Treasury and Federal Reserve Foreign Exchange Operations

November 1990—January 1991

The dollar was subjected to conflicting forces during the November-January period. Sentiment toward dollar investments continued to deteriorate as the U.S. economy weakened and as interest rate differentials moved further in favor of foreign currencies. But at times, political developments abroad—particularly the Persian Gulf conflict—encouraged greater demand for dollars and limited the extent to which negative sentiment toward the currency was reflected in exchange rates. With these offsetting factors helping to maintain a sense of two-way risk to dollar exchange rates, the dollar ended the period mixed against major foreign currencies, and the U.S. monetary authorities conducted no intervention operations in the foreign exchange market. The dollar closed the period down slightly against the German mark and up slightly against the Japanese yen (Chart 1). On a trade-weighted basis as measured by the staff of the Federal Reserve Board of Governors, the dollar ended the period 1 percent below its level at the beginning of the period.

The first part of the period: early to mid-November
In the early part of the period, market attention centered on evidence of diverging growth and interest rate trends in the major industrial economies. Ever since the Iraqi invasion of Kuwait in August and the associated rise in oil prices and decline in consumer confidence, analysts had been progressively revising downward their forecasts for U.S. economic growth. The release of October payroll employment data in the first week of November revealed an unexpectedly large drop which, together with subsequent data, reinforced the view that the U.S. economy was slowing down (Chart 2). At the same time, preliminary indications suggested inflationary pressures were subsiding. Under these circumstances, market participants widely expected the Federal Reserve to continue to ease money market conditions and possibly to reduce its discount rate.

In contrast, market forecasts for the German and Japanese economies remained relatively upbeat. The need to rebuild eastern Germany was seen as providing ongoing stimulus to the German economy. Japanese economic data provided little evidence that the economy or price pressures were slowing in response to the central bank's tight policy stance. Mindful of these economic trends, market participants expected German and Japanese interest rates either to rise further or to remain at existing levels. Indeed, on the first day of the period, the Bundesbank announced a one-half percentage point increase in its official Lombard rate, and many market participants expected further tightening after German national elections in early December. The Bank of Japan was considered less likely than the Bundesbank to tighten monetary policy, but was nonetheless seen as unwilling to ease monetary conditions given high oil prices and Japan's tight labor market conditions.

The divergent outlook for interest rates weighed on the dollar in early to mid-November. Short-term interest rate differentials had been steadily moving against the dollar since the spring of 1989, when dollar investments

A report presented by Sam Y. Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account. Daniel H. Brotman was primarily responsible for preparation of the report.

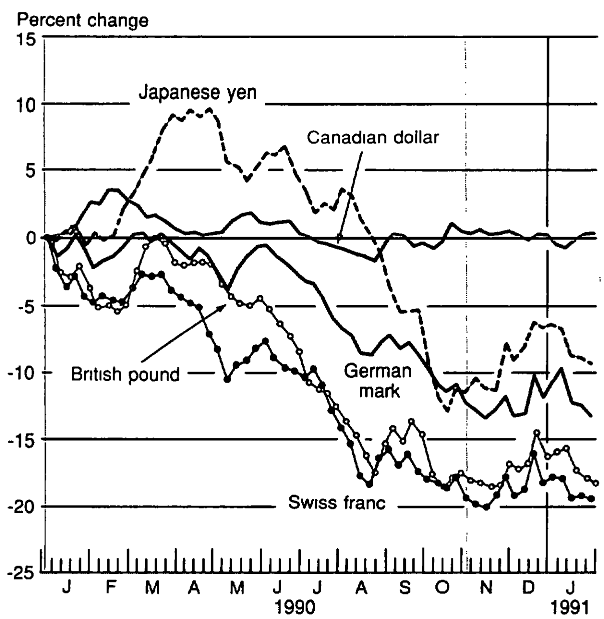
held a 4 to 6 percentage point interest rate advantage relative to the mark and yen (Chart 3). By late summer of 1990, the dollar's short-term interest rate advantage had been entirely eliminated. Thus, in early November, expected further declines in dollar interest rates, coupled with steady to higher rates abroad, threatened to push short-term U.S. interest rates well below mark and yen rates for the first time since 1980. Under these circumstances, the dollar declined 3¼ percent against the mark from its opening level of DM1.5170 to its November low of DM1.4660 on November 16. Its decline against the yen measured 2½ percent from ¥130.07 at the opening of the period to ¥126.70 on November 22.

