Treasury and Federal Reserve Foreign Exchange Operations

May-July 1990

The dollar generally declined during the May-July reporting period. At first the easier tone for the dollar largely reflected improving sentiment towards other currencies, especially the mark and yen. But by late June, the focus began to shift to the dollar, and sentiment towards the dollar deteriorated in the midst of talk of a worsening U.S. fiscal deficit, a weakening domestic economy, and possible declines in U.S. interest rates in an environment of rising worldwide demand for capital. By the close of the period, the dollar had declined more than 8 percent against the yen and 5½ percent against the mark, approaching the previous postwar low against the latter currency. Against sterling, the dollar declined 12 percent. On a trade-weighted basis, as measured by the staff of the Federal Reserve Board of Governors, the dollar declined about 6 percent.

During the period, no operations aimed at influencing the level of the dollar were carried out. Over the course of the reporting period, the Desk sold a total of $1 billion equivalent of marks in the market on behalf of the Exchange Stabilization Fund (ESF). The sales were part of a U.S. Treasury operation to adjust balances and facilitate the retiring of a portion of the amounts held by the Federal Reserve under the ESF's warehousing arrangements with the Federal Reserve.

May through mid-June

The dollar was trading narrowly around DM1.68 and ¥159 as the period opened. The dollar benefited from the release of reports late in the previous period and early in May suggesting that U.S. economic growth and price pressures were strong enough that any move in monetary policy would be toward greater restraint. That perception of U.S. economic prospects was temporarily challenged early in May following a weaker than expected April U.S. employment report released May 4, growing concerns about the U.S. budget deficit, and nervousness about the impact of the savings and loan crisis on the economic outlook. The April retail sales and producer price data released on May 11 raised further questions about the strength of the economy, and the dollar moved down to DM1.6260 and ¥152.62. These factors were offset later in the month by comments from a number of Federal Reserve officials reaffirming their view that the principal challenge facing the economy was the persistence of inflationary pressures.

Much of the market's attention during the weeks of May and early June, however, focused on other currencies. A major area of interest was how the mark would be affected by German economic and monetary union. Ever since the West German government had first announced in February its commitment to rapid economic and monetary union, there had been great interest in the terms of the forthcoming currency conversion. Market participants had been wary of the possibility that, in an effort to stabilize the East German economy, the authorities might set a conversion rate for the East German "ost-mark" so favorable to the East Germans as to generate an explosive increase in deutsche mark monetary aggregates and spending power. The actual terms of the conversion,

