EMBARGOED:
FOR RELEASE AT 4:00 P.M., EDT, THURSDAY, JANUARY 30, 2003

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October-December 2002

During the fourth quarter of 2002, the dollar depreciated 6.0 percent against the euro and 1.9 percent against the yen. On a trade-weighted basis, the dollar fell 3.0 percent. Early in the quarter, with U.S. interest rates reaching historic lows, the value of the dollar fluctuated along with shifting views on interest rate differentials in the United States and other countries. In December, the dollar depreciated steadily against other major currencies and geopolitical risks dominated market attention. The U.S. monetary authorities did not intervene in the foreign exchange market during the quarter.

DOLLAR FLUCTUATES AGAINST OTHER CURRENCIES IN OCTOBER AND NOVEMBER

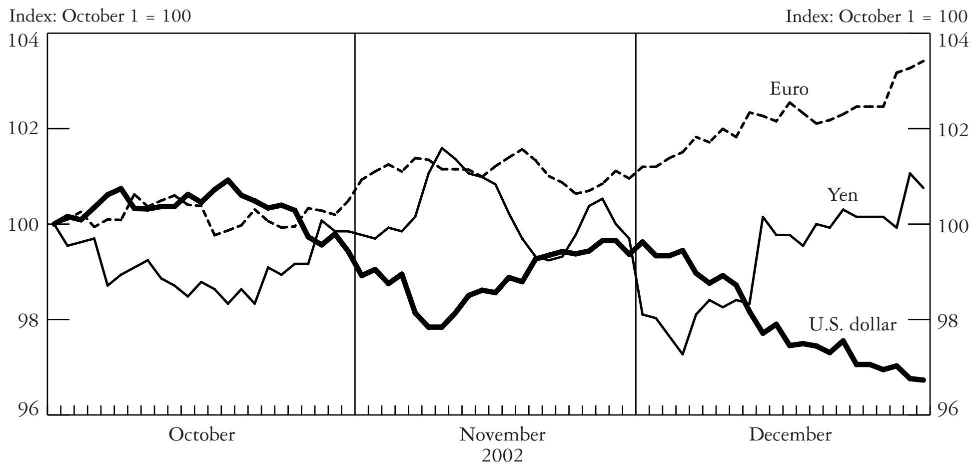
Early in the fourth quarter, the value of the dollar was buffeted by changing views on interest rate and growth rate differentials between the United States and other major economies. The dollar initially appreciated against other major currencies in early October but fell later in the month amid a renewed focus among market participants on the higher interest rates available outside the United States. The euro, British pound, and the New Zealand and Australian dollars appreciated between approximately 2 percent and 4 percent against the U.S. dollar. The Federal Open Market Committee (FOMC) lowered the target federal funds rate by 50 basis points on November 6, bringing the key U.S. policy rate to a historic low. The FOMC's decision contrasted with decisions

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 October through December 2002. Kathryn Chen was primarily responsible for preparation of the report.

by the European Central Bank (ECB) and the Bank of England that same week to keep their policy rates unchanged, and some market participants suggested that higher interest rates in other countries would support those countries' currencies against the dollar. Against this backdrop of generalized dollar selling, the currency also depreciated approximately 2 percent against the yen.

