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TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October–December 1999

During the fourth quarter of 1999, the dollar depreciated 3.7 percent against the yen and appreciated 6.2 percent against the euro. On an effective trade-weighted basis, the dollar appreciated 0.8 percent. Market expectations for sustained economic growth in the United States provided underlying support for the dollar and U.S. equity markets. Changes in the dollar's value were also influenced by portfolio flows that contributed to the continued appreciation of the yen and depreciation of the euro. Daily foreign exchange trading volumes fell sharply toward the very end of the quarter, although financial markets demonstrated no discernible signs of dislocation ahead of the century date change. The U.S. monetary authorities did not intervene in the foreign exchange markets during this quarter.

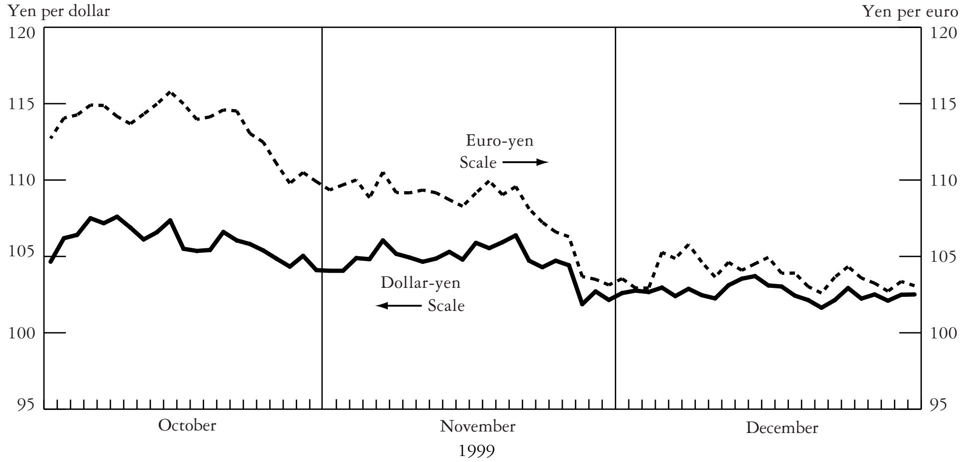
YEN STRENGTH AND EURO WEAKNESS DOMINATE CURRENCY MOVEMENTS

Over the course of the fourth quarter, the yen rose steadily to a four-year high of ¥101.64 against the dollar and an all-time high of ¥102.60 against the euro. The yen's appreciation accompanied continued perceptions of economic improvement in Japan, capital flows into Japanese assets, and uncertainty regarding the prospects for additional stimulus by the Bank of Japan. The movement prompted several publicly confirmed interventions in the foreign exchange markets by the Japanese monetary authorities.

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 October 1999 through December 1999. Deborah L. Leonard was primarily responsible for preparation of the report.

Chart 1

THE DOLLAR AND EURO AGAINST THE YEN



Source: Bloomberg L.P.

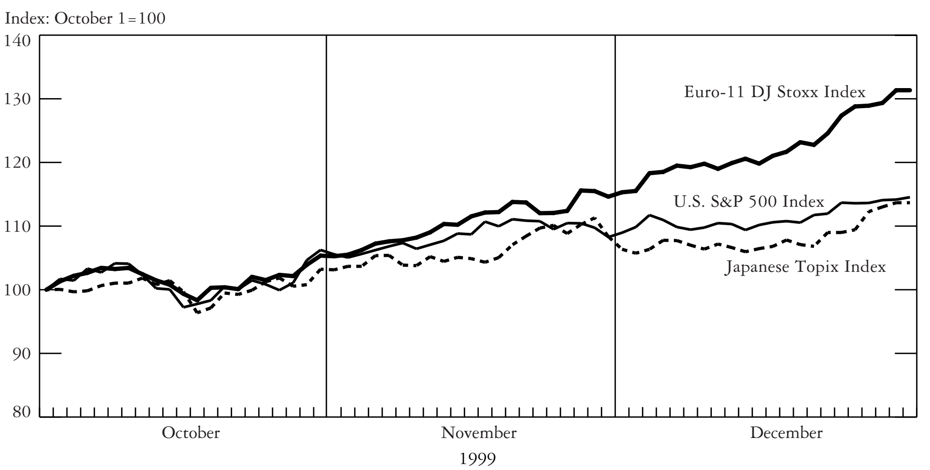
Market participants cited modest signs of improvement in several key Japanese economic data reports and revisions to previous reports as evidence that Japan's economic cycle was turning. September and December Tankan business sentiment indexes of –22 and –17, respectively, reached the survey's highest levels in two years, although the improvement mainly reflected the results for large manufacturing firms. On November 15, Japan's third-quarter industrial production was reported to have risen 3.9 percent since the previous quarter. On December 6, Japan's third-quarter GDP was reported to have contracted by 1.0 percent for the quarter; second-quarter GDP growth, however, was revised upward from 0.1 to 1.0 percent. Market participants also took note of three consecutive positive reports of the Economic Planning Agency's monthly leading and coincident diffusion indexes. The Japanese government's November 11 announcement of an ¥18 trillion supplementary spending package, including an expected ¥6.5 trillion of actual spending, was perceived as demonstrating an ongoing government commitment to employing fiscal stimulus measures.

