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## Financial Performance and Profile

In this chapter we consider the ESF's financial performance over the decades and the present condition of the account.

### Performance Assessment

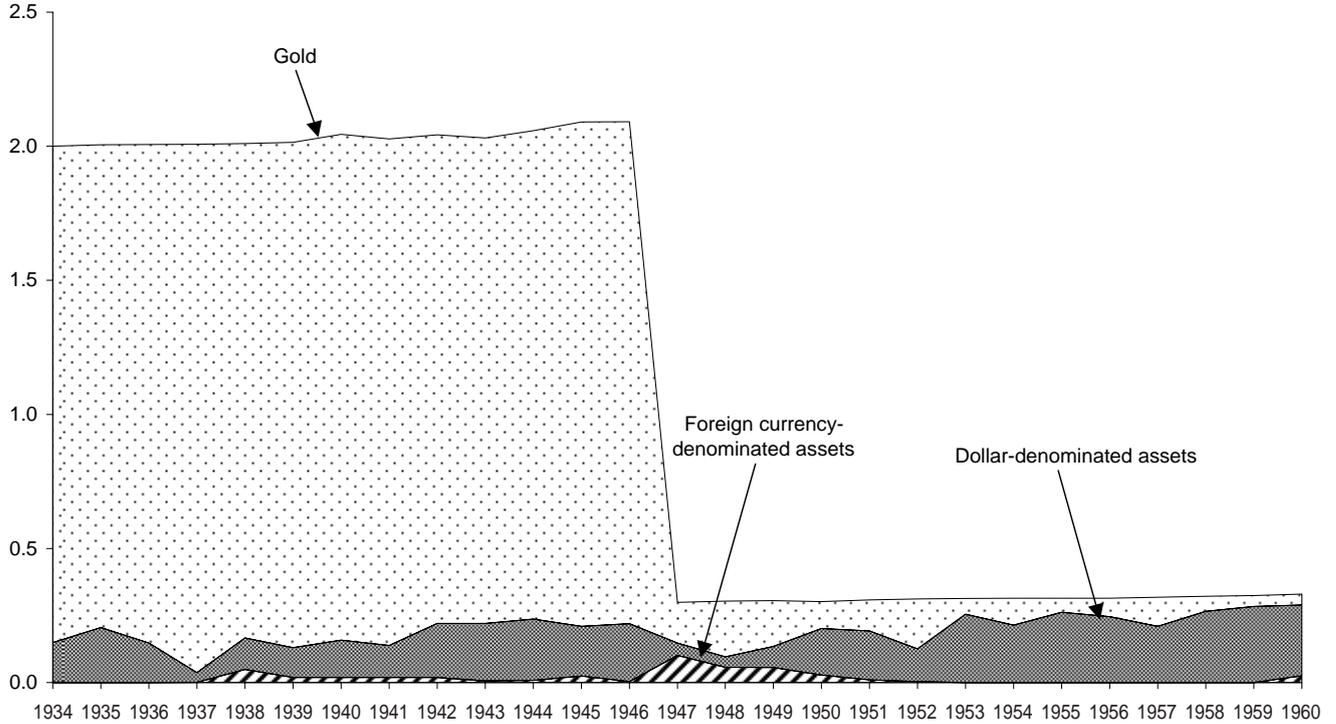
The first phase of the financial history of the ESF, from 1934 to 1945, saw modest activity with the stabilization of currencies during the late interwar period and World War II. But the Treasury did not tap 90 percent of the \$2 billion in resources allocated to the ESF, deciding to hold these in gold. The growth in assets was correspondingly small, with total assets in 1945 only 4.5 percent above their 1934 level (figure 5).

Shortly after the beginning of the second major period, the Treasury transferred \$1.8 billion in gold holdings to the International Monetary Fund as part of the first quota payment in 1946 and 1947 (US Treasury Department, *Annual Report of the Secretary* 1947). The total assets of the ESF declined to roughly \$300 million, half of which remained in gold. Growth in assets over this period was also low, with total assets rising only to \$330 million in 1960.

