TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

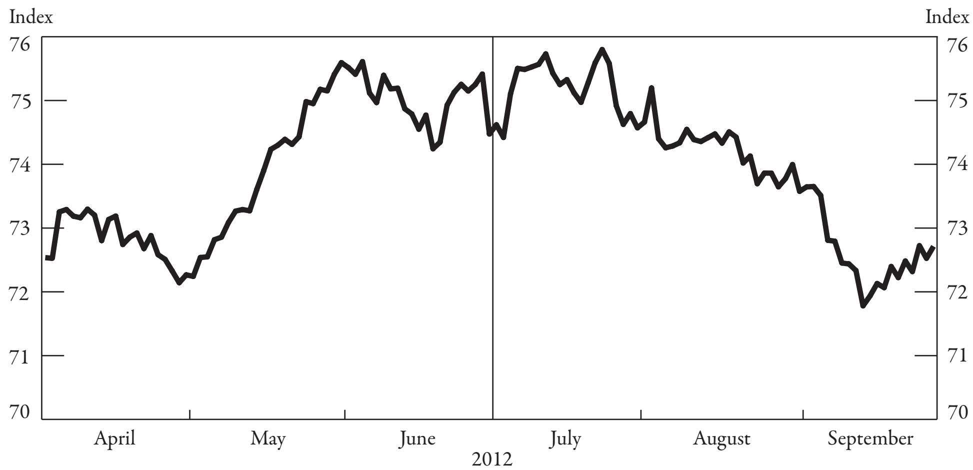
July–September 2012

During the third quarter, the U.S. dollar's nominal trade-weighted exchange value declined 2.6 percent as measured by the Federal Reserve Board's major currencies index. The dollar depreciated broadly, with depreciations of 1.5 percent against the euro and 2.4 percent against the Japanese yen. The dollar's depreciation occurred against a backdrop of weaker-than-expected U.S. economic data and expectations for additional U.S. monetary accommodation as well as improved sentiment toward the euro area's sovereign debt and banking crisis. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

This report, presented by Simon Potter, 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 July through September 2012. Jeffrey Kong was primarily responsible for preparation of the report.

Chart 1

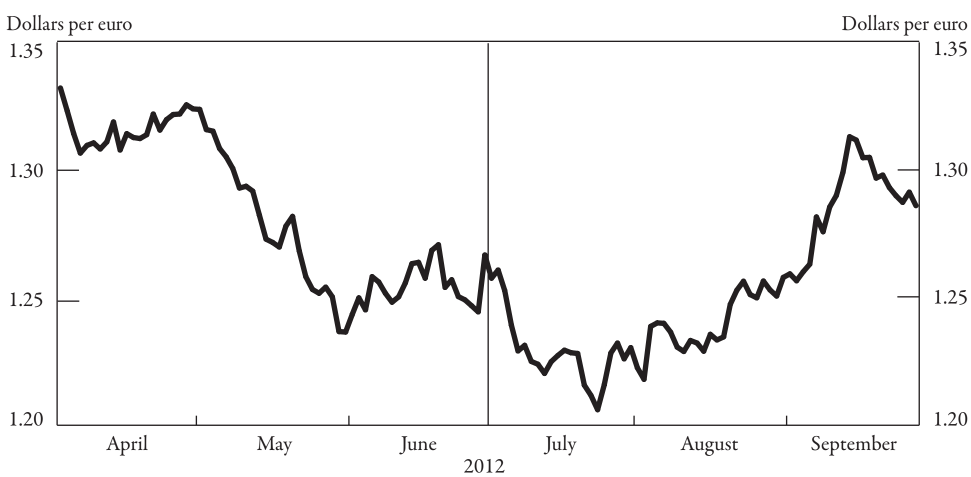
TRADE-WEIGHTED U.S. DOLLAR



Sources: Board of Governors of the Federal Reserve System; Bloomberg L.P.

