February-July 1984 Semiannual Report
(This report was released to the Congress and to the press on September 7, 1984)

Treasury and Federal Reserve Foreign Exchange Operations

During the February-July period under review, the exchange markets were subject to frequent shifts in expectations, shifts that were reflected in swings in dollar rates. The dollar declined substantially during February and early March only to strengthen thereafter. By end-July it had risen on balance against major currencies to trade at an 11-month high against the Japanese yen, an 11-year high against the German mark, and at record levels against many other European currencies.

In early February, sentiment toward the dollar turned decidedly cautious, though it was trading in the exchange markets close to highs reached in early January. Market observers were concerned that economic policies would be unduly stimulative given the economy's underlying strength and came to focus on the risk for the dollar of a potential rekindling of inflation. Evidence indicated that the U.S. economy was growing far more rapidly than had been estimated just weeks before. Budget deliberations left the impression that the deficit problems were unlikely to be resolved quickly. Market participants felt that the scope for flexibility in monetary policy would similarly be limited in view of sensitivities to the high level of interest rates both in nominal and real terms.

Meanwhile, the climate for investment abroad appeared to be improving. News of strengthening foreign industrial activity and orders, especially in Germany, generated expectations of rising earnings and prompt relief from earlier financial strains. Inflation remained quiescent, and several countries were making clear progress in reducing the structural components of their budget deficits.

Under these circumstances, foreign exchange market participants questioned whether the burgeoning current account deficit of the United States could be financed at prevailing exchange rates and interest differentials. The deficits projected for 1984-85 implied that the United States would require capital inflows of such a magnitude as to eliminate the large net creditor position the United States had established over the entire postwar period. Public officials and private commentators around the world expressed concern about the size of the financing requirements ahead, the dependency of the United States on foreign capital inflows, and the vulnerability of the dollar to a potential shift in investor sentiment.

Market participants were, therefore, sensitive to reports that some internationally-oriented investors were already reducing the share of dollar-denominated assets in their portfolios in favor of the German mark and other currencies. The belief spread that the dollar had begun a long-awaited decline. Commercial leads and lags as well as professional positions were turned against the dollar. As the dollar declined and economic statistics confirmed that U.S. economic growth remained stronger than expected, some market observers pointed to the additional impact a drop in the dollar would have on

A report by Sam Y. Cross, Executive Vice President, Federal Reserve Bank of New York and Manager of the Foreign Operations of the System Open Market Account. Officers of the Foreign Exchange Function, together with Richard F. Alford, Andrew Hook, Thaddeus Russell and Elisabeth Klebanoff contributed to its preparation.

domestic prices. Although U.S. interest rates rose modestly during February and March, the increases were seen as not fully compensating for the escalation of inflationary expectations. Thus, the dollar fell steadily through the first week in March. Its decline of 10 percent against the German mark was among the largest. On a trade-weighted average basis the dollar declined about 7 percent.

In March, market participants began to sense more restraint in U.S. monetary policy and more progress in reducing the fiscal deficit than they had previously anticipated. The narrowly defined monetary aggregate (M1) had strengthened relative to its intended growth range. More fundamentally, the preliminary statistics for the first quarter showed credit demands accelerating rapidly and the overall economy expanding far more quickly than the Federal Open Market Committee (FOMC) had assumed when it set its monetary targets for the current year. Senior Federal Reserve officials expressed concern about the implications of these developments for a sustained expansion. Consequently, as the Federal funds rate continued to firm, market participants no longer expected the central bank to resist a rate rise. By late March, U S interest rates of all maturities had increased about one percentage point, and on April 9 the Federal Reserve raised its discount rate to 9 percent, bringing it more in line with money market rates. About the same time, Congress and the Administration were moving toward agreement on a "down payment" to reduce the fiscal deficit Indeed, work on some of the legislation to cut the deficit by $150 billion over three years was completed before the Congressional summer recess.

Largely in response to these developments, the dollar reversed course in the exchange markets early in March. With real interest rates in the United States again perceived to be rising, concerns about financing the current account deficit receded Also, earlier predictions of gathering economic strength abroad were disappointed The immediate outlook was complicated in a number of important countries by labor disputes in key industries that drew attention to serious labor-management conflicts, inflexibility of work rules, and a variety of domestic political issues. Thus, the earlier, more positive assessment of the investment climate abroad tended to erode, and talk of portfolio shifts out of the dollar gave way to reports of investors returning to dollar assets.

By early May, economic statistics suggested that the U.S. economic expansion was remaining exceptionally vigorous in the second quarter and that credit demands were reflecting heavy borrowing needs in both the private and public sectors. With the Federal Reserve then widely presumed to be willing to let these developments

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility July 31, 1983	Amount of facility July 31, 1984
Austrian National Bank	250	250
National Bank of Belgium	1,000	1,000
Bank of Canada	2,000	2,000
National Bank of Denmark	250	250
Bank of England	3,000	3,000
Bank of France	2,000	2,000
German Federal Bank	6,000	6,000
Bank of Italy	3,000	3,000
Bank of Japan	5,000	5,000
Bank of Mexico		
Regular facility	700	700
Special facility	269*	*
Netherlands Bank	500	500
Bank of Norway	250	250
Bank of Sweden	300	300
Swiss National Bank	4,000	4,000
Bank for International Settlements		
Swiss francs-dollars	600	600
Other authorized European currency-dollars	1,250	1,250
Total	30,369	30,100

*Facility, which became effective August 30, 1982, expired on August 23, 1983

Table 2

Net Profits (+) or Losses (−) on United States Treasury and Federal Reserve Current Foreign Exchange Operations

In millions of dollars

Period	Federal Reserve	United States Treasury: Exchange Stabilization Fund	United States Treasury: General account
Third quarter 1983	-0-	-0-	+70 1
Fourth quarter 1983	-0-	−204 8	-0-
First quarter 1984	-0-	-0-	-0-
Second quarter 1984	−17 7	−21 4	-0-
July 1984	-0-	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1984	−1,084 0	−742 5	-0-

Data are on a value-date basis

show through in rising interest rates, expectations solidified that dollar-based rates would increase substantially further. Banks sought to lengthen their liabilities so as to lock in the cost of funds, putting medium-term interest rates especially under pressure. By the end of May, most dollar-based market rates had risen another full percentage point. Since most foreign interest rates held steady during the spring, interest differentials moved further in the dollar's favor.

