TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October-December 2003

During the fourth quarter of 2003, the dollar's trade-weighted exchange value declined 5.8 percent, as measured by the Federal Reserve Board's major currencies index. The dollar depreciated against most major currencies, declining 7.5 percent against the euro and 3.8 percent against the yen. The dollar fell steadily during the quarter, except for a brief period in late October and early November. Although economic data releases provided evidence of ongoing economic recovery, concerns regarding the size of the current account deficit and expectations for U.S. interest rates to remain low weighed on the dollar. The U.S. monetary authorities did not intervene in the foreign exchange market during the quarter.

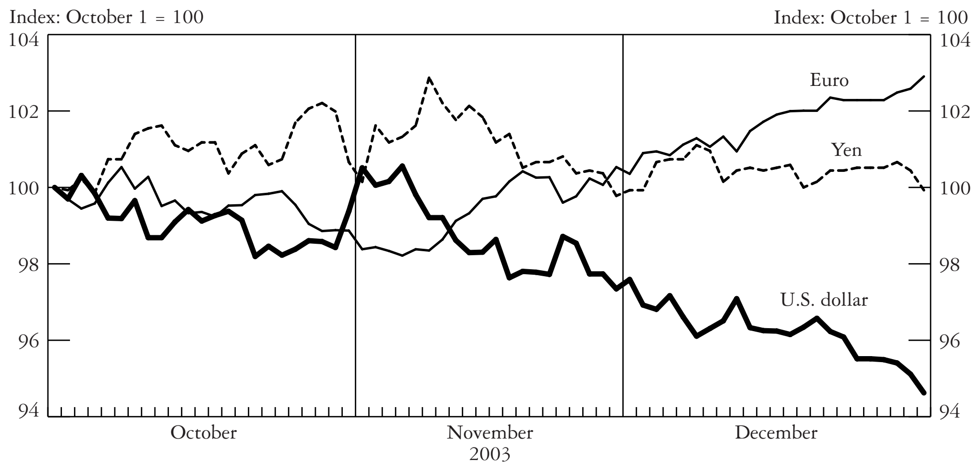
DOLLAR'S DECLINES ARE LIMITED IN OCTOBER

After falling sharply in September, the dollar declined more modestly in October, depreciating 2.7 percent and 0.1 percent against the yen and the euro, respectively. From the end of September through October, the yen's gains against the dollar exceeded the euro's amid a continuing discussion about the possibility of further dollar declines against some of the Asian currencies following the G-7 meeting on September 20. The yen gained despite widely perceived intervention by the Japanese authorities, as ongoing foreign investment into Japanese equities supported the currency. At the end of October, Japan's Minister of Finance publicly confirmed ¥1.6563 trillion in yen sales for dollars between October 1 and October 29.

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 October through December 2003. Amelia Moncayo was primarily responsible for preparation of the report.

Chart 1

TRADE-WEIGHTED G-3 CURRENCIES



Sources: Board of Governors of the Federal Reserve System; Bank of England.

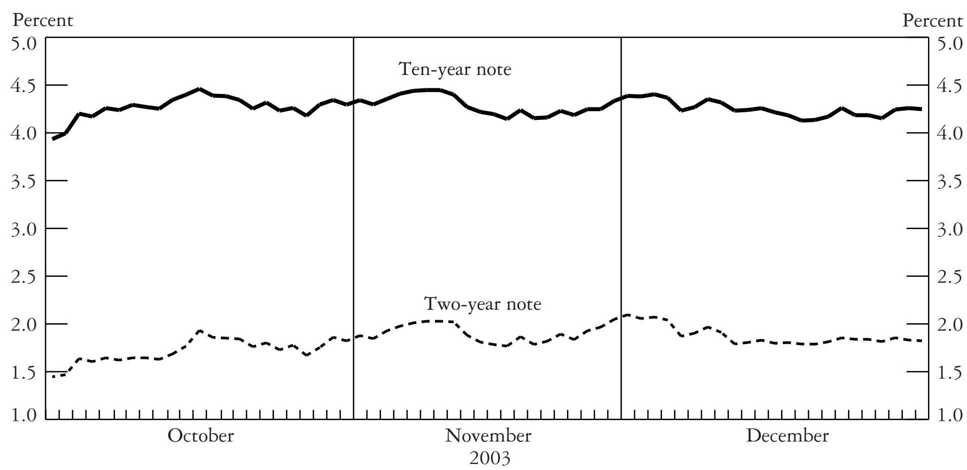
Toward the end of October, the dollar rebounded following a number of economic data releases, which bolstered optimism regarding the pace of the U.S. economic recovery. Third-quarter GDP growth, manufacturing activity for September and October, and the October employment report were all above consensus expectations. Two-year Treasury yields rose 28 basis points between the last week of October and first week of November amid intensified market discussion over the potential timing for a shift in the monetary policy stance of the Federal Open Market Committee (FOMC). Even though the FOMC at the October 28 meeting reiterated that "policy accommodation can be maintained for a considerable period," market participants focused their attention on the characterization of labor market conditions as "stabilizing" rather than "weakening."

