Treasury and Federal Reserve Foreign Exchange Operations

February-April 1990

The dollar gained support during the February-April reporting period as the prospects for U.S. growth came to be viewed as somewhat better and earlier expectations that monetary policy would ease were replaced by consideration of a possible tightening. At the same time, factors abroad strongly influenced individual exchange rates. Accordingly, the dollar moved up the most against the Japanese yen, which was affected by political uncertainties and weakness in Japan's stock market. The dollar also stopped its decline against the German mark amid concern about the potential inflationary implications for Germany of economic and monetary union between East and West.

During the three-month period, the dollar declined less than ½ percent against the mark and more against some other European currencies, ending the period about 18 percent below its mid-June 1989 highs against the mark. In contrast, the dollar rose 10 percent against the yen to trade nearly 5 percent above its mid-June 1989 levels. On a trade-weighted basis as measured by the staff of the Federal Reserve Board of Governors, the dollar rose more than 1 percent to end the period 12½ percent below its highs of mid-June 1989.

Intervention operations carried out by the U S. monetary authorities during the period were aimed primarily at moderating the rise of the dollar against the yen. During the three-month period, the Desk sold a total of $1,780 million, of which $1,580 million was sold against yen and the remainder against marks. Of these totals, $375 million of the dollar sales against yen was financed by the Federal Reserve System. The remaining $1,205 million sold against yen, together with the entire $200 million sold against marks, was financed by the U.S. Treasury through the Exchange Stabilization Fund (ESF).

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February through the beginning of April

Reports indicating that U.S economic growth was quickening helped improve sentiment toward the dollar as the period opened, tending to dispel the prevailing impression that U.S. monetary policy was likely to ease. In the first weeks of February, data were released showing strong increases in employment, a strengthening of retail sales, and a sharp rise in producer prices for January. About the same time, comments from some Federal Reserve officials suggested that the likelihood of a recession in the United States had diminished. Subsequent data and testimony by U.S. monetary officials reinforced the view that the balance of policy concerns had shifted from supporting growth to restraining inflation.