At the outset of the quarter, attention focused on the prospects for the Bank of Japan to adopt "quantitative easing" measures in order to invigorate Japan's economy further. The Bank of Japan's announcements of measures aimed at improving the flexibility of its operations and at providing ample liquidity over the turn of the year were perceived as introducing technical changes that did not alter the stance of Japanese monetary policy. Short-term interest rates in Japan rose marginally over the quarter, at times affected by continued evidence of improving economic conditions, strength in the equity markets, and comments from Bank of Japan officials regarding the extraordinary nature of the zero interest rate policy.

Expressing growing confidence in prospects for an upswing in Japan's economy, foreign investors increased their direct and portfolio capital investments in Japan. The Nikkei rose to a two-year high, while broader Japanese equity indexes rose even more sharply, buoyed by evidence of corporate restructuring and the global rally in the equity markets. As foreign portfolio inflows continued, the Ministry of Finance reported that foreign direct investment rose to ¥1.3 trillion during the first half of 1999, more than twice the amount during the same period in 1998. In the meantime, the yen's persistent appreciation continued to reduce the value of unhedged foreign assets for Japanese investors, further encouraging hedging or liquidation of those positions. Some Japanese investors, reluctant to maintain large overseas exposures amid year-end uncertainty, reportedly repatriated capital or curtailed investment outflows ahead of the century date change, thus creating additional demand for yen.

Chart 2

GLOBAL BENCHMARK STOCK INDEXES

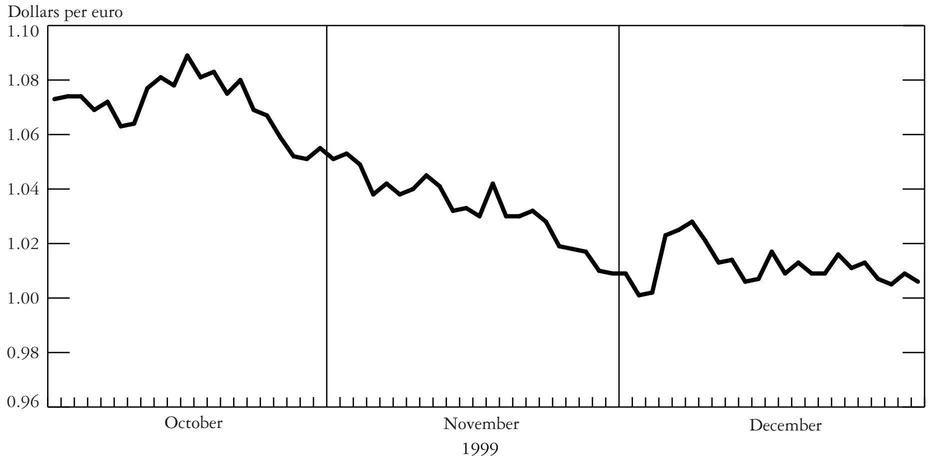


Source: Bloomberg L.P.

