Treasury and Federal Reserve Foreign Exchange Operations

November 1992-January 1993

During the November-January period, the dollar continued to appreciate against the German mark and Japanese yen from the low levels established in the prior period. The U.S. authorities did not intervene in the foreign exchange markets.

Developments in dollar exchange markets

Over the period, the dollar gained 1 percent in value against the yen, 4.5 percent against the mark, and 5.5 percent on a trade-weighted basis.[1] The dollar's upward movement was supported, first, by the perception that the incoming Clinton Administration would pursue a policy of fiscal stimulus and, subsequently, by stronger than expected U.S. economic growth and persistent expectations of official rate reductions in Germany and Japan. The dollar's trend was interrupted by changing estimates of the amount of any U.S. fiscal stimulus, by perceived postponements of German rate reductions, and by widespread market reports of European central bank sales of dollars.

The dollar trends higher. Following the U.S. election in November, analysts were predicting that the U.S. economy would begin to outperform those of other industrialized countries and that a narrowing of interest rate differentials would favor the dollar in the coming year. The prospect of a strengthening dollar was given continued support by indications that President-elect Clinton would apply fiscal stimulus early in 1993 should there be any signs of economic weakness. Although hopes for a reduction in official rates by the Bundesbank were disappointed in both November and December, expectations for such a move early in the new year persisted. Anticipating a stronger dollar in the new year, market participants in late December and early January bid up the dollar to its period highs of DM 1.6490 on January 8 and ¥126.21 on January 13.

After mid-January, however, there was an unwinding of long-dollar positions as it became apparent that a reduction in official rates by the Bundesbank was not imminent and that the Clinton Administration's overall fiscal policy might put greater weight on reducing the budget deficit. Many market participants then assumed that if U.S. economic conditions were to worsen, responsibility for ensuring adequate economic growth would fall on the Federal Reserve. Although a reduction in official U.S. rates was still not seen as likely, an easing was perceived to be in the range of possible monetary policies, and that perception contributed to the dollar's brief reversal. But at the end of January, the release of stronger than expected U.S. economic data, particularly the strong fourth-quarter 1992 gross domestic product and December 1992 durable goods orders, seemed to erase the prospects for interest rate reductions by the Federal Reserve and refresh the expectation that the U.S. economy would be outperforming others over the year. Thus, in the closing days

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[1]The dollar's movements on a trade-weighted basis in terms of the other Group of Ten currencies are measured using an index developed by the staff of the Board of Governors of the Federal Reserve System.

of the period, the dollar moved up from January lows of DM 1.5660 and ¥122 85 to close the period at DM 1.6102 and ¥124.60.

The market awaits interest rate reductions in Germany and Japan. Throughout the period, on-again off-again expectations for reductions in official interest rates by the Bundesbank and the Bank of Japan punctuated the dollar's movements.

In response to continued pressures within the European Exchange Rate Mechanism (ERM), many market participants expected the Bundesbank to ease interest rates in early November and, when this did not occur, attention focused on the prospects for an easing in December. Although no official rate reduction came in December, the Bundesbank's market operations were designed to avoid end-of-year upward pressure on interest rates. Moreover, in statements that appeared to acknowledge a weakening in the German economy while expressing optimism about the central bank's ability to control inflation, senior Bundesbank officials predicted sharp reductions in German interest rates during the course of 1993. In the final week of December, Bundesbank officials added that an easing could occur earlier in 1993 than was previously expected. It was during this period that the dollar posted most of its gains toward its January 8 high against the mark

