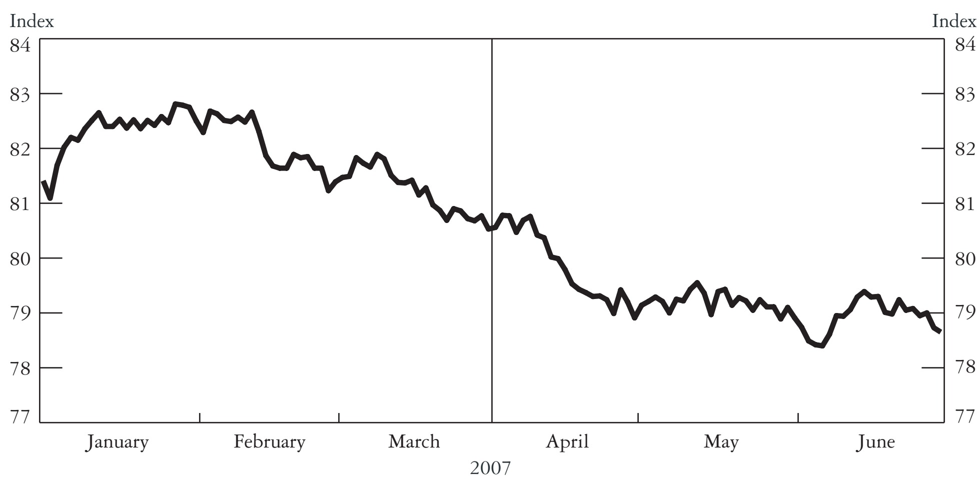
TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 2007

During the second quarter of 2007, the dollar's trade-weighted exchange value decreased 2.3 percent as measured by the Federal Reserve Board's major currencies index. The exchange rate movements of most currency pairs closely tracked the changing perceptions of economic fundamentals and relative interest rate differentials. The dollar depreciated 1.4 percent against the euro and appreciated 4.5 percent against the yen. Actual and option-implied volatilities in the currency markets remained near historically low levels, although volatility in other asset classes increased notably toward the end of the period. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

Chart 1
TRADE-WEIGHTED U.S. DOLLAR



Source: Board of Governors of the Federal Reserve System.

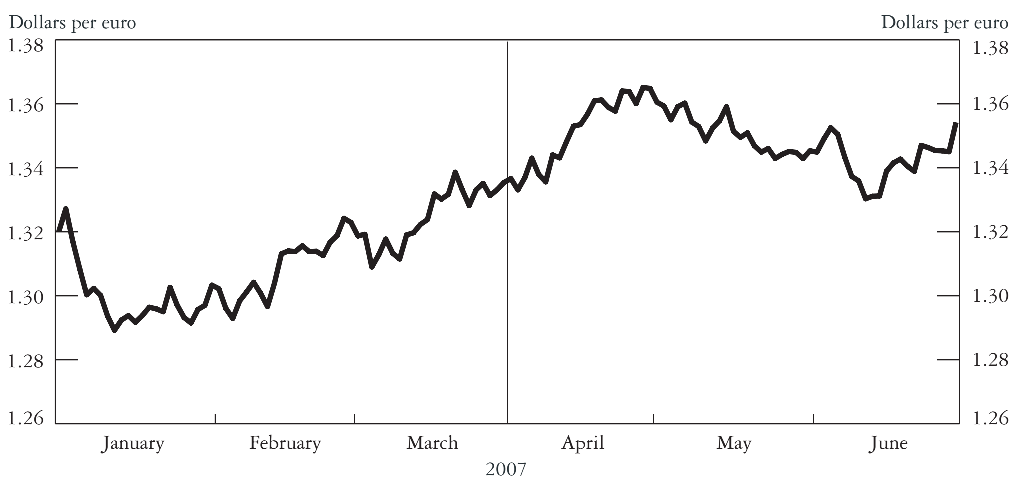
This report, presented by William Dudley, Executive Vice President, Federal Reserve Bank of New York, and Manager of the System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from April through June 2007. Matthew Lieber was primarily responsible for preparation of the report.

