TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

January-March 2004

During the first quarter of 2004, the dollar's trade-weighted exchange value increased by approximately one-half percent, as measured by the Federal Reserve Board's major currencies index. The dollar depreciated early in the quarter, before consolidating and then appreciating sharply against most other major currencies during the second half of February. Shifting views about the outlook for global economic growth and interest rates, as well as a reassessment of the potential for further dollar depreciation after more than two years of fairly steady declines, led many investors to scale back short dollar positions. Although the dollar retained its gains against the euro, ending the period 2.3 percent stronger, it more than reversed its gains against the yen in March and ended the quarter 2.8 percent weaker against the Japanese currency. The U.S. monetary authorities did not intervene in the foreign exchange market during the quarter.

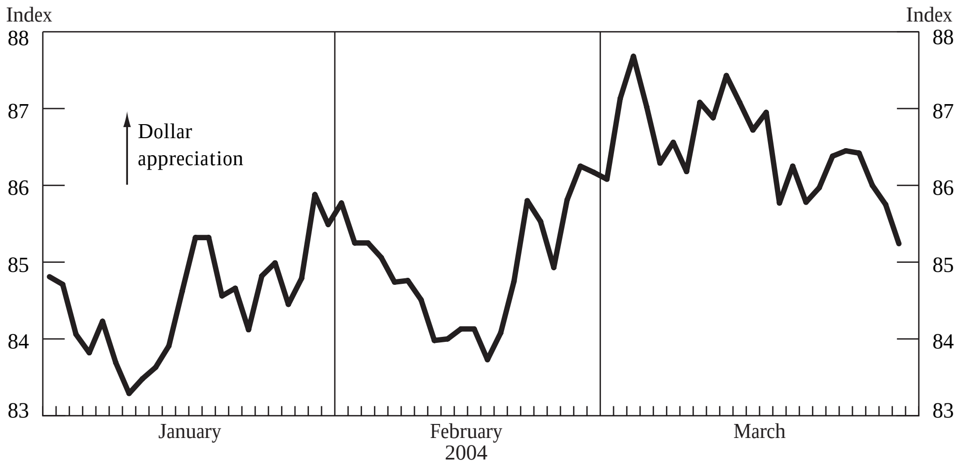
DOLLAR'S DECLINES CONTINUE IN EARLY 2004

After falling 5.8 percent during the fourth quarter of 2003, the Federal Reserve's major currencies index of the dollar's exchange value continued to decline early in 2004. The U.S. December employment report, released on January 9, showed that job growth had not accelerated as much as some market participants had expected and heightened investor concerns about the pace and sustainability of the U.S. economic recovery. These concerns, as well as speeches from several Federal Open Market Committee (FOMC) members interpreted as suggesting no discomfort with

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 January through March 2004. Eric Winograd was primarily responsible for preparation of the report.

Chart 1

TRADE-WEIGHTED U.S. DOLLAR



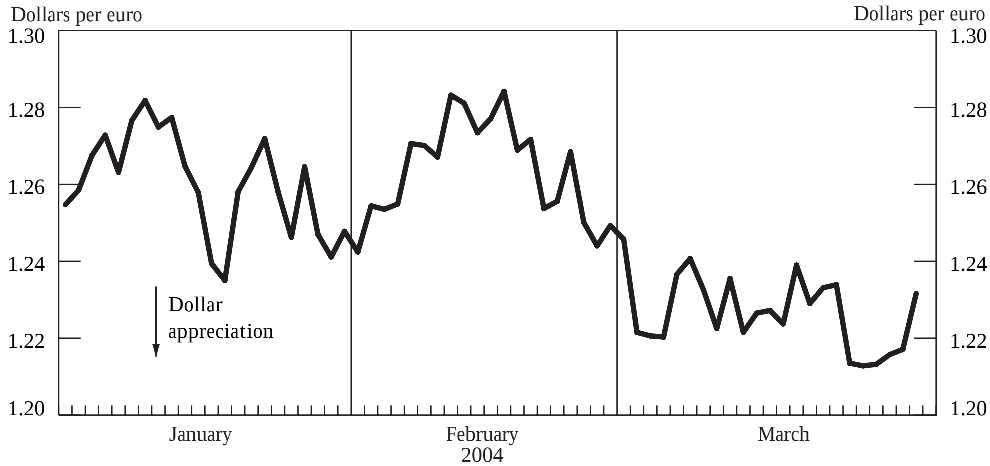
Source: Board of Governors of the Federal Reserve System.

