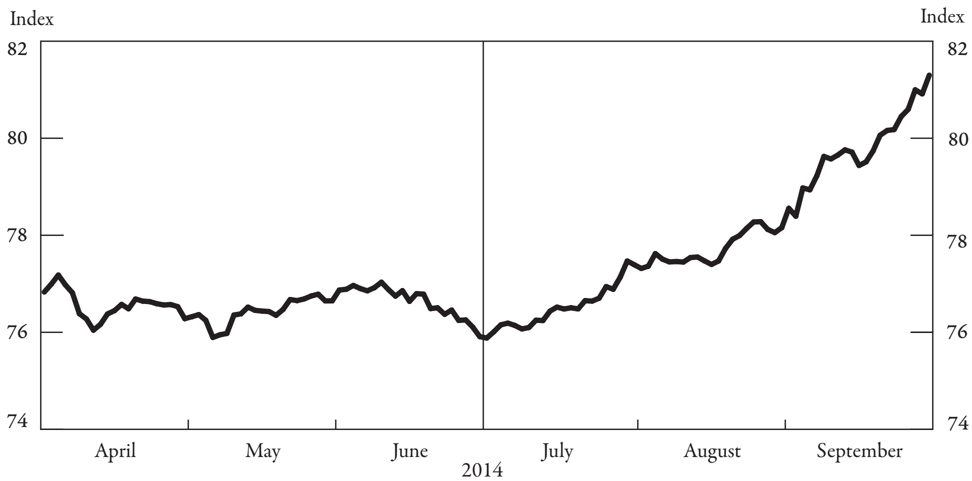
TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

July–September 2014

During the third quarter, the U.S. dollar's nominal trade-weighted exchange value appreciated 7.1 percent, as measured by the Federal Reserve Board's major currencies index. The U.S. dollar appreciated notably against all major and most emerging market currencies, reportedly reflecting market expectations for divergent economic growth prospects and monetary policy between the United States and other economies. In particular, the dollar appreciated 8.4 percent against the euro and 8.2 percent against the Japanese yen. The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.

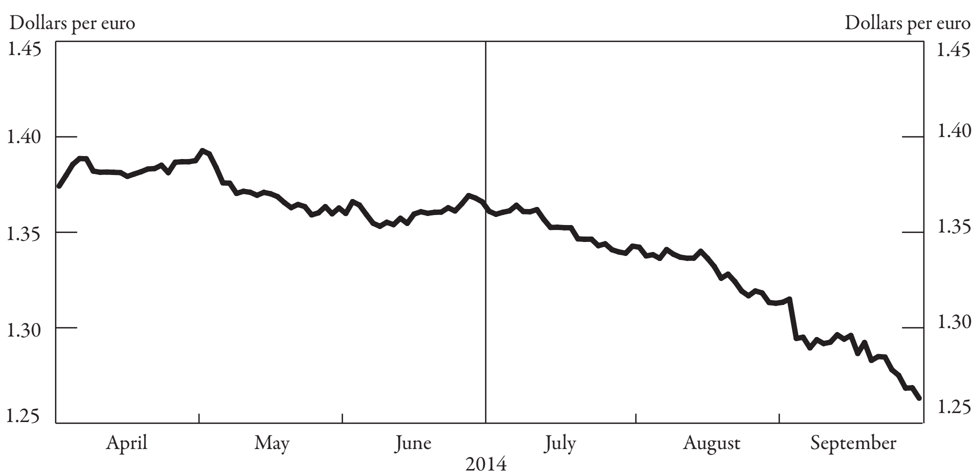
This report, presented by Simon Potter, Executive Vice President, Federal Reserve Bank of New York, and Manager of the System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from July through September 2014. Evan Kereiakes was primarily responsible for preparation of the report.

Chart 1
TRADE-WEIGHTED U.S. DOLLAR



Source: Board of Governors of the Federal Reserve System.

