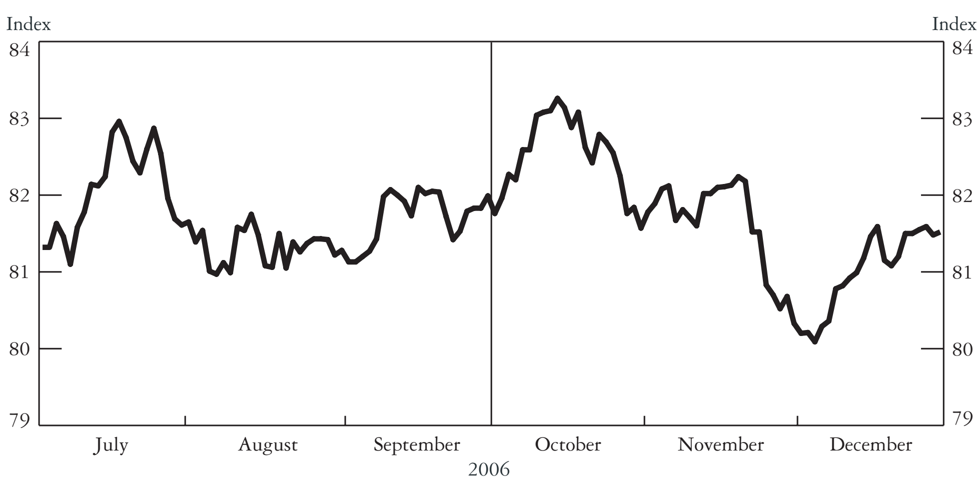
TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October–December 2006

During the final quarter of 2006, the trade-weighted exchange value of the dollar, as measured by the Federal Reserve Board's major currencies index, decreased 0.6 percent. The dollar appreciated 0.8 percent against the yen and depreciated 4.1 percent against the euro. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

Chart 1

TRADE-WEIGHTED U.S. DOLLAR



Sources: Bloomberg L.P.; Board of Governors of the Federal Reserve System.

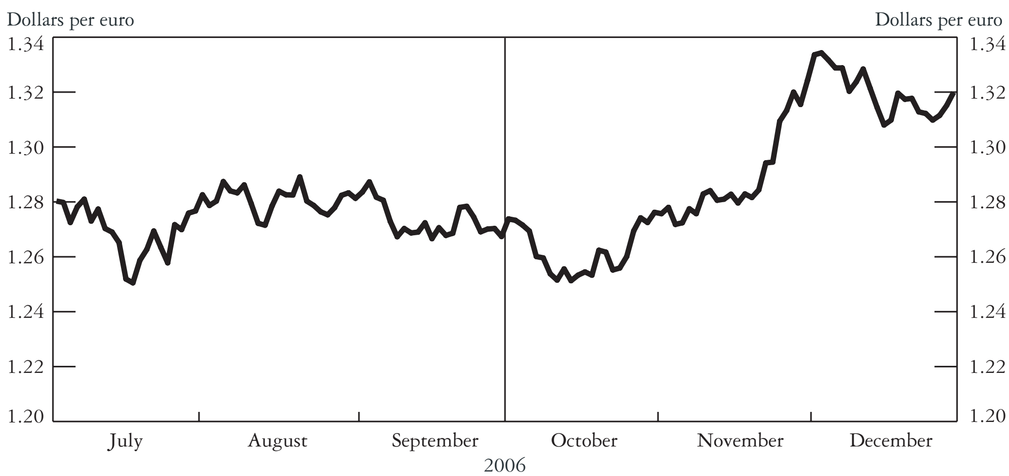
This report, presented by Dino Kos of the Federal Reserve Bank of New York, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from October through December 2006. Mr. Kos, who currently serves as Executive Vice President and Advisor to the President of the Federal Reserve Bank of New York, was Executive Vice President and Manager of the System Open Market Account during the period covered by this report. Ilan Solot was primarily responsible for preparation of the report.

RELATIVE GROWTH DIFFERENTIALS FAVOR THE EURO

Movements in the euro-dollar currency pair during the fourth quarter largely reflected market participants' changing expectations for the relative economic growth outlook for the U.S. and euro-area economies. The dollar appreciated 1.3 percent against the euro during the first two weeks of October, supported by continued better-than-expected U.S. economic data—particularly the September employment report, which was released on October 6. Although the dollar appreciated to its strongest level against the euro for the quarter over this two-week period, it remained within the relatively narrow range of 1.25-1.29 dollars per euro that had prevailed since May 2006.