RELATIVE GROWTH PROSPECTS AND INTEREST RATE DIFFERENTIALS DRIVE EURO-DOLLAR CURRENCY PAIR

During April, the dollar depreciated 2.2 percent against the euro, as expectations for economic growth in the United States and the euro area continued to diverge. In the United States, the ongoing adjustment in the housing sector and sluggish business-fixed investment led investors to reduce their near-term growth forecasts and increase their expectations for policy rate easings by the Federal Open Market Committee (FOMC). During this period, the calendar spread between implied rates on the December 2008 and December 2007 eurodollar futures contracts widened 17 basis points, to -39 basis points. In the euro area, strong manufacturing, employment, and business confidence data contributed to an improved outlook for growth. Accordingly, investors continued to anticipate further policy rate tightening by the European Central Bank. The interest rate differential between two-year yields on U.S. and German sovereign debt narrowed 9 basis points in the euro's favor in April, and the dollar established its lowest level on record against the euro, above 1.36 dollars per euro.

Chart 2

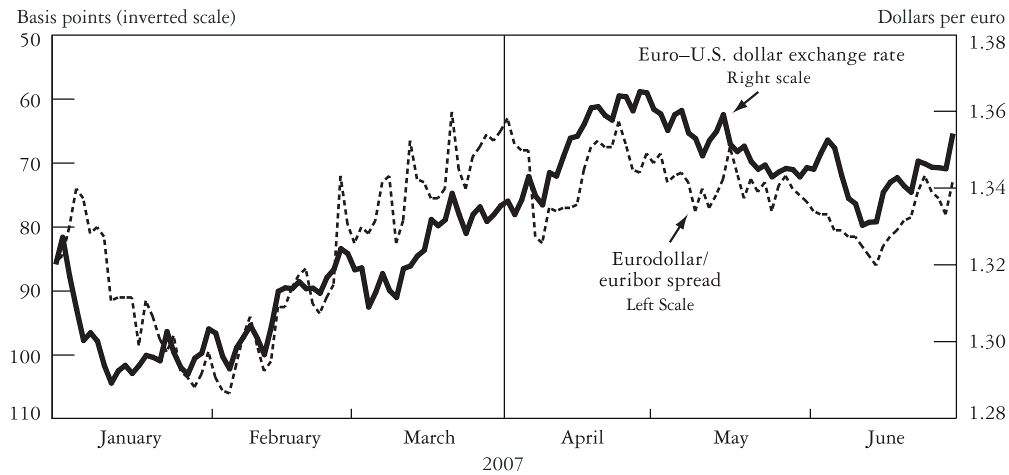
EURO–U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 3

YIELD SPREAD BETWEEN DECEMBER 2007 EURODOLLAR AND EURIBOR FUTURES CONTRACTS, AND EURO–U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

During May, the dollar appreciated 1.4 percent against the euro, as worries about the downside risks to U.S. growth receded. Factors that led to a reassessment of the risks to growth included upward revisions to real GDP growth estimates for the second quarter as well as sustained gains in employment and a pickup in manufacturing activity. Expectations for FOMC policy rate easings gradually diminished, as evidenced by the 23 basis point narrowing in the calendar spread between implied rates on the December 2008 and December 2007 eurodollar futures contracts. In addition, longer-dated Treasury yields increased sharply from mid-May to mid-June, further supporting the dollar. During this period, the yield on the ten-year Treasury note increased more than 60 basis points, and the interest rate differential between ten-year yields on U.S. and German sovereign debt widened more than 20 basis points in the dollar's favor.

