Treasury and Federal Reserve Foreign Exchange Operations

This quarterly report describes Treasury and System foreign exchange operations for the period from January through March 1996. 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. Daniel Katzive was primarily responsible for preparation of the report.[1]

During the first quarter of 1996, the dollar appreciated 3.9 percent against the Japanese yen, 3.0 percent against the German mark, and 2.1 percent on a trade-weighted basis against other Group of Ten (G-10) currencies.[2] The dollar strengthened in the first weeks of the new year, reaching its highs for the quarter of DM1.4945 on January 25 and ¥107.57 on January 31. After briefly weakening in February, the dollar proceeded to trade in a narrow range, closing the quarter at DM1.4764 and ¥107.24. The U.S. monetary authorities did not undertake any intervention operations in the foreign exchange market during the quarter. However, the U.S. Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve

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, Dec. 31, 1995	Quarterly changes in balances by source				Balance, Mar. 31, 1996
		Net purchases and sales[1]	Impact of sales[2]	Investment income	Currency valuation adjustments[3]	
FEDERAL RESERVE						
Deutsche marks	13,514.7	0	0	137.4	−386.1	13,266.0
Japanese yen	6,872.4	0	0	6.2	−242.0	6,636.6
Mexican pesos[4]	601.9	−658.5	0	8.5	48.1[5]	0
Interest receivables[6]	113.5	...	...	...	...	75.7
Other cash flow from investments[7]	−3.3	...	...	...	...	7.1
Total	**21,099.1**	...	...	...	...	**19,985.4**
U.S. TREASURY EXCHANGE STABILIZATION FUND						
Deutsche marks	6,838.4	0	0	72.4	−195.3	6,715.5
Japanese yen	10,088.1	0	0	5.2	−363.0	9,730.5
Mexican pesos[4]	11,150.0	−900.9	0	250.9	0[5]	10,500.0
Interest receivables[6]	302.6	...	...	...	...	272.7
Other cash flow from investments[7]	−12.7	...	...	...	...	7.5
Total	**28,366.4**	...	...	...	...	**27,226.2**

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.

System did receive final repayments from Mexico on the remaining balances of $650 million outstanding under each of their respective short-term swap arrangements. An additional $10.5 billion remains outstanding under the ESF's medium-term swap facility.

Strengthening of the Dollar at the Outset of the New Year

Early in the year the dollar appreciated against the German mark and other European currencies because of the widespread perception that monetary easing in Europe would proceed at a faster pace than in the United States. This expectation was bolstered by the release of weak German economic data in January: The seasonally adjusted west German unemployment rate for December rose to 8.6 percent, and forecasts for 1996 real growth in German gross domestic product began to be revised downward to below 2.0 percent.

Against the yen the dollar was supported by indications of a continued narrowing of the U.S.–Japan current account imbalance. Trade statistics released in Japan showed that Japan's November current account surplus had fallen 17.1 percent year over year and confirmed that Japan's 1995 current account surplus was the lowest in four years. Similarly, U.S. trade data indicated that in October 1995 the U.S. trade deficit with Japan, although slightly higher than in September 1995, had fallen almost $2 billion from its year-ago level.

Early in the quarter the dollar also benefited indirectly against the yen because of the market perception of a broad-based revival of investors' risk appetite and a demand for higher yields. This dynamic served to support the currencies and credit markets of the higher-yielding European countries, including Italy, Sweden, and Spain, at the expense of lower-yielding currencies, such as the Japanese yen. The generalized weakness in the yen helped support the dollar–yen exchange rate.

Investors also became more optimistic about the outlook for the dollar after the end of the U.S. government shutdown in December and after a subsequent easing of market concern about the budget impasse. Finally, comments made by German and other Group of Seven (G-7) officials around the time of the January G-7 meeting of finance ministers and central bank governors suggested a preference for a stronger U.S. currency.

Changes in Monetary Policy Expectations and the Decline of the Dollar

In February, bond markets in Germany and Japan weakened amid a broad reassessment of interest rate expectations before recovering later in the quarter. At the same time, U.S. Treasury bond yields also rose.

In the United States, credit markets were hurt by a shift in the budget debate. Negotiations on balancing the federal budget appeared unlikely to progress further, while the commencement of the 1996 presidential campaign focused attention on the prospects for stronger economic growth. During February the yield on the benchmark thirty-year Treasury bond rose nearly 50 basis points. Weakness in the U.S. bond market contributed to a weakening of the dollar as market participants anticipated that the bond market's performance would prompt foreign investors to liquidate positions in dollar-denominated securities.

Meanwhile, in early February the German Bundesbank announced that it would fix its repurchase rate at 3.3 percent. The announcement suggested to some market participants that the Bundesbank might be at or near the end of its easing cycle. These concerns were magnified by widespread rumors that February data would indicate that German M3 had risen at a rate well above the Bundesbank's target range in January. The prospect that German economic growth would resume and that interest rates would not continue to fall prompted strengthening of the mark.

Also in early February a report of strong Japanese housing starts and higher-than-expected Japanese industrial production prompted market participants to wonder whether Japan's accommodative monetary policy stance might soon end, despite continued generous injections of liquidity by the Bank of Japan. On February 15, Japanese Finance Minister Kubo made comments indicating that low interest rates were hurting senior citizens, and these comments were interpreted by market participants as confirming that Japan's official rates would soon rise. This sentiment contributed to a broad-based unwinding of short yen positions against the U.S. dollar and other major currencies. The dollar weakened against the yen and the mark, reaching February lows of DM 1.4411 on February 19 and ¥103.35 on February 27. Against the yen, the dollar was supported by widespread reports of intervention by the Japanese monetary authorities and the subsequent perception that Japanese monetary authorities did not wish to see renewed strength of the yen.

