Treasury and Federal Reserve Foreign Exchange Operations

May-July 1993

The dollar appreciated against most major currencies during the May-July period, more than reversing its decline earlier in the year. It rose 9.9 percent against the German mark, for example, and 6.6 percent on a trade-weighted average basis.[1] The one major exception was the dollar's performance relative to the Japanese yen: the dollar extended its earlier decline by dropping 5.8 percent and hitting successive new lows in June and July.

These exchange rate movements occurred in a context of cumulating evidence that several major industrialized countries were experiencing less growth than had been expected at the start of the year. At the same time, central banks in many of these countries, including the Federal Reserve, demonstrated by their actions and policy statements that they remained cautious about the extent to which they would provide more monetary accommodation, and long-term interest rates continued to decline in the United States and in most of the Group of Ten (G-10) countries.

The U.S. authorities intervened on three occasions during the period, purchasing a total of $1067.5 million against the yen to show that they were willing to cooperate with other monetary authorities as appropriate and were not favoring a weak dollar as a matter of policy.

This report, presented by Margaret L. Greene, Senior Vice President and Deputy Manager for Foreign Operations, describes the foreign exchange operations of the United States Department of Treasury and the Federal Reserve System for the period from May 1993 through July 1993. Frank Keane was primarily responsible for preparation of the report.

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

The dollar's depreciation against the yen resumes

During the first few weeks of the period, the dollar was relatively stable against the yen, trading cautiously around ¥111 after having declined about 11 percent against the yen earlier in the year. Market participants had taken note of Japan's widening trade surplus and tried to assess the extent to which the exchange rate might be expected to adjust to help redress this growing imbalance. In April, just prior to the period, the U.S. monetary authorities had intervened in the exchange market. They had also issued a public statement that underscored the Administration's belief that exchange rates should reflect economic fundamentals and that attempts to influence artificially or manipulate exchange rates were inappropriate. However, with the passage of time, intense trade negotiations with Japan, and the release of worse than expected U.S. trade data on May 19, many market participants came again to believe that a dollar decline against the yen would be welcomed by the U.S. authorities.

In this context, the yen again began to strengthen against the dollar as well as all other currencies. In the weeks between the beginning of May and June 15, the yen's strength was reflected in a decline of the dollar against the yen of 5.6 percent from ¥111.05 to a low of ¥104.80 and a drop of the mark against the yen of 8.5 percent from ¥70.09 to a low of ¥64.12. For much the same reasons as in April, the U.S. authorities intervened as the dollar moved lower on three days—May 27, May 28, and June 8—buying $200 million, $492.5 million, and $375 million against the yen. These operations were shared equally between the Federal Reserve and the Treasury's Exchange Stabilization Fund (ESF).

Around mid-June the yen's rise temporarily reversed course and the dollar rose to a high of ¥111.80 when the Miyazawa government lost a confidence vote in the Diet, an event that presaged the end of thirty-eight years of Liberal Democratic Party rule in Japan. For a time, market participants were uncertain whether trade negotiations would continue in the midst of a change in leadership. They were also unsure what changes in economic policy might emerge from this unusual government transition. But then the dollar eased below ¥110 as market participants focused on the upcoming Economic Summit of the Group of Seven (G-7) in Tokyo on July 7-9.

