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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 2000

The dollar ended the second quarter of 2000 little changed against the euro and 3.1 percent stronger against the yen. The dollar initially appreciated by as much as 5.9 and 6.2 percent against the euro and yen, respectively, but slipped mid-quarter as expectations for the U.S. economy moderated. On a trade-weighted basis, the dollar ended the period modestly stronger against the United States' major trading partners' currencies, rising 1.3 percent. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

At the beginning of the quarter, weakness in technology shares led declines in U.S. equity markets as the Nasdaq fell 27.4 percent during the first two weeks of April. The equity markets' decline reportedly fostered some flows into U.S. Treasury securities, and two-year yields fell 24 basis points during the same period. However, economic data released in April were widely interpreted as reflecting a pattern of strong growth along with some inflationary pressure, as March retail sales and March producer and consumer price indexes exceeded expectations. Market participants came to anticipate further rate increases, raising consensus expectations for a May 16 tightening to 25 and then to 50 basis points. After its May 16 meeting, the Federal Open Market Committee (FOMC) announced a 50 basis point increase in the Federal funds target rate to 6.50 percent. Immediately following the meeting, the dollar appreciated 1.1 percent against the euro but was little changed against most other major currencies. Later in the quarter, economic data were widely interpreted as suggesting signs of moderation in the U.S. economy and contributed to a gradual depreciation of the dollar from its earlier highs.

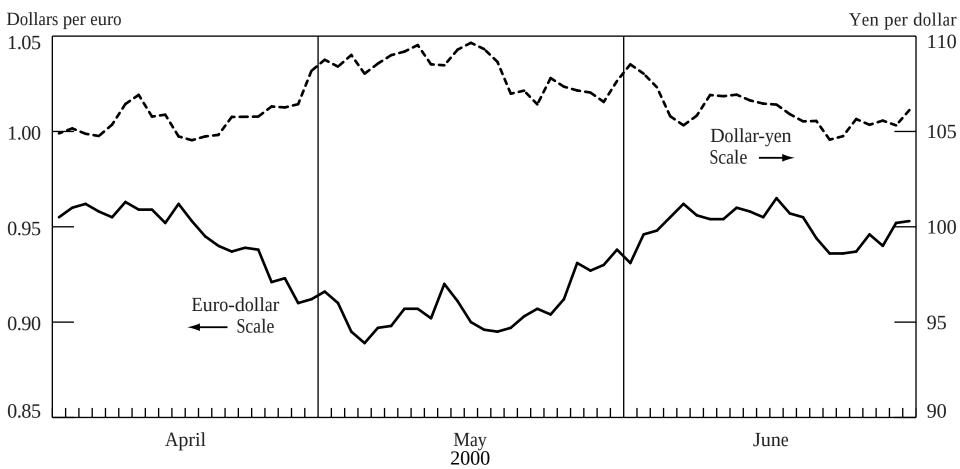
This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from April 2000 through June 2000. Laura Sarlo was primarily responsible for preparation of the report.

THE EURO AND YEN WEAKEN AGAINST THE DOLLAR DURING THE FIRST HALF OF THE QUARTER

During the first half of the quarter, the dollar appreciated against most major currencies as market participants reaffirmed expectations that U.S. economic growth would continue to outpace that of other major economies, including the euro area, and as U.S. asset markets continued to be perceived as generally attractive investment opportunities.

Chart 1

THE EURO AND YEN AGAINST THE DOLLAR



Source: Bloomberg L.P.

Data released during this time indicated that the U.S. economy grew by 5.4 percent year-on-year during the first quarter, while euro-area fourth-quarter GDP rose by 3.1 percent, and a June 9 release indicated that first quarter euro-area economic growth was 3.2 percent year-on-year. In addition, surveys reflected global investors' preference to maintain lower levels of exposure to euro-area assets, or to further reduce euro holdings. Traders also suggested that euro sales related to merger and acquisition activity may have increased demand for other currencies. Additionally, euro-area political developments, including the resignation of Italian prime minister D'Alema and further tension between Austria and its European Union partners, may have dampened sentiment toward the euro.

After starting the period at $0.9555, the euro fell to $0.8845 intraday on May 4, the lowest level since its January 1999 launch. The euro then rebounded as markets responded to numerous comments by euro-area senior officials regarding the prospects for intervention. Implied volatility in one-month euro-dollar options rose to a high of 15.1 percent on May 5.

