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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 1999

During the second quarter of 1999, the dollar appreciated 4.0 percent against the euro and was largely unchanged against the yen. Movements in the major currency pairs were influenced by shifts in growth outlooks for the United States, Japan, and Europe. The dollar benefited from the continued robust expansion of the U.S. economy, while the yen strengthened as prospects emerged for an economic recovery in Japan. The dollar received some support against the euro during much of the quarter from a widening differential between U.S. and European interest rates. Yield differentials, however, narrowed sharply toward the end of the quarter, helping to slow the rate of decline of the euro's exchange value. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

MARKETS REACT TO GLOBAL ECONOMIC GROWTH TRENDS

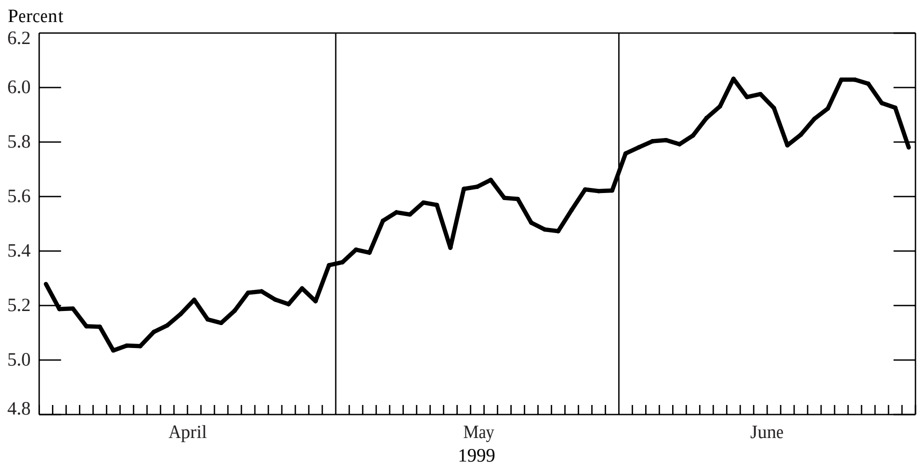
The U.S. economy continued to grow at a solid pace in the second quarter, negating prior expectations of a moderation in growth and leading to heightened anticipation of a modest tightening of U.S. monetary policy. Concern that the Federal Open Market Committee (FOMC) might embark on an aggressive course of tightening emerged after the release of higher-than-expected consumer inflation

This report, presented by Peter R. Fisher, 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 April 1999 through June 1999. Laura F. Ambroseno was primarily responsible for preparation of the report.

data on May 13 and the FOMC announcement of a tightening bias on May 18. The yield on the ten-year U.S. Treasury bond reached a high of 6.03 percent on June 11, which was nearly 100 basis points above the low point for the quarter. The implied yield on the September Fed funds futures contract also rose to a period high of 5.22 percent on June 11, but stabilized somewhat after Chairman Greenspan indicated on June 19 that the FOMC should employ “modest preemptive action.” On June 30, the FOMC increased the Fed funds target by 25 basis points, to 5.00 percent, and adopted “a directive that includes no predilection about near-term policy.” Treasury yields marginally retraced their increases and the implied yield on the September Fed funds futures contract fell to 5.13 percent, as market participants interpreted the removal of the tightening bias as an indication that further rate hikes might not be imminent.

