Treasury and Federal Reserve Foreign Exchange Operations

August-October 1991

The dollar, having already come down from its post-Gulf war highs before the beginning of August, moved irregularly and moderately lower during the August-October period under review. This development occurred as the recovery of the U.S. economy appeared both slower to emerge and less vigorous than had been anticipated in earlier months. The dollar eased during the three-month period by over 4 percent against the mark, close to 5 percent against the yen, and about 3¾ percent on a trade-weighted basis.[1] The U.S. monetary authorities did not intervene in the foreign exchange markets during the period.

August

As the period opened, the dollar was generally trading with a negative bias, weighed down by widening interest rate differentials adverse to the dollar. Previously, market participants had expected that the United States would emerge quickly out of recession at a time when some other economies might be slowing, and that the large interest rate differentials providing a disincentive to investment in dollar-denominated assets would thereby be eliminated. But U.S. data released around the beginning of August caused a reappraisal of this view, raising questions about the vigor of the U.S. economy and renewing talk of further declines in U.S. interest rates. At the same time, the Japanese authorities were trying to dampen expectations that a reduction of the Bank of Japan's official discount rate in early July would quickly be followed by another such move. In Germany, new data revealing rising inflation encouraged expectations that the Bundesbank would raise official interest rates to contain inflationary pressures before the start of important labor negotiations for the coming year.

Against this background, the dollar showed some vulnerability to selling pressure in early August, particularly against the mark. Publication of a weak July nonfarm payroll employment report, following a succession of other worse than expected U.S. statistics, prompted a 2 percent drop in the dollar from its high of DM 1.7675 on August 2. Evidence that the Federal Reserve had eased the federal funds rate 25 basis points on August 6 triggered a new round of selling of the dollar against the mark that took the exchange rate briefly below DM 1.70 on August 8. But around mid-August when the Bundesbank announced that it was raising its official Lombard rate by less than the market had expected, the dollar almost completely reversed its decline of the previous weeks. Against the yen, the dollar followed a similar pattern, easing from a high of ¥138 on August 2 to almost ¥135 about a week later before retracing some of this decline. But these movements were somewhat more subdued since revelations surrounding scandals in Japan's financial markets were weighing on the Japanese currency.

News early Monday, August 19, that Soviet President Gorbachev had been removed from office sparked a sudden scramble for dollars. The prospect that the Soviet leader would be replaced by a reactionary gov-

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[1]The trade-weighted value of the dollar is measured by the Federal Reserve Board staff's index.

ernment seeking to roll back the reforms that permitted liberalization in eastern Europe and the unification of Germany inflamed the markets' deepest anxieties about the outlook for Europe in general, and Germany in particular Market participants, seeking currency safe havens, moved funds out of marks and into other currencies, including the U S and Canadian dollars and the Swiss franc—currencies thought to be geographically insulated from whatever potential political disruption and social unrest might ensue. In a matter of hours, the dollar rose 7 pfennigs, or about 4 percent, to touch DM 1 8350 amid fears that the coup attempt would lead immediately to widespread violence By the time New York trading began that day, the dollar had come well off its highs after reports circulated that a number of central banks had been intervening and as the likelihood of violence in the Soviet Union appeared to diminish In these circumstances, no intervention was undertaken by the U.S. authorities By Wednesday, August 21, reports circulated that the putsch had failed and that Gorbachev would return to office Market participants were impressed by the strength of public support for a more democratic government in the Soviet Union and at the same time surmised that the threat to continued liberalization might induce western nations to offer substantial assistance to eastern Europe. Thus, the outlook for Germany and the mark appeared somewhat improved on balance. In response, the dollar quickly fell back below its pre-coup levels By the end of August, the dollar was trading near levels that prevailed at the beginning of the month, closing at DM 1.7465 and ¥136 80

The very sharp swings in exchange rates that occurred around the time of the events in the Soviet Union, following the volatility that had been evident beforehand, had an unnerving effect on many market participants. There were numerous reports that substantial losses arising from the Soviet episode had induced many market participants subsequently to reduce their position-taking activities The dollar's sharp rise also served as a reminder of the risk of holding short-dollar positions