Meanwhile, concern deepened in some quarters that rising interest rates were increasing burdens on the heavily indebted developing countries. Some market participants were also wary of the possibility that a meeting of Latin American debtor countries in Cartagena, Colombia in July would lead to a polarization of the debt negotiations.

It was in this context that one large American bank experienced funding difficulties in mid-May, following market rumors that it had substantial undisclosed losses on its domestic loans. Support efforts were organized by other large banks and the Federal authorities But market participants were unsure that the financial strains could be contained without modification of monetary policy and took particular note of a temporary easing in the Federal funds rate. During late May, rumors circulated that deposits were being withdrawn from a few large U.S. banks known to have sizable exposures in Latin America. The dollar eased back as exchange markets became somewhat unsettled over the implications of these developments as well as the prospect of sizable amounts of funds being moved out of dollar assets. By May 24, rumors had come to encompass American banks more generally, and the exchange markets became extremely disorderly. The U.S. authorities conducted their only intervention operation of the period that day, selling $135 million-equivalent of German marks to counter the disorder. Trading conditions did improve thereafter, though the dollar continued to decline for several more days.

Early in June the dollar resumed its climb as some of the concerns of May began to dissipate Market professionals came to realize that the Federal Reserve had been able to provide the needed liquidity without compromising its monetary targets. Some questions about the adequacy of U S. banks' accounting procedures were laid to rest as the rules on reporting loans to be "nonaccruing" were clarified Concern over the LDC debt problem also eased amid discussion of multiyear debt restructurings for countries demonstrating the greatest progress in external adjustment. Another positive factor was the emergence of a constructive attitude from the Cartagena meeting.

Later on the demand for dollars intensified as U S capital markets regained their attraction to foreign investors. A succession of economic statistics suggested that a significant deceleration of real growth in the United States had yet to occur. At the same time, statistics on U.S. inflation were much better than had been expected, implying that interest-rate differentials adjusted for comparative price performance had become even more favorable to dollar investments. Moreover, the deficit-reduction legislation nearing passage in the Congress contained a provision to remove a long-standing 30 percent withholding tax on interest earned on U.S. investments by nonresidents. This legislation, which was subsequently enacted, prompted talk that large new foreign inflows of capital would be attracted to the United States as certain investors who had been subject to the tax gained greater access to U.S. markets. When the U.S. bond and stock markets staged a strong rally late in July, market participants therefore anticipated substantial foreign interest.

The dollar was bid up quite strongly at the end of July to reach its highs for the period under review. The dollar's net advance for the six months was greatest against the Swiss franc and pound sterling, at 10 percent and 8 percent, respectively. Against most other major currencies the dollar rose on balance about 4 to 5 percent, and in trade-weighted terms it increased $4\frac{1}{4}$ percent

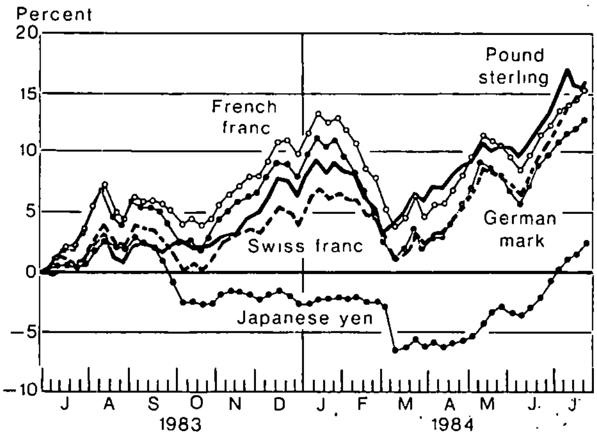
There were few changes in currency relationships among the other major currencies during the six months. Indeed, during the latter part of the period when the dollar was rising, the currencies participating in the joint intervention arrangements of the European Monetary System traded without strain. The authorities in those countries whose currencies had previously been under pressure were thereby able to rebuild their official reserve positions as well as to move cautiously in the direction of easing domestic interest rates and relaxing exchange controls. As a group, the major industrialized countries abroad sold dollars on balance during the six months in their intervention operations to support their own currencies. But these intervention sales were more than offset by interest earnings and acquisitions of currencies through foreign borrowings and other transactions, so that the foreign currency reserves of the major countries continued to grow.

At the beginning of the six-month period, the only drawing outstanding on credit arrangements of the U.S. monetary authorities was $10 million drawn on December 29, 1983 by the Bank of Jamaica against a $50 million U.S. Treasury temporary swap facility. The Bank of Jamaica fully repaid this amount on March 2 whereupon this facility expired.

On March 30 the U.S. Treasury announced that it would participate in an arrangement related to the efforts of the Government of Argentina to put into place

Chart 1

The Dollar against Selected Foreign Currencies

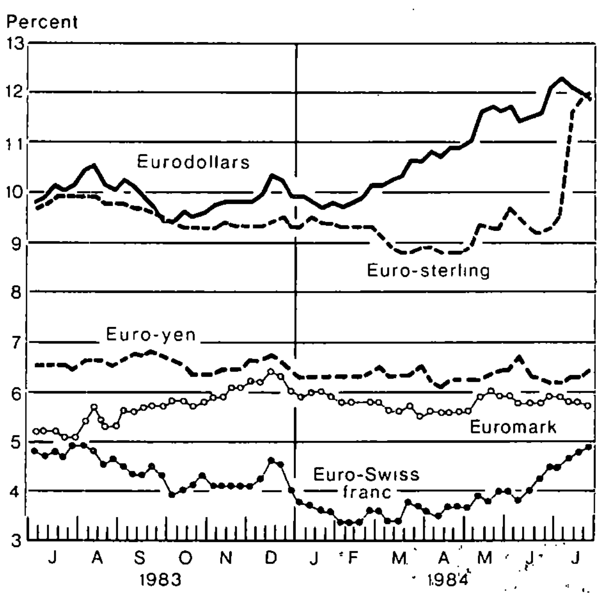


Percentage change of weekly average bid rates for dollars from the average rate for the week of June 27-July 1, 1983 Figures calculated from New York noon quotations

