Treasury and Federal Reserve Foreign Exchange Operations

August-October 1990

During the August-October period, sentiment towards the dollar was generally negative. Exchange market participants continued to focus on signs of sluggish economic activity in the United States and on the movement of interest rates against the dollar. The growth prospects of the U.S economy were widely perceived as weak, and the adverse trend in interest rate differentials, which had narrowed by several hundred basis points since early 1989, was expected to continue

The crisis in the Persian Gulf had both positive and negative effects on the dollar. Immediately following the Iraqi seizure of Kuwait on August 2, the dollar rose to its highs of the period amid expectations that the conflict would trigger heavy flows into the dollar Thereafter, although market participants were attracted to U S assets at times when fears of war intensified, the dollar was undermined by concerns that the U.S economy was more vulnerable than other major economies to the steep rise in oil prices caused by the conflict.

In this environment, the dollar moved generally lower during the period, declining almost 5 percent on a trade-weighted basis as measured by the index of the staff of the Federal Reserve Board of Governors. Against individual currencies, the dollar declined between 4 percent and 4½ percent on balance against the major European currencies, reaching record lows against the German mark and Swiss franc It declined against the Japanese yen by almost 11 percent to trade at its lowest levels against that currency since January 1989 The dollar was relatively unchanged against the Canadian dollar The U S. authorities did not intervene in the foreign exchange market during the period.

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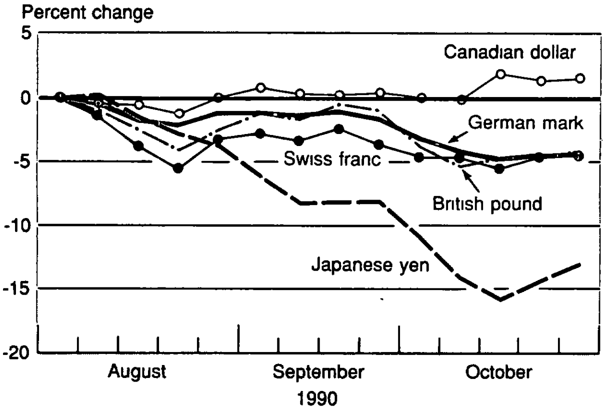
The outlook for the U.S economy was a focus of attention in the exchange market throughout the period under review as market participants looked to each new economic statistic for signs of how significantly the U S. economy was slowing A report released just before the period had shown second-quarter GNP growth to be less rapid than had been expected at an annual rate of 1 2 percent. In early August, a number of data releases and reports reinforced impressions of slowing economic activity, including data on employment, industrial production, and capacity utilization as well as the Federal Reserve's "beige book" survey of economic conditions around the country.

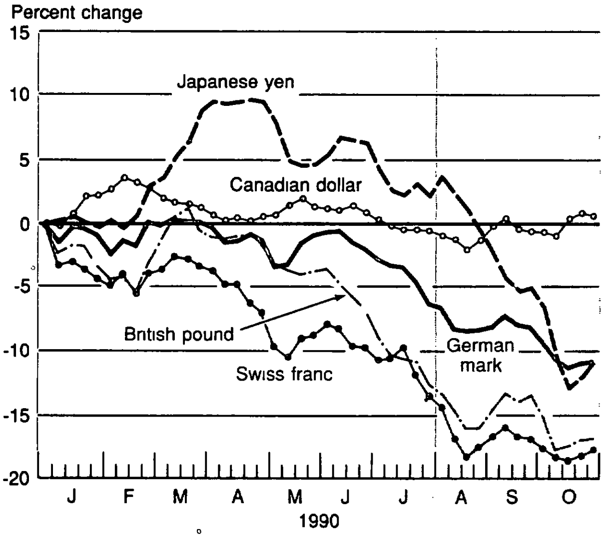
As the period progressed, subsequent data releases provided mixed and hard-to-interpret signals about the U S economy But the view of the economy in the exchange market and among observers more generally became increasingly negative, in large part because of concern over the economic impact of the sharp increases in oil prices resulting from the Persian Gulf crisis Market participants believed that the U S economy was less able to cope than some of the other industrial economies with the potential effects of sharply higher oil prices on business activity and prices. A September 25 report revising second-quarter economic growth downwards to a 0.4 percent rate suggested to market participants that the U S. economy was weakening markedly, even before the economic effects associated with the Persian Gulf crisis had begun to affect it. Other economic data released over the period provided a more mixed impression, including preliminary U.S. GNP data released on October 30 estimating growth of 1.8 percent at an annual rate for the third quarter.