The third period, from 1961 to the present, is more relevant to an analysis of the current financial and economic merits of the account. Between 1963 and the end of the fixed-rate regime in 1973, the assets of the ESF rose from \$363 million to well over \$5 billion (figure 6), through borrowing, swaps, and especially SDR allocations as described in chapter 3. From the end of the Bretton Woods regime, the total assets of the ESF

**Figure 5 Assets of the ESF, FY1934-60**

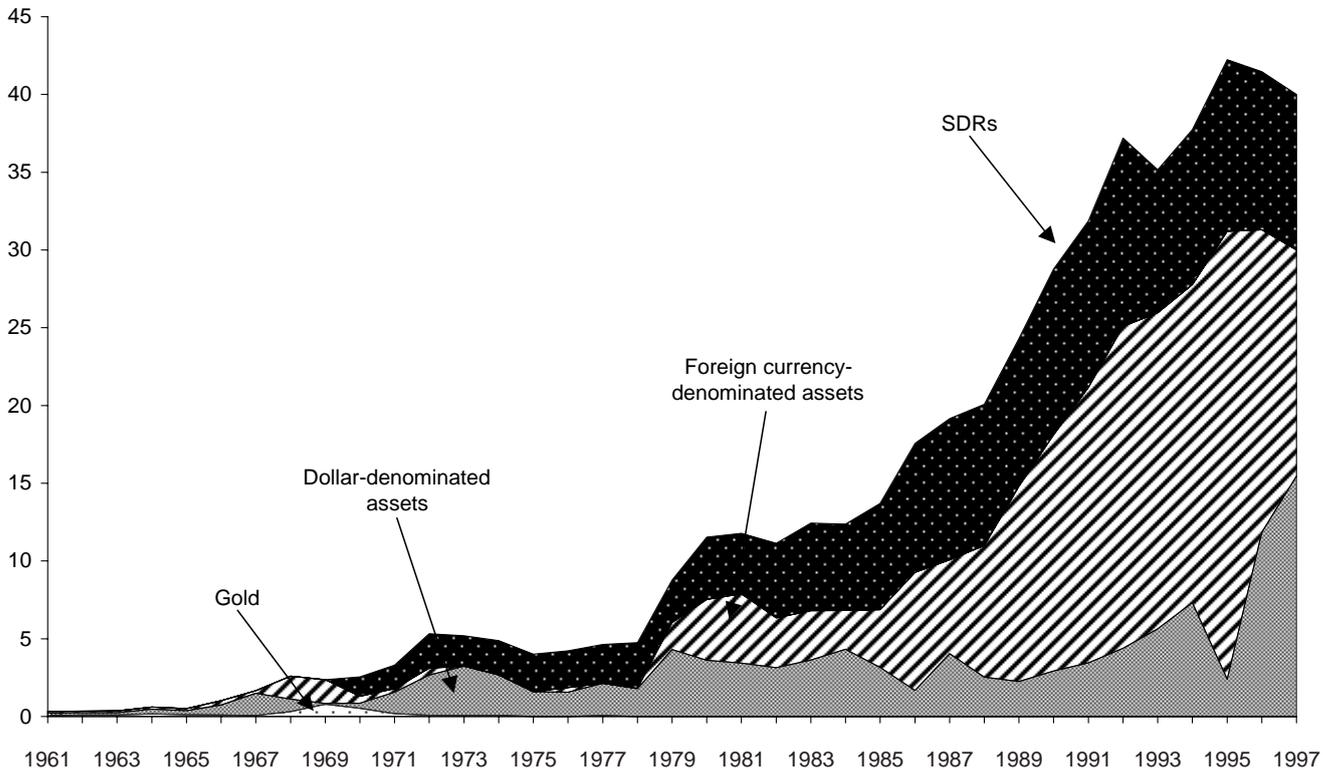
Billions of dollars



Sources: US Treasury Department, *Annual Report of the Secretary of the Treasury* (1934-53); *ESF Annual Report* (1954-60).

**Figure 6 Assets of the ESF, FY1961-97**

Billions of dollars



Source: US Treasury Department, *ESF Annual Report* (1961-97).

had doubled by the end of the 1980s, doubled again by 1988, and doubled yet again by 1995 to \$42.6 billion, the all-time high as of this writing. The foreign exchange component of these assets attained significant proportions beginning in the late 1970s, and became a substantial majority of total assets in the late 1980s and 1990s. German marks and Japanese yen were the principal foreign currencies held in the account (figure 7).

