TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 2005

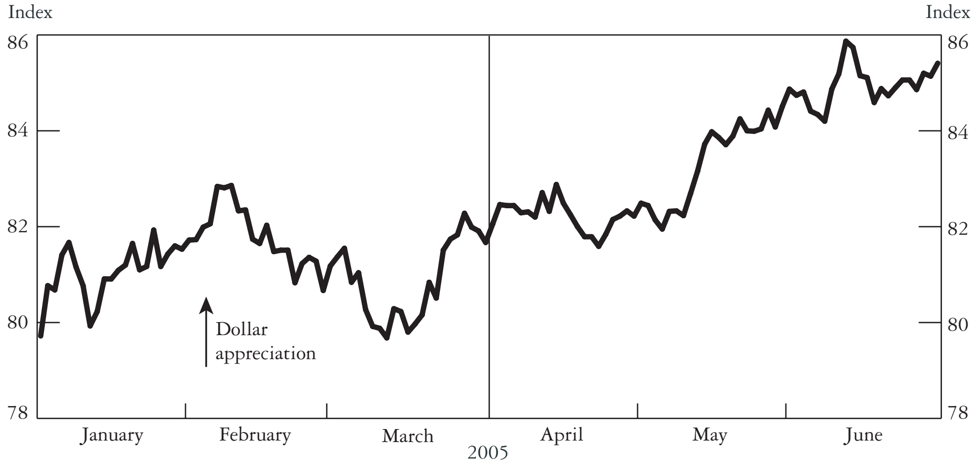
During the second quarter of 2005, the dollar's trade-weighted exchange value rose 4.6 percent as measured by the Federal Reserve Board's major currencies index. The dollar appreciated 6.6 percent against the euro and 3.4 percent against the yen. The dollar's exchange value rose over the period as growth and interest rate differentials were perceived to favor the dollar over other major currencies. Despite the marked appreciation of the dollar against other major currencies, both historical and option-implied volatilities in the currency market remained historically low. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

THE DOLLAR APPRECIATES AMID AN IMPROVED U.S. ECONOMIC OUTLOOK

After trading in a narrow range for the first four months of the year, the dollar appreciated broadly starting in May and, on a trade-weighted basis, ended the second quarter of 2005 close to its highest level since October 2004. The appreciation of the dollar could, in part, be attributed to an improving view of the United States' prospects for economic growth since weaker-than-expected economic data were released in late April. The larger-than-expected increase in April nonfarm payrolls, issued on May 6, and narrower-than-expected March trade deficit released on May 11 contributed to the positive sentiment toward U.S. growth and the dollar. The improved sentiment appeared to be confirmed by the June release of an upward revision of first-quarter GDP growth to 3.8 percent. Additionally, weaker-than-expected economic data in Europe and continued uncertainty about Japan's growth prospects reportedly bolstered the dollar's rise.

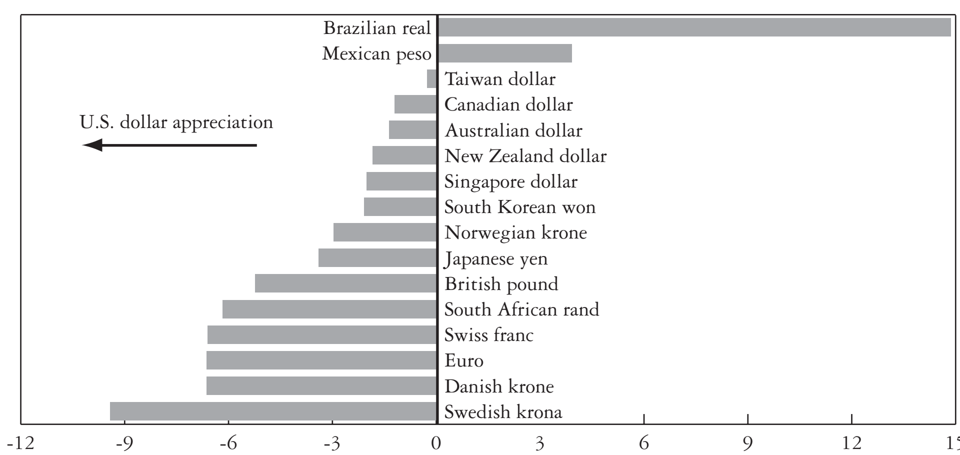
This report, presented by Dino Kos, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from April through June, 2005. Phil de Imus was primarily responsible for preparation of the report.