Chart 1

The dollar moved generally lower through the period. The downward movement was particularly sharp against the Japanese yen, . . .



making the dollar's decline against the yen over the course of the year comparable to its decline against the German mark.



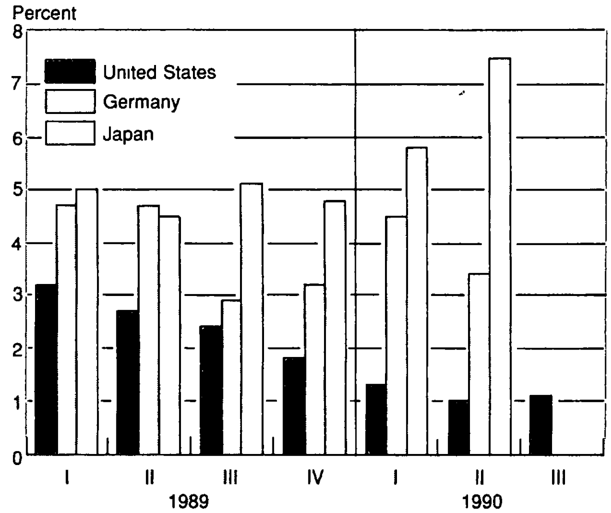
Notes: The top chart shows the percent change of weekly average rates for the dollar from July 31, 1990. The bottom chart shows the percent change of weekly average rates for the dollar from December 31, 1989. All rates are calculated from New York closing quotations.

Spreading perceptions of slowing U.S. economic activity added to the view that interest rates in the United States would continue to go down and that interest rate differentials would move further against the dollar. Expectations of lower interest rates were reinforced by the prospect that some form of compromise would be reached to reduce the U.S. fiscal deficit. After a major U.S. money center bank announced large staff cuts and increased provisions for problem loans late in September, U.S. banks also became a focus of discussion in the exchange market, with some market participants believing that the condition of U.S. banks added to the likelihood that the Federal Reserve would ease.

On September 30, news of a budget accord between negotiators from the White House and Congress also increased expectations that the Federal Reserve would soon allow an easing in the federal funds rate. After that initial budget package failed to pass Congress on October 5, however, the focus of market attention shifted away from interest rates. As the budget negotiations became protracted, the market grew preoccupied with the stalemate itself, which was widely viewed as evidence of the unmanageability of the budget process and of serious disarray within the U.S. government over economic management generally. Thus, concern over the impasse continued to weigh on the dollar until the

Chart 2

During the past two years, the pace of economic activity measured on a year-on-year basis has slowed in the United States while remaining strong in Japan and Germany.



Note: This chart shows quarterly changes in real GNP on a year-on-year basis.