Chart 2

Selected Interest Rates

Three-month maturities*



*Weekly averages of daily rates

an economic adjustment program supported by the International Monetary Fund (IMF) The Treasury's participation consisted of agreeing to extend temporary swap credits of up to $300 million to Argentina upon agreement on an economic adjustment program between Argentina and the IMF, Argentina agreed to repay any such drawings on the Treasury from proceeds of IMF drawings This undertaking was part of a $500 million financing package that was used by Argentina to pay certain interest arrears The $500 million package consisted of $300 million credits extended to Argentina by the governments of Mexico, Venezuela, Brazil and Colombia, to be repaid upon Argentina's drawing from the U S Treasury, $100 million additional credits extended by the eleven commercial banks in the working group for Argentina and $100 million provided from Argentina's resources. The U S commitment, originally made for a 30-day period, was extended at the end of April for another month and again at the end of May for an additional 15 days The Treasury's commitment under this agreement lapsed on June 15

The Federal Reserve and the Treasury invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve had invested $1,424 2 million of its foreign currency resources in securities issued by foreign governments as of July 31 In addition, the Treasury held the equivalent of $1,746 8 million in such securities as of end-July

In the period from February through July, the Federal Reserve and the Exchange Stabilization Fund (ESF) of the Treasury received earnings of $111 8 million and $84 2 million, respectively, on their foreign-currency balances They realized losses of $17 7 million and $21 4 million, respectively, on all of their operations in the market As of July 31, cumulative bookkeeping, or valuation, losses on outstanding foreign currency balances were $1,084 0 million for the Federal Reserve and $742 5 million for the ESF (Valuation gains and losses represent the increase or decrease in the dollar value of outstanding currency assets and liabilities, using end-of-period exchange rates as compared with rates of acquisition) These valuation losses reflect the fact that the dollar has appreciated since the foreign currencies were acquired

German mark

Through February and early March, the German mark strengthened against the dollar in response to substantial investment inflows, only to decline unevenly through July when these inflows subsequently slowed and then reversed. The capital inflows early in the period reflected optimism that the difference in economic performance of the United States and Germany would substantially narrow. But by spring it was clear that the U.S. economy remained stronger than expected and predictions of more rapid expansion in Germany were again disappointed.

At the opening of the period, the near-term outlook for the German economy and the German mark had become more buoyant. The pace of economic activity had regained momentum around the turn of the year, stimulated by a pickup of incoming foreign orders, renewed spending on plant and equipment, and a rebuilding of inventories in anticipation of a progressive revival of demand. Inflation remained low and earlier concerns were receding that the rise in import prices, reflecting last year's rise of the dollar against the mark, would generate generalized price pressures. Meanwhile, the government had made even more progress than expected in reducing its fiscal deficit during 1983. The growth of central bank money had dropped within the Bundesbank's target range by end 1983 and was remaining close to the lower limit of the central bank's even narrower, 4 to 6 percent target for 1984. With the outlook for sustained noninflationary growth thus improving, the capital markets in Germany strengthened.

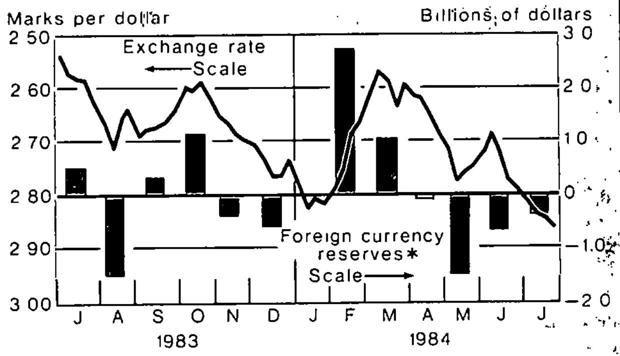
Under these circumstances, the mark was the currency to benefit most from the shift in international portfolio investment flows which developed early in the year. Investors were attracted by the prospect of favorable trends in both asset prices and the mark's exchange rate, even though interest differentials remained strongly negative by comparison with the dollar and with most currencies within the European Monetary System (EMS). Long-term capital had begun to flow into Germany in January, reversing the capital outflows which had been stimulated over much of the preceding two years by the prospect of greater growth opportunities or higher yields abroad. The flows continued in February, and reports of foreign buying in the rallying German bond and stock markets received wide publicity. With Germany's current account expected to remain in substantial surplus for the year, reports of these investment transactions helped to encourage the view that the mark was embarked on a long-awaited upward trend. The mark's rise gained additional momentum from statements by public officials to the effect that the dollar was increasingly vulnerable to a sharp decline. The mark rose against the dollar to DM 2.5210 by March 7, 13 percent above its low of January and 11½ percent from end-January levels. This rise occurred even though German interest yields for most maturities eased and negative yield differentials compared with dollar investments widened by a full percentage point. As the mark strengthened the Bundesbank bought back some of the dollars sold in earlier intervention operations. In addition, its reserve position in the EMS improved as other countries in that arrangement sold marks to slow the advance of the mark against their own currencies. During February and March, Germany's foreign currency reserves rose $3.8 billion to $41.0 billion.

