TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October–December 2005

During the fourth quarter of 2005, the dollar's trade-weighted exchange value increased 2.0 percent as measured by the Federal Reserve Board's major currencies index. The dollar appreciated approximately 1.5 percent against the euro and 3.7 percent against the yen. Actual and option-implied volatilities in the currency market were slightly higher than in the preceding quarter but remained at historically low levels, consistent with the low volatility observed in many asset classes. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

THE DOLLAR APPRECIATES MODESTLY AGAINST THE EURO

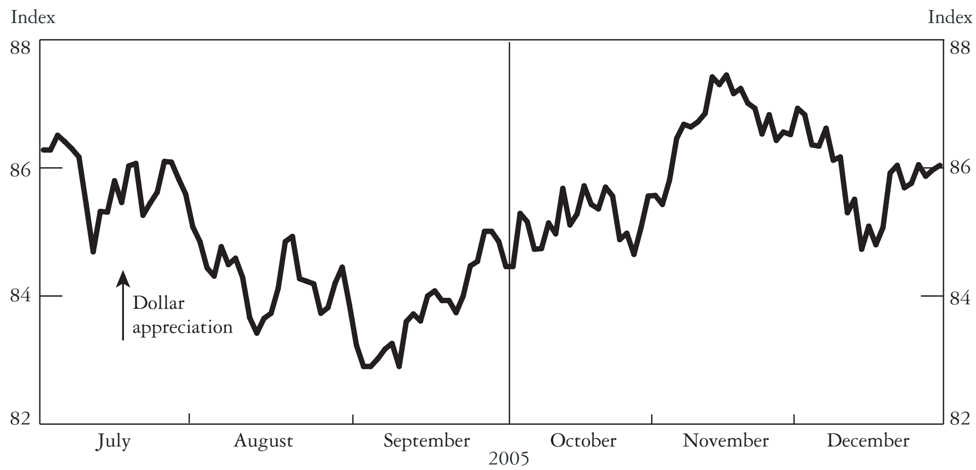
The dollar traded within a range of about \$1.1670 to \$1.2180 per euro in the fourth quarter, its narrowest range in more than a year. This narrow trading range contributed to the low levels of both actual and implied volatility for the euro-dollar currency pair over the period. The dollar ended the quarter moderately stronger against the euro, at \$1.1849 per euro.

The dollar's appreciation against the euro in early November partly reflected increased optimism about the outlook for the U.S. economy as concerns diminished about the potentially negative impact of elevated energy prices. This optimism was reinforced by the November 1 Federal Open Market Committee (FOMC) statement announcing the FOMC's decision to increase the target federal funds rate by 25 basis points. The statement was interpreted as expressing confidence that the economic impact of the Gulf Coast hurricanes would prove to be temporary. The FOMC

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 October through December 2005. Laura Brookins was primarily responsible for preparation of the report.

Chart 1

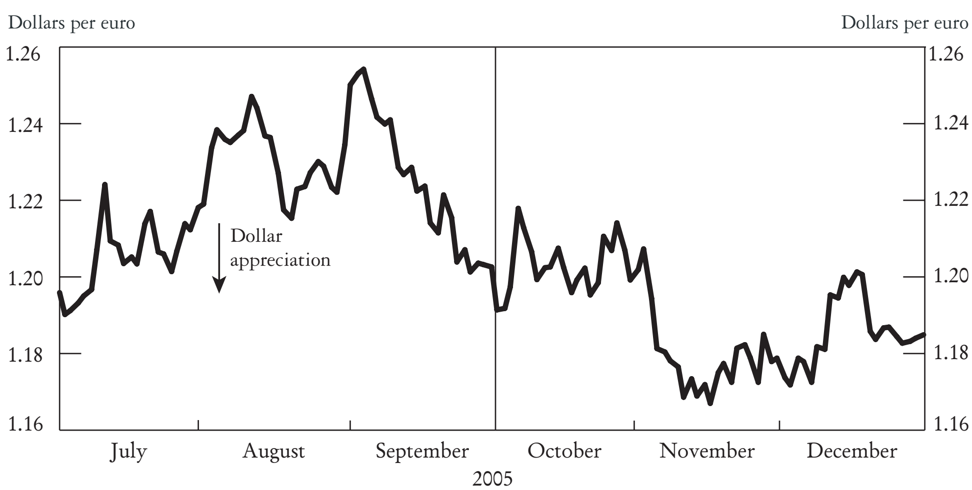
TRADE-WEIGHTED U.S. DOLLAR



Source: Bloomberg L.P.