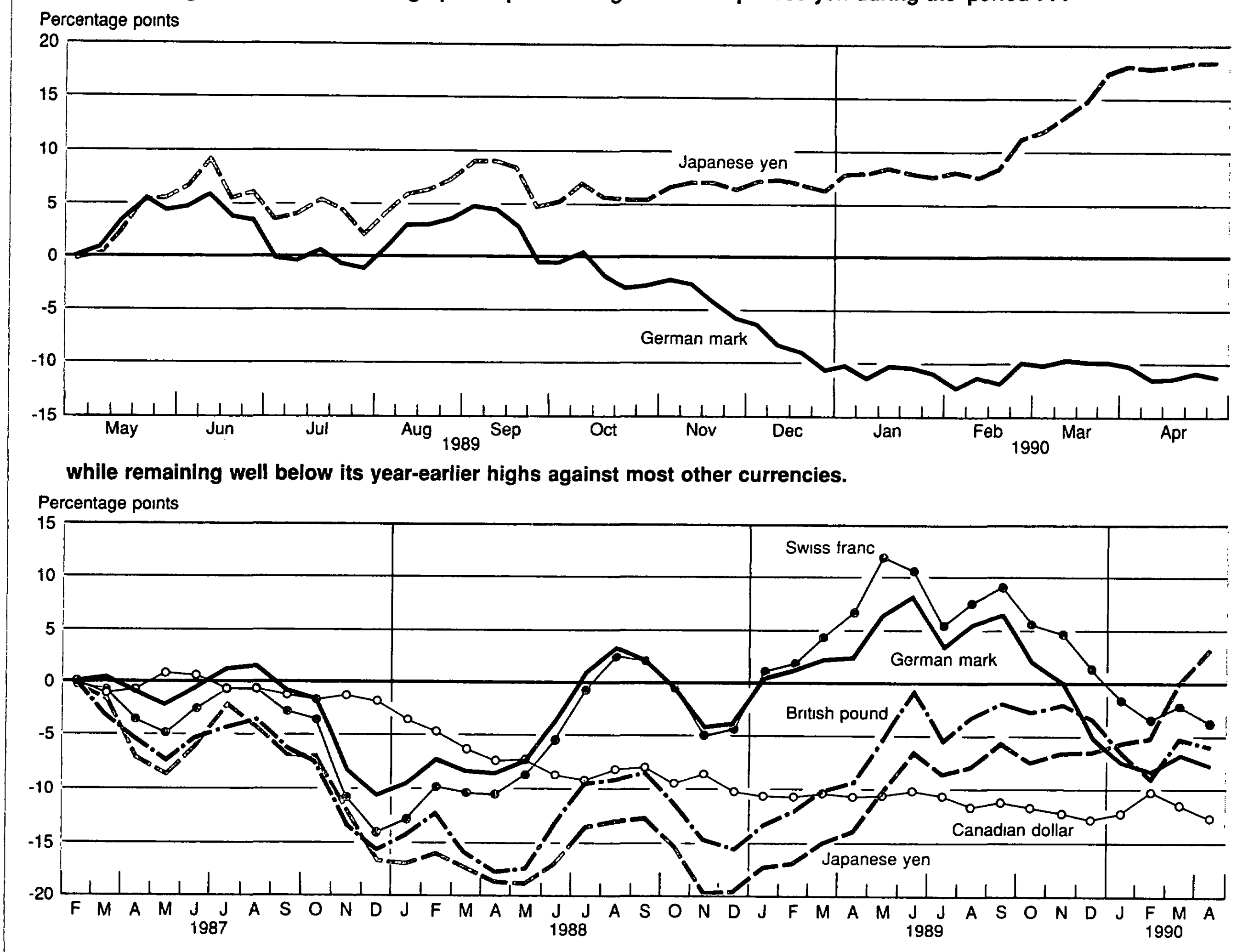
This shift in assessments of economic and policy conditions in the United States provided a foundation for a firmer tone to the dollar for much of the period under review. Within that framework, the extent to which the dollar advanced against another country's currency depended very much on developments in that country.

Thus, as the period began, the European currencies continued to gain support from the enthusiasm engendered late last year by reforms in Eastern Europe. With institutional investors, especially Japanese investors, reportedly expanding their portfolio investments in European currencies, the dollar extended the decline against the mark that had begun when the Berlin Wall was opened in October. On February 7 the dollar reached DM 1.6490—its lowest level against the mark in almost two years.

Then on February 7, the West German government announced plans for immediate talks on monetary union between East and West Germany, and the dollar began to firm against the mark as attention quickly focused on the possible inflationary consequences of such a move. Market participants feared that the conversion of East German marks into West German marks would result in a worrisome increase in German monetary aggregates or unleash pent-up demand for German products. They noted that the new source of demand would materialize at the same time that West German residents would be feeling the effects of a tax cut. A new round of wage negotiations by the country's largest trade union was an additional source of concern. As inflation anxieties mounted, German bond prices softened, and yields hit levels above comparable

Chart 1

The dollar again came under strong upward pressure against the Japanese yen during the period . . .



The top chart shows the percent change of weekly average rates for the dollar from May 1989 The bottom chart shows the percent change of weekly average rates for the dollar from February 23, 1987, the date of the Louvre Accord All rates are calculated from New York closing quotations

U.S. bond yields for the first time in ten years.