Chart 2

EURO–U.S. DOLLAR EXCHANGE RATE



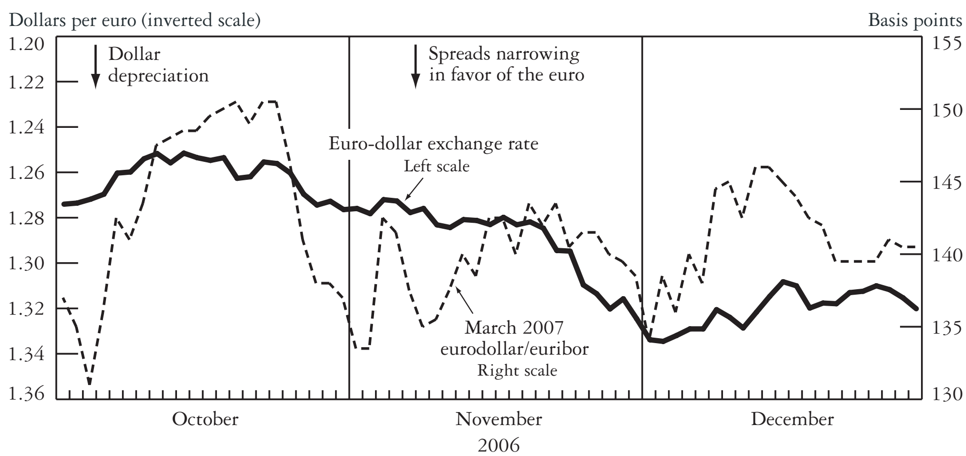
Source: Bloomberg L.P.

Between mid-October and early December, in contrast, the dollar depreciated 6.6 percent against the euro, reaching its lowest level against the euro since March 2005; disappointing U.S. manufacturing and housing data led market participants to lower their expectations for the U.S. economic growth outlook during this period. Although near-term expectations for Federal Open Market Committee (FOMC) policy rate decisions through January 2007 were little changed, investors began to price in more policy easing for later in 2007, as reflected in the further inversion of the eurodollar futures curve. The spread between rates implied by March 2007 and December 2007 contracts widened by 30 basis points, to -61 basis points, implying approximately two 25-basis-point target rate cuts by the FOMC by the end of 2007.

While U.S. economic data over this period were perceived as weak, euro-area economic data were interpreted by market participants as confirming the improved outlook for the region, contributing to a narrowing of interest rate differentials in favor of the euro. Market participants were particularly focused on the German IFO business sentiment survey for October and third-quarter GDP, which helped allay concerns that the increase in the value-added tax in Germany could hinder economic growth in the region. In reaction to these developments, the spread implied by yields on March 2007 eurodollar and euribor futures contracts narrowed by 10 basis points.

Chart 3

EURO-DOLLAR AND IMPLIED RATES ON FUTURES CONTRACTS



Source: Bloomberg L.P.

In addition, some analysts also noted that the euro, as well as the British pound, may have been supported by increased central bank interest in diversifying foreign exchange reserves away from the dollar. The pound appreciated 4.6 percent against the dollar in the quarter, and in early December sterling reached its highest level against the dollar since the United Kingdom exited the Exchange Rate Mechanism in 1992. Some analysts suggested that comments by officials of the central banks of China and the United Arab Emirates support the conjecture that reserve diversification has become a source of support for the euro and the British pound.

Chart 4

BRITISH POUND–U.S. DOLLAR EXCHANGE RATE

Source: Bloomberg L.P.

Starting in early December, the dollar partially recovered as unexpectedly strong retail sales and nonmanufacturing Institute for Supply Management data in the United States mitigated concerns that further weakness in the manufacturing and housing sectors could lead economic growth to decelerate even more. Accordingly, market participants scaled back some of their anticipation of monetary easing by the FOMC, and the spread between rates implied by the March 2007 to December 2007 eurodollar futures contracts declined 24 basis points, to -37 basis points, through December. Over the same period, Treasury yields rose as much as 30 basis points across the two-to-ten-year coupon curve, also reflecting the improvement in investors' outlook for U.S. economic growth.