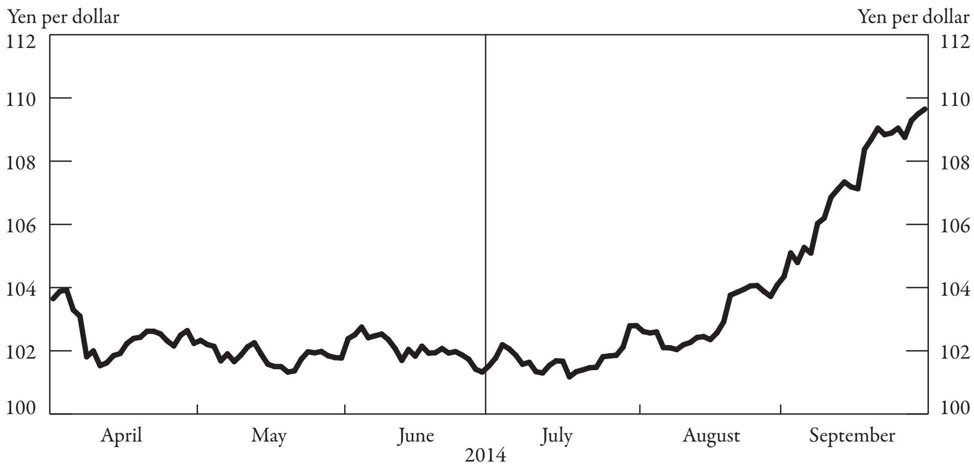
Chart 2
EURO–U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 3

U.S. DOLLAR–YEN EXCHANGE RATE



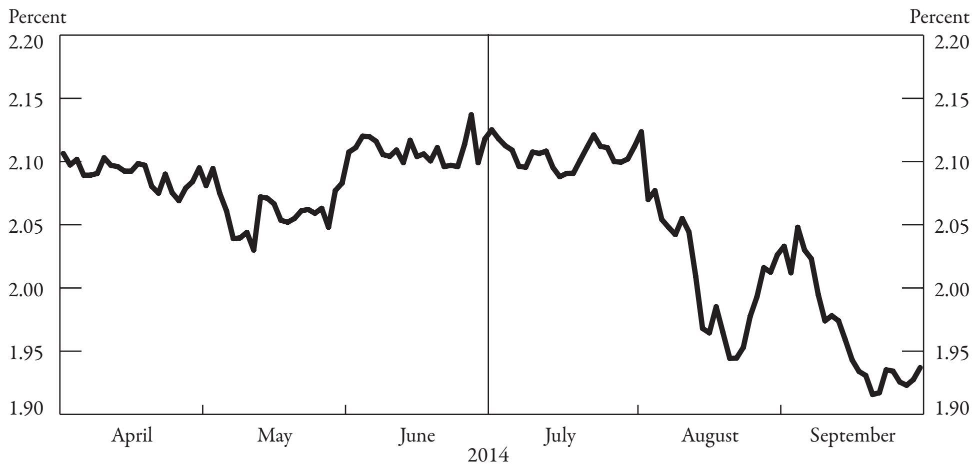
Source: Bloomberg L.P.

U.S. DOLLAR APPRECIATES AGAINST ADVANCED-ECONOMY CURRENCIES AMID DIVERGENT GROWTH AND MONETARY POLICY EXPECTATIONS

During the third quarter, the trade-weighted U.S. dollar appreciated 7.1 percent, reflecting expectations for the divergent economic growth and policy outlook of the United States relative to other advanced economies. U.S. economic data during the period were generally better than expected, including the final reading of second-quarter GDP, as well as Institute for Supply Management manufacturing, consumer confidence, and employment data. Market participants noted that these economic data releases, combined with the July Federal Open Market Committee meeting minutes, which also pointed to improving U.S. data, reinforced expectations for U.S. policy normalization in the course of 2015.

Contrary to the U.S. outlook, incoming euro-area economic data during the quarter, including inflation, growth, and manufacturing data, were generally seen as worse than expected. In response, at its September policy meeting, the European Central Bank (ECB) further lowered its policy rates and introduced an asset-backed security and covered bond purchase program. Expectations for further policy action had increased following ECB President Mario Draghi's speech in Jackson Hole in August, when he specifically referenced the downward path of euro-area inflation and inflation expectations, noting that the five-year/five-year-forward euro-area inflation swap rate had declined to below 2 percent.

