TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 2011

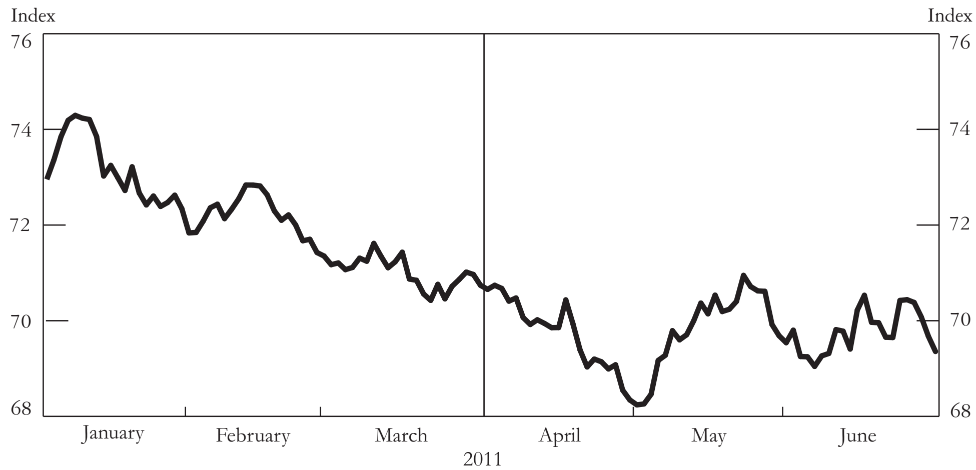
During the second quarter, the U.S. dollar's nominal trade-weighted exchange value depreciated 2.0 percent as measured by the Federal Reserve Board's major currencies index. The dollar depreciated 2.4 percent against the euro and 3.2 percent against the Japanese yen, but largely stabilized compared with the steady trend of depreciation witnessed in the first quarter. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

The dollar's depreciation occurred amid increased foreign exchange market volatility, although market participants characterized trading conditions as orderly. Several factors contributed to this volatility, including a series of weaker-than-expected U.S. economic data, shifts in relative monetary policy expectations, and ongoing concerns about the sovereign debt problems facing some countries in the euro area.

This report, presented by Brian Sack, 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 April through June 2011. Jeffrey Kong was primarily responsible for preparation of the report.

