Treasury and Federal Reserve Foreign Exchange Operations

This quarterly report describes Treasury and System foreign exchange operations for the period from October through December 1995. It was presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager for Foreign Operations, System Open Market Account. Soo J. Shin was primarily responsible for preparation of the report.[1]

During the fourth quarter of 1995, the dollar appreciated modestly, strengthening 3.7 percent against the Japanese yen and 0.5 percent against the German mark. The dollar also rose 0.6 percent on a trade-weighted basis against other Group of Ten (G-10) currencies.[2] Toward the end of the quarter, the dollar consolidated in increasingly narrow ranges, and trading activity declined as market participants reduced their appetite for risk before year-end. The U.S. monetary authorities did not undertake any intervention operations during the quarter. In other operations, the U.S. Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve System received repayments from Mexico of $350 million each on their respective short-term swap arrangements, and

1. The charts for the report are available on request from Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551.

2. The dollar's movements on a trade-weighted basis in terms of other G-10 currencies are measured using an index developed by staff at the Board of Governors of the Federal Reserve System.

1. Foreign exchange holdings of U.S. monetary authorities, based on current exchange rates

Millions of dollars

Item	Balance, Sept. 30, 1995	Quarterly changes in balances by source: Net purchases and sales[1]	Impact of sales[2]	Investment income	Currency valuation adjustments[3]	Balance, Dec. 31, 1995
FEDERAL RESERVE						
Deutsche marks	13,429.8	.0	.0	132.6	–47.8	13,514.7
Japanese yen	7,152.9	.0	.0	9.3	–289.8	6,872.4
Mexican pesos[4]	956.2	–362.4	.0	12.4	–4.3[5]	601.9
Interest receivables[6]	114.1	...	...	...	...	113.5
Other cash flow from investments[7]	...	...	...	...	...	–3.3
Total	**21,653.0**	...	...	...	...	**21,099.1**
U.S. TREASURY EXCHANGE STABILIZATION FUND						
Deutsche marks	6,795.1	.0	.0	67.5	–24.2	6,838.4
Japanese yen	10,509.3	.0	.0	4.4	–425.6	10,088.1
Mexican pesos[4]	11,500.0	–608.9	.0	258.9	.0[5]	11,150.0
Interest receivables[6]	304.0	...	...	...	...	302.6
Other cash flow from investments[7]	...	...	...	...	...	–12.7
Total	**29,108.5**	...	...	...	...	**28,366.4**

NOTE. Figures may not sum to totals because of rounding.

1. Purchases and sales include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

2. Calculated using marked-to-market exchange rates; represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are shown in table 2.

3. Foreign currency balances are marked to market monthly at month-end exchange rates.

4. See table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to the Bank of Mexico.

5. Valuation adjustments on peso balances do not affect profit and loss because the effect is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark to market its peso holdings, but the Federal Reserve System does.

6. Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked to market until interest is paid.

7. Cash flow differences from payment and collection of funds between quarters.

they renewed the same arrangements in the amount of $650 million each for an additional ninety days.

Subdued Year-End Market Activity

The dollar opened the quarter at DM 1.4273 and ¥99.55 and proceeded to fluctuate between DM 1.3808 and DM 1.4550 and ¥99.28 and ¥104.12 during the period. In the environment of limited risk-taking witnessed during the quarter, countervailing political and economic developments in the United States and other countries helped keep the dollar in these relatively narrow ranges. The dollar closed the quarter at DM 1.4339 and ¥103.20.

Gradual Appreciation of the Dollar against the Yen

The dollar modestly extended its gains against the yen from the previous quarter as the wide differential in interest rates and signs of reduced trade imbalances between the United States and Japan continued to favor the dollar. In addition, the prospects for fiscal consolidation in the United States combined with a better U.S. economic outlook relative to other major economies also helped to support market sentiment for the dollar.