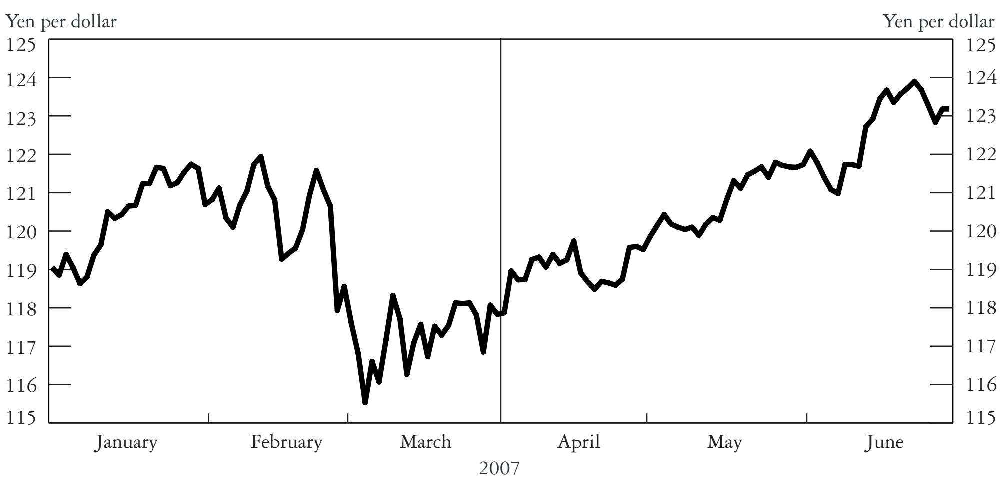
In mid-June, the dollar's depreciation against the euro resumed, as relative interest rate differentials shifted in the euro's favor. In the United States, the continued increase in subprime adjustable-rate mortgage loan delinquencies and uncertainty about investor losses associated with subprime mortgage-backed securities prompted Treasury yields to decline. The interest rate differential between two-year yields on U.S. and German sovereign debt narrowed 12 basis points in the euro's favor during the second half of the month.

RELATIVE INTEREST RATE DIFFERENTIALS AND JAPANESE INVESTOR DEMAND FOR FOREIGN ASSETS SUPPORT THE DOLLAR AGAINST THE YEN

During the second quarter, the dollar appreciated against the yen, continuing its trend from the latter part of the first quarter. The yen's depreciation was driven by a combination of shifting interest rate differentials, continued strong Japanese investor demand for foreign assets, and further increases in speculative short positioning in the yen. Although investors moved forward their expectation about the timing of the next Bank of Japan policy rate hike, the cumulative magnitude of expected interest rate increases over the next year remained the same. With expectations for FOMC policy rate easings reduced, the spread between rates implied by the December 2007 eurodollar and euroyen futures contracts widened 27 basis points in the dollar's favor. The dollar appreciated steadily against the yen, and in June the dollar-yen currency pair moved above the trading range of 110 to 122 yen per dollar that had prevailed for nearly two years.

Chart 4

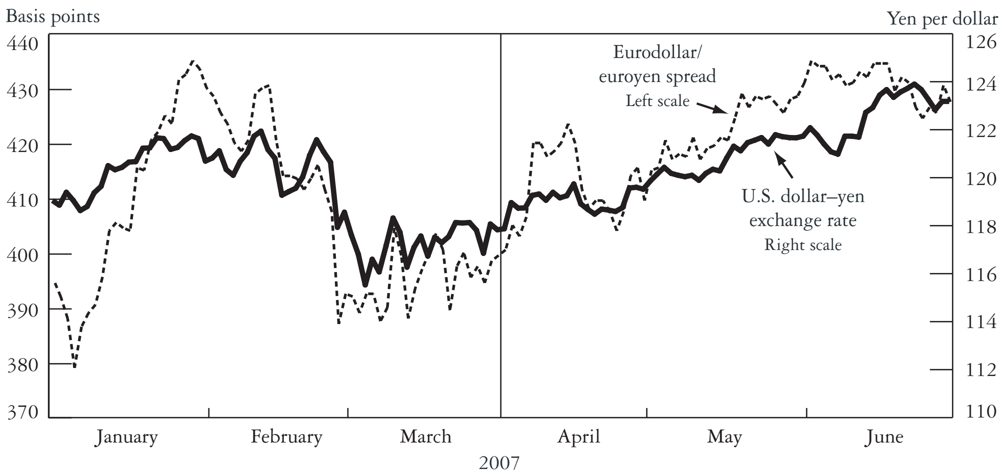
U.S. DOLLAR–YEN EXCHANGE RATE



Source: Bloomberg L.P.

