Treasury and Federal Reserve Foreign Exchange Operations

August-October 1993

During the August-October period the dollar appreciated 3 7 percent against the Japanese yen, depreciated 3 2 percent against the German mark, and was little changed on a trade-weighted average basis,[1] declining 0 4 percent On August 19, the U S monetary authorities purchased $165 million against yen in the period's only intervention operation

The yen appreciates, then reverses against the dollar

During early August, the yen strengthened against the currencies of all major industrialized countries, reaching record highs against the dollar, mark, Swiss franc, the pound sterling, and the Canadian and Australian dollars On August 11, the release of data indicating a wider than expected 28 percent year-on-year expansion of Japan's merchandise trade surplus to $11 84 billion triggered sharp yen appreciation, and the yen traded to a new high against the dollar of ¥103 50 Continuing weakness in domestic economic indicators was perceived as evidence that reduction of Japan's current account surplus was unlikely in the near term, and the yen moved to several new daily highs against the dollar, peaking at a postwar high against the dollar of ¥100 40 on August 17

From August 16 to 18, conditions in the Japanese money markets were eased On August 19, the Japanese cabinet met and agreed to try to devise additional measures to stimulate domestic demand The dollar was trading at ¥102 50 in early New York dealing on August 19, but then declined quickly to ¥101 35 following the release of the worse than expected $12 1 billion U S merchandise trade deficit for June, at the same time, the dollar abruptly declined one pfennig against the mark The U S monetary authorities intervened shortly after the release of the trade data During the day they purchased a total of $165 million against the yen, shared equally between the Federal Reserve and the Treasury's Exchange Stabilization Fund This operation was coordinated with another monetary authority

Initially, the operations surprised market participants, and the dollar promptly rose During the morning, Treasury Under Secretary Summers released a statement welcoming the decline in Japanese money market rates and expressing concern that further yen appreciation could retard growth in the Japanese and world economies Operations continued after Under Secretary Summers' statement but ceased before noon Market participants subsequently continued to cover short positions throughout the afternoon, and the dollar reached a high of ¥106 75 before closing the day at ¥105 95

In the month following the operation, the dollar-yen exchange rate largely traded between ¥103 00 and ¥106 00 as market participants increasingly focused on the apparent weakness of the Japanese economy A series of Japanese data releases showed continued weak business sentiment, deteriorating corporate profits, and a 0 4 percent decline in second-quarter GDP Consequently, when the Bank of Japan lowered the official discount rate (ODR)

This report presented by Peter R Fisher, Senior Vice President, Federal Reserve Bank of New York, and Manager for Foreign Operations System Open Market Account, describes the foreign exchange operations of the U S Department of Treasury and the Federal Reserve System for the period from August 1993 through October 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

on September 21 by a greater than expected 75 basis points to 1 75 percent, the action was perceived as an appropriate supplement to the government's efforts to stimulate the economy, not as a device to avoid further yen appreciation Favorable reactions by senior U S officials to the Bank of Japan's action led to a perception that tensions between the U S and Japan on trade issues had given way to greater cooperation, and the yen declined about 1 5 percent, closing on September 21 at ¥106 18