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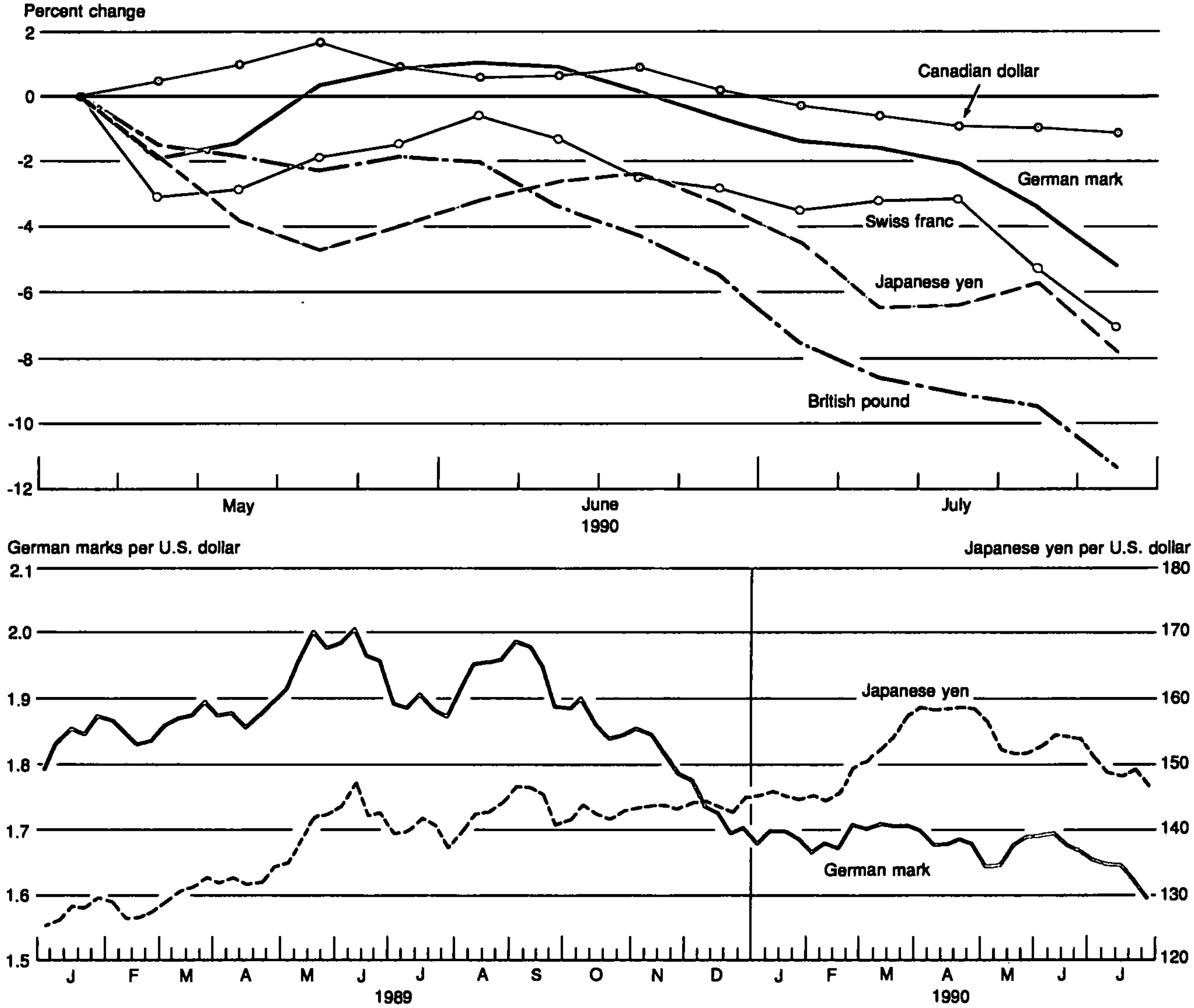
announced in early May, alleviated these concerns. Accordingly, early in the period, with most market participants convinced that union would boost an already strong German economy and impart to monetary policy a further bias towards restraint for the period ahead, the mark found renewed support in the exchange markets.

Nevertheless, some market participants remained leery of Germany's ability to accommodate union without serious negative repercussions for financial markets, price pressures, or the political landscape. As a result, sentiment towards the mark tended to fluctuate for most of May and June, alternating between more and less sanguine views of the likely short-term reper-

Chart 1

Through mid-June the dollar fluctuated without clear direction, largely in response to developments affecting other currencies, then declined through the end of the period as sentiment deteriorated.



The top chart shows the percent change of weekly average rates for the dollar from May 1, 1990. The bottom chart shows the weekly average rates for the dollar against the German mark and Japanese yen from January 1989. All rates are New York closing quotations.

cussions. Among the issues attracting market attention were the mix of tax and debt financing that the West German government would use to help finance structural adjustment in East Germany, the possibility of a backlash against the incumbent political parties by West German voters alarmed by the potential costs of union, and recurrent reports of conflicts between the Bundesbank and the government over the mechanisms of monetary union.