Chart 5

YIELD SPREAD BETWEEN DECEMBER 2007 EURODOLLAR AND EUROYEN FUTURES CONTRACTS, AND U.S. DOLLAR–YEN EXCHANGE RATE

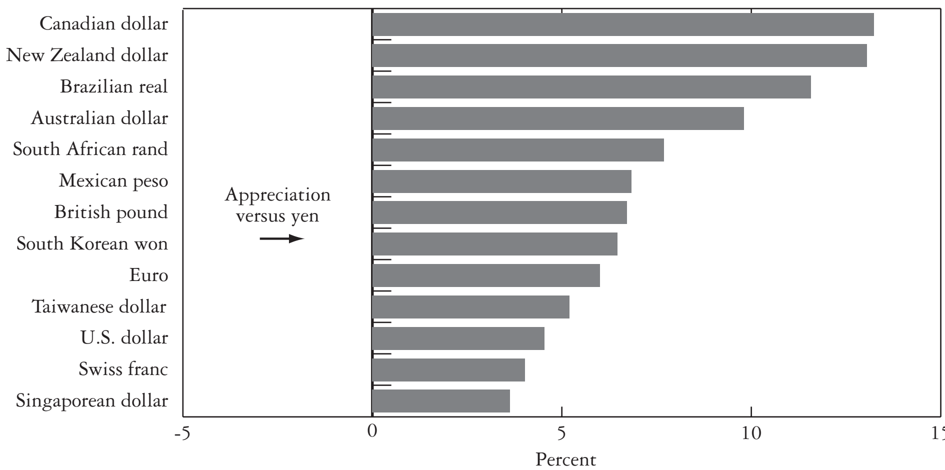


Source: Bloomberg L.P.

As shown below, the yen depreciated noticeably against most currencies. Japanese capital outflows likely contributed to the yen's depreciation, as Japanese residents were net purchasers of foreign securities in April and May. Many corporations reportedly initiated outward investments at the start of the fiscal year in April. Additionally, retail demand for investment trusts that invest in foreign-currency-denominated assets reportedly remained robust, and issuance of such trusts during the second quarter was historically strong. Also, many Japanese retail margin trading accounts reportedly maintained short yen exposure against a variety of currencies.

Chart 6

JAPANESE YEN AGAINST SELECTED CURRENCIES IN SECOND QUARTER 2007

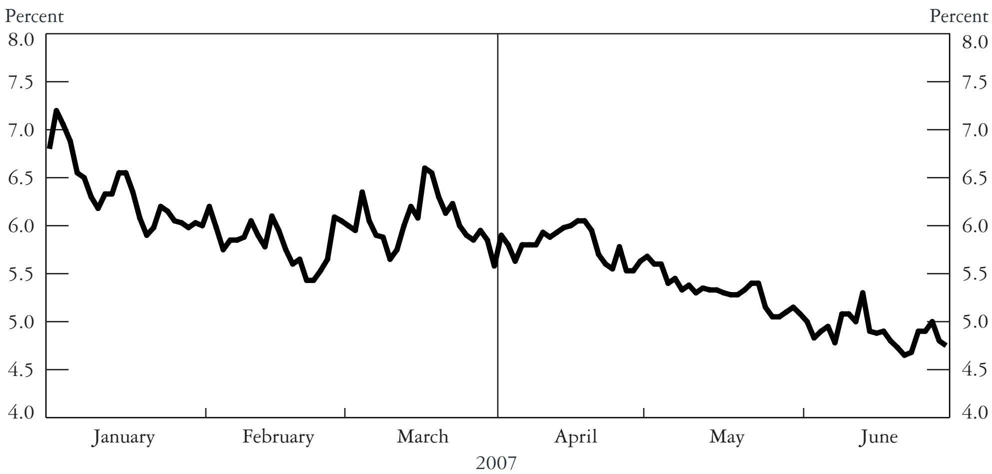


Source: Bloomberg L.P.