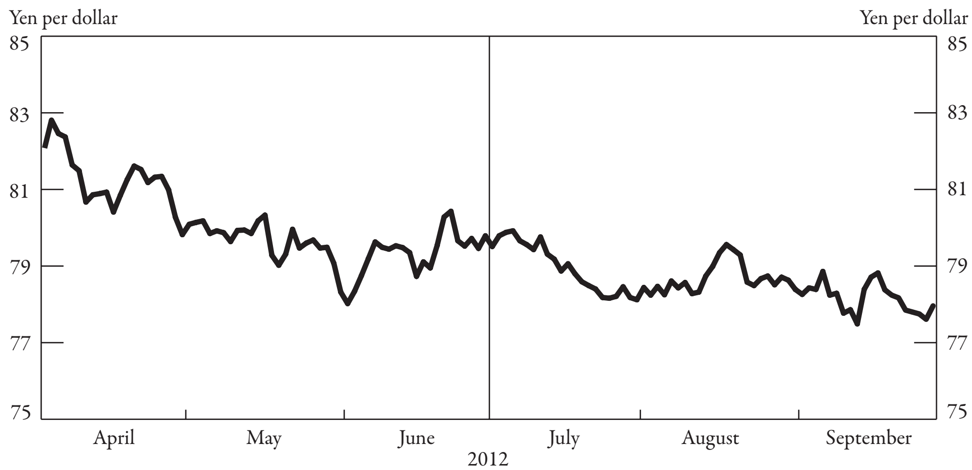
Chart 2

EURO–U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 3
U.S. DOLLAR–YEN EXCHANGE RATE



Source: Bloomberg L.P.

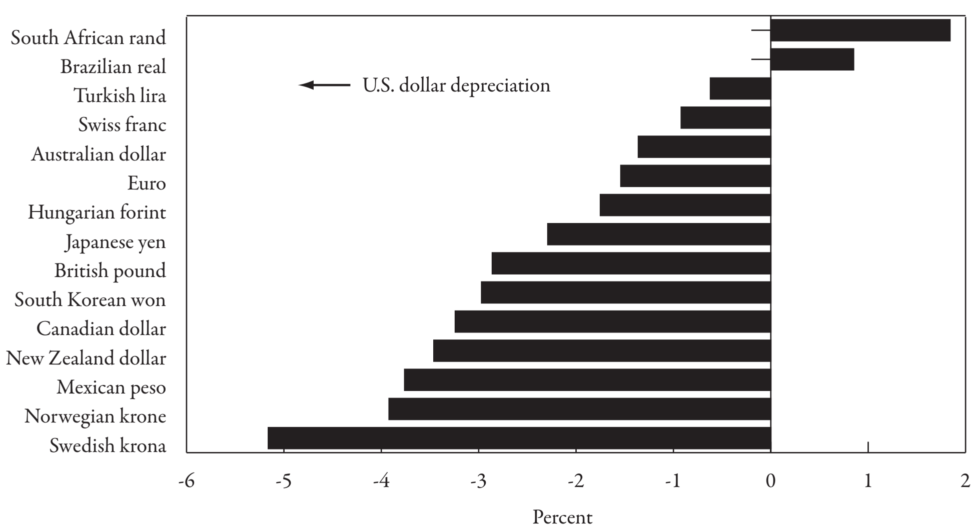
U.S. DOLLAR DEPRECIATES AMID EXPECTATIONS OF FURTHER FOMC POLICY EASING

During the third quarter, the dollar depreciated against most major currencies amid weaker-than-expected U.S. economic data and rising expectations for additional accommodative action by the Federal Open Market Committee (FOMC). In particular, the weaker-than-expected August employment report and regional manufacturing data as well as weakening or generally limited improvement in other economic data contributed to increased expectations for additional policy easing by the FOMC. These expectations were reinforced by the August FOMC meeting minutes and Chairman Bernanke's Jackson Hole speech, which was generally perceived as reinforcing the Chairman's accommodative policy stance and economic assessment. Despite some debate among market participants regarding the form of accommodation, expectations remained anchored toward additional easing throughout the quarter.

At its September meeting, the FOMC extended its forward-rate guidance on the path of the federal funds rate, initiated new purchases of agency mortgage-backed securities, and communicated expectations for the accommodative stance of policy to remain appropriate even after the economic recovery strengthens. Although market participants overall characterized the FOMC's decision as more accommodative than expected, the U.S. dollar was little changed immediately following the decision. Market participants generally suggested that the limited change in the dollar indicated that additional easing was largely priced in following weaker-than-expected August employment data. Indeed, the U.S. dollar's value as measured by the Federal Reserve Board's major currencies index declined 1.4 percent following weaker-than-expected employment data in the week leading up to the FOMC meeting.