The ESF's capital position traced a path different from that of total assets during this period. Total capital, the sum of originally appropriated capital and cumulative retained earnings, stood at \$342 million in June 1963. By June 1973, total capital had risen to \$466 million. That this increase was modest compared to the increase in assets reflects the fact that assets were acquired through the issuance of liabilities rather than retained earnings. Keep in mind as well that the administrative expenses on the books of the ESF, which went well beyond the administration of the ESF itself, reduced net earnings somewhat through the 1970s. By 1978 and 1979, operating losses had *technically* eliminated the book value of capital entirely<sup>1</sup> (see figure 4).

The 1980s saw a dramatic change in fortunes for the ESF's capital position. From \$368 million in September 1980, it grew to \$1.8 billion by September 1984, \$8.4 billion by September 1989, and \$25 billion in September 1995, the all-time high as of this writing. The depreciation of the dollar after 1984, raising the dollar value of German marks and Japanese yen held by the ESF, was the impetus for most of that growth. Realized and unrealized exchange rate gains, supplemented by interest income, thus generated a rate of return on capital that would be the envy of most successful private fund managers.

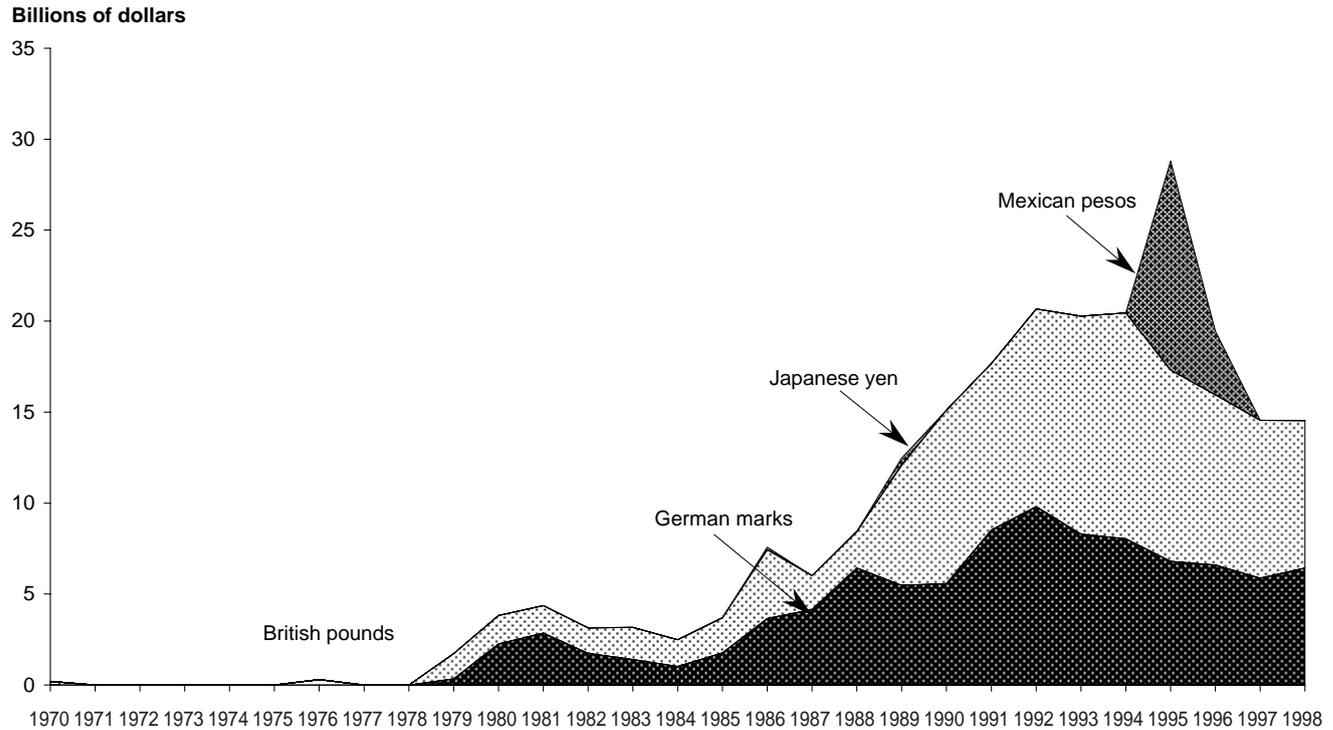
The rate of return on assets is another measure of the efficiency in the use of ESF resources. Net earnings divided by total assets for the years 1961 through 1997 are presented in table 2 (see also Schwartz 1997). The returns generally are low, and in some cases negative, into the early 1980s. With the depreciation of the dollar beginning in the mid-1980s, the annual return on assets rose greatly during the period 1985-95, with losses registered for 1996 and 1997. Even the low rates of return of the 1964-84 period exceeded by a substantial margin the rates of return on assets of private banks.

