Treasury and Federal Reserve Foreign Exchange Operations

May-July 1991

The dollar rose significantly in June and early July, only to ease back during the next few weeks and end the May-July reporting period with little net change. Over the three months as a whole, the dollar rose about 2 percent against the mark, about 1 percent against the yen, and just under 1 percent on a trade-weighted basis.[1]

Shifting assessments of the strength of economic recovery in the United States were important in stimulating movements of the dollar exchange rate during the period. In addition, political turbulence in Eastern Europe helped support the dollar against the mark through most of the period, while intervention and evidence of international cooperation around the time of the Group of Seven (G-7) summit meeting in July was seen in the market as limiting the prospect of a continuing dollar rise.

The U.S. monetary authorities intervened on two occasions to signal an interest in resisting the rise of the dollar, selling a total of $150 million against marks as part of their cooperation with other central banks. The U.S. monetary authorities also engaged in off-market transactions with foreign monetary authorities, selling $8,548.5 million equivalent of their foreign currency reserves for dollars.

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[1]The trade-weighted basis is as measured by the Federal Reserve Board index

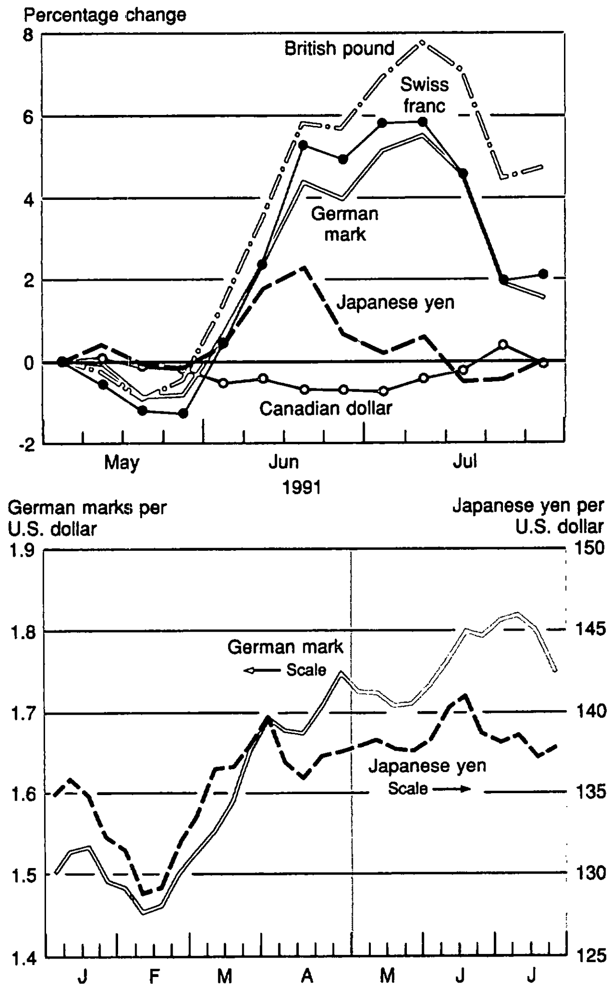
The dollar fluctuates without clear direction in May

As the period opened, sentiment toward the dollar was favorable but market participants appeared uncertain whether the dollar could extend the sharp rise that it had experienced during the preceding two months. The U.S. discount rate cut of 50 basis points to 5.5 percent on April 30 had been unexpected, and that move generated some downward pressure on dollar rates on May 1. The U.S. employment data for April, released on May 3, were stronger than expected, but on inspection, other details of the report revealed areas of continuing weakness. In that environment, the dollar traded in a narrow range for the first half of May.

Then, late in European trading on Friday, May 17, Sweden's Riksbank announced that it would link the Swedish krona to the ECU, replacing its trade-weighted basket of currencies, in which the dollar carried the largest weight, with a basket composed entirely of European Community currencies. Within a few hours of the announcement the dollar moved up by about four pfennigs against the mark as Swedish and other Scandinavian entities rushed to adjust the currency composition of their liabilities to that of the ECU by purchasing dollars to repay dollar-denominated liabilities. With Swedish interest rates relatively high, Swedish entities had borrowed extensively abroad, partly to finance domestic operations, confident that they were largely shielded from exchange rate risk because the Swedish authorities would limit the movement of the krona's exchange rate relative to the trade-weighted basket to only a couple of percentage points. With the change in the krona's peg, the exchange risk these companies would henceforth face on their dollar liabilities was perceived to be much higher than before, and they had an incentive to replace dollar-denominated liabilities with those of European currencies more heavily represented in the ECU. With U.S. markets still open after the Swedish announcement, and with the mark relatively widely traded in the U.S. market, the pressures resulting from the May 17 exchange-market operations were concentrated in dollar/mark transactions, resulting in the sharp rise of the dollar against the mark. Under these circumstances, there was some intervention; the U.S. authorities sold $50 million on that Friday. After the weekend, with pressures continuing, there was intervention by a number of foreign central banks. Soon thereafter the markets settled down and the dollar traded in a narrow range for the rest of the month.

