Treasury and Federal Reserve Foreign Exchange Operations

August–October 1992

The August-October period was marked by serious strains in European exchange rate relationships and shifting market views about the outlook for interest rates in the major countries. Although the dollar briefly reached all-time lows against the mark and yen in September, it closed the period up on balance 4.5 percent against the German mark, down about 3.0 percent against the Japanese yen, and up 6.8 percent on a trade-weighted basis.[1]

The U.S. monetary authorities intervened in the exchange markets in two episodes during August in their only operations during the period. Entering the market on a total of four days that month, they sought to counter persistent downward pressure on the dollar by buying $1.1 billion against the German mark, in amounts shared equally by the U.S. Treasury and the Federal Reserve.

Dollar declines against the mark in response to interest rate pressures

Interest rate considerations were the dominant factor in exchange rate movements during the period. Interest rate differentials provided a strong incentive for capital flows into the higher yielding securities denominated in German marks and in other currencies thought to be closely linked to the mark. They also made it attractive for U.S.-based entities that were building up foreign currency receivables to postpone the repatriation of these funds so as to benefit from higher interest rates overseas and, perhaps, from a continued depreciation of dollar exchange rates.

For many market participants, however, the dollar's position in the exchange market carried a two-sided risk. On the one hand, the fact that the dollar was already trading relatively close to the historical low reached in 1991 against the German currency gave rise to fears that if selling pressures against the dollar became intense enough to break through this level, the dollar's decline might gain significant momentum. On the other hand, market participants were still mindful of the experience the previous month, when the authorities of the United States and other industrialized countries intervened to buy dollars, triggering a sharp short-covering rally.

Under these circumstances, market participants were particularly sensitive to indications either that the interest differentials might widen further—thereby putting renewed selling pressure on dollar rates—or that the authorities might again intervene. The economic data for the United States released early in August gave no clear indication of serious further deterioration, but neither did they offer assurance of a sustained upswing. The Federal Reserve had eased monetary policy in early July, and markets expected further ease in the absence of a stronger recovery. Meanwhile, in the face of rapid monetary growth in Germany, the Bundesbank had tightened monetary policy in mid-July. But above-target money growth continued, and it was thought

This report, presented by William J McDonough, Executive Vice President of the Federal Reserve Bank of New York and Manager of the System Open Market Account for the Federal Open Market Committee, describes the foreign exchange operations of the United States Department of Treasury and the Federal Reserve System for the period from August to October 1992

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

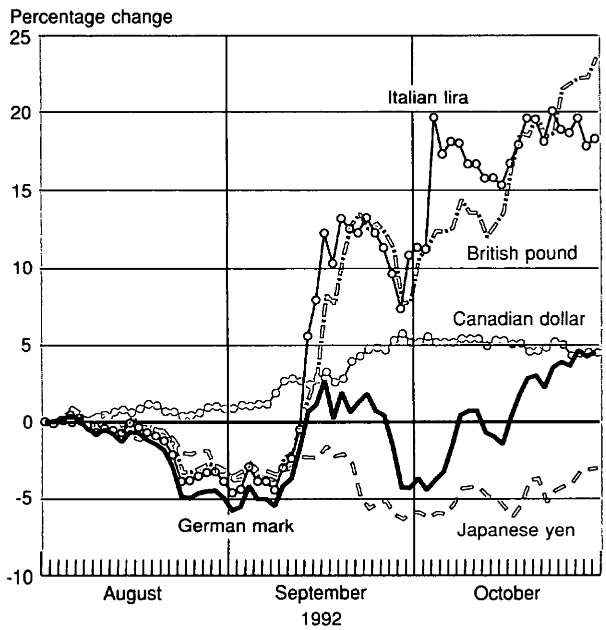
that the Bundesbank would keep monetary policy firm—perhaps even tighten policy once more—despite data suggesting that the German economy might be beginning to slow.