Comparisons to financial performance of private financial institutions, even if favorable, can be misleading, because the mission of the ESF is

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1. The Treasury divested the ESF of all gold holdings in December 1974, when it consolidated three different gold accounts into its general fund in anticipation of gold sales in 1975 and later in the decade (Schwartz 1997). Because the divestment occurred at the official price of gold, \$42.22 per ounce, rather than the prevailing market price, \$175 per ounce, the transaction effectively transferred \$268 million in gold profits out of the ESF to the general account. While those profits represented only about 5 percent of ESF assets at the time, they represented roughly half of ESF capital. Gold holdings are still recorded in US reserve statistics at the official price, substantially understating the market value of reserves.

**Figure 7 Foreign currency holdings of the ESF, FY1970-97**



Sources: US Treasury Department, *ESF Annual Report (1970-97)*; *Federal Reserve Bulletin* (December 1998).

**Table 2 Return on ESF assets, 1961-97** (millions of dollars)

	Total assets	Net income	Rate of return (percentage)
1961	336	9	2.7
1962	343	9	2.7
1963	363	8	2.2
1964	611	11	1.8
1965	518	25	4.7
1966	1,016	37	3.7
1967	1,664	56	3.4
1968	2,547	83	3.3
1969	2,373	44	1.9
1970	2,561	34	1.3
1971	3,309	39	1.2
1972	5,336	(64)	-1.2
1973	5,253	(82)	-1.6
1974	4,902	105	2.1
1975	4,039	129	3.2
1976	4,100	94	2.3
1977	4,673	19	0.4
1978	4,798	(641)	-13.4
1979	8,876	107	1.2
1980	11,810	588	5.0
1981	12,147	(323)	-2.7
1982	11,563	488	4.2
1983	12,675	1,090	8.6
1984	12,495	213	1.7
1985	13,821	1,043	7.5
1986	17,684	2,714	15.3
1987	19,288	1,276	6.6
1988	20,230	880	4.3
1989	24,500	808	3.3
1990	29,036	3,964	13.7
1991	32,158	1,764	5.5
1992	37,455	4,792	12.8
1993	35,299	1,199	3.4
1994	37,920	2,383	6.3
1995	42,628	2,345	5.5
1996	41,584	(250)	-0.6
1997	40,106	(584)	-1.5

Source: US Treasury Department, *ESF Annual Report* (1961-97).

so profoundly different from private investment objectives. Maximizing the rate of return on assets or capital has never been the primary objective of the ESF, although recent administrations have placed asset and capital growth among the secondary objectives of the account. The purpose of the ESF has been to stabilize the dollar and the international monetary system, consistently with US obligations in the IMF, through intervention and credit arrangements with foreign governments. Managers of the ESF

therefore typically hold a depreciating currency rather than sell it, generating unrealized exchange rate losses on holdings from time to time as the dollar fluctuates. Indeed, it could contravene the statutory objectives of the ESF to sell a depreciating currency in order to avoid a loss on the valuation of such holdings. Given its mission, therefore, we would expect the ESF to record larger unrealized losses occasionally and greater volatility in financial performance than private investment funds.

Although an extensive analysis of the effectiveness of foreign exchange intervention would go beyond the scope of this study, a few words are nonetheless in order. Studies conducted in the 1980s tended to question the effectiveness of foreign currency operations in general (for a review, see Edison 1993). However, in the 1990s the balance of opinion in academic circles shifted toward the view that intervention can be effective. Two studies, one by American economists Dominguez and Frankel (1993) and the other by Italian economists Catte, Galli, and Rebecchini (1994), argue that since the mid-1980s intervention has been quite successful.<sup>2</sup> Such operations have been found to be particularly effective when coordinated among central banks, “leaning with the wind” (building upon a short-term movement), and disclosed to the public. Adding the experience of the Clinton administration to this body of analysis reinforces these findings: intervention to support the dollar against the yen in August 1995 and to cap the dollar against the yen in June 1998 was highly effective.