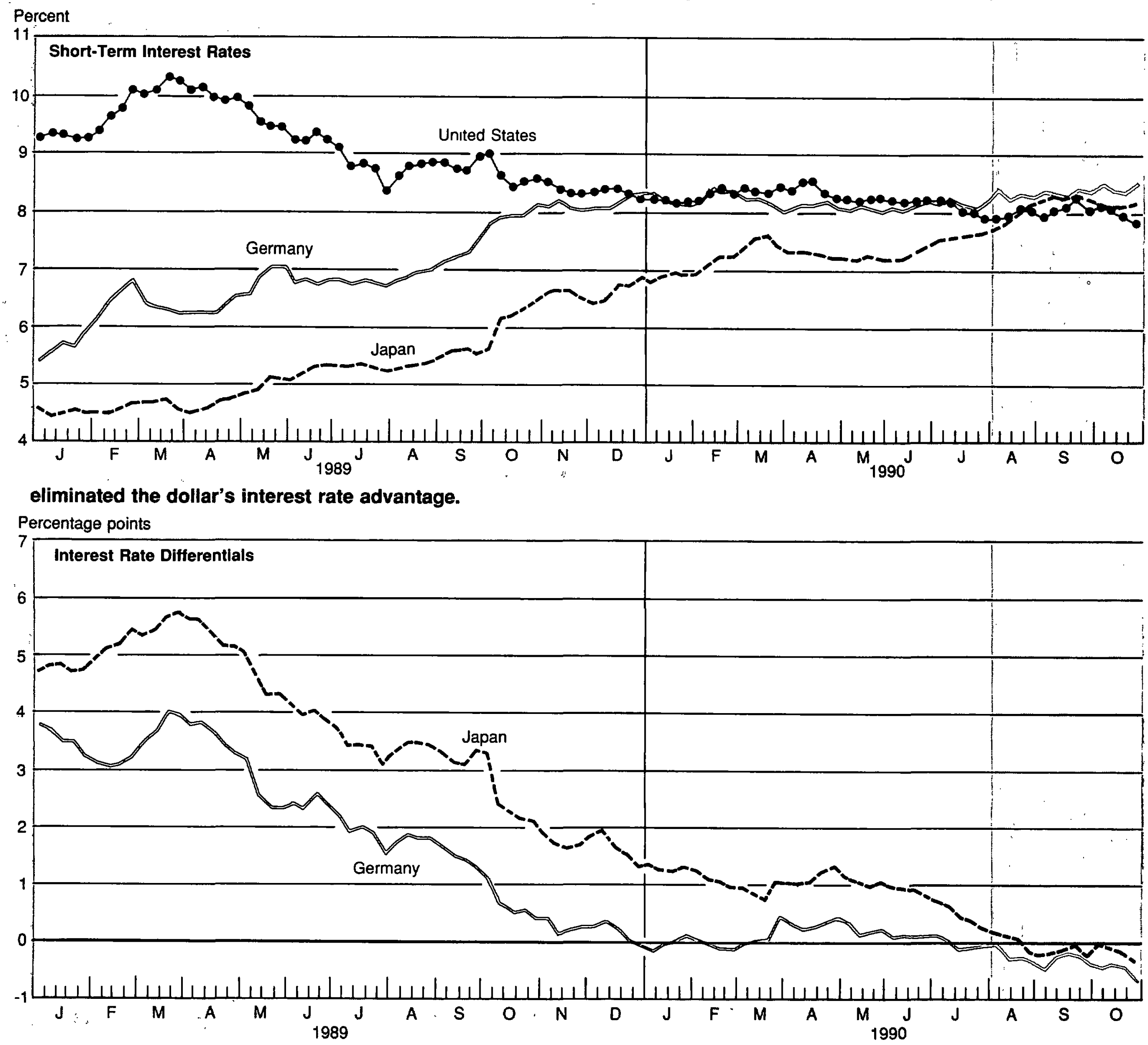
closing days of the period. Even when a new budget acceptable to the President was finally approved by Congress on October 27, it gave little lift to market sentiment toward the dollar

The decline in the dollar during the period occurred principally during three waves of selling pressure

The first occurred during the first three weeks of August. Although the dollar initially firmed on news of Iraq's invasion of Kuwait, reaching its period highs on August 2 of DM 1.6215 against the mark and ¥151.60 against the yen, it quickly started to decline against the European currencies as market participants became

Chart 3

Since early 1989, increases in Japanese and German interest rates, together with declines in U.S. rates, . . .



Notes The top chart shows weekly average three-month Euro interest rates The bottom chart shows the dollar rate less the foreign rate more concerned over U S. economic prospects. At this time, the dollar showed little net movement against the Japanese yen, the currency initially the most negatively affected by fears of a disruption of oil flow from the Middle East

The second wave took place around mid-September when the dollar declined against the yen but traded relatively steadily against other major currencies The dollar's decline against the yen stalled for a time around the September 22 meeting in Washington of the Group of Seven Finance Ministers and Central Bank Governors The communiqué released after the meeting stated that the officials had noted the yen's appreciation since their last meeting and that they had "concluded that exchange rates were now broadly in line with continued adjustment of external imbalances."