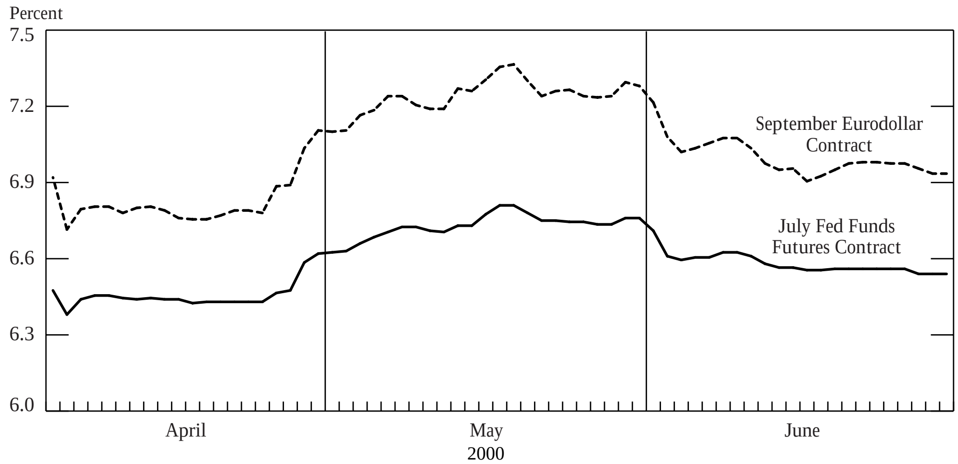
The yen weakened 1.9 percent against the dollar during the first two weeks of the quarter. After Prime Minister Obuchi became incapacitated on the first day of the period and the March Tankan report indicated an improvement in business sentiment and a smaller-than-expected decline in planned capital expenditures, Japanese monetary authorities reportedly sold yen against other currencies. The yen weakened intraday from ¥102.82 to ¥105.65 against the dollar. For the remainder of the second quarter, the yen weakened a further 1.2 percent against the dollar, although it was seemingly little affected by the change in cabinet and the June 25 legislative election. Declines in the Nikkei and net portfolio investment outflows during the quarter may have also contributed to the yen's depreciation.

THE DOLLAR DEPRECIATES MODESTLY DURING THE SECOND HALF OF THE QUARTER

Beginning in late May, many market participants perceived a moderating trend in U.S. economic growth, as reflected in several economic data releases. Among these data were the weaker-than-expected National Association of Purchasing Managers (NAPM) and Chicago Purchasing Managers Index (PMI) surveys, the May employment report, May Consumer Price Index (CPI), and retail sales data. This shift in growth expectations prompted many to revise downward their forecasts for further monetary tightening. The implied yield on the July Federal funds futures contract declined 19 basis points from mid-May to the end of the quarter. During this period, market participants reassessed the probability of an FOMC rate increase at the June 28 meeting and began to debate the degree of additional tightening expected before the year-end. The revision in policy expectations, as well as a series of strong first-quarter earnings reports, boosted U.S. equities, with the Nasdaq gaining 12.4 percent between May 15 and the end of the quarter.

Chart 2

IMPLIED YIELDS ON U.S. INTEREST RATE FUTURES CONTRACTS

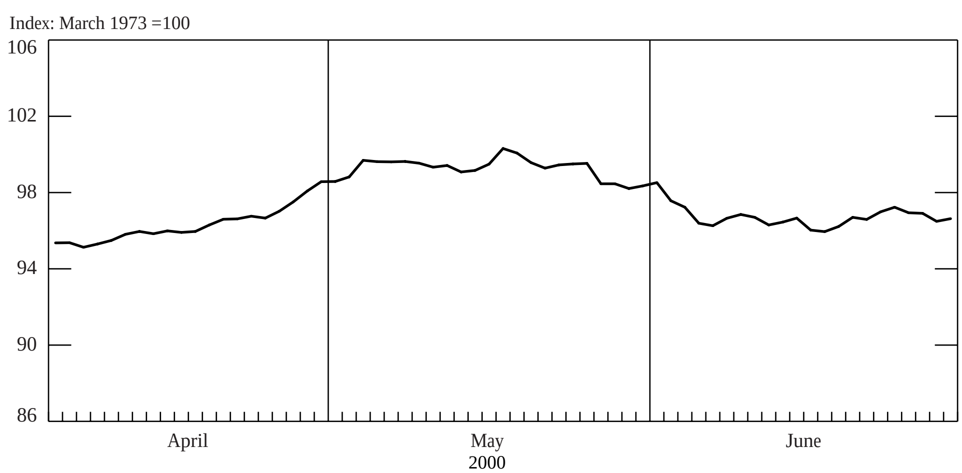


Source: Bloomberg L.P.