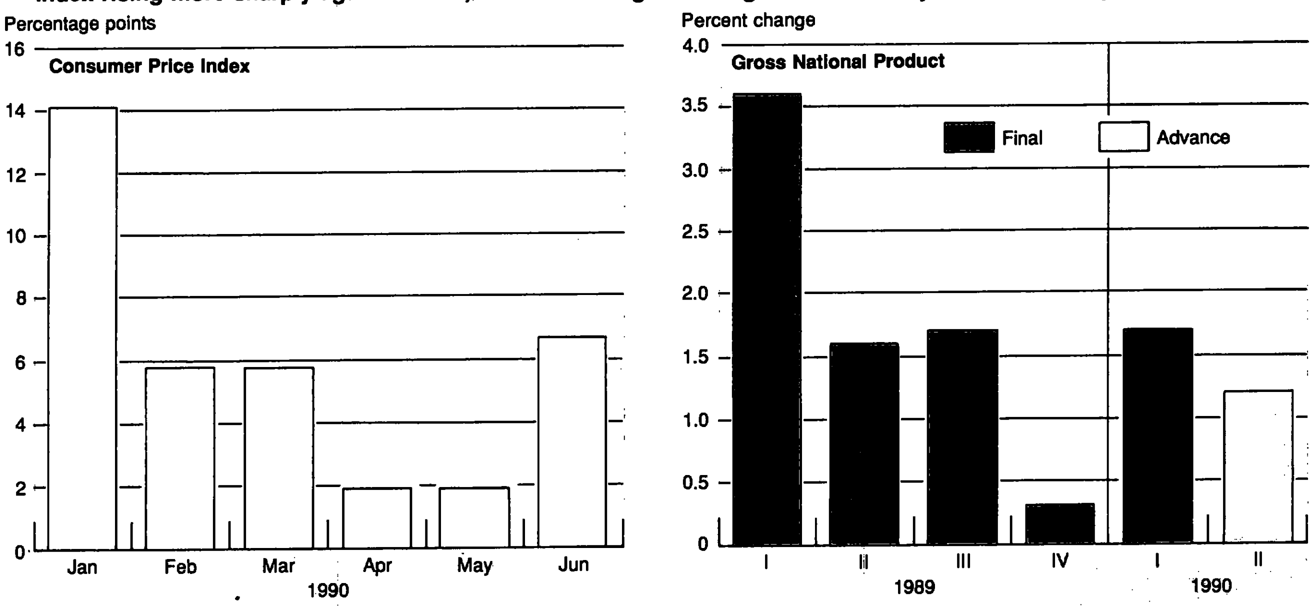
The yen, on the other hand, consistently strengthened during much of May. Analysts were articulating a more balanced assessment of Japanese economic policy and political stability than had been heard for several months. Political, financial, and economic concerns that had weighed on that currency earlier in the year subsided. Public opinion polls indicated that Prime Minister Kaifu had succeeded in clearly establishing his own leadership and in translating his personal popularity into renewed support for the ruling Liberal Democratic Party. The May 6 Group of Seven (G-7) meeting was seen in the market as demonstrating more cohesion among the governments with respect to Japanese concerns. The volatility displayed by Japanese financial markets earlier in the year had dampened — in fact, the Nikkei Dow-Jones index had recovered steadily since early April — and concerns that Japanese financial market conditions would have a major negative impact on economic performance gave way to renewed expectations that interest rates might tend to firm. In this context, reports circulated that Japanese investors were reconsidering their expectations of persistent yen weakness and the hedging strategies for dollar investments associated with those expectations. Amid these conditions, the dollar declined through the ¥150 level on May 25 before recovering somewhat.

Thus, the dollar moved up on balance against the mark from its early May low and was trading around DM 1.68 by the middle of June, showing at times a tendency to firm. Against the yen, in contrast, it declined more than 3 percent since early May to trade around ¥154 by mid-June.

Meanwhile, a number of high-yielding currencies showed strength, as they would from time to time through the end of the period. The Canadian dollar, although weighed down during May and June by concerns over political uncertainty relating to the constitutional status of Quebec, demonstrated considerable underlying buoyancy as differentials over U.S. interest

Chart 2

Data released during the period provided evidence of the persistence of price pressures, with the consumer price index rising more sharply again in June, notwithstanding a slowing of the economy in the second quarter.