In Europe, perceptions that the euro-area economic outlook had improved, views that there were upside risks of inflation, and commentary from European Central Bank (ECB) officials prompted heightened expectations of an interest rate hike by the ECB during the fourth quarter. Expectations solidified after October 27, when year-on-year euro-area M3 money supply was reported to have grown 6.1 percent in September, outpacing the ECB's target rate of 4.5 percent. On November 4, the ECB raised its two-week refinancing rate 50 basis points to 3.00 percent. Commenting after the action, ECB President Duisenberg said that the "timely rise [in interest rates] will avoid the need for a bigger rise later." Following the move, the yield implied by the March 2000 Euribor futures contract fell to its period low of 3.46 percent, and European sovereign bond yields fell as market participants noted that the rate rise helped to mitigate expectations of a sustained cycle of monetary tightening in Europe. Yields rebounded in the second half of the quarter, with ten-year sovereign benchmark bond yields rising approximately 50 basis points but remaining below their period highs, amid global declines in bond prices and as economic data pointed to stronger European growth. Germany's 3.2 percent rise in October manufacturing orders, 1.7 percent rise in industrial production the same month, and a better-than-expected November business climate survey by the German IFO Institute all supported the improved expectations for growth. Annualized euro-area third-quarter growth of 2.3 percent also exceeded consensus forecasts.

Despite higher domestic interest rates and economic growth prospects, the euro weakened steadily against the dollar and the yen. On December 2 and 3, the euro briefly dipped below $1.00. Throughout the quarter, the impact on the euro of widening U.S.-European yield differentials and reported global portfolio reallocations appeared to outweigh Europe's improving growth outlook and robust gains in its equity markets. In the first half of the quarter, market participants noted sizable euro sales as portfolio managers, who reportedly had been overweight euros relative to their benchmarks, moved toward more neutral currency positions in early preparation for year's end. Net speculative positions on currency futures exchanges, as well as flow survey data, appeared to show similar patterns. Japanese investors reportedly continued to hedge their European investments to protect against foreign exchange losses on capital investments.

Chart 3
THE EURO AGAINST THE DOLLAR

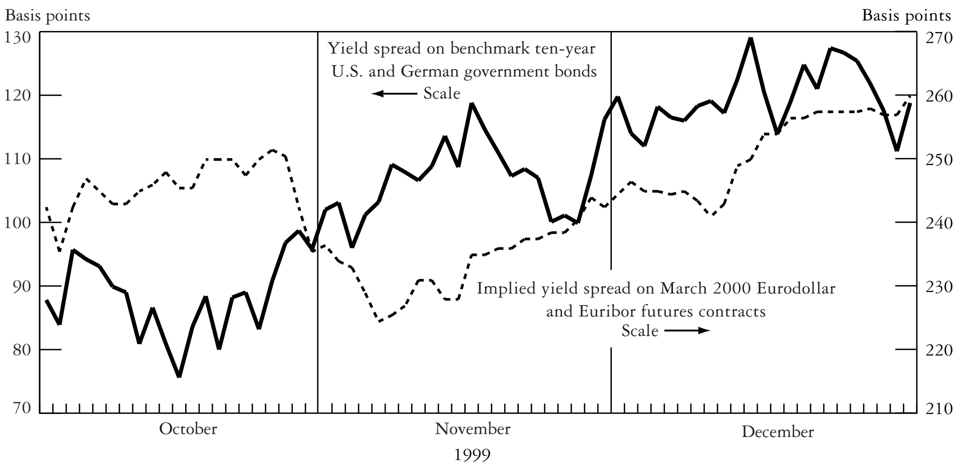


Source: Bloomberg L.P.

Market participants also noted the resilience of U.S. asset markets and widening yield differentials as factors weighing on the euro. The annualized yield spread between the benchmark ten-year U.S. Treasury and German bund widened from 89 to 119 basis points by the end of the quarter. European sovereign bonds outperformed U.S. Treasuries as market participants estimated that inflation in Europe would remain relatively low, that moderate European rate hikes in the future already were reflected in prices, and that a more pronounced cycle of monetary tightening in the United States was underway. Lastly, some cited concerns that intervention by European governments in mergers and acquisitions and bankruptcy proceedings could signal a slowing in euro-area corporate restructuring efforts.

