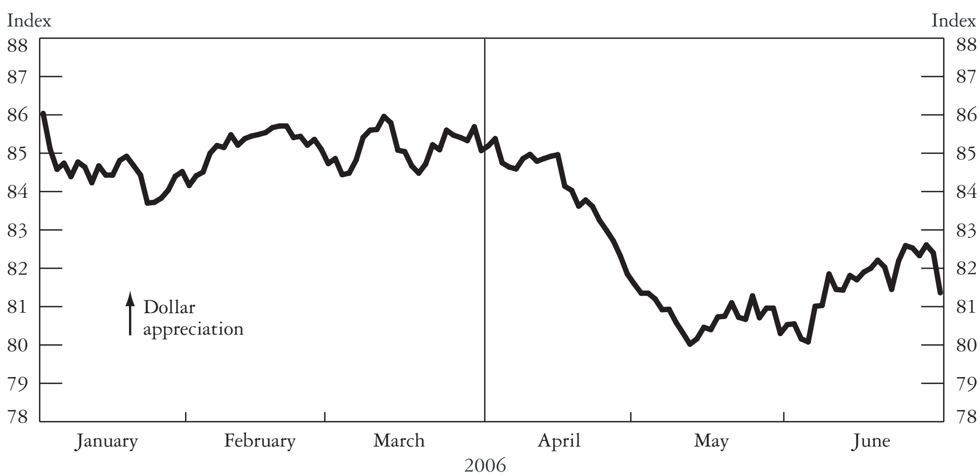
TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 2006

During the second quarter of 2006, the dollar's trade-weighted exchange value decreased 4.5 percent as measured by the Federal Reserve Board's major currencies index. The dollar depreciated 5.5 percent against the euro and 2.9 percent against the yen. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

Chart 1

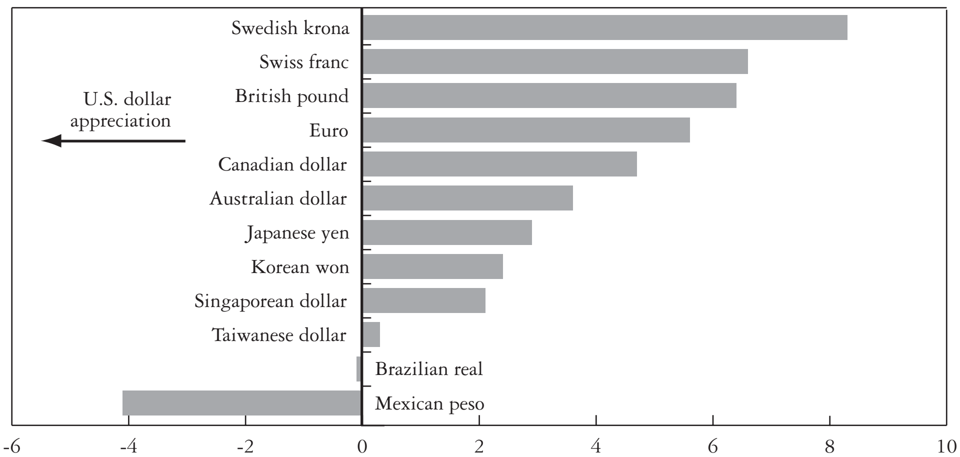
TRADE-WEIGHTED U.S. DOLLAR



Source: Bloomberg L.P.

This report, presented by Dino Kos, 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 2006. Brian Jackson was primarily responsible for preparation of the report.

Chart 2
PERCENTAGE CHANGE IN MAJOR CURRENCIES
SECOND QUARTER, 2006



Source: Bloomberg L.P.