As in the previous quarter, market participants continued to anticipate increased private capital outflows from Japan as a result of low domestic interest rates and the sizable amount of domestic debt maturing in the fourth quarter. The substantial decrease in Japan's current account surplus also contributed to the negative sentiment toward the yen. Furthermore, most Japanese exporters were perceived to be absent from the marketplace, having already filled their hedging requirements. On the other hand, Japanese institutional investors reportedly purchased dollars in conjunction with acquisitions of U.S. government securities. Amidst these factors the dollar rose to the quarter's high of ¥104.12 on November 2.

The dollar also benefited, in part, from market perceptions of a weak Japanese banking system and of a lack of transparency in Japanese bank accounting practices and disclosures of nonperforming loans. After several Japanese banks were downgraded by a credit rating agency, short-term funding costs for nearly all Japanese banks increased sharply, exacerbated by year-end funding pressures. Stress on the Japanese banking system was highlighted by problems related to Daiwa Bank's operations in the United States and the lack of a resolution to the troubled housing loan corporations (jusen). These concerns were manifested in additional premia on yen- and dollar-denominated LIBOR (London Interbank Offered Rate) deposits that Japanese banks had to pay to borrow money. Although the Japan premium subsequently receded, concerns about the health of the Japanese banking system continued to linger through the remainder of the quarter.

Tensions among Currencies in the European Union

As the quarter began, the dollar eased against the mark. Among the factors adversely affecting the dollar, tensions among currencies in the European Union (EU) remained most discernible. These strains sporadically escalated as public sector strikes against social-security-reform measures intensified in France, and uncertainty in Italy regarding the future of Prime Minister Dini's government threatened to jeopardize the 1996 budget process. In late October, as these events increasingly drew the attention of market participants, the German mark generally strengthened against other EU currencies. Subsequently the dollar sustained losses against the mark to reach the quarter's low of DM 1.3808. Later, however, the French government demonstrated its commitment to preserve the core social-security-reform measures, and

2. Net profits or losses (–) on U.S. Treasury and Federal Reserve foreign exchange operations, based on historical cost-of-acquisition exchange rates

Millions of dollars

Period and item	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities, Sept. 30, 1995		
Deutsche marks	2,939.8	1,079.0
Japanese yen	2,016.4	2,964.7
Total	**4,956.3**	**4,043.7**
Realized profits and losses from foreign currency sales, Sept. 30–Dec. 31, 1995		
Deutsche marks	.0	.0
Japanese yen	.0	.0
Total	**.0**	**.0**
Valuation profits and losses on outstanding assets and liabilities, Dec. 31, 1995[1]		
Deutsche marks	2,892.0	1,054.8
Japanese yen	1,726.6	2,539.2
Total	**4,618.6**	**3,593.9**

Note. Figures may not sum to totals because of rounding.

1. Valuation profits or losses are not affected by peso holdings, which are canceled by forward contracts.

Italy's 1996 budget process advanced. As a result, the mark reversed its earlier trend and weakened against other European currencies. In turn, this weakening trend helped the dollar to recover against the mark.

Expectations of Lower Interest Rates in Europe

As the quarter progressed, expectations that European interest rates would decline, bolstered by evidence of slowing economic growth and subsiding inflationary pressures in major European countries, boosted the dollar to the quarter's high of DM 1.4550 against the mark on December 8. Subsequently central banks in Germany, the United Kingdom, France, and several other European countries lowered their official interest rates 25–50 basis points in December, a development that led market participants to expect further easing.

3. Currency arrangements
Millions of dollars

Institution	Amount of facility	Outstanding, Dec. 31, 1995
	FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS	
Austrian National Bank	250	0
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	0
Bank of Mexico[1]		
Regular swaps	3,000	650
Temporary swaps	3,000	0
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	0
Total	**35,400**	**650**
	U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS	
Deutsche Bundesbank	1,000	0
Bank of Mexico[1]		
Regular swaps	3,000	650
United Mexican States[1]		
Medium-term swaps	. . .	10,500
Total[1]	. . .	**11,150**

1. Facilities available to Mexico comprise short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is $20 billion, less any outstanding drawings on the short-term facilities.

