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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

January–March 2005

During the first quarter of 2005, the dollar's trade-weighted exchange value rose 2.9 percent as measured by the Federal Reserve Board's major currencies index. The dollar appreciated roughly 4.5 percent against both the euro and the yen. Throughout the quarter, both historical and option-implied volatility in the currency markets were low. The dollar's exchange value moved within a relatively narrow range as market focus shifted among various factors over the period. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

THE DOLLAR APPRECIATES, TRADES WITHIN A NARROW RANGE

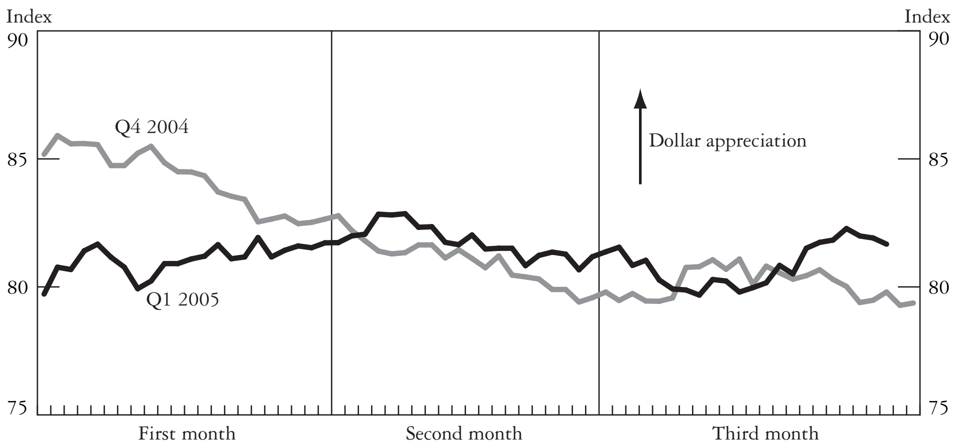
On a trade-weighted basis, the dollar's exchange value rose during the period, although different factors drove the dollar's value in opposing directions and contributed to the limited magnitude of the dollar's gains. The range of trading values, as measured by the percentage difference between the highest and lowest value set in the period, was only about half that in the prior quarter. Still, the standard deviation of the daily percentage changes was similar to that in the prior quarter.

In contrast to the dollar's broad declines in late 2004, the dollar appreciated against other major currencies in the first quarter of 2005. However, the dollar's gains only partially offset the declines incurred during the prior quarter. Consistent with the relatively narrow trading range in the currency market, one-month option-implied volatility in both the euro-dollar and dollar-yen currency pairs remained low.

This report, presented by Dino Kos, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from January through March, 2005. Jamie Pfeifer was primarily responsible for preparation of the report.

Chart 1

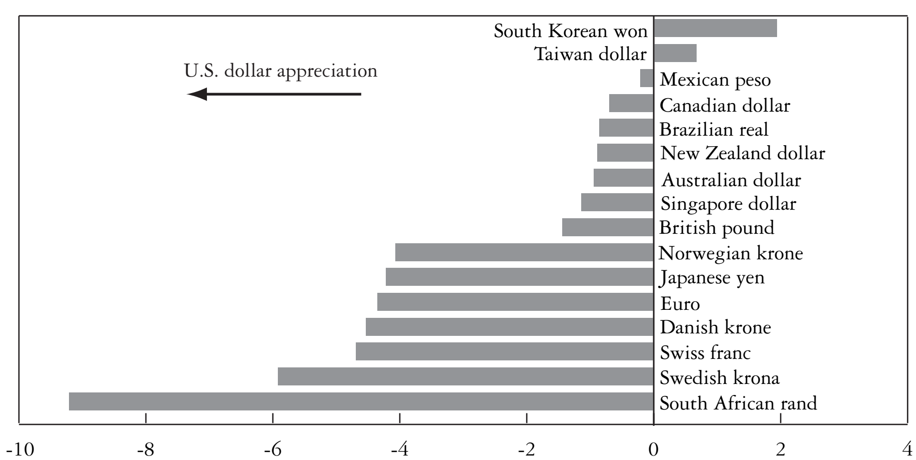
TRADE-WEIGHTED U.S. DOLLAR



Source: Board of Governors of the Federal Reserve System.