Chart 1

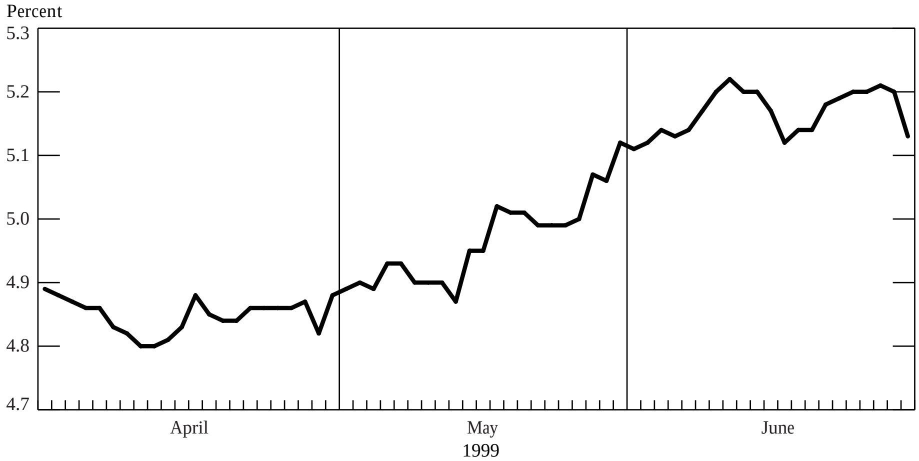
TEN-YEAR TREASURY YIELD



Source: Bloomberg L.P.

Chart 2

IMPLIED YIELD ON SEPTEMBER 1999 FED FUNDS FUTURES CONTRACT



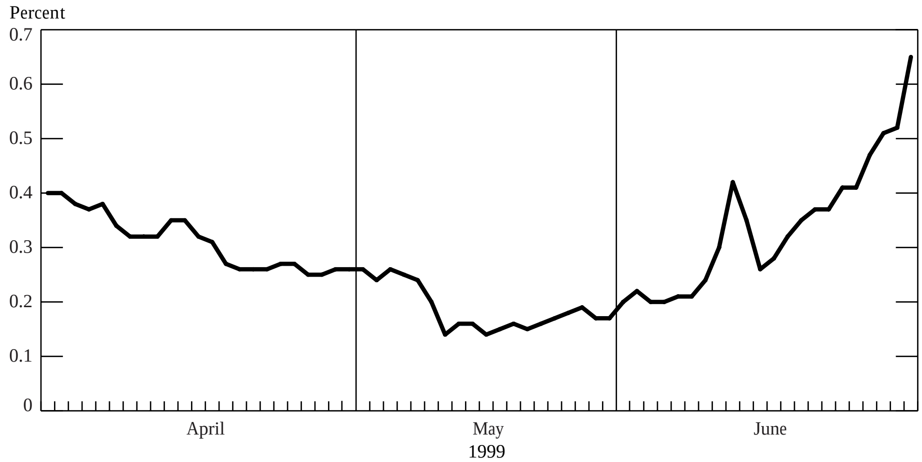
Source: Bloomberg L.P.

In Japan, the surprisingly strong first-quarter GDP figure released on June 10 prompted market participants to reevaluate the time frame for possible economic recovery. Japanese yields were pressured higher by the prospect of economic growth and by bond supply concerns given renewed discussion of additional stimulus measures and tax cuts. The yield on the ten-year Japanese government benchmark bond rose from a low of 1.23 percent on May 17 to a high of 1.84 percent by quarter-end. Japanese equities also reacted to the economic data and to further evidence of corporate restructuring, with the Nikkei index rising 10.7 percent over the quarter. Foreign investors were noteworthy buyers of Japanese equities, continuing to increase the weight of Japanese assets in their portfolios. The three-month implied yield of the March 2000 euroyen futures contract rose 25 basis points over the quarter, to a level of 65 basis points, as speculation mounted that the Bank of Japan might abandon its zero-interest-rate policy earlier than expected.

The Governing Council of the European Central Bank (ECB) cut the interest rate on its main refinancing operations by 50 basis points to 2.50 percent on April 8, a move that was perceived as positive for future growth prospects in Europe. However, evidence of a near-term pickup in economic activity remained scant for most of the quarter. European bonds outperformed U.S. Treasuries, with the spread between ten-year U.S. and ten-year German government bond yields reaching a high of 178 basis points on