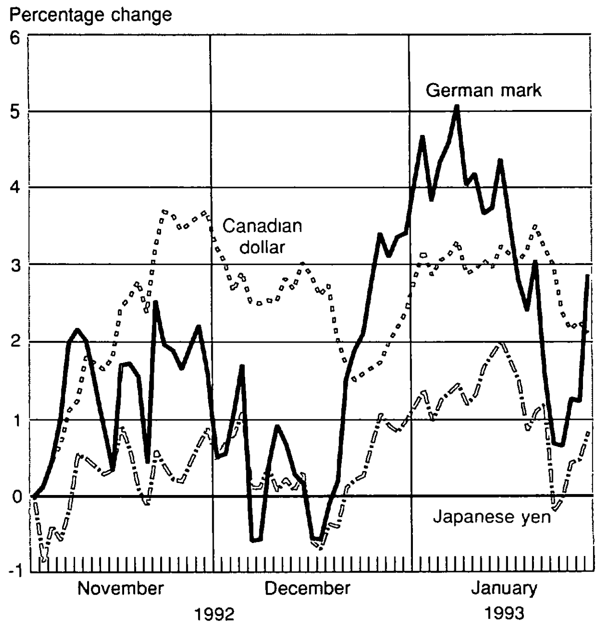
In early January the Bundesbank did engineer a small reduction in market interest rates through its market repurchase operations. However, by mid-January, when the decline in market rates had not been followed by a reduction in the Bundesbank's official Discount and

Chart 1

The Dollar against the German Mark and the Japanese Yen

Chart 2

The Dollar against Selected Foreign Currencies



Notes: The chart shows the percentage change in daily rates for the dollar from November 1992 through January 1993 All figures are calculated from New York closing rates.

Table 1

Federal Reserve Reciprocal Currency Arrangements

Millions of Dollars

Institution	January 31, 1993
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

Lombard rates, expectations for an easing in German monetary policy were postponed to early March and the dollar began its brief reversal against the mark.

Expectations for a reduction in the Official Discount Rate (ODR) by the Bank of Japan persisted during the period, gaining in strength as the period closed, though with less direct effect on exchange rates than in the German case. In December, comments by Japanese officials focused on the need to stimulate demand through fiscal policy and, as a result, prospects for a cut in the ODR receded. But in January, the release of weak Japanese retail sales, production, and employment data and a declining stock market heightened concerns about weakness in the Japanese economy and returned attention to the prospects for an immediate reduction in the ODR. Despite widespread expectations for an ODR cut at the end of January, the dollar was not able to sustain its mid-January high against the yen as exchange market attention focused on the January 22 report of a record Japanese trade surplus for the calendar year 1992 and on the risk that policy makers might respond to the trade imbalance by seeking an appreciation of the yen.

Currency tensions in Europe continue. Pressures on a number of European exchange rates, particularly the German mark/French franc rate, persisted during the November-January period. In response to these pressures, German and French authorities repeatedly stated their commitment to the existing parity between their currencies and confirmed their participation in market intervention in support of the franc. The Spanish peseta and the Portuguese escudo were each devalued within the ERM by 6 percent on November 22, and the Irish punt was devalued by 10 percent on January 30. In addition, the Swedish and Norwegian monetary authorities abandoned their currencies' links to the European Currency Unit on November 19 and December 10, respectively.

While these exchange rate pressures within Europe had little direct impact on dollar exchange rates, particularly in comparison with the previous period, transactions related to the financing of official European intervention were perceived as affecting the dollar. Throughout the period, market participants reported that both in the course of rebuilding official reserves and in transactions related to financing official borrowings, a number of European central banks were heavy sellers of dollars and that, at times, this selling pressure restrained the dollar's upward trend against the mark.