Chart 2

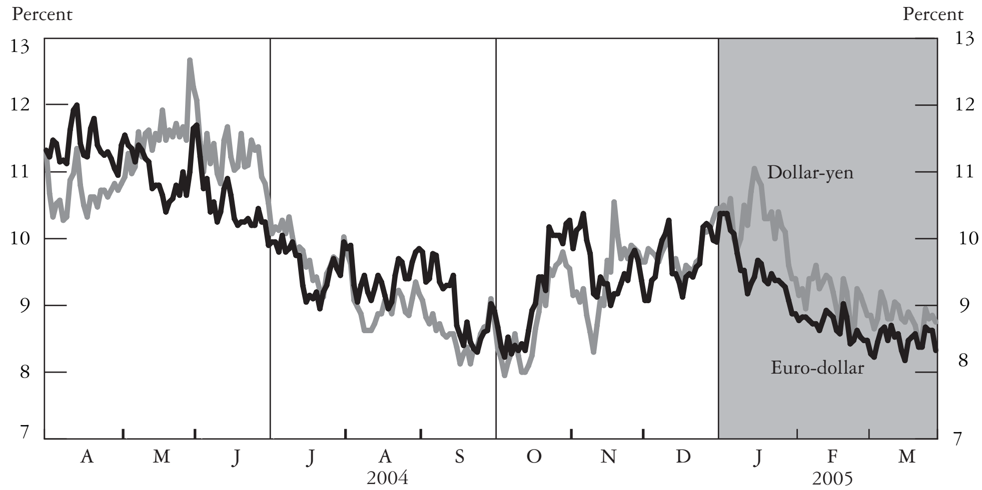
PERCENTAGE CHANGE IN WORLD CURRENCIES
FIRST QUARTER, 2005



Source: Bloomberg L.P.

Chart 3

ONE-MONTH OPTION-IMPLIED VOLATILITY



Source: Bloomberg L.P.

FOCUS IN CURRENCY MARKET SHIFTS THROUGHOUT THE PERIOD

For much of January, the U.S. currency found support as investors reportedly pared back short dollar positions that had been established during the dollar's depreciation at the end of 2004 and ahead of a variety of events set to take place in the first week of February. These events included a Federal Open Market Committee (FOMC) meeting, President Bush's State of the Union Address, the release of the January U.S. employment report, and the Group of Seven (G-7) meeting of finance ministers and central bankers in London. Even though these events were not widely expected to lead to any significant change in the outlook for the dollar, the presence of all these events on the near-term horizon prompted some investors to reduce currency exposure and thus reduce short dollar positions.

The dollar reached its strongest level of the quarter, on a trade-weighted basis, on February 9, the day before the release of the December U.S. trade balance. Although there was a decrease in the trade deficit from November, the dollar's exchange value began to decline as the release of the data redirected market attention to concerns regarding the outlook for the U.S. current account and budget deficits. In addition, market participants were sensitive to any news regarding the potential for official foreign reserve diversification. On February 22, the dollar posted its largest daily percentage decline within the period against both the yen and euro following news reports indicating that the Bank of Korea planned to diversify its foreign currency reserves. That report was later clarified, however, with officials noting that the proportion of the bank's foreign reserves held in dollars would not change.

These dollar declines were reversed late in the period as the market focus shifted to widening growth and interest rate differentials between the United States and both Europe and Japan. The yield on the ten-year Treasury note rose roughly 23 basis points in the week ended March 11, and the spread between U.S. and German two-year yields, which had just turned positive late in the preceding year, widened further over the quarter to roughly 130 basis points. Over the period, market participants focused on generally positive U.S. economic growth data and on the potential for rising inflationary pressures, particularly in light of the rise of nearly $12 per barrel in the price of the front-month West Texas Intermediate (WTI) crude oil futures contract. The FOMC raised the target federal funds rate by 25 basis points at each of its two policy meetings during the quarter to 2.75 percent, and expectations for further interest rate increases solidified. The FOMC's action contrasted with the unchanged policy stance of both the European Central Bank and the Bank of Japan. In addition, interest rate expectations, as measured by the implied rate on December 2005 interest rate futures contracts, declined in both Japan and the euro area. In Japan, preliminary fourth-quarter GDP data reported a 0.1 percent quarter-over-quarter decline, compared with the 0.1 percent increase that had been forecast, and downward revisions to both second- and third-quarter GDP data were also announced. The yen depreciated roughly 1 percent against the dollar in the trading session following this data release. Subsequent Japanese economic data for February, including data on employment, household spending, and industrial production, were also weaker than the survey-based forecast reported on Bloomberg. In Europe, economic data releases were perceived by market participants to reflect continued but subdued economic growth. Both the February and March German IFO Institute surveys registered declines from the prior month and were below the Bloomberg survey forecast. Following the release of the March survey, the euro depreciated roughly 0.8 percent against the dollar.