Chart 4

U.S. DOLLAR AGAINST SELECTED CURRENCIES DURING THIRD QUARTER

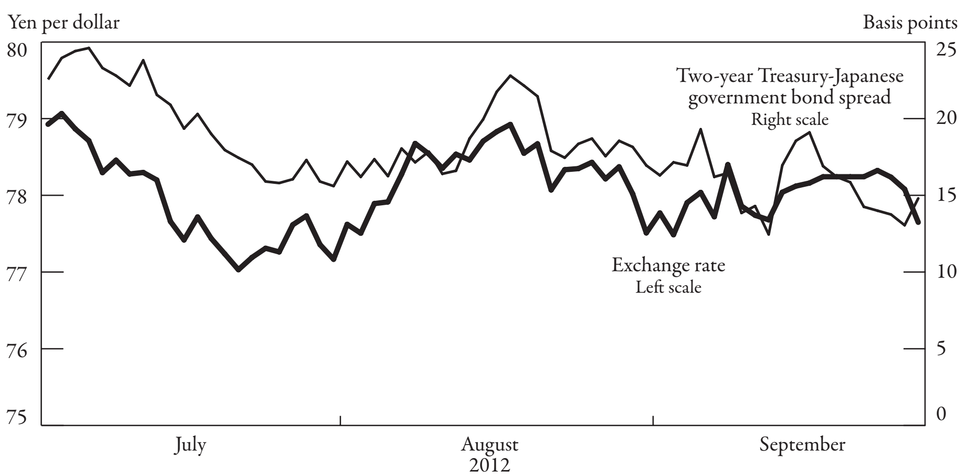


Source: Bloomberg L.P.

During the quarter, the U.S. dollar depreciated 2.4 percent against the Japanese yen. The moves tended to track U.S. and Japanese interest rate differentials, as the spread of two-year Treasury yields over Japanese government bonds (JGB) declined on net during the period. Toward the end of the quarter, the dollar-yen exchange rate reached a seven-month intraday low of ¥77.13 per dollar, near the level at which Japanese authorities last intervened in foreign exchange markets. Indeed, Japanese officials raised the prospect of foreign exchange intervention by commenting publicly that movements in the yen did not reflect the state of the Japanese economy and that options were available to counter such moves, if necessary. These comments reportedly helped limit further yen appreciation toward the end of September. Of note, the Bank of Japan (BoJ) announced additional easing measures at its September meeting, including a ¥10 trillion increase in the purchasing capacity of its asset purchase program, a six-month extension of the program, and a removal of the minimum bid rate of 10 basis points for JGB purchases.

Chart 5

U.S. DOLLAR–JAPANESE YEN EXCHANGE RATE AND TWO-YEAR INTEREST RATE DIFFERENTIAL



Source: Bloomberg L.P.

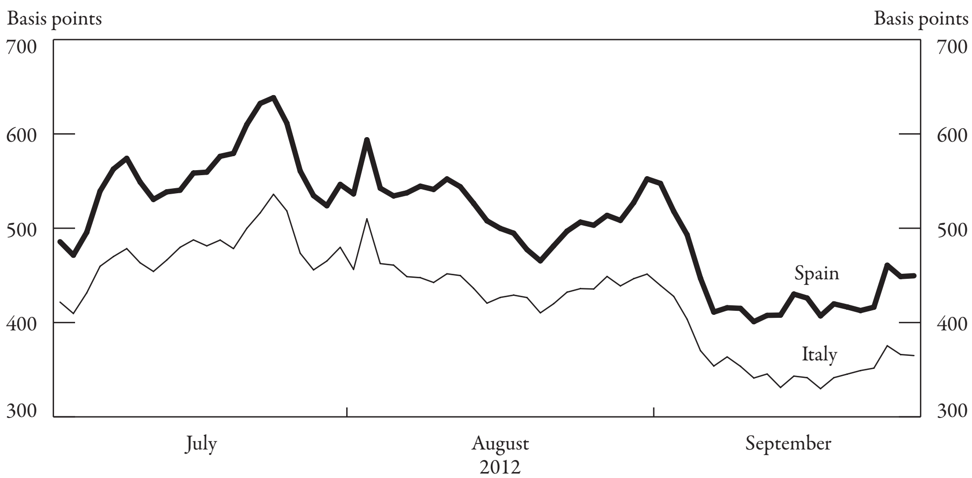
U.S. DOLLAR DEPRECIATES AMID PERCEIVED REDUCTION IN NEAR-TERM TAIL RISKS IN EURO AREA

