TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October–December 2004

During the last quarter of 2004, the dollar's trade-weighted exchange value declined 6.7 percent as measured by the Federal Reserve Board's nominal major currencies index. The dollar depreciated 8.2 percent against the euro and 6.7 percent against the yen. While the dollar remained relatively range-bound in the prior quarter, it declined broadly in this quarter as market participants renewed focus on the size of the U.S. current account deficit and its implications for the dollar. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

THE DOLLAR DECLINES BROADLY IN THE PERIOD

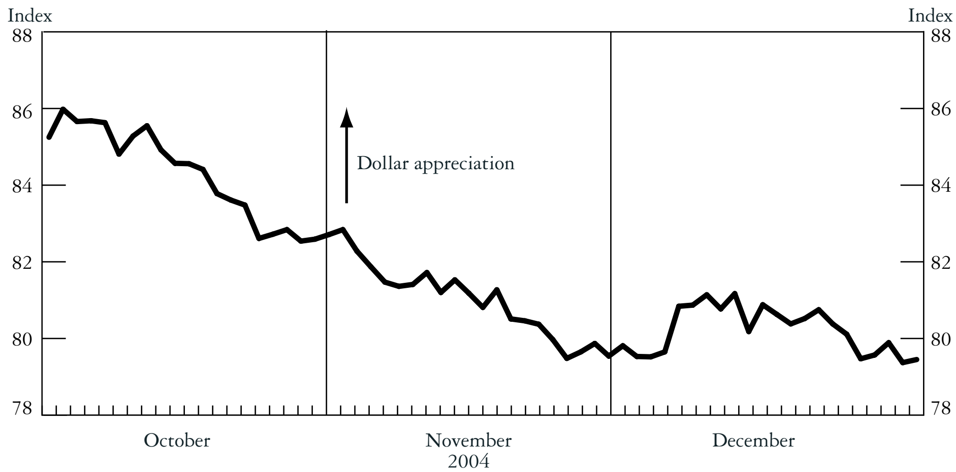
The dollar depreciated broadly over the fourth quarter of 2004. The dollar broke out of the range in which it traded in the prior quarter, but option-implied volatility remained relatively low. The distribution of the dollar's declines was fairly widespread over the period, and the Federal Reserve's nominal major currencies index of the dollar's exchange value reached its weakest level since April 1995.

Toward the end of the fourth quarter, the yen closed at its strongest level against the dollar since early 2000, while the euro reached its highest level against the dollar since the euro's inception in January 1999. The synthetic euro—which offers a longer data history for comparison based upon the currencies expected to convert to the euro upon its launch—reached its strongest level against the dollar since 1992.

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 2004. Jamie Pfeifer was primarily responsible for preparation of the report.

Chart 1

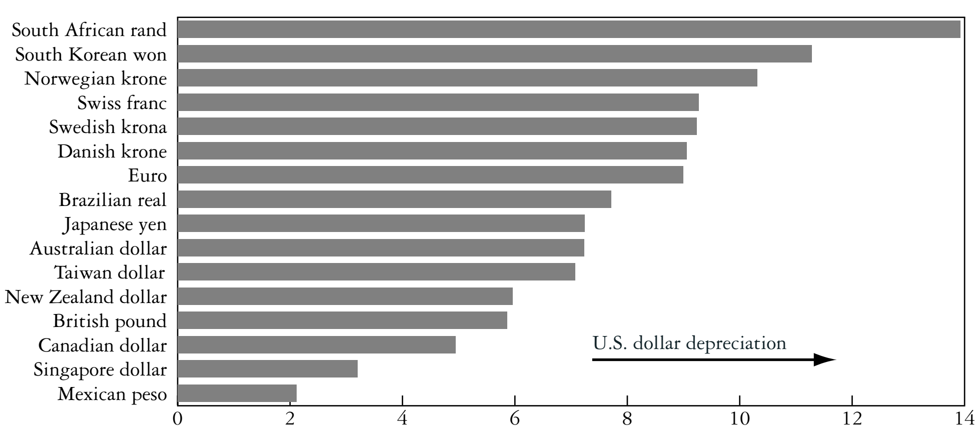
TRADE-WEIGHTED U.S. DOLLAR



Source: Board of Governors of the Federal Reserve System.