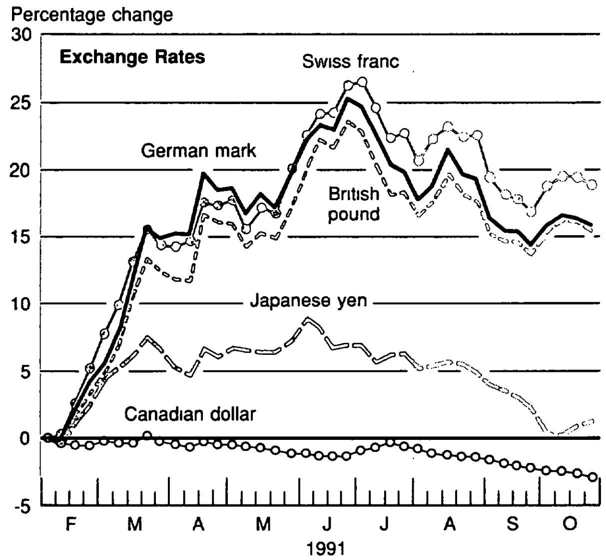
The movement of the dollar against the yen, though broadly in the same direction, had been less sharp because the developments in the Soviet Union were perceived to have a less immediate impact on Japan than on Germany As a result, market participants became persuaded of the merits of using the Japanese yen as a vehicle for taking positions either in favor of or against the German mark since the yen might not entail as much price risk as the dollar

Early September

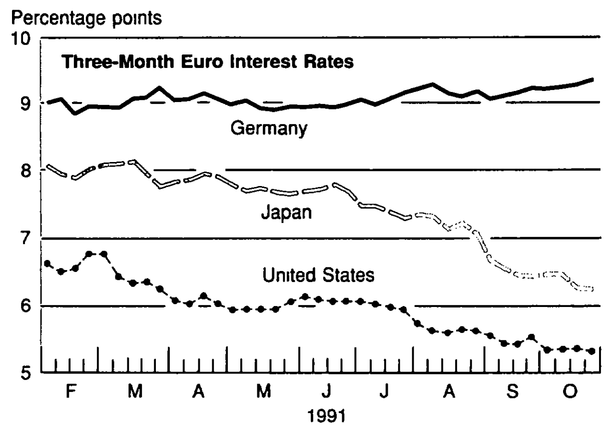
In early September, the release of a new round of monthly U S data reinforced doubts about the strength of the U S recovery and, in a context of renewed calls by U S. officials for lower U.S. interest rates, revived the negative market sentiment toward the dollar A steep downward revision in U.S nonfarm payroll data was reported on September 6, following a downward revi-

Chart 1

The dollar declined moderately and irregularly during the period as doubts arose over the vigor of the U.S. economic recovery.



During the August-October period German interest rates firmed while U.S. and Japanese interest rates declined.

