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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

July-September 2002

During the third quarter of 2002, the dollar appreciated 0.3 percent against the euro and 1.8 percent against the yen. On a trade-weighted basis, the dollar rose 1.5 percent as it fluctuated in response to shifting attitudes toward global economic and geopolitical risks. Global equity declines, continued questions about corporate credit quality, and growing expectations of a military conflict with Iraq appeared to benefit the currency as short dollar positions were covered in an environment of heightened risk aversion. The U.S. monetary authorities did not intervene in the foreign exchange market during the quarter.

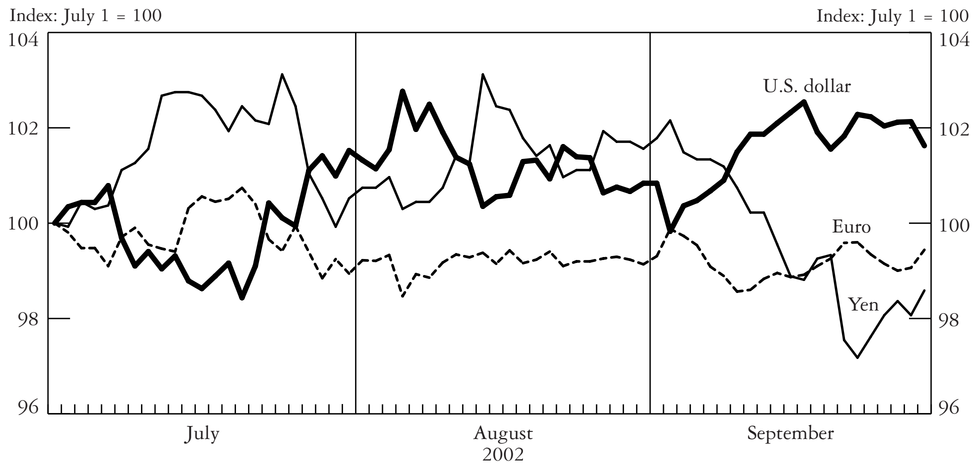
DOLLAR APPRECIATES SLIGHTLY IN MID-JULY

The dollar rose modestly against most major currencies in mid-July, partially reversing its depreciation against many European currencies and the yen in the prior quarter. The dollar's gains against many major currencies occurred as risk positions were reduced in light of sharp equity market declines, corporate bond spread widening, and an increasingly negative outlook among market participants for U.S. and global growth.

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 July through September 2002. Kathryn Chen was primarily responsible for preparation of the report.