Chart 2

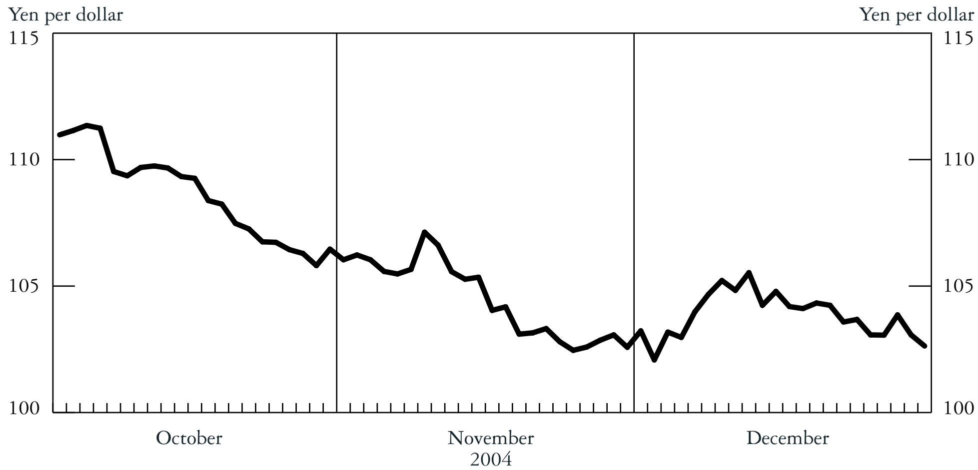
PERCENTAGE CHANGE OF WORLD CURRENCIES, FOURTH QUARTER 2004



Source: Bloomberg L.P.

Chart 3

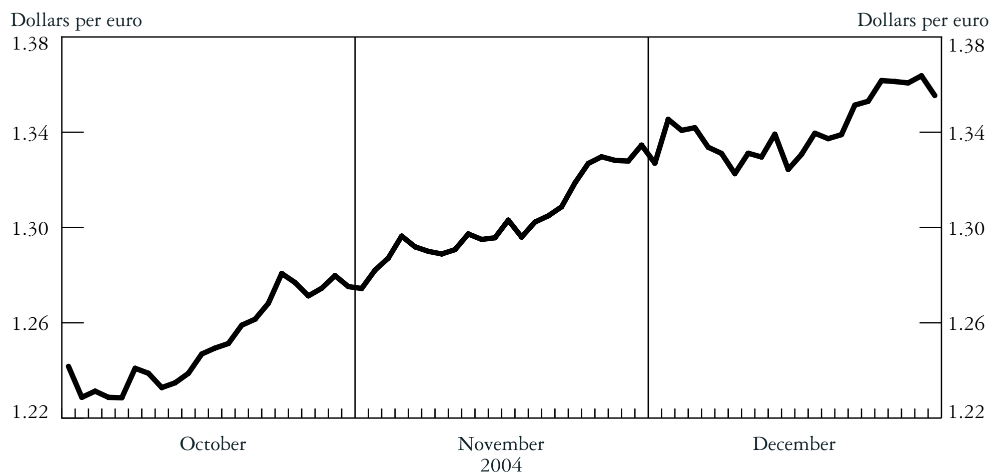
YEN AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