After the first week of March, however, the mark began a decline that was to continue, except for one major interruption, through the remainder of the period under review. As interest rates in the United States rose and figures were released showing that the expected increase in inflation had not yet materialized, market participants came to question whether large investment flows into Germany would be sustained. Market participants doubted the Bundesbank would allow any corresponding rise in Germany short-term interest rates, since the domestic recovery had not yet led to a significant reduction in unemployment. This perception deepened in April when new data showed some faltering of industrial activity. Thus, the earlier positive evaluations of the relative attractiveness of mark-denominated

Chart 3

Germany

Movements in exchange rate and official foreign currency reserves



Exchange rates shown in this and the following charts are weekly averages of noon bid rates for dollars in New York. Foreign currency reserves shown in this and the following charts are drawn from IMF data published in International Financial Statistics.

*Foreign exchange reserves for Germany and other members of the European Monetary System, including the United Kingdom, incorporate adjustments for gold and foreign exchange swaps against European currency units (ECUs) done with the European Monetary Fund.

investments eroded, and net portfolio inflows to Germany slowed markedly in March before turning negative in April.

Developments in the German labor market also contributed to the mark's decline starting early in April By mid-month it became clear that annual wage negotiations between the union and employers in Germany's important metalworking industries were locked in a dispute over the union's demand for a five hour reduction in the standard work week Strikes began in May in two major regions, initiating the most serious work stoppage in German industry for many years Exchange market participants viewed the strike as important because of potential reductions in Germany's industrial production and current account performance for the year, as well as the possible long-term effect on Germany's competitiveness of any substantial concession to the union's demands. Against this background, trading in German marks became sensitive to news of the labor negotiations from April onward

In these circumstances, news that Germany continued to register sizable trade account surpluses, while U S monthly trade deficits mounted to record levels, made little impression on the exchange markets. The mark dropped through several psychologically important levels, and its decline drew added impetus from selling by commercial entities and technically oriented speculators By May 10, the mark fell some 10 percent from its March peak to DM 2 8010, less than 2 percent above the lowest level reached during the previous January.

The mark's decline against the dollar stalled at that point as problems of the U.S and international banking systems became a dominant preoccupation in exchange markets for a time. The mark was temporarily buoyed from the belief that the Federal Reserve would modify its monetary stance to ease financial strains At the same time, signs of a modest firming in money market interest rates in Germany were taken as presaging a possible move toward tighter monetary policy by the Bundesbank Thus, the mark rose through much of May

The exchange markets also became nervous in response to rumors of liquidity problems at several major U.S. banks with sizable LDC loan exposures or other problem loans On May 24 trading conditions became extremely disorderly as these rumors began indiscriminately to refer to American banks more generally. Many traders attempted to withdraw from dealing in the face of such rumors. As the German mark jumped some $1^{1}/_{2}$ percent in less than an hour, spreads between bid and asked quotes widened sharply and transactions became difficult to execute In these circumstances the Desk entered the market to counter disorder, selling $135 million equivalent of German marks. These marks were drawn in equal proportion from the foreign currency balances of the U S Treasury and the Federal Reserve. Following the operation, trading became more normal The mark continued its rise at a more subdued pace through the first days of June, reaching DM 2 6600 on June 5.

The mark then resumed its decline against the dollar as new estimates indicated that U.S. growth still overshadowed Germany's growth performance and as further increases in U S. interest rates widened the rate differentials adverse to the mark. The Bundesbank made clear it was not tightening monetary policy, even though it raised the discount rate, effective June 29, by $^{1}/_{2}$ percent to $4^{1}/_{2}$ percent. The central bank acted at the same time to expand quotas of discount credit available to German banks, specified that the change was designed merely to shift more of its liquidity provision from the Lombard facility to the discount window, and kept its Lombard interest rate unchanged at 5.5 percent. These steps did not lead to any rise of German money market interest rates which remained steady throughout June and July.

In addition, the labor situation continued to influence the German currency during the summer As the metalworkers' strike dragged on far longer than most observers had initially predicted, forecasts of Germany's 1984 growth and current account performance were revised downward. Even after settlement was announced late in June, press commentary questioned whether the upward momentum of the German economy could be recaptured. There was also uncertainty about the likely effects of the agreement on productivity in the affected industries and the extent it might become a standard for settlements in other sectors of the German economy

Thus, the mark became vulnerable to renewed investor enthusiasm for dollar-denominated assets By late July, the German mark had dropped below its previous low for the year, falling to DM 2 9205 on July 31 before closing that day at DM 2.9180 At this point the mark was trading 4 percent below its end-January levels Within the EMS, the mark remained at the top of the narrow band but its margin over the other currencies had been considerably reduced As pressures against the other EMS currencies subsided, some participating central banks purchased marks in the market to add to their own reserves

Meanwhile, German foreign exchange reserves dropped some $2.5 billion equivalent after March to $38.4 billion. The change partly reflected dollar sales by the Bundesbank to slow the decline of its currency against the dollar, as well as some reduction in Germany's creditor position within the European Monetary System resulting from repayment of mark debt by partner countries

Japanese Yen

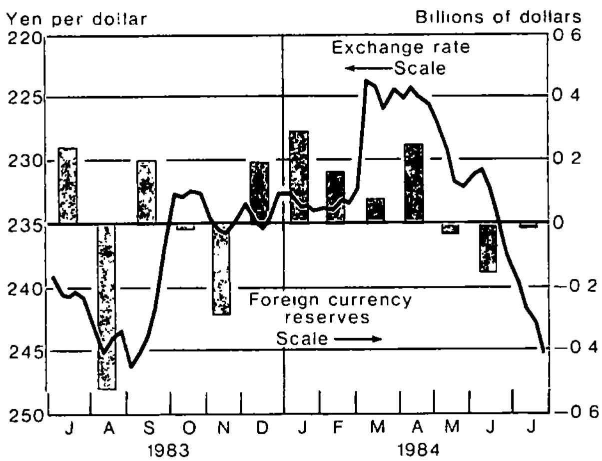
As the period opened, the Japanese yen was trading near record levels against European currencies, while showing somewhat less buoyancy against the dollar. By comparison with Europe, Japan's economic recovery was moving ahead more briskly. Its current account surplus, expected to exceed the previous year's $21 billion, was likely to surpass by far any other country's surplus. These factors had attracted some investment from abroad. But, overall, inflows to Japan through the current account and through nonresident investments were more than offset by outflows of residents long-term capital—outflows that slowed the yen's advance against the dollar. To some extent these outflows were attracted by the relatively high interest rates and even more rapid growth in the United States. In part they reflected continuing diversification by Japanese investors of their rapidly growing financial assets. In addition, discussion about liberalizing the Japanese capital market, internationalizing the yen, and improving access of foreign firms to the Japanese capital market added to uncertainties about the immediate outlook for the dollar-yen exchange rate.