Chart 3

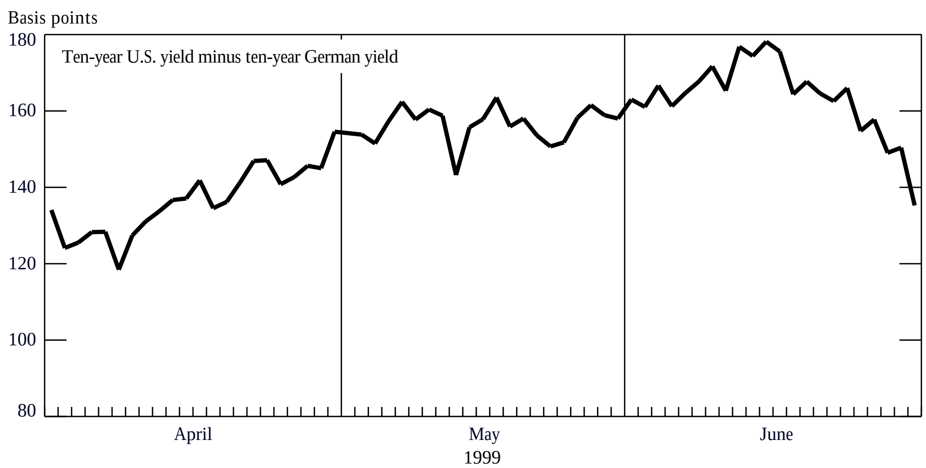
THREE-MONTH IMPLIED YIELD ON MARCH 2000 EUROYEN FUTURES CONTRACT



Source: Bloomberg L.P.

Chart 4

SPREAD BETWEEN TEN-YEAR U.S. AND GERMAN GOVERNMENT BOND YIELDS

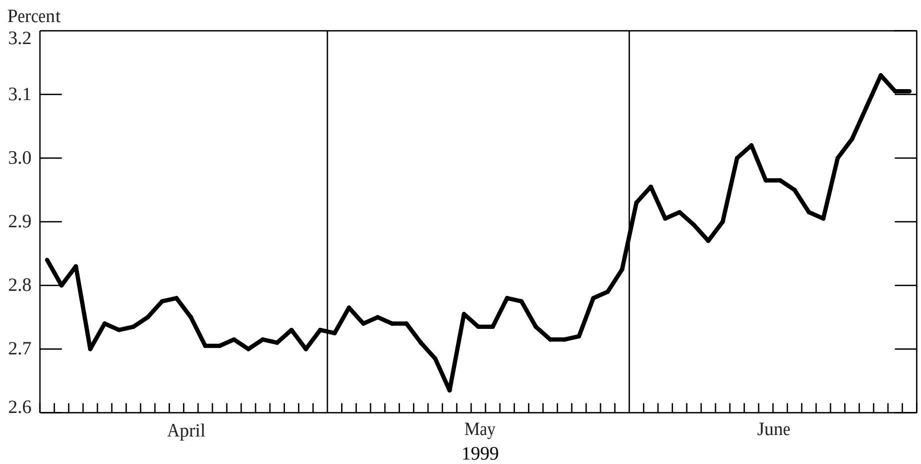


Source: Bloomberg L.P.

June 15. Late in the quarter, better-than-expected business confidence and German GDP data led to a marginal shift in sentiment toward the European economy. Following the June 17 release of the May business sentiment survey in Germany, which showed a sharp improvement in business expectations, the yield on the ten-year benchmark German bund rose 25 basis points, to 4.51 percent, and the ten-year U.S.-German bond yield spread narrowed to 135 basis points by quarter-end. The rise in bund yields was attributed in part to developments in the U.S. Treasury market, but fiscal policy concerns in the euro area and a surge in euro-denominated bond issuance were also cited as contributing factors. While a pick-up in European growth was widely discussed, many market participants remained cautious about growth prospects in the euro area. Nonetheless, by the end of the period, the three-month implied yield on the March 2000 euribor futures contract had risen 44 basis points, from a period low of 2.64 percent, as market participants anticipated a possible shift by the ECB toward a tighter interest rate policy.