Chart 4

SPREADS BETWEEN U.S. AND EUROPEAN YIELDS

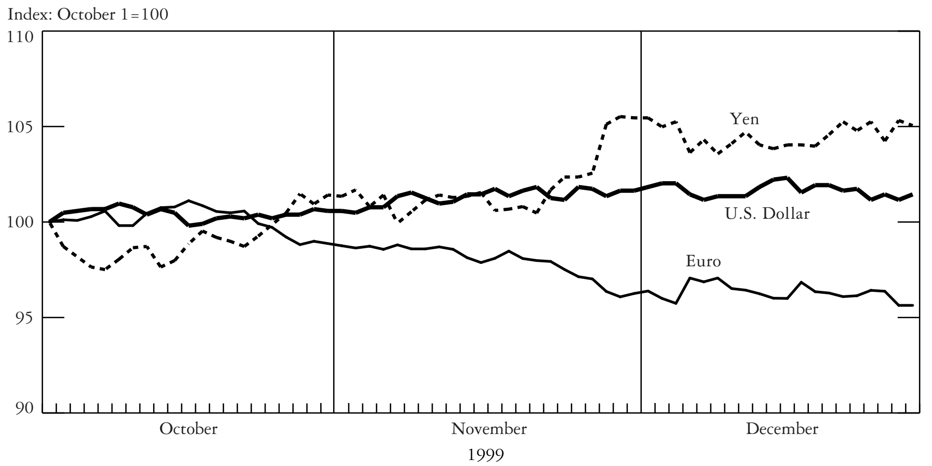


Source: Bloomberg L.P.

EXPECTATIONS FOR SUSTAINED U.S. GROWTH SUPPORT DOLLAR

Despite its mixed performance against the euro and the yen, the dollar's value remained relatively stable on a trade-weighted basis. When measured broadly against the currencies of major trading partners, the dollar appreciated 0.8 percent, while the yen appreciated 6.3 percent and the euro depreciated 4.4 percent during the fourth quarter. The relative resilience of U.S. asset markets amid tightening monetary conditions in the United States provided underlying support for the dollar.

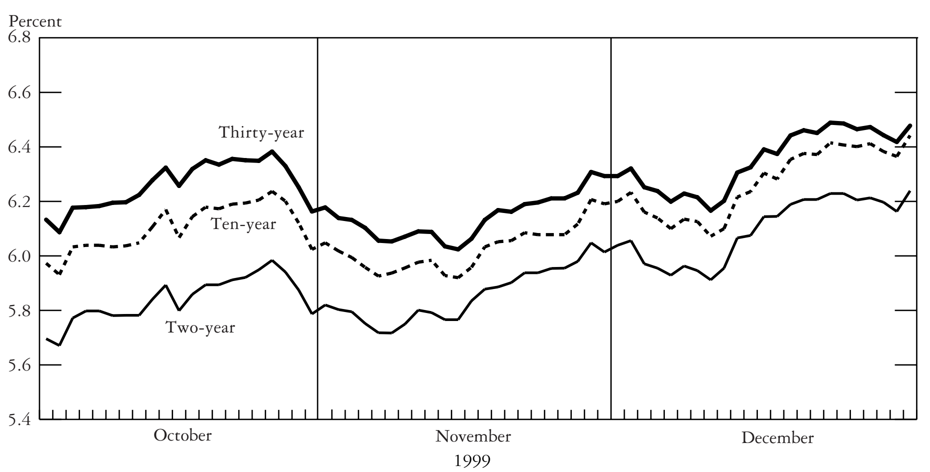
Chart 5
TRADE-WEIGHTED VALUES FOR G-3 CURRENCIES



Source: Bank of England.

Yields on U.S. Treasuries rose to their highest levels in more than two years following the Federal Open Market Committee's (FOMC) adoption of a tightening bias at its October 5 meeting and its decision to raise the federal funds target rate from 5.25 to 5.50 percent on November 16. Data releases throughout the quarter were perceived to show strong, non-inflationary U.S. growth, which contributed to a

Chart 6
U.S. TREASURY YIELDS



Source: Bloomberg L.P.