The dollar was not the only currency affected by the divergent performance of major national economies. Pressures also developed among the European currencies during early November as the pace of German expansion contrasted with slowing growth or actual declines in the United Kingdom, Italy, France, and certain other European countries. The market conditions that had allowed several European central banks to lower domestic interest rates earlier in the year dissipated with the November increase in German interest rates. As the mark moved up from its relatively low position in the exchange rate mechanism of the European Monetary System (EMS), a number of participating central banks responded to the softening of their currencies relative to the mark by raising interest rates at a time when their economies were weakening or by intervening against marks to support their currencies. The Italian lira, the French franc, and the British pound were the currencies to come under the strongest downward pressures in November.

Dollar selling in response to the diverging economic trends was tempered somewhat by developments in the Persian Gulf. The Gulf conflict, while not the dominant market force that it later became, served as a background factor supporting the dollar at times during early and mid-November. Developments in the military and diplomatic arena at that time suggested that the probability of a war in the near term was rising. Many market participants interpreted the U.S. Administration's

Chart 1

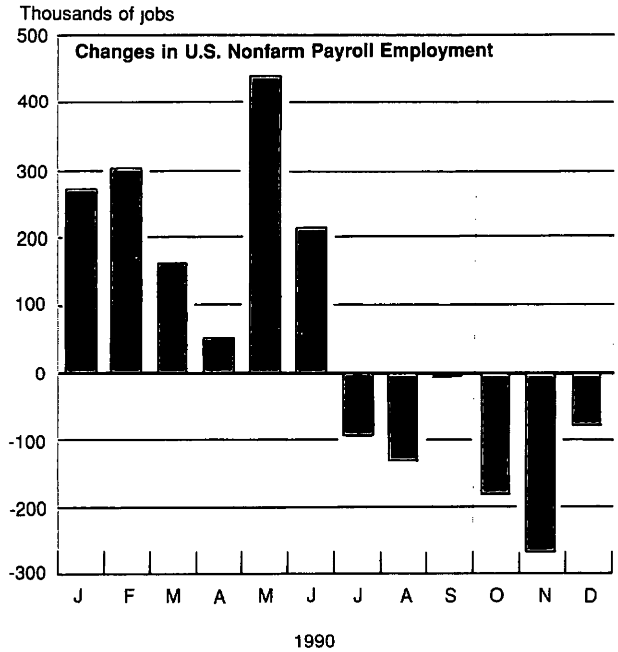
Concerns over the Persian Gulf conflict limited the extent to which negative sentiment toward the dollar was reflected in exchange rates.



Note: The above chart shows the percentage change of weekly average rates for the dollar from January 1990 through January 1991.

Chart 2

Declines in employment pointed to a weakening U.S. economy.