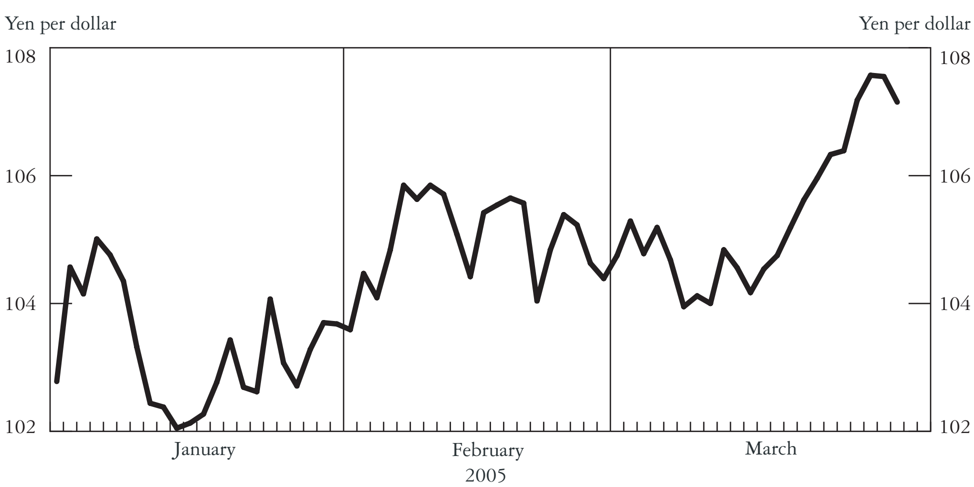
Chart 4

EURO AGAINST U.S. DOLLAR

Source: Bloomberg L.P.

Chart 5

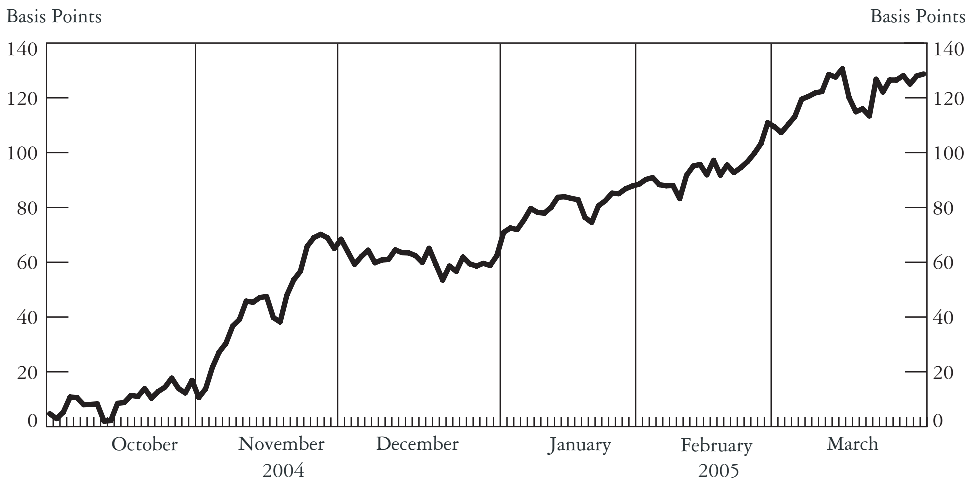
YEN AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