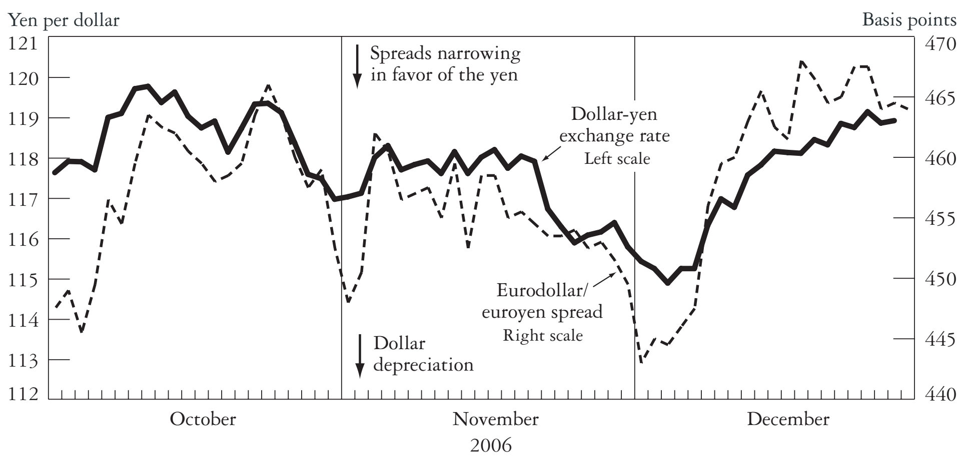
The dollar appreciated 1.1 percent against the euro between its early December lows and the end of the quarter, less than the dollar recovered against most other major currencies. Market participants attributed the euro's relative resilience largely to continued favorable sentiment toward the euro-area economy. Following the December 7 European Central Bank (ECB) meeting, investors began gradually to bring forward, from summer to spring, their expectations for the ECB's next 25-basis-point target rate increase. These revisions were mostly driven by strong economic data in the euro area, as well as by the December Eurosystem projections, which revised upward GDP growth for the euro area and suggested that inflation would likely remain above the ECB's target. Moreover, the apparent absence of comments by ECB officials about the elevated level or pace of appreciation relative to the dollar lent further support to the euro.

RELATIVE GROWTH AND INTEREST RATE DIFFERENTIALS DRIVE DOLLAR-YEN EXCHANGE RATE

In line with the movements in the euro-dollar currency pair, the yen appreciated 3.7 percent against the dollar from mid-October to early December, also supported by changing expectations for the relative economic growth outlook for the United States and Japan. In addition, higher-than-expected third-quarter Japanese GDP growth and comments by Bank of Japan (BoJ) officials persuaded some investors to bring forward their expected timing of the next policy rate increase by the BoJ. The yield spread between the March 2007 eurodollar and euroyen futures contracts narrowed by 17 basis points in favor of the yen over this period.

Chart 5

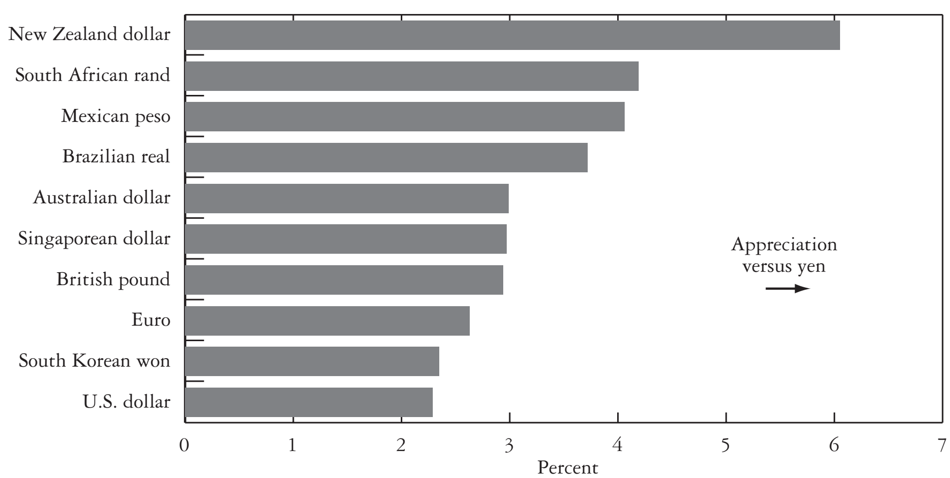
DOLLAR-YEN AND IMPLIED RATES ON FUTURES CONTRACTS



Source: Bloomberg L.P.