Chart 2

EURO AGAINST U.S. DOLLAR



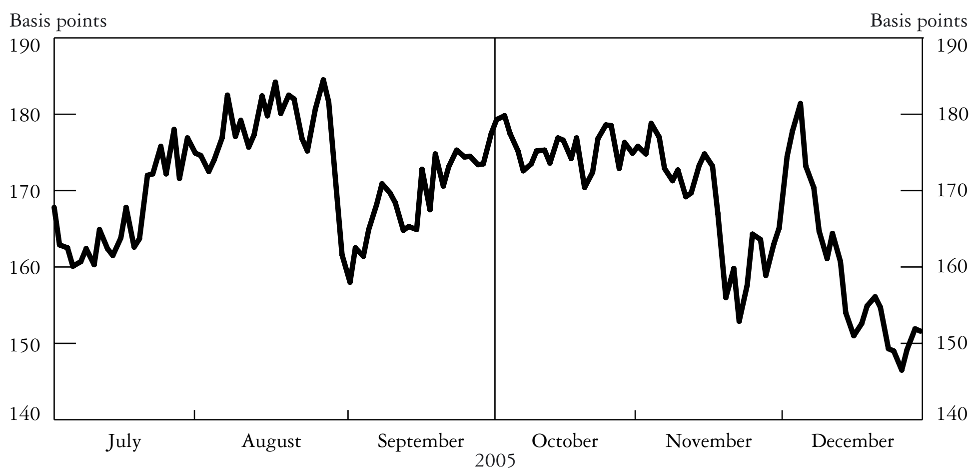
Source: Bloomberg L.P.

statement also implied that additional rate increases would be likely at upcoming meetings. Following this statement, U.S. interest rates increased modestly and interest rate differentials between the United States and the euro area remained relatively wide, lending further support to the dollar in November.

In late November and December, however, the euro partially reversed its weakness earlier in the quarter as sentiment toward the euro area's economic outlook began to improve. Growing speculation that the European Central Bank (ECB) would increase its target overnight rate at upcoming policy meetings was confirmed when the ECB raised this rate 25 basis points at its December 1 meeting for the first time since October 2000. This move led short-dated interest rates in the euro area to rise, and over the quarter the spread between U.S. and German two-year sovereign debt yields declined 23 basis points, a decrease that reportedly contributed to the dollar's modest depreciation against the euro toward the end of the fourth quarter of 2005. The narrowing of shorter-dated interest rate differentials occurred late in the quarter as market participants increasingly speculated that the FOMC was nearing the end of its tightening cycle and that the ECB was expected to raise its target overnight rate an additional 50 basis points over the upcoming six to twelve months.

Chart 3

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



Source: Bloomberg L.P.

THE DOLLAR APPRECIATES AGAINST THE YEN

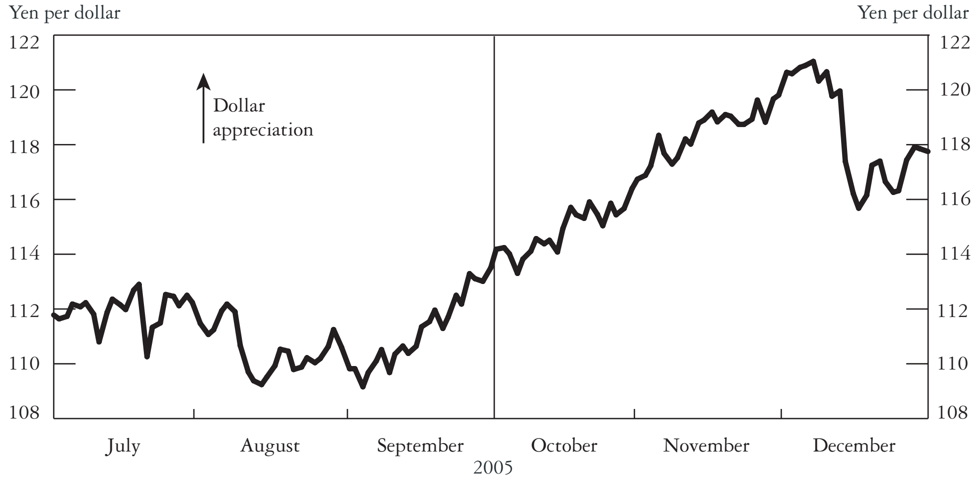
The dollar appreciated against the yen as interest rate differentials remained supportive of the U.S. currency despite data suggesting that the Japanese economy continued to improve. The dollar ended the quarter at ¥117.75 per dollar, but in early December the dollar had appreciated to ¥121.04, a two-and-a-half-year high. Market participants acknowledged that signs of improved economic growth in Japan had contributed to increased speculation that the Bank of Japan (BoJ) would move away from its quantitative easing policy sometime in 2006. Still, some market analysts suggested that the BoJ was unlikely to end its zero-nominal-interest-rate policy until inflation was zero or higher for a sustained period of time. In addition, improving sentiment about the Japanese economic outlook coupled with increased risk appetite among Japanese investors reportedly supported demand among Japanese investors for foreign assets. This factor was consistent with data from the Japanese Ministry of Finance indicating that Japanese investors were predominantly net purchasers of foreign securities during the fourth quarter.