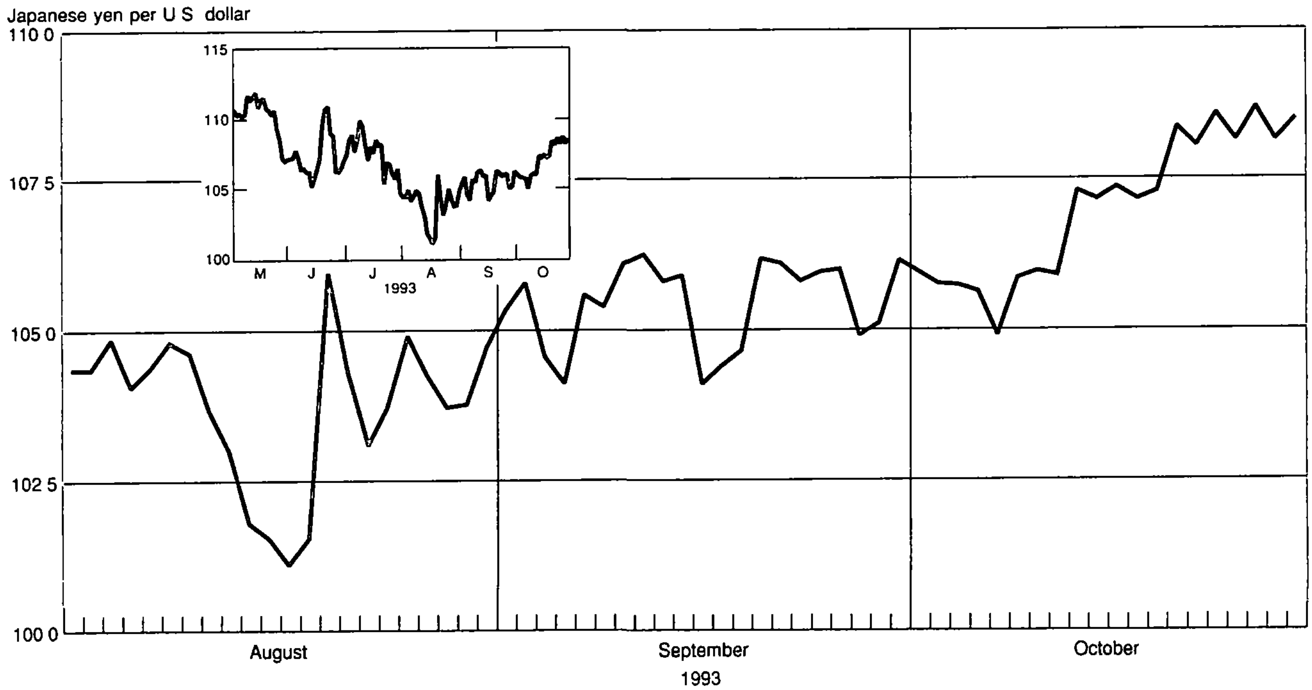
The dollar firmed gradually over the latter half of the three-month period while expectations of near-term volatility in the dollar-yen exchange rate dwindled substantially The implied one-month option volatility fell from about 14 percent in mid-September to around 10 percent in late October The period closed with the dollar-yen exchange rate trading steadily above ¥108 00 in late October

Mark appreciates against dollar in wake of ERM crisis
The European Community finance ministers and central bank governors agreed, effective Monday, August 2, to permit currencies participating in the Exchange Rate Mechanism (ERM) to fluctuate within 15 percent of their central parities However, authorities from Germany and the Netherlands agreed to maintain their bilateral exchange rate within 2 25 percent of their central parity During the uncertainty created by the currency turmoil in Europe, market participants had aggressively accumulated dollar positions in late July When widely anticipated European interest rate reductions failed to materialize in the first few weeks of August, the mark began to appreciate against the dollar The negative sentiment toward the dollar during this period was reinforced by market reports of dollar sales by European central banks to adjust reserve positions after July's currency turmoil, and by a widening of interest rate differentials in the mark's favor implied by Eurocurrency futures contracts

The Bundesbank Council's decision on August 26 to leave official rates unchanged disappointed market expectations of an interest rate cut, and banks were caught short of funds at the end of a reserve period When the Council