Chart 1

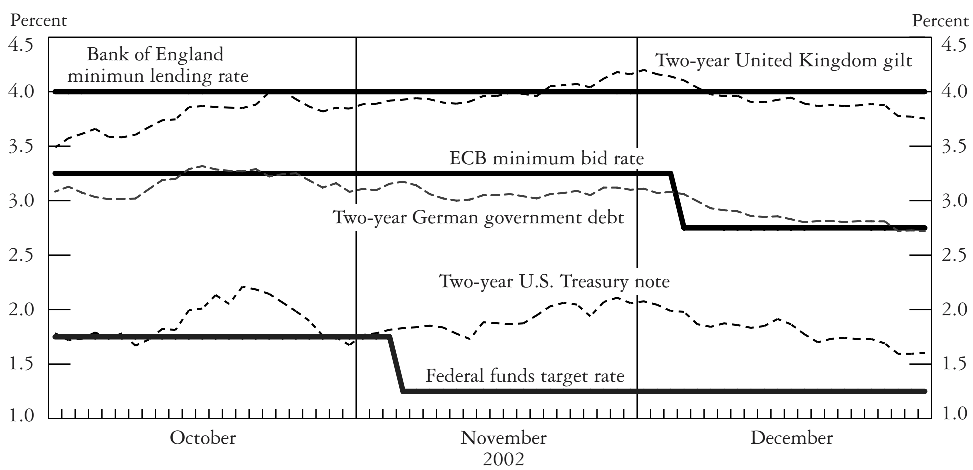
TRADE-WEIGHTED G-3 CURRENCIES



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

Chart 2

TWO-YEAR GOVERNMENT DEBT YIELDS AND POLICY RATES

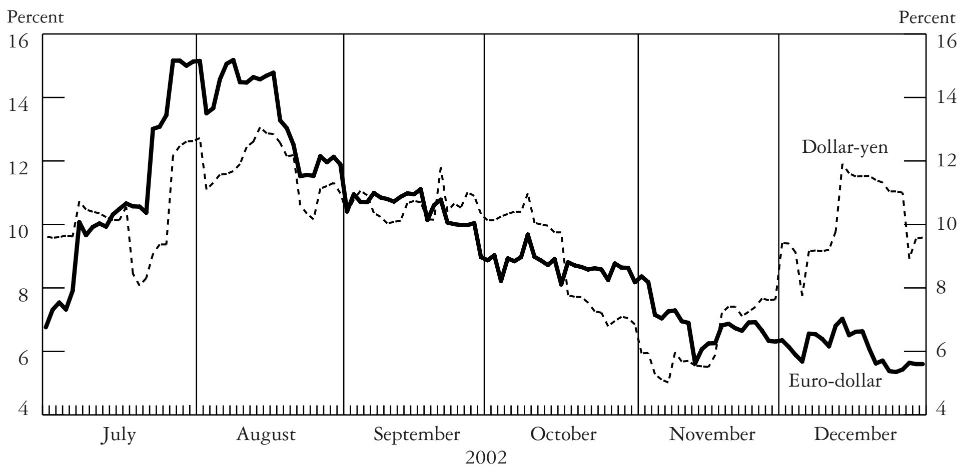


Source: Bloomberg L.P.

The dollar rose modestly in the second half of November, reversing some of its previous losses, as better-than-expected economic data releases and improvements in equity and corporate bond market conditions buoyed market sentiment toward the dollar. Equity prices were boosted by the release of economic data suggesting an improvement in economic activity, including stronger-than-expected retail sales figures and regional manufacturing indexes. The spread of corporate bond yields over U.S. Treasury yields narrowed sharply after having widened significantly in October, and issuance increased modestly. Amid this somewhat improved sentiment toward U.S. assets, the dollar also benefited from the paring of short dollar positions that had previously been established against the euro and other currencies. Nevertheless, trading volumes and realized volatility in foreign exchange markets during October and November remained at relatively low levels.

Chart 3

REALIZED EXCHANGE RATE VOLATILITY



Source: Bloomberg L.P.

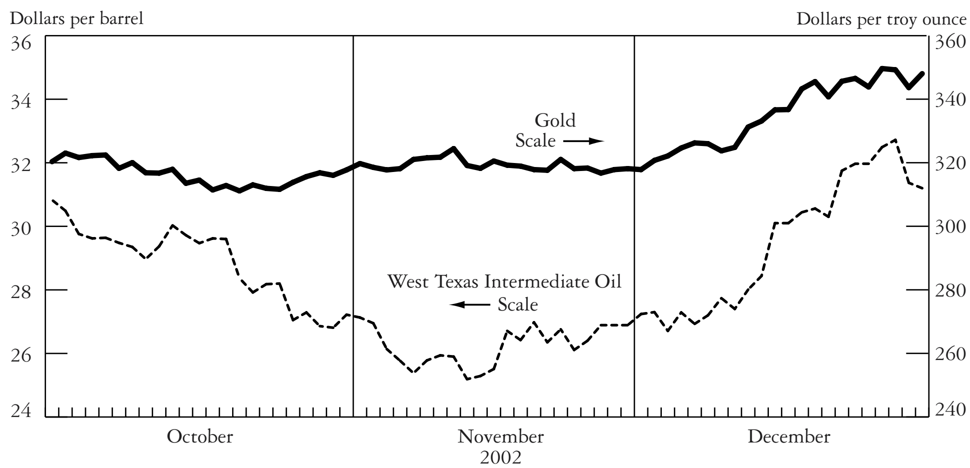
Note: Based on rolling twenty-day intervals.

