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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

January-March 2002

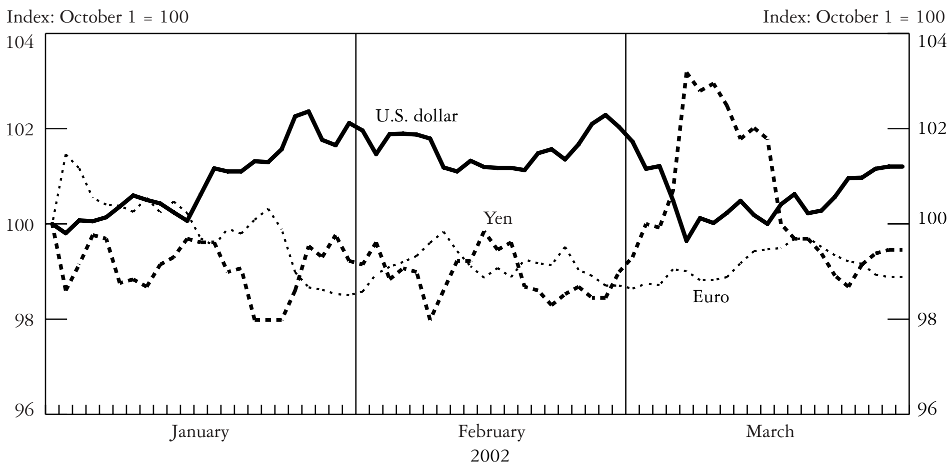
During the first quarter of 2002, the dollar appreciated 2.0 percent against the euro and 0.8 percent against the yen. Against the other major foreign currencies, the dollar gained 1.2 percent. The dollar's appreciation appeared to reflect positive investor sentiment regarding the economic recovery in the United States. Expectations for euro-area economic growth to underperform U.S. economic growth generally weighed on the euro, which depreciated 1.1 percent on a trade-weighted basis. The yen was supported ahead of Japan's fiscal year-end, despite continued pessimism regarding economic conditions in Japan. Nevertheless, the trade-weighted yen declined 0.5 percent over the quarter. The U.S. monetary authorities did not intervene in the foreign exchange market during this period.

DOLLAR APPRECIATES ON SIGNS OF U.S. ECONOMIC RECOVERY

The first quarter marked a significant turn in market expectations regarding the prospects for global economic growth. Some market participants initially anticipated monetary easing in the United States to continue into the new year. However, economic data releases pointing toward stronger growth prompted a reassessment of the U.S. economic outlook. Early in the quarter, releases of higher-than-expected manufacturing and retail sales data suggested to market participants that the U.S. economy had reached a bottom in the fourth quarter of 2001. Against this backdrop, the trade-weighted dollar returned to near sixteen-year highs in January.

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 2002. Kameke Sweeney was primarily responsible for preparation of the report.

Chart 1
TRADE-WEIGHTED G-3 CURRENCIES



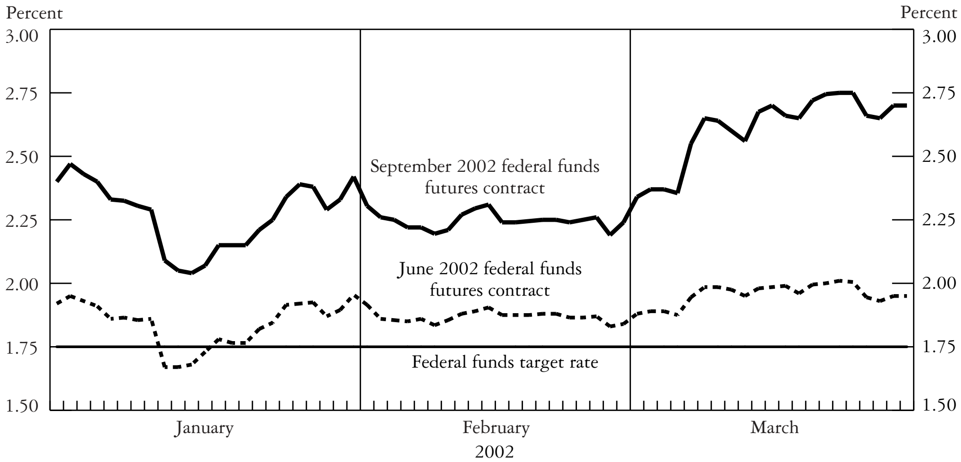
Sources: Board of Governors of the Federal Reserve System, Bank of England.