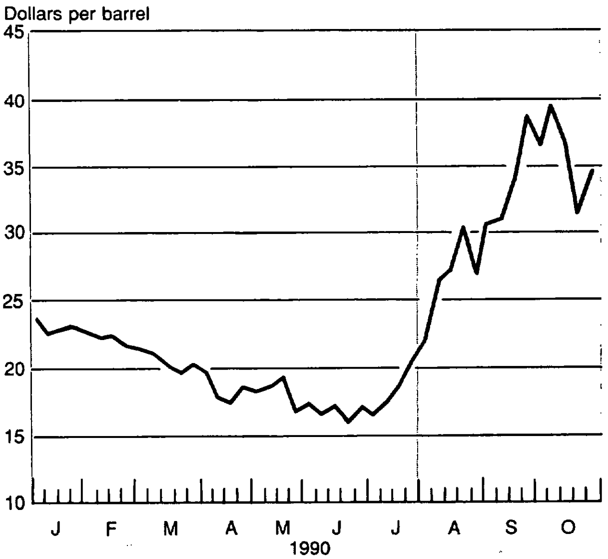
From late September through mid-October, the third wave occurred, with the yen leading a generalized rise of foreign currencies against the dollar. At that time, market participants became increasingly concerned about the impasse over the U.S government budget, and perceptions developed in the market that officials, both in the United States and abroad, were not concerned about the dollar's decline The dollar traded as low as ¥123 75 against the yen on October 18 and DM 1.4910 against the mark the next day, its lows for the period

Late in October, steps were taken toward dispelling the impression of a lack of official concern Treasury officials made clear in statements to the press that the Administration was concerned about the dollar, and rejected suggestions that the decline was welcomed At about the same time, market rumors of U S intervention served as a reminder to market participants of the possibility of official action to support the dollar In fact, the U S. monetary authorities did not intervene during the three months under review.

The extent to which the dollar moved against individual currencies was further influenced by developments in their respective countries With the formal unification of Germany on October 3, the pressures and anticipated costs associated with the integration of the East German economy into that of West Germany were a matter for reevaluation in the exchange market The German mark continued to benefit from the perception that a large fiscal deficit and the fast pace of domestic economic expansion underway in the western part of the country, driven in part by demand from the east, would keep German interest rates firm or rising Market participants noted repeated assurances from the Bundesbank that it would adhere to a strict, anti-inflationary policy stance, as well as the call for a strong mark to keep inflation in check and to help attract capital to

Chart 4

Oil prices rose sharply during the period.



Note The chart shows weekly average prices per barrel of West Texas oil

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility October 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

finance economic integration. The mark's strength was dampened periodically during the period as large upward revisions in estimates of the expenses associated with unification suggested that the costs and difficulties had been misgauged Concerns about these problems and the upward trend in German interest rates also contributed to the sharp declines in German stock prices during the period.