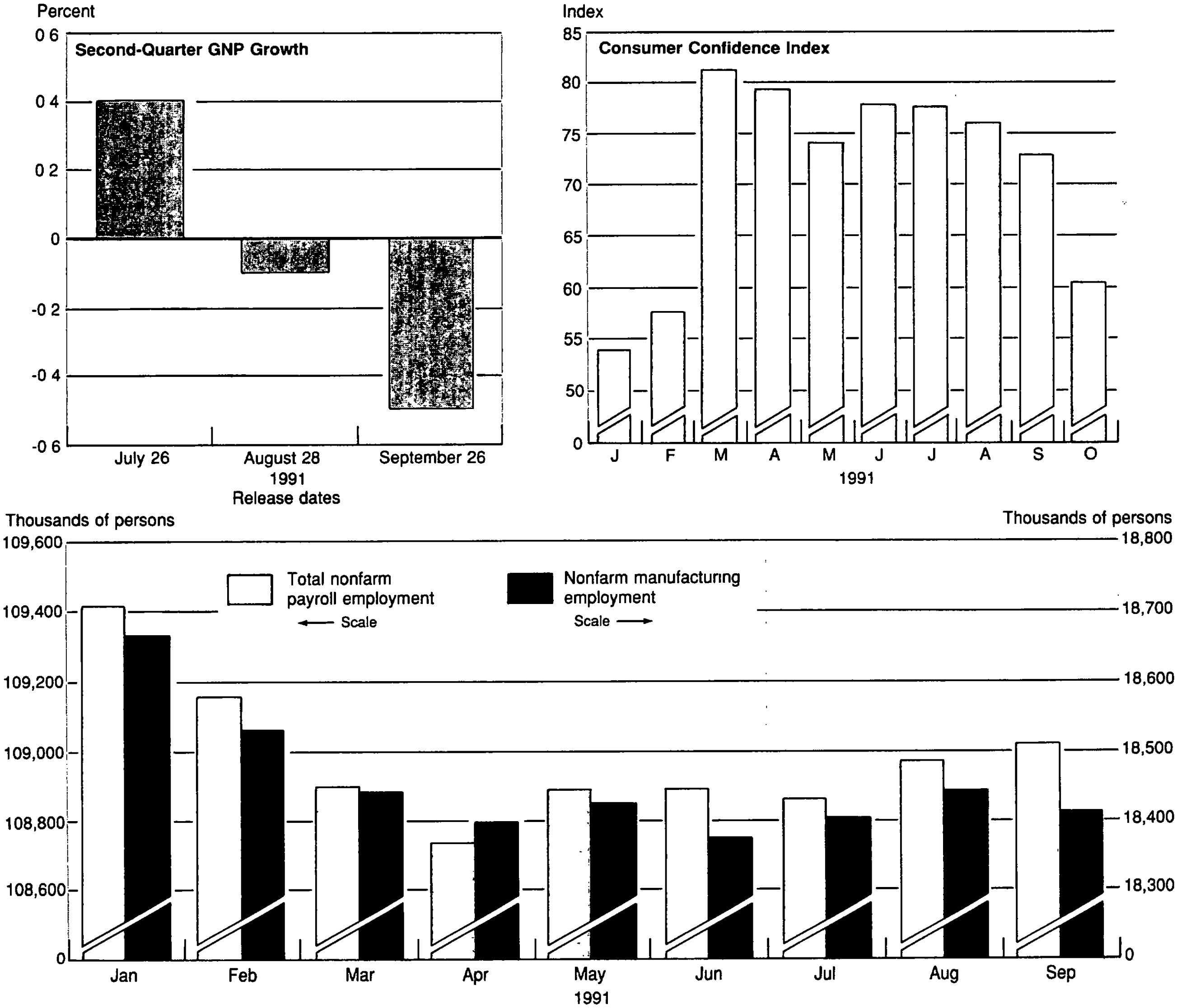


Notes The top panel shows the percentage change of weekly average rates for the dollar from February 6, 1991 The bottom panel shows weekly average U S , German, and Japanese three-month Euromarket interest rates from February 6, 1991 sion in late August of U S. second-quarter GNP growth. The following week, the Bureau of Labor Statistics released price data that appeared to suggest that the risks of reigniting inflation were low These data, along with reports of anemic growth in monetary aggregates, further intensified expectations that more aggressive easing by the Federal Reserve lay ahead On September 13, the Federal Reserve announced a 50 basis point cut in the discount rate to 5 percent

At the same time, developments in Germany and

Chart 2

Data released during the period reinforced perceptions that the U.S. economic recovery was failing to live up to expectations.