ACTUAL AND OPTION-IMPLIED VOLATILITY IN CURRENCY MARKETS REMAIN NEAR HISTORICALLY LOW LEVELS

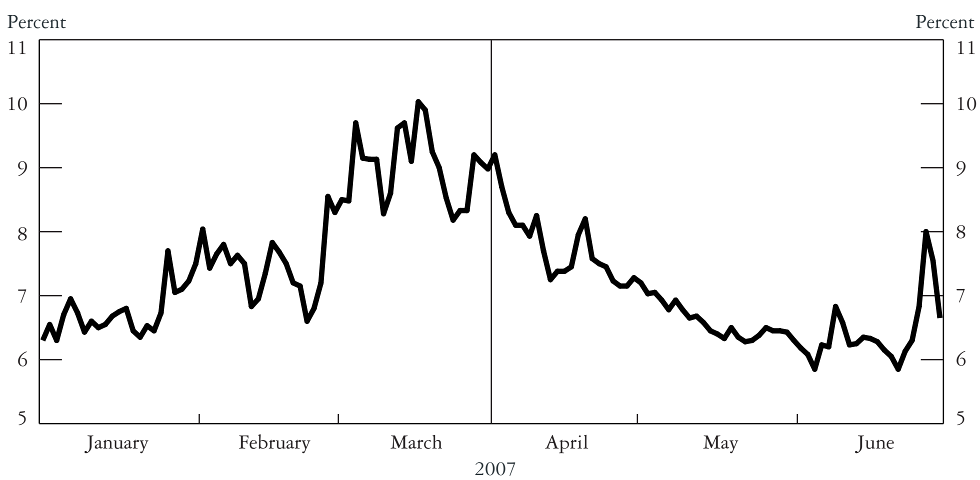
Levels of actual and option-implied volatility for major currency pairs declined for most of the second quarter and remained at or near historically low levels. The absence of major economic or policy surprises, as well as expectations that the global economic expansion would remain on solid footing, contributed to the low-volatility environment.

Chart 7
ONE-MONTH EURO–U.S. DOLLAR IMPLIED VOLATILITY



Source: Bloomberg L.P.

Chart 8
ONE-MONTH U.S. DOLLAR–YEN IMPLIED VOLATILITY

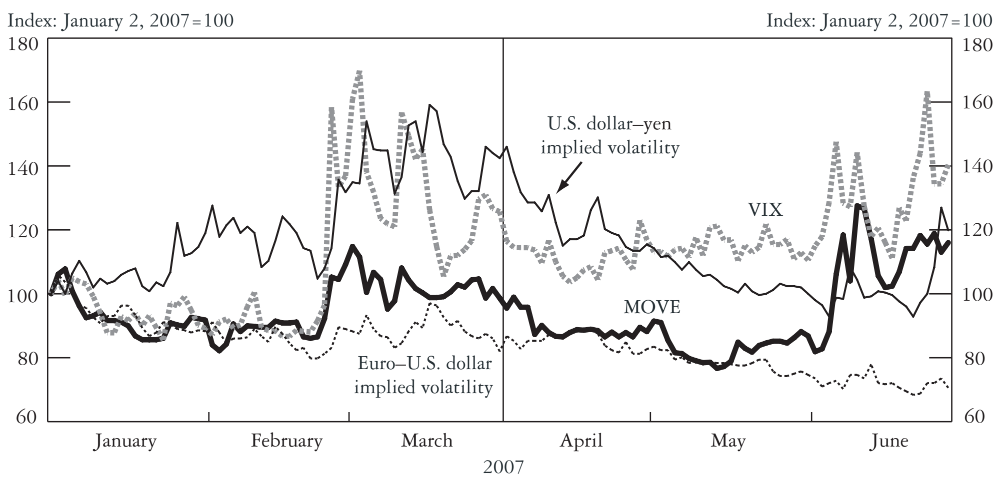


Source: Bloomberg L.P.