DOLLAR DECLINES STEADILY THROUGH THE END OF THE PERIOD

The dollar resumed its weakening trend in November, reaching fresh multiyear lows against a number of currencies, as market participants focused again on the current account deficit and the potential for U.S. interest rates to remain low relative to those of other countries. The belief that U.S. interest rates would stay unchanged for some time was bolstered by comments from several FOMC members, who emphasized the existing excess resources in the economy and the absence of inflationary pressures. Treasury yields initially rose in response to the release of the FOMC statement at the December 9 meeting. Whereas the statement reiterated that accommodative policy could be maintained for a "considerable period," upside and downside inflation risks were described as "almost equal," and the labor market was characterized as "improving modestly." The minutes of the October FOMC meeting, released two days later, however, once again reduced expectations for any near-term increase in rates, as they reflected a view among Committee members that the large margins of unemployed labor and other resources would not likely be eliminated until perhaps the latter part of 2005 or later. On balance, two-year Treasury yields declined 19 basis points, from the first week of November through the end of the quarter. Concerns over terrorist attacks overseas and perceived threats to U.S. interests also weighed on the dollar in the last two months of the quarter.

Chart 2

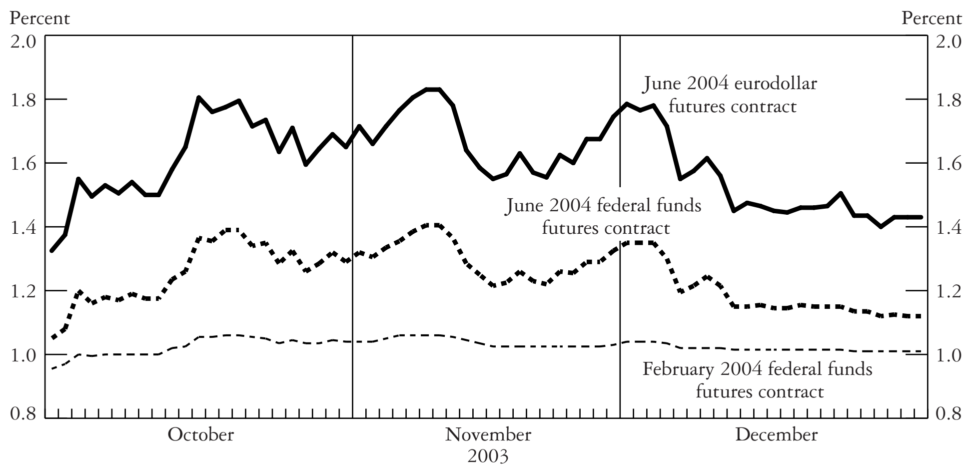
U.S. TREASURY YIELDS



Source: Bloomberg L.P.