Market participants looked to the release of monthly U.S. labor force data early in August to give direction to dollar rates. They expected that if the data proved to be weaker than expected, the Federal Reserve would soon ease pressures on bank reserves. When the data, released on Friday, August 7, appeared to confirm economic weakness, the dollar showed some initial resistance but then came on offer later that same day, and the U.S. authorities intervened to stabilize the dollar. When pressures reemerged the following Tuesday, the U.S. authorities again intervened in an operation joined by other central banks. Over the two days, the U.S. authorities bought a total of $600 million against the German mark. Selling pressures were somewhat blunted by the interventions, but the operations did not interrupt the tendency of the dollar to decline.

By late August, the German mark was strengthening not only against the dollar but also against other European currencies in response to strains that were to become far more intense later in the period. With the

Chart 1

The Dollar against Selected Foreign Currencies



Notes: The chart shows the percentage change in daily rates for the dollar from July 31, 1992. All figures are calculated from New York closing rates.

dollar again approaching its 1991 low, the U.S. authorities intervened on August 21 and 24, in cooperation with other monetary authorities, buying a total of $500 million. But when these operations did not appear to discourage the bidding for marks, the U.S. authorities refrained from further intervention.

The dollar continued to ease, establishing a new historical low against the mark of DM 1.3862 on September 2. But trading conditions for the dollar were relatively orderly, even in the face of the disappointing labor market statistics released in early September and the continuing market expectations of declining U.S. interest rates, which appeared to be confirmed by Federal Reserve operations on September 4 that eased conditions in the federal funds market.

European currencies face severe pressures

By late August and during most of September, market attention focused on pressures within the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) and between the EMS and those currencies linked to it through the European Currency Unit (ECU)—for example, the Finnish markka and Swedish krone. During the lengthy negotiations among European Community countries on European Monetary Union that had led up to the December 1991 Maastricht Treaty, market participants had become impressed by the participating governments' evident commitment to exchange rate stability. Though the treaty did not provide for fixed exchange rates within the system for several more years, market participants came to assume that few of these governments would countenance devaluation in the interim. As a result, investors felt increasingly secure holding securities denominated in ERM currencies other than the mark. Investors purchasing assets that carried even higher yields than DM-denominated assets appeared to give little weight to exchange rate risk in *ex ante* calculations of risk-adjusted returns. During the long interval since the last general ERM realignment in 1987, the total amount of assets allocated on the basis of this view reached substantial sums.

Doubts had begun to develop as to the durability of existing exchange rate relationships and the effectiveness of efforts to achieve greater economic convergence within Europe after Danish voters rejected a referendum on the Maastricht Treaty in June. In mid-August, reports began to spread that voters in France might also vote "no" on a referendum on the Maastricht treaty, and pressures on exchange rates within Europe intensified. In the ensuing weeks an exchange crisis swept through the EMS and related currencies that entailed interventions of unprecedented size, large changes in interest rate differentials within Europe, a small cut in German official interest rates, two realignments, and the suspension of the pound sterling and the Italian lira from the ERM. The French franc came under selling pressure but stabilized amid intervention purchases of francs and a rise in French interest rates Outside of the EMS, severe pressures had developed on the Nordic currencies, resulting in sizable interventions and considerable increases in short-term interest rates, particularly in Sweden. The Finnish markka's peg to the ECU was also suspended