Chart 6

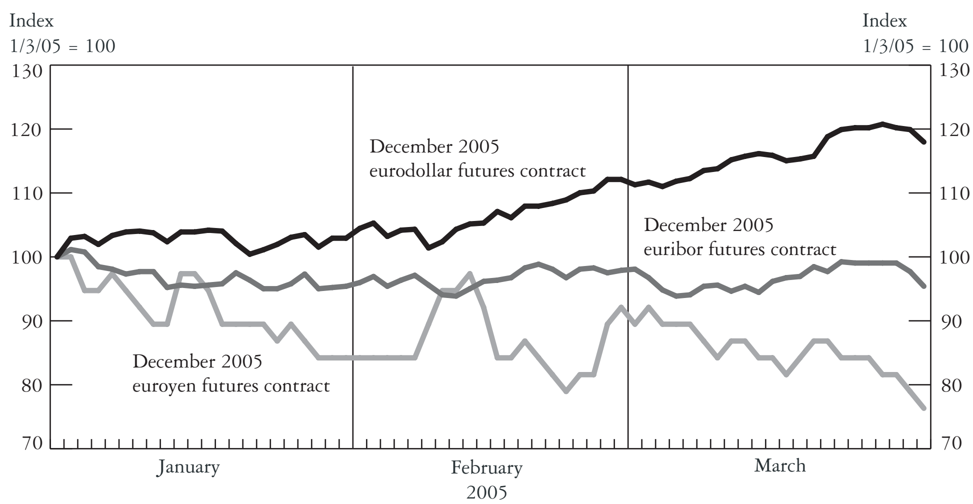
SPREAD OF U.S. TWO-YEAR TREASURY NOTE YIELD OVER GERMAN TWO-YEAR SOVEREIGN NOTE YIELD



Source: Bloomberg L.P.

Chart 7

CHANGE IN IMPLIED RATES ON G-3 INTEREST RATE FUTURES CONTRACTS



Source: Bloomberg L.P.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities did not undertake any intervention operations during the quarter. At the end of the quarter, the current values of euro and yen reserve holdings totaled $20.5 billion for the Federal Reserve System Open Market Account and $20.5 billion for the Treasury's Exchange Stabilization Fund. The U.S. monetary authorities 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. To the greatest extent practicable, the investments are split evenly between the System Open Market Account and the Exchange Stabilization Fund.

A significant portion of the U.S. monetary authorities' foreign exchange reserves is invested in European and Japanese government securities. On an outright basis, the U.S. monetary authorities hold German, French, and Japanese government securities. Under euro-denominated repurchase agreements, the U.S. monetary authorities accept sovereign debt backed by the full faith and credit of the following governments: Belgium, France, Germany, Italy, the Netherlands, and Spain. Foreign currency reserves are also invested at the Bank for International Settlements and in facilities at other official institutions. As of March 31, direct holdings of foreign government securities totaled $22.3 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4.1 billion at the end of the quarter and were also split evenly between the two authorities.

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of Dollars

		Change in Balance by Source				
	Carrying Value December 31, 2004[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Profit/Loss on Sale[d]	Unrealized Profit/ Loss on Foreign Currency Revaluation[e]	Carrying Value March 31, 2005[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	12,168.8	0	72.6	0	-512.1	11,729.3
Yen	9,199.0	0	0.1	0	-389.5	8,809.6
Total	21,367.8	0	72.7	0	-901.6	20,538.9
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	12,151.4	0	72.1	0	-511.4	11,712.1
Yen	9,199.1	0	0.1	0	-389.5	8,809.7
Total	21,350.5	0	72.2	0	-900.9	20,521.8

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

[a] Carrying value of the reserve asset position includes interest accrued on foreign currency, which is based on "day of" accrual method.

[b] Net purchases and sales include daily foreign currency purchases from cash collected on maturities and coupons. In case of intervention or other official activity, amounts would be reflected and details footnoted.

[c] Investment earnings include accrued interest and amortization.

[d] Gains and losses on sales are calculated using average cost.

[e] Reserve asset balances are revalued daily at the noon buying rates.

Table 2

BREAKDOWN OF FOREIGN RESERVE ASSETS HELD

Carrying Value in Millions of Dollars, as of March 31, 2005

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:	**11,712.1**	**11,729.3**
Cash held on deposit at official institutions	5,832.3	5,852.0
Marketable securities held under repurchase agreements[a]	2,074.2	2,074.2
Marketable securities held outright[b]	3,805.6	3,803.1
German government securities	1,781.9	1,779.4
French government securities	2,023.7	2,023.7
Yen-denominated assets:	**8,809.7**	**8,809.6**
Cash held on deposit at official institutions	1,474.4	1,474.4
Marketable securities held outright[b]	7,335.2	7,335.2

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

[a] Sovereign debt obligations of Belgium, France, Germany, Italy, the Netherlands, and Spain are presently eligible collateral for reverse repo transactions.

[b] As of March 31, euro and yen securities holdings had Macaulay durations of 28.9 months and 3.3 months, respectively.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 2005
	Federal Reserve System Open Market Account (SOMA)	
Bank of Canada	2,000	0
Bank of Mexico	3,000	0
Total	5,000	0
	U.S. Treasury Exchange Stabilization Fund (ESF)	
Bank of Mexico	3,000	0
Total	3,000	0

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