Chart 3

RATES IMPLIED BY U.S. INTEREST RATE FUTURES CONTRACTS

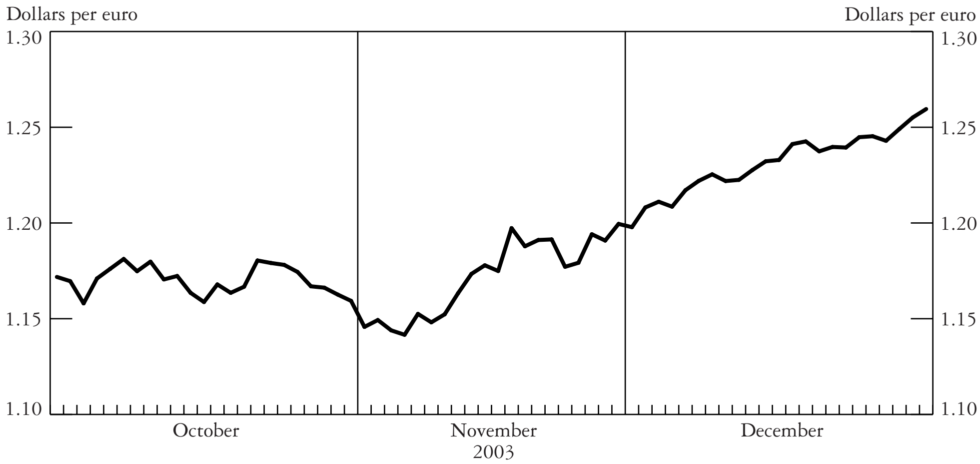


Source: Bloomberg L.P.

The euro appreciated to a record high against the dollar late in the quarter. Market participants reportedly felt more comfortable expressing negative dollar views against the euro and other higher-yielding currencies as they remained highly attuned to official views on recent currency movements. Many noted that while Asian officials consistently expressed discomfort with their currencies' appreciation, there was less certainty about the views of European officials on policy implications of a strong euro. Comments from European Central Bank (ECB) officials were followed closely, with ECB Governing Council members generally reiterating the ECB's support for a strong and stable euro. At the same time, market participants noted concerns expressed by several European finance ministers over the euro's rise. The euro's higher yield relative to the dollar also supported the single currency, with market participants generally expecting the ECB's main policy interest rate to remain at 2.0 percent for some time.

Chart 4

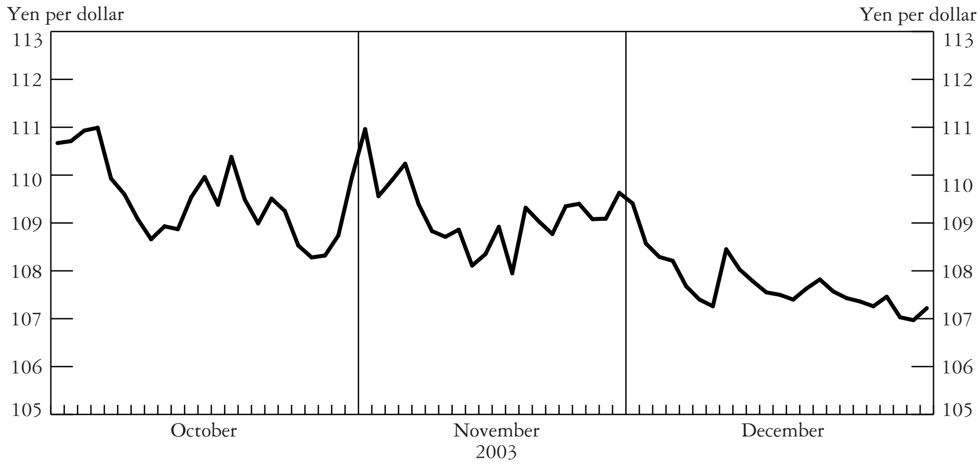
EURO AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

The yen's gains against the dollar were limited throughout the quarter by continued evidence of the Japanese authorities' commitment to stem the yen's appreciation. The Japanese Ministry of Finance (MoF) announced that it sold ¥1.5996 trillion in yen sales for dollars between October 30 and November 26 and ¥2.2519 trillion between November 27 and December 26. Given this large intervention activity, market participants noted that the MoF was likely nearing its ¥79 trillion statutory borrowing limit on the Foreign Exchange fund used to finance interventions. However, on December 26, the Bank of Japan announced that it would establish a ¥10 trillion facility to enter into yen-denominated repurchase agreements with the MoF using U.S. Treasury notes as collateral. The Ministry of Finance also announced plans to support an increase in its borrowing limit on the Foreign Exchange fund by ¥21 trillion as part of a supplementary budget for the Japanese fiscal year 2003 and by ¥40 trillion for fiscal year 2004. Market participants suggested that these announcements highlighted the MoF's intent to fully maintain its intervention capabilities. From the second week of November through the end of the quarter, the yen appreciated 2.0 percent against the dollar compared with the euro's 9.3 percent rise in that same period.