An examination of the profitability of intervention reinforces the arguments of the more recent studies. Milton Friedman (1953) argued nearly 50 years ago that stabilizing intervention would be profitable, whereas destabilizing intervention would be unprofitable. Although it has become clear since then that the profit test does not yield unambiguous conclusions (see, for example, Leahy 1990), it remains nonetheless highly suggestive of the stabilizing or destabilizing character of intervention.

Academic analysts in the 1980s debated the profitability of US foreign exchange intervention (Edison 1993). Working with Federal Reserve and Treasury data not available to previous studies, Leahy (1995) has resolved this empirical question. He found that, from the beginning of the floating exchange rate period in March 1973 through 1992, foreign exchange intervention was indeed quite profitable, adding \$16.5 billion to US net worth. Moreover, he concluded, these profits seem to have been generated, not through luck or compensation for risk bearing, but from outpredicting the market. Because the Federal Reserve and the Treasury have generally, though not always, split intervention 50-50 since about 1980, the ESF’s portion of these profits has been roughly half of the total (Leahy 1990 and 1995).

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2. Critiques of these studies are offered by Mussa (1990), Basevi (1994), Frankel (1994), and Truman (1994).

The profits accruing to the ESF are not terribly important in themselves. They are important because they suggest that the currency markets have not been fully efficient and that foreign currency operations have been stabilizing. By limiting exchange rate fluctuations, furthermore, intervention has reduced the extent to which misleading price signals were sent to the real economy. Peter B. Kenen's (1988, 20) comments on the appreciation of the dollar in the first half of the 1980s—caused in part by skewed macroeconomic policies and in part by a speculative bubble—and its subsequent depreciation are germane:

Whole industries and regions in the United States have been affected permanently, because plants that were shut down when they became uncompetitive will not be reopened. They were not inefficient in 1980 but have been rendered obsolete by decisions and events taken in response to the swing in the real exchange rate. Export and domestic markets have been lost to foreign competitors, who invested heavily to capture them initially and will not give them up, even though they are not as profitable now. This is not a mercantilistic dirge. It is a lament for wasted resources—for the physical and human capital that has been misallocated, not only in the United States but in the rest of the world as well.

We can infer from the profitability of intervention that it increased the efficiency with which productive resources have been employed in the real economy. Though difficult to quantify, it is these gains that represent the most important returns to the United States from maintaining the ESF.

## Recent Balance Sheet

The balance sheet of the ESF at the end of FY1998 is reproduced in table 3, and the income statement in table 4. These tables inform the discussion that follows, which describes the basic accounting concepts of the fund and examines its condition. Readers with limited appetite for accounting could skip these sections and proceed directly to chapter 5.

### Assets

The assets of the ESF are mainly of three types: US dollars, foreign currency, and Special Drawing Rights (SDRs). These assets are presented in the balance sheet in two main categories: cash and noncash assets.

US government securities and foreign currency-denominated assets are listed within the category of cash and cash-equivalent assets, investments maturing in less than three months. These represent the most liquid resources of the ESF, those available for foreign exchange intervention and emergency loans. At the end of FY1998, cash assets amounted to \$24.7 billion.

**Table 3 Balance sheet for the ESF for FY1997 and FY1998**

Years ended 30 September (in thousands)	1997	1998
<b>Assets</b>		
Cash and cash equivalents		
US government securities	15,459,803	15,980,577
Foreign currency-denominated assets	<u>8,786,401</u>	<u>8,710,718</u>
Total cash and cash equivalents	24,246,204	24,691,295
Other foreign currency-denominated assets	2,099,038	2,094,253
Special Drawing Right holdings	9,997,262	10,105,705
Investment securities, held to maturity	3,655,189	3,724,029
Accrued interest receivable	108,005	122,469
Total assets	<u>40,105,698</u>	<u>40,737,751</u>
<b>Liabilities and equity</b>		
Certificates issued to Federal Reserve banks	9,200,000	9,200,000
Special Drawing Right allocations	6,688,897	6,718,836
Due to Treasury	-	1,196
Accrued expenses	<u>46,522</u>	<u>47,292</u>
Total liabilities	15,935,419	15,967,324
<b>Equity</b>		
Appropriated capital	200,000	200,000
Retained earnings	<u>23,970,279</u>	<u>24,570,427</u>
Total equity	24,170,279	24,770,427
Total liabilities and equity	<u>40,105,698</u>	<u>40,737,751</u>

Source: US Treasury Department, *Audited Fiscal Years 1997 and 1998 Financial Statements of the Exchange Stabilization Fund*.

