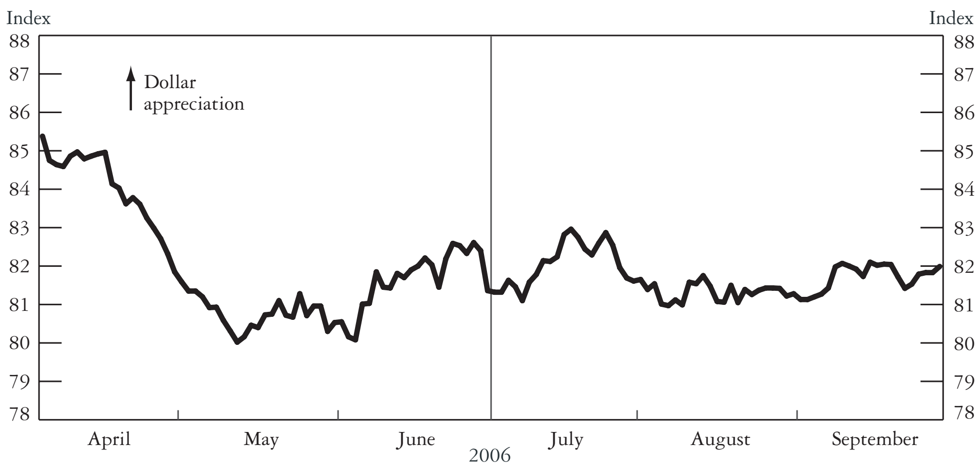
TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

July–September 2006

During the third quarter of 2006, the trade-weighted exchange value of the dollar, as measured by the Federal Reserve Board's major currencies index, increased 0.8 percent. The dollar appreciated 3.3 percent against the yen and 0.9 percent against the euro. Actual and option-implied volatilities on the dollar-yen and euro-dollar currency pairs edged down further from already historically low levels. 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, 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 July through September 2006. Niall Coffey was primarily responsible for preparation of the report.

MARKET PARTICIPANTS SHIFT EXPECTATIONS FOR GLOBAL GROWTH

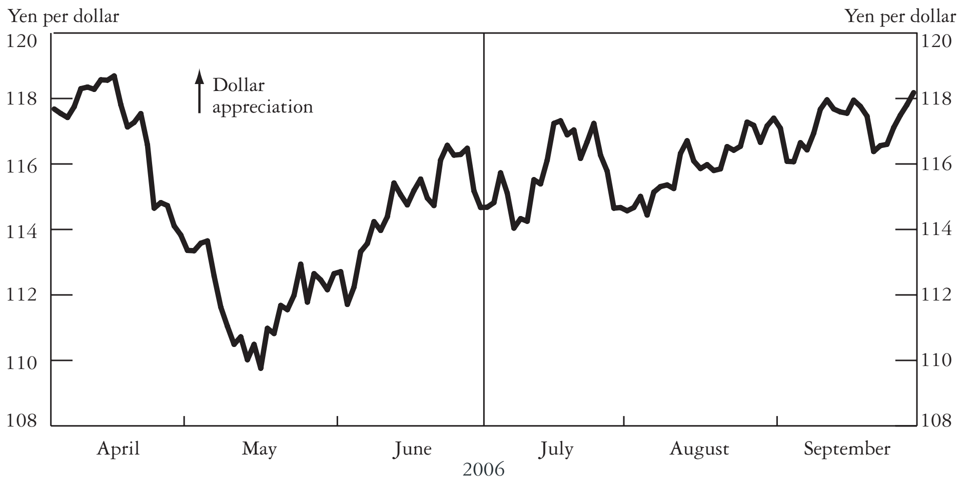
Throughout the third quarter, market participants shifted their attention from the formation of near-term expectations for monetary policy to reassessments of the relative outlook for U.S. and foreign economic growth. As the quarter began, many debated when the Federal Open Market Committee (FOMC) would choose to pause from raising the target federal funds rate. Nevertheless, the dollar's appreciation against the euro and yen in the first two weeks of July reflected, in part, the relatively high probability that market participants attached to the likelihood of some further increases in the U.S. policy rate. Heightened geopolitical tensions in the Middle East and India also reportedly added to the variability of the dollar around this time, particularly because of the uncertain effect of elevated oil prices on the U.S. inflation outlook.