With the improvement in U.S. economic conditions, market participants began to expect that the Federal Open Market Committee (FOMC) had completed its easing cycle. From a low of 1.67 percent on January 11, the rate implied by the June federal funds contract rose 28 basis points to end the quarter at 1.95 percent. At its January 30 meeting, the FOMC left the federal funds target rate unchanged at 1.75 percent, but left the balance of risks assessment weighted toward conditions that may generate economic weakness. At the March 19 FOMC meeting, the committee shifted to a balanced assessment of risks to the economy.

U.S. interest rate futures and Treasury yields fluctuated widely during the first quarter amid changing perceptions of the risks to economic recovery. Bond market volatility increased as investors responded to developments in the Middle East and concerns over U.S. corporate accounting practices. Treasury yields declined in the first half of the quarter, with the yield on the two-year note reaching a low of 2.73 percent. However, as the U.S. economic outlook continued to improve, market participants increasingly contemplated the possibility that monetary policy would be tightened in 2002. In this environment, Treasury yields rose sharply. Over the quarter, the yield on the two-year note rose 69 basis points to 3.71 percent, with the bulk of the increase occurring in March. The two-to-ten-year Treasury coupon curve flattened 34 basis points to a spread of 169 basis points.

Chart 2

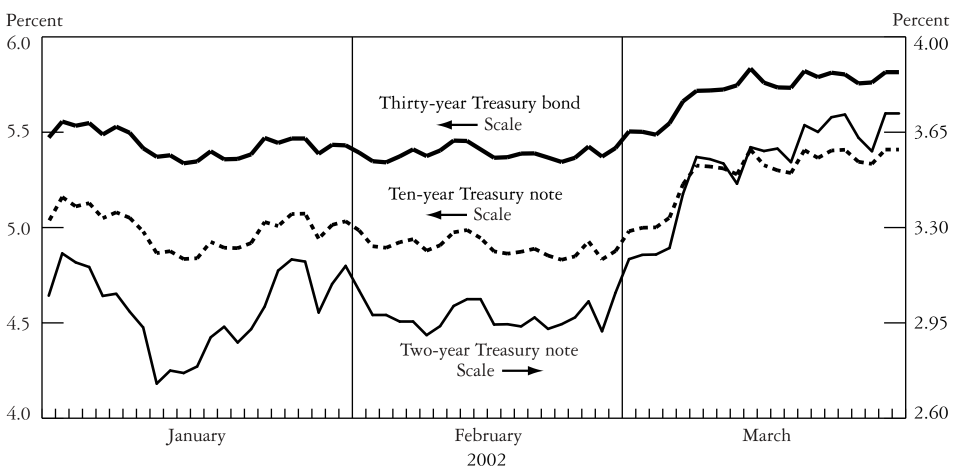
FEDERAL FUNDS TARGET RATE AND YIELDS IMPLIED BY THE JUNE AND SEPTEMBER FEDERAL FUNDS FUTURES CONTRACTS



Source: Bloomberg L.P.

Chart 3

U.S. TREASURY YIELDS



Source: Bloomberg L.P.

In contrast to increased volatility in U.S. bond markets, option implied volatility in G-3 currency pairs decreased during the quarter. Market participants attributed declining volatilities to a lack of conviction about the near-term direction of currencies and a general absence of large positions in foreign exchange markets. However, option implied volatility in yen currency pairs increased toward the end of the quarter as the yen appreciated sharply in spot currency markets ahead of the Japanese fiscal year-end.