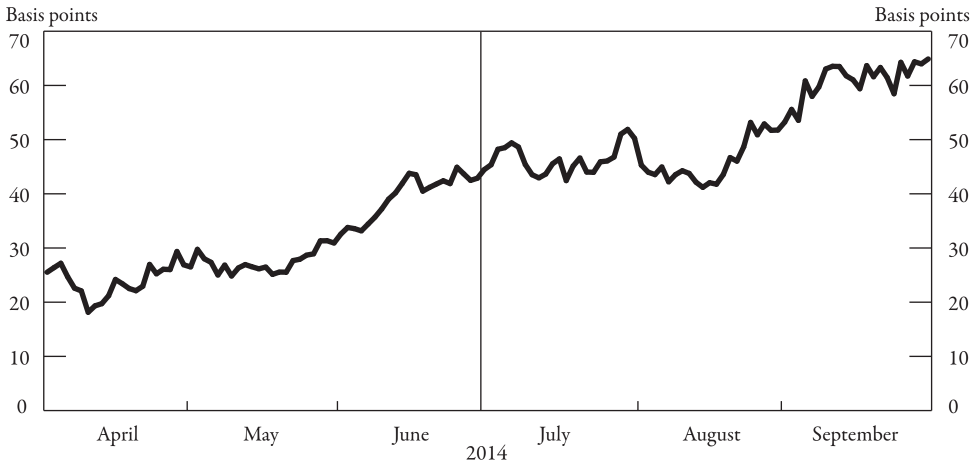
Chart 4
FIVE-YEAR/FIVE-YEAR-FORWARD EURO-AREA INFLATION RATE



Source: Bloomberg L.P.

Nevertheless, the ECB's September policy decision to further lower its key policy rates was somewhat earlier than expected by market participants, which led in part to further declines in euro-area interest rates and the euro–U.S. dollar currency pair. Overall, the spread between two-year U.S. Treasury and German Bund yields widened by 22 basis points to 65 basis points, and the U.S. dollar appreciated 8.4 percent against the euro during the quarter. In addition, noncommercial positioning in euro–U.S. dollar currency futures increased to near-record-level net short positioning over the period.

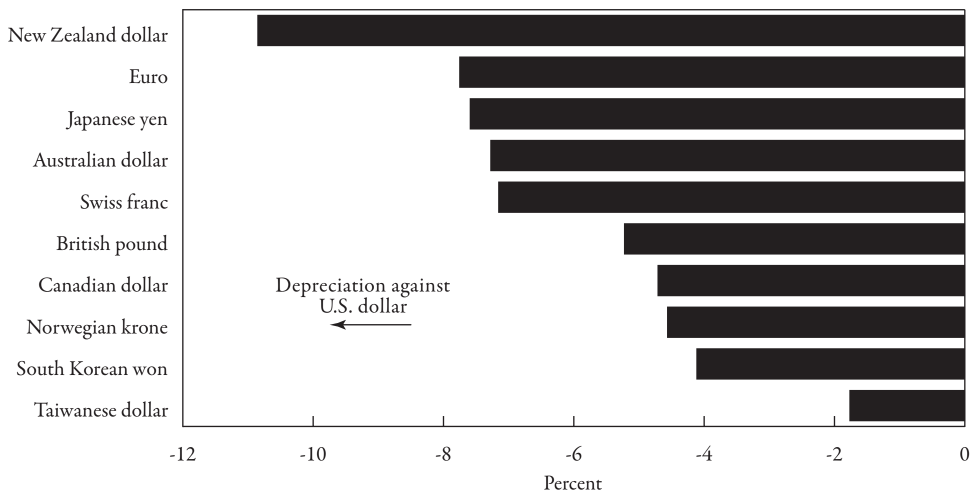
Chart 5
TWO-YEAR U.S.–GERMAN SOVEREIGN BOND YIELD SPREAD



Source: Bloomberg L.P.