Chart 1
TRADE-WEIGHTED U.S. DOLLAR



Source: Board of Governors of the Federal Reserve System.

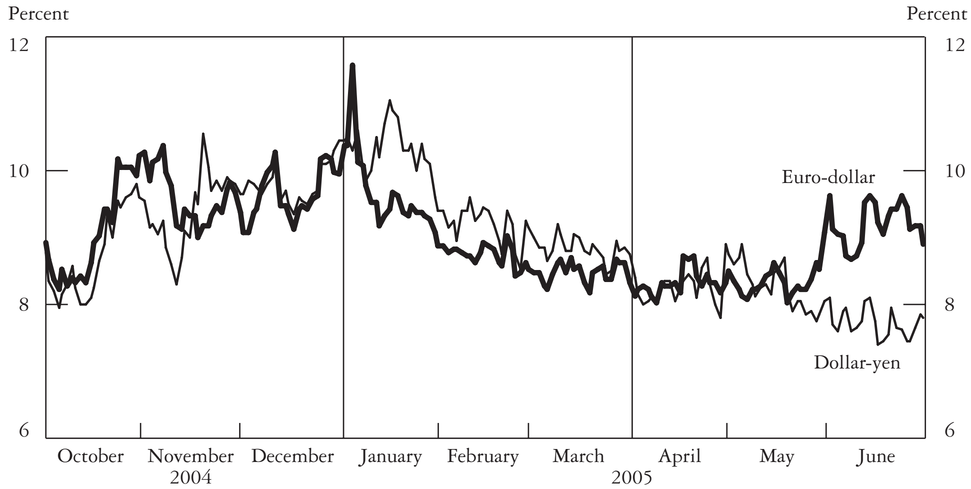
Chart 2
PERCENTAGE CHANGE IN WORLD CURRENCIES
SECOND QUARTER, 2005



Source: Bloomberg L.P.

Chart 3

ONE-MONTH OPTION-IMPLIED VOLATILITY



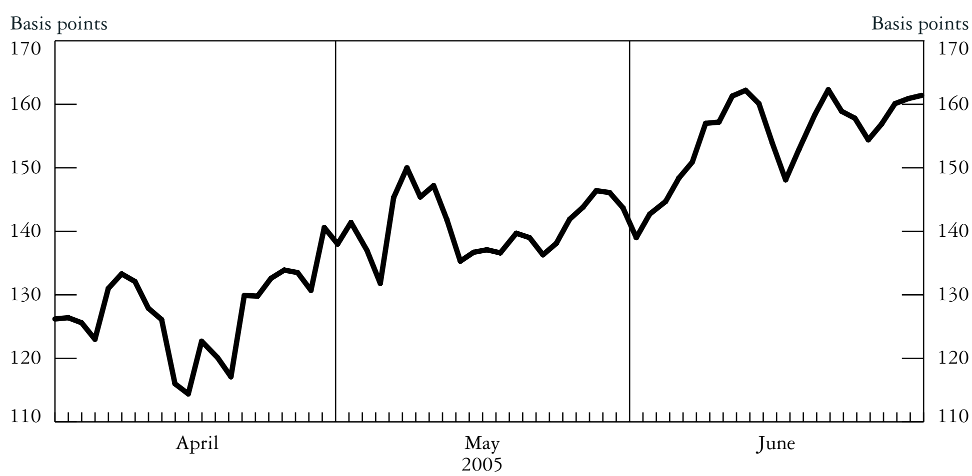
Source: Bloomberg L.P.

Another factor that supported the dollar during the quarter was the expectation of wider interest rate differentials between the United States and both Europe and Japan. Market participants continued to expect further interest rate increases by the Federal Reserve while expecting no change in the policy stance of the Bank of Japan or the European Central Bank (ECB) in the near term. The Federal Open Market Committee did raise its target for the federal funds rate by 25 basis points at both the May 3 and June 30 meetings, increasing the target to 3.25 percent at the end of the period. Additionally, although implied rates on December 2005 eurodollar futures contracts changed only modestly during the quarter, those on December 2005 euribor and euroyen futures contracts declined significantly. Contributing to these declines were the Swedish Riksbank's decision on June 21 to cut its benchmark interest rate by a greater-than-expected 50 basis points, to 1.50 percent, and the vote by two of the nine members of the Bank of England's Monetary Policy Committee to cut the two-week repo rate during the committee's June meeting. Market participants interpreted these actions as signs that the economic slowdown in Europe was greater than previously thought, a view that could increase the possibility that the ECB might cut interest rates at some point in 2006. This view contributed to the 33 basis point increase in the spread between U.S. and German two-year government note yields.