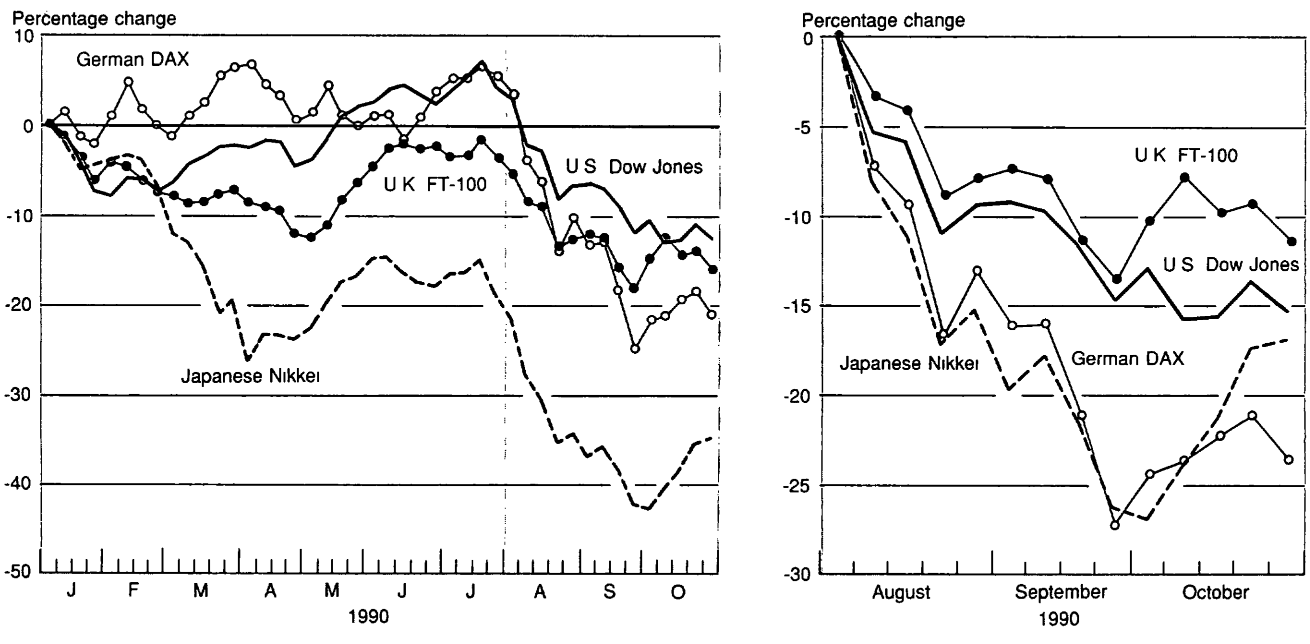
Among other European currencies, the pound sterling moved higher against the dollar during the period. It thereby moved broadly in line with the rise of the mark, despite signs of a weakening in economic activity, rising unemployment, and declining output and retail sales The pound gained some support from safe-haven flows and from the perception that sterling would benefit from the United Kingdom's North Sea oil fields. Also, through much of the period, sterling was buoyed by expectations that the currency would soon join the Exchange Rate Mechanism (ERM) of the European Monetary System On October 5, these expectations were borne out when it was announced that the pound was entering the ERM with a 6 percent margin of fluctuation. During the rest of October, the pound declined, moving below its ERM parity rate against the mark of DM 2.95.

Like the mark, the Swiss franc closed the three-month period almost 4½ percent higher on balance against the dollar Early in the period, the Swiss franc led the rise against the dollar and strengthened against all major currencies At that time, the franc appeared to benefit to some extent from the nervousness and uncertainties surrounding the situation in the Middle East. Its strength was also based on the Swiss National Bank's tight, anti-inflationary policy stance. After moving up to an all-time high of SF 1.2525 against the dollar on August 23, the franc fluctuated below this level through the end of October, while other foreign currencies subsequently moved higher. The franc's rise stalled after the Swiss central bank took advantage of the leeway provided by the currency's strength to moderate its tight monetary policy slightly, a move acknowledged in public comments towards the end of August.

The Japanese yen appreciated significantly against other major currencies during all but the initial days of the three-month period The first effect of the invasion of Kuwait was to push the yen down against other currencies as the exchange market initially reacted to Japan's heavy dependence on imported oil and fears of a complete disruption of Persian Gulf oil shipments.

Chart 5

The world's major stock markets declined during August and September.



Notes The panel on left shows the percent change in weekly averages of daily closing levels Panel on right shows the percent change in the weekly averages since the beginning of the quarter under review

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 July 31, 1990	August	September	October	Outstanding as of October 31, 1990
Bank of Guyana†	31 8	13 4	0 0	−13 4	—	—
National Bank of Hungary‡	20 0	20 0	−12 1	−7 9	—	—
Central Bank of Honduras§	82 3	57 3	−22 6	0 0	0 0	34 8

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

The ESF's special facility with the Bank of Mexico, inactive since July 31, 1990, expired on September 14, 1990

†Represents the ESF portion of a $178 million short-term credit facility that expired on September 20, 1990

‡Represents the ESF portion of a $280 million short-term credit facility that expired on September 14, 1990

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

However, the yen soon began moving higher against both the dollar and other currencies as these concerns receded and market participants came to focus more on the rising cost of oil—a cost which the Japanese economy seemed better able to absorb than other countries. Furthermore, market participants expected that movements in interest rate differentials would continue to favor the yen. Market participants believed that the Bank of Japan, already concerned about the fast pace of Japan's economic expansion and inflationary pressures, would be quick to raise interest rates in response to the increase in energy costs resulting from the Persian Gulf crisis. In fact, the Japanese central bank did raise its discount rate by ¾ percentage point on August 30

In response to rising market interest rates that both preceded and followed the discount rate hike, talk spread that Japanese investors were finding the returns they were getting at home to be adequate and would no longer be investing abroad as much as before, especially in the United States. Meanwhile, the decline in Japanese equity prices resumed, with the Nikkei index of the Tokyo Stock Exchange down 48 percent at the beginning of October from its levels at the start of the year. Accordingly, a number of Japanese banks, in response to the sharp falls in values of their domestic stock investments as well as their bond holdings, repatriated funds to shore up their domestic capital positions ahead of the end of the fiscal half year September 30. The yen's rise gained more momentum as Japanese companies and investors also moved to raise their hedge ratios on foreign holdings from below-average to above-average levels.