Chart 1

After generally rising through June and early July, the dollar eased towards the end of the period.



Notes: The top chart shows the percentage change of the weekly average of daily closing rates from May 1991 through July 1991. The bottom chart shows the weekly average closing rates for the German mark and the Japanese yen from January 1991 through July 1991.

The dollar advances during June and early July

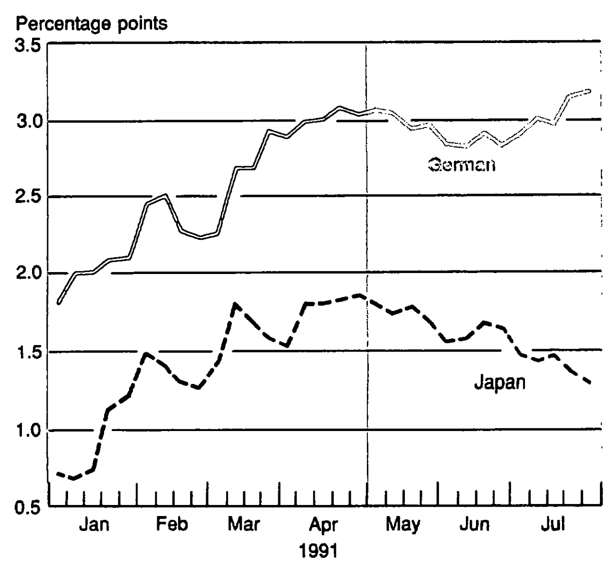
During early June, a slew of U.S. economic indicators were released that were generally much more favorable than expected, and market observers began to talk about the possibility that the U.S. recovery might be more vigorous than previously anticipated. In response, expectations of a further decline in U.S. interest rates faded and the dollar started to rise. In particular, on June 7, when it was reported that May employment rose well above expectations, the dollar rose almost two pfennigs on the day to close at DM 1.7720.

Developments in Germany during June also tended to strengthen the dollar. News of Germany's first trade deficit since 1981, evidence that inflation was higher than previously anticipated—even before the imposition of a consumption tax that would raise all major price indexes for the upcoming months—and what some saw as the reluctance of the Bundesbank to raise official interest rates all weighed on the mark. By late June, the

Chart 2

Three-Month Eurorate Differentials

Foreign Rate minus U.S. Rate



dollar had risen well above DM 1.80 in intraday trading.

With respect to the yen, the dollar showed its greatest strength of the reporting period during the first half of June, breaking above the ¥142 level three times. The dollar-yen exchange rate reflected not only the more buoyant outlook for the U.S. economy but also concerns in Japanese financial markets about possible problems with banking and stock market practices.

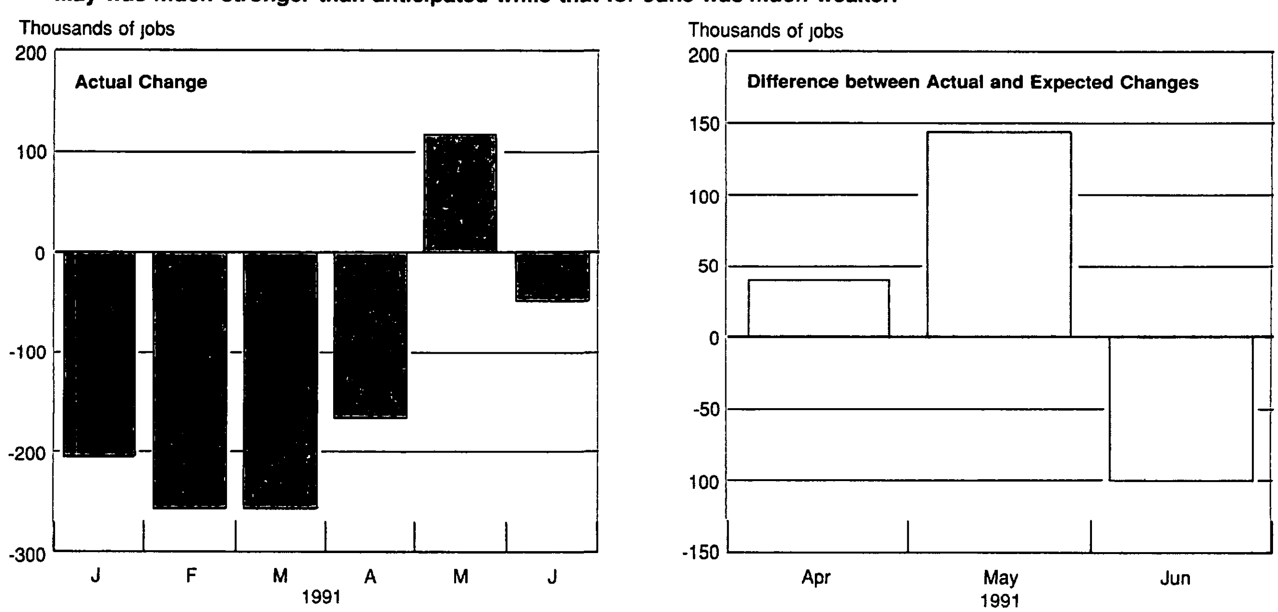
As the dollar moved up to levels not seen for more than a year, market participants became wary of the possibility that some action to curb the dollar's rise might be decided upon at the G-7 meeting of finance ministers and central bankers, scheduled to be held in London on June 23. As a result, the market became less concerned about the upside risk for the dollar, and the currency traded in a narrow range as the meeting approached