The positive effect on the dollar stemming from expectations of lower European interest rates was partly offset by increasing expectations of monetary easing in the United States, where signs of somewhat slower economic growth and subdued inflationary pressures persisted. On December 19 the Federal Reserve reduced the federal funds rate 25 basis points. Subsequently, expectations of monetary easing in Europe outpaced expectations in the United States and remained a dollar-supportive factor.

Uncertainties Surrounding the U.S. Budget Negotiations

Throughout the quarter, the apparent consensus on achieving a balanced budget in the United States was viewed by market participants as a positive development for U.S. asset markets. At times, however, particularly toward the end of the quarter, concerns about the ceiling on the U.S. Treasury's borrowing authority somewhat impeded the dollar's gains. In the U.S. government securities market, the protracted impasse in budget negotiations raised concerns about possible disruptions in the regular Treasury auction schedule and contractions in the supply of Treasury securities. Because foreign exchange market participants generally did not take significant dollar positions based on the potential outcome of the budget negotiations, however, the net effect of these concerns on the dollar was muted.

North American Developments

In Canada financial markets were volatile preceding the referendum on Quebec independence. In the third week of October, the Canadian dollar fell to a four-month low of Can$1.3790 against the U.S. dollar as opinion polls indicated an even split between "yes" and "no" votes. After the secessionist referendum was defeated, the Canadian dollar recovered, but given the narrow margin of defeat, focus turned immediately to the possibility of another referendum in the near future.

After the referendum, market participants increasingly anticipated monetary easing by the Bank of Canada, and the Canadian dollar resumed its weakening trend against the U.S. dollar. On December 20 the Bank of Canada lowered its overnight call rate 25 basis points after the Federal Reserve's policy easing. The Canadian dollar traded calmly for the remainder of the month.

4. Drawings/rollovers and repayments (–) by Mexican monetary authorities

Millions of dollars

Item	Outstanding, Sept. 30, 1995	Oct.	Nov.	Dec.	Outstanding, Dec. 31, 1995
Reciprocal currency arrangements with the Federal Reserve					
Bank of Mexico					
Regular	1,000	–350 –650[1] 650[1]	0	0	650
Currency arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico					
Regular	1,000	–350 –650[1] 650[1]	0	0	650
Medium-term	10,500	0	0	0	10,500

NOTE. Data are on a value-date basis.

1. Remainder of February 2 drawing was renewed on October 30 for an additional ninety days.

In Mexico financial markets encountered abrupt selling pressures in the first half of the quarter as political concerns and worse-than-expected economic data rekindled doubts about the timing of and prospects for economic recovery. The ensuing selloff was exacerbated by the reluctance among many investors to hold Mexican assets toward year-end. Near the end of the quarter, the Mexican monetary authorities tightened liquidity conditions and purchased pesos in the foreign exchange market to dampen volatility. The Mexican financial markets stabilized, and the peso, at NP 7.70, closed the quarter 17.2 percent weaker against the dollar.

Mexican Swap Activity

On October 11 Mexico made partial repayment on its short-term swap arrangements with the U.S. monetary authorities. A total of $700 million was repaid, divided evenly between the Federal Reserve System and the ESF. Subsequently the respective short-term arrangements, with principal amounts totaling $1.3 billion, were renewed on October 30 for ninety days.

Treasury and Federal Reserve Foreign Exchange Reserves

The U.S. monetary authorities did not undertake any intervention operations this quarter. At the end of the quarter, the current values of the German mark and Japanese yen reserve holdings of the Federal Reserve System and the ESF were $20.5 billion and $17.0 billion respectively. The U.S. monetary authorities invest all of their foreign currency balances in a variety of official instruments that yield market-related rates of return and that have a high degree of liquidity and credit quality. A significant portion of these holdings are invested in German and Japanese government-issued securities. As of December 31 the Federal Reserve and the ESF held $7.3 billion and $10.9 billion, respectively, in German and Japanese government securities either directly or under repurchase agreement.[3] In addition, the ESF held $10.5 billion equivalent in nonmarketable Mexican government securities in connection with the medium-term swap arrangement. □

3. This sentence is corrected and revised from the original text of the "Treasury and Federal Reserve Foreign Exchange Operations" report released February 7, 1996.