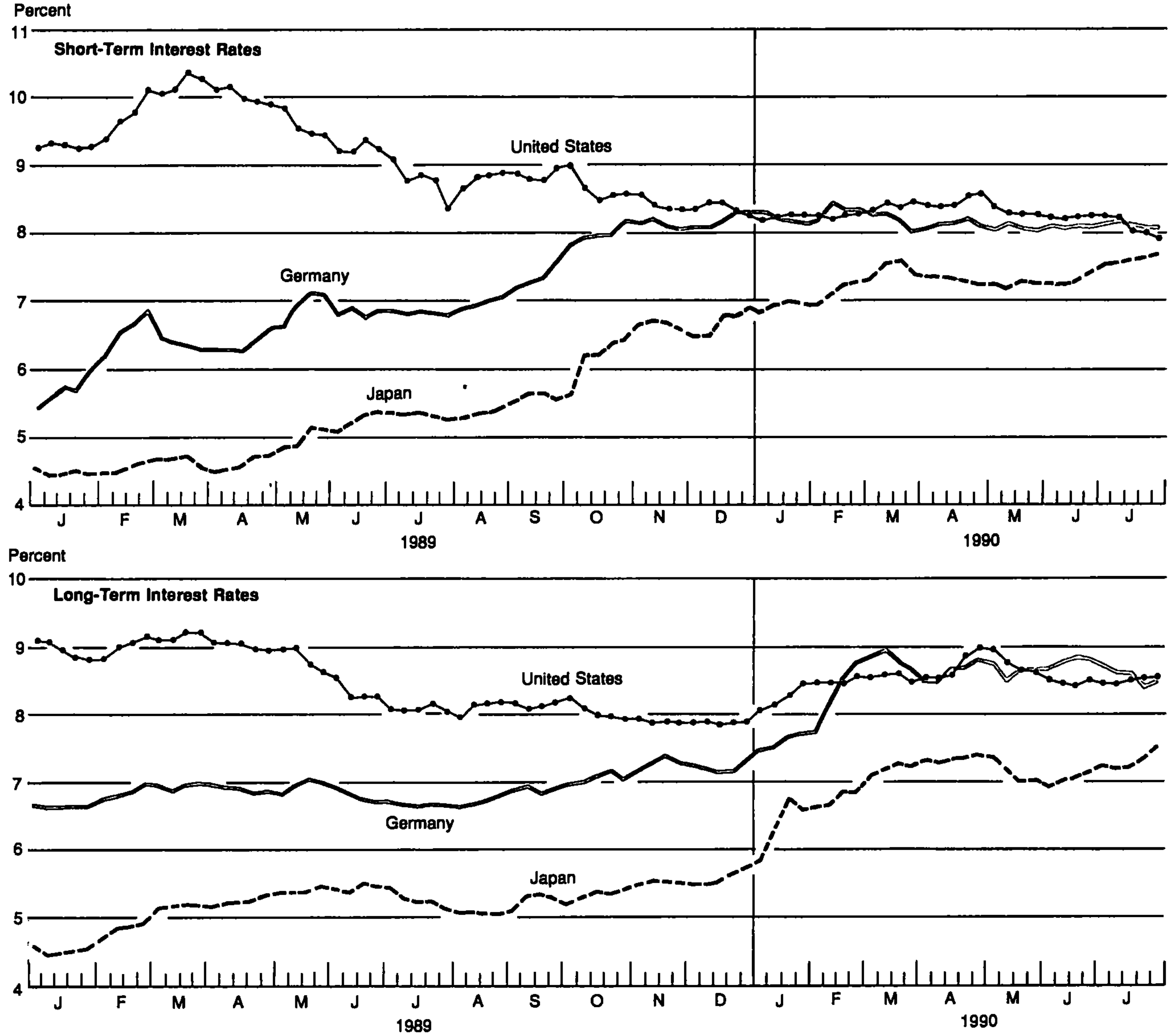
The left chart shows the monthly rise in the seasonally adjusted U.S. consumer price index, annualized. Consumer price data for April, May, and June were released on May 16, June 15, and July 18, respectively. The right chart shows the seasonally adjusted rate of change in gross national product, adjusted for inflation. The advance report for the second quarter, as well as revisions to data for previous quarters, was released July 27.

rates increased from already high levels. Even though the Quebec question was left unresolved when a June 23 deadline for unanimous provincial approval of the so-called Meech Lake Accord passed without the necessary action, the Canadian dollar rebounded quickly. The currency then traded near ten-year highs for most of July.

Sterling also benefited during this period as relatively high yields coincided with an increasing sense on the part of market participants that the United Kingdom would soon join the Exchange Rate Mechanism (ERM) of the European Monetary System. Attention to the

Chart 3

U.S. interest rates appeared to be on a declining trend, while rates abroad were steady or rising.



The top chart shows weekly average U.S., German, and Japanese three-month Euromarket interest rates.
The bottom chart shows weekly average U.S., German, and Japanese government long-bond yields.

possibility of early ERM entry was sparked by a press report on June 12 that the government was contemplating entry as early as the fall. Sterling promptly strengthened, rising above $1.70, and subsequently reached a nineteen-month high of $1.8650 on July 31.

Finally, the higher yielding ERM currencies also strengthened as market participants perceived that there was little risk of an ERM realignment in the foreseeable future. In particular, the Italian lira remained at the top of the narrow band throughout the period and the Spanish peseta moved to the top of its wider band. All other currencies tended to bunch together at the bottom of the bands against the lira and the peseta, and a number of currencies reached their bilateral limits at times.