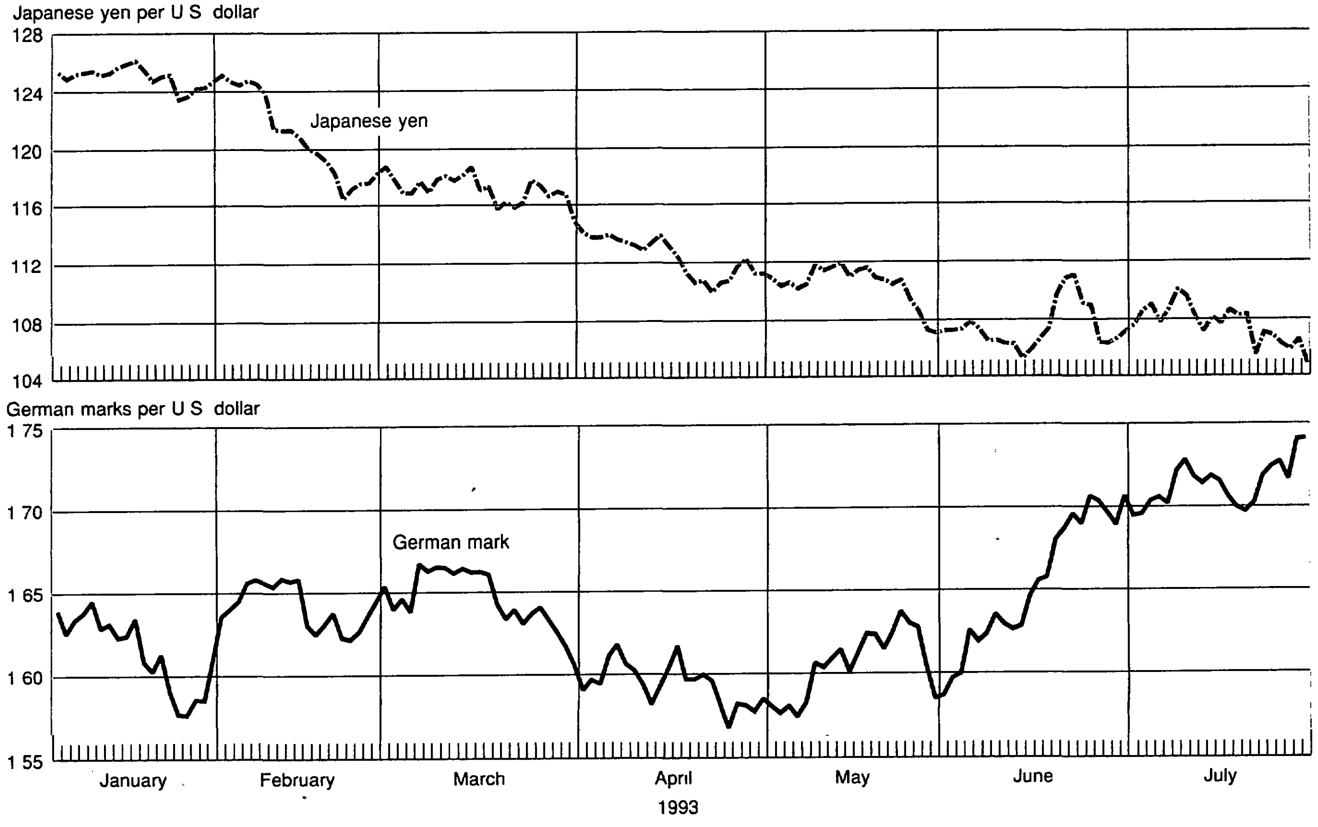
Although the dollar received some lift from the perception that greater than expected progress on trade negotiations was made around the time of the summit, the dollar's gains against the yen proved temporary During the balance of the period under review, market participants came to believe that achieving near-term progress on trade issues with Japan would be difficult In addition, anxieties about the effects of the change in leadership on Japan's economic policy began to dissipate Moreover, with the renewal of exchange rate pressure in Europe, market participants bid up the yen as Japanese and other investors hedged their assets denominated in European currencies As a result of these factors, the dollar again declined against the yen as the period ended, recording a historic low against the yen of ¥104 23 on July 30

Dollar appreciates against the mark and other European currencies on expectation of narrowing interest rate differentials

The dollar, as well as many other currencies, was firming against the German mark, especially during June when the market focused on growing evidence of recession, a widening fiscal deficit, and high labor costs in Germany. From the beginning of May to the end of June, the dollar rose against the mark by nearly 8 percent During this period, market participants expected that the German Bundesbank would continue to ease short-term interest rates in response to the

Chart 1

The Dollar against the Japanese Yen and the German Mark



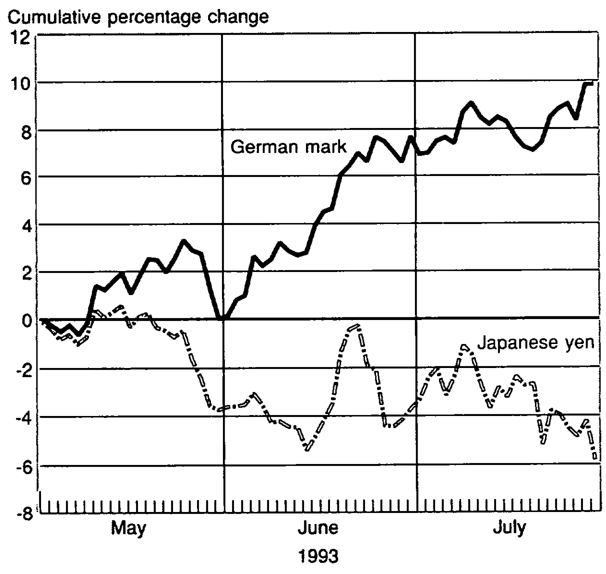
weakening German economy. These expectations contributed not only to the firming of the dollar against the mark, but also to a general diminishing of strains within the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) that permitted other European countries, either within or outside the ERM, to rebuild their foreign currency reserves, lower interest rates, or do both. Indeed, on July 1 the Bundesbank announced a reduction in its official discount and Lombard rates of 50 and 25 basis points to 6.75 and 8.25 percent, respectively.

As July progressed, however, it became evident that further easing of German interest rates would come only gradually and cautiously. Germany's money market rates continued to trend downward during the month. The Bundesbank accepted a drop in the rate at which it routinely supplies liquidity to the banking system and announced a further reduction in its Lombard rate of ½ a percentage point to 7.75 percent. However, the Bundesbank did not further reduce the discount rate, an adjustment that many market participants had expected and hoped might pave the way for a new round of official interest rate cuts throughout Europe.