Currency market volatility was largely unaffected by the sharp rise in long-term interest rates that occurred from mid-May through mid-June, in part because the rise in long-term rates occurred broadly around the world. Even as measures of interest rate and equity market volatility increased significantly, measures of implied volatility for major currency pairs remained steady or declined during this time. This period of relatively stable currency market volatility contrasts with the period of sharp asset market repricing in February/March, when actual and option-implied volatility for the dollar-yen currency pair increased notably.

Chart 9

COMPARISON OF IMPLIED VOLATILITY ACROSS ASSET CLASSES



Sources: Bloomberg L.P., Chicago Board Options Exchange, Merrill Lynch.

Note: VIX is the Chicago Board Options Exchange Volatility Index; MOVE is the Merrill Lynch Option Volatility Estimate Index.

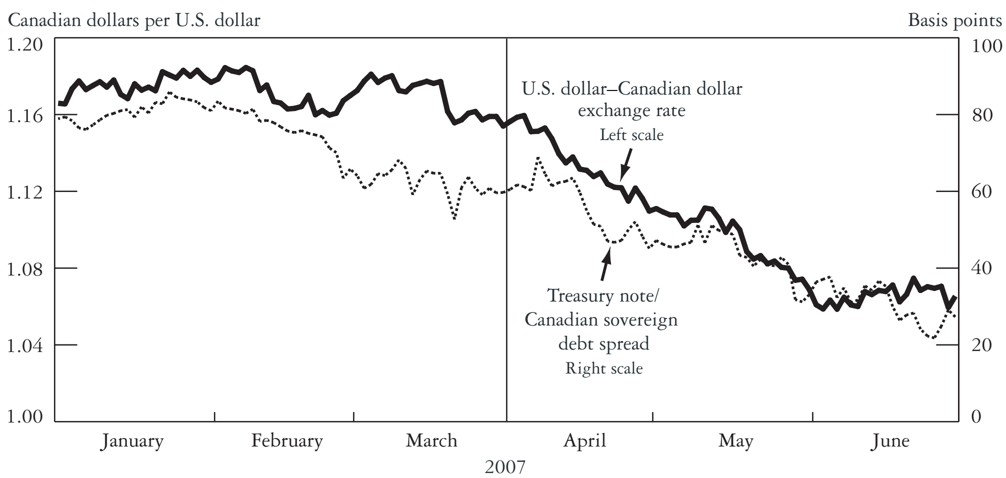
RISK APPETITE IN CURRENCY MARKETS REMAINS STRONG

The low-volatility environment helped to stimulate risk taking in currency markets. As a result, some of the higher yielding currencies showed the greatest strength during the second quarter. The currencies of commodity-exporting countries also benefited from continued terms-of-trade improvements resulting from higher commodity prices. For example, the Canadian dollar and the New Zealand dollar each appreciated approximately 8 percent against the U.S. dollar.

The Canadian dollar's appreciation also reflected continued strong foreign direct investment flows to Canada and expectations for additional policy rate tightening by the Bank of Canada. The interest rate differential between two-year yields on U.S. and Canadian sovereign debt narrowed 33 basis points in the Canadian dollar's favor, and the U.S. dollar fell to its lowest level against the Canadian dollar in thirty years.

Chart 10

YIELD SPREAD BETWEEN TWO-YEAR TREASURY NOTE AND TWO-YEAR CANADIAN SOVEREIGN DEBT, AND U.S. DOLLAR–CANADIAN DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

On June 11, the Reserve Bank of New Zealand (RBNZ) confirmed that it had intervened in the foreign exchange market, selling the New Zealand dollar against the U.S. dollar. The RBNZ viewed the New Zealand dollar's strength as exceptional and unjustified, according to its assessment of economic fundamentals. During the year preceding the intervention, the trade-weighted New Zealand dollar, as measured by the RBNZ, had appreciated more than 20 percent. Following the intervention, the New Zealand dollar continued to appreciate, rising about 3 percent further during the remainder of the quarter. At quarter-end, the New Zealand dollar was trading against many currencies at its highest level in twenty-five years, despite the country's current account deficit being close to 9 percent of GDP. The appreciation of the New Zealand dollar suggests that investors may have become more sanguine about the sustainability of large current account imbalances.