Chart 1

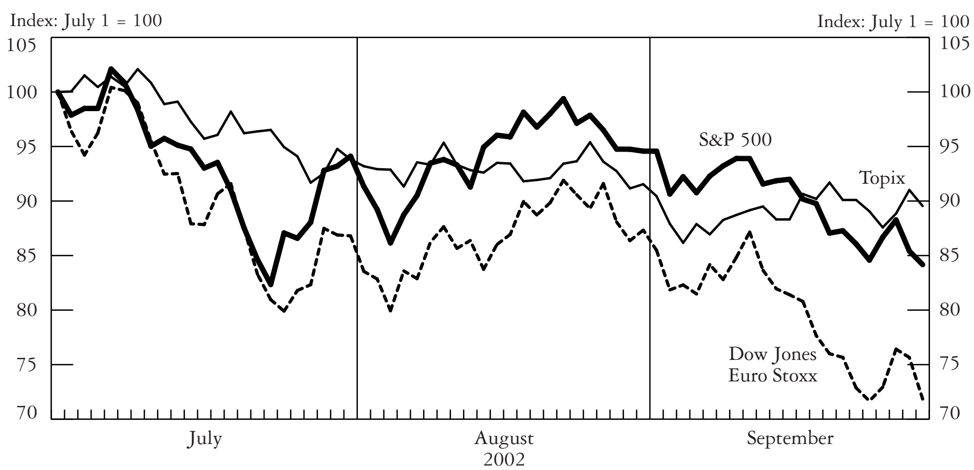
TRADE-WEIGHTED G-3 CURRENCIES



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

Chart 2

GLOBAL BENCHMARK EQUITY INDEXES



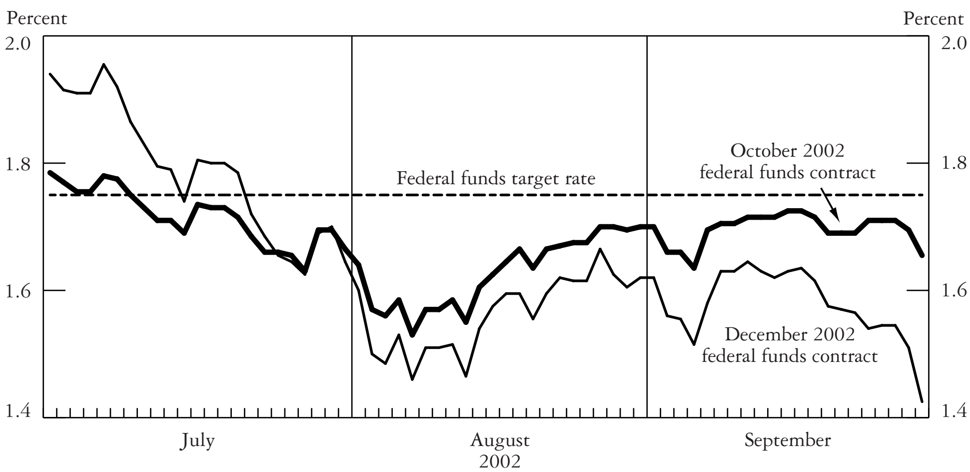
Source: Bloomberg L.P.

Major U.S. equity indexes declined, with the S&P 500 reaching five-year lows on July 23 amid growing concerns over reports of new corporate accounting irregularities and bankruptcies, the financial sector's exposure to these companies, and continued equity mutual fund redemptions. The VIX index of volatility implied by S&P 100 options reached 50.5 percent, the highest closing level since 1987. In addition, by some measures, investment-grade corporate spreads widened to record levels and non-investment-grade spreads reached their widest levels in eleven years. Treasury yields fell on reported flight-to-quality purchases following losses in other asset markets. Geopolitical concerns associated with the anniversary of the September 11, 2001 terrorist attacks and the possibility of military conflict with Iraq added to investor nervousness across markets.

As equity indexes declined in relatively volatile trading, expectations for a reduction in interest rates increased, with the rates implied by the October and December federal funds futures contracts both falling below the 1.75 percent federal funds target rate during the quarter. The release of lower-than-expected U.S. employment and manufacturing data also contributed to these expectations.

Chart 3

FEDERAL FUNDS TARGET RATE AND RATES IMPLIED BY U.S. INTEREST RATE FUTURES CONTRACTS



Source: Bloomberg L.P.

Trends in global equity and sovereign debt markets generally tracked developments in U.S. markets. Major European equity indexes shed 20 percent to 37 percent of their value, and euro-area government bonds yields declined. Market participants pared expectations for a rate increase by the European Central Bank (ECB) and by the end of the quarter began to price in the possibility of an ease. Expectations for monetary policy tightening in Australia, Canada, and the United Kingdom were also revisited, and interest rates implied by short-term futures contracts also declined.

The dollar appeared to benefit from the increased risk aversion and volatile trading in global asset markets, reversing some of the previous months' depreciation. In the previous quarter, market participants had reportedly established short dollar positions against most major currencies. In mid-July, these positions were largely reduced, contributing to the dollar's appreciation against most major currencies. Over the remainder of the quarter, the dollar was generally stable, trading in relatively narrow ranges as many currency market participants were sidelined. On balance, currencies such as the Canadian and Australian dollars, which were perceived as particularly sensitive to global growth and commodity prices, closed the period approximately 4 percent lower against the dollar. In contrast, the Swiss franc and Norwegian krone closed the period modestly higher against the dollar; both currencies were buoyed by the current account surpluses in their respective countries, while the Swiss franc also drew support from its perception among many investors as a safe-haven currency.