During February and early March, the yen was slow to benefit from the shift in sentiment against the dollar. In contrast to the mark, the yen remained steady against the dollar trading around ¥233 until early March 2.

Chart 4

Japan

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3.

Then it rose abruptly as bidding appeared from both commercial and professional sources. The yen's advance quickened after market participants sensed that the yen might be catching up with the earlier rise of the mark. By March 7, the currency had risen some 6 percent to ¥220.00 against the dollar, its high for the period.

Following this rise, calls on the Bank of Japan to cut the discount rate were heard from diverse quarters. The central bank, however, rejected these suggestions, arguing that the yen's recovery was not yet sufficiently well established and that domestic as well as international developments should be taken into account. As it was, monetary policy was generally viewed as accommodative, with the Bank of Japan forecasting monetary growth to continue at about an 8 percent annual rate. Also, the Bank of Japan raised the ceiling for net new domestic lending by Japanese banks, as the domestic demand for funds continued to grow apace. Although the central bank's discount rate remained unchanged during the period, the banks lowered the long-term prime rate from 8.2 percent to 7.9 percent at the end of March.

From March on, interest differentials favoring dollar over yen assets widened steadily in part because short-term interest rates in Japan remained little changed or even declined slightly. At first, the yen held steady against the dollar, and thereby regained some ground against European currencies, as optimism about the Japanese economy was reinforced by fresh evidence of strengthening growth and a widening current account surplus. Domestic demand picked up and business confidence improved. With the prospect of rising profits for Japanese companies, prices on the Tokyo stock exchange were still climbing and reports circulated of increased foreign demand for Japanese equities.

But the yen started to decline against the dollar late in April. Soon afterward it began falling against other currencies as well, so that the yen did not return to the peak levels against the mark registered earlier in the year. Late in April the Tokyo stock market lost its upward momentum as stock prices started to erase some of the 11 percent gain of the first four months of the year. Talk of capital outflows then intensified.

In addition, attention had been directed to new discussions between the Japanese Ministry of Finance and the U.S. Treasury about liberalizing the Japanese capital market and internationalizing the yen. As one moved towards liberalization, the Japanese authorities eliminated, effective April 1, the requirement that corporations identify underlying commercial transactions before entering a forward contract, as well as making other changes in the administration of the foreign exchange market during spring. On May 29, the Japanese Minister of Finance and the U.S. Secretary of the Treasury released a report containing a broad range of policy changes expected to affect the exchange rate over time (box). The report stated that the measures "...will help enable the yen to reflect more fully its underlying strength".[1]

During the remainder of the period, large-scale liquidation of nonresident's holdings of Japanese securities and heavy Japanese investment in foreign securities persisted Overall long-term capital outflows jumped well in excess of the underlying current account surplus—to a record $4 4 billion in April and to more than $6 billion by June Under these circumstances, the yen steadily declined against the dollar, easing to a low for the period of ¥ 247.30 on July 23. Trading at the close at ¥ 246.9, the yen had declined 5 percent against the dollar and 1½ percent against the mark from end-January levels. The Bank of Japan intervened during the second half of the period to moderate the downward pressure on the yen at times when trading became especially volatile. But over the six-month period, Japan's foreign exchange reserves showed little change, since declines due to intervention were offset by interest receipts

Yen/Dollar Exchange Rate Issues

The Japanese Minister of Finance and the U S Secretary of the Treasury released on May 29 a report containing a broad range of policy changes The report contained announcements by Japanese authorities of policy change in three broad areas the Euro-yen market, the operation of Japan's domestic capital market, and the access of foreign financial institutions to the Japanese capital market. In the area of the Euro-yen market, perhaps the most important area for the internationalization of the yen, the authorities announced the basic commitment and decisions necessary to allow for the development of Euro-yen bond and banking markets, where nonJapanese can freely invest in or borrow a range of yen-denominated instruments

Specifically, in the Euro-yen bond market, the announcement provided for the first time for the issue by nonJapanese corporations of yen-denominated bonds Foreign issuers will face no restrictions on the number or size of issues and will not be required to use the Samurai market (Japanese domestic market for foreign bonds) as a prerequisite. In the Euro-yen banking market, the announcements include authorization for foreign and Japanese banks to issue short-term negotiable Euro-yen certificates of deposit from their offices outside of Japan On the lending side, Japanese and nonJapanese banks will be free to extend Euro-yen loans to nonresidents of Japan.

Substantial changes in domestic financial market policies were also announced by the Ministry of Finance These include the removal of nonprudential restrictions on overseas yen lending from Japan; the elimination of limits on oversold spot foreign exchange positions—so-called swap limits; relaxation of regulations on domestic certificates of deposit, permitting banks to sell new types of large-denomination deposit instruments with market-determined interest rates, a plan for establishment of a yen-denominated banker's acceptance market in Japan, and allowing qualified Japanese branches of foreign banks to trade Japanese government securities in the secondary market

In the area of access by foreign financial institutions to the Japanese market, foreign banks will for the first time be allowed to engage in the trust banking business, the Tokyo Stock Exchange has begun to study ways to provide membership opportunities to foreign firms; and the Japanese authorities expressed their commitment to permit greater participation of foreign institutions in discussions pertaining to development of and in the implementation of financial policies.