the pace of dollar depreciation and reinforcing the view that monetary policy accommodation could be maintained for a sustained period, led most market participants to conclude that U.S. interest rates were likely to remain low. The dollar depreciated, reaching more than $1.29 per euro, its weakest level since the euro's inception, and also declined to multiyear lows against many other higher-yielding currencies, including the British pound and the Australian, Canadian, and New Zealand dollars.

The dollar depreciated more modestly against the yen, declining 1.4 percent in January. Appreciation pressure on the Japanese currency from significant foreign inflows into Japanese equities and speculative yen purchases was mitigated by reported official Japanese sales of yen. Ministry of Finance portfolio flow data showed foreign inflows into Japanese assets of almost ¥2.8 trillion in January. According to data published by the Japanese Ministry of Finance, however, the Japanese monetary authorities sold ¥7.15 trillion against the dollar in January, the largest amount of yen sales in any month in at least a decade.

Chart 2

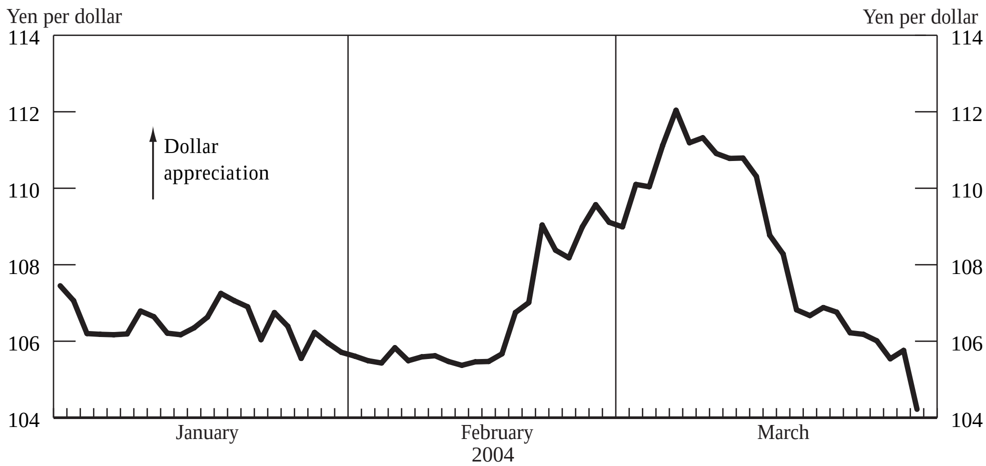
EURO AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

Chart 3

YEN AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

DOLLAR DEPRECIATION PAUSES

Toward the end of January, the dollar's depreciation stalled as investors increasingly focused on official views about exchange rates. In discussing the exchange value of the euro at a press conference on January 12, European Central Bank (ECB) President Trichet was quoted as saying that "excessive volatility and brutal moves are not welcome and not appropriate." Market participants interpreted his statement as suggesting that the central bank was becoming increasingly uncomfortable with the euro's appreciation and might take steps to limit the euro's gains.

Also stemming the dollar's depreciation were some signs of strength in U.S. economic growth and shifting expectations for U.S. monetary policy. The statement released following the FOMC January 28 meeting indicated that the FOMC believed it could be "patient in removing its policy accommodation," a shift from the wording of previous FOMC statements that had suggested that rates could remain low for a "considerable period." Though few interpreted the statement as indicating that a change in rates was imminent, it nonetheless highlighted to market participants that interest rates could rise sooner than some had previously expected. Implied rates on fed funds futures contracts settling in 2004 rose as much as 12 basis points following the release of the statement.