Chart 1

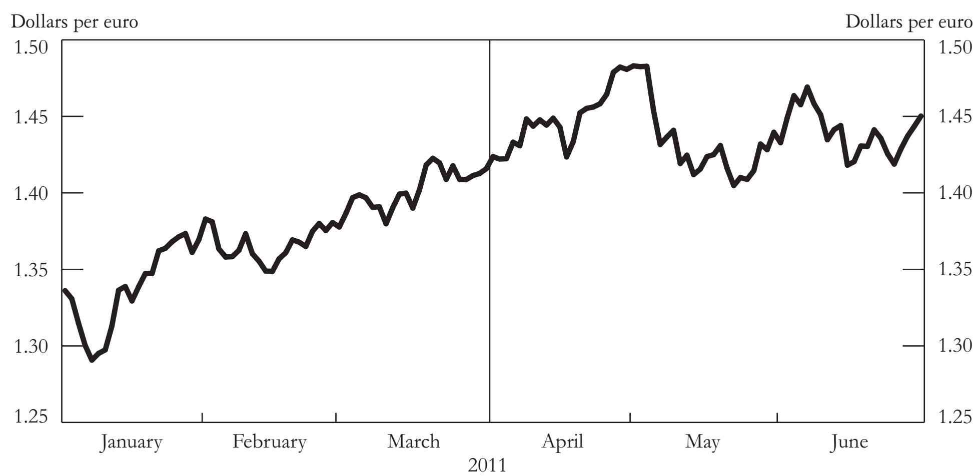
TRADE-WEIGHTED U.S. DOLLAR



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

Chart 2

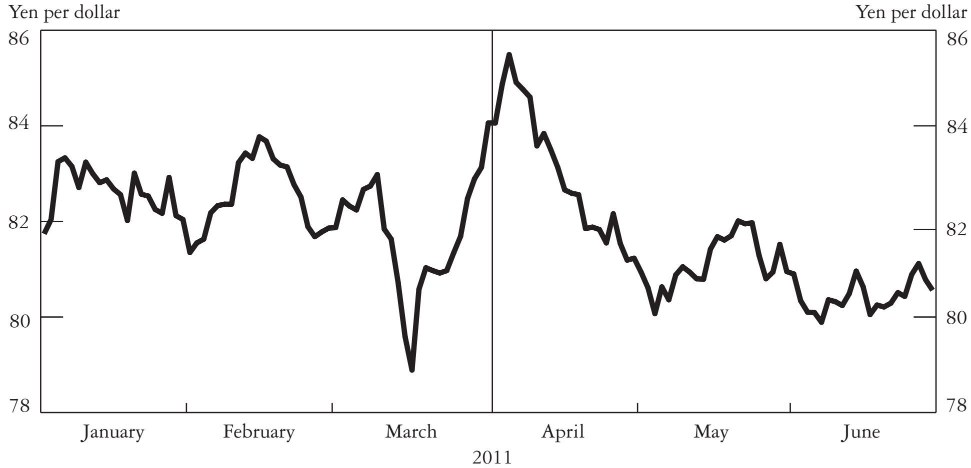
EURO–U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 3

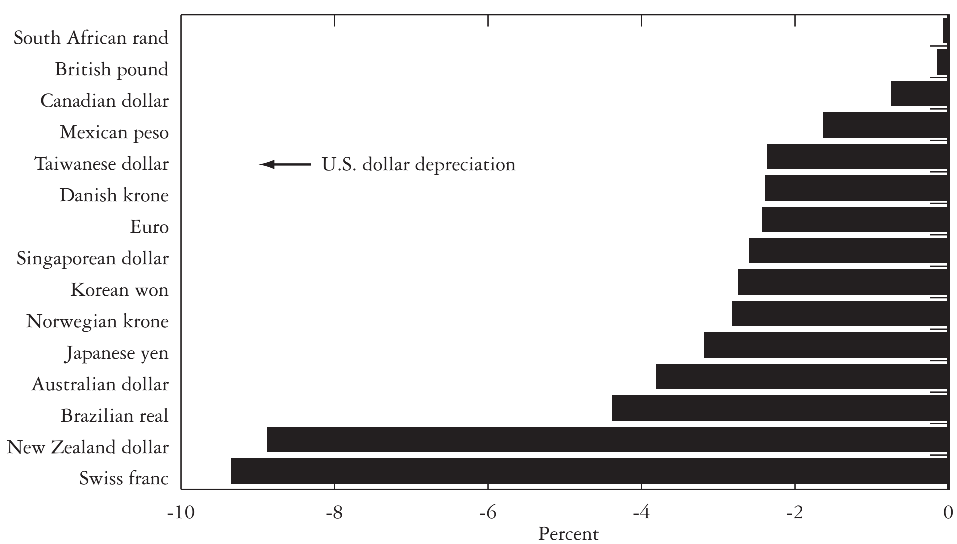
U.S. DOLLAR–YEN EXCHANGE RATE



Source: Bloomberg L.P.

Chart 4

U.S. DOLLAR AGAINST SELECTED CURRENCIES DURING SECOND QUARTER



Source: Bloomberg L.P.