The category of noncash assets covers four subentries: other foreign currency-denominated assets, SDRs, investment securities, and accrued interest receivable.

The first category, "other" foreign currency-denominated assets, includes investments of German marks and Japanese yen, for example, in instruments with maturities of greater than three months, which the Treasury Department purchases to obtain a higher interest rate on reserves judged unlikely to be used in the near term. The category also includes foreign currency acquired through swap agreements with other countries, such as holdings of Mexican pesos when the medium-term swaps with Mexico were in effect in 1995 and 1996.

Special Drawing Rights at the disposal of the US government are held in the ESF.<sup>3</sup> As of the end of FY1998, those holdings amounted to \$10.1

3. Special Drawing Rights are an international reserve asset created and backed by the International Monetary Fund to supplement international reserves. In the 1970s and early 1980s the IMF issued a total of SDR21.4 billion (roughly \$30 billion at the present exchange

**Table 4 Statement of income and retained earnings of the ESF for FY1997 and FY1998**

Years ended 30 September (in thousands)	1997	1998
<b>Interest revenue</b>		
Interest on US government securities	770,823	864,169
Interest on foreign currency-denominated assets	257,535	186,053
Interest on Special Drawing Right holdings	397,768	428,313
Interest on investment securities	<u>40,749</u>	<u>44,737</u>
Total interest revenue	1,466,875	1,523,272
<b>Interest expense</b>		
Interest on Special Drawing Right allocations	271,434	280,188
Interest on Special Drawing Rights received as remuneration by the US Treasury	2,322	4,142
Total interest expense	<u>273,756</u>	<u>284,330</u>
Net interest revenue	1,193,119	1,238,942
<b>Net gains and losses</b>		
Gain (loss) on valuation of Special Drawing Rights	(163,044)	8,519
Unrealized loss on valuation of foreign currency-denominated assets	<u>(1,612,722)</u>	<u>(645,924)</u>
Total net losses	(1,775,766)	(637,405)
<b>Other expenses</b>		
International Monetary Fund annual assessment	<u>1,308</u>	<u>1,389</u>
Total other expenses	1,308	1,389
<b>Net income (loss)</b>	(583,955)	600,148
Retained earnings, beginning of year	<u>24,554,234</u>	<u>23,970,279</u>
Retained earnings, end of year	<u>23,970,279</u>	<u>24,570,427</u>

*Source: US Treasury Department, Audited Fiscal Years 1997 and 1998 Financial Statements of the Exchange Stabilization Fund.*

billion. The large majority of these SDRs, \$9.2 billion, backed SDR certificates issued to the Federal Reserve and were thus not immediately available for SDR transactions. They are nonetheless permanent resources, barring cancellation of SDRs by the IMF, US withdrawal from the Special Drawing Rights Department of the IMF, or abolition of the IMF itself.

rate) to most of its members. SDRs can be exchanged for foreign currencies with the IMF and national authorities, and net SDR holdings earn interest. With roughly \$10 billion equivalent in SDRs on the balance sheet, the ESF thus holds about one-third of all SDRs issued. Although new allocations have been proposed, none have been made since the early 1980s (IMF 1995a).

SDR holdings are revalued monthly at the SDR exchange rate calculated by IMF staff.

Each year, the general fund of the Treasury receives interest payments on the US reserve position (the creditor position in the IMF reflecting other countries' drawings), which the Treasury has opted to receive in the form of SDRs, which in turn the ESF purchases with US dollars. The liquid portion of SDR holdings are available to exchange for national currency, in order, for example, to conduct foreign exchange operations, or to lend to foreign governments. During FY1996, for example, the ESF engaged in one-day swaps with Zambia and Haiti to facilitate their meeting their quota obligations (US Treasury Department, *ESF Annual Report 1996*, 17).