A reduction in short dollar positions ahead of the Group of Seven (G-7) Finance Ministers meeting in Boca Raton, Florida, during the first week of February also contributed to modest dollar appreciation. Market participants viewed the meeting as a potentially significant event in foreign exchange markets, given the increased sensitivity to official views about exchange rates. The perception grew that Japanese authorities could come under pressure at the G-7 meeting to reduce intervention activity and allow the yen to appreciate against the dollar. Intervention was perceived to be an important factor limiting yen appreciation in early 2004, and the expectation that it could diminish added to appreciation pressure on the yen. The persistence of Japanese intervention in the days ahead of the meeting, however, reportedly limited the price impact of demand for yen.

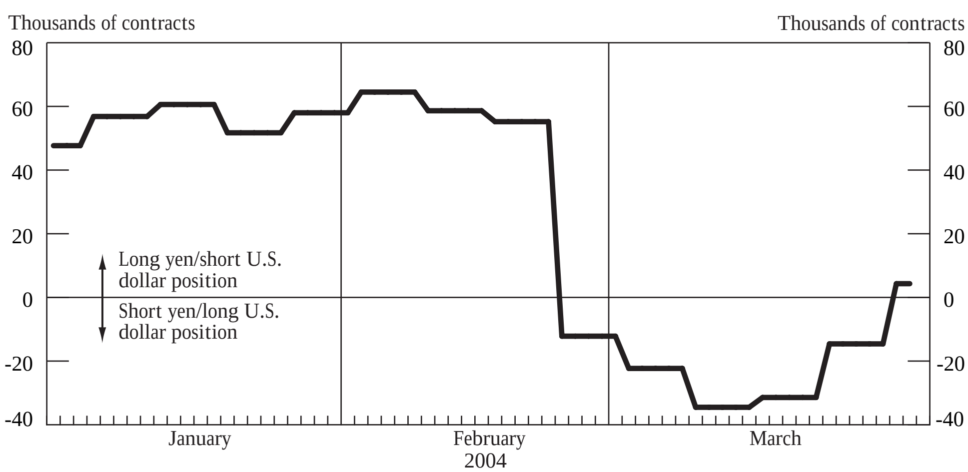
DOLLAR APPRECIATES SHARPLY THROUGH MID-MARCH

Beginning in mid-February, the dollar appreciated sharply for several weeks against both the euro and the yen as market participants responded to shifting views about the potential for further dollar declines. The communiqué issued at the conclusion of the G-7 Finance Ministers meeting on February 7 was interpreted as implying no major change in global foreign exchange policy, and market participants perceived little or no reduction in Japanese intervention following the meeting.

The perception that the Ministry of Finance remained committed to preventing yen appreciation reportedly caused some investors to reassess the potential benefits of holding long yen positions against the dollar. Market participants noted significant liquidation of long yen positions in the middle of February. Consistent with these reports, International Monetary Market (IMM) net noncommercial yen positions declined from a peak of more than 64,000 long contracts to a net short position of approximately 34,000 contracts by mid-March. The Japanese currency depreciated sharply against the dollar, even as economic data were released showing that Japan's economy expanded at its fastest rate in more than a decade. Market participants believed that yen-selling intervention continued and at some points accelerated even as the dollar appreciated against the yen.

Chart 4

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



Source: Bloomberg L.P.