Diminished focus on the U.S. current account deficit as the second quarter progressed also contributed to the dollar's appreciation. The monthly trade balances for March and April — released in May and June, respectively — showed a narrower-than-expected deficit. This outcome encouraged investors to pay greater attention to growth and interest rate differentials among countries and less attention to the current account deficit during the period. Moreover, the U.S. Treasury Department's release of lower-than-expected net purchases of U.S. long-term securities for March and April had a limited impact on the dollar's exchange value, suggesting that investors were less concerned about the funding of the current account deficit.

Chart 4

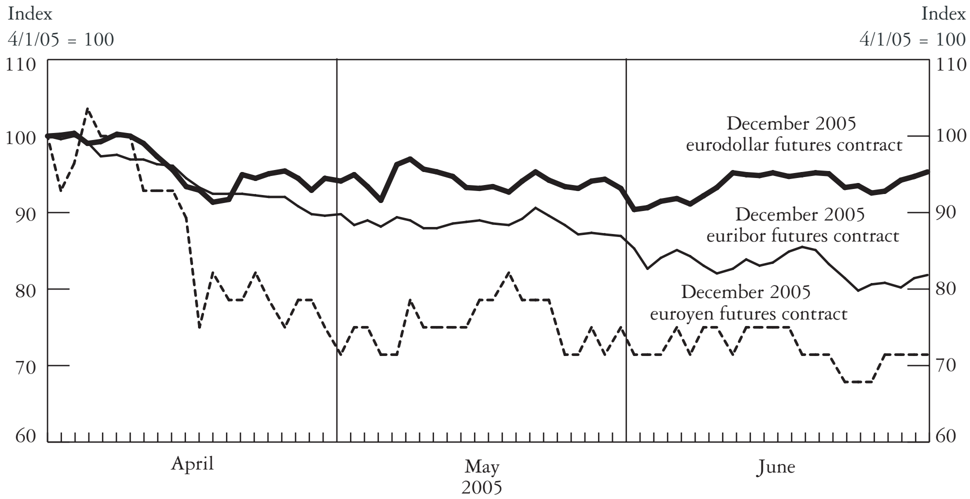
SPREAD OF U.S. TWO-YEAR TREASURY NOTE YIELD OVER GERMAN TWO-YEAR SOVEREIGN NOTE YIELD



Source: Bloomberg L.P.

Chart 5

CHANGE IN IMPLIED RATES ON G-3 INTEREST RATE FUTURES CONTRACTS



Source: Bloomberg L.P.

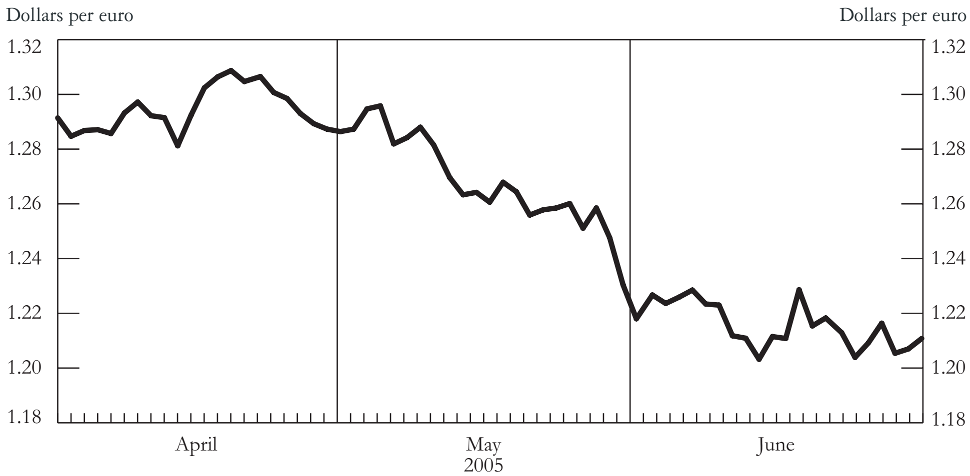
DEVELOPMENTS IN EUROPE AND ASIA ALSO AFFECTED THE DOLLAR