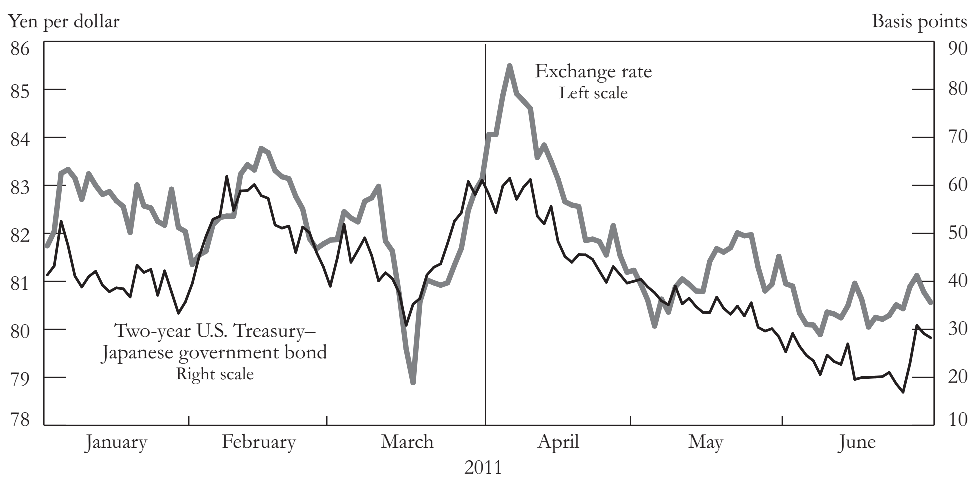
DOLLAR FLUCTUATES ON WEAKER DOMESTIC AND GLOBAL ECONOMIC SIGNALS

The dollar depreciated broadly early in the second quarter amid continued weakness in domestic economic data and expectations for a slower pace of monetary policy normalization relative to other countries. In particular, continued weakness in the labor market and still-anchored longer term inflation expectations supported market analysts' view that the Federal Open Market Committee (FOMC) would likely maintain its accommodative monetary policy stance for a longer period. Market participants interpreted the April FOMC statement and Federal Reserve Chairman Ben Bernanke's comments at the press conference that followed as being consistent with this view.

Changes in interest rate differentials during the quarter coincided with movements in the euro–dollar and dollar–yen currency pairs. The dollar depreciated 2.4 percent against the euro as the spread of the two-year German government bond yield over U.S. Treasury securities widened approximately 18 basis points. Over the same period, the dollar depreciated 3.2 percent against the Japanese yen as the spread of the two-year U.S. Treasury yield over Japanese government bonds narrowed 33 basis points.

Chart 5

U.S. DOLLAR–YEN EXCHANGE RATE AND TWO-YEAR INTEREST RATE DIFFERENTIALS



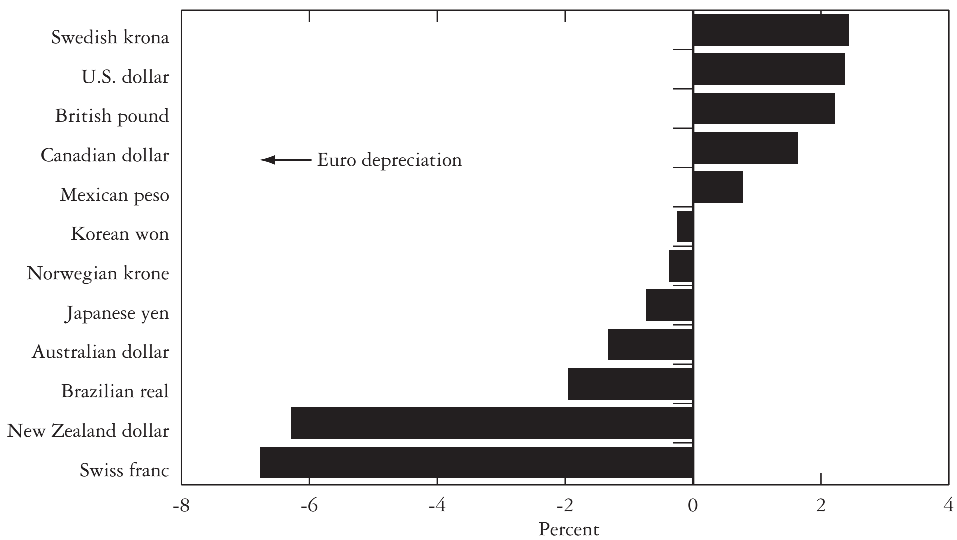
Source: Bloomberg L.P.