In September, global equity markets slid further, with major U.S. equity indexes ending the quarter with the largest losses since 1987 and European indexes reaching multiyear lows. U.S. Treasury yields declined to historic levels. Even as new economic data releases were seen as mixed, expectations reemerged of possible monetary policy easing in the United States by the end of 2002. The yield implied by the November federal funds futures contact ended the quarter at 1.51 percent, and the October federal funds contract suggested some expectations of an inter-meeting interest rate cut. Overall, however, the dollar continued to trade in a relatively narrow range, as market participants expressed reluctance to enter into new positions or take longer term currency views.

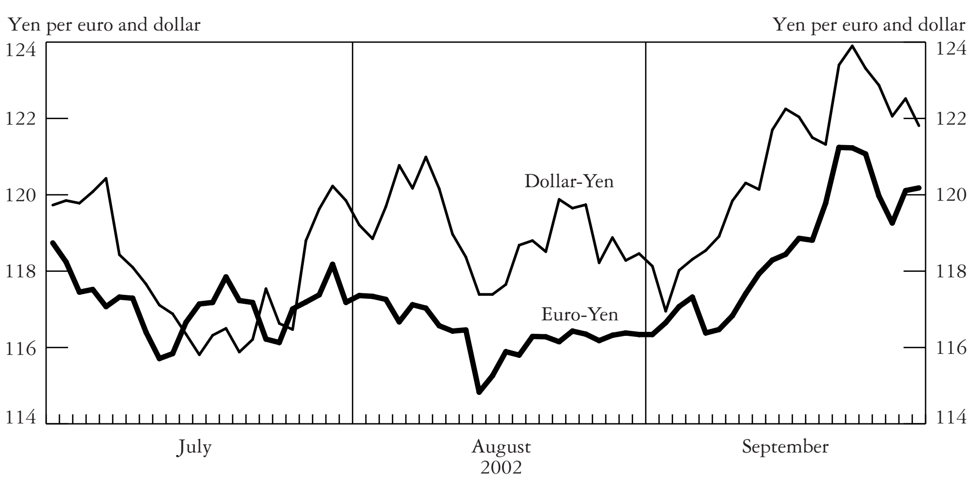
YEN DEPRECIATES AMID HINTS OF NEW POLICY DEVELOPMENTS IN JAPAN

During September, the yen depreciated against most major currencies, falling 2.5 percent against the dollar, after trading in a relatively narrow range over the first part of the quarter. Japanese Ministry of Finance data showed net portfolio outflows from Japan into overseas markets throughout the quarter, contrary to some expectations that Japanese domestic investors would repatriate funds ahead of the end of the fiscal first half on September 30. In addition, while various economic data releases in early summer had suggested a bottoming out in the Japanese economy, concerns reemerged toward the end of the quarter that slowing global growth would weigh on any export-led recovery in Japan. Market participants also focused on the heightened policy debate in Japan regarding measures to address deflation and financial sector problems. The Bank of Japan surprised most market participants on September 18 by announcing that it would study various measures to help stabilize financial markets, including the purchase of a portion of banks' equity holdings. In addition, the Japanese government stated that it would shortly announce a new anti-deflation package. The government also announced a cabinet reshuffle on the last day of the quarter that resulted in the replacement of the government minister responsible for banking sector reform. Some participants speculated that the various reform measures could be supportive of the yen in the near term if they led to a rise in equity prices, but many believed that further details on the actual reform measures would be needed before taking a long-term view on the yen. In this environment, the yen closed the quarter 1.8 percent and 1.3 percent lower against the U.S. dollar and the euro, respectively.