Decisions by French and Dutch voters to reject the proposed European Union constitution reportedly hurt sentiment toward the euro. Although market participants had expected a negative outcome, the percentage of the no votes in both countries was larger than anticipated. In addition, the inability of European finance ministers to reach a European Union budget agreement weighed on the euro.

Market participants also focused on the possibility of a near-term revaluation of the Chinese currency, the renminbi, which contributed to exchange rate activity. Movements during the quarter in some other Asian currencies' exchange rates, including the Japanese yen's, tended to track sentiment regarding the possibility of a renminbi revaluation. Market participants expected that other Asian currencies would also appreciate in the event of a revaluation of the renminbi. Rising crude oil prices from the middle of May also reportedly contributed to uncertainty about Japan's economic growth prospects. From May 19, the intra-quarter low in crude oil prices, the price on the front-month West Texas intermediate crude oil futures contract rose about 15 percent, to more than $57 per barrel, by the end of the quarter.

Chart 6

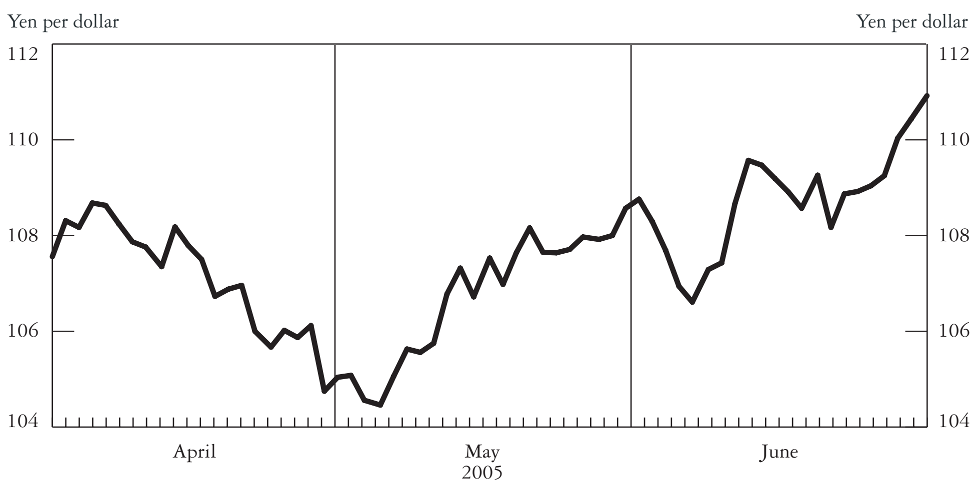
EURO AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

Chart 7

YEN AGAINST U.S. DOLLAR



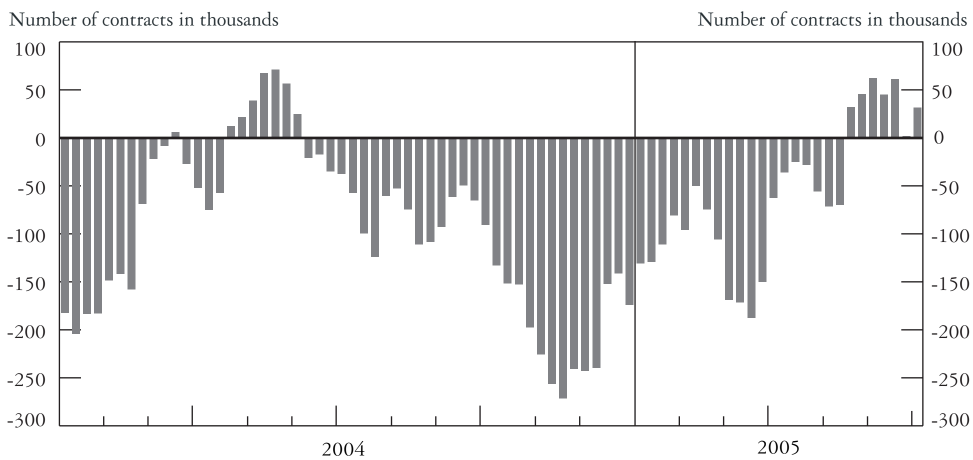
Source: Bloomberg L.P.