The dollar depreciated 1.5 percent against the euro during the third quarter, as sentiment toward the euro area improved following a speech by European Central Bank (ECB) President Mario Draghi in late July and the ECB's September policy announcement. The perceived reduction in near-term tail risks in the euro area contributed to the dollar's depreciation during the quarter against other major currencies, with depreciations of 5.4 percent against the Swedish krona, 3.9 percent against the Mexican peso, and 2.9 percent against the British pound. Market participants focused on President Draghi's statements suggesting that the ECB would act to preserve the euro and maintain proper functioning of the monetary policy transmission channel. In September, the ECB announced a plan to conduct Outright Monetary Transactions aimed at safeguarding an appropriate monetary policy transmission and a singleness of euro area monetary policy. These developments reversed the euro's depreciation against the dollar that had occurred throughout the second quarter and carried into the third, including the more than 1 percent depreciation following the ECB's July decision to reduce its main refinancing and deposit rates by 25 basis points, to 0.75 percent and 0 percent, respectively. Following the July ECB meeting, sovereign bill yields of several euro area countries declined notably, some of which to negative levels. Overall, the improved tone during the quarter was reflected across asset classes, with intra-euro-area sovereign yield spreads narrowing, equities rising, and foreign exchange market indicators showing reduced concerns about near-term euro depreciation.

These developments led to significant declines in ten-year Spanish and Italian government debt spreads. Indeed, the Spanish ten-year spread to the German equivalent bond narrowed from a record 639 basis points on July 24, just prior to President Draghi's speech, to 450 basis points by the end of the quarter. At the same time, five-year sovereign credit default swap spreads for Spain declined from a record 641 basis points on July 24 to end the quarter at 381 basis points, while spreads in Italy fell from 573 to 356 basis points.

Chart 6

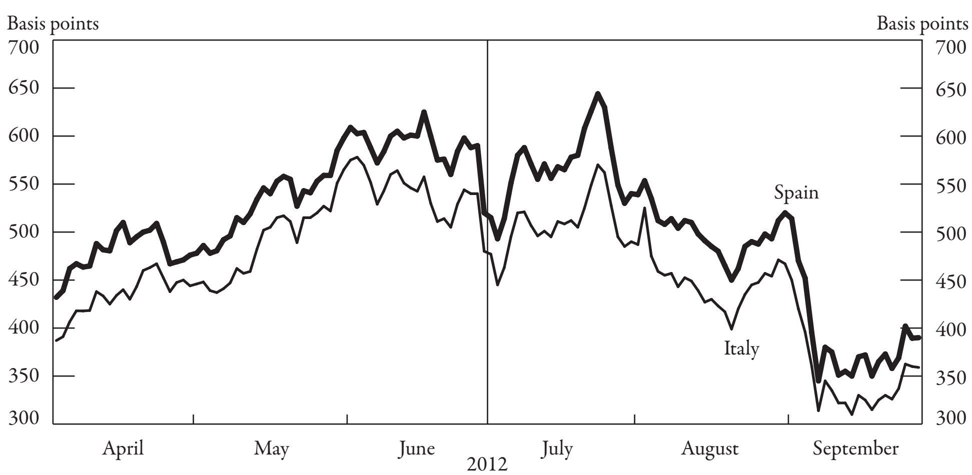
TEN-YEAR YIELD SPREAD OVER GERMAN EQUIVALENT



Source: Bloomberg L.P.