The category "investment securities" includes foreign-currency instruments, such as deutsche mark bonds and Japanese Treasury bills, with maturities typically of less than one year. The category "accrued interest receivable" describes interest owed to but not yet received by the ESF.

At the end of September 1998 these noncash assets amounted to \$16.0 billion, bringing total assets to \$40.1 billion.

## Liabilities and Equity

The ESF annual report lists liabilities in four categories: SDR certificates issued to Federal Reserve Banks, SDR allocations "due to Treasury," and accrued expenses.

First, at the discretion of the Secretary, the Treasury can issue SDR certificates to the Federal Reserve in exchange for dollars. The certificates are backed by the SDRs held in the ESF and pay no interest. By issuing such certificates, Treasury obtains dollars with which it can buy SDRs from foreign monetary authorities, buy foreign currency on the open market (depressing the value of the dollar), or undertake credit operations. The SDR certificates outstanding are a liability of the ESF and amounted to \$9.2 billion at the end of FY1998. The Secretary can decide when and in what amounts to redeem the certificates. This exchange, called "monetization" of SDRs, was authorized by the Special Drawing Rights Act of 1968.

Second, because SDRs are backed by the membership of the SDR Department of the IMF, a certain portion of all SDRs outstanding in the international monetary system is a liability of the United States. That liability is registered on the ESF balance sheet, amounting to \$6.7 billion at the end of FY1998. Just as SDR assets can be considered permanent resources, the balancing liability is largely theoretical: it would be activated only by cancellation of SDRs, US withdrawal from the SDR Department of the IMF, or the closure of the IMF, none of which is likely. Thus, as the Treasury often points out, the SDR allocations have characteristics of equity.

The four categories of liabilities amounted to \$16.0 billion in FY1998, leaving \$24.7 billion in equity in the ESF. Equity in turn is divided into appropriated capital of \$200 million, plus retained earnings—the accumulated net interest and foreign exchange gains over the life of the account.

In addition to the balance sheet, the Treasury Department also publishes an income statement and a cash flow statement for the ESF (see table 4 and appendix A). The income statement reveals that the ESF had substantial interest income, amounting to \$1.2 billion on a net basis in 1998. However, appreciation of the dollar against the deutsche mark and the yen reduced the dollar value of foreign exchange holdings. The value of these holdings are “marked to market,” generating an unrealized loss of \$0.6 billion, and a net loss for the year of about \$0.6 billion. As these foreign exchange holdings will be held for a substantial period, however, the eventual realized return could well be positive, as has been the norm historically.

Exactly how much of the assets of the ESF is available for foreign exchange intervention and financial rescues at any one point in time is a critical question. That amount is calculated simply: total assets minus SDR certificates outstanding, which equaled \$31.5 billion at the end of FY1998. During that year the Treasury said that it would be prepared to provide up to \$3 billion to Indonesia and up to \$5 billion to South Korea in contingent financial support as part of a second line of defense to supplement other resources available to these countries. In November 1998 the Treasury also agreed to provide up to \$5 billion in guarantees of BIS lending to Brazil. The available resources of the ESF decline to the extent that such financial support is drawn upon, as was done by Brazil in the amount of \$1.6 billion in December 1998.

Two further aspects of the account’s structure are noteworthy. First, the composition of the portfolio matters. When holdings of foreign currency rise as a result of transactions involving dollars, the ESF’s capacity for further dollar sales or dollar loans is reduced. However, under such circumstances, the ESF can “warehouse” foreign currency with the Federal Reserve (warehousing is defined and discussed in chapter 5). Second, the \$31.5 billion figure substantially understates the total resources available to US monetary authorities. The Federal Reserve has substantial foreign exchange holdings of its own, amounting to \$18.4 billion at the end of FY1998. If funds were needed to defend the dollar, the United States could borrow its reserve, first credit, and upper credit tranches from the IMF, up to its full quota of roughly \$52 billion in any one year. IMF lending guidelines permit countries to borrow cumulatively up to three times quota, and more by special decision of the Executive Board. The US borrowing capacity in an emergency would depend on the IMF’s liquidity position. The United States could also borrow large amounts from foreign monetary authorities under standing and special swap facilities.