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The Federal Reserve in the International Sphere

The U.S. economy and the world economy are linked in many ways. Economic developments in this country have a major influence on production, employment, and prices beyond our borders; at the same time, developments abroad significantly affect our economy. The U.S. dollar, which is the currency most used in international transactions, constitutes more than half of other countries' official foreign exchange reserves. U.S. banks abroad and foreign banks in the United States are important actors in international financial markets.

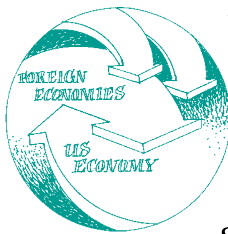
THE ACTIVITIES OF THE FEDERAL RESERVE and the international economy influence each other. Thus, in deciding on the appropriate monetary policy for achieving basic economic goals, the Board of Governors and the Federal Open Market Committee consider the record of U.S. international transactions, movements in foreign exchange rates, and other international economic developments. And in the area of bank supervision and regulation, innovations in international banking require continual assessments of and modifications in the Federal Reserve's orientation, procedures, and regulations.

Not only do Federal Reserve policies shape and get shaped by international developments; the U.S. central bank also participates directly in international affairs. For example, the Federal Reserve undertakes foreign exchange transactions in cooperation with the U.S. Treasury. These transactions, and similar ones by foreign central banks involving dollars, may be facilitated by reciprocal currency (swap) arrangements that have been established between the Federal Reserve and the central banks of other countries. The Federal Reserve also works with other agencies of the U.S. government to conduct international financial policy, participates in various international organizations and forums, and is in almost continuous contact with other central banks on subjects of mutual concern.

INTERNATIONAL LINKAGES

The primary instruments of monetary policy—open market operations, the discount window, and reserve requirements—are employed essentially to attain basic economic objectives for the U.S. economy. But their use also influences, and is influenced by, international developments.

For example, U.S. monetary policy actions influence exchange rates. Thus, the dollar's foreign exchange value in terms of other currencies is one of the channels through which U.S. monetary policy affects the U.S. economy. If Federal Reserve actions raised U.S. interest rates, for instance, the foreign exchange value of the dollar generally would rise. An increase in the foreign exchange value of the dollar, in turn, would raise the foreign price of U.S. goods traded on world markets and lower the price of goods imported into the United States. These developments could lower output and price levels in the U.S. economy. An increase in interest rates in a foreign country, in contrast, could raise worldwide demand for assets denominated in that country's currency and thereby reduce the dollar's value in terms of that currency. U.S. output and price levels would tend to increase—directions just opposite of when U.S. interest rates rise.



Therefore, in formulating monetary policy, the Board of Governors and the FOMC draw upon information about and analysis of international as well as U.S. domestic influences. Changes in public policies or in economic conditions abroad and movements in international variables that affect the U.S. economy, such as exchange rates, must be evaluated in assessing the stance of U.S. monetary policy.

In the 1980s, recognizing their growing economic interdependence, the United States and the other major industrial countries intensified their efforts to consult and cooperate on macroeconomic policies. At the 1986 Tokyo Economic Summit, they agreed upon formal procedures to improve the coordination of policies and the multilateral surveillance of their economic performance. The Federal Reserve works with the U.S. Treasury in coordinating international policy, particularly when, as has been the norm since the late 1970s, they intervene together in currency markets to influence the external value of the dollar.

Using the forum provided by the Bank for International Settlements (BIS), in Basle, Switzerland, the Federal Reserve works with representatives of the central banks of other countries on mutual concerns regarding monetary policy, international financial markets, banking supervision and regulation, and payments systems. (The Chairman of the Board of Governors also represents the U.S. central bank on the Board of Directors of the BIS.) Representatives of the Federal Reserve participate in the activities of the International Monetary Fund (IMF), discuss macroeconomic, financial market, and structural issues with representatives of other industrial countries at the Organisation for Economic Co-operation and Development, in Paris, and work with central bank officials of Western Hemisphere countries at meetings such as that of the Governors of Central Banks of the American Continent.

FOREIGN CURRENCY OPERATIONS

The Federal Reserve has conducted foreign currency operations—the buying and selling of dollars in exchange for foreign currency—for customers since the 1950s and for its own account since 1962. These operations are directed by the FOMC, acting in close cooperation with the U.S. Treasury, which has overall responsibility for U.S. international financial policy. The Manager of the System Open Market Account at the Federal Reserve Bank of New York acts as the agent for both the FOMC and the Treasury in carrying out foreign currency operations.

The purpose of Federal Reserve foreign currency operations has evolved in response to changes in the international monetary system. The most important of these changes was the transition in the 1970s from the Bretton Woods system of fixed exchange rates to a system of flexible exchange rates for the dollar in terms of other countries' currencies.[1] Under the latter system, the main aim of Federal Reserve foreign currency operations has been to counter disorderly conditions in exchange markets through the

1. The IMF and the International Bank for Reconstruction and Development (known informally as the World Bank) were created at an international monetary conference held in Bretton Woods, New Hampshire, in 1944. As part of the Bretton Woods arrangements, a system of fixed exchange rates was established.