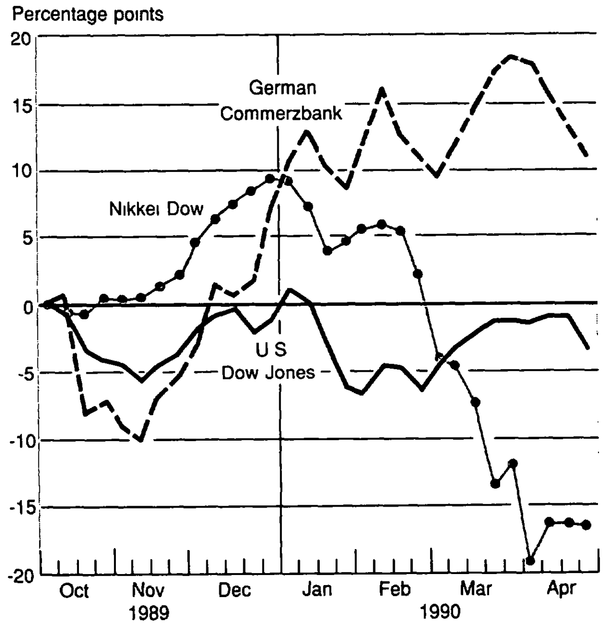
Against the yen, the dollar was trading in a fairly narrow range when the period opened, as market participants awaited the results of parliamentary elections in Japan on February 18 to see whether the ruling Liberal Democratic party (LDP) could maintain control in the lower house. On news that the LDP had won a larger than expected majority, the dollar declined to touch its period low against the yen of ¥143.60 on February 19 But soon thereafter, the dollar began to firm as market participants questioned whether the LDP's strong showing would be sufficient to ward off pressures from the opposition-dominated upper house and address in a meaningful way the challenging economic and trade issues confronting Japan. Before the elections, Japanese short- and long-term money market yields had been rising slowly in the expectation that an increase in the Bank of Japan's discount rate would be announced soon afterward. In the event, concerns over escalating interest rates abroad and accelerating monetary expansion at home combined to trigger a sharp drop in Japanese stock and bond prices in the weeks following the elections. The Nikkei Dow index of the Tokyo stock market fell 10 percent and Japanese government bond yields climbed well above 7 percent. Market participants came to believe that the Bank of Japan would be reluctant to tighten monetary policy in these circumstances, but they remained concerned whether adequate measures would be taken to break the rapidly deteriorating sentiment surrounding Japan's financial markets.

Against this background, upward pressure on the dollar against the yen intensified On February 23, the U.S. monetary authorities, in keeping with Group of Seven (G-7) understandings on exchange rate cooperation, intervened to resist the dollar's rise against the Japanese currency. As upward pressure on the dollar against the yen continued, the U.S authorities intervened in moderate amounts through March 2, selling a total of $650 million against yen. Financing of these operations was shared equally by the Federal Reserve and the U.S. Treasury.

At that time, the dollar also came under more intense upward pressure against the mark as fears of German

Chart 2

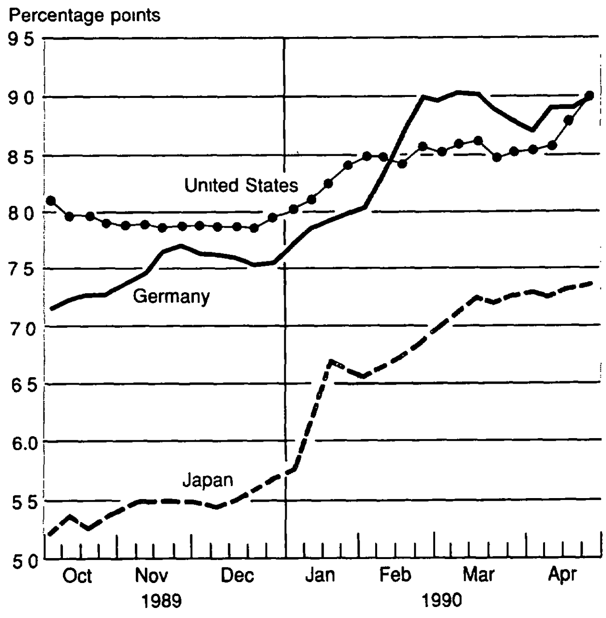
The Japanese stock market came under intense downward pressure during the period, stabilizing in mid-April.



The chart shows the percentage changes for the weekly average stock indexes from September 31, 1989 All figures are based on closing rates

Chart 3

Long-term interest rates rose nearly 1 percentage point in Germany and Japan and about 1/2 of 1 percentage point in the United States.