However, interest rate differentials between the United States and Japan stabilized in the second half of the quarter amid increasing expectations that the BOJ could phase out its quantitative easing policy during the second quarter of 2006. Market participants reported that over much of the second half of 2005, the yen had been a popular currency in which to borrow funds because of the low levels of Japanese interest rates. The International Monetary Market (IMM) noncommercial positioning data, as tracked by the Chicago Mercantile Exchange, showed that net short yen positions had reached elevated levels by December. As speculation increased about an earlier-than-expected change in the BoJ's quantitative easing policy, some investors reportedly elected to take profits ahead of year-end on trades funded in yen. The yen appreciated more than three and a half percent against the dollar over a few trading days just before mid-December but still ended the quarter weaker against the dollar. Interest rate differentials continued to favor the dollar over the yen in absolute terms, a condition that, in the view of some market participants, had likely limited the extent of the yen's appreciation against the dollar in the final weeks of 2005.

The sharp move lower in the dollar-yen currency pair in mid-December contributed to an increase in actual and implied currency volatility over the quarter. However, implied volatility for the dollar-yen currency pair remained at historically low levels, with minimal spillover into higher implied volatility for the euro-dollar currency pair and other major currency pairs.

Chart 4

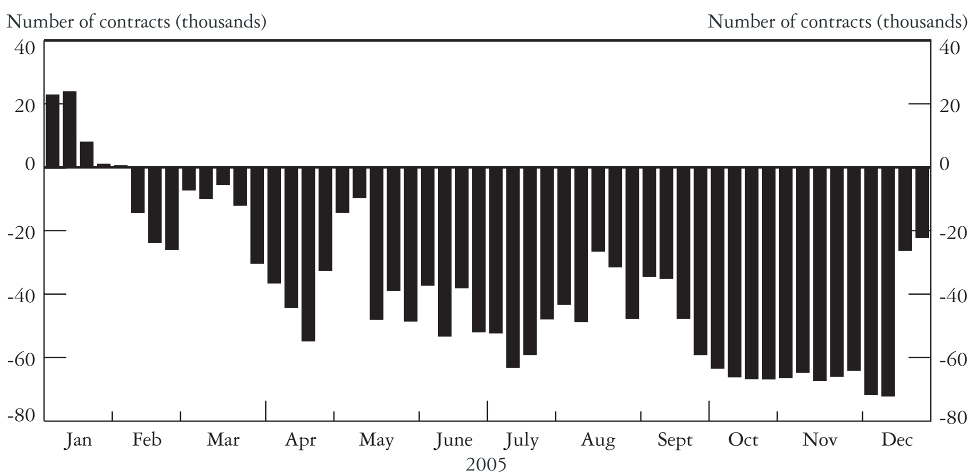
YEN AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