Chart 5

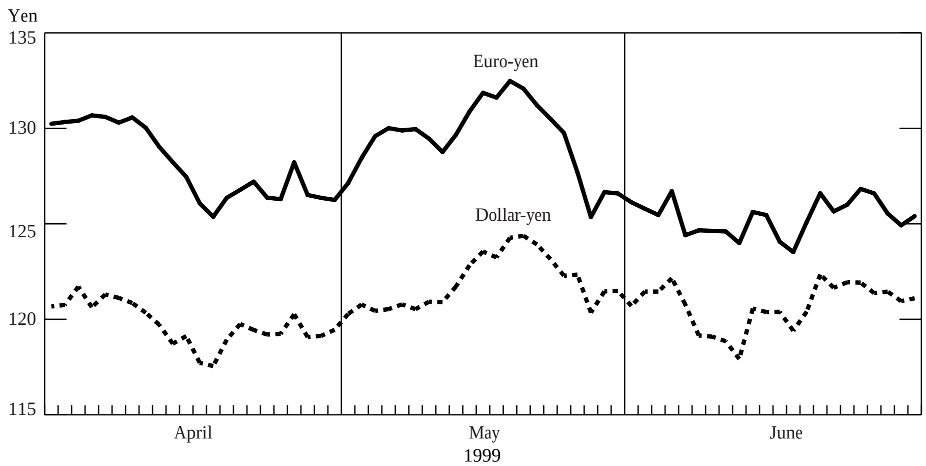
THREE-MONTH IMPLIED YIELD ON MARCH 2000 EURIBOR FUTURES CONTRACT



Source: Bloomberg L.P.

Chart 6

THE YEN AGAINST THE DOLLAR AND THE EURO



Source: Reuters.

CURRENCY MOVEMENTS REFLECT CHANGING GROWTH PROSPECTS

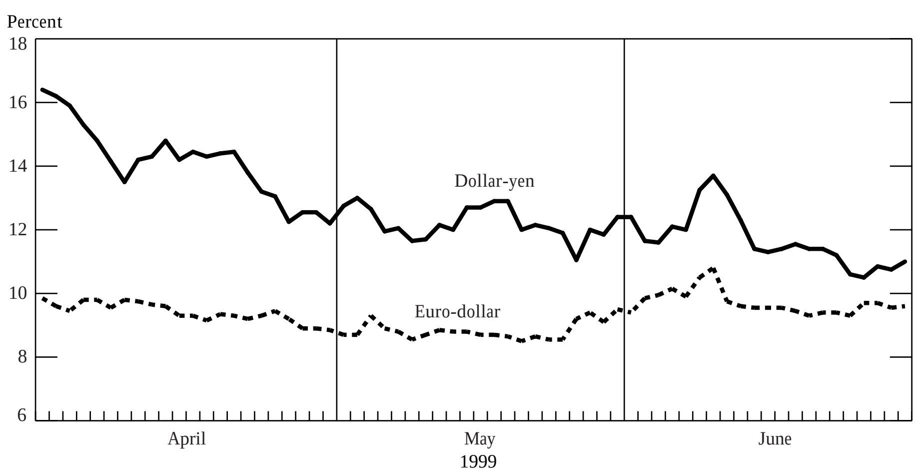
A strong correlation between the dollar-yen and euro-yen exchange rates suggested that the yen continued to dominate movements in the major currency pairs this quarter. Against the dollar, the yen depreciated to ¥124.32 in the first half of the quarter as expectations for the economic outlook in Japan remained unchanged and bond supply concerns waned. The yen's decline reflected the 90-basis-point widening of the long-term U.S.-Japanese interest rate differential from the start of the quarter to May 17. During this time, demand for dollars was encouraged by sustained U.S. economic growth, higher U.S. interest rates, and the perception that the FOMC would remain vigilant against inflation.