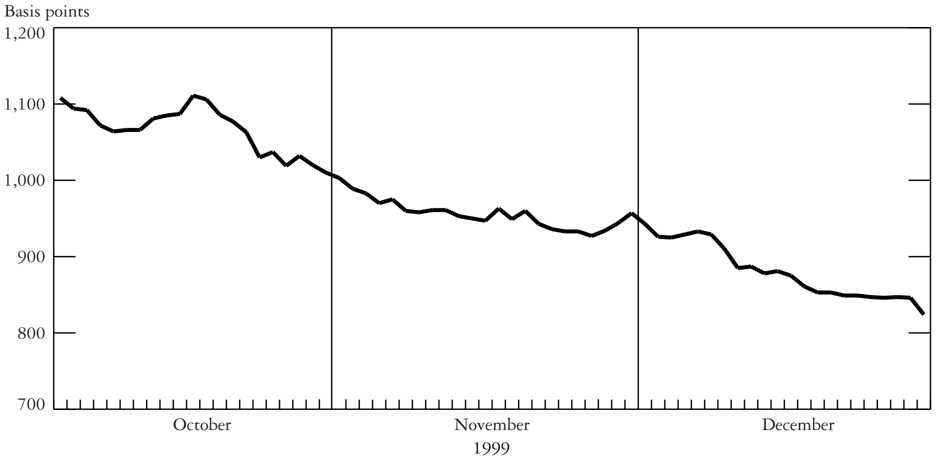
20-basis-point flattening of the two-to-thirty-year Treasury coupon curve to a fifteen-month low of 23 basis points. While earnings, producer price, and consumer price data continued to show somewhat modest upward pressures on prices, stronger-than-expected growth and consumption data raised market expectations that subsequent rate hikes would moderate the pace of U.S. growth. The third-quarter employment cost index, reported on October 28, fell from 1.1 percent in the second quarter to 0.8 percent. Employment reports released during the quarter generally showed lower-than-expected gains in nonfarm payrolls and average hourly earnings. However, third-quarter GDP growth of 4.8 percent and a deflator of 0.9 percent, reported on October 28, were revised upward to 5.5 percent and 1.1 percent, respectively, on November 24. September and October retail sales figures, excluding autos, also were higher than expected. Market participants perceived that the tone of the FOMC's December 21 directive was relatively hawkish, even though the Committee maintained its symmetric directive "in light of market uncertainties associated with the century date change." By the end of the quarter, the implied yield on the February fed funds futures contract had risen 37 basis points to 5.79 percent.

Despite rising bond yields, U.S. and global equity markets surged to record highs as market participants expressed increased confidence in the prospects for sustained global growth and as global liquidity remained high. The Dow Jones Industrial Average and the S&P 500 indexes rose 11.2 and 14.5 percent, respectively, while the NASDAQ skyrocketed 48.2 percent. The momentum contributing to the NASDAQ's rapid outperformance accelerated following the October 28 release of third-quarter GDP and employment cost figures, as well as Chairman Greenspan's speech on the same day noting the contributions that technology has made to U.S. productivity and recent economic performance.

Higher interest rates in the United States did not appear to weigh negatively on sentiment toward emerging market assets. On the contrary, confidence in global growth prospects fueled investor interest in emerging market assets throughout the quarter. Emerging market sovereign debt spreads over comparable U.S. Treasuries narrowed, with the spread between J.P. Morgan's Emerging Market Bond Index (EMBI+) sovereign yield and U.S. Treasuries falling 274 basis points to 824 basis points, its lowest level since August 1998. Moreover, Latin American and Asian telecommunication stocks rallied along with other global technology shares as growth in those regions continued to improve from technology exports and gains in productivity.

Chart 7

EMERGING MARKET BOND INDEX (EMBI+)
SOVEREIGN SPREAD OVER COMPARABLE U.S. TREASURIES



Source: J.P. Morgan.

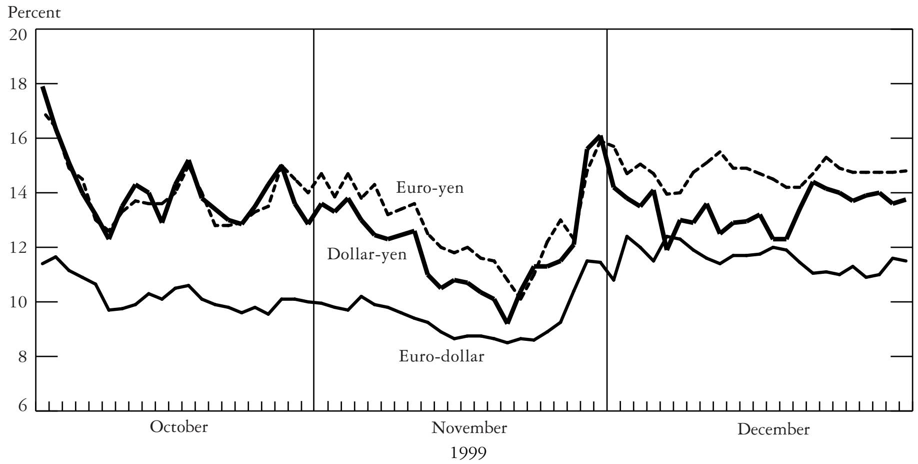
FINANCIAL MARKETS REMAIN ORDERLY AHEAD OF Y2K TURN

Uncertainties associated with the century date change did not create any visible distress in the foreign exchange market as the year's end approached. Overall trading volumes reportedly remained within their average ranges for 1999 until well into December, longer than many would have predicted earlier in the year. By December 31, however, trading volumes had ground nearly to a halt as market participants postponed all but absolutely necessary transactions until the new year.