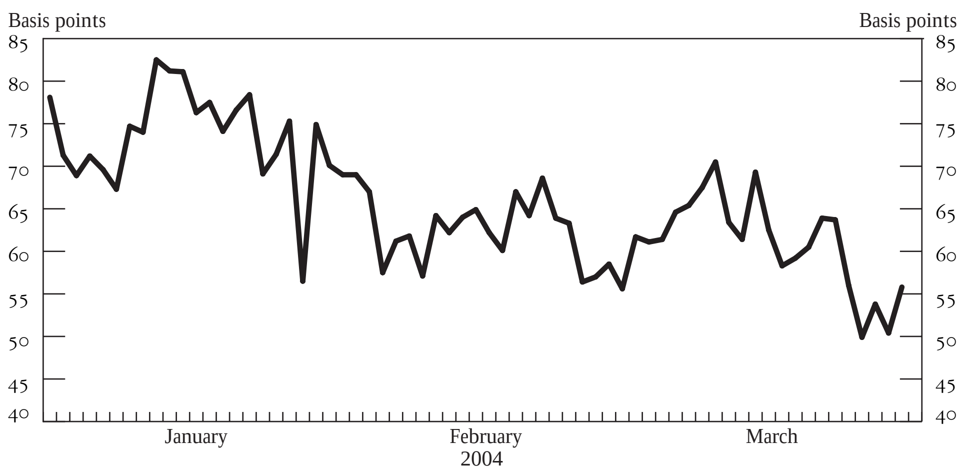
During this period, market participants also reassessed the likelihood of additional euro appreciation against the dollar as euro-area economic data continued to suggest that the region's economy was expanding less rapidly than the U.S. and Japanese economies. Data released on February 13 showed that euro-area GDP grew at an annualized 0.6 percent in the fourth quarter of 2003, compared with the 4.1 percent annualized growth posted by the United States and the 6.4 percent annualized growth of the Japanese economy in that same quarter. The perception that European officials were concerned about the impact of the euro's strength, particularly in light of the euro-area's subdued economic performance, led many to believe that the probability of monetary easing had increased and the potential for additional euro appreciation had diminished.

DOLLAR APPRECIATES AGAINST EURO, DEPRECIATES AGAINST YEN

Later in the quarter, the dollar's performance against the euro and the yen diverged, with the dollar appreciating more than one percent against the euro in March while depreciating 4.5 percent against the yen. The growing perception that the ECB might cut rates in the near term and would be less likely than the FOMC to raise rates in the medium term reportedly weighed on the euro. Implied rates on the June 2004 Euribor futures contract declined 35.5 basis points during the quarter, while the implied rate on the June 2004 eurodollar futures contract declined only 26 basis points, to 1.17 percent. The spread of the two-year German sovereign yield over the two-year Treasury yield narrowed by 22 basis points, reflecting expectations that U.S. interest rates were likely to rise more rapidly than were euro-area rates.

Chart 5

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

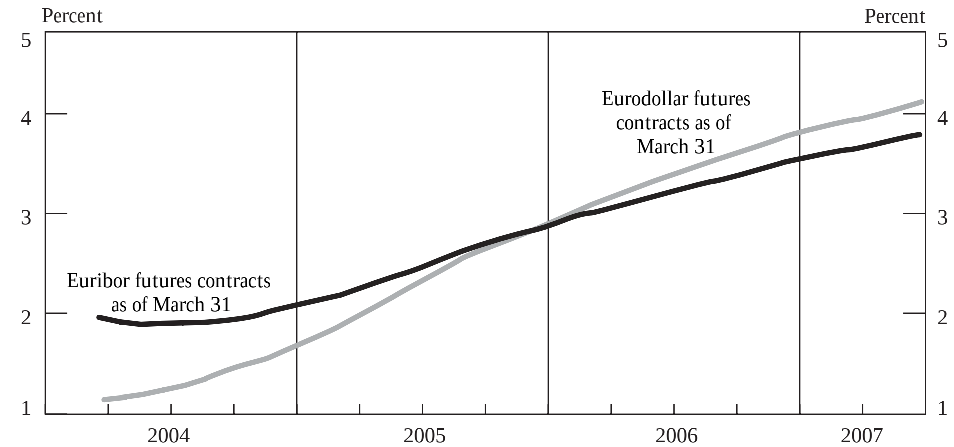


Source: Bloomberg L.P.