Growing expectations for moderating U.S. economic growth also contributed to the appreciation of a broad range of currencies against the dollar. On a trade-weighted basis, the dollar declined 1.9 percent in June against the United States' major trading partners' currencies. After June 1, the Canadian dollar and British pound strengthened 0.7 and 1.5 percent against the U.S. dollar, respectively, as market participants revisited forecasts for interest rate differentials.

Chart 3

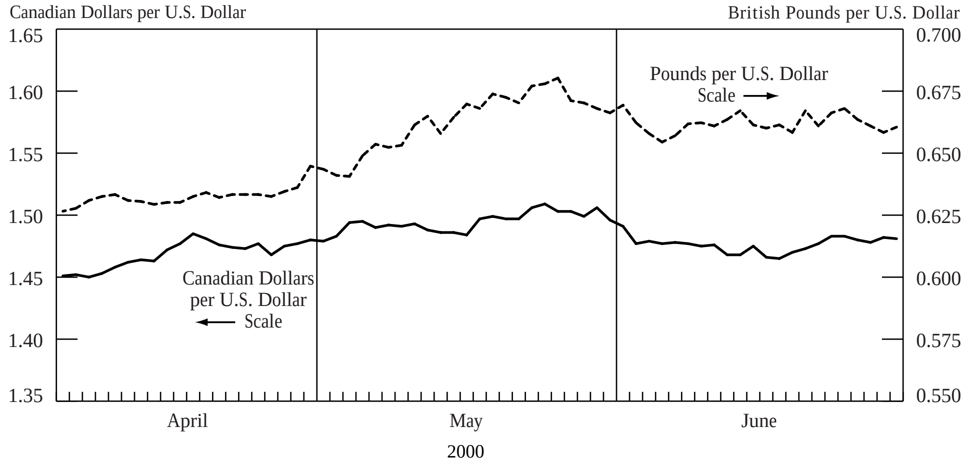
THE TRADE-WEIGHTED DOLLAR AGAINST MAJOR CURRENCIES



Source: Federal Reserve Board of Governors

Chart 4

THE CANADIAN DOLLAR AND BRITISH POUND AGAINST THE U.S. DOLLAR

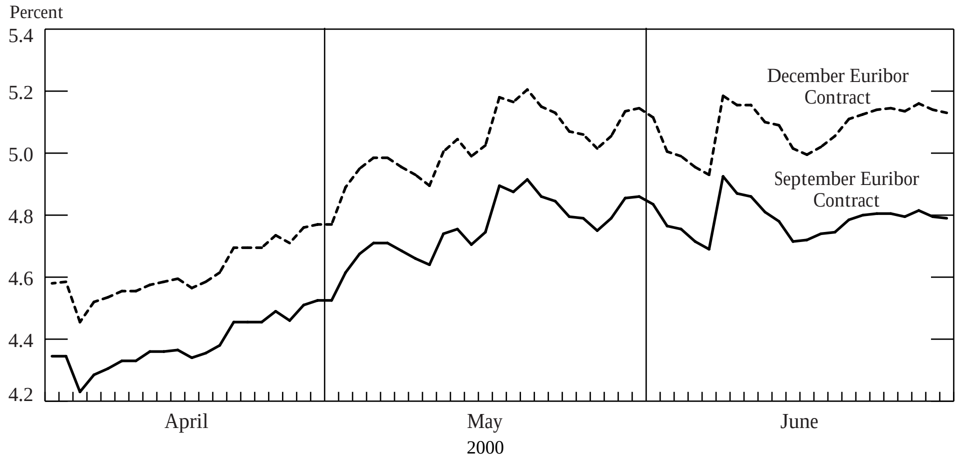


Source: Bloomberg L.P.

In late May, the euro began a reversal of its April depreciation. Demand for the euro appeared to grow as short-term investors reportedly established long euro positions and some longer-term investors began buying the euro on dips. This retracement was also supported by the release of stronger-than-expected euro-area economic data, including euro-area March industrial production and national consumer price indexes. Increases in M3 solidified expectations that the European Central Bank (ECB) would tighten monetary policy, although the June 8 announcement of a 50 basis point rate increase to 4.25 percent exceeded market expectations. Some market participants suggested that the expectation for potential narrowing of the interest rate differential between the U.S. and euro area supported the euro against the dollar. During the quarter, the spread between two-year dollar and euro swap rates narrowed 55 basis points to 190 basis points.