Chart 11

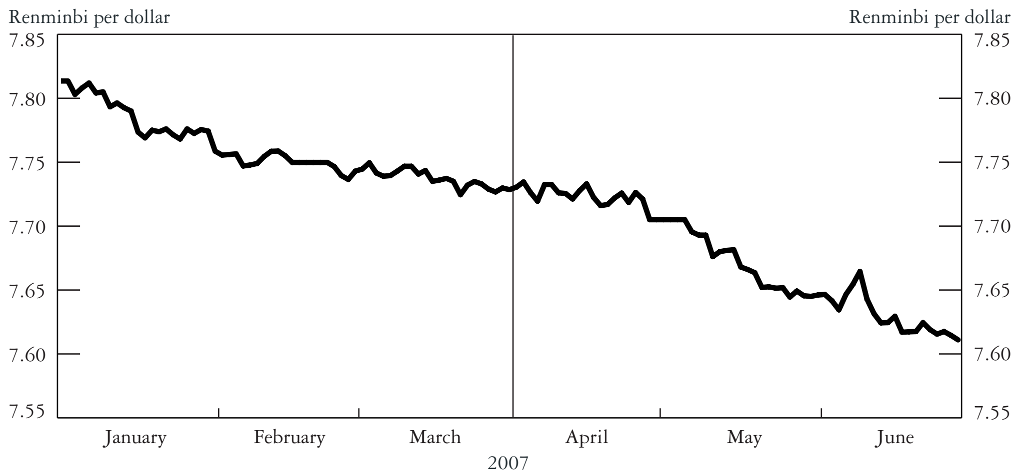
TRADE-WEIGHTED NEW ZEALAND DOLLAR

Source: Reserve Bank of New Zealand.

THE CHINESE RENMINBI CONTINUES TO APPRECIATE MODESTLY AGAINST THE DOLLAR

During the second quarter, the Chinese renminbi appreciated 1.5 percent against the dollar, after appreciating 1.1 percent against the dollar during the first quarter. In mid-May, the People's Bank of China widened, from 0.3 percent to 0.5 percent, the intraday trading band of the currency against the dollar in the interbank spot foreign exchange market. The pace of renminbi appreciation fluctuated intermittently during the quarter, and non-deliverable forward contracts continue to suggest that the Chinese currency will appreciate approximately 5 percent against the U.S. dollar over the next twelve months.

Chart 12
U.S. DOLLAR–CHINESE RENMINBI EXCHANGE RATE



Source: Reuters.

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 $20.8 billion for the Federal Reserve System Open Market Account and $20.7 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 June 30, direct holdings of foreign government securities totaled $18.8 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4.6 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 March 31, 2007[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sale[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value June 30, 2007[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	12,809.4	0	120.4	0	139.6	13,069.4
Yen	8,059.0	0	10.6	0	-380.9	7,688.7
Total	20,868.4	0	131.0	0	-241.3	20,758.1
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	12,788.3	0	120.1	0	139.3	13,047.7
Yen	8,059.1	0	10.6	0	-380.9	7,688.8
Total	20,847.4	0	130.7	0	-241.6	20,736.5

[a] Carrying value of the reserve asset position includes interest accrued on foreign currency, which is based on the "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 June 30, 2007

	U.S. Treasury Exchange Stabilization Fund (ESF)[b]	Federal Reserve System Open Market Account (SOMA)[b]
Euro-denominated assets:	**13,047.7**	**13,069.4**
Cash held on deposit at official institutions	6,493.1	6,514.8
Marketable securities held under repurchase agreements[a]	2,314.0	2,314.0
Marketable securities held outright	4,240.6	4,240.6
German government securities	2,119.1	2,119.1
French government securities	2,121.5	2,121.5
Yen-denominated assets:	**7,688.8**	**7,688.7**
Cash held on deposit at official institutions	2,537.5	2,537.4
Marketable securities held outright	5,151.3	5,151.3

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

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

[b] As of June 30, euro and yen portfolios had Macaulay durations of 9.2 months and 11.7 months, respectively, for both the ESF and SOMA portfolios.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2007
	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