The upward trend in the dollar-yen exchange rate reversed sharply following the FOMC's shift toward a tightening bias on May 18 and renewed speculation of an additional stimulus package in Japan. The yen's appreciation gained momentum following the Japanese first-quarter GDP release, and mirrored the narrowing of the long-term U.S.-Japanese interest rate differential by 47 basis points, to a level of 393 basis points, from May 17 to quarter-end. The yen was further supported as both domestic and foreign investors purchased Japanese equities in anticipation of an economic recovery. In addition, the persistent depreciation of the euro reportedly prompted Japanese institutional investors to sell euros against the yen to hedge euro-denominated debt holdings.

Treasury Secretary-designate Summers, in his confirmation hearing on June 17, said that "a strong currency is very much in our national interest. That has been our policy and will continue to be our policy if I am confirmed as secretary." Also during June, Japanese government officials repeatedly warned against any "premature" strengthening of the yen.

The yen's upward momentum was interrupted by reports of intervention operations by the Bank of Japan late in the quarter, involving purchases of dollars and euros. The ECB confirmed that it operated as agent for the Bank of Japan on one occasion. Some market participants interpreted the estimated scale of the operations as indicative of the Japanese authorities' determination to resist yen appreciation. However, there was also a substantial body of opinion in the market that the main effect of the reported intervention operations was to provide more attractive levels for Japanese investors to hedge exposure to the euro. In the options market, one-month implied volatility for the dollar-yen exchange rate collapsed from over 16 percent to below 11 percent over the quarter, reflecting market expectations for dollar-yen to trade in a relatively narrow range.

Chart 7
ONE-MONTH IMPLIED VOLATILITIES

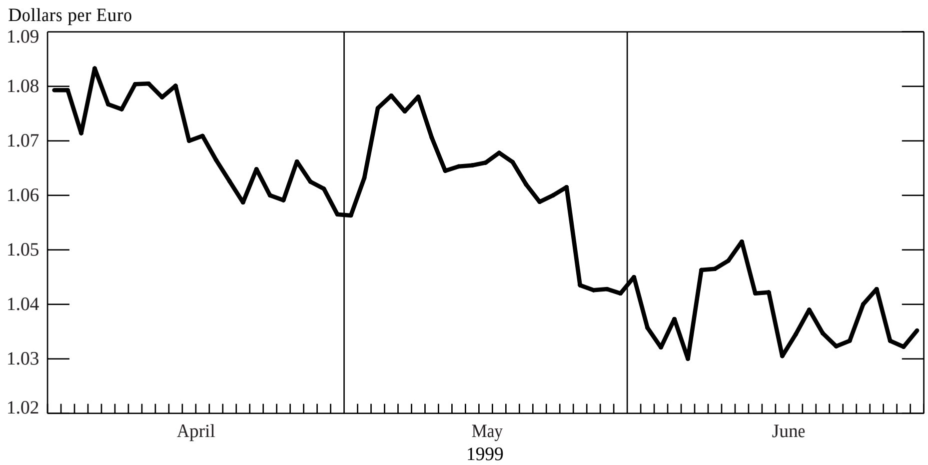


Source: Reuters.

The euro depreciated on balance against both the dollar and yen, as the marginal improvement in euro-area growth prospects lagged the shift in sentiment toward Japan and the surprising resilience of U.S. economic performance. The euro was also pressured lower by market perceptions that EMU monetary authorities placed a higher priority on internal price stability in the euro area than on the euro's exchange rate. The euro registered a particularly sharp depreciation toward the end of May, when the European Union finance ministers agreed to relax Italy's budget deficit target to 2.4 percent of GDP from 2.0 percent. In the final weeks of the quarter, the euro stabilized within a lower trading range, supported in part by the narrowing of spreads between U.S. and European interest rates.

Chart 8

THE EURO AGAINST THE DOLLAR



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 Japanese yen reserve holdings totaled $14.7 billion for the Federal Reserve System and $14.7 billion for the Exchange Stabilization Fund. The U.S. monetary authorities invest all of 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. A significant portion of these balances is invested in German and Japanese government securities held directly or under repurchase agreement. As of June 30, outright holdings of foreign government securities by U.S. monetary authorities totaled $8.1 billion.