Chart 4

EURO AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

MARKET PARTICIPANTS RENEW FOCUS ON SIZE OF U.S. CURRENT ACCOUNT DEFICIT AND FORECAST DOLLAR DECLINES

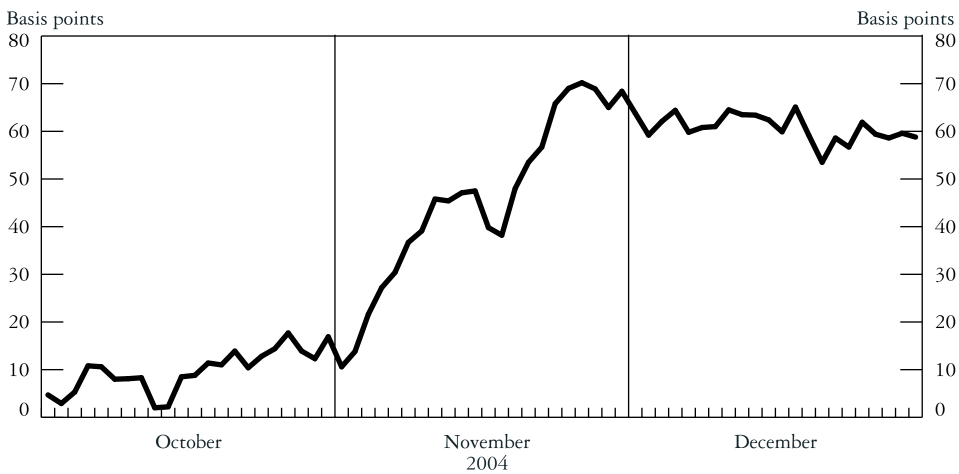
The fourth quarter of 2004 began with a renewed market focus on the U.S. current account deficit. Although this factor had been present in the background in prior quarters, it shifted to the foreground in this quarter. Market participants were especially sensitive to any developments associated with the U.S. trade and current account positions, such as the release of trade balance and international flow data. On October 14, the August U.S. trade balance recorded a $54 billion deficit compared with the consensus forecast of a $51.4 billion deficit. Following the news of the larger-than-expected trade deficit, the dollar depreciated roughly 0.7 percent on a trade-weighted basis. Later in the quarter, the dollar was pressured to decline further following the release of October Treasury International Capital data. The exchange value of the dollar declined heading into the release of the data on December 15 and then extended the depreciation following the announcement of a net foreign inflow of $48.1 billion in long-term securities, the lowest level since October 2003. While the headline figure in the October 2004 report was lower than the prior month's number, the private net inflows component remained relatively robust. Following the data release, the dollar ended 1.2 percent weaker on a trade-weighted basis.

The focus on the U.S. trade and current account positions reinforced expectations of further dollar depreciation and made investors particularly sensitive to official comments on currency market issues. In a November 17 speech in London, Treasury Secretary Snow commented, "Let me be clear: our policy is for a strong dollar," and further noted that "the desired policy of exchange values that are set in open, competitive markets are reflected in the G7 communiqué." In a November 19 speech in Frankfurt, Chairman Greenspan commented, "given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point." While neither of these comments was significantly different from those in the past, analysts noted that the remarks likely had more of an impact given the heightened degree of attention on the subject over this quarter. The dollar closed nearly 0.5 percent weaker on a trade-weighted basis on November 17 and 0.9 percent weaker on November 19. Outside the United States, official commentary was similar to past comments, with European officials characterizing recent currency movements as unwelcome and Japanese officials remarking that they were monitoring developments closely.

With investors focused on the current account deficit, the dollar found little support from the U.S. economic data released during the period and from widening interest rate differentials. Over the quarter, the Federal Open Market Committee (FOMC) raised the target federal funds rate by a total of 50 basis points; the yield on the two-year Treasury note also rose by nearly that amount. In addition, expectations that the FOMC would continue to increase the target rate at a measured pace were supported by the economic data released in the fourth quarter. Implied rates on U.S. interest rate futures contracts moved higher over the period, particularly for contracts maturing in 2005. In contrast, implied rates on comparable interest rate futures in the euro area were modestly lower over the quarter, and the spread between U.S. and German two-year sovereign debt yields rose from nearly zero to roughly 60 basis points.

Chart 5

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



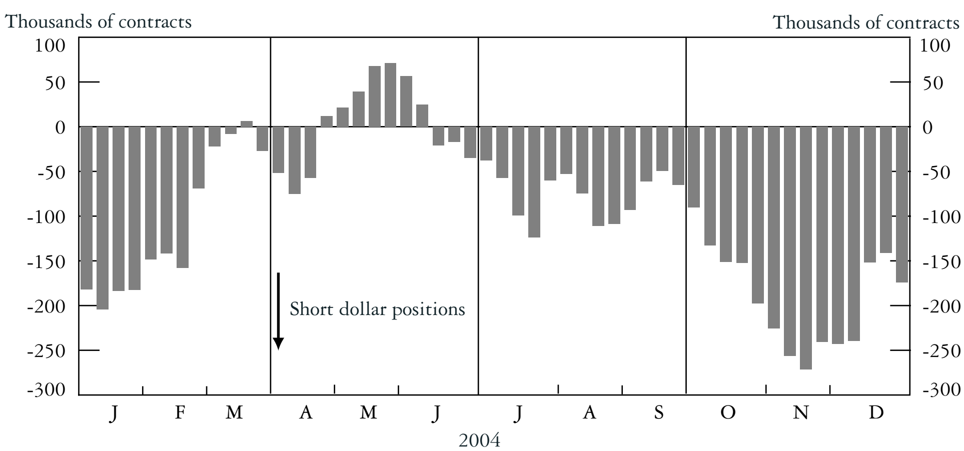
Source: Bloomberg L.P.