The chart shows daily U S , German, and Japanese government long-bond yields inflation intensified. As the dollar advanced to DM 1.7237 on March 1, its highest level against that currency since January, widespread reports circulated through the markets that the Bundesbank and other European central banks were intervening in the foreign exchange markets to support the mark and resist the dollar's rise.

On March 5, with the dollar rising against both currencies, U.S. Treasury officials decided to reinforce their intervention in yen with sales of dollars against marks. Prior to those mark purchases, several officials within the Federal Reserve had expressed concern that the size of the intervention operations might contribute to uncertainty about the Federal Reserve's priority toward achieving price stability. Concerns were also voiced that expanding the operations to include other currencies might be seen as an attempt to promote a broad-based decline in dollar exchange rates. At the time, Federal Reserve holdings of foreign currencies, taking into account anticipated further interest earnings, were approaching the limit of $21 billion authorized by the Federal Open Market Committee (FOMC). Under these circumstances, the decision was made not to seek authorization from the FOMC for continued

Table 1

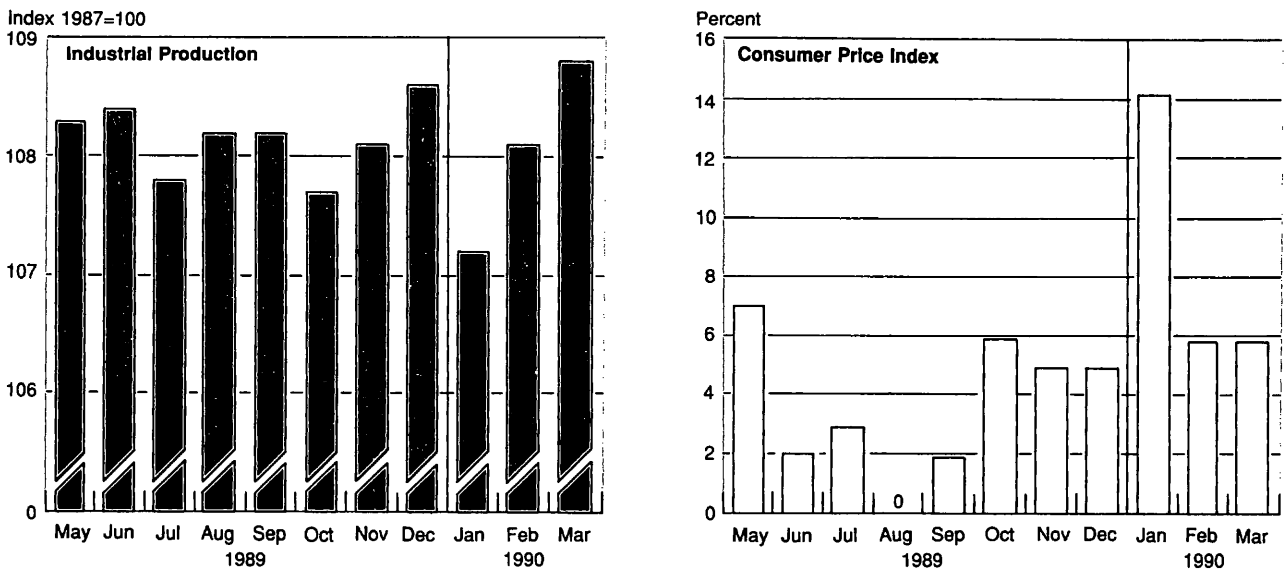
Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility April 30, 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 4

Data released during the period were seen as indications of stronger growth and price pressures in the U.S. economy.



The left chart shows monthly industrial production figures for January, February, and March, seasonally adjusted. The right chart shows the monthly rise in the seasonally adjusted U S consumer price index, annualized Consumer price data for January, February, and March were released on February 21, March 20, and April 17, respectively Industrial production figures for January, February, and March were released on February 16, March 16, and April 17, respectively

Federal Reserve operations pending a review of Federal Reserve foreign currency operations at the FOMC's March 27 meeting. Thus, from March 5 through March 27, all U.S. intervention operations, totaling $830 million against yen and $200 million against marks, were financed solely by the U.S. Treasury through the ESF.