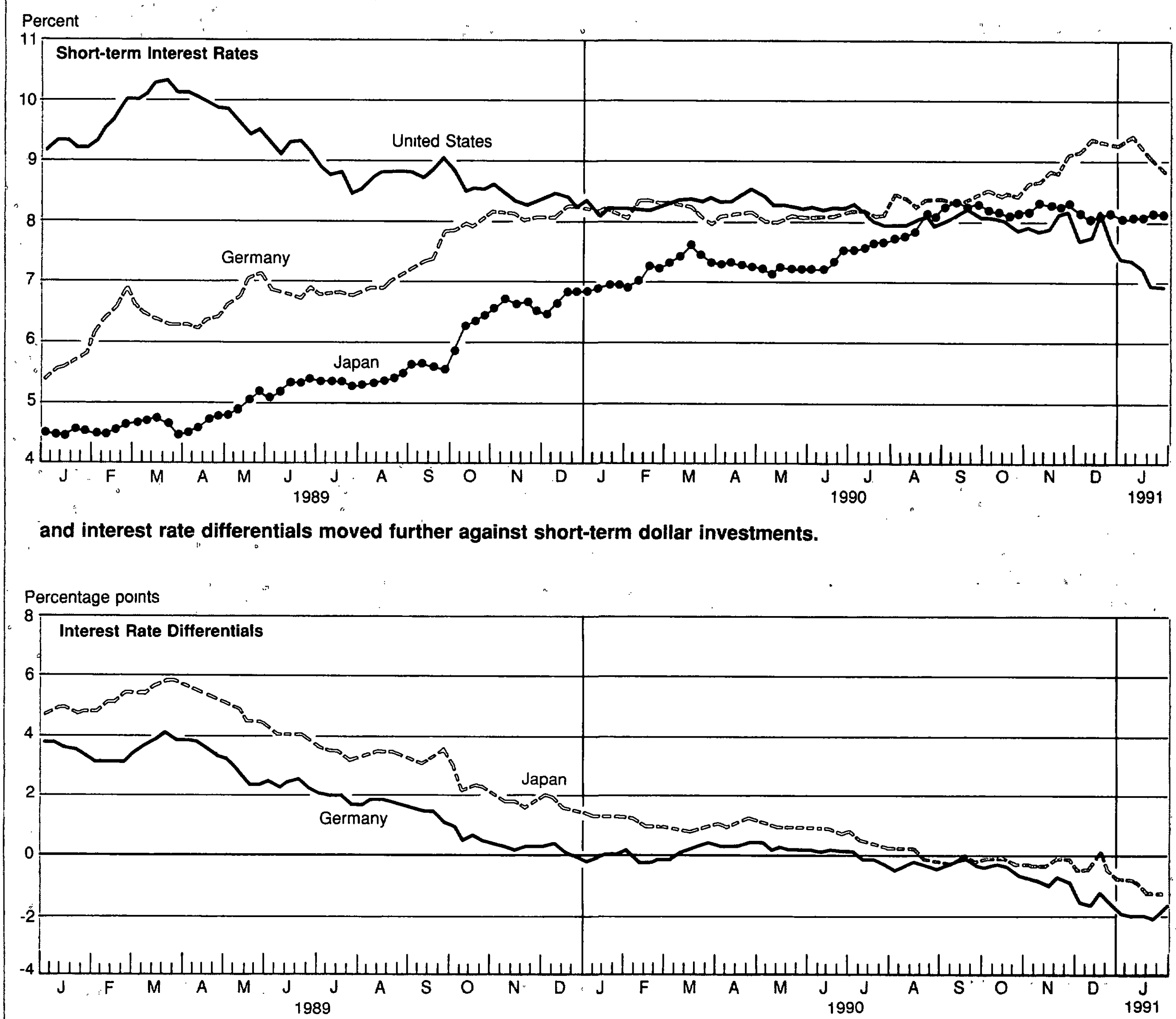


Note: The above chart shows changes in monthly U.S. nonfarm payroll employment from January through December 1990. The shaded area represents data released during the period. The December figure is preliminary.

announcement on November 8 of a large reinforcement of U.S. forces in the Gulf as indicating that the United States was preparing for an outbreak of hostilities Past experience had demonstrated a tendency for the U.S dollar exchange rate to benefit from "safe haven" inflows during periods of political instability or military conflict abroad, and market participants increasingly came to build in a safe haven premium for the dollar. Inthat environment, dealers became increasingly reluctant to take on large short dollar positions. Thus, notwithstanding negative sentiment about the U.S economy and the belief that interest rate differentials against the dollar would increase, the prospect of a safe haven effect associated with the outbreak of war helped

Chart 3

U.S. short-term interest rates continued to decline . . .



Note. The top chart shows weekly average U.S , German, and Japanese three-month Eurocurrency interest rates from January 1989 The bottom chart shows the dollar rate less the foreign rate to cushion the dollar's decline

The middle of the period: late November to mid-January

Beginning in late November, the dollar came under several waves of upward pressure that pushed the currency above its opening levels and to its highs of the period. These pressures primarily reflected heightening expectations that the Gulf conflict would result in an early war But the dollar's rise was aided by other factors, including a perceived deterioration of the political situation in the Soviet Union and two episodes of acute upward pressure on U.S money market rates.