Chart 2

The Dollar against the German Mark and the Japanese Yen

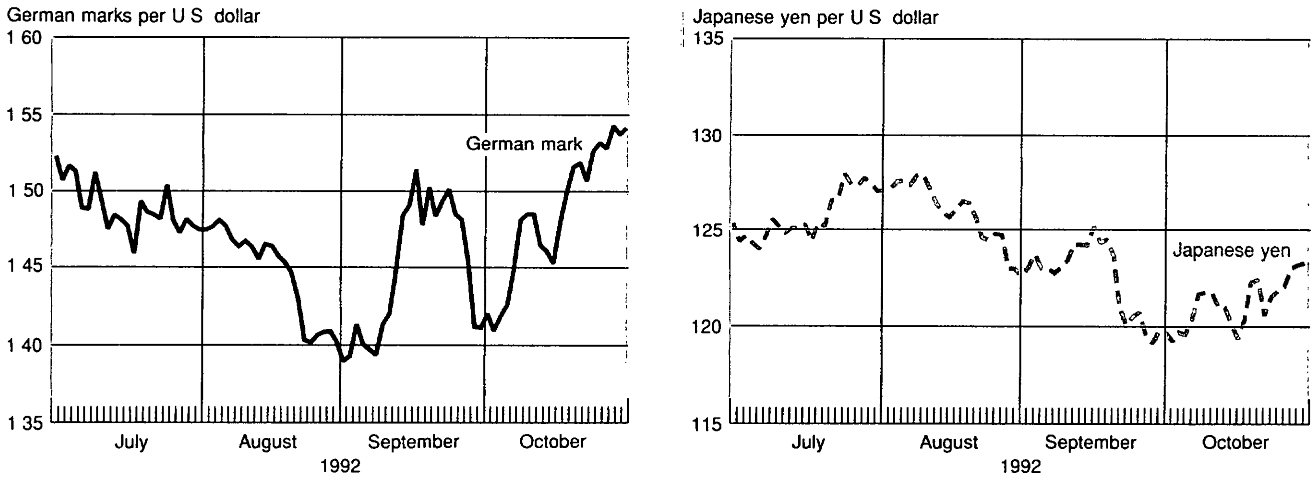
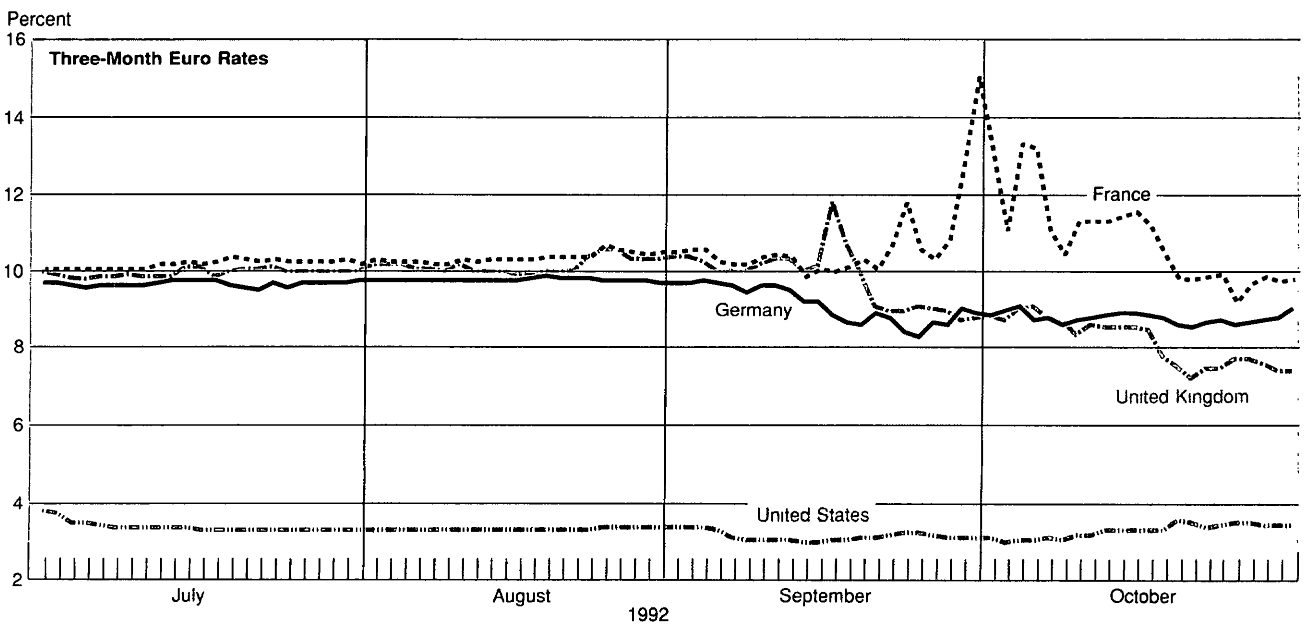


Chart 3

Short-Term Interest Rates for Selected Countries



While dollar exchange rates responded at times to pressures among European currencies in September, the dollar was not the focal point of market attention at that time. It initially encountered selling pressure against the mark as investors sought to cover their intra-European exposures by buying marks. Then, in mid-September, the dollar snapped up rather quickly against the mark when dollar-based investors and U.S. entities sought refuge from the European tensions by converting foreign currency investments or balances into dollars. With the European intervention being conducted in European currencies—mostly in German marks—the financial intermediaries effecting these transactions sold marks in the market to get dollars demanded by their customers. Once the pressures began to subside late in September, the dollar began to drift down toward the levels of late August.