Consistent with negative market sentiment toward the dollar over the period, short dollar positions were reported to have increased. According to Commodity Futures Trading Commission data, net noncommercial dollar positions were short throughout the quarter and particularly short toward the middle of the quarter—patterns consistent with anecdotal reports of changes in positioning more generally.

In addition, as short dollar positions increased and the dollar broke out of its trading ranges of the prior quarter, option-implied volatility also picked up. Still, volatility remained relatively subdued and below levels seen earlier in the year.

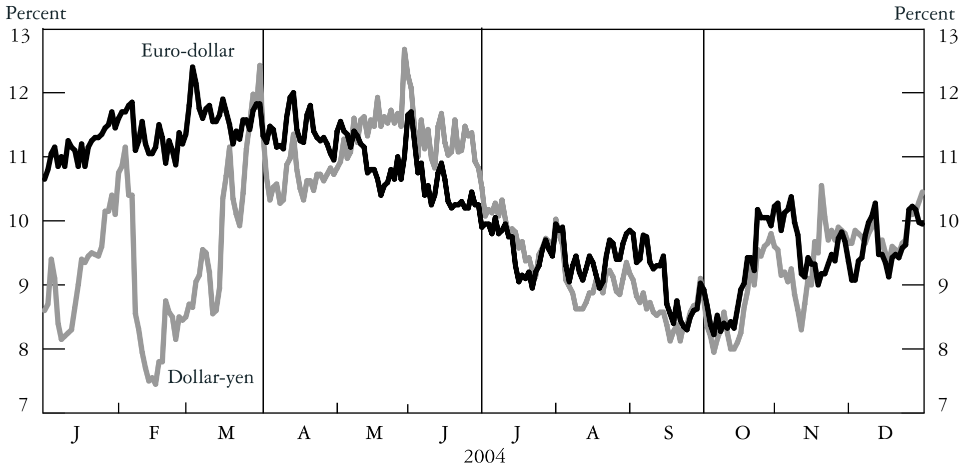
Chart 6

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



Source: Commodity Futures Trading Commission.

Chart 7
ONE-MONTH OPTION-IMPLIED VOLATILITY



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 $21.4 billion for the Federal Reserve's System Open Market Account and $21.4 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 December 31, direct holdings of foreign government securities totaled $23.2 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4.3 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

		Changes in Balances by Source				
	Carrying Value September 30, 2004[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 December 31, 2004[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	11,091.8	0	73.7	0	1,003.3	12,168.8
Yen	8,571.1	0	0.2	0	627.7	9,199.0
Total	19,662.9	0	73.9	0	1,631.0	21,367.8
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	11,076.2	0	73.2	0	1,002.0	12,151.4
Yen	8,571.1	0	0.2	0	627.8	9,199.1
Total	19,647.3	0	73.4	0	1,629.8	21,350.5

[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 December 31, 2004

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:	**12,151.4**	**12,168.8**
Cash held on deposit at official institutions	6,058.1	6,078.5
Marketable securities held under repurchase agreements[a]	2,143.6	2,143.6
Marketable securities held outright[b]	3,949.6	3,946.6
German government securities	1,886.7	1,883.7
French government securities	2,062.9	2,062.9
Yen-denominated assets:	**9,199.1**	**9,199.0**
Cash held on deposit at official institutions	1,539.6	1,539.5
Marketable securities held outright[b]	7,659.5	7,659.5

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

[b] As of December 31, euro and yen securities holdings had Macaulay durations of 29 months and 3.4 months, respectively.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of December 31, 2004
	Federal Reserve System Open Market Account	
Bank of Canada	2,000	0
Bank of Mexico	3,000	0
Total	5,000	0
	U.S. Treasury Exchange Stabilization Fund	
Bank of Mexico	3,000	0
Total	3,000	0