Against this backdrop, market participants reportedly continued to unwind long euro positions against the dollar. In addition to its gains against the euro, the dollar also appreciated against other currencies in which large speculative positions had been built up earlier, gaining almost 2 percent against both the Australian dollar and the New Zealand dollar during the quarter.

Chart 6

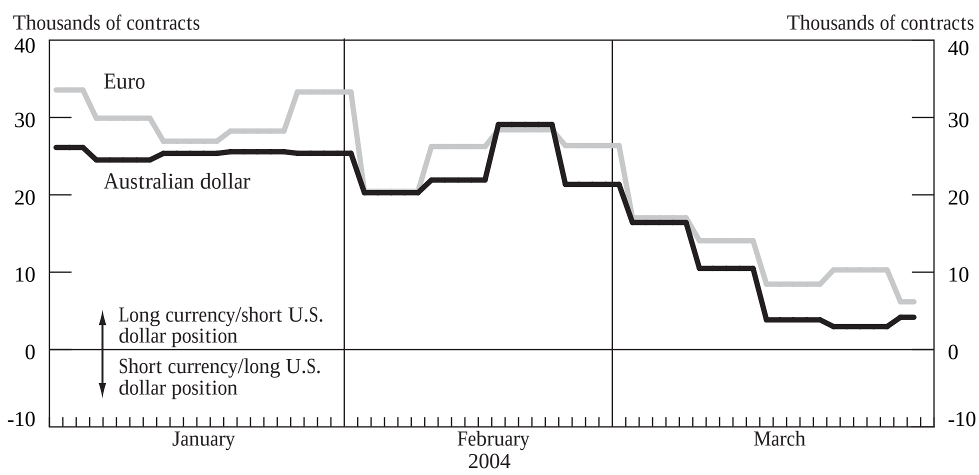
IMPLIED RATES ON EURODOLLAR AND EURIBOR FUTURES CONTRACTS MATURING IN 2004 THROUGH 2007



Source: Bloomberg L.P.

Chart 7

NET EURO AND AUSTRALIAN DOLLAR POSITIONS AGAINST THE U.S. DOLLAR HELD BY NONCOMMERCIAL ACCOUNTS ON THE CHICAGO MERCANTILE EXCHANGE

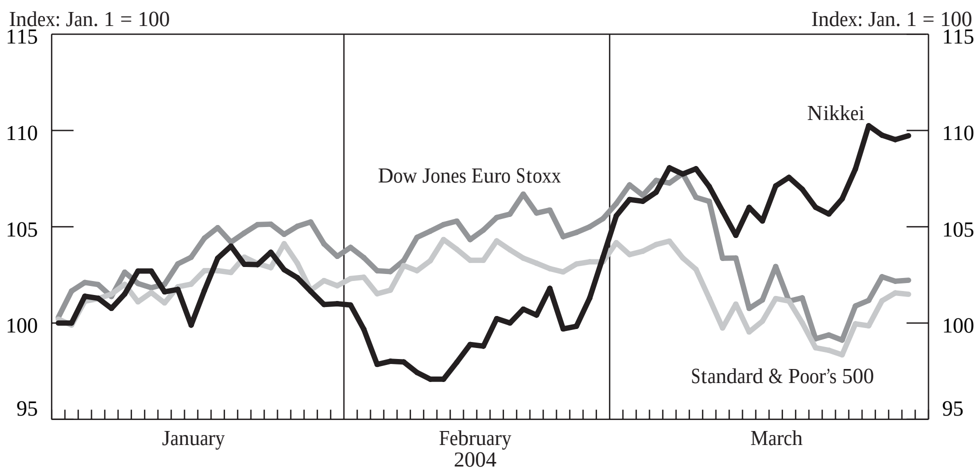


Source: Bloomberg L.P.