Chart 1

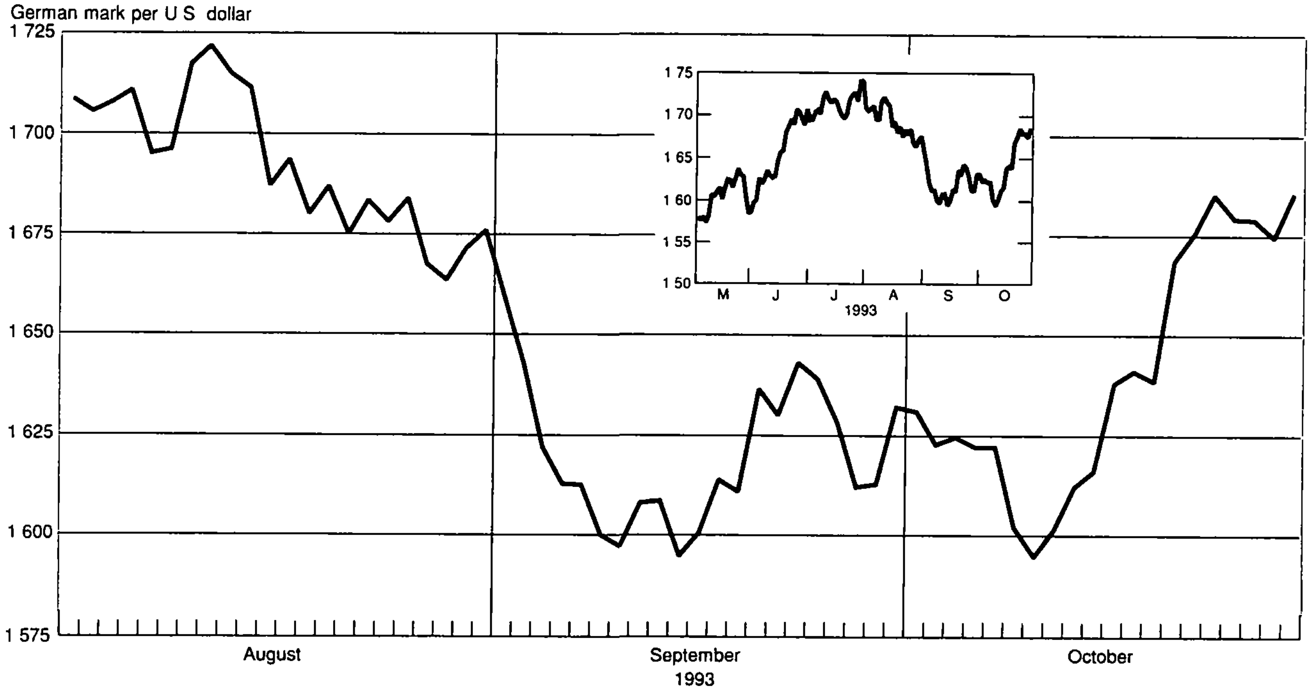
The Dollar against the Japanese Yen



Note Inset panel shows the six-month exchange rate movement

Chart 2

The Dollar against the German Mark



Note Inset panel shows the six-month exchange rate movement

did lower the discount and Lombard rates by 50 basis points to 6 25 percent and 7 25 percent, respectively, on September 9, the concurrent smaller than expected 10 basis point reduction in the Bundesbank's money market repurchase rate, to 6 70 percent, led to continued tightness in short-term German money markets. These developments resulted in continued mark strength against the dollar Although the mid-September political unrest in Russia caused the dollar to appreciate briefly against the mark, the dollar again drifted lower against the mark when the crisis was resolved, closing at DM 1 6013 on October 13

On October 21, the Bundesbank Council surprised exchange markets by again reducing its discount and Lombard rates by 50 basis points to 5 75 percent and 6 75 percent, respectively The Council also announced that it would conduct the following week's fourteen-day repurchase agreement at a fixed rate of 6 40 percent, a 27 basis point reduction from the prior day's variable rate repurchase agreement The dollar, which had begun rising gradually against the mark before the announcement, rose steadily over the remainder of the period, closing at DM 1 6857 on October 29