Swiss franc

At the beginning of the period under review, the Swiss franc was trading steadily around SF2 2455 in terms of the dollar, slightly above seven-year lows reached in early January. Against the mark, however, the franc was strong by historical standards and near the SF0 80 level which, in the past, had prompted official concern over the competitiveness of Swiss exports Yet, this time, market participants concluded that the authorities would not act to prevent a further appreciation of the franc if doing so would require them to deviate from their monetary policy objective of controlling inflation Accordingly, exchange market participants had established positions in Swiss francs against marks and, thereby, had helped the franc to hold up better against the dollar just before the period.

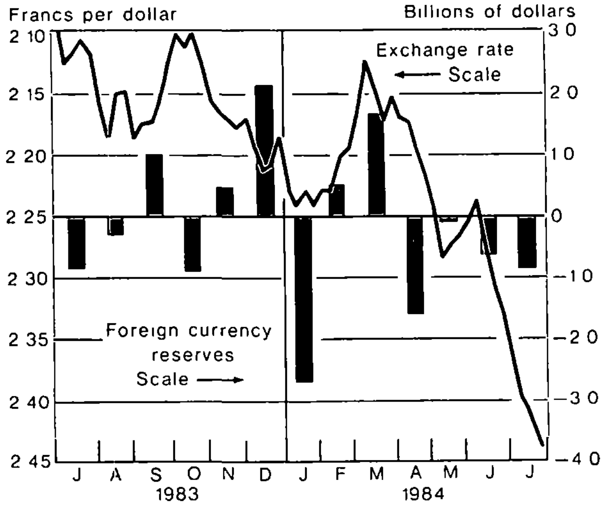
During February and early March, however, the Swiss franc did not benefit as much as the mark from the shift in investor preferences then taking place, and the franc failed to keep up with the rise of EMS currencies against the dollar. The outlook for economic growth had not improved as much as for Germany and, though inflation was running at comparable rates, interest rates in Switzerland remained more than 2 percentage points lower than those on mark assets. Encouraged both by the interest rate differentials and by an easing of official regulations at the beginning of 1984, foreign bond offerings in the Swiss market picked up The conversion

[1]Japanese Ministry of Finance—United States Department of the Treasury Working Group, *Report on Yen/Dollar Exchange Rate Issues*, (May 1984), page 33

Chart 5

Switzerland

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

of these borrowings into foreign currencies put pressure on the Swiss franc At the same time, market professionals moved to reverse positions in Swiss francs against marks established earlier Thus, the Swiss franc, while climbing 7¼ percent against the dollar to its high for the period of SF2 0940 on March 7, fell nearly 4 percent to nearly SF0 83 in terms of the German mark

From March on the Swiss franc moved more in line with other European currencies as it fell against the dollar. Swiss interest rates rose somewhat But, with U S rates also rising, adverse interest differentials compared with dollar assets widened to more than 7 percentage points for the three-month maturity Thus capital outflows continued, reflecting borrowings by Japanese corporations in particular Thus the Swiss franc declined against the dollar to SF2 4760 by the end of July, a fall of 9½ percent for the six-month period Against the mark, the franc dropped about 3 percent to around SF0 85 in the final two months of the period, bringing the decline for the six-month interval to 6 percent By late June, settlement of a major strike in Germany eliminated a factor that had tended to favor the Swiss franc relative to the mark In addition, the Swiss franc did not benefit as did the mark from large scale central bank intervention purchases

The Swiss authorities did not intervene during the period Fluctuations in Switzerland's foreign currency reserves reflected foreign currency swap operations to adjust liquidity in the Swiss banking system

Sterling

Between February and July, Sterling extended the decline that had taken place with only few interruptions since early 1981. After staging a short-lived advance as the dollar generally eased, in February and early March sterling dropped during the period 7½ percent against the dollar and 4 percent according to the Bank of England's trade-weighted index During the period, Britain's economy was showing distinct signs of improvement, but several questions remained about the immediate outlook Economic expansion was far more established in the United Kingdom than in most other European countries, but output growth was not yet sufficient to reverse a rise in unemployment. Inflation had stabilized at about 5 percent, but prices and cost pressures were even more subdued in some other countries so that Britain's competitive position failed to show further improvement The three-year weakening in Britain's nonoil trade position slowed as demand began to pick up in major export markets, but foreign exchange market participants continued to perceive Britain's overall external position to be vulnerable to further declines in oil prices Thus, trading in the pound was frequently influenced by developments in the oil market, as well as by changes in yield on short-term investments in sterling relative to those in other currencies—especially the dollar

During February both interest rate and oil market factors tended to favor sterling The government had continued to aim at moderately restrictive fiscal and monetary targets, but both public sector borrowing and monetary growth had been running somewhat over their targets for the fiscal year At least until these economic indicators had come closer to their intended ranges, market participants expected the pound would be supported by relatively attractive short-term interest rates. British interest rates were substantially higher than those in most major markets and close to parity with those available for U S dollar assets In addition, intensifying military conflict in the Persian Gulf at times threatened to interrupt oil supplies, and the resulting upward pressure on crude oil prices was expected to improve Britain's current account position Thus, sterling rose some 6½ percent in terms of the dollar during the month to a high of $1 4955 on February 29 The currency was not, however, identified in market talk as one of those benefiting from reported shifts in portfolio capital out of dollar investments Overall, the British currency rose nearly 2 percent on average to close the month at 83 3 in terms of the Bank of England's trade-weighted index, its highest level during the period. At the same time, Britain's foreign currency reserves rose $0.6 billion to $9.1 billion.