In the event, the G-7 ministers and governors issued a communiqué that "reaffirmed their commitment to cooperate closely, taking account of the need for orderly markets, if necessary through appropriately concerted action in foreign exchange markets" Market participants did not initially construe the G-7 statement as a firm commitment to intervene to resist the dollar's rise But comments following the meeting by several officials, including Japanese Finance Minister Hashimoto, French Finance Minister Beregevoy and U.S Treasury Under Secretary Mulford, reinforced the feeling that the possibility of intervention was being actively considered Rumors about off-market transactions between the Bundesbank and the Federal Reserve, which were later confirmed by the authorities (see below), were also taken as indications that preparations to contain the dollar's rise were underway.

Thereafter, the dollar remained well below its earlier highs against the yen. The release on June 25 of data indicating a larger than expected rise in U.S. durable goods orders for May temporarily supported the dollar against all currencies But the spreading talk of new financial scandals in Japan was by this time having offsetting effects on the yen On the one hand, market participants came to expect that the authorities might move more quickly than otherwise to lower interest rates as Japanese share prices continued to decline. In fact, the Bank of Japan announced a one-half percentage point cut in its discount rate, to 5.5 percent, on

Chart 3

Data released during the period first supported the dollar and later led it to ease. The employment report for May was much stronger than anticipated while that for June was much weaker.



Notes The left panel shows the reported monthly changes in nonfarm payroll employment as of end-July The right panel shows the actual minus expected monthly changes in payroll employment the actual changes used in computing these differences are the preliminary numbers for April, May, and June 1991 reported on May 3, June 7, and July 5, 1991, respectively, while the corresponding expected changes are based on surveys of market expectations

July 1. On the other hand, market participants viewed the adverse impact of the stock market's decline on Japanese banks' capital ratios as increasing the likelihood that major Japanese investors would be repatriating overseas funds to invest in new subordinated debt instruments that these banks would be issuing to shore up their capital positions. These offsetting developments helped to keep the dollar-yen exchange rate relatively steady, trading around ¥138 for the remainder of the three-month reporting period.

The mark, however, came under further selling pressure at the end of June and early July The dollar initially strengthened against the mark in response to the better than expected U S data for May durable goods orders released on June 25. Two days later, when, in response to a controversial German court ruling, German officials reportedly suggested that a withholding tax on investment income might be reinstated, the dollar broke decisively through the DM 1.80 level. The idea that such a tax—very unpopular when it was imposed in 1989 and quickly withdrawn—might again be under consideration had an immediate depressing impact both on the mark and mark-denominated assets The DAX index of share prices slumped 2 5 percent the following day, and the dollar continued to rise in the following days to reach its high against the mark for the period and the year of DM 1.8427 in European trading on July 5.

Table 1

Federal Reserve Reciprocal Currency Arrangements

In Millions of Dollars

Institution	Amount of Facility July 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

The dollar gives back most of its gains during the rest of July

Just as the dollar was reaching its highs of the period against the mark, market confidence in the U.S. recovery began to weaken U.S. economic data released during the month no longer provided unambiguous evidence of economic recovery The release on July 5 of the employment report for June, in particular, showed an unexpected drop in employment

Simultaneously, expectations began to grow that the Bundesbank would tighten monetary policy and pursue a more aggressive monetary stance than previously supposed By then, the release of price figures for several German states that suggested a sharp acceleration in prices for "core" items was seen as giving the Bundesbank more reason for an early policy tightening move Market participants appeared to be uncertain only about the extent and timing of such a move—whether it would come before or after the succession of Dr Schlesinger to the Presidency of the Bundesbank at the end of July