Developments in the dollar/yen exchange rate

The movements of the dollar against the yen during August and September were, in contrast to those against the European currencies, relatively muted. The interest differentials between the United States and Japan were narrower, and market participants believed that the authorities in Japan, like their counterparts in the United States, would be tending to ease monetary conditions. The dollar reached its high for the period of ¥128.19 on August 10 as evidence mounted that the slowdown in the Japanese economy was intensifying and as the Japanese equity market showed persistent weakness. But the yen then appreciated during September. This move reflected some repatriation of capital by Japanese companies with the approach of the fiscal half-year end on September 30, a reaction to a rebound in the Japanese equity market, and some flows into yen-denominated assets in response to the developments taking place in the EMS. The dollar gradually declined against the yen through September, setting a new historical low against that currency of ¥118.60 on September 30.

Market tensions subside during October

Early in October, the pressures in the EMS started to wane. After the British and Italian governments had chosen to suspend their currencies' participation in the ERM, the pound and the lira depreciated to trade well below their previous ERM floors. These and other changes in exchange rates in Europe led to an effective appreciation of the German mark. The Bundesbank lowered both of its official interest rates in mid-September, and money market rates also subsequently eased. Although market participants remained uncertain about the outlook for monetary union and the eventual configuration of the EMS, funds started to flow back to France and short-term interest rates in most of the EMS countries were lowered from the crisis levels reached the previous month. As market participants noted that the slowdown in European economic activity was increasingly evident, they came to believe that the trend of interest rates abroad might turn supportive of the dollar.

Meanwhile, in the United States expectations diminished that monetary policy in the United States would

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility October 31, 1992
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

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, 1992	+4,536.7	+2,503.9
Realized July 31–October 31, 1992	+358.1	+119.9
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1992	+3,746.3	+2,293.8

Note: Data are on a value-date basis.

continue to be eased. The labor market data for September, released in early October, were seen as insufficiently weak to trigger a policy reaction. As the month progressed, talk spread that a fiscal stimulus package would be introduced early in the next year. Under these circumstances, the outlook for interest differentials became more favorable to the dollar. With some of the leads and lags that had built up against the dollar earlier in the year now being reversed, the dollar recovered substantially against the mark and to a lesser extent against the yen in fairly active trading through the rest of October.

Other operations

In other activity, a total of $1,873.1 million in off-market spot and forward foreign currency sales, executed by the U.S. monetary authorities, settled during the period.

- Forward purchases of $740.1 million and $733.0 million against German marks from the Deutsche Bundesbank settled on August 21 and October 21, respectively. These mark sales constituted a portion of the original $6,176.6 million of spot and forward transactions initiated in May. As previously reported, 60 percent of each transaction was executed for the Federal Reserve and 40 percent was for the Exchange Stabilization Fund (ESF) account.
- On September 8, the Federal Reserve agreed to purchase $400 million against German marks in an off-market transaction at the request of a foreign monetary authority.

The Federal Reserve realized profits of $358.1 million, including $230.3 million from off-market transactions that settled during the August-October period. The Treasury realized profits of $119.9 million, which included $33.5 million from off-market transactions that settled during the same three-month period. Cumulative bookkeeping or valuation gains on outstanding foreign currency balances were $3,746.3 million for the Federal Reserve and $2,293.8 million for the Treasury's ESF. 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 October, holdings of such securities by the Federal Reserve amounted to the equivalent of $8,146.1 million, and holdings by the Treasury amounted to the equivalent of $8,666.9 million valued at end-of-period exchange rates.