Chart 5
YEN AGAINST U.S. DOLLAR

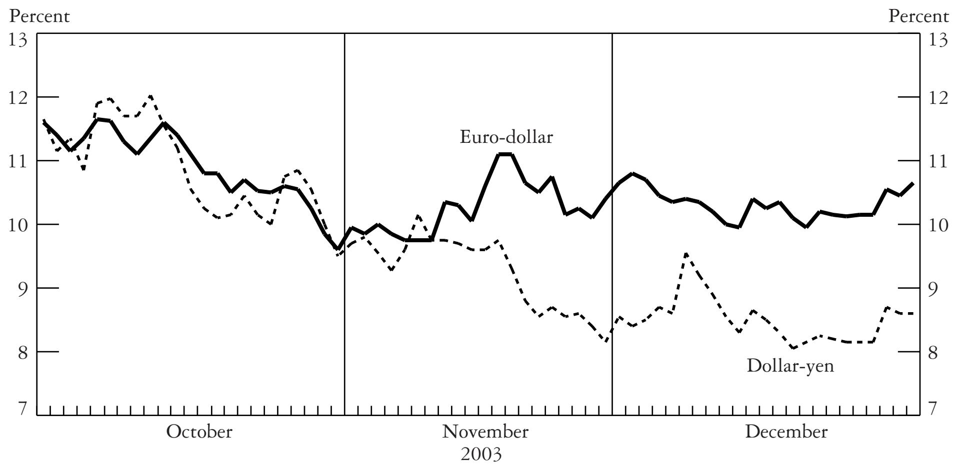


Source: Bloomberg L.P.

Currency option-implied volatility for G-3 currencies remained at relatively low levels for much of the quarter. Volatility implied by one-month euro-dollar currency options was modestly lower on net over the quarter, declining slightly as the dollar appreciated at the end of October but rising slightly toward the end of the quarter when the dollar depreciated rapidly. Volatility implied by one-month dollar-yen currency options trended lower as the dollar-yen currency pair traded within a narrow range for much of the quarter. In general, implied volatility for the two currency pairs remained within ranges maintained over the course of the year.

Chart 6

ONE-MONTH CURRENCY OPTION-IMPLIED VOLATILITY



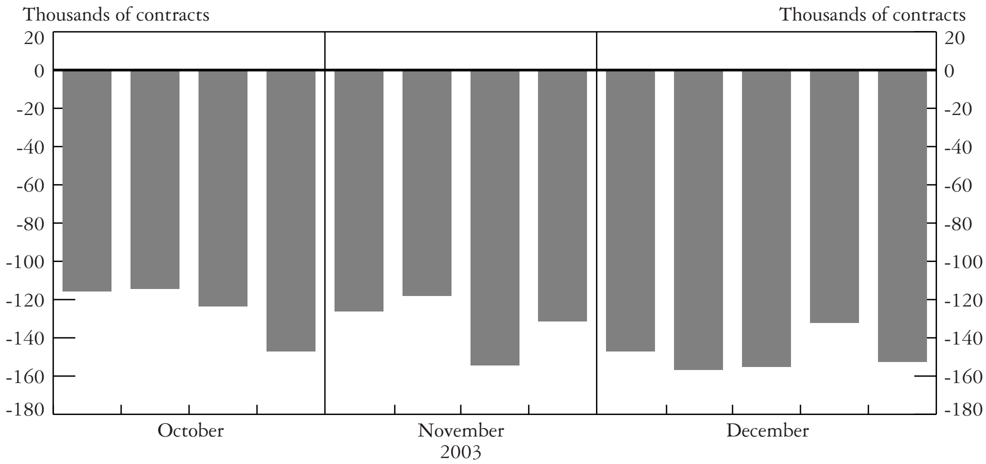
Source: Bloomberg L.P.