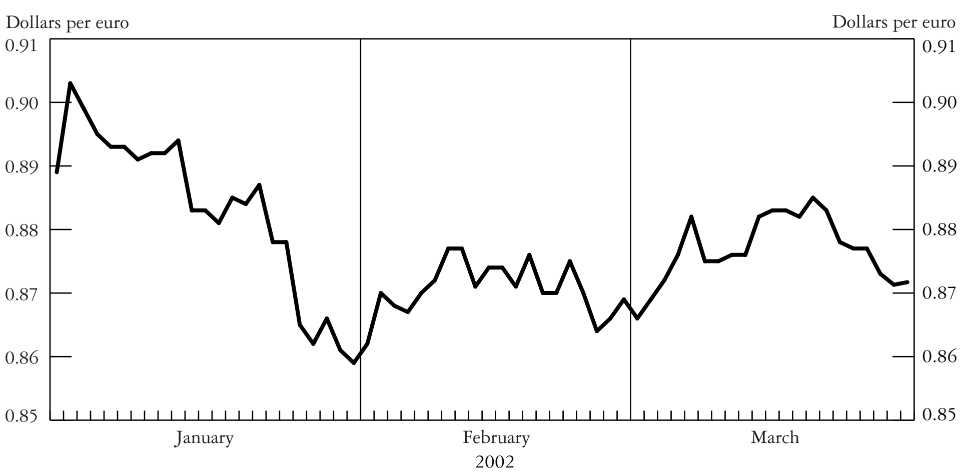
EURO DEPRECIATES IN LACKLUSTER TRADING

The initial euphoria surrounding the introduction of euro notes and coins supported the euro at the start of the new year. On its first trading day, the euro appreciated 1.6 percent against the dollar to $0.9033. However, these gains were quickly reversed as optimism toward the euro gave way to renewed focus on growth differentials. Even as data began to suggest that the euro-area economy was improving, expectations that economic recovery in the euro area would prove less dynamic than that in the United States generally weighed on the euro. During the quarter, some analysts also suggested that the European Commission's warning to Germany and Portugal over their widening budget deficits weighed negatively on euro sentiment as the warning raised concerns over the way in which fiscal developments and imbalances would be managed in the euro area.

After declining to a low of $0.8593 on January 31, the euro traded in a narrow range of $0.8600 and $0.8850 for the remainder of the quarter. The euro rose to the upper end of this range in the

Chart 4

EURO AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

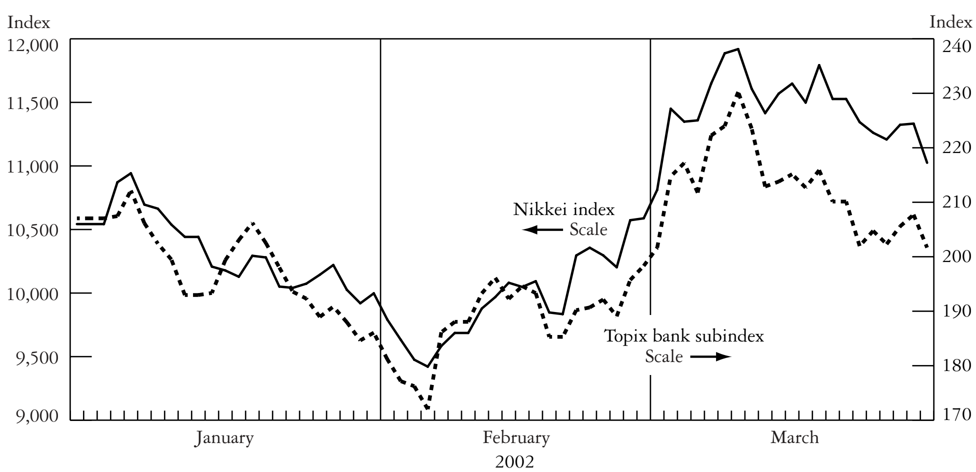
second half of the period amid the releases of the February German Business Climate Index (Ifo) and the February euro-area Purchasing Manager's Index, both of which were above market expectations. The euro also gained amid a reported reduction in speculative long dollar positions, reallocation into higher yielding non-dollar assets, and sales of dollars in favor of currencies seen as more likely to benefit from a global economic upturn and higher commodity prices.