Other European currencies, such as the Swedish krona and Swiss franc, also depreciated against the dollar, in line with the euro. The Swiss franc, however, appreciated modestly against the euro, prompting Swiss National Bank (SNB) officials to reiterate their resolve to defend the euro–Swiss franc 1.20 exchange rate floor, if necessary. The U.S. dollar also appreciated, by 5.5 percent, against the British pound. Factors weighing on the British pound included the Bank of England (BoE) quarterly Inflation Report, which was viewed as more accommodative than expected, lower-than-expected wage growth, and uncertainty surrounding the Scottish independence referendum.

Chart 6
U.S. DOLLAR PERFORMANCE AGAINST DEVELOPED MARKET CURRENCIES



Source: Bloomberg L.P.

The U.S. dollar appreciated 8.2 percent against the Japanese yen in the third quarter. Market participants attributed the yen's depreciation in part to continued expectations for additional accommodative measures by the Bank of Japan (BoJ), a sentiment supported by lower-than-expected inflation data released during the quarter.

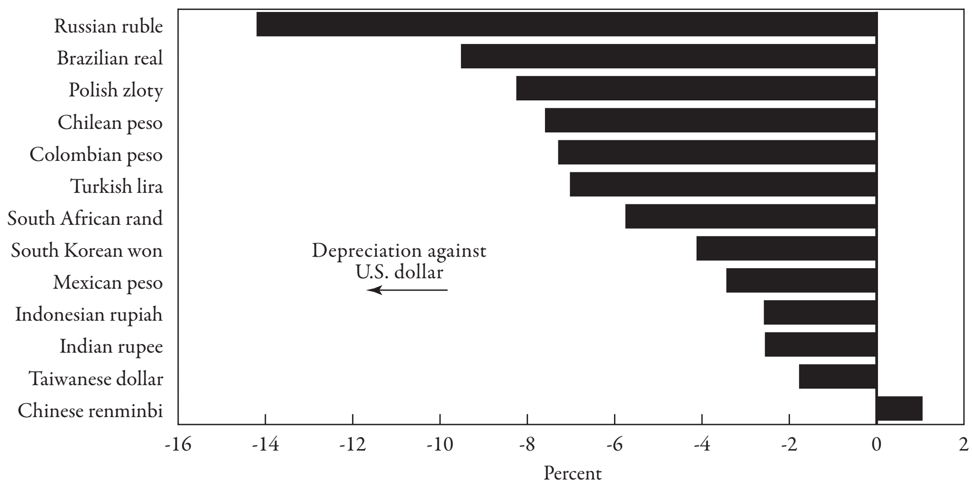
The Australian dollar and Canadian dollar depreciated against the U.S. dollar, driven by a decline in commodity prices and a reduction in the attractiveness of higher-yielding currency trades in light of dollar appreciation and increased foreign exchange market volatility. The Canadian dollar declined 4.7 percent, less than other advanced-economy currencies, as higher Canadian inflation data over the quarter raised the prospect of an earlier policy rate increase. The New Zealand dollar depreciated 10.8 percent, the largest depreciation among advanced-economy currencies. Notably, the Reserve Bank of New Zealand intervened to weaken its currency during the quarter, with the central bank stating that it viewed the currency as overvalued.

U.S. DOLLAR APPRECIATES AGAINST EMERGING MARKET CURRENCIES AMID SENSITIVITY TO RELATIVE MONETARY POLICY EXPECTATIONS AND SOFTER EMERGING MARKET ECONOMIC DATA

Emerging market (EM) currencies depreciated against the U.S. dollar amid sensitivity to shifts in global monetary policy expectations, weaker-than-expected economic data from a number of emerging market countries, and declines in commodity prices. In particular, economic activity, credit growth, and housing data from China fell short of expectations and weighed on EM sentiment and currencies, which declined approximately 4 to 8 percent against the U.S. dollar. However, EM currency depreciation did not deter debt, equity, and foreign direct investment flows into EM countries, which totaled $64 billion in the third quarter, according to the Institute for International Finance. Flows into EM countries were comparable to the quarterly average since the beginning of 2010.