G7 STATEMENT PROMPTS SHARP DOLLAR DEPRECIATION

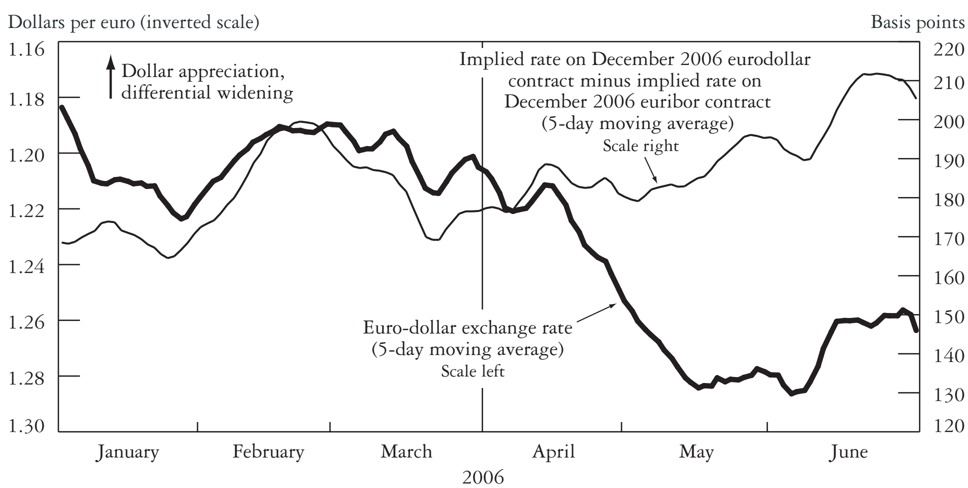
Throughout the second quarter, market participants remained focused on the timing of a possible end to the series of target federal funds rate increases by the Federal Open Market Committee (FOMC). Expectations for further increases initially rose following the publication of the stronger-than-expected U.S. employment report in early April. However, these expectations were largely reversed following the release of the minutes of the March FOMC meeting on April 18, which noted that most members of the Committee considered that "the end of the tightening process was likely to be near." Movements in the dollar's exchange rate broadly tracked these shifts in expectations in the first three weeks of the quarter.

However, this focus by investors in the foreign exchange market on interest rate differentials was interrupted by the release on April 21 of a statement on exchange rates by officials attending the Group of Seven (G7) Finance Ministers meeting. The statement said expressly that greater exchange rate flexibility would be desirable in emerging market economies with large current account surpluses, especially China, for necessary adjustments in global imbalances to occur.

Although the statement made no reference to the exchange value of the U.S. dollar, its call for greater exchange rate flexibility was interpreted by many market participants as a signal that policymakers might acquiesce to significant dollar depreciation as a way to foster a reduction in global imbalances. A number of senior U.S., European, and Japanese officials subsequently denied that the statement was intended to convey such a signal, but this interpretation remained widespread among investors. The statement also prompted increased speculation that the U.S. Treasury might cite China for exchange rate manipulation in its semiannual Report to Congress on International Economic and Exchange Rate Policies, an action that many expected would put further downward pressure on the dollar. Reflecting these considerations, the dollar weakened sharply against most major currencies, including the euro and particularly the yen and other Asian currencies associated with the Chinese renminbi in the weeks immediately following the G7 meeting.

Chart 3

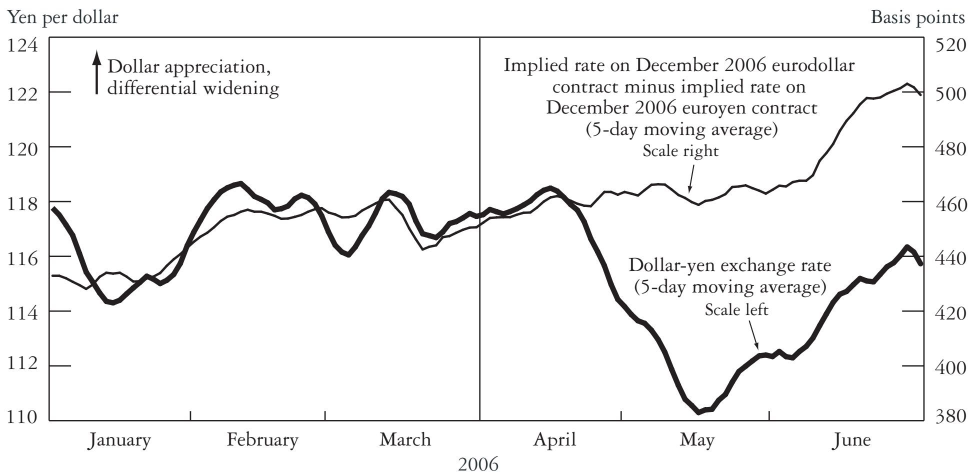
EURO-DOLLAR AND IMPLIED RATES ON FUTURES CONTRACTS



Source: Bloomberg L.P.