Other operations

The Federal Reserve and the Treasury's Exchange Stabilization Fund (ESF) each realized profits of $22 1 million from the sales of Japanese yen in the market. Cumulative valuation gains on outstanding foreign currency balances as of the end of October were $3,368 5 million for the Federal Reserve and $2,839 0 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 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 October, the Federal Reserve and the ESF held either directly or under repurchase agreements $10,004 3 million and $10,276.6 million, respectively, in foreign government securities valued at end-of-period exchange rates

Chart 3
Dollar-Yen Interest Rate Differential
Implied by the Three-Month Eurodeposit Futures (December Contract)

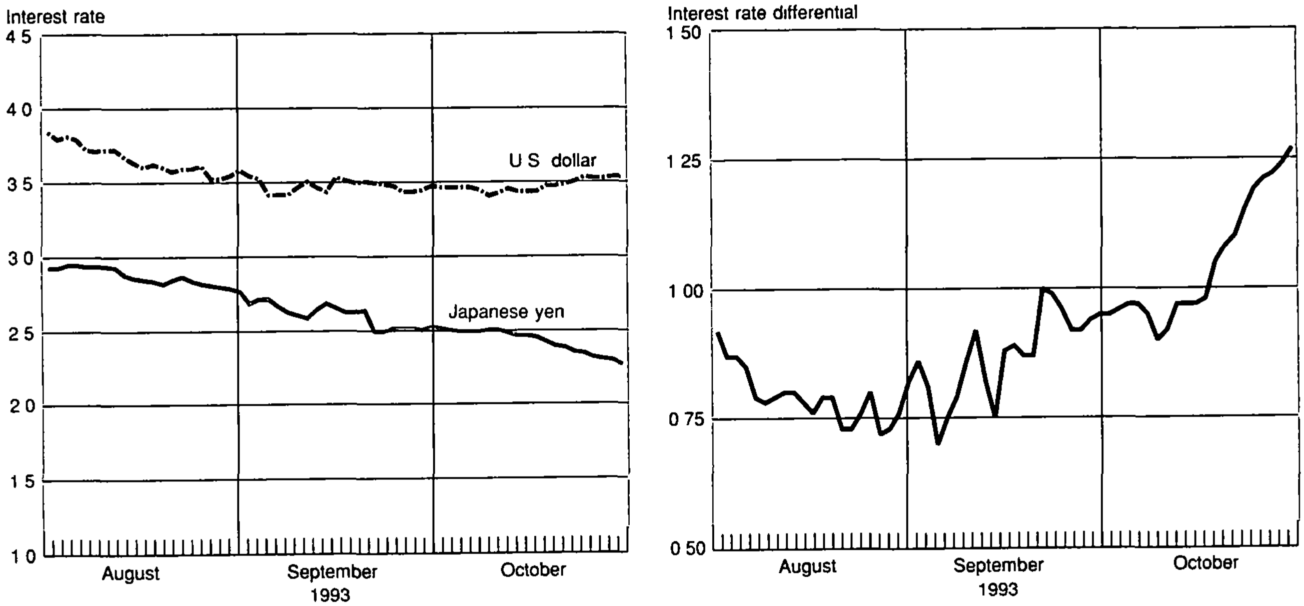


Chart 4
German Mark-Dollar Interest Rate Differential
Implied by the Three-Month Eurodeposit Futures (December Contract)