Country-specific developments exacerbated the depreciation of the Russian ruble and the Brazilian real, which declined 14.1 percent and 9.5 percent, respectively, against the U.S. dollar. Geopolitical tensions weighed on the Russian ruble, which depreciated amid capital outflows, diminishing growth expectations, and deteriorating access to dollar liquidity in Russia, as evidenced by the more-than-150-basis-point widening of the one-year U.S. dollar–Russian ruble cross-currency basis swap. In Brazil, political uncertainty surrounding the outcome of the presidential election, higher-than-expected inflation and fiscal deficit data, and lower-than-expected current account and growth data contributed to the depreciation of the Brazilian real.

Chart 7
U.S. DOLLAR PERFORMANCE AGAINST EMERGING MARKET CURRENCIES



Source: Bloomberg L.P.

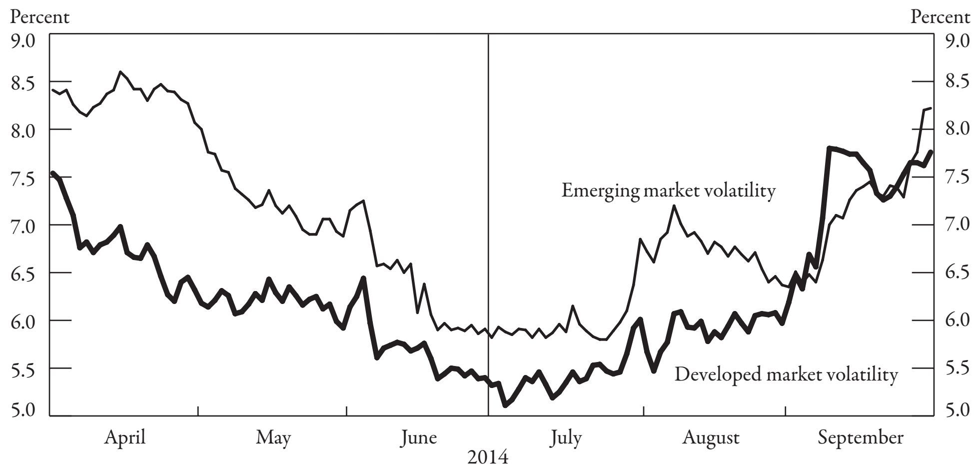
The Chinese renminbi appreciated 1.1 percent against the U.S. dollar during the third quarter, while the central parity rate set by the People's Bank of China was largely unchanged. China's currency appreciated despite weaker-than-expected data for housing, industrial production, retail sales, and manufacturing.

FOREIGN EXCHANGE VOLATILITY INCREASES MODESTLY FROM HISTORIC LOWS

With the divergence in expectations for advanced-economy central bank policy trajectories, implied currency volatility increased from its recent historic lows to levels last seen in the first quarter of the year. Despite the recent rise, foreign exchange volatility remained at relatively low levels in a historical context. Some of the recent moves in volatility appear idiosyncratic in nature, such as the spike in British pound volatility ahead of the Scottish independence referendum, but in general the modest increase in volatility across currencies was broad-based.

Chart 8

IMPLIED DEVELOPED AND EMERGING MARKET CURRENCY VOLATILITY



Sources: Bloomberg L.P.; JPMorganChase.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE HOLDINGS

The U.S. monetary authorities did not undertake any intervention operations during the quarter. As of September 30, the value of the U.S. Treasury's Exchange Stabilization Fund foreign-currency-denominated assets totaled $22.24 billion, comprised of euro and yen holdings. The Federal Reserve System Open Market Account holdings of foreign-currency-denominated assets totaled $22.26 billion, also comprised of euro and yen holdings.

Liquidity Swap Arrangements with Foreign Central Banks

As of September 30, the ECB had no outstanding U.S. dollar liquidity swaps, for the first time since September 2011. The BoJ had $240 million of outstanding swaps, all in the one-week tenor transaction. The Bank of Canada, BoE, and SNB did not have any outstanding swaps at the end of the quarter. The final eighty-four-day operation was held at the end of April 2014, and the ECB, BoE, BoJ, and SNB announced on June 17 that they would continue to offer one-week U.S. dollar liquidity-providing operations after July 31 until further notice.