DOLLAR DEPRECIATES AGAINST OTHER CURRENCIES IN DECEMBER

The dollar resumed its depreciation against most other major currencies in December, influenced by several factors. Perceptions of geopolitical risks intensified in December as U.S. government officials stated that Iraq was in material breach of its agreements with the United Nations, North Korea revealed more information about its nuclear weapons program, and various terrorist incidents in Kenya and Chechnya raised anxiety. Certain asset prices that often benefit during times of increased security concerns rose. Gold prices increased $30 to $348 per ounce in December—the highest price since mid-1997—and the Swiss franc appreciated 6.7 percent against the dollar and 1.6 percent against the euro. In addition, renewed concerns over the pace of the U.S. economic recovery, prompted by new economic data releases including lower-than-expected holiday retail sales, weighed on equity prices and supported Treasury prices. Concerns grew that rising oil prices would negatively impact U.S. economic growth, as oil prices reached their highest levels since November 2000 following strikes by oil workers in Venezuela and amid rising tensions between the United States and Iraq.

Chart 4

SPOT GOLD AND FRONT-MONTH CRUDE OIL FUTURES CONTRACT PRICES



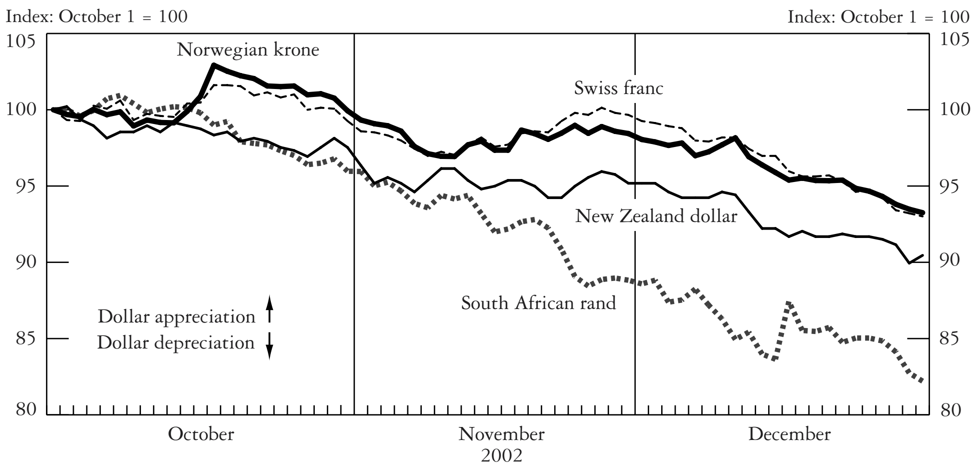
Source: Bloomberg L.P.

Market participants noted that with U.S. interest rates at historic lows and a limited appetite among investors to establish new risk positions, the large external financing needs of the United States could make the dollar vulnerable to depreciation in the event of a general pullback in international capital. Currencies of countries with higher interest rates, including the British pound, the New Zealand dollar, and the South African rand, rose between 3 percent and 8 percent against the dollar in December. The Norwegian krone rose more than 5 percent against the dollar, benefiting from Norway's status as a relative safe haven and an oil producer, as well as the higher yields on its government debt.