As the yen rose, Japanese officials were increasingly questioned about their attitudes towards exchange rates as some small- and medium-sized Japanese firms began to report that they were losing export competitiveness Official comments at first left questions in the market as to whether either the Japanese or the U.S. authorities cared if the yen continued to rise But in late October a large customer purchase of dollars against yen carried out by this Bank was seen in the market. Then, various remarks by U.S., Japanese, and French officials renewed market participants' wariness that the authorities might intervene to support the dollar.

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 July 31, 1990	+3,547 5	+1,519 5
Realized August 1, 1990–October 31, 1990	0	+415 6
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1990	+5,363 3	+2,876 3

Note Data are on a value-date basis

The U.S. dollar rose slightly on balance against the Canadian dollar during the three months. In the early part of August, the Canadian currency firmed to its highest levels in twelve years against the U S dollar. At that time, market concerns over a possible disruption of Persian Gulf oil shipments helped buoy the currency because of Canada's position as a net exporter of oil. However, the currency subsequently began to move lower, particularly after Canadian officials confirmed that the economy had entered a recession and that they were prepared to lower interest rates

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The Exchange Stabilization Fund (ESF) renewed warehousing arrangements with the Federal Reserve that fell due within the period These transactions resulted in realized profits of $415 6 million for the ESF, reflecting the difference between the rates at which the Treasury had acquired the funds and the rates at which the warehousing agreements were renewed. As of October 31, the last day of the period under review, the ESF's outstanding warehousing of foreign currencies with the Federal Reserve totaled $7,000 million, unchanged for the period under review

The U S. Treasury, however, had initiated steps prior to the end of the period that resulted in the reversal of $2,500 million of the warehousing of foreign currencies effective November 1, the day after the period's close. The reversal of warehousing of foreign currencies finalized on November 1 was financed in part by the Treasury's issue on October 31 of an additional $1,500 million of SDR certificates to Federal Reserve Banks. The remainder was financed from ESF cash balances. As of November 1, outstanding warehousing of foreign currencies with the Federal Reserve totaled $4,500 million, half the level outstanding earlier in the year.

The Treasury also continued to exchange SDRs for dollars with foreign monetary authorities that needed SDRs for payment of IMF charges and for repurchases, exchanging a total of $558 4 million equivalent of SDRs during the period.

Multilateral credit facilities previously established for Guyana and Hungary, in which the ESF participated, were repaid in full during this period, while a similar facility for Honduras was partially repaid. On September 14, a special Mexican short-term credit facility established in March by the U S. monetary authorities expired All drawings on the facility had been repaid prior to the period under review.

Guyana At the beginning of the period, Guyana's outstanding commitment to the Treasury on its multilateral financing facility totaled $13 4 million. Guyana made four payments in September, including final repayment on September 20, the facility's expiration date

Hungary The Treasury's $20 million share of the first two drawings by Hungary was outstanding at the start of the period Hungary reduced the amount outstanding on its second drawing by $4 8 million on August 1 and the amount outstanding on its first drawing by $7.3 million on August 20 The drawings were fully repaid on September 5. Hungary also completed repayments to the BIS (representing certain member central banks) before the September 14 expiration date of the facility.

Honduras On August 1, Honduras made a partial repayment of $22.6 million to the Treasury, leaving an outstanding balance of $34 8 million on the Treasury's part of a multilateral facility.

As of the end of October, cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $5,363.3 million for the Federal Reserve and $2,876.3 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 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 October, holdings of such securities by the Federal Reserve amounted to $8,238.7 million equivalent, and holdings by the Treasury amounted to the equivalent of $8,331 6 million valued at end-of-period exchange rates.