At the March 27 meeting, the FOMC voted to approve an increase in the authorized limit on Federal Reserve holdings of foreign currencies from $21 billion to $25 billion. When the dollar again came under upward pressure against the yen on March 28, the

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 January 31, 1990	February	March	April	Outstanding as of April 30, 1990
Bank of Mexico†	700 0	700 0	−700 0	—	—	0
Bank of Mexico‡	700 0	—	—	+700 0	−158 2	541 8

Data are on a value-date basis

†Drawn as a part of the $2,000 million near-term credit facility established on September 14, 1989 Facility expired on February 15, 1990

‡Represents the FOMC portion of a $1,300 million short-term credit facility established on March 23, 1990

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 January 31, 1990	February	March	April	Outstanding as of April 30, 1990
Bank of Mexico†	125 0	34 1	−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 14, 1989 Facility expired on February 15, 1990

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 January 31, 1990	February	March	April	Outstanding as of April 30, 1990
Bank of Mexico†	425 0	334 1	−334 1	—	—	—
Bank of Mexico‡	600 0	—	—	+600 0	−135 6	464 4
Central Bank of Venezuela§	104 0	—	—	+25 0	−25 0	—
National Bank of Poland‖	200 0	86 0	−86 0	0 0	0 0	0 0

Data are on a value-date basis

†Represents the ESF portion of a $2,000 million near-term credit facility that expired on February 15, 1990

‡Represents the ESF portion of a $1,300 million short-term credit facility established on March 23, 1990

§Represents the ESF portion of a $400 million near-term support facility that expired on April 30, 1990

‖Represents the ESF portion of a $500 million short-term credit facility established on December 27, 1989 The ESF facility will expire on May 31, 1990

Desk intervened to sell $50 million against yen, financed once more by the Federal Reserve and the U.S. Treasury equally.

As April began, sentiment toward the yen was still negative and Japanese stock and bond prices remained under downward pressure amid market concerns about political leadership and economic policy in Japan A March 20 increase of 1 percentage point in the Bank of Japan's discount rate had not immediately relieved the pressures against the yen. An important round of negotiations under the Structural Impediments Initiative was getting under way between the United States and Japan in an atmosphere of growing U.S. concern and considerable uncertainty in Japan over their possible outcome. On the first trading day of the new Japanese fiscal year, the Nikkei Dow index closed nearly 25 percent below — and yields on Japanese government bonds about 75 basis points above — levels prevailing at the beginning of the period. Against that background, the dollar reached ¥160.35 on April 2, the highest level for the dollar against that currency since December 1986

Up to that point, most market participants had not expected the upcoming G-7 meeting to focus strongly on currency issues. But as developments in Japan unfolded, reports began to circulate that the G-7 might implement a massive yen support package. Market participants therefore adopted a more cautious attitude as the date of the April 7 meeting approached, and the dollar began to ease somewhat against the yen.

April developments following the Paris G-7 meeting

The statement released following the G-7 meeting on April 7 reported that the G-7 "Ministers and Governors discussed developments in global financial markets, especially the decline of the yen against other currencies, and its undesirable consequences for the global adjustment process and...reaffirmed their commitment to economic policy coordination, including cooperation in the exchange markets."

On the Monday following the G-7 meeting, the dollar moved erratically as market participants assessed the implications of the statement. In Far Eastern trading before the opening of the Tokyo market, the dollar rose sharply against the yen as market participants interpreted the statement as indicating a lack of G-7 commitment to aggressive intervention in support of the yen In Tokyo, however, market reports predicting stepped-up concerted intervention by the G-7 countries brought the dollar under strong downward pressure, and the dollar moved down from ¥160 to ¥155.45 within a few hours. During the day, the dollar began to rise once again on reports of coordinated, but not large-scale, intervention. As the dollar continued to rise against the yen in New York, the U.S. monetary authorities, in their only intervention in the month of April, sold $50 million against yen, shared equally between the Federal Reserve and the U.S. Treasury

In the weeks that followed, a number of developments combined to lessen negative sentiment towards the yen. First, market participants came to view the Bank of Japan's March discount rate increase as sufficient, at least for the time being, and expectations of a further rise in interest rates dissipated. Furthermore, in retrospect, market participants came to see the variety of international negotiations leading up to the Structural Impediments Initiative talks and the G-7 meeting as being rather successful and diminishing the strains within the Japanese leadership. Finally, Japanese stock and bond markets became more settled in early April, recouping some of the losses sustained earlier in the period.