During the second half of July, however, the dollar reversed its gains as market participants increasingly anticipated an imminent pause in the FOMC's tightening cycle. The minutes of the June 29 FOMC meeting, released on July 20, were interpreted as suggesting a desire among Committee members to accumulate additional economic data before making further adjustments to their monetary policy stance. Subsequently, second-quarter U.S. GDP data and the July Federal Reserve Beige Book were interpreted as indicating a moderating pace of economic activity, while declines in oil prices led to reduced concerns over inflationary pressures. The FOMC kept the target fed funds rate on hold at 5.25 percent at its August 8 and September 20 meetings.

Throughout July, market participants generally expected that other major economies would perform relatively well despite slowing U.S. growth. The Bank of Japan's (BoJ) July 14 decision to raise its policy rate from zero to 0.25 percent was widely expected, and Japanese economic data released early in the third quarter appeared to reinforce many analysts' views that the BoJ would increase rates further before the end of the year. The European Central Bank (ECB) raised its minimum refinancing rate by 25 basis points to 3.00 percent on August 3, while comments by ECB officials were taken to indicate that further increases would likely be needed to guard against rising inflation expectations. The dollar's decline over the second half of July generally reflected a divergence in expectations for global monetary policy cycles, consistent with narrowing interest rate differentials. The spread implied by yields on December 2006 eurodollar and euroyen futures contracts narrowed by 10 basis points over the quarter, while the yield spread between December 2006 eurodollar and euribor futures contracts narrowed by 33 basis points.

Chart 2

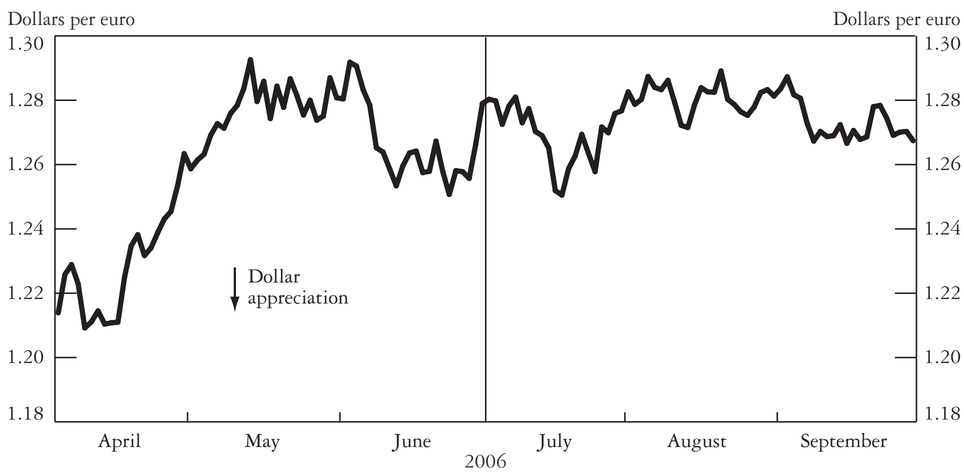
U.S. DOLLAR–YEN EXCHANGE RATE



Source: Bloomberg L.P.