Japanese bank stocks outperformed the broader equity indexes in September, buoyed by the prospect of the central bank's purchase of a portion of bank equity holdings. However, bank share prices fell on the last day of the quarter, as many market participants considered the cabinet reshuffle a sign of a more aggressive government policy toward banks in the future. Longer-dated Japanese government bond yields rose sharply in September amid uncertainty over the various policy initiatives, but ended the quarter modestly lower.

Chart 4

YEN AGAINST EURO AND U.S. DOLLAR



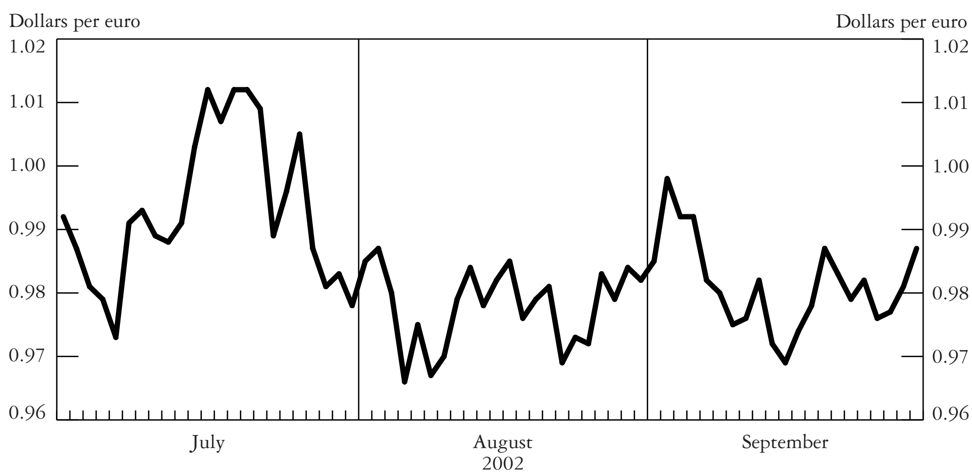
Source: Bloomberg L.P.

EURO TRADES IN NARROW RANGE AGAINST THE U.S. DOLLAR

Early in the quarter, the euro briefly rose above the parity level with the dollar, trading to its highest level since January 2000. However, these gains were subsequently reversed and the euro traded in a narrow range against the dollar for the remainder of the quarter amid concern over the pace of the economic recovery in the euro area. Damage from the summer floods, lower-than-expected business sentiment data, and rising oil prices led many to reduce economic growth forecasts for Europe. Growing expectations that several national government budget deficits would soon breach the terms of the Stability and Growth Pact raised concern over the ability of fiscal policy to address slowing growth. Moreover, higher oil prices and inflation data undermined market expectations that an ECB interest rate cut would be forthcoming in the near to medium term. Euro-area equity indexes underperformed their U.S. counterparts, with the German DAX losing 37 percent over the quarter. At the same time, some participants expressed concern over the financial health of the euro-area insurance and banking sectors. Nevertheless, after falling back below parity in mid-July, the euro-dollar exchange rate traded in a narrow range for most of the quarter, as market participants reportedly saw the risks in taking significant positions in the euro against the dollar as relatively balanced.

Chart 5

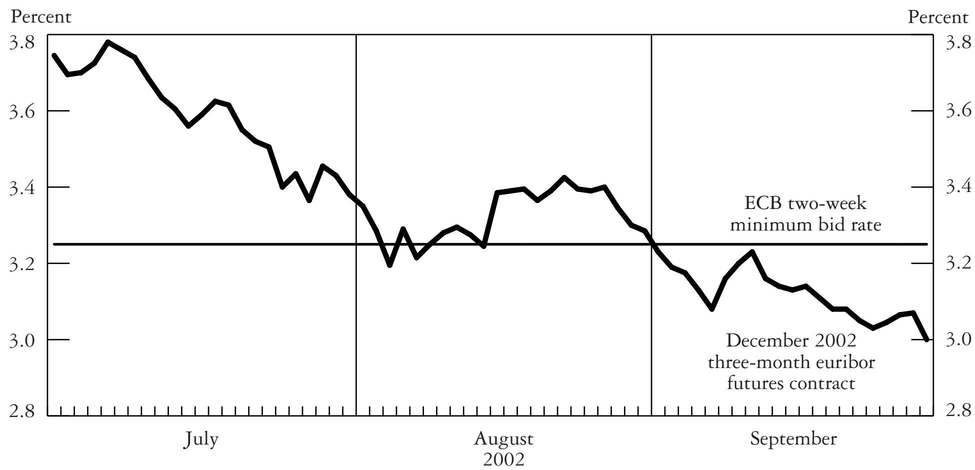
EURO-U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 6