Chart 4

DOLLAR-YEN AND IMPLIED RATES ON FUTURES CONTRACTS

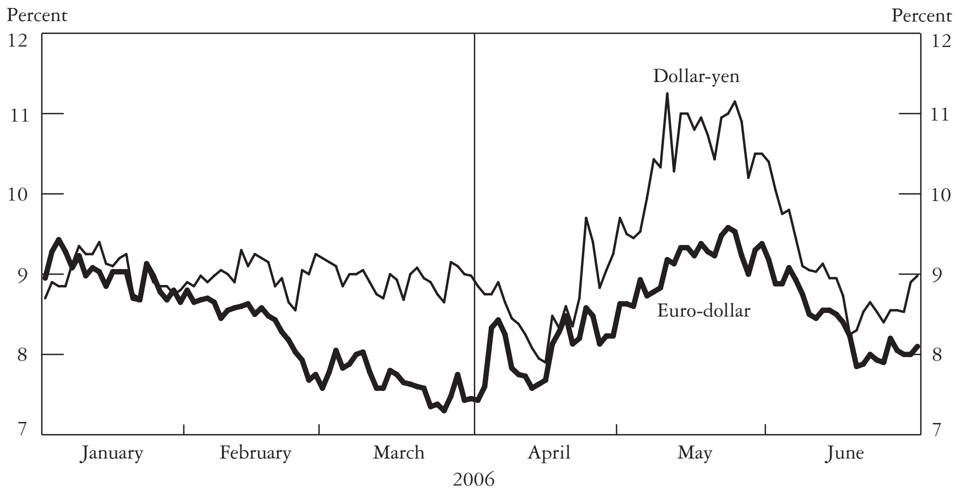


Source: Bloomberg L.P.

Despite the relatively pronounced price action following the G7 meeting, market participants generally reported orderly trading conditions with little change in bid-ask spreads of major currency pairs. Trading volume was heavy, with major electronic trading platforms reporting record daily levels during this period. Option-implied volatility in the currency market also rose notably over this period, with implied volatility in major currency pairs reaching their highest levels in several months, before falling back to levels observed earlier in the quarter.

Chart 5

ONE-MONTH OPTION-IMPLIED VOLATILITY



Source: Bloomberg L.P.

DOLLAR RECOVERS AMID EXPECTATIONS OF HIGHER U.S. INTEREST RATES AND A DECLINE IN INVESTOR RISK APPETITE

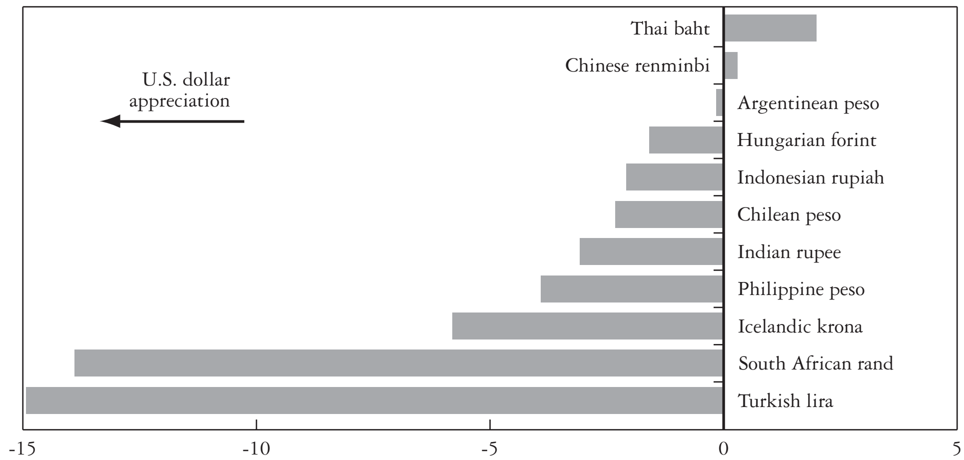
Between the April 21 G7 meeting and mid-May, the dollar declined to its lowest level against the euro since May 2005 and the yen since September 2005. From mid-May, however, interest rate differentials appeared to regain influence on exchange rate movements, with the dollar appreciating in line with expectations of higher U.S. policy rates. Following the May 17 release of higher-than-expected U.S. CPI data for April, U.S. interest rate differentials widened relative to those in the euro area and Japan. Although this widening appeared initially to have little impact on the exchange rate, market participants suggested that the prospect of tighter U.S. monetary policy began to outweigh investor concerns about global imbalances, prompting some unwinding of previously extended short-dollar positions. Additionally, market participants noted that the U.S. Treasury did not cite China for currency manipulation in its semiannual Report to Congress in early May, a development that also reportedly reduced investors' focus on global imbalances.