From November 29, when the U N. Security Council set a deadline for Iraq to withdraw from Kuwait, until January 16, when Operation Desert Storm began, market attention focused almost entirely on the Gulf crisis As the threat of war hung over the market during this month and a half, market participants of all types showed an increased reluctance to take on new risks or to respond fully to changes in underlying economic conditions. With interbank dealing in any case about to wind down as the year-end approached, many dealing institutions took the opportunity to impose an early halt to or reduction in their market-making activities Many commercial and institutional participants decided to move to the sidelines and, to the extent possible, to postpone further transactions until the Persian Gulf situation was clarified. In this environment, markets became unusually thin and illiquid, and managers of interbank trading rooms at many institutions took steps to reduce the position-taking latitude of their trading staff.

Meanwhile, pressures in the federal funds and other short-term money markets began to appear in late November as banks bid aggressively to secure money to cover year-end accounting statements. These pressures, coming earlier and with much greater intensity than in past years, occurred against a background of heightened concerns over bank credit quality. At the same time, the efforts of many institutions to improve capital ratios, trim balance sheet size, and enhance internal liquidity reduced the availability of and increased the demand for short-term interbank funds, thereby pushing rates upward. Some market participants unable to secure funds in the interbank market bought dollars in the foreign exchange market to meet their year-end requirements. In response, the dollar moved up in late November and early December. When these pressures temporarily subsided in early December, the dollar retraced most of its rise and, in fact, edged down to touch a new post-World War II low against the mark of DM1 4625 But year-end pressures reemerged late in December and again helped support the dollar at that time.

Another reason for the dollar's rise starting in lateNovember was the growing expectation that the finance ministers and central bank governors of the Group of Seven (G-7) would soon meet and discuss exchange rate issues With strains appearing in the exchange market involving the dollar and other currencies, some market participants believed the G-7 might take steps to stabilize exchange rates This notion gained credence as several G-7 officials indicated that a meeting would occur in January

Around mid-December, market unease over the political situation in the Soviet Union also contributed to the dollar's resilience The December 20 resignation of Soviet Foreign Minister Shevardnadze raised concerns about the outlook for the success of the Soviet leadership's policies of political openness and economic restructuring Because Germany was viewed as most vulnerable to the spillover effects of negative developments in the Soviet Union, the mark eased The mark moved lower not only against the dollar and the yen but also against its partner currencies in the EMS. The mark's softer tone helped reduce, albeit temporarily, pressures that had been building throughout December within the EMS exchange rate mechanism

In these circumstances, the dollar reacted only modestly to a series of actions by the Federal Reserve to ease monetary conditions These included three moves in December and early January which led to declines in the federal funds rate totaling 75 basis points and one move to reduce the Federal Reserve's discount rate by

Table 1

Federal Reserve
Reciprocal Currency Arrangements
In Millions of Dollars

Institution	Amount of Facility January 31, 1991
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 November 1, 1990	November	December	January	Outstanding as of January 31, 1991
Central Bank of Honduras†	82 3	34 8	−34 8	—	—	—

Note Data are on a value-date basis Components may not add to totals due to rounding

†Represents the ESF portion of a $147 3 million short-term credit facility established on June 28, 1990

50 basis points on December 18 In addition, the Federal Reserve on December 2 announced plans to eliminate reserve requirements on nonpersonal time deposits and on net Eurocurrency liabilities in two stages during December

Trading in the foreign exchange market remained listless even after the usual year-end holiday lull During the early weeks of January, as participants awaited the January 15 U.N deadline for Iraq to withdraw from Kuwait, the dollar tended to move during the day in response to the latest statements or signals regarding diplomatic efforts to avert war Thus, the dollar eased following announcements that U S Secretary of State Baker would meet his Iraqi counterpart in Geneva and that the U N Secretary General would visit Iraqi leader Saddam Hussein in Baghdad, only to rebound later when these approaches proved fruitless Against this background, however, the dollar edged up intermittently The dollar's movements around this time were greatest against the Japanese yen, which was seen as having the most to lose from any disruption in oil supplies as a result of war and the most to gain from an expected oil price decline in the event of a peaceful settlement But the dollar also rose against the mark By mid-January, the dollar was trading up to levels as high as ¥137 against the yen and DM 1 55 against the mark, or roughly 5 percent and 2 percent, respectively, above its early November levels against those two currencies