Chart 5

U.S. DOLLAR AGAINST OTHER CURRENCIES

Foreign Currency per Dollar



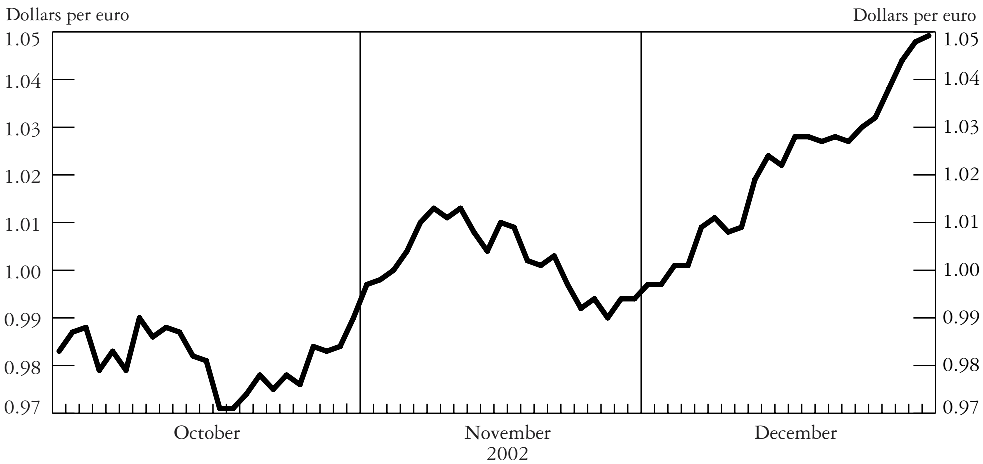
Source: Bloomberg L.P.

The announcement of the resignation of both U.S. Treasury Secretary Paul O'Neill and White House economic advisor Lawrence Lindsey on December 6 did not have an immediately discernable impact on the value of the dollar. Although the announcement did prompt market participants to watch for a change in the U.S. administration's stance toward the dollar, many noted that the long-term significance of the personnel shift on the value of the dollar would not be clarified until the confirmation of a new Treasury secretary.

The euro appreciated 5.5 percent against the dollar in December and reached its strongest level against the yen since August 1999, even though economic releases, notably German business confidence and employment data, contributed to the view that economic growth in Europe would be slower than previously anticipated. Nevertheless, market participants noted that the euro benefited from the relatively higher interest rates in the euro area. Although the ECB lowered its minimum refinancing rate by 50 basis points to 2.75 percent on December 5, the interest rate differential with the United States continued to favor the euro over the dollar. Furthermore, market participants suggested that cross-border portfolio flows may have been supportive of the euro against other currencies; economic data showed net portfolio inflows to the euro area for the eight months prior to November, and anecdotal reports suggested this trend continued to the end of the year.

Chart 6

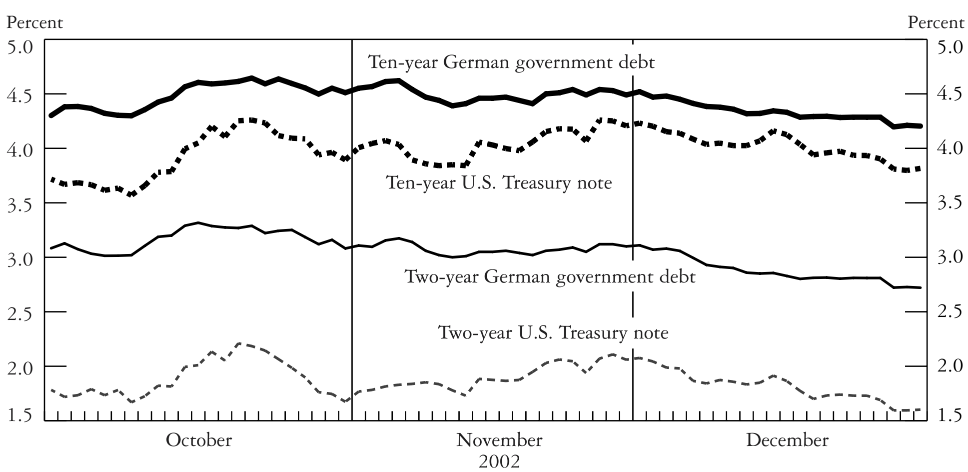
EURO-U.S. DOLLAR EXCHANGE RATE



Source: Bloomberg L.P.