Chart 7

FIVE-YEAR CREDIT DEFAULT SWAP SPREAD

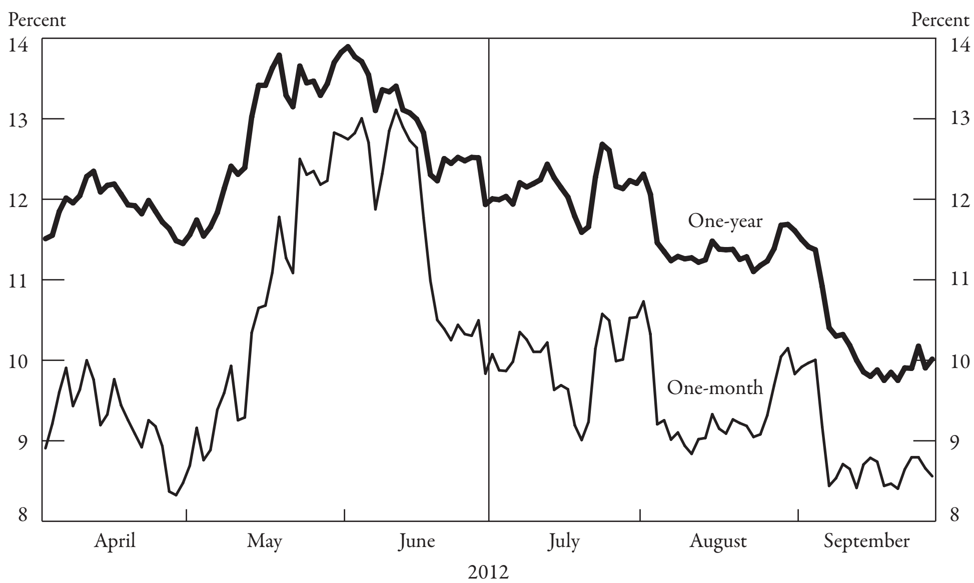


Source: Bloomberg L.P.

The improved tone in the euro area was also reflected in a number of foreign exchange market indicators that showed an easing in concerns about near-term euro depreciation. Measures of one-month and one-year implied volatility in the euro-dollar pair declined to pre-Lehman Brothers levels. Risk reversals, which measure the relative price premium of call and put options, suggested that demand for protection against euro depreciation declined during the quarter. However, on balance euro-dollar risk reversals continued to indicate a premium for put options over call options on the currency pair, suggesting that sentiment toward the euro remained cautious.

Chart 8

EURO–U.S. DOLLAR AT-THE-MONEY OPTION-IMPLIED VOLATILITY



Source: Bloomberg L.P.

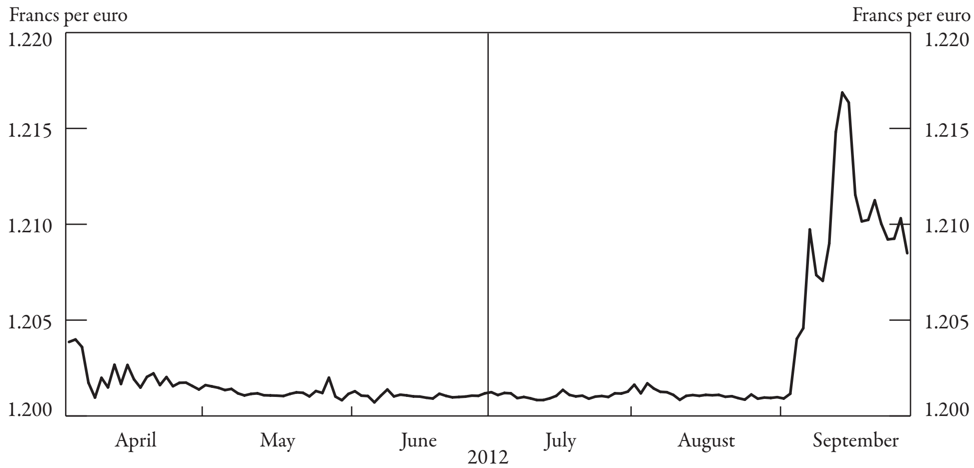
Chart 9

EURO–U.S. DOLLAR 25-DELTA RISK REVERSALS

Source: Bloomberg L.P.

Market participants also cited improved sentiment toward the euro area as contributing to an appreciation of the euro against the Swiss franc. During the quarter, the franc depreciated against the euro as the euro-Swiss franc exchange rate traded above the CHF1.20 per euro exchange rate floor established by the Swiss National Bank (SNB) in September 2011. The exchange rate increased to an intraday high of CHF1.21846 per euro during the quarter, the highest level since the beginning of 2012. Consistent with the easing pressure on the euro-Swiss franc pair, the pace of reserves accumulation slowed during the quarter as the SNB's foreign exchange reserves increased by CHF64 billion, compared with a CHF128 billion rise in the second quarter. Monthly increases in foreign exchange reserves during the quarter confirmed the reduced pace of accumulation, with increases of CHF44 billion in July, CHF12 billion in August, and CHF8 billion in September—bringing total reserves to CHF429 billion.

Chart 10
EURO–SWISS FRANC EXCHANGE RATE



Source: Bloomberg L.P.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE HOLDINGS

The U.S. monetary authorities did not undertake any intervention operations during the quarter. As of September 30, the value of the U.S. Treasury's Exchange Stabilization Fund foreign-currency-denominated assets totaled $25.77 billion, comprised of euro and yen holdings. The Federal Reserve System Open Market Account holdings of foreign-currency-denominated assets totaled $25.79 billion, also comprised of euro and yen holdings.

