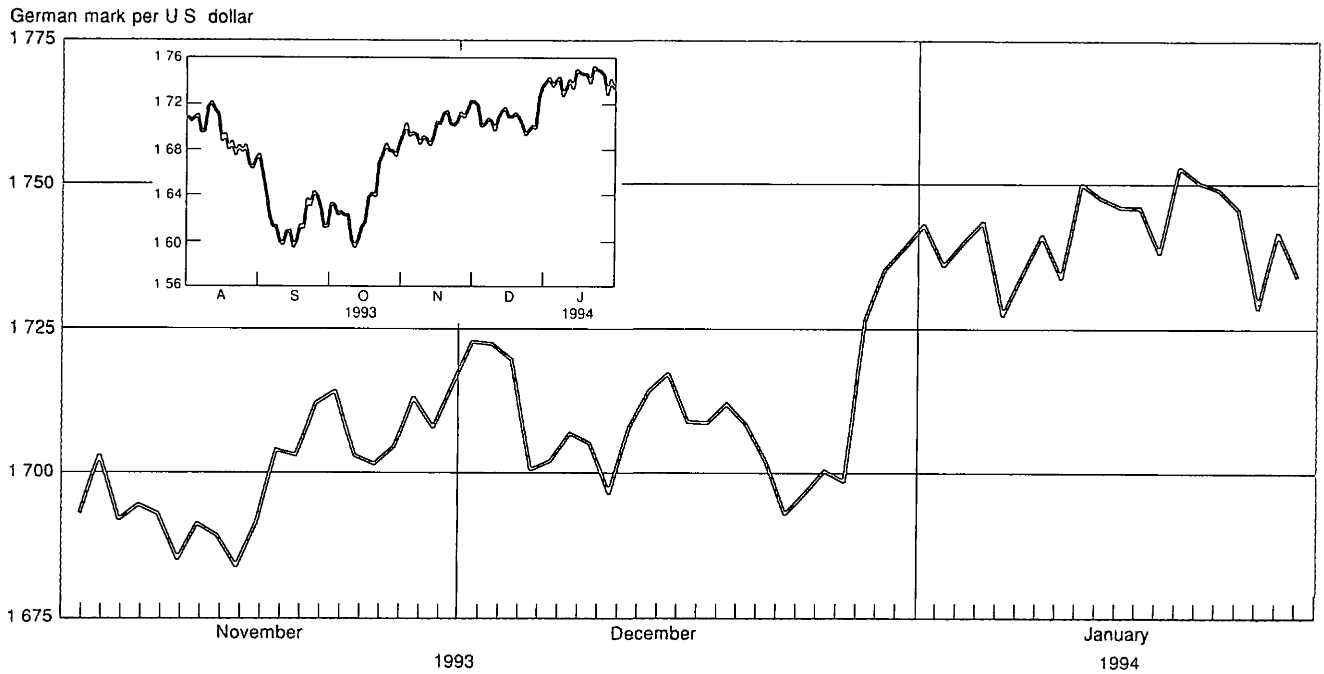
	Federal Reserve	U S Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1993	+3,368.5	+2,839 0
Realized profits and losses November 1, 1993–January 31, 1994	0 0	0 0
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1994	+2,868 4	+2,513 0