By early December, however, lower-than-expected data releases on consumption and inflation in Japan prompted investors to scale back their expectations for near-term monetary policy tightening by the BoJ, leading to a broad-based depreciation of the yen. In December, the yen posted its largest one-month depreciation against the dollar since November 2005, more than reversing its gains against the dollar earlier in the quarter. Market participants also suggested that widening interest rate differentials against the yen, combined with elevated risk appetite during the end of the quarter, led to increased investor interest in establishing yield-seeking trades using the yen as the funding currency.

Chart 6
JAPANESE YEN AGAINST SELECTED CURRENCIES IN DECEMBER 2006

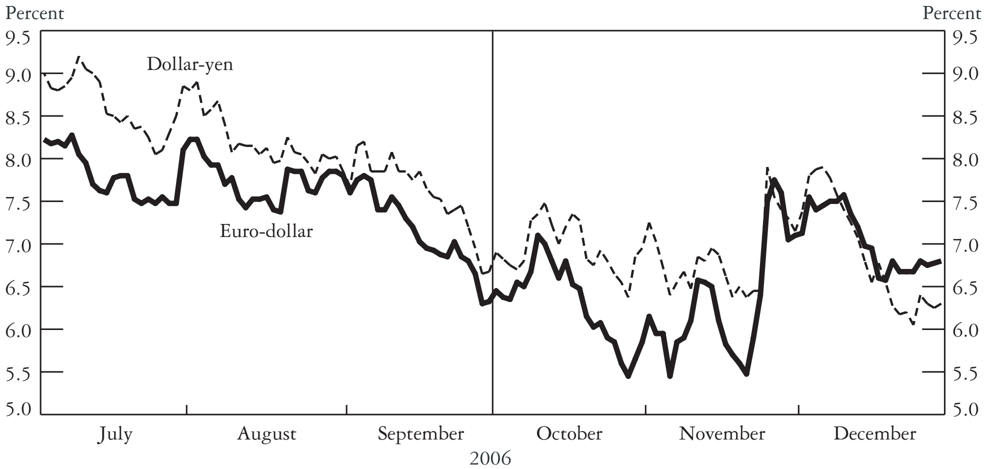


Source: Bloomberg L.P.

OPTION-IMPLIED VOLATILITY WAS LITTLE CHANGED OVER THE QUARTER

Although the dollar fell relatively rapidly against the euro and several other major currencies in late November, market participants did not report disorderly trading conditions. Option-implied volatility for the euro-dollar exchange rate moved up only moderately during this period and was, on net, little changed over the quarter, remaining close to historically low levels.

Chart 7
ONE-MONTH EURO-DOLLAR AND DOLLAR-YEN 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 $20.5 billion for the Federal Reserve System Open Market Account and $20.5 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 practical, 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 $18.8 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4.4 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, 2006[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sale[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value December 31, 2006[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	11,944.5	0	104.4	0	481.1	12,530.0
Yen	8,016.3	0	5.1	0	-69.4	7,952.0
Total	19,960.8	0	109.5	0	411.7	20,482.0
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	11,925.2	0	104.0	0	480.3	12,509.5
Yen	8,016.4	0	5.1	0	-69.4	7,952.1
Total	19,941.6	0	109.1	0	410.9	20,461.6

[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, 2006

	U.S. Treasury Exchange Stabilization Fund (ESF)[b]	Federal Reserve System Open Market Account (SOMA)[b]
Euro-denominated assets:	**12,509.4**	**12,530.0**
Cash held on deposit at official institutions	6,221.0	6,241.9
Marketable securities held under repurchase agreements[a]	2,214.1	2,214.1
Marketable securities held outright	4,074.3	4,074.0
German government securities	1,959.8	1,959.5
French government securities	2,114.5	2,114.5
Yen-denominated assets:	**7,952.1**	**7,952.0**
Cash held on deposit at official institutions	2,601.5	2,601.4
Marketable securities held outright	5,350.6	5,350.6

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

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

[b] As of December 31, euro and yen portfolios had Macaulay durations of 9.9 months and 10.7 months, respectively, for both the ESF and SOMA portfolios.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of December 31, 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