Japanese and German government securities held under repurchase agreement are arranged either through transactions executed directly in the market or through agreements with official institutions. Foreign government securities held under repurchase agreement by the U.S. monetary authorities totaled $12.1 billion at the end of the quarter. Foreign currency reserves are also invested in deposits at the Bank for International Settlements and in facilities at other official institutions.

On April 9, the ESF placed $1,697.4 million at the disposal of the Federal Reserve Bank of New York (FRBNY) to put into effect the ESF share of the multilateral guarantee of Brazil's second drawing on its credit facility with the Bank for International Settlements (BIS). On June 18, Brazil made a partial repayment of its December 18, 1998 drawing on the BIS facility. The ESF share of the guarantee of that drawing was reduced by $467.7 million. An amount of $1,097.0 million remained at the FRBNY's disposal in connection with the guarantee of that part of the December 18 drawing which was rolled over. The ESF received a commission of $35.5 million at the time of this partial repayment.

Table 1

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

Millions of Dollars

		Quarterly Change in Balance by Source					
	Balance as of March 31, 1999	Net Purchases and Sales[a]	Impact of Sales[b]	Investment Income	Currency Valuation Adjustments[c]	Interest Accrual (Net) and Other	Balance as of June 30, 1999
System Open Market Account (SOMA)							
EMU euro	7,227.6	0.0	0.0	50.6	(334.5)	0.0	6,943.7
Japanese yen	7,950.1	0.0	0.0	1.6	(164.8)	0.0	7,786.9
Subtotal	15,177.7	0.0	0.0	52.2	(499.3)	0.0	14,730.6
Interest receivables[d]	53.7	0.0	0.0	0.0	0.0	14.7	68.4
Other cash flow from investments[e]	13.9	0.0	0.0	0.0	0.0	(13.9)	0.0
Total	15,245.3	0.0	0.0	52.2	(499.3)	0.8	14,799.0
U.S. Treasury Exchange Stabilization Fund (ESF)							
EMU euro	7,236.6	0.0	0.0	42.5	(334.5)	0.0	6,944.6
Japanese yen	7,950.1	0.0	0.0	1.7	(164.8)	0.0	7,787.0
Subtotal	15,186.7	0.0	0.0	44.2	(499.3)	0.0	14,731.6
Interest receivables[d]	35.8	0.0	0.0	0.0	0.0	(9.7)	45.5
Other cash flow from investments[e]	18.4	0.0	0.0	0.0	0.0	(18.4)	0.0
Total	15,240.9	0.0	0.0	44.2	(499.3)	(8.7)	14,777.1

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

[a] Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

[b] This figure is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

[c] Foreign currency balances are marked-to-market monthly at month-end exchange rates.

[d] Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at average cost of acquisition and are not marked-to-market until interest is paid. Interest receivables for the Federal Reserve System are net of unearned interest collected.

[e] Values are cash flow differences from payment and collection of funds between quarters.

Table 2

NET PROFITS (+) OR LOSSES (-) ON U.S. TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON HISTORIC COST-OF-ACQUISITION EXCHANGE RATES

Millions of Dollars

	SOMA	ESF
Valuation profits and losses on outstanding assets and liabilities as of March 31, 1999		
EMU euro	(10.6)	(227.5)
Japanese yen	911.2	1,123.3
Total	900.6	895.8
Realized profits and losses from foreign currency sales April 1, 1999 – June 30, 1999		
EMU euro	0.0	0.0
Japanese yen	0.0	0.0
Total	0.0	0.0
Valuation profits and losses on outstanding assets and liabilities as of June 30, 1999		
EMU euro	(345.0)	(562.0)
Japanese yen	746.3	958.5
Total	401.3	396.5

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 1999
Bank of Canada	2,000	0.0
Bank of Mexico	3,000	0.0
Total	5,000	0.0

U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 1999
Bank of Mexico	3,000	0.0
Total	3,000	0.0