Capital flow and trade data, as well as news on international trade disputes, garnered market participants' attention given concerns about the U.S. current account balance. Treasury International Capital (TIC) data for September, released in mid-November, revealed a significant decrease in net foreign investment into the United States, though it was followed by an increase in the October TIC release. Separately, the September trade figures showed the trade deficit expanded to $41.3 billion from $39.6 billion the previous month, and the October trade figures showed the deficit rose further to $41.6 billion. Heightened trade tensions between the United States and other countries further weighed on the dollar amid a perception that these disagreements could impede U.S. exports. Threats of retaliation by other countries against U.S. steel tariffs led to concerns over a possible escalation in trade conflicts and protectionism, although the dispute was resolved later in the quarter. News that imports of textiles from China would be limited also raised concerns about global protectionism.

The number of short dollar positions against most currencies were significant and were reportedly established by a variety of investors. Net short dollar positions held by noncommercial accounts on the International Money Market of the Chicago Mercantile Exchange neared the highest level in 2003 toward the end of the quarter.

Chart 7

NET U.S. DOLLAR POSITIONS HELD BY NONCOMMERCIAL ACCOUNTS ON THE CHICAGO MERCANTILE EXCHANGE[a]



Source: Bloomberg L.P.

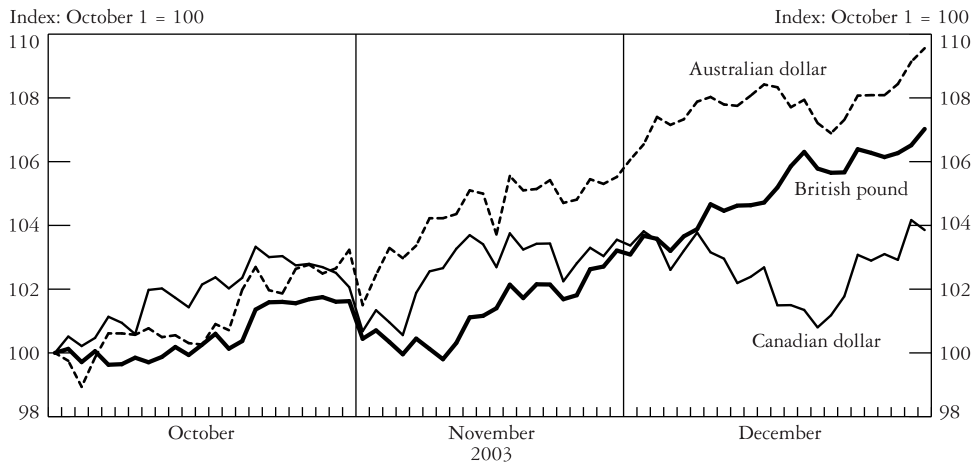
[a]Net dollar positions against the Australian dollar, British pound, Canadian dollar, euro, Japanese yen, Mexican peso, and Swiss franc.

INTEREST RATE DIFFERENTIALS SUPPORT HIGHER-YIELDING CURRENCIES

Contrasting expectations for monetary policy between the United States and other major economies contributed to the sharp appreciation of several major currencies against the dollar. As prospects for a global economic recovery improved, a few central banks began to tighten policy rates. The Bank of England raised its benchmark repo rate by 25 basis points to 3.75 percent on November 6. Although market expectations suggested only a gradual tightening cycle, the increased yield differential reportedly benefited the British pound, which appreciated 7.5 percent against the dollar over the quarter. Two 25-basis point increases to the Reserve Bank of Australia's target rate supported the Australian dollar. Expectations for additional rate increases in Australia amid strong economic fundamentals led the Australian dollar to gain 10.6 percent against the U.S. dollar, outperforming other major currencies' gains against the U.S. dollar. The Canadian dollar's gains against the dollar were more limited compared with some of the other major currencies due to expectations that additional rate cuts might be possible, especially in light of comments by Canadian officials, who expressed concerns over the impact of the currency's strength on the Canadian economy.