Table 1

Federal Reserve Reciprocal Currency Arrangements
In Millions of Dollars

Institution	Amount of Facility July 31, 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

Late June and July

A succession of statements by Federal Reserve officials during June had strengthened the view that the central bank remained sensitive to the need to resist inflation and that the economic signs did not warrant a change in policy direction. At the same time, market participants adopted a moderately cautious attitude towards the yen as the final round of the Structural Impediments Initiative (SII) negotiations approached with what appeared to be major areas of disagreement outstanding. There was also some caution towards the mark as the July 1 effective date of economic and monetary union neared. By June 25 the dollar was trading around DM 1.67 and ¥155.

Toward the end of June, market participants began to reassess the outlook for the U.S. economy and monetary policy. After President Bush's statement acknowledging that tax revenue increases could be a part of a deficit reduction package, market participants began to expect that agreement with Congress on such a package might lead to a decline in U.S. interest rates at a time when German and Japanese rates appeared likely to remain steady or, looking further ahead, even rise. The initial reaction of the foreign exchange market was muted as attention was focused on political and economic developments elsewhere.

In the weeks that followed, the dollar softened as developments in Germany and Japan were seen as favorable for their currencies. In Germany, initial reports following German economic and monetary union and the currency conversion were reassuring. Indications were that the feared surge in consumption was not materializing. Although some monetary tightening was still expected eventually, there appeared to be no immediate large increase in demand pressures, as East Germans took a cautious view of their prospects in light of the economic restructuring and uncer-

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 April 30, 1990	May	June	July	Outstanding as of July 31, 1990
Bank of Mexico†	700.0	541.8	−28.4	−117.0	−396.5	0

Note: Data are on a value-date basis. Components in Table 3 may not add to totals because of rounding.
†Represents the FOMC portion of a $1,300 million short-term credit facility established on March 23, 1990.

tainties that lay ahead. Nevertheless, the mark, which had moved down in the ERM since early in the year, declined further to trade near its bilateral parity limit with the Italian lira and Spanish peseta. With regard to the yen, the conclusion of the SII negotiations was seen as a positive development. Fears that the negotiations would result in agreements that would undermine support for the Kaifu government were largely erased when the highly visible issue of increased public works spending by the Japanese government was satisfactorily resolved. By July 9 the dollar had drifted down more than 1 percent against the mark and almost 3 percent against the yen from its level in late June to close at DM1.65 and ¥151.

On July 10, at the time of the Houston Summit, a number of comments by U.S. officials served to revive market participants' expectations of an early easing in U.S. monetary policy. The dollar began to trade with a softer tone. The dollar firmed somewhat the next day when the final summit communiqué was released and did not contain any references to new initiatives on exchange rates, which some had expected. Then, on July 12, Chairman Greenspan told the Senate Banking Committee that the Federal Reserve might ease monetary policy to offset a firming in credit market conditions suggested by a tightening of terms on credit from banks and sluggish growth in M2. The market had not expected that statement and the dollar promptly declined, closing the day at ¥147.45 and DM1.6355.

During the remaining two weeks of the period, the dollar declined by a modest amount as interest rate and financial market developments further reduced the attractiveness of dollar investments. In particular, market participants noted the decline in the U.S. stock market on July 23, which was associated with disappointing earnings by a number of firms. New signs of weakening U.S. economic growth, particularly the second-quarter GNP data released July 27, were seen in

Warehousing Operations

During the three-month period, the Exchange Stabilization Fund (ESF) of the Treasury both unwound and renewed warehousing transactions with the Federal Reserve. Warehousing operations have been carried out from time to time since 1963. In carrying out such an operation, the Federal Reserve buys the foreign currency in a spot purchase from the Treasury and simultaneously sells it back to the Treasury at the same exchange rate for a future maturity date. A key aspect of this arrangement is that the Federal Reserve and the Treasury agree to use the same exchange rate to initiate and reverse the transaction; consequently, neither party incurs any foreign exchange rate risk as a result of the transaction itself. The ESF may realize a profit or loss at the time the warehousing transaction is undertaken or renewed, and it remains exposed to valuation gains or losses on the foreign currencies being warehoused (Table 4). A warehousing transaction is reversed when the Treasury repays dollars and the Federal Reserve repays the foreign currency it has acquired from the Treasury.

Table 3

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 April 30, 1990	May	June	July	Outstanding as of July 31, 1990
Central Bank of Costa Rica†	27.5	—	+27.5 −27.5	—	—	—
Bank of Mexico‡	600.0	464.4	−24.3	−100.2	−339.9	0.0
Bank of Guyana§	31.8	—	—	+31.8	−18.3	13.4
National Bank of Hungary‖	20.0	—	—	+11.1	+8.9	20.0
Central Bank of Honduras*	82.3	—	—	+82.3	−25.0	57.3

Note: Data are on a value-date basis. The ESF's facility with the National Bank of Poland, inactive since February 9, expired on May 31, 1990. Components may not add to totals in Table 2 because of rounding.