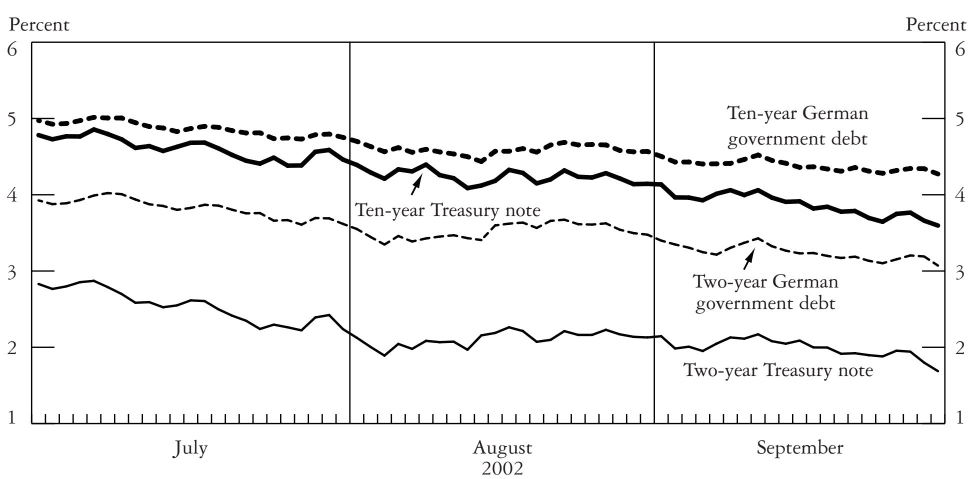
EUROPEAN CENTRAL BANK POLICY RATE AND RATE IMPLIED BY THE DECEMBER EURIBOR FUTURES CONTRACT



Source: Bloomberg L.P.

Chart 7

U.S. TREASURY AND GERMAN GOVERNMENT DEBT YIELDS



Source: Bloomberg L.P.

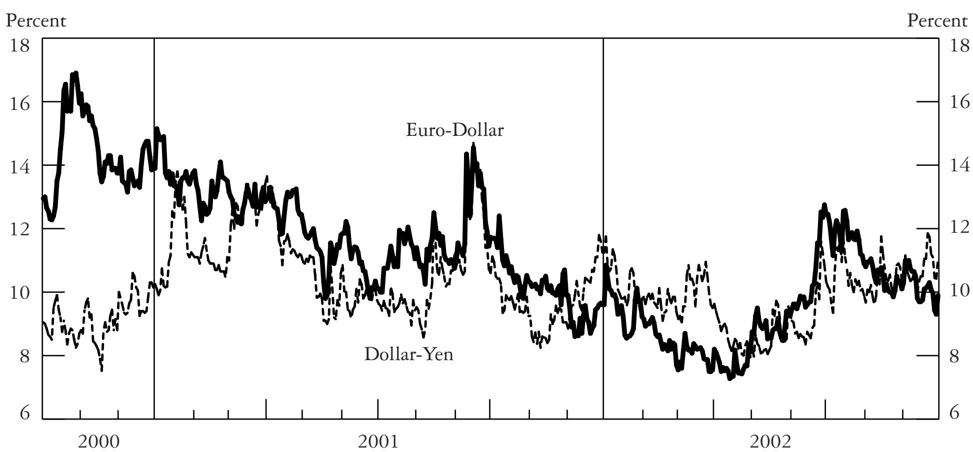
Expectations for euro-area interest rates gradually declined throughout the quarter, with expectations emerging in the beginning of September that the ECB may lower interest rates by the end of 2002. The December Euribor futures contract implied an interest rate 25 basis points below the current ECB minimum bid rate by the end of the quarter. Euro-area bond yields also fell throughout the quarter, but the interest rate differential with the United States increased, also helping to limit the euro's declines against the dollar. The spread between ten-year U.S. and German government bond yields increased by 53 basis points to 67 basis points over the quarter, as U.S. Treasuries outperformed.