Foreign Exchange Reserve Holdings

The U.S. monetary authorities invest their foreign currency reserves in a variety of instruments that yield market 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 typically invested on an outright basis in German, French, and Japanese government securities. A smaller portion of the reserves is typically invested in euro-denominated repurchase agreements, under which the U.S. monetary authorities may 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 30, direct holdings of foreign government securities totaled $22.36 billion. In addition, foreign government securities held under repurchase agreements declined to $0 billion, a decrease from $1.40 billion at the end of the second quarter, while cash held in euro-denominated deposits at official institutions totaled $16.52 billion, a decrease from $18.69 billion. This shift in the portfolio occurred amid extremely low or negative rates across money market instruments in the third quarter following the ECB's September 4 decision to reduce the main refinancing and deposit rates to 0.05 percent and -0.20 percent, respectively. The amount of yen-denominated deposits has remained fairly steady over recent quarters.

Table 1

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

Millions of U.S. Dollars

		Changes in Balances by Source				
	Carrying Value, June 30, 2014[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, September 30, 2014[a]
Federal Reserve System Open Market Account (SOMA)						
Euro	14,899	0	16	0	(1,156)	13,758
Japanese yen	9,207	0	3	0	(704)	8,506
Total	24,106	0	18	0	(1,860)	22,264

		Changes in Balances by Source				
	Carrying Value, June 30, 2014[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, September 30, 2014[a]
U.S. Treasury Exchange Stabilization Fund (ESF)						
Euro	14,875	0	16	0	(1,155)	13,736
Japanese yen	9,207	0	3	0	(704)	8,506
Total	24,082	0	18	0	(1,858)	22,242

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, repayments, and warehousing.

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

[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

Carrying Value in Millions of U.S. Dollars, as of September 30, 2014

	U.S. Treasury Exchange Stabilization Fund (ESF)[a]	Federal Reserve System Open Market Account (SOMA)[a]
Euro-denominated assets	**13,736.2**	**13,757.9**
Cash held on deposit at official institutions	8,250.0	8,271.7
Marketable securities held under repurchase agreements[b]	0.0	0.0
Marketable securities held outright	5,486.2	5,486.2
German government securities	2,347.9	2,347.9
French government securities	3,138.3	3,138.3
Japanese-yen–denominated assets	**8,506.2**	**8,506.1**
Cash held on deposit at official institutions	2,811.5	2,811.5
Marketable securities held outright	5,694.6	5,694.6
Reciprocal currency arrangements		
European Central Bank[c]		0
Bank of Japan[c]		240
Swiss National Bank[c]		0
Bank of Canada[c]		0
Bank of England[c]		0
Banco de México[c]		0

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

[a] As of September 30, the euro SOMA and ESF portfolios both had Macaulay durations of 11.6 months; the yen SOMA and ESF portfolios both had Macaulay durations of 11.5 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, the Bank of England, and Banco de México.

Table 3

RECIPROCAL CURRENCY ARRANGEMENTS

Millions of U.S. Dollars

Institution	Amount of Facility	Outstanding as of September 30, 2014
	Federal Reserve System Open Market Account (SOMA)	
Reciprocal currency arrangement		
Bank of Canada	2,000	0
Banco de México	3,000	0
Standing dollar liquidity swap arrangement		
European Central Bank	No preset limit	0
Swiss National Bank	No preset limit	0
Bank of Japan	No preset limit	240
Bank of Canada	No preset limit	0
Bank of England	No preset limit	0
	No preset limit	240
Standing foreign currency liquidity swap arrangement		
European Central Bank	No preset limit	0
Swiss National Bank	No preset limit	0
Bank of Japan	No preset limit	0
Bank of Canada	No preset limit	0
Bank of England	No preset limit	0
	No preset limit	0
	U.S. Treasury Exchange Stabilization Fund (ESF)	
Banco de México	3,000	0
	3,000	0