Chart 7

U.S. TREASURY AND GERMAN GOVERNMENT DEBT YIELDS

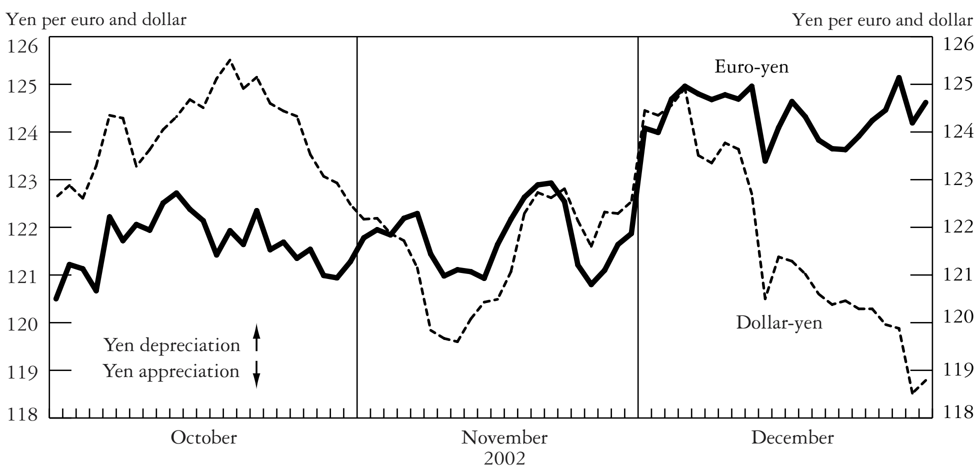


Source: Bloomberg L.P.

The dollar also depreciated 3.1 percent against the yen in December, reaching a four-month low, despite comments from several Japanese government officials that the yen should weaken. At the same time, the yen depreciated modestly against many other currencies, reaching a multi-year low against the euro and the British pound. Increased speculation among market participants that the Bank of Japan may adopt an inflation target in the near future and that the Japanese government could adopt a more aggressive policy toward reform in the Japanese financial sector, contributed to the weakness of the yen against most currencies other than the dollar.

Chart 8

YEN AGAINST EURO AND U.S. DOLLAR



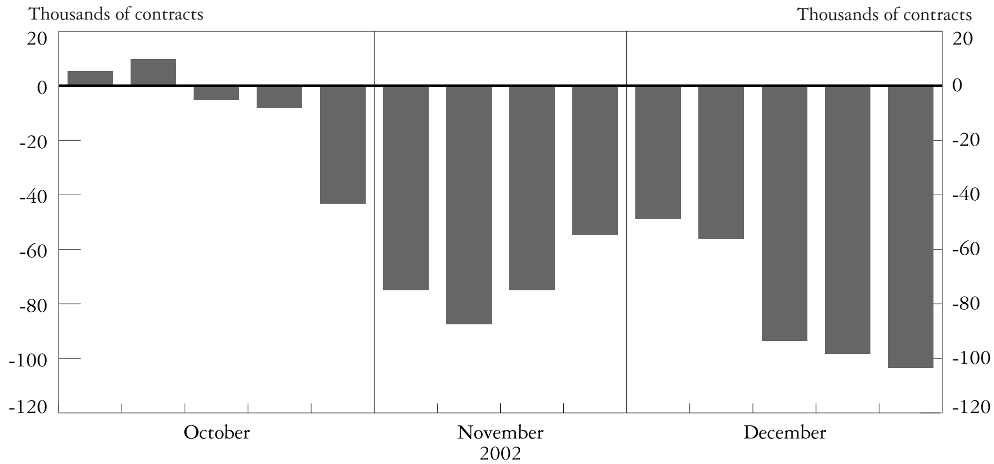
Source: Bloomberg L.P.