Chart 5

IMPLIED YIELDS ON EURO-AREA INTEREST RATE FUTURES CONTRACTS



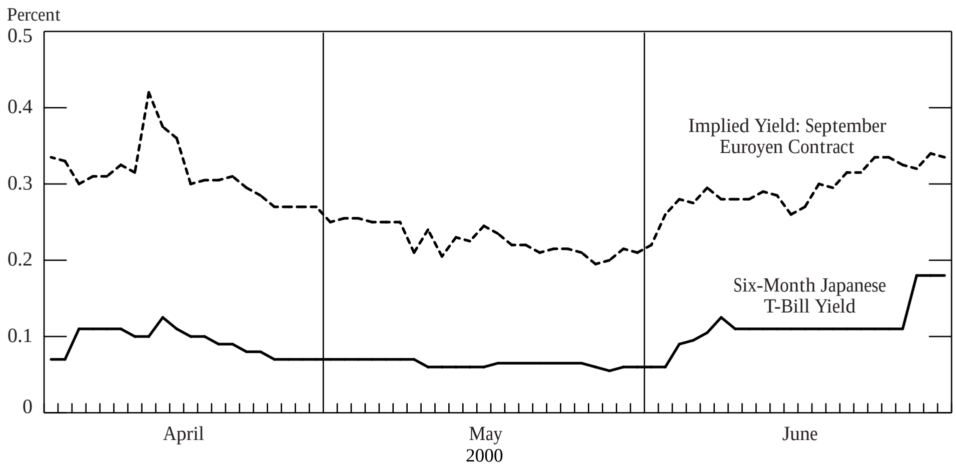
Source: Bloomberg L.P.

However, the euro did not appreciate following the June 8 ECB announcement and subsequent official comments, which were interpreted as a signal that the ECB would not undertake any additional rate increases until September. Late in the period, market participants reconsidered such expectations following the release of higher-than-expected national and euro-area June producer and consumer price indexes, along with continued increases in oil prices. Rising shorter-dated yields did not appear to support the currency, which retreated from its quarter-high close of $0.9655 on June 16 to end the period at $0.9537.

Compared with the euro, the yen appreciated more modestly against the dollar during the second half of the quarter. Market discussion of a possible end to the near-zero interest rate policy, a background factor throughout the quarter, intensified after mid-May. Comments by Bank of Japan (BoJ) officials contributed to some participants' estimation that the BoJ Policy Board was increasingly likely to repeal the near-zero interest rate policy, perhaps as early as July. Yields on six-month Japanese Treasury bills rose sharply, increasing from 0.06 to 0.18 percent.

Chart 6

YIELDS ON SHORT-TERM JAPANESE FIXED INCOME SECURITIES



Source: Bloomberg L.P.

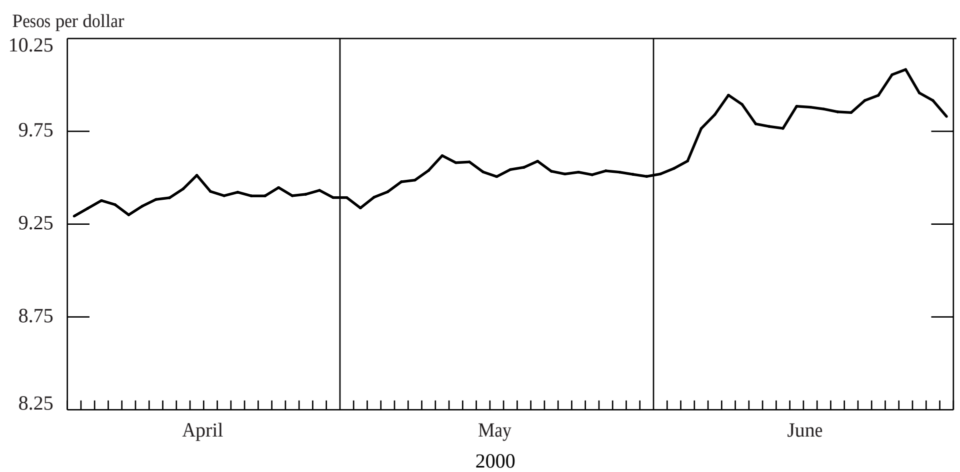
While the yen appreciated on a short-term basis on days on which the possible end of the near-zero interest rate policy was a market focus, the dollar-yen exchange rate largely remained above the ¥105 level during the period. Widespread market concern that yen appreciation beyond 105 yen per dollar might prompt official action in currency markets may have supported the dollar against the yen. Ongoing concern about the Japanese corporate sector, marked by several notable bankruptcies and an absence of a pick-up in bank lending, may also have limited the Japanese currency's appreciation. The June 25 election success of the Liberal Democratic Party (LDP) led by Prime Minister Mori appeared to have little impact on the currency.