Although market observers thought it likely that the FOMC would maintain its accommodative stance for a longer period, expectations increased that other foreign central banks would raise interest rates at a relatively faster pace. Indeed, the European Central Bank (ECB) at its April meeting raised its policy rate 25 basis points, and market-based indicators suggested expectations for further interest rate increases at subsequent meetings. Other foreign central banks, such as Banco Central do Brasil, the Reserve Bank of India, and the Central Bank of Russia, also continued to raise interest rates during the quarter, while the People's Bank of China increased reserve requirements.

After reaching a record low in late April, the U.S. dollar trade-weighted index increased as concerns about a slower pace of recovery for the global economy emerged and expectations for further near-term interest rate increases by the ECB diminished. Indeed, a number of global economic data releases, including global manufacturing and export data and economic sentiment surveys, were weaker than expected. Additionally, contributions by emerging market Asian countries to global growth were expected to moderate, as policy actions aimed at managing rising inflation concerns were expected to dampen growth prospects. These factors contributed to a decline in commodity prices, including a 15-percent decline in front-month West Texas Intermediate crude oil during the first week of May, weighing on many commodity-linked currencies. During May, the U.S. dollar appreciated roughly 2.5 percent against the Canadian dollar, Australian dollar, and Norwegian krone. Concurrent with the decline in commodity prices, expectations for future ECB policy rate increases began to diminish in May, contributing to the euro's depreciation against the dollar.

Chart 6

EURO AGAINST SELECTED CURRENCIES DURING SECOND QUARTER



Source: Bloomberg L.P.

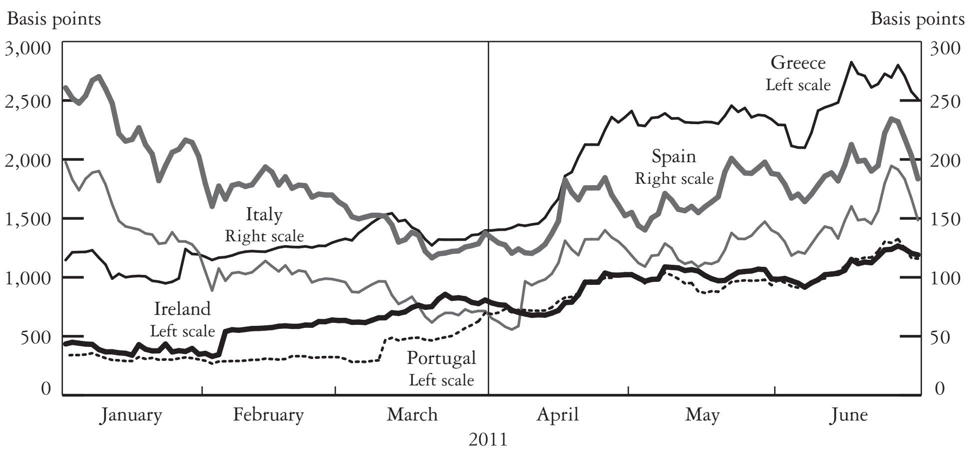
RENEWED CONCERNS ABOUT FISCAL CRISIS IN EURO-AREA PERIPHERY COUNTRIES CONTRIBUTE TO FOREIGN EXCHANGE MARKET VOLATILITY

During the quarter, the euro was modestly stronger and generally traded in a narrow range against the U.S. dollar, but it depreciated nearly 7 percent against the Swiss franc. Much of the weakness in the euro was attributed to the reemergence of fiscal concerns in euro-area periphery countries, which prompted the countries' sovereign debt spreads to widen and implied volatility in the euro–U.S. dollar currency pair to rise.