Trading activity appeared orderly throughout the period, although bid-ask spreads on major currency pairs more than doubled in the last trading days of the year. However, volatility implied by currency options remained in recent ranges in the final weeks of the year as spot market activity diminished. While some portfolio managers concerned about year-end liquidity reportedly moved toward more neutral positions relative to their benchmarks early in the period, other indications by the end of the quarter suggested that broadly based risk-aversion was not prevalent in the financial markets. Global stock markets rallied amid relatively heavy trading volume through December, confidence in emerging market growth prospects improved, and credit and swap spreads narrowed.

Chart 8

VOLATILITY IMPLIED BY ONE-MONTH OPTION PRICES



Source: Reuters.

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 Japanese yen reserve holdings totaled $16.1 billion for the Federal Reserve System and $16.2 billion for the 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 greatest extent practicable, these investments are split evenly between the Federal Reserve System and the Exchange Stabilization Fund.

A 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 December 31, direct holdings of foreign government securities totaled $9.2 billion, split evenly between the two authorities. Foreign government securities held under repurchase agreement totaled $13.7 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

		Quarterly Change in Balance by Source					
	Balance as of September 30, 1999[e]	Net Purchases and Sales[a]	Impact of Sales[b]	Investment Income	Currency Valuation Adjustments[c]	Interest Accrual and Other	Balance as of December 31, 1999
Federal Reserve							
EMU euro	7,221.8	0.0	0.0	38.9	(390.1)	0.0	6,870.6
Japanese yen	8,831.9	0.0	0.0	0.7	388.9	0.0	9,221.5
Subtotal	16,053.7	0.0	0.0	39.6	(1.2)	0.0	16,092.1
Interest receivable (net)[d]	64.5	0.0	0.0	0.0	0.0	(16.5)	48.0
Total	16,118.2	0.0	0.0	39.6	(1.2)	(16.5)	16,140.1
U.S. Treasury Exchange Stabilization Fund (ESF)							
EMU euro	7,219.1	0.0	0.0	39.4	(390.0)	0.0	6,868.5
Japanese yen	8,831.8	0.0	0.0	0.7	389.0	0.0	9,221.5
Subtotal	16,050.9	0.0	0.0	40.1	(1.0)	0.0	16,090.0
Interest receivable[d]	66.2	0.0	0.0	0.0	0.0	12.4	78.6
Total	16,117.1	0.0	0.0	40.1	(1.0)	12.4	16,168.6

Note: Prior period figures have been reclassed to current presentation.

[a] 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.

[b] 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.

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

[d] Interest receivable for the ESF is revalued at month-end exchange rates. Interest receivable for the Federal Reserve System is carried at average cost of acquisition and is not marked-to-market until interest is paid. Interest receivable for the Federal Reserve is net of amortization of premium/discount on securities held.

[e] Not included as part of September 30, 1999 balances is unearned interest collected of $13.4 million and $13.3 million for the Federal Reserve and ESF, respectively. These amounts are cash flow differences from payment and collection of funds between quarters.

Table 2

NET PROFITS (+) OR 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 September 30, 1999		
EMU euro	(119.9)	(336.9)
Japanese yen	1,775.8	1,988.0
Total	1,655.9	1,651.1
Realized profits and losses from foreign currency sales September 30, 1999 – December 31, 1999		
EMU 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 December 31, 1999		
EMU euro	(510.0)	(726.9)
Japanese yen	2,178.1	2,390.2
Total	1,668.0	1,663.4

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of December 31, 1999
Bank of Canada	2,000	0.0
Bank of Mexico	3,000	0.0
Total	5,000	0.0

U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS

Millions of Dollars

Institution	Amount of Facility	Outstanding as of December 31, 1999
Bank of Mexico	3,000	0.0
Total	3,000	0.0