The increased expectations for further policy tightening in the United States followed comments from FOMC Chairman Bernanke and other Federal Reserve officials expressing concerns about the inflation outlook toward the end of May and early June. Expectations for tighter U.S. monetary policy were further reinforced following the mid-June release of higher-than-expected U.S. CPI data for May. In contrast, euro-area monetary policy expectations rose to a lesser extent over the period, beginning in mid-May, while investors revised down their expectations for monetary policy tightening by the Bank of Japan.

The dollar's exchange rate against the euro and the yen broadly tracked this divergence among Group of Three (G3) policy expectations toward the end of the quarter. In the case of Japan, where interest rate differentials widened particularly sharply, the dollar appreciated around 4.3 percent against the yen relative to the level recorded in mid-May. Meanwhile, against the euro, the dollar appreciated around 1.1 percent over the same period, reflecting the smaller widening of interest rate differentials. However, the dollar was still weaker, on net, over the quarter against both the euro and the yen notwithstanding the notable increase in U.S. policy rate expectations over this period.

The appreciation of the dollar against both the euro and the yen since mid-May was accompanied by strong gains against other currencies, especially those of emerging economies. These exchange rate movements broadly coincided with price action in global equity markets, with emerging market equity indexes falling particularly sharply. Commodity prices also fell sharply over this period, further supporting the dollar against several commodity-exporting countries' currencies. Market participants generally attributed this cross-market price action to a sharp reduction in investors' risk appetite in response to concerns about the prospect of tighter global monetary policy and weaker global growth. Such concerns were reinforced by decisions, in some cases unexpected, by several central banks, including those in Korea, Turkey, India, Thailand, and South Africa, to increase policy rates over this period.

Chart 6
PERCENTAGE CHANGE IN SELECTED CURRENCIES
SECOND QUARTER, 2006



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 \$20.2 billion for the Federal Reserve System Open Market Account and \$20.2 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 \$18.9 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled \$4.2 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, 2006[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 June 30, 2006[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	11,260.5	0	83.4	0	594.3	11,938.2
Yen	8,044.1	0	3.1	0	208.6	8,255.8
Total	19,304.6	0	86.5	0	802.9	20,194.0
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	11,242.8	0	83.4	0	593.0	11,919.2
Yen	8,044.2	0	3.0	0	208.6	8,255.8
Total	19,287.0	0	86.4	0	801.6	20,175.0

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 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, 2006

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:[a]	**11,919.2**	**11,938.2**
Cash held on deposit at official institutions	5,931.2	5,951.0
Marketable securities held under repurchase agreements[b]	2,108.1	2,108.1
Marketable securities held outright	3,879.9	3,879.1
German government securities	1,736.1	1,735.3
French government securities	2,143.8	2,143.8
Yen-denominated assets:[a]	**8,255.8**	**8,255.8**
Cash held on deposit at official institutions[c]	2,699.7	2,699.7
Marketable securities held outright	5,556.1	5,556.1

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

[a] As of June 30, euro and yen portfolios had Macauley durations of 9.85 months and 9.64 months, respectively.

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

[c] SOMA and ESF each hold $1,319 million in a collateralized deposit facility.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2006
	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.