In particular, market participants expressed concern about the uncertainty surrounding disbursement of additional tranches of aid to Greece from the International Monetary Fund and European Union that hinged upon parliamentary approval of further austerity measures. Additionally, market participants focused on official-sector discussions about the need for private sector involvement to help alleviate Greece's debt burden. During the quarter, two-year spreads of Greek, Portuguese, and Irish sovereign debt to German equivalents widened 1,115 basis points, 459 basis points, and 383 basis points, respectively. Two-year spreads of Italian and Spanish debt to German equivalents also began to widen, increasing 77 basis points and 46 basis points, respectively.

Chart 7

TWO-YEAR SOVEREIGN SPREADS TO GERMANY FOR SELECTED EURO-AREA COUNTRIES

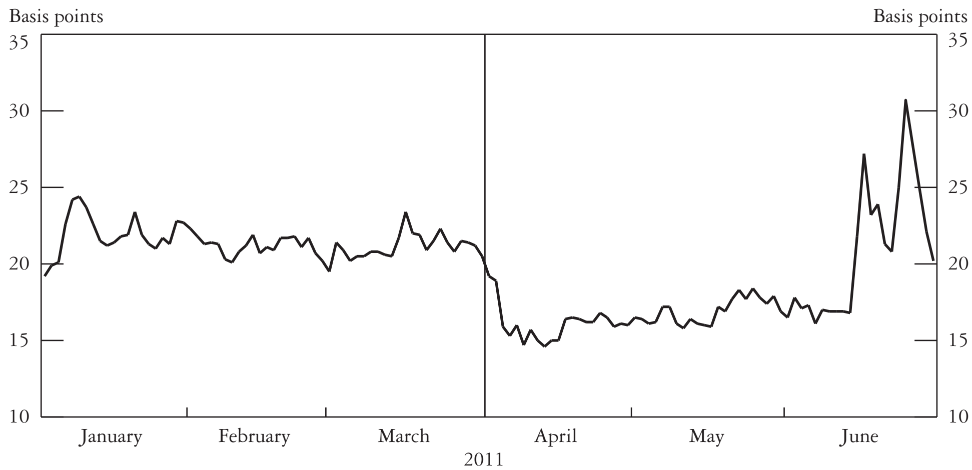


Source: Bloomberg L.P.

Rating actions on Greece and other euro-area periphery countries, as well as news that Moody's had placed some French banks on review for a possible downgrade, contributed to further market volatility. The possibility that some French banks would be downgraded because of their exposure to Greek debt brought about modest signs of tension in eurodollar funding markets later in the quarter. Specifically, the spreads between three-month forward rate agreements and overnight indexed swaps increased about 13 basis points during the second half of June.

Chart 8

SPREAD BETWEEN U.S. DOLLAR THREE-MONTH FORWARD RATE AGREEMENT AND THREE-MONTH OVERNIGHT INDEXED SWAP RATE THREE MONTHS FORWARD