Chart 5

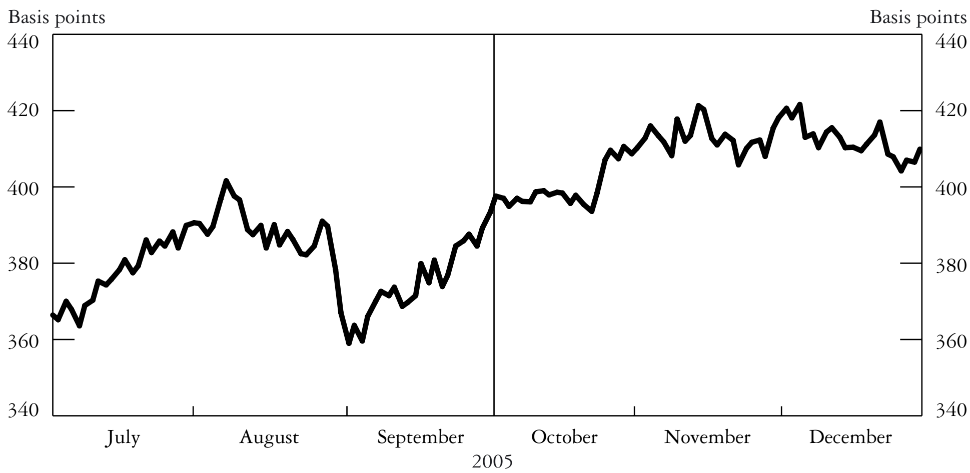
IMM NET NONCOMMERCIAL POSITIONING IN THE JAPANESE YEN



Source: Bloomberg L.P.

Chart 6

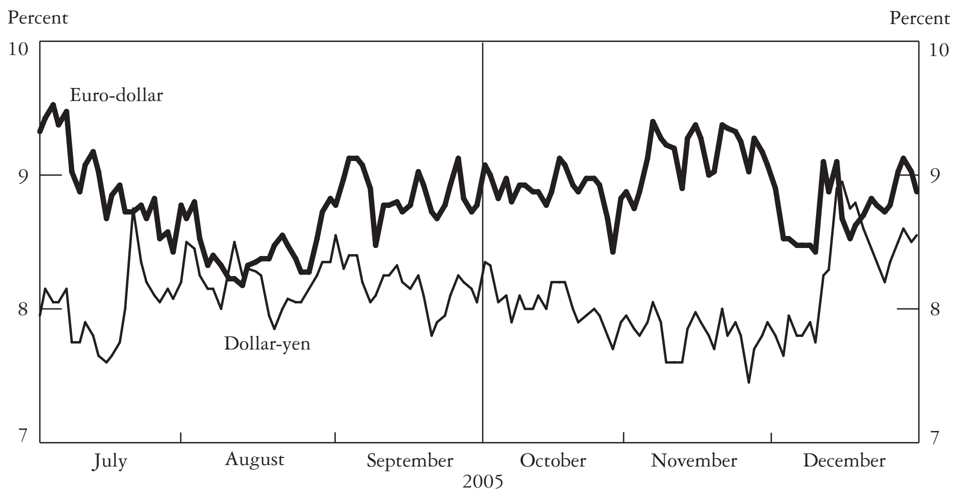
SPREAD OF U.S. TWO-YEAR TREASURY NOTE YIELD
OVER JAPANESE TWO-YEAR SOVEREIGN NOTE YIELD



Source: Bloomberg L.P.

Chart 7

ONE-MONTH OPTION-IMPLIED VOLATILITY



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 $18.9 billion for the Federal Reserve System Open Market Account and $18.9 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 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 $17.9 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

		Change in Balance by Source				
	Carrying Value September 30, 2005[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, 2005[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	11,041.5	0	69.4	0	-198.0	10,912.9
Yen	8,338.0	0	1.3	0	-324.7	8,014.6
Total	19,379.5	0	70.7	0	-522.7	18,927.5
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	11,024.7	0	68.9	0	-197.7	10,895.9
Yen	8,338.1	0	1.2	0	-324.7	8,014.6
Total	19,362.8	0	70.1	0	-522.4	18,910.5

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 December 31, 2005

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets[a]:	**10,895.9**	**10,912.9**
Cash held on deposit at official institutions	5,405.2	5,423.5
Marketable securities held under repurchase agreements[b]	1,928.5	1,928.5
Marketable securities held outright	3,562.2	3,560.9
German government securities	1,594.7	1,593.4
French government securities	1,967.5	1,967.5
Yen-denominated assets[a]:	**8,014.6**	**8,014.6**
Cash held on deposit at official institutions	2,617.6	2,617.6
Marketable securities held outright	5,397.0	5,397.0

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

[a]As of December 31, euro and yen portfolios had Macaulay durations of 10.2 months and 10.6 months, respectively. These numbers were revised February 13, 2006.

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

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of December 31, 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.