CURRENCY MARKET VOLATILITY REMAINS LOW

Option-implied volatility for currency markets remained at relatively low levels despite changing interest rate expectations for the United States and the euro area, falling equity market indexes, and increased volatility in asset prices. Volatility implied by one-month euro-dollar currency options declined over the quarter, falling 2.9 percentage points to 9.9 percent. Volatility implied by one-month dollar-yen currency options rose slightly in September, but remained within recent ranges amid the uncertainty over new policy measures that may be taken by the Bank of Japan and the Japanese government.

Chart 8

ONE-MONTH CURRENCY 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 $16.1 billion for the Federal Reserve's System Open Market Account and $16.1 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 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 for International Settlements and in facilities at other official institutions. As of September 30, direct holdings of foreign government securities totaled $16.1 billion, split evenly between the Federal Reserve System and the Treasury. Foreign government securities held under repurchase agreements totaled $3.0 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

Thousands of Dollars

	Carrying Value June 30, 2002[a]	Quarterly Changes in Balance by Source: Net Purchases and Sales[b]	Quarterly Changes in Balance by Source: Investment Earnings[c]	Quarterly Changes in Balance by Source: Realized Profit/Loss on Sale[d]	Quarterly Changes in Balance by Source: Unrealized Profit/ Loss on Foreign Currency Revaluation[e]	Carrying Value September 30, 2002[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	8,281,101	0	72,182	0	19,711	8,372,994
Yen	7,879,538	0	86	0	(122,330)	7,757,294
Total	16,160,639	0	72,268	0	(102,619)	16,130,288
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	8,272,208	0	71,711	0	19,688	8,363,607
Yen	7,879,571	0	87	0	(122,331)	7,757,327
Total	16,151,779	0	71,798	0	(102,643)	16,120,934

[a] Carrying value of the reserve asset position includes interest accrued on foreign currency.

[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 are reported on an accrual basis and include accrued interest and amortization.

[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

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

Thousands of Dollars

	Federal Reserve System Open Market Account	U.S. Treasury Exchange Stabilization Fund
Profits (Losses) from Foreign Exchange Operations as of June 30, 2002		
Total	1,473,416	1,472,569
July 1, 2002, to September 30, 2002		
Unrealized profits (losses) from foreign currency holdings		
Euro	19,711	19,688
Yen	(122,330)	(122,331)
Subtotal	(102,619)	(102,643)
Realized profits (losses) from foreign currency sales		
Euro	0.0	0.0
Yen	0.0	0.0
Subtotal	0.0	0.0
Profits (Losses) from Foreign Exchange Operations as of September 30, 2002		
Total	1,370,797	1,369,926

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Thousands of Dollars

Institution	Amount of Facility	Outstanding as of September 30, 2002
Bank of Canada	2,000,000	0
Bank of Mexico	3,000,000	0
Total	5,000,000	0

U.S. TREASURY EXCHANGE STABILIZATION FUND RECIPROCAL CURRENCY ARRANGEMENTS

Thousands of Dollars

Institution	Amount of Facility	Outstanding as of September 30, 2002
Bank of Mexico	3,000,000	0
Total	3,000,000	0