†Represents intraday facility with the ESF established May 18, 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 $178 million short-term credit facility established on June 18, 1990.
‖Represents the ESF portion of a $280 million short-term credit facility established on June 18, 1990.
*Represents the ESF portion of a $147.3 million short-term credit facility established on June 28, 1990.

contrast with continued strong growth in a number of other countries. These factors suggested that interest rate differentials would move further against the dollar. Despite occasional upward movements associated with increased tensions in the Middle East, the dollar closed the period at DM1.5868 and ¥145.85, within a few basis points of its lows for the period reached earlier that day.

The U.S. monetary authorities did not intervene in the exchange market during the reporting period to influence exchange rates. From late May through mid-July, the Desk acquired dollars against sales of marks on behalf of the ESF as part of an operation to adjust ESF balances and facilitate reversal of a portion of the outstanding warehousing of foreign currency with the Federal Reserve. During this time, a total of $2,000 million was acquired, of which $1,000 million was acquired in the market and $1,000 million in a direct transaction with another central bank. The market transactions were conducted as conditions permitted without significantly influencing prevailing exchange rates.

The ESF exchanged the dollars acquired through these transactions for foreign currencies it had warehoused with the Federal Reserve, leaving at the close of the period an amount of $7,000 million equivalent of foreign currency still warehoused with the Federal Reserve. The Treasury realized profits of $329.7 million from the sale of German marks, as well as profits of $459.0 million from renewals of warehousing transactions that also occurred during the period.

* * *

In other operations during the period, the Treasury agreed with the International Monetary Fund (IMF) to exchange SDRs for dollars with foreign monetary authorities that needed SDRs for payment of IMF charges and for repurchases. Through end-July, a total of $120.9 million equivalent of SDRs was exchanged. The Treasury, through the ESF, also participated in multilateral credit facilities to provide near-term economic support to Guyana, Honduras, and Hungary and provided assistance to Costa Rica through an intraday facility. Mexico repaid in full the remainder of its commitments to the U.S. authorities.

Table 4

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

In Millions of Dollars

May 1, 1990 to July 31, 1990	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Realized	0	+788.7
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1990	+3,547.5	+1,519.5

Note: Data are on a value-date basis.

Guyana. On June 18, the ESF, along with the Bank for International Settlements (representing certain member central banks) and the Kreditanstalt für Wiederaufbau of West Germany, agreed to establish a multilateral financing facility for Guyana to help clear arrears with the IMF and with other international financial institutions and to facilitate the introduction of an economic adjustment program supported by the IMF and the World Bank. The ESF's share of the $178 million facility was $31.8 million. Guyana drew the entire amount of the facility on June 20 and repaid $18.3 million to the ESF on July 31.

Honduras. On June 28, the ESF, together with certain Latin American central banks, established a financing facility for Honduras totaling $147.3 million to facilitate implementation of an IMF-supported economic adjustment program. Honduras drew the full amount on the same day. The ESF participation in the facility was $82.3 million. On July 5, Honduras repaid $25.0 million to the ESF.

Hungary. On June 18, the ESF and the Bank for International Settlements (acting for certain member central banks) agreed to provide a multilateral facility for Hungary. Hungary received the full proceeds of the $280 million facility through three drawings made on June 21, July 16, and July 30. The ESF provided $20 million under the facility.

Costa Rica. The ESF agreed to provide Costa Rica a $27.5 million intraday facility to facilitate the implementation of its debt restructuring agreement. On May 21, Costa Rica drew the entire amount of the facility and repaid on the same day, thereby liquidating the facility.

Mexico. At the beginning of the period, Mexico's outstanding commitments on a short-term credit facility to the Federal Reserve and Treasury stood at $541.8 million and $464.4 million, respectively. Partial repayments were made on May 23, June 1, and July 11 and a final payment on July 31.

As of the end of July, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $3,547.5 million for the Federal Reserve and $1,519.5 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 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 July, holdings of such securities by the Federal Reserve amounted to $7,239.2 million equivalent, and holdings by the Treasury amounted to the equivalent of $7,391.7 million valued at end-of-period exchange rates.