In Europe, the focus of market attention during April remained on Germany and German monetary union. Market participants began to feel that the inflationary risks of monetary union had been exaggerated. As confidence grew that Bundesbank policy would be sufficiently restrictive to contain pressures that might emerge, sentiment toward the mark became more favorable.

Under these circumstances, the dollar stopped advancing against the mark and the yen during April. But at the same time that sentiment towards these other currencies was improving, the dollar continued to draw support from U.S. data releases suggesting strong economic activity and from the belief that U S. monetary policy would remain directed at dealing with price pressures. The dollar therefore closed the period near its three-month high against the yen at ¥158.90

Table 5

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

In Millions of Dollars

February 1, 1990 to April 30, 1990	Federal Reserve	U S Treasury Exchange Stabilization Fund
Realized	0	+292 4
Valuation profits and losses on outstanding assets and liabilities as of April 30, 1990	+1,996 9	+881 8

Data are on a value-date basis

and around the midpoint of its three-month trading range against the mark at DM 1.6790.

For the period as a whole, the U.S. monetary authorities sold a total of $1,780 million—$1,580 million against Japanese yen and $200 million against German marks. The U.S. Treasury, through the ESF, sold $1,205 million against yen and $200 million against marks, while the Federal Reserve sold $375 million against yen. During March, the ESF "warehoused" $2,000 million equivalent of foreign currencies with the Federal Reserve, bringing the total of warehoused funds to $9,000 million equivalent. The warehousing transactions resulted in realized profits of $292.4 million for the ESF, reflecting the difference between the rate at which the warehoused funds had originally been acquired in the market and the rate at which they were exchanged with the Federal Reserve.

* * *

In other operations during the period, on February 9, 1990, Poland repaid in full its outstanding commitment to the ESF of $86.0 million. The commitment was from a drawing made at the end of 1989 under a $500 million short-term support package established with the ESF and the Bank for International Settlements (acting for certain participating member banks).

Also in February, Mexico repaid in full its outstanding commitments under the $2,000 million multilateral facility established on September 14, 1989. Mexico made partial repayments of $6.1 million each to the Federal Reserve and ESF on February 2. Final repayments of $728.0 million and $328.0 million were made to the Federal Reserve and ESF, respectively, on February 15.

On March 23, the Federal Reserve and Treasury agreed to establish a $1,300 million short-term credit facility with Mexico. The Federal Reserve's share of $700 million was provided under an existing reciprocal swap line, while the ESF's share of $600 million was provided under a special swap arrangement. On March 28, Mexico drew the entire amount of the facility. Subsequently, Mexico made partial repayments on two occasions in April, reducing its outstanding commitments to $541.8 million for the Federal Reserve and $464.4 million for the ESF by the end of the period.

On March 16, 1990, the U.S. Treasury and the Bank for International Settlements (acting for certain participating member banks) agreed to provide the Republic of Venezuela with short-term support of $400 million for economic adjustment efforts. The ESF's share in the facility was $104 million, of which $25.0 million was drawn on March 30. Venezuela repaid $15.3 million to the ESF on April 6 and the balance on April 30, thereby liquidating the facility.

As of the end of April, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $1,996.9 million for the Federal Reserve and $881.8 million for the ESF (the latter figure includes valuation gains on warehoused funds). 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 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, holdings of such securities by the Federal Reserve amounted to $6,631.3 million equivalent, and holdings by the Treasury amounted to the equivalent of $6,977.3 million valued at end-of-period exchange rates.