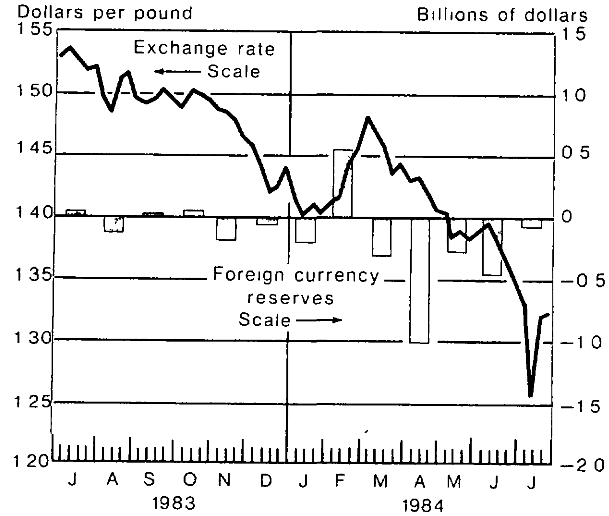
After the end of February, sterling began to decline against the dollar and other currencies. Unemployment had risen steeply in January and February and there were fears—borne out in early April—that industrial production would turn down as a result of a miners' strike. Expectations grew that the British authorities would be under pressure to lower interest rates. Then, publication of statistics showing that sterling M3 had dropped within its target range in the first two months of the year led market participants to believe that the authorities were in a position to let interest rates ease in order to stem the rise in unemployment.

Sterling's decline was interrupted briefly in the aftermath of the government's announcement on March 13 of its budget and monetary targets for 1984-85. Market participants generally praised the budget, which projected a decline in the public sector borrowing target and a reduced rate of monetary expansion along with some corporate tax reductions and other tax support for sterling as the period went on. Even with reforms. Sterling rose as foreign buying of British bonds and equities reportedly contributed to strong rallies in London's capital markets.

Chart 6

United Kingdom

Movements in exchange rate and official foreign currency reserves



See footnotes on Chart 3

But the exchange rate rise was soon erased when market attention reverted to the developing pattern of interest rates. The Bank of England endorsed a half percentage point decline in the general level of short-term interest rates by cutting its dealing rates in two steps around mid-March. Combined with the rise of dollar interest rates then underway, this caused short-term differentials *vis-á-vis* the dollar to move some 2 percentage points and to become decidedly negative for sterling by late March

The world oil market situation also provided less support for sterling as the period went on. Even with the continued fighting in the Persian Gulf, market participants became less convinced of the potential for higher oil prices in light of apparently ample supplies. In these circumstances, an occasional flare-up of Middle East tensions no longer caused the same surge of sterling buying as before, and market professionals, who as a group had been willing to hold long-sterling positions for a brief period in February, reestablished short positions

Domestic labor problems also contributed to sterling's weakness at times. The strike by Britain's coal miners was not a particularly serious concern in the exchange markets at its inception in March, in view of the limited support given the miners' position by unions in other industries and the ample coal stocks available to supply the country's needs But the strike began to be viewed more negatively as time went on. Sterling exchange rates thus became more sensitive to news of the miners' strike and other labor disputes later in the period.

During May and June, negative interest differentials relative to the dollar widened further as U S. interest rates rose. Market participants became increasingly convinced that, if faced with the choice, British authorities would let sterling depreciate rather than put further economic expansion at risk by raising domestic interest rates substantially This view was consistent with the perception that, at current exchange rates, production costs in the United Kingdom were still high relative to those on the Continent, and that much of the growth in consumption during this recovery had been met by imports. It persisted even after the Bank of England endorsed a 1/2 percentage point rise in short-term market interest rates in early May It was reinforced when, as the Bank of England announced a technical adjustment of the structure of its dealing rates in late June, the central bank indicated there was no need on monetary grounds for a general increase in interest rates.

Under these conditions, which were aggravated by a national dock strike, sterling's drop accelerated in early July, until the pound hit an all-time low of $1.2970 and an eight-year low in effective terms. This drop quickly led to a sharp rise in interest rates in the London market that ended with a cumulative 2 3/4 percentage point increase in the Bank of England's money market dealing rates and the major banks' base lending rates. These increases restored sterling's short-term interest rate advantage relative to the dollar. Subsequently, helped by settlement of the dock strike, sterling steadied to fluctuate along with other currencies against the dollar. Although it closed July at a new low against the dollar of $1.2970, it had recovered nearly 2 percent in effective terms. During the five months to end-July, Britain's foreign currency reserves declined almost continuously, dropping $2.3 billion to $15.4 billion by the end of the period.

European Monetary System

During the period under review, the alignment of central exchange rates within the EMS remained relatively free from strain. Economic divergencies among the participating countries were reduced as all seven countries continued to implement policies aimed at reducing fiscal deficits, strengthening current account positions, and holding down inflation. Increases in wages and consumer prices had decelerated during 1983 in France, Italy, Denmark, Belgium, and Ireland, bringing inflation in these countries somewhat closer to—although still much higher than—the low rates prevailing in Germany and the Netherlands. The large current account deficits of France, Italy, Belgium, Denmark, Ireland had all been substantially cut—in the case of Italy, reversed—while the German and Dutch surpluses remained rather stable by comparison.

The joint float came under some pressure in the early part of the period as the dollar fell from its January highs. Flows out of dollar assets were attracted into the German mark to a far greater extent than to other EMS currencies—reflecting sanguine assessments of the investment climate in Germany as well as the wider opportunities for inflows afforded by its relatively open financial system. Thus, by the beginning of February, the mark was trading at or near its upper limit against the Belgian franc, after having quickly risen to the top of the EMS narrow band. All of the other EMS currencies were also clustered near the mark at the top of the narrow band, except for the Italian lira which traded about 3½ percent above the band within the wider limits established for that currency.

The German mark continued to strengthen through early March against all EMS currencies. The Belgian franc became pinned at its lower EMS limit against the mark. The Belgian central bank countered speculative pressure against its currency partly by raising its official lending rates one percentage point, effective February 16. The currencies that had shared the top of the narrow EMS band with the mark at the beginning of the period dispersed through the top half of the band, and the Italian lira moved down closer to the narrow band.

Intervention support was provided to several currencies. The central banks of France, Belgium and Ireland financed the bulk of their official currency sales from the proceeds of external borrowings or other sources so that their foreign exchange reserves were little changed or even rose during the two months. Belgium also drew on the very short-term facility available through the European Monetary Cooperation Fund (EMCF). In the case of Italy, however, official sales of marks and dollars were partly reflected in a drop of foreign currency reserves of $0.7 billion for February and March.