RECOVERY OF THE DOLLAR AND SUBSEQUENT TRADING IN A TIGHT RANGE THROUGH THE END OF THE QUARTER

Concerns about an end to German monetary easing began to diminish after the release of the January M3 report, which, although above the Bundesbank's target range, was lower than the market's worst fears. In early March, the release of negative fourth-quarter GDP figures and high February unemployment data in Germany as well as continuing evidence of subdued inflationary pressures helped revive expectations of further German interest rate reductions.

Similarly, in Japan, the March 1 release of a somewhat weaker-than-expected Tankan survey by the Bank of Japan indicated that the Japanese economy was recovering more slowly than market participants had previously anticipated. This development served to unwind market expectations of a near-term change in Japanese monetary policy and caused yields implied by 1996 Euroyen futures contracts to fall as much as 33 basis points.

On March 8, it was reported that U.S. February nonfarm payrolls had grown 705,000, an increase more than twice as large as consensus expectations, and that the unemployment rate had fallen to 5.5 percent. The strong data led to a reassessment of expectations for future Federal Reserve policy and suggested to many that stronger growth in the United States would move interest rate differentials between the United States and Japan and between the United States and Germany in favor of the dollar.

The combined effect of the data in the three markets was to resurrect, at least partially, the relative growth scenarios that had been favorable to the dollar early in the year. The dollar recovered against the mark and the yen and proceeded to trade in a narrow range for the remainder of the quarter, firming against the yen as trading thinned in the final week of the Japanese fiscal year. The market consensus that Japanese exporters had largely hedged their dollar revenues well in advance of the conclusion of the Japanese fiscal year helped prevent the heavy dollar selling that had been evident in March in recent years.

STABILITY IN NORTH AMERICAN MARKETS

Canadian credit markets performed well during the quarter, with the spread between Canadian and U.S.

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, Dec. 31, 1995		
Deutsche marks	2,892.0	1,054.8
Japanese yen	1,726.6	2,539.2
Total	**4,618.6**	**3,593.9**
Realized profits and losses from foreign currency sales, Dec. 31, 1995–Mar. 31, 1996		
Deutsche marks	0	0
Japanese yen	0	0
Total	**0**	**0**
Valuation profits and losses on outstanding assets and liabilities, Mar. 31, 1996[1]		
Deutsche marks	2,505.9	859.5
Japanese yen	1,487.9	2,188.9
Total	**3,993.8**	**3,048.3**

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.

3. Currency arrangements

Millions of dollars

Institution	Amount of facility	Outstanding, Mar. 31, 1996
	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	
Bank of Mexico[1]	3,000	
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	**32,400**	**0**
	U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS	
Deutsche Bundesbank	1,000	0
Bank of Mexico[1]		
Regular swaps	3,000	0
United Mexican States[1]		
Medium-term swaps	. . .	10,500
Total[1]	. . .	**10,500**

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.

government ten-year benchmark bond yields falling sharply amid favorable fiscal developments in Canada and diminished perceptions of political risk. The Canadian dollar closed the quarter 0.5 percent stronger against the U.S. dollar.

Mexican markets also stabilized, largely ignoring volatility in U.S. equity and credit markets. The Mexican peso appreciated 2.3 percent against the dollar, despite weakening in February, and overnight interest rates fell nearly 900 basis points to 35 percent. Shifting investor appetites—fueled by expectations for moderating inflation, signs of improving economic fundamentals, and increasing confidence in Mexican monetary policy—supported the peso.

The Rise of Gold Prices

Gold prices reached their highest levels in nearly six years, trading as high as $418.40 per ounce. Three factors appear to have fueled the rally: strong demand from physical end-users in Asia, low opportunity costs for holding the metal as global interest rates declined, and reduced forward sales by producers. Later in the quarter, these price gains were partially reversed as high prices spurred additional sales. The price of the metal closed the quarter $8.35 higher, at $395.45 per ounce.

Mexican Swap Activity

On January 29, Mexico made the final repayment on its short-term swap arrangements with the U.S. monetary authorities. A total of $1.3 billion was repaid, divided evenly between the Federal Reserve System and the ESF. On January 31, 1996, the special $3 billion swap facility established by the Federal Reserve System on February 1, 1995, expired according to its original terms without being renewed.

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 reserve holdings of German marks and Japanese yen of the Federal Reserve System and the ESF were $20 billion and $16.5 billion respectively. The U.S. monetary authorities invest all of 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 significant portion of these balances is invested in German and Japanese government securities held either directly or under repurchase agreement. As of March 31, outright holdings of government securities by U.S. monetary authorities totaled $3.6 billion and included investments in Japanese treasury bills and German government bonds.

Japanese and German government securities are also held under repurchase agreement through transactions executed directly in the market or through agreements with official institutions. Government securities held under repurchase agreements by the U.S. monetary authorities totaled $14.3 billion. In addition to government securities, foreign currency reserves are also invested in deposits at the Bank for International Settlements and in facilities at other official institutions.

In addition, the ESF held $10.5 billion equivalent in nonmarketable Mexican government securities in connection with the ESF's medium-term swap arrangement. □

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

Millions of dollars

Item	Outstanding, Dec. 31, 1995	Jan.	Feb.	Mar.	Outstanding, Mar. 31, 1996
Reciprocal currency arrangements with the Federal Reserve					
Bank of Mexico					
Regular	650	–650	0	0	0
Currency arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico					
Regular	650	–650	0	0	0
Medium-term	10,500	0	0	0	10,500

NOTE. Data are on a value-date basis.