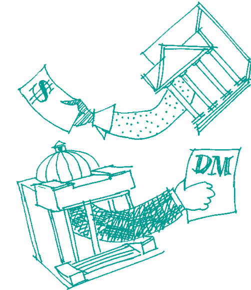
purchase or sale of foreign currencies (called intervention operations), primarily in the New York market. During some episodes of downward pressure on the foreign exchange value of the dollar, the Federal Reserve has purchased dollars (sold foreign currency) and has thereby absorbed some of the selling pressure on the dollar. Similarly, the Federal Reserve may sell dollars (purchase foreign currency) to counter upward pressure on the dollar's foreign exchange value. The Federal Reserve Bank of New York also carries out transactions in the U.S. foreign exchange market as an agent for foreign monetary authorities.

Intervention operations involving dollars could affect the supply of reserves in the U.S. depository system. A purchase of foreign currency by the Federal Reserve with newly created dollars, for instance, would increase the supply of reserves. In practice, however, such operations are not allowed to alter the supply of monetary reserves available to U.S. depository institutions. That is, interventions are "sterilized" through open market operations so that they do not lead to a change in the market for domestic monetary reserves different from that which would have occurred in the absence of intervention.

For example, the Federal Reserve, perhaps in connection with German authorities, may want to counter downward pressure on the dollar's foreign exchange value in relation to the German mark. The Federal Reserve reduces its balances denominated in German marks (an asset on the Federal Reserve balance sheet) and sells the marks for dollars on the open market, reducing the supply of dollar bank reserves. Unless an explicit decision has been made to lower the supply of bank reserves, the Federal Reserve uses the dollars it has acquired in the transaction to purchase a Treasury security and thus

The Foreign Exchange Desk at the Federal Reserve Bank of New York.

restores the supply of dollar bank reserves to the former level. The net effect of such an intervention operation on the private sector is a reduction in the supply of dollar-denominated securities and an increase in the supply of mark-denominated assets. The German central bank, in turn, will sterilize the unwanted effects of the transaction, if any, on the level of mark-denominated bank reserves.



A dollar intervention initiated by a foreign central bank also leaves the supply of bank reserves in the United States unaffected, unless it changes the deposits that the central bank holds with the Federal Reserve. If, for example, the foreign central bank were to purchase dollars and place them in its account with the Federal Reserve, it would take these dollars from the U.S. banking system. However, the Domestic Trading Desk at the Federal Reserve Bank of New York would offset this withdrawal by buying a Treasury security to supply reserves. Most dollar sales by foreign central banks are implemented by drawing down holdings of dollar securities or by borrowing dollars in the market, and thus they do not need to be countered by open market operations to leave the supply of reserves unchanged.

Swap Network

An important feature of the foreign currency operations of the Federal Reserve and of foreign central banks over the past thirty years has been the reciprocal currency (swap) network, which consists of reciprocal short-term arrangements (comparable to repurchase and matched sale–purchase agreements in the domestic government securities market) among the Federal Reserve, other central banks, and the BIS. These arrangements, which have been used infrequently in recent years, give the Federal Reserve temporary access to the foreign currencies it needs for intervention operations to support the dollar and give the partner foreign central banks temporary access to the dollars they need to support their own currencies. Swap transactions involving dollars are implemented through the Federal Reserve Bank of New York, acting as an agent for the Federal Reserve System.

A swap transaction involves both a spot (immediate delivery) transaction, in which the Federal Reserve transfers dollars to another central bank in exchange for foreign currency, and a simul-

taneous forward (future delivery) transaction, in which the two central banks agree to reverse the transaction, typically three months in the future. The Federal Reserve may initiate a swap transaction (make a swap drawing) when it needs the foreign currency obtained in the spot half of the transaction to finance intervention sales of foreign currency in support of the dollar. To repay the drawings at maturity, the Federal Reserve re-acquires the foreign currency. Such acquisitions have usually been accomplished by purchasing foreign currency in the market, thereby reversing the original intervention in support of the dollar. When a foreign central bank initiates the swap drawing, it uses the dollars obtained in the spot half of the transaction to finance sales of dollars to support its own currency. Subsequently, it meets its obligation to deliver dollars to the Federal Reserve by re-acquiring dollars in the market. In these swap transactions, the foreign central bank pays interest on the dollar drawings, at the U.S. Treasury bill rate,

Table 4.1
Federal Reserve reciprocal currency arrangements, June 30, 1994
Millions of dollars

Institution	*Amount of facility*
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
German Bundesbank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	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**

and the Federal Reserve pays a comparable rate on the foreign currency counterpart.