Dollar Liquidity Swap Arrangements with Foreign Central Banks

On November 30, 2011, the Federal Reserve, in coordination with the Bank of Canada, the Bank of England, the BoJ, the ECB, and the SNB, agreed to reduce the rate charged on dollar liquidity swap arrangements and to extend authorization of these swap arrangements through February 1, 2013. The rate charged on the dollar liquidity swap arrangements was reduced from the U.S. dollar overnight index swap (OIS) rate plus 100 basis points to the OIS rate plus 50 basis points. As of September 30, the ECB had $12.55 billion outstanding in swaps with the Federal Reserve. Balances on all other dollar liquidity and bilateral liquidity swap arrangements were zero. In addition, as a contingency measure, the central banks agreed to establish temporary bilateral liquidity swap arrangements so that each bank could provide liquidity, if necessary, in any of the respective currencies.

Foreign Exchange Reserve Holdings

The U.S. monetary authorities invest their foreign currency reserves 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 on an outright basis in German, French, and Japanese government securities. Another portion is invested in euro-denominated repurchase agreements, under which 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 September 30, 2012, direct holdings of foreign government securities totaled $25 billion. Additionally, foreign government securities held under repurchase agreements were $1.54 billion, a decrease from $4.84 billion at the end of the second quarter, as rates offered on such investments were either very low or negative in the third quarter following the ECB's policy decision to reduce the main refinancing and deposit rates to 0.75 percent and 0 percent, respectively, on July 5.

Table 1

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

Millions of U.S. Dollars

		Changes in Balances by Source				
	Carrying Value, June 30, 2012[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sales[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value, September 30, 2012[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	13,622	0	27	0	203	13,852
Japanese yen	11,648	0	6	0	283	11,936
Total	25,270	0	32	0	485	25,788

		Changes in Balances by Source				
	Carrying Value, June 30, 2012[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sales[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value, September 30, 2012[a]
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	13,600	0	27	0	203	13,830
Japanese yen	11,648	0	6	0	283	11,936
Total	25,249	0	32	0	485	25,766

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 the "day of" accrual method.

[b] Net purchases and sales include foreign currency purchases related to official activity, repayments, and warehousing.

[c] Investment earnings include accrued interest and amortization on outright holdings.

[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 U.S. Dollars, as of September 30, 2012

	U.S. Treasury Exchange Stabilization Fund (ESF)[a]	Federal Reserve System Open Market Account (SOMA)[a]
Euro-denominated assets	**13,829.5**	**13,851.6**
Cash held on deposit at official institutions	8,549.3	8,571.4
Marketable securities held under repurchase agreements[b]	771.4	771.4
Marketable securities held outright	4,508.9	4,508.9
German government securities	1,905.5	1,905.5
French government securities	2,603.4	2,603.4
Japanese-yen–denominated assets	**11,936.5**	**11,936.4**
Cash held on deposit at official institutions	3,943.1	3,943.0
Marketable securities held outright	7,993.4	7,993.4
Reciprocal currency arrangements		
Euro-denominated assets		**12,550.6**
Other assets[c]		12,550.6
Japanese-yen–denominated assets		**0.0**
Other assets[c]		0.0
Swiss-franc–denominated assets		**0.0**
Other assets[c]		0.0
Canadian-dollar–denominated assets		**0.0**
Other assets[c]		0.0
British-pound–denominated assets		**0.0**
Other assets[c]		0.0

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

[a] As of September 30, the euro SOMA and ESF portfolios both had Macaulay durations of 9.1 months; the yen SOMA and ESF portfolios both had Macaulay durations of 11.7 months.

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

[c] Carrying value of outstanding reciprocal currency swaps with the European Central Bank, the Swiss National Bank, the Bank of Japan, the Bank of Canada, and the Bank of England.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of U.S. Dollars

Institution	Amount of Facility	Outstanding as of September 30, 2012
	Federal Reserve System Open Market Account (SOMA)	
Bank of Canada	2,000	0
Banco de México	3,000	0
European Central Bank[a]	Unlimited	12,551
Swiss National Bank[a]	Unlimited	0
Bank of Japan[a]	Unlimited	0
Bank of Canada[a]	30,000	0
Bank of England[a]	Unlimited	0
	Unlimited	12,551
	U.S. Treasury Exchange Stabilization Fund (ESF)	
Banco de México	3,000	0
	3,000	0

[a]Temporary swap arrangement.