MEXICAN ASSETS SWAYED BY ELECTION CONCERNS

The dollar appreciated 5.8 percent against the Mexican peso as the peso weakened against a broad range of currencies ahead of the July 2 presidential election. Yields on short-dated Mexican debt instruments rose as investors sought to offset the additional perceived event risk and as the Banco de Mexico tightened monetary conditions by increasing the shortage of reserves in the banking system. Longer-dated yields rose more modestly, remaining within recent ranges. The Mexican sub-index of the J.P. Morgan Emerging Market Bond Index Plus (EMBI+) spread over U.S. Treasuries rose from 354 to 381 basis points, underperforming the broader index by 50 basis points.

Chart 7

THE MEXICAN PESO AGAINST THE DOLLAR



Source: Bloomberg L.P.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

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 $15.5 billion for the Federal Reserve System and $15.5 billion for the Treasury's Exchange Stabilization Fund. The U.S. monetary authorities invest all of 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, these investments are split evenly between the Federal Reserve System and the Exchange Stabilization Fund.

A significant portion of the balances is invested in German and Japanese government securities held directly or under repurchase agreement. Government securities held under repurchase agreement are arranged either through transactions executed directly in the market or through agreements with official institutions. Foreign currency reserves are also invested in deposits at the Bank for International Settlements and in facilities at other official institutions. As of June 30, direct holdings of foreign government securities totaled $8.2 billion, split evenly between the two authorities. Foreign government securities held under repurchase agreement totaled $13.3 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

		Changes in Balance by Source					
	Balances as of March 31, 2000	Net Purchases and Sales[1]	Impact of Sales[2]	Investment Income	Currency Valuation Adjustments[3]	Interest Accrual and Other[5]	Balances as of June 30, 2000
System Open Market Account (SOMA)							
Euro	$6,597.4	$0.0	$0.0	$58.6	($18.5)		$6,637.5
Japanese yen	$9,171.4	0.0	0.0	$5.8	(299.3)		$8,877.9
Subtotal	$15,768.7	$0.0	$0.0	$64.4	($317.7)		$15,515.4
Interest Receivable (net)[4]	34.3					0.2	34.5
Other cash flow from investments[5]						4.6	4.6
Total	$15,803.0	0.0	0.0	$64.4	($317.7)	4.8	$15,554.5
U.S. Treasury Exchange Stabilization Fund (ESF)							
Euro	$6,594.5	0.0	0.0	$58.6	(18.5)		$6,634.7
Japanese yen	$9,171.4	0.0	0.0	$5.8	(299.4)		$8,877.8
Subtotal	$15,765.9	0.0	0.0	$64.4	($317.8)		$15,512.5
Interest Receivable[4]	59.8					(3.4)	56.4
Other cash flow from investments[5]						4.7	4.7
Total	$15,825.7	0.0	0.0	$64.4	($317.8)	1.3	$15,573.6

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

[1] Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

[2] This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

[3] Foreign currency balances are marked-to-market monthly at month-end exchange rates.

[4] Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at average cost of acquisition and are not marked-to-market until interest is paid.

[5] Values are cash flow differences from payment and collection of funds between quarters.

Table 2

NET PROFITS (LOSSES) ON U.S. TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON HISTORIC COST-OF-ACQUISITION EXCHANGE RATES

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of March 31, 2000		
Euro	(851.1)	(1,067.8)
Japanese yen	(2,126.90)	(2,339.10)
Total	(2,978.00)	(3,406.90)
Realized profits and losses from foreign currency sales March 31, 2000-June 30, 2000		
Euro	0.0	0.0
Japanese yen	0.0	0.0
Total	0.0	0.0
Valuation profits and losses on outstanding assets and liabilities as of June 30, 2000		
Euro	(869.6)	(1,086.3)
Japanese yen	1,832.3	2,044.4
Total	962.7	958.2

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2000
Bank of Canada	2,000	0
Bank of Mexico	3,000	0
Total	5,000	0

FEDERAL RESERVE AND U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of June 30, 2000
Bank of Mexico	3,000	0
Total	3,000	0