Pressures within the float ebbed after the first week of March, as the dollar began rising again and inflows into the German mark subsided. The mark eased against its partner currencies and, at times, the Dutch guilder alternated with the mark at the top of the narrow band. In addition, the spread between the topmost currency and the Belgian franc at the bottom narrowed to less than one percent by the end of July.

With the waning of tensions in the EMS, the French and Italian central banks were able to purchase substantial amounts of foreign currencies in the market to rebuild their reserve positions. Over the six-month period as a whole, foreign exchange reserves of these two countries rose on balance—by $2.4 billion equivalent for France and by $0.6 billion equivalent for Italy—to close at $20.1 billion and $18.5 billion, respectively. The Belgian central bank was able to cease its intervention sales of foreign currency and used the proceeds of further external borrowings to reduce its liabilities to the EMCF. Although Belgium's foreign currency reserves declined by $0.5 billion during the six months to $3.1 billion by the end of July, the decline was considerably smaller than its repayments of indebtedness to the EMCF over the six-month period.

The authorities of France, Italy and Belgium also took advantage of the easing of exchange-market pressures against their currencies to ease interest rates or, in the case of the first two countries, to ease foreign exchange controls. Money market interest rates in the three countries declined by ½ to 1 percentage point in the last four months of the period Italy's Trade Ministry reduced the extent to which Italian exporters are required to conduct their trade financing in foreign currencies. In France, one of the first official actions of the new cabinet that took power in July was to relax restrictions on the use of credit cards abroad, which had been part of the March 1983 austerity program.

By the end of July, the EMS currencies had fallen between 13 and 16 percent from their March highs against the dollar, but were only 2 to 4 percent lower over the six-month period as a whole. Nevertheless they closed at levels that represented, in most cases, all-time lows against the dollar. These wide movements against the dollar contrasted with their steadiness against one another. By the end of the period, the exchange rate structure which had been adopted in March 1983 had lasted longer than any other in the six year history of the EMS.

Canadian dollar

By the opening of the six-month period under review, the Canadian dollar had settled into a trading range around Can.$1.245 ($0.803), drawing support from surpluses on Canada's trade and current accounts. But sentiment toward the Canadian dollar deteriorated early in February when published figures revealed that, despite an impressive recovery during 1983, the Canadian economy had not yet returned to satisfactory levels of production and employment and investment remained sluggish. Looking ahead, observers questioned whether exports, a major contributor to Canada's growth last year, would remain so buoyant if the economic expansion in the United States were to moderate. They wondered also if credit demands would be as strong in Canada as they appeared to be in the United States. Thus, market participants focused on the monetary authorities' potential policy conflict between lending support to further economic growth and incurring the inflationary consequences of a weakening in the exchange rate Against this background the currency showed vulnerability to selling pressure when Canadian short-term interest rates slipped below comparable U.S. rates.

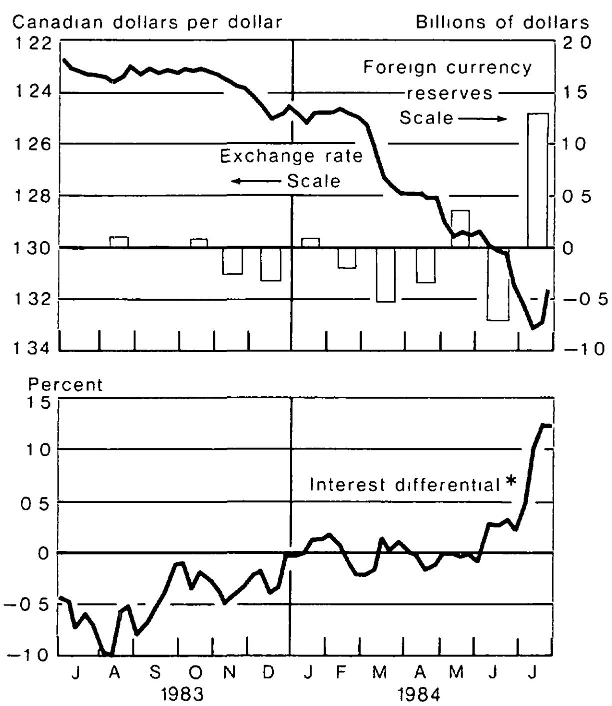
Public officials denied that they would welcome a sharp drop in the Canadian dollar and the central bank's *Annual Report* pointed to the dangers of currency depreciation. The central bank asserted that in the event of sharp downward movements of the Canadian dollar, "the successful pursuit in Canada of increasing price stability requires that Canadian policy try to moderate the exchange rate movements and to offset their inflationary effects "[2] But, for several months, market par-

[2]Bank of Canada, *1984 Annual Report*, page 8

Chart 7

Canada

Movements in exchange rate, official foreign currency reserves, and interest differential



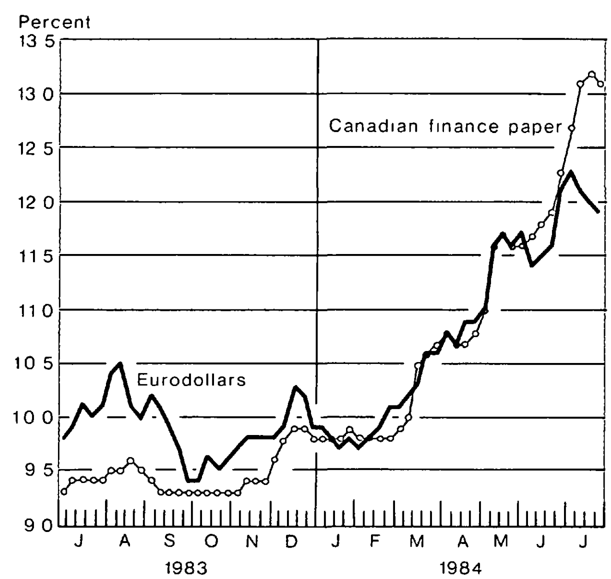
*Canadian finance paper minus Eurodollars