Chart 3

EURO–U.S. DOLLAR EXCHANGE RATE

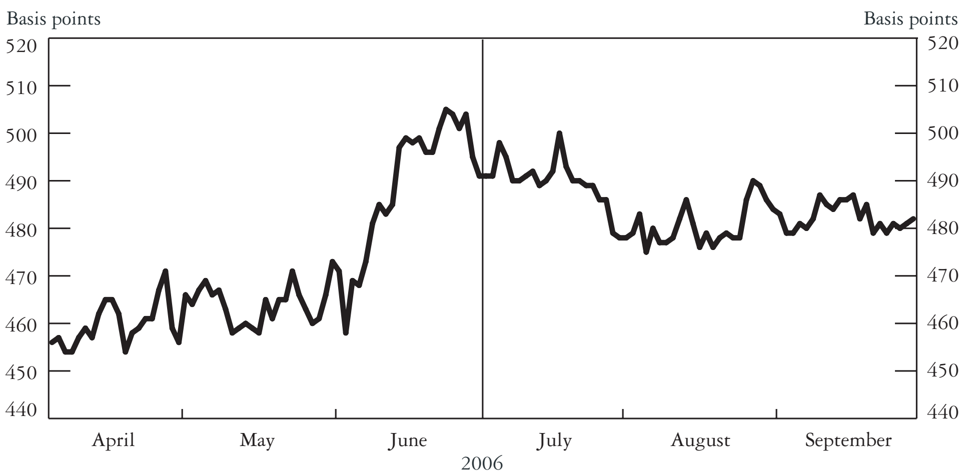


Source: Bloomberg L.P.

From early August to the end of the quarter, however, the dollar found support against the yen and euro as market participants increasingly questioned the outlook for growth in other major economies. Japanese economic data released in the second half of the quarter, including capital expenditure and machine order data, were interpreted as indicating a slower than expected pace of activity, while July consumer price data, released on August 24, were interpreted as signaling moderating inflation in Japan. These developments prompted market participants to scale back their expectations for the extent and timing of BoJ policy rate increases. In the euro area, expectations for additional monetary tightening in 2006 remained in place, supported by comments from ECB officials stressing "vigilance" against inflation. However, mounting uncertainties about the global economic outlook and the impact of forthcoming corporate and consumer tax increases in Germany contributed to expectations that the cumulative amount of ECB tightening into 2007 would be limited.

Chart 4

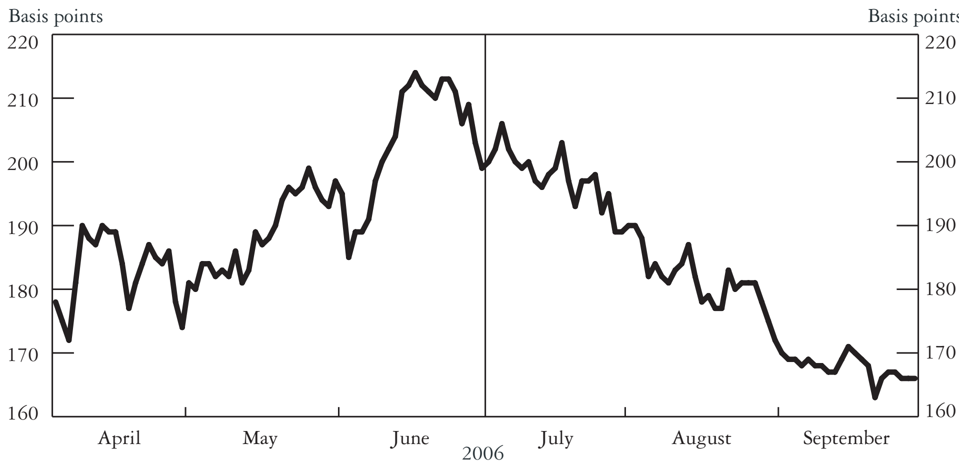
IMPLIED YIELD ON DECEMBER 2006 EURODOLLAR FUTURES CONTRACT
LESS IMPLIED YIELD ON DECEMBER 2006 EUROYEN FUTURES CONTRACT



Source: Bloomberg L.P.