Under these circumstances, other European curren-

Chart 2

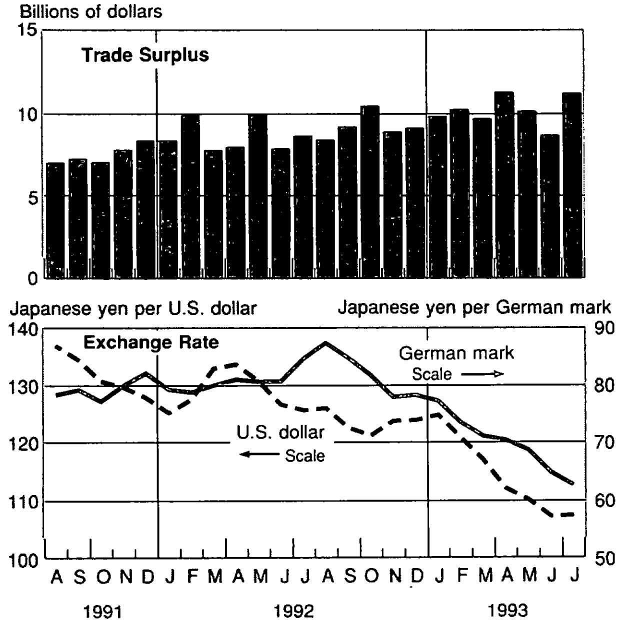
Percentage Change of the Dollar against the German Mark and the Japanese Yen



Notes: The chart shows the percentage change in daily rates for the dollar from May to July 1993. All figures are calculated from New York closing rates.

Chart 3

Japanese Trade Surplus and the Exchange Rate



Notes: Trade data are seasonally adjusted monthly surplus figures. Exchange rate is monthly average.

Chart 4

Short-Term Interest Rates for Selected Countries

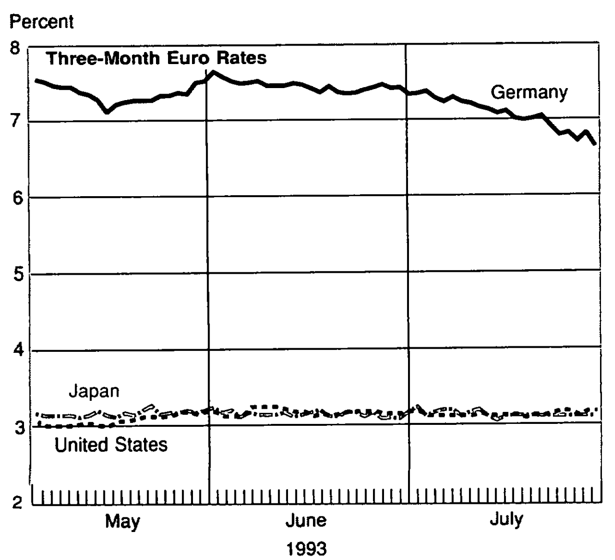


Table 1
Federal Reserve Reciprocal Currency Arrangements
Millions of Dollars

Institution	Amount of Facility July 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

cies came under increasing selling pressure as market participants came to question how long European monetary authorities could justify using interest rates to support existing ERM parities in the face of high unemployment and slowing or negative growth. During the month, pressures within the ERM intensified Several currencies fell toward their intervention floors against the mark, leading to a decision on August 1 to widen temporarily, by a significant amount, the obligatory intervention bands in the ERM.

The dollar was at times caught up in these pressures as market participants attempted to gauge the impact of these developments and of possible policy responses on the dollar-mark exchange rate On balance, the dollar benefited somewhat as investors either hedged exposures resulting from investments in European currencies other than the mark or otherwise turned to the dollar as a refuge from the currency turmoil in Europe. As a result, the dollar firmed on balance during July, gaining roughly another 2 percent, to close near the period high at DM 1.7410

Other operations

The Federal Reserve and the Treasury's Exchange Stabilization Fund realized profits of $128.0 million and $127 7 million, respectively, from the sales of yen in the market during the period. Cumulative bookkeeping or valuation gains on outstanding foreign currency balances as of the end of July were $3,226.6 million for the Federal Reserve and $3,005.5 million for the ESF.

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 liquidity and credit quality A portion of the balances is invested in securities issued by foreign governments As of the end of July, the

Table 2
Net Profit (+) 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 April 30, 1993	+4,152 0	+3,221 8
Realized profits and losses May 1–July 31, 1993	+128 0	+127 7
Valuation profits and losses on oustanding assets and liabilities as of July 31, 1993	+3,226 6	+3,005 5

Note Data are on a value-date basis

Federal Reserve and the ESF held either directly or under repurchase agreements $9,784.6 million and $10,115.8 million, respectively, in foreign government securities valued at end-of-period exchange rates.