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Chart 3

The Dollar against the German Mark and the Japanese Yen

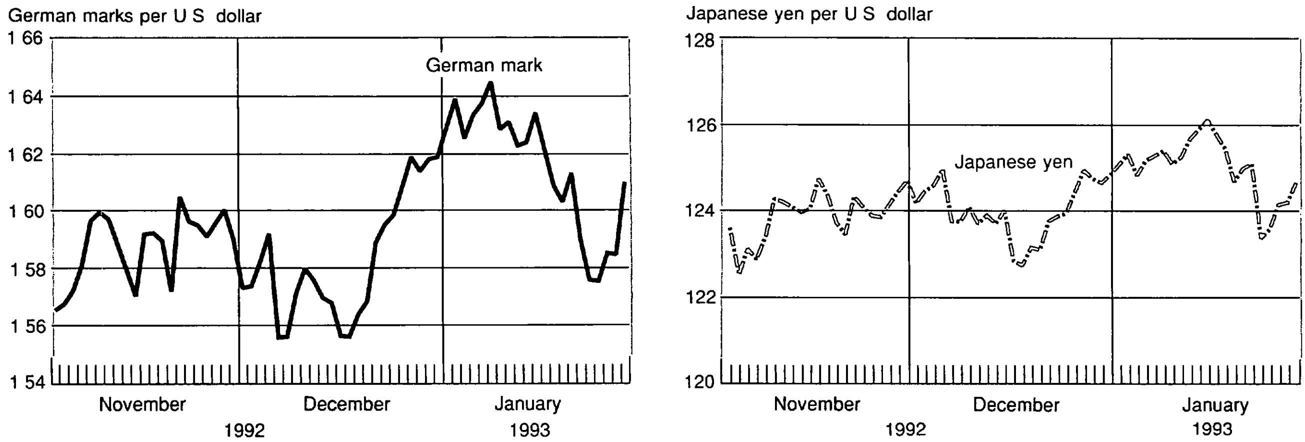

Chart 4

Short-Term Interest Rates for Selected Countries

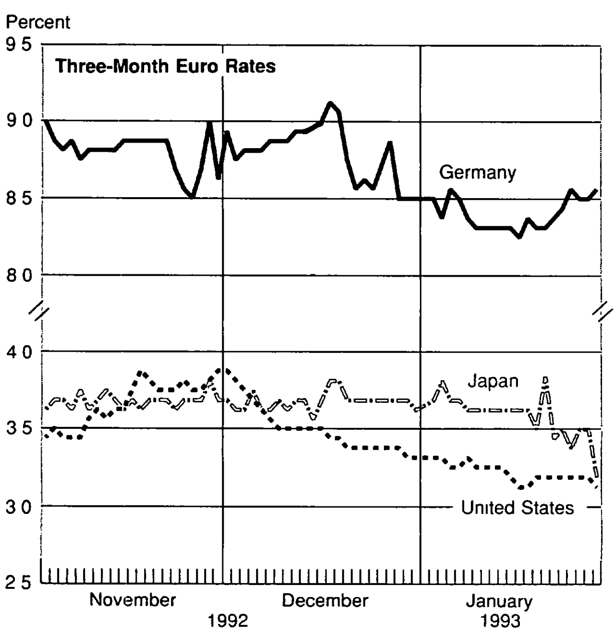

Table 2

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

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1992	+3,746.3	+2,293.8
Realized October 31, 1992–January 31, 1993	+109.5	+25.1
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1993	+2,868.4	+1,749.9

Note: Data are on a value-date basis.

While the U.S. authorities did not execute any foreign exchange transactions during the period, settlements were completed on a total of $1,455.8 million in forward sales of German marks. As previously reported, these settlements were executed in May 1992 with the Deutsche Bundesbank in an effort by both the U.S. and German monetary authorities to adjust the level of their respective foreign currency holdings. During the period, $729.4 million and $726.5 million against marks settled on November 23 and December 21, respectively, completing the total of $6,176.6 million of spot and forward dollar purchases from the Bundesbank. For each transaction, 60 percent was executed for the account of the

Federal Reserve and 40 percent for the account of the Treasury's Exchange Stabilization Fund (ESF). The Federal Reserve and the ESF realized profits of $109.5 million and $25.1 million, respectively, from these settlements. As of the end of January, cumulative valuation gains on outstanding foreign currency balances were $2,868.4 million for the Federal Reserve and $1,749.9 million for the ESF.

The Federal Reserve and the ESF invest their foreign currency holdings in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A portion of the balances is invested in securities issued by foreign governments. As of the end of January, the Federal Reserve and the ESF held either directly or under repurchase agreements $7,834.0 million and $8,356.0 million equivalent, respectively, in foreign government securities valued at end-of-period exchange rates.