Chart 5

IMPLIED YIELD ON DECEMBER 2006 EURODOLLAR FUTURES CONTRACT
LESS IMPLIED YIELD ON DECEMBER 2006 EURIBOR FUTURES CONTRACT



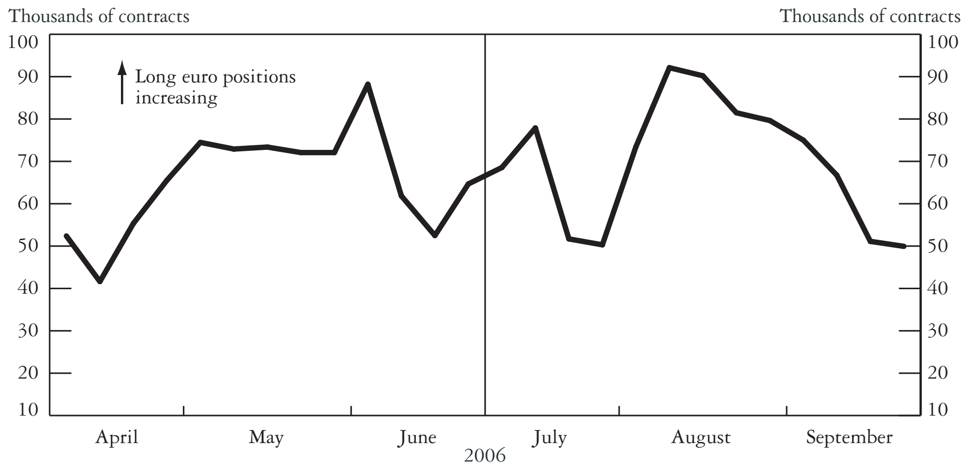
Source: Bloomberg L.P.

Over the second half of the quarter, the reassessment of relative growth outlooks prompted a shift in speculative positioning and market participants' appraisals of broader portfolio investment opportunities, reportedly lending support to the dollar. Net long euro positions against the dollar held by noncommercial accounts on the International Monetary Market, as tracked by the Chicago Mercantile Exchange, rose to a record-high level during August. These speculative positions were subsequently reduced over the second half of the quarter. Similarly, reported net long dollar positions against the yen rose steadily.

In addition, despite a mild narrowing of interest rate differentials during July, the spread between yields on benchmark U.S. Treasuries and Japanese government bonds remained relatively wide in absolute terms, a factor that reportedly kept dollar-denominated assets attractive to Japanese investors as uncertainty over the global growth outlook increased. Consistent with this notion, the Japanese Ministry of Finance reported that Japanese investors were predominantly net purchasers of foreign securities during the third quarter of 2006.

Chart 6

INTERNATIONAL MONETARY MARKET NET NONCOMMERCIAL POSITIONING IN THE EURO AGAINST THE U.S. DOLLAR



Sources: Bloomberg L.P.; Chicago Mercantile Exchange.

The pace of Chinese renminbi appreciation increased from the middle of August, which reportedly led to increased focus on issues relating to global imbalances. However, the official statement following the September 15 meeting of the Group of Eight Finance Ministers and Central Bank Governors was interpreted as providing little new information regarding policymakers' outlook on these issues. Subsequently, market participants questioned whether concerns over declining growth in the United States and uncertainties over its broader impact on global growth could reduce the willingness of policymakers to address global imbalance issues associated with the U.S. current account deficit. Some observers suggested that the reduced focus on structural imbalances provided support to the dollar during the final weeks of the quarter, particularly against the yen, and contributed to the decline in implied volatility.