The Federal Reserve established its first swap arrangement with the Bank of France in March 1962. It subsequently made similar arrangements with other central banks, and the sizes of the facilities have increased from time to time. At the end of June 1994, the Federal Reserve had swap arrangements with fourteen foreign central banks and the BIS totaling $32.4 billion (table 4.1). Since the establishment of the network, eleven foreign central banks and the BIS have made swap drawings. Foreign drawings were more frequent and on a larger scale in the 1960s than they have been since. The Federal Reserve has, at various times, made swap drawings on nine foreign central banks and the BIS.

Exchange Market Intervention

The nature and scope of exchange market operations by the Federal Reserve and the use of the swap network have changed in response to changes in the character of the international monetary system. Under the Bretton Woods system of fixed exchange rates, foreign authorities were responsible for intervening in exchange markets to maintain their countries' exchange rates within 1 percent of their currencies' parities with the U.S. dollar; direct exchange market intervention by U.S. authorities was extremely limited because the United States stood ready to buy and sell dollars against gold at $35 per ounce. After the United States suspended the gold convertibility of the dollar in 1971, a regime of managed flexible exchange rates emerged; in 1973, under that regime, the United States began to intervene in exchange markets on a more significant scale. Federal Reserve swap drawings financed much of this intervention. In 1978, the regime of flexible exchange rates was codified in an amendment to the IMF's Articles of Agreement.

In the early 1980s, the United States curtailed its official exchange market operations, although it remained ready to enter the market when needed to counter disorderly conditions. In 1985, particularly after September, when representatives of the five major industrial countries reached the so-called Plaza Accord on exchange rates, the United States began to use exchange market intervention more frequently as a policy instrument. During the second

half of the 1980s, U.S. intervention to restrain the rise in the dollar's value on foreign exchange markets (that is, official U.S. purchases of assets denominated in foreign currencies) was sufficiently heavy that the stock of foreign exchange reserves acquired enabled the Federal Reserve to finance purchases of dollars, when it needed to support the dollar's external value, without drawing on its swap lines with other central banks.

Other U.S. Foreign Currency Resources

Since the late 1970s, the U.S. Treasury has financed about half of total U.S. support for the dollar, and the Federal Reserve has financed the rest. The Treasury acquired foreign currency resources partly through its own swap arrangement with the German central bank but mainly through drawings on the International Monetary Fund (IMF), sales of special drawing rights, and issuance of securities denominated in foreign currencies (these securities have since been retired).[2] Moreover, over the post–Bretton Woods era, Federal Reserve and Treasury interventions have on balance been net purchases of foreign currencies against dollars; these net purchases, along with cumulated earnings on the assets, have tended to build up the stock of U.S. official foreign exchange reserves.

At the end of June 1994, the United States held foreign currency reserves valued at $42.8 billion. Of this amount, the Federal Reserve held foreign currency assets of $22.5 billion, and the Exchange Stabilization Fund of the Treasury held the rest.

INTERNATIONAL BANKING

The Federal Reserve is interested in the international activities of banks not only because of its role as a bank supervisor but also because such activities are often close substitutes for domestic banking activities and need to be monitored carefully to help interpret U.S. monetary and credit conditions. Moreover, international banking institutions are important vehicles for capital flows into and out of the United States.

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2. Special drawing rights (SDRs) are unconditional credit lines created by the IMF and allocated on occasion to the members of the IMF to supplement their international reserve assets.

The location of international banking depends on such factors as the business needs of customers, the scope of operations permitted by a country's legal and regulatory framework, and tax considerations. The international activities of U.S.-chartered banks include lending to and accepting deposits from foreign customers at the banks' U.S. offices and engaging in other financial transactions with foreign counterparts. However, the bulk of the international business of U.S.-chartered banks takes place at their branch offices located abroad and at their foreign-incorporated subsidiaries, usually wholly owned. Much of the activity of foreign branches and subsidiaries of U.S. banks has been Eurocurrency business—that is, taking deposits and lending in currencies other than that of the country in which the banking office is located. U.S. banks are also increasingly offering a range of sophisticated financial products to residents of other countries and to U.S. firms abroad.

The international role of U.S. banks has a counterpart in foreign bank operations in the United States. U.S. offices of foreign banks actively participate as both borrowers and investors in U.S. domestic money markets and are active in the market for loans to U.S. businesses. (See chapter 5 for a discussion of the Federal Reserve's supervision and regulation of the international activities of U.S. banks and the U.S. activities of foreign banks.)

International banking by both U.S.-based and foreign banks facilitates the holding of Eurodollar deposits—dollar deposits in banking offices outside the United States—by nonbank U.S. entities. Similarly, Eurodollar loans—dollar loans from banking offices outside the United States—can be an important source of credit for U.S. companies (banks and nonbanks). Because they are close substitutes for deposits at domestic banks, Eurodollar deposits of nonbank U.S. entities at foreign branches of U.S. banks are included in the U.S. monetary aggregate M3; Eurodollar term deposits of nonbank U.S. entities at all other banking offices in the United Kingdom and Canada are also included in M3. Overnight Eurodollar deposits of nonbank U.S. entities at foreign branches of U.S. banks are included in M2. (See box in chapter 2 for the U.S. monetary aggregates.) ■