YEN APPRECIATES AHEAD OF JAPANESE FISCAL YEAR-END

The yen traded in a relatively wide range of ¥127.50 and ¥135.00 against the dollar during the first quarter. In the first half of the quarter, the yen reached ¥134.7, its weakest level against the dollar since early October 1998. Investors sold yen for dollars and other major currencies as concern increased over the possibility of a financial sector crisis ahead of Japan's March 31 fiscal year-end. Reduced expectations for the use of public funds to recapitalize banks, the lifting of the blanket government guarantee at the end of March for bank time deposits, and Standard & Poor's downgrades of several major Japanese banks contributed to investors' perceptions of a potential deepening of financial problems. Reflecting the elevated concern among investors, Japanese equity and bond markets sold off, exacerbating the yen's weakness. Japanese government bond (JGB) yields rose and the Nikkei traded below the 10,000 level to its lowest level in sixteen years as expectations for structural reform receded with the decline in Prime Minister Koizumi's popularity. Banking shares underperformed, with the Topix equity bank subindex declining 20.1 percent to a low of 172 on February 6, amid debate over the disposal of non-performing loans.

Chart 5

JAPANESE EQUITY PRICES



Source: Bloomberg L.P.

Chart 6

TEN-YEAR JAPANESE GOVERNMENT BOND YIELD

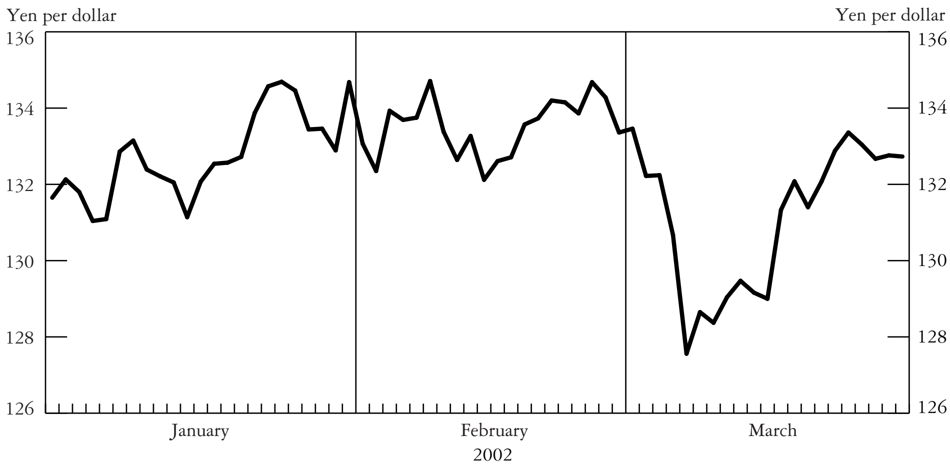
Source: Bloomberg L.P.

Concerned over the health of bank balance sheets, the Japanese government expressed a commitment to stabilize markets and avoid a financial crisis ahead of the fiscal year-end. Equity and bond markets rose from record lows as the government announced it would contribute funds to the Bank Shareholding Purchase Corporation, an entity designated to buy equity shares from banks. Furthermore, market participants speculated that government-related pension funds were also purchasing shares to support the equity market. Also, on February 27, the Japanese government released its anti-deflation plan, which received a lukewarm reaction in the market. The plan, however, included a measure to increase enforcement of restrictions on Japanese equity short-selling, which contributed to the Nikkei's full retracement of earlier declines. Japanese equities came under modest selling pressure following comments from Financial Services Agency Minister Yanagisawa that stock-supportive measures would not continue into the new fiscal year. Nevertheless, the index ended the quarter 1.4 percent stronger.

Meanwhile, JGB yields declined as market participants became less concerned that banks would liquidate bond holdings to compensate for equity losses. After reaching a high of 1.56 percent, the yield on the ten-year benchmark JGB declined to end the quarter at 1.40 percent. Additionally, to help prevent funding pressures associated with the fiscal year-end, the Bank of Japan (BoJ) increased monthly outright JGB purchases from ¥800 billion to ¥1 trillion at its February 27-28 monetary policy meeting. With the increase in liquidity provisions, current account balances held at the BoJ spiked to ¥27 trillion at the end of the quarter.

Chart 7

YEN AGAINST U.S. DOLLAR



Source: Bloomberg L.P.