Notes The top left panel shows the seasonally adjusted annual rate of growth in U S second-quarter real GNP The advance, preliminary, and final releases of the GNP data occurred on July 26, August 28, and September 26, respectively The top right panel shows the Conference Board's consumer confidence index The shaded portion in the bottom panel represents payroll reports released during the August-October period and revised on November 1, 1991

Japan served to improve sentiment for the currencies of those countries. Market participants felt that because the Bundesbank's official interest rate hike in August was at the lower end of the range of expectations, another tightening of German monetary policy could not be ruled out The contrast in monetary policy orientation in the United States and Germany weighed on the dollar relative to the mark With respect to the yen, the prospects for interest rates were not so divergent from those in the United States Indeed, the Japanese authorities were seen as exerting downward pressure on Japanese short-term interest rates to shore up confidence in Japanese financial markets and to respond to evidence suggesting that the Japanese economy was losing steam At times there was even talk in the market that the authorities in Japan and the United States might act jointly to lower interest rates Nevertheless, the yen tended to firm relative to the dollar as the outflow of portfolio capital from Japan appeared to be slowing Many market participants believed that Japanese firms were anxious to improve the yen liquidity of their balance sheets, particularly ahead of the fiscal half-year reporting date at the end of September. It appeared as well that domestic and foreign investors were becoming more confident that the time had come to take advantage of attractive buying opportunities in the Japanese stock market.

Under these circumstances, market participants became more willing to sell dollars, and those who needed to buy felt content to postpone their dollar purchases During the first two weeks of September, the dollar eased more than 3 percent against the mark to just under DM 1 69 as well as 2 percent against the yen to just under ¥134

Mid-September to late October

Starting in mid-September, the dollar drew support against the mark from developments in eastern Europe The economic and political situation there appeared vulnerable to the kind of sudden political or military crisis that could cause the dollar to appreciate substantially, as it had during the Soviet putsch. The military and social disintegration taking place in Yugoslavia was both a disturbing development in itself and an example of the risks facing countries trying to make the adjustment to democratic governance and market economies Moreover, talk began to circulate that the Soviet Union might not be able to remain current in its international obligations, and these financial pressures were seen as posing severe strains on the Soviet economy ahead of the difficult winter season

In early October, economic factors also came to lend more support to the dollar Unexpectedly positive data on U.S. employment and new home sales led market participants temporarily to question their negative view of U S economic prospects. Furthermore, proposals then circulating in the U.S administration and Congress to encourage bank lending and to cut taxes led market participants to consider that instruments other than monetary policy might be employed in efforts to spur the economy. As a result, earlier expectations that U S interest rates would continue to decline until economic activity picked up more decisively in the United States diminished.

This change in expectations roughly coincided with a revision of expectations concerning German interest rates. Market participants were becoming increasingly impressed with evidence of decelerating economic activity in many of Germany's neighbors They were also aware of the intensifying pace of negotiations within the European Community over European monetary union As time passed and the Bundesbank did not move to raise interest rates again in September, many market participants began to consider the possibility that a combination of domestic and international considerations might make another increase in official German rates unlikely

Under these circumstances, the pace of the dollar's decline against the mark slowed during the second half of September, even as the exchange rate eased to its low for the period under review of DM 1.6577 on September 30 Then in October, the dollar actually firmed a

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility October 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

little against the mark and subsequently fluctuated without clear direction, trading as high as DM 1 7218 on October 28.

Against the yen, by contrast, the dollar showed a more pronounced tendency to weaken, especially in early October As market participants considered the implications of a deflation of Japan's asset-price bubble and consumer boom, the prospect loomed that Japan might once again develop a troublesome current account surplus In fact, Japan's surplus with Europe had grown, attracting political attention in at least some European countries With the approach of the G-7 meetings in mid-October, talk developed that the major industrialized nations would agree to seek an appreciation of the yen as a means of containing Japan's growing surpluses with Europe and the United States. Statements by Japanese government officials suggesting that the yen might appreciate, in addition to a meeting between U.S Treasury Secretary Brady and Japanese Finance Minister Hashimoto before the G-7 talks, encouraged these expectations. When the G-7 communiqué of October 12 was interpreted as suggesting that the yen's recent appreciation had been appropriate, the yen advanced further against the dollar, reaching an eight-month high close to ¥128.50. But thereafter market participants focused anew on the prospects for a cut in Japan's official discount rate Expectations of continued easing of Japanese monetary policy were reinforced in late October by several factors, including data releases showing both a further slowing of growth in Japan's money supply and a moderation of inflation, official comments promoting lower interest rates, and the accession to the prime minister's office of former Finance Minister Miyazawa—who was viewed as supporting an easier monetary policy As a result, outflows of portfolio capital resumed, the yen gave up some of its gains, and the dollar was again trading as high as ¥132.50 on October 28.