Against this background, the dollar's rise against the mark stalled, and the exchange rate fluctuated without direction just above DM 1.80 However, on July 11, when the Bundesbank did not raise official interest rates at its biweekly meeting and when a sharp drop in U S weekly unemployment insurance claims was reported, the dollar jumped back up to almost DM 1.84 Early the next morning, as the dollar continued to move higher, foreign central banks conducted several rounds of intervention, selling dollars against both marks and other currencies. After the New York market opened, the U S monetary authorities also participated, selling $100 million against marks. The widespread participation of central banks in the concerted intervention, ahead of the G-7 summit meeting the next week, and the fact that the central banks continued to operate throughout the day suggested to market participants that the central banks were united in their intention to curb the dollar's rise. As a result, the dollar declined by about five pfennigs during the day to close in New York at DM 1 7893. This episode of intervention, together with an increasingly uncertain U S economic scenario, set the tone for trading for the rest of the month. The dollar again reached the DM 1 80 level on two occasions the next week in response to strong industrial production data and Chairman Greenspan's statement in his semiannual Humphrey-Hawkins testimony that a recovery was under way, but it failed to move higher

The communiqué released on July 17 after the G-7 summit meeting reiterated support for close cooperation in foreign exchange markets, monetary and fiscal policies to foster low real interest rates, and Soviet economic and political transformation. While the communiqué had little immediate impact on exchange rates, it contributed to an atmosphere in which the fear of concerted intervention remained. In that environment, the dollar did not strengthen even when unexpectedly favorable housing starts data were released later that day.

During the rest of July, new U.S data releases brought into question the vigor and even the sustainability of economic recovery. Sentiment also spread among U.S financial market analysts that a significant decline in U.S. inflation, both actual and prospective, would be reflected in a decline in long bond yields Moreover, statements by a variety of U S officials, including some FOMC members, about the need to respond if M2 growth remained weak revived market expectations that U S. short rates might still decline As a result, the dollar fell below DM 1.80 during the third week of July and to levels around DM 1 75 for the rest of the period.

The dollar closed the May-July reporting period about 2 percent higher against the mark and 1 percent higher against the yen. The dollar rose about 5.5 percent against the Swiss franc as expectations grew that the monetary authorities in Switzerland would not follow those in Germany by tightening monetary policy. The dollar eased very slightly against the Canadian dollar as the market came to believe that the Canadian authorities would be more restrained about easing monetary policy than would the U.S monetary authorities

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During the reporting period, the U S. monetary authorities conducted off-market operations directly with foreign monetary authorities to adjust the foreign currency reserve assets of both the Exchange Stabilization Fund (ESF) and the Federal Reserve. The U.S. authorities exchanged $8,548 5 million equivalent of foreign currencies for dollars:

- On June 25, the U.S. authorities purchased a total of $5,548.5 million against German marks from the Deutsche Bundesbank in spot and forward transactions The U.S. and German authorities agreed that their respective holdings of German marks and dollars were in excess of current needs and that it was to their mutual advantage to reduce those holdings. For each of these transactions, 60 percent of the purchase was to be executed for the account of the Federal Reserve and 40 percent for the account of the ESF. A spot transaction of $2,230.5 million settled on June 27. A forward transaction of $556.2 million settled on July 29. The remaining forward transactions are to be settled during the remainder of the calendar year
- On July 16, the U S authorities purchased a total of $3,000 million against another foreign currency in spot and forward transactions with a foreign monetary authority. The dollars purchased were split equally between the ESF and the Federal Reserve. A spot transaction of $1,000 million settled on July 18. Forward transactions totaling $2,000 million are to be settled during the next quarterly reporting period.

In addition, in July, the ESF sold a total of $130.2 million equivalent of marks against SDRs The ESF also purchased a total of $230 4 million against sales of SDRs in transactions with foreign monetary authorities in need of SDRs either for payment of IMF charges or for repurchases. Both the sales and purchases of SDRs were arranged by the IMF.

Primarily because of its acquisition of dollars in the foreign currency exchanges and SDR transactions described above, the ESF was able, after the end of the reporting period, to repurchase $2,500 million equivalent of foreign currency warehoused with the Federal Reserve 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 as of the end of August.

During the May-July period, the Federal Reserve realized profits of $147 5 million from the off-market foreign currency exchanges described above. The Treasury realized profits of $60.3 million, of which $18 8 million was from the off-market foreign currency and SDR exchanges and $41.5 million was from the renewal of certain warehousing operations.

The Federal Reserve and the ESF regularly invest

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 April 30, 1991	+2,316 3	+570 6
Realized April 30, 1991 to July 31, 1991	+147 5	+ 60 3
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1991	+1,919 9	+321 4

Note Data are on a value-date basis

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 are invested in securities issued by foreign governments. As of the end of July, holdings of such securities by the Federal Reserve amounted to $7,807.7 million equivalent, and holdings by the Treasury amounted to the equivalent of $7,540.2 million valued at end-of-period exchange rates.