By contrast, the dollar ended the period with a weaker tone against the yen. The Japanese economy continued to demonstrate signs of an improved outlook, and a perceived cessation of intervention activity after mid-March also contributed to the yen's appreciation. Economic data suggested that Japan's economy would likely expand more rapidly in 2004 than had previously been expected. Retail trade and industrial production data for January exceeded consensus forecasts, and measures of business confidence indicated that optimism about the economic recovery was increasing and spreading to smaller enterprises. Foreign demand for Japanese equities remained robust, with net inflows of almost ¥5 trillion during the quarter, according to the Japanese Ministry of Finance. Major Japanese equity indexes outperformed U.S. and European indexes, supported in large part by flows of international capital. Those flows supported the yen, and the Japanese currency ended the quarter at ¥104.22 per dollar, its strongest level against the dollar since 2000.

Chart 8

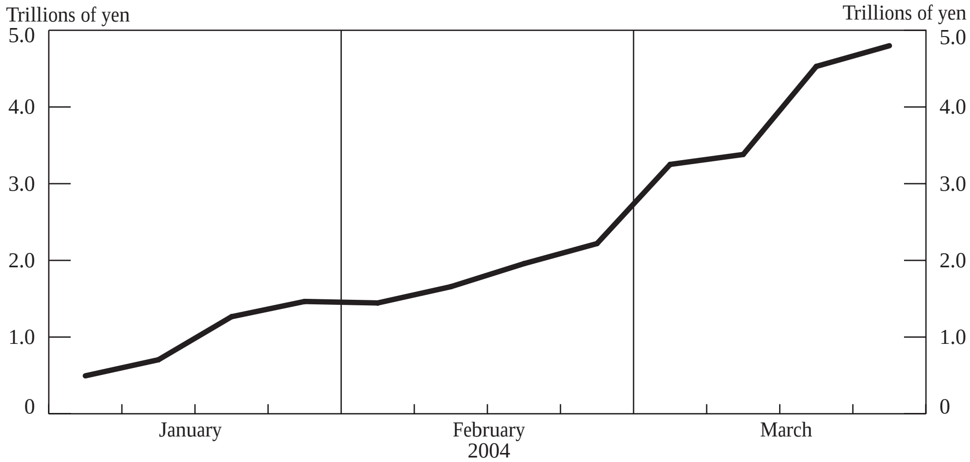
GLOBAL EQUITY INDEXES



Source: Bloomberg L.P.

Chart 9

CUMULATIVE WEEKLY NET FOREIGN INFLOWS INTO JAPANESE EQUITIES



Source: Japanese Ministry of Finance.

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 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 March 31, direct holdings of foreign government securities totaled $20.0 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4 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 December 31, 2003[a]	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 March 31, 2004[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	11,052.1	0	64.5	0	(268.1)	10,848.5
Yen	8,816.0	0	0.2	0	249.7	9,065.9
Total	19,868.1	0	64.7	0	(18.4)	19,914.4
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	11,037.7	0	64.0	0	(267.7)	10,834.0
Yen	8,816.0	0	0.2	0	249.7	9,065.9
Total	19,853.7	0	64.2	0	(18.0)	19,899.9

[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 March 31, 2004	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:	10,834.0	10,848.5
Cash held on deposit at official institutions	6,380.4	6,398.6
Marketable securities held under repurchase agreements[a]	2,015.1	2,015.1
Marketable securities held outright[b]	2,438.5	2,434.8
German government securities	1,348.3	1,344.5
French government securities	1,090.3	1,090.3
Yen-denominated assets:	9,065.9	9,065.9
Cash held on deposit at official institutions	1,516.8	1,516.8
Marketable securities held outright[b]	7,549.1	7,549.1

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

[b] As of March 31, euro and yen securities holdings had Macaulay durations of 31.1 and 3.4 months, respectively.

Table 3

FEDERAL RESERVE SYSTEM OPEN MARKET ACCOUNT RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 2004
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

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 2004
Bank of Mexico	3,000	0
Total	3,000	0