Note Data are on a value-date basis

Chart 4

The Dollar against the German Mark

Spot Exchange Rate



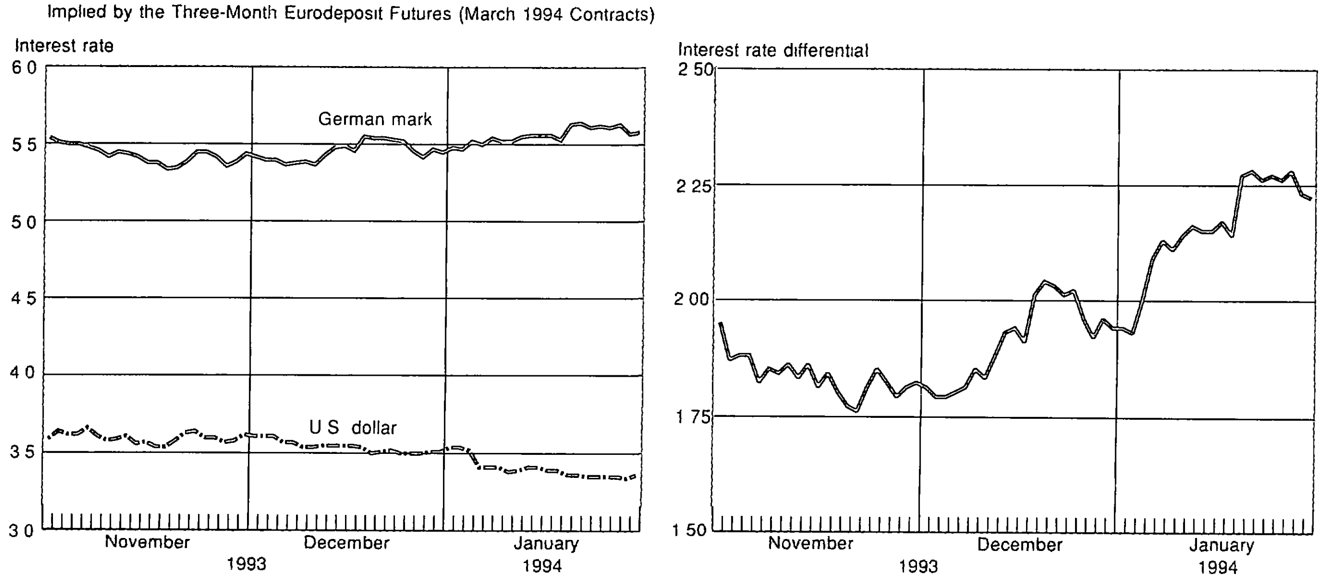
Source Federal Reserve Bank of New York

Note Inset panel shows the six-month exchange rate movement

Chart 5

Differential between German Mark and Dollar Interest Rates

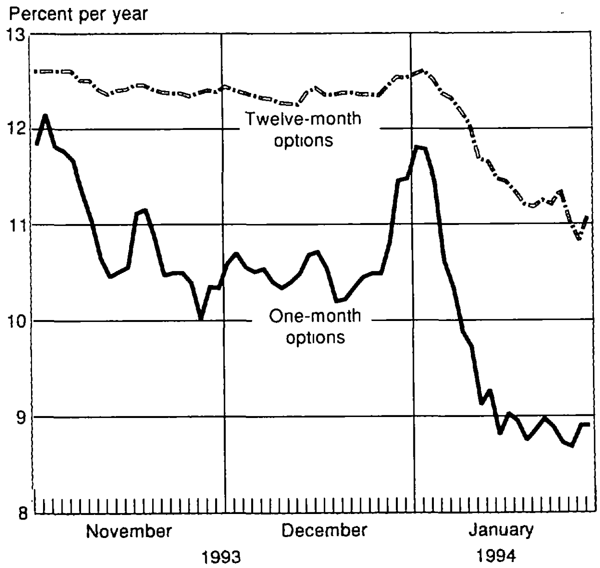
Implied by the Three-Month Eurodeposit Futures (March 1994 Contracts)



Source Bloomberg L P

Chart 6

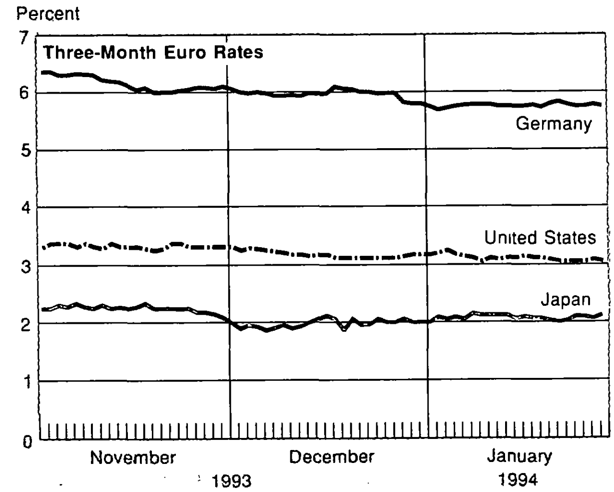
Dollar-Mark Exchange Rate Volatility Implied by Option Prices



Source Reuters

Chart 7

Short-Term Interest Rates for Selected Countries



Source: Bank for International Settlements