Table 3

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 October 31, 1990	+5,363 3	+2,876 3
Realized November 1, 1990–January 31, 1991	0	0
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1991	+5,688 0	+3,027 2

Note Data are on a value-date basis

The end of the period: mid- to late January

The dollar's response to the outbreak of war on January 16 took many market participants by surprise Having anticipated a wave of sustained dollar buying upon the outbreak of war, many interbank dealers had quietly been building up long dollar positions as the January 15 deadline approached In the event, the dollar did move up on the first reports of bombing over Baghdad to highs of DM1 5525 and ¥138 00 However, the currency quickly gave way to selling pressures as market participants took profits on these long positions Within a few hours after Operation Desert Storm began, the dollar had declined from its highs by about 3 to 4 percent Oil prices fell back sharply while bond and stock markets around the world rallied

Thereafter, the dollar edged lower through the remainder of January From time to time, dollar demand increased in response to concerns over the severity and scope of the Gulf conflict This was the case, for instance, when missile attacks on Israel raised fears that the war might widen. But the dollar's tendency to firm on negative reports out of the Gulf began to wane as market participants appeared to grow more confident that the war would be relatively short and that the United States and its allies would be victorious

As the exchange market grew accustomed to news from the Gulf and liquidity returned to more normal levels, market participants directed more attention to the economic developments and interest rate changes that had gone almost unnoticed in December and early January. Against this background, the dollar began to decline again Statements by Federal Reserve Chairman Greenspan on the potential for further monetary easing if growth of the monetary aggregates remained sluggish, and on the risks of a long and deep recession if the Gulf war were to drag on, were noted These comments, coupled with President Bush's call for lower interest rates in his State of the Union speech, heightened expectations of further near-term cuts in dollar interest rates

In a statement issued after their January 21 meeting, G-7 finance ministers and central bank governors "agreed to strengthen cooperation and to monitor developments in exchange markets" and stated they were "prepared to respond as appropriate to maintain stability in international financial markets " Market participants did not conclude at the time, however, that officials were prepared to take immediate and concrete action to stem further dollar declines

Some market participants came to interpret the January 21 G-7 statement as suggesting that further interest rate increases abroad might be avoided as U.S rates declined Indeed, the expectation that Germany would postpone further tightening became so widespread during the last two weeks in January that pressures within the EMS eased, and European authorities were reportedly able to scale back their intervention mark sales. On the last day of the period, however, the Bundesbank increased its official discount and Lombard rates by 50 basis points, an action whose timing took the market by surprise However, the Bundesbank characterized its move as technical and subsequently took steps to keep money market rates from rising

Thus, as the period closed, sentiment toward the dollar remained negative as market participants, believing that dollar interest rates would decline further, expected interest rate differentials to continue to move against the dollar The dollar closed the period at DM1 4768 against the mark, down 2½ percent from its November opening levels and only slightly above its post-World War II low against that currency Against the yen, the dollar closed the period 1 percent above its opening levels at ¥131 25

* * * *

As noted in our report for the August-September 1990 period, the U.S. Treasury Exchange Stabilization Fund (ESF) repurchased $2,500 million of foreign currencies from the Federal Reserve on November 1 to reverse certain previous warehousing operations From that date through the close of the period, outstanding warehousing of foreign currencies with the Federal Reserve remained at $4,500 million, down from the peak of $9,000 million reached in March 1990

The Treasury also continued to provide SDRs in exchange for dollars to foreign monetary authorities requiring SDRs for the payment of IMF charges and for repurchases These exchanges totaled $204 3 million equivalent of SDRs over the three-month period

The ESF's share of a multilateral credit facility established in June 1990 for Honduras was repaid in full during the period, with payments of $34 0 million on November 15 and $0 8 million on November 20 The ESF portion of this special facility expired at the end of November, and as of the end of January 1991, the Treasury had no special swap arrangements outstanding

As of the end of January, cumulative bookkeeping or valuation gains on outstanding foreign currency balances amounted to $5,688 0 million for the Federal Reserve and $3,027 2 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 January, holdings of such securities by the Federal Reserve amounted to $8,114 8 million equivalent, and holdings by the Treasury amounted to the equivalent of $8,000 6 million valued at end-of-period exchange rates