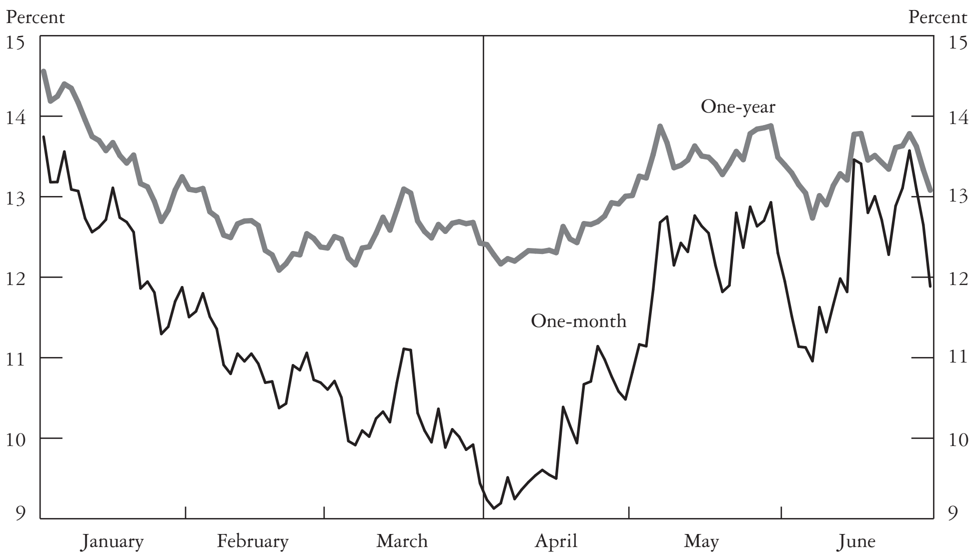


Source: Bloomberg L.P.

One-month implied volatility in the euro–dollar currency pair increased as much as 4 percentage points between early April and late June as attention increasingly centered on fiscal issues in the euro-area periphery. Additionally, one-month 25-delta risk reversals on the euro–dollar currency pair declined to levels last observed in June 2010, reflecting increased demand for protection from further euro depreciation against the dollar.

Chart 9

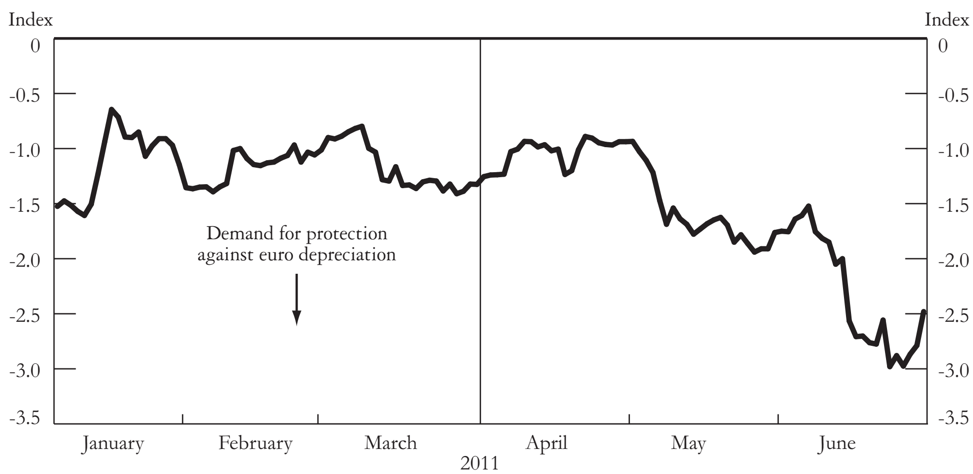
ONE-MONTH AND ONE-YEAR U.S. DOLLAR–EURO AT-THE-MONEY OPTION-IMPLIED VOLATILITY



Source: Bloomberg L.P.

Chart 10

ONE-MONTH 25-DELTA EURO–U.S. DOLLAR RISK REVERSALS



Source: Bloomberg L.P.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE HOLDINGS

The U.S. monetary authorities did not undertake any intervention operations during the quarter. As of June 30, 2011, the value of the U.S. Treasury's Exchange Stabilization Fund foreign-currency-denominated assets totaled $26.91 billion, comprised of euro and yen holdings. The Federal Reserve's System Open Market Account holdings of foreign-currency-denominated assets totaled $26.93 billion, also comprised of euro and yen holdings.

Temporary Reciprocal Currency Arrangements (Dollar Liquidity Swap Lines)

On June 29, the Federal Reserve announced an extension of its existing dollar liquidity swap lines with the Bank of Canada (BoC), the Bank of England (BoE), the ECB, and the Swiss National Bank (SNB) through August 1, 2012.[1] As of June 30, there were no outstanding draws. The Federal Reserve had reestablished in May 2010 temporary U.S. dollar liquidity swap arrangements with a number of foreign central banks in response to the reemergence of strains in offshore U.S. dollar short-term funding markets. These swap arrangements were reestablished with the BoC, the BoE, the ECB, the BoJ, and the SNB through August 1, 2011. The BoE, the ECB, the BoJ, and the SNB have unlimited swap lines, while the BoC has a $30 billion swap line.