Chart 8

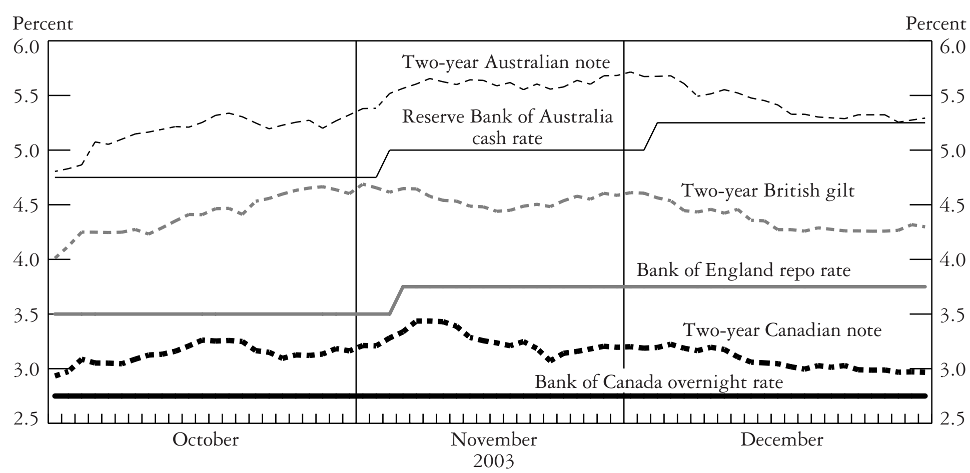
U.S. DOLLAR AGAINST SELECT HIGHER-YIELDING CURRENCIES



Source: Bloomberg L.P.

Chart 9

TWO-YEAR GOVERNMENT DEBT YIELDS AND POLICY RATES



Source: Bloomberg L.P.

TREASURY AND FEDERAL 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 $19.9 billion for the Federal Reserve's System Open Market Account and $19.9 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 French, German, 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 December 31, 2003, 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 $4.1 billion at the end of the quarter and also were split evenly between the two authorities.

Table 1

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

Millions of Dollars

	Carrying Value September 30, 2003[a]	Quarterly Changes in Balances by Source: Net Purchases and Sales[b]	Investment Earnings[c]	Realized Profit/Loss on Sale[d]	Unrealized Profit/ Loss on Foreign Currency Revaluation[e]	Carrying Value December 31, 2003[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	10,160.5	0	62.9	0	828.7	11,052.1
Yen	8,475.5	0	0.3	0	340.2	8,816.0
Total	18,636.0	0	63.2	0	1,168.9	19,868.1
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	10,147.6	0	62.5	0	827.6	11,037.7
Yen	8,475.5	0	0.3	0	340.2	8,816.0
Total	18,623.1	0	62.8	0	1,167.8	19,853.7

[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

Millions of Dollars

Carrying Value as of December 31, 2003	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:	**11,037.7**	**11,052.1**
Cash held on deposits at official institutions	6,872.8	6,891.4
Marketable securities held under repurchase agreements[a]	2,035.0	2,035.0
Marketable securities held outright[b]	2,129.9	2,125.7
German government securities	1,349.4	1,345.2
French government securities	780.5	780.5
Yen-denominated assets:	**8,816.0**	**8,816.0**
Cash held on deposit at official institutions	1,474.8	1,474.8
Marketable securities held outright[b]	7,341.2	7,341.2

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

[b] As of December 31, 2003, euro and yen securities holdings had Macaulay durations of 30.0 and 3.3 months, respectively.

Table 3

FEDERAL RESERVE SYSTEM OPEN MARKET ACCOUNT RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	**Amount of Facility**	**Outstanding as of December 31, 2003**
Bank of Canada	2,000	0
Bank of Mexico	3,000	0
Total	5,000	0

U.S. TREASURY EXCHANGE STABILIZATION FUND RECIPROCAL CURRENCY ARRANGEMENT

Million of Dollars

Institution	**Amount of Facility**	**Outstanding as of December 31, 2003**
Bank of Mexico	3,000	0
Total	3,000	0