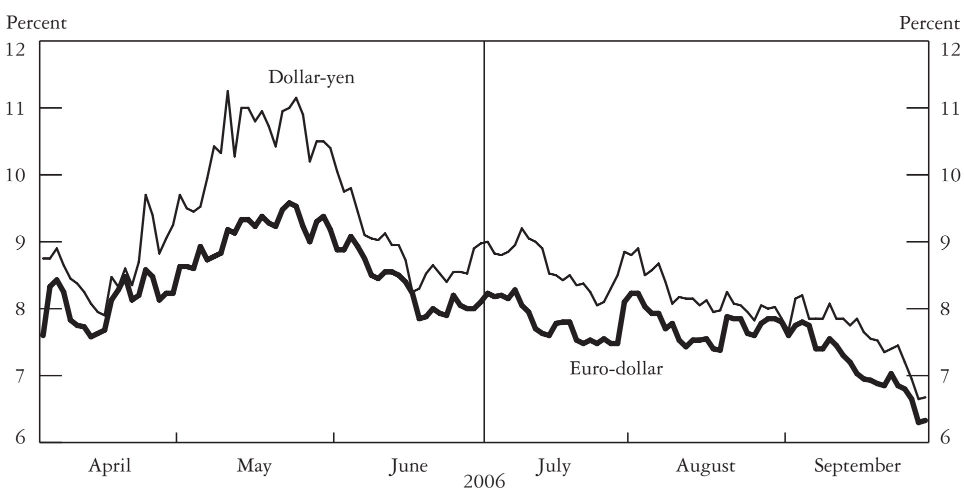
From early August through the end of the quarter, the dollar appreciated steadily against the yen, ending the quarter at ¥118.18 per dollar, its highest level since April. The dollar appreciated 3.3 percent against the yen over the full quarter, more than reversing the 2.9 percent depreciation experienced during the second quarter. Price action in the euro-dollar exchange rate was more moderate, and the dollar ended the quarter 0.9 percent higher against the euro at $1.2674 per euro.

IMPLIED VOLATILITY DECLINES TOWARD HISTORIC LOWS

Shifting expectations for cyclical and structural factors during the quarter also contributed to reduced conviction and willingness among market participants to position for broader trends among major currency pairs. Reflecting this reduced interest in holding medium-term speculative currency positions, actual and implied volatilities on both the euro-dollar and dollar-yen exchange rates continued their broad trend lower, falling toward their lowest levels over the past decade. The decline in implied volatility on major currency pairs was associated with low levels of volatility on other major assets classes, a development that prompted much discussion among market participants, although there was no broad consensus as to the factors contributing to this development. Some suggested that greater transparency of monetary policy had reduced the variability of asset prices, while others suggested that the general longer term trend of moderating variability of economic cycles continued to support the decline in volatility. Other observers suggested that increased automation and technological enhancements associated with electronic trading have improved the efficiency of price discovery in many markets. These developments, along with broader participation by investors, may have also reduced the expected variability of exchange rates.

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 $19.9 billion for the Federal Reserve 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 September 29, direct holdings of foreign government securities totaled $18.6 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $4.2 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 June 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 September 29, 2006[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	11,938.2	0	92.6	0	-86.4	11,944.4
Yen	8,255.8	0	4.1	0	-243.5	8,016.4
Total	20,194.0	0	96.7	0	-329.9	19,960.8
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	11,919.2	0	92.2	0	-86.3	11,925.1
Yen	8,255.8	0	4.1	0	-243.5	8,016.4
Total	20,175.0	0	96.3	0	-329.8	19,941.5

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] Realized 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 September 29, 2006

	U.S. Treasury Exchange Stabilization Fund (ESF)	Federal Reserve System Open Market Account (SOMA)
Euro-denominated assets:	**11,925.2**	**11,944.5**
Cash held on deposit at official institutions	5,931.5	5,951.4
Marketable securities held under repurchase agreements[a]	2,110.4	2,110.4
Marketable securities held outright[b]	3,883.2	3,882.6
German government securities	1,810.4	1,809.8
French government securities	2,072.8	2,072.8
Yen-denominated assets:	**8,016.4**	**8,016.3**
Cash held on deposit at official institutions	2,622.0	2,622.0
Marketable securities held outright[b]	5,394.4	5,394.4

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 September 29, entire euro and yen portfolios had Macaulay durations of 9.9 months and 8.3 months, respectively.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of September 29, 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

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