THE DOLLAR'S APPRECIATION CONTRIBUTES TO A SHIFT IN POSITIONING AND SENTIMENT

As the dollar appreciated over the course of the quarter, some common indicators of investor positioning and market sentiment turned in favor of the dollar. The IMM noncommercial positioning data, as tracked by the Chicago Mercantile Exchange, shifted to a net long dollar position from a net short position. Also during the quarter, a number of currency analysts revised their short-term exchange rate forecasts to favor further dollar appreciation, and moderated their forecasts for the dollar to depreciate over the longer term. Moreover, short-dated risk reversals in the euro-dollar currency pair shifted to suggest increased demand for protection against further dollar appreciation against the euro. Risk reversals on the dollar-yen currency pair suggested diminished demand for protection against an appreciation of the yen relative to the dollar.

Chart 8

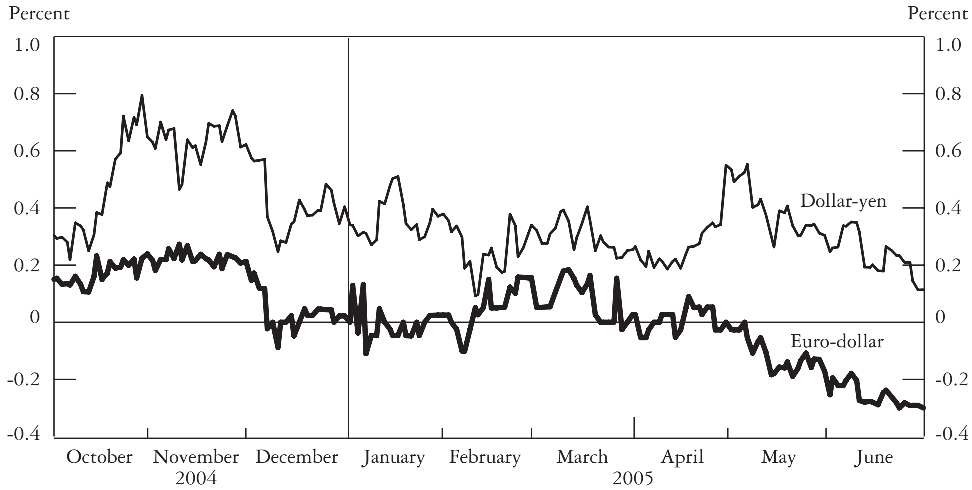
IMM NET NONCOMMERCIAL POSITIONING IN THE DOLLAR



Source: Bloomberg L.P.

Chart 9

ONE-MONTH RISK REVERSALS



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 $19.5 billion for the Federal Reserve System Open Market Account and $19.5 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 $21.3 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $3.9 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

	Carrying Value March 31, 2005[a]	Change in Balance 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 June 30, 2005[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	11,729.3	0	69.8	0	-789.7	11,009.4
Yen	8,809.6	0	0.1	0	-293.1	8,516.6
Total	20,538.9	0	69.9	0	-1,082.8	19,526.0
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	11,712.1	0	69.4	0	-788.6	10,992.9
Yen	8,809.7	0	0.1	0	-293.1	8,516.7
Total	20,521.8	0	69.5	0	-1,081.7	19,509.6

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 "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, 2005

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets[a]:	**10,992.9**	**11,009.4**
Cash held on deposit at official institutions	5,465.4	5,483.8
Marketable securities held under repurchase agreements[b]	1,951.2	1,951.2
Marketable securities held outright	3,576.3	3,574.4
German government securities	1,587.2	1,585.3
French government securities	1,989.1	1,989.1
Yen-denominated assets[a]:	**8,516.7**	**8,516.6**
Cash held on deposit at official institutions	1,425.4	1,425.3
Marketable securities held outright	7,091.3	7,091.3

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

[a] As of June 30, euro and yen portfolios had Macaulay durations of 10.6 months and 2.3 months, respectively. These numbers were revised February 13, 2006.

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

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2005
	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.