Foreign Exchange Reserve Holdings

The U.S. monetary authorities invest their foreign currency reserves 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 on an outright basis in 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 $25.4 billion, split evenly between the Federal Reserve System Open Market Account and the U.S. Treasury Exchange Stabilization Fund. Foreign government securities held under repurchase agreements totaled $5.4 billion at the end of the quarter and were also split evenly between the two authorities.

[1] The swap arrangement with the Bank of Japan (BoJ) was extended at its policy meeting after the quarter ended, on July 12.

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of U.S. Dollars

		Change in Balances by Source				
	Carrying Value, March 31, 2011[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sales[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value, June 30, 2011[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	15,012	0	60	0	360[f]	15,431
Japanese yen	11,200	0	8	0	294[f]	11,502
Total	26,211	0	68	0	654	26,934

		Change in Balances by Source				
	Carrying Value, March 31, 2011[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Gains/Losses on Sales[d]	Unrealized Gains/ Losses on Foreign Currency Revaluation[e]	Carrying Value, June 30, 2011[a]
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	14,987	0	60	0	359	15,406
Japanese yen	11,200	0	8	0	294	11,502
Total	26,187	0	68	0	654	26,909

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 foreign currency purchases related to official activity, swap drawings and repayments, and warehousing.

[c] Investment earnings include accrued interest and amortization on outright and swap-related holdings.

[d] Gains and losses on sales are calculated using average cost.

[e] Reserve asset balances are revalued daily at the noon buying rates.

[f] Valuation adjustments on swap-related holdings do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date.

Table 2

BREAKDOWN OF FOREIGN RESERVE ASSETS HELD

Carrying Value in Millions of U.S. Dollars, as of June 30, 2011

	U.S. Treasury Exchange Stabilization Fund (ESF)[a]	Federal Reserve System Open Market Account (SOMA)[a]
Euro-denominated assets:	**15,406.5**	**15,431.4**
Cash held on deposits at official institutions	7,688.6	7,713.5
Marketable securities held under repurchase agreements[b]	2,694.9	2,694.9
Marketable securities held outright	5,023.0	5,023.0
German government securities	2,065.9	2,065.9
French government securities	2,957.1	2,957.1
Japanese-yen–denominated assets:	**11,502.4**	**11,502.3**
Cash held on deposit at official institutions	3,797.1	3,797.1
Marketable securities held outright	7,705.2	7,705.2
Reciprocal currency arrangements:		
Euro-denominated assets:		**0.0**
Other assets[c]		0.0
Japanese-yen–denominated assets:		**0.0**
Other assets[c]		0.0
Swiss-franc–denominated assets:		**0.0**
Other assets[c]		0.0
Canadian-dollar–denominated assets:		**0.0**
Other assets[c]		0.0
British-pound–denominated assets:		**0.0**
Other assets[c]		0.0

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

[a] As of June 30, the euro SOMA and ESF portfolios both had Macaulay durations of 8.8 months; the yen SOMA and ESF portfolios both had Macaulay durations of 11.0 months.

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

[c] Carrying value of outstanding reciprocal currency swaps with the European Central Bank, the Swiss National Bank, the Bank of Japan, the Bank of Canada, and the Bank of England.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of U.S. Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2011
	Federal Reserve System Open Market Account (SOMA)	
Bank of Canada	2,000	0
Banco de México	3,000	0
European Central Bank[a]	Unlimited	0
Swiss National Bank[a]	Unlimited	0
Bank of Japan[a]	Unlimited	0
Bank of Canada[a]	30,000	0
Bank of England[a]	Unlimited	0
	Unlimited	0
	U.S. Treasury Exchange Stabilization Fund (ESF)	
Banco de México	3,000	0
Total	3,000	0

[a] Temporary swap arrangement.