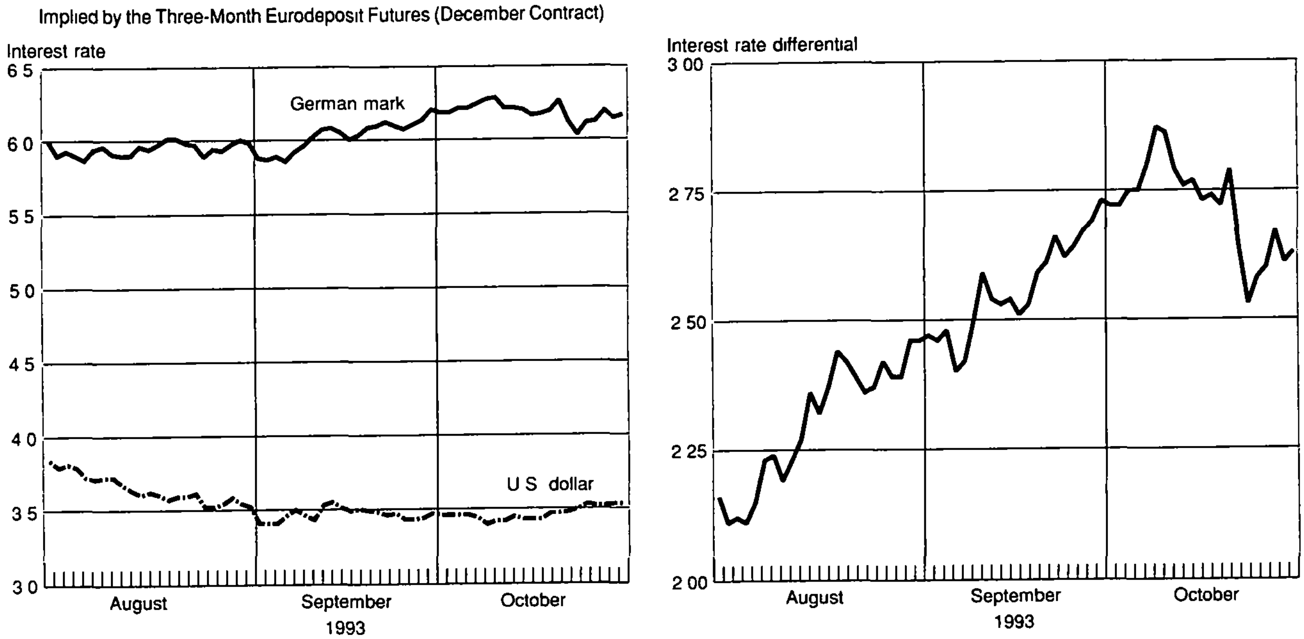


Table 1

Federal Reserve Reciprocal Currency Arrangements

Millions of Dollars

Institution	Amount of Facility October 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

Chart 5

Short-Term Interest Rates for Selected Countries

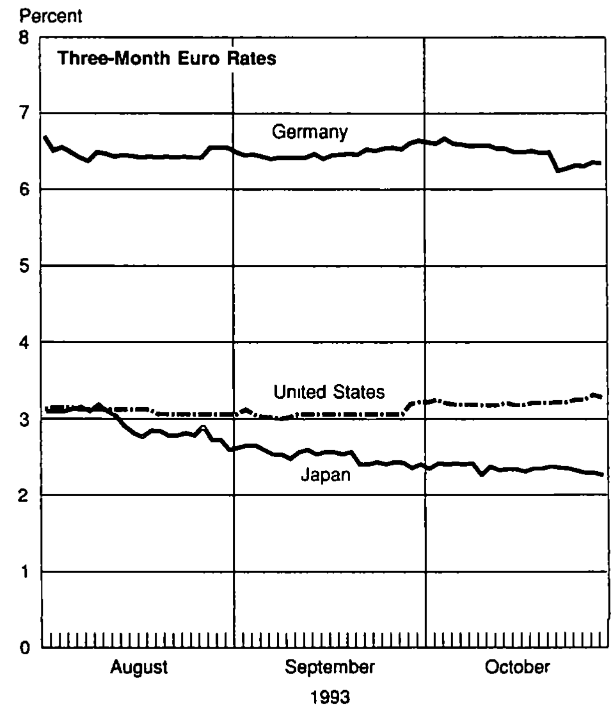


Table 2

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 July 31, 1993	+3,226 6	+3,005 5
Realized profits and losses August 1–October 31, 1993	+22 1	+22 1
Valuation profits and losses on outstanding assets and liabilities as of October 31, 1993	+3,368 5	+2,839 0

Note Data are on a value-date basis