Table 2

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

In Millions of Dollars

	Federal Reserve	U S Exchange Treasury Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1991	+1,919 9	+321 4
Realized August 1, 1991-October 31, 1991	+105 1	+9 4
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1991	+2,764 8	+1,132 6

Note Data are on a value-date basis

Last days of October

During the last days of October, sentiment toward the dollar turned decidedly negative, and the dollar eased across the board Market participants began to forecast an even feebler U S recovery than had been anticipated and to expect further easing of U S interest rates. A much worse than expected U.S. consumer confidence report, coupled with what were viewed as pessimistic comments about the economy by Federal Reserve Chairman Greenspan, revived expectations that the Federal Reserve would move soon to ease monetary policy. Meanwhile, in Germany, a combination of rising money supply growth, double-digit wage demands, and reports from the Bundesbank and German economic institutes warning of inflationary pressures appeared to market participants to give the Bundesbank reason to tighten monetary policy if it so desired.

Therefore, at the close of the period, market attention was again focused on the contrasting demands on monetary policy in the major countries. With the existing interest rate differentials also remaining adverse to the dollar, the U.S currency moved lower The dollar's decline against the yen was somewhat constrained in light of clear evidence that Japanese monetary policy was also on an easing trend. Yet, the dollar closed the August-October period at DM 1.6713 and ¥130.75, so that the decline that had started in midsummer continued well into fall. At these closing levels, the dollar was 9 percent below its high against the mark reached in July but still 16 percent above the all-time low reached in mid-February during the Gulf war Against the yen, the dollar had come down more than 8 percent from its high in June to trade only 3 percent above its mid-February lows

The U.S. monetary authorities did not intervene during the period. However, the settlement of a large portion of the U.S monetary authorities' forward dollar purchases against foreign currencies—which, as previously reported, were initiated in June and July to adjust the foreign currency reserves of the Federal Reserve and Exchange Stabilization Fund (ESF)—took place during the period

- Three of the forward transactions, entered into with the Bundesbank on June 25, settled during the period. $554 9 million on August 27, $553.6 million on September 27, and $552 3 million on October 28 For each transaction, 60 percent was executed for the account of the Federal Reserve and 40 percent for the account of the ESF Of the original $5,548 5 million of forward dollars purchased at that time, a remaining $1,101 million will be settled by the end of the calendar year.

- The two remaining forward transactions of $1,000 million each against another foreign currency settled, one on August 19 and the other on September 18. The dollars purchased were split evenly between the Federal Reserve and the ESF.

In other operations, the ESF continued to execute transactions as agreed with the International Monetary Fund (IMF) to facilitate transactions in Special Drawing Rights (SDRs). During the period, it sold German marks against SDRs equivalent to $227.4 million, of which $186.4 million was settled during the period. The ESF also purchased a total of $324.1 million against sales of SDRs with foreign monetary authorities in need of SDRs for payment of IMF charges or for repurchases, of which $273.6 million was settled during the period.

As previously reported, the ESF repurchased a total of $2,500 million of foreign currency warehoused by the Federal Reserve in August. These repurchases reduced the amount of ESF foreign currency balances warehoused with the Federal Reserve from $4,500 million equivalent to $2,000 million equivalent.

During the August-October period, the Federal Reserve realized profits of $105.1 million and the Treasury realized profits of $9.4 million from the currency exchanges described above conducted directly with foreign monetary authorities. Cumulative bookkeeping or valuation gains on outstanding foreign currency balances at the end of October were $2,764.8 million for the Federal Reserve and $1,132.6 million for the ESF (the latter figure includes valuation gains on warehoused funds). These valuation gains represent the increase in the 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 October, holdings of such securities by the Federal Reserve amounted to $7,583.4 million equivalent, and holdings by the Treasury amounted to $8,684.9 million equivalent, both valued at the end-of-period exchange rates.