While comments on December 17 from White House and Treasury spokespersons that official dollar policy was unchanged seemed to temporarily slow the depreciation of the dollar, sales of dollars from a range of participants subsequently resumed. According to the Commodity Futures Trading Commission, short dollar positions held by non-commercial accounts on the Chicago Mercantile Exchange rose to the highest level since October 1999. Dollar-based currency options also suggested increased investor demand to protect against dollar depreciation, with the premium for dollar puts over dollar calls against the euro and the yen rising to 1.4 percent and 1.3 percent, respectively. Moreover, in contrast to previous periods, the dollar depreciation in December persisted even as other asset prices indicated relative stability in U.S. financial markets. Corporate credit spreads narrowed, returning to levels last seen in July 2002, while U.S. equity indexes outperformed many other global indexes, rising between 8 percent and 14 percent over the quarter.

The VIX index, a measure of volatility implied by options on the Standard & Poor's 100 index, declined steadily throughout the quarter to close at 32 percent, well below the 50 percent level reached in the previous quarter.

Chart 9

NET U.S. DOLLAR POSITIONS HELD BY NON-COMMERCIAL ACCOUNTS ON THE CHICAGO MERCANTILE EXCHANGE

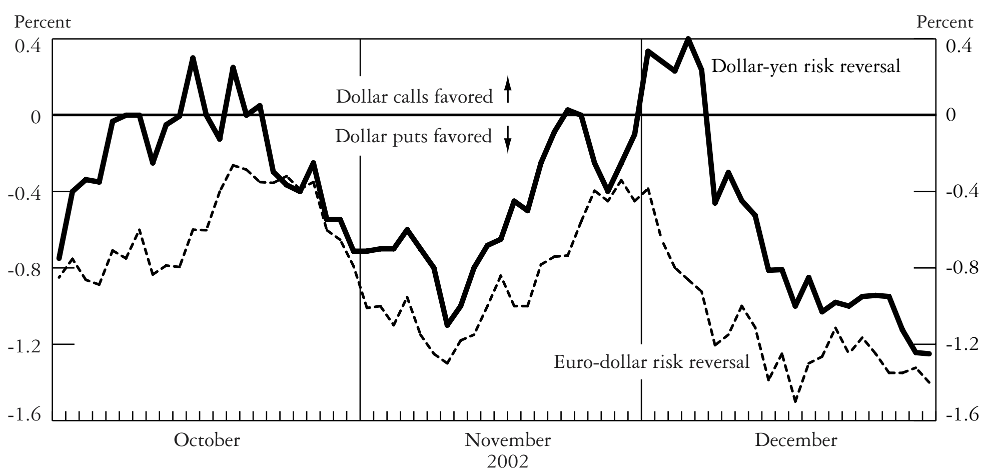


Source: Commodity Futures Trading Commission.

Note: Positive (negative) values indicate net long (short) U.S. dollar positions against foreign currencies traded on the Chicago Mercantile Exchange.

Chart 10

ONE-MONTH CURRENCY RISK REVERSALS



Source: UBS Warburg.

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 $16.9 billion for the Federal Reserve's System Open Market Account and $16.9 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 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 December 31, direct holdings of foreign government securities totaled $15.8 billion, split evenly between the Federal Reserve and the Treasury. Foreign government securities held under repurchase agreements totaled $3.2 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

		Quarterly Changes in Balance by Source				
	Carrying Value September 30, 2002[a]	Net Purchases and Sales[b]	Investment Earnings[c]	Realized Profit/Loss on Sale[d]	Unrealized Profit/ Loss on Foreign Currency Revaluation[e]	Carrying Value December 31, 2002[a]
Federal Reserve System						
Open Market Account (SOMA)						
Euro	8,372,994	0	72,038	0	516,397	8,961,429
Yen	7,757,294	0	66	0	195,322	7,952,682
Total	16,130,288	0	72,104	0	711,719	16,914,111
U.S. Treasury Exchange						
Stabilization Fund (ESF)						
Euro	8,363,607	0	71,590	0	515,804	8,951,001
Yen	7,757,327	0	66	0	195,323	7,952,716
Total	16,120,934	0	71,656	0	711,127	16,903,717

[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] 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 September 30, 2002		
Total	1,370,797	1,369,926
October 1, 2002, to December 31, 2002		
Unrealized profits (losses) from foreign currency holdings		
Euro	516,397	515,804
Yen	195,322	195,323
Subtotal	711,719	711,127
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 December 31, 2002		
Total	2,082,516	2,081,053

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Thousands of Dollars

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