With the rebound in domestic asset markets, the yen appreciated sharply against the dollar. From February 26 to March 7, the yen appreciated 5.6 percent against the dollar to ¥127.56. Reports of Japanese repatriation transactions and expectations for such flows also supported the yen's appreciation. Investor portfolio data from the Ministry of Finance showed that Japanese investors reduced foreign asset holdings ahead of the fiscal year-end, while foreign investors, who reportedly were underweight versus their benchmarks, increased holdings of Japanese equities. The yen's gains, however, were reversed as investors began to reestablish short yen positions in anticipation of Japanese capital outflows following the fiscal year-end. The yen steadily reversed most of its gains to end the quarter at ¥132.73 against the dollar.

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 Japanese yen reserve holdings totaled $14.3 billion for the Federal Reserve's System Open Market Account and $14.3 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 extent practicable, the investments are split evenly between the Federal Reserve 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 held outright or under repurchase agreements. 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 of International Settlements and in facilities at other official institutions. During the quarter, the U.S. monetary authorities began to purchase French sovereign debt as part of an effort to diversify their euro-denominated holdings. Going forward, the U.S. monetary authorities will hold, on an outright basis, euro-denominated debt backed by the full faith and credit of the French and German governments. As of March 31, direct holdings of foreign government securities totaled $12.3 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $3.1 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

		Quarterly Changes in Balance by Source					
	Balances as of December 31, 2001	Net Purchases and Sales[a]	Impact of Sales[b]	Interest Collected[c]	Revaluation[d]	Interest Accrual and Other[e]	Balances as of March 31, 2002
Federal Reserve System							
Open Market Account (SOMA)							
Euro	7,287.6	0.0	0.0	76.1	(150.8)	(4.4)	7,208.5
Japanese yen	7,206.4	0.0	0.0	0.3	(90.1)	(0.2)	7,116.4
Subtotal	14,494.0	0.0	0.0	76.4	(240.9)	(4.6)	14,324.9
Interest receivable	65.6	0.0	0.0	0.0	(1.3)	(10.6)	53.7
Total	14,559.6	0.0	0.0	76.4	(242.2)	(15.2)	14,378.6
U.S. Treasury Exchange							
Stabilization Fund (ESF)							
Euro	7,280.6	0.0	0.0	75.9	(152.5)	(2.9)	7,201.1
Japanese yen	7,206.4	0.0	0.0	0.3	(90.1)	(0.1)	7,116.5
Subtotal	14,487.0	0.0	0.0	76.2	(242.6)	(3.0)	14,317.6
Interest receivable	65.5	0.0	0.0	0.0	(1.3)	(10.6)	53.6
Total	14,552.5	0.0	0.0	76.2	(243.9)	(13.6)	14,371.2

Note: Balances are stated at amortized cost.

a) Purchases and sales include foreign currency purchases and sales related to official activity, swap drawings and repayments, and warehousing.

b) Gains and losses on sales are calculated using average cost.

c) Interest-collected figures are stated at the foreign exchange rate on the date of the receipt.

d) Reserve assets balances are revalued daily at prevailing exchange rates.

e) Includes interest accrued, current amortization, and original premium and discount of matured securities.

Table 2

NET PROFITS (LOSSES) ON U.S. TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

Millions of Dollars

	Federal Reserve System Open Market Account	U.S. Treasury Exchange Stabilization Fund
January 1, 2002, to March 31, 2002		
Unrealized profits (losses) from foreign currency holdings		
Euro	(152.1)	(153.8)
Japanese yen	(90.1)	(90.1)
Subtotal	(242.2)	(243.9)
Realized profits (losses) from foreign currency sales		
Euro	0.0	0.0
Japanese yen	0.0	0.0
Subtotal	0.0	0.0
Profit (Loss) from Foreign Exchange Operations		
Total	(242.2)	(243.9)

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 2002
Bank of Canada	2,000	0
Bank of Mexico	3,000	0
Total	5,000	0

U.S. TREASURY EXCHANGE STABILIZATION FUND RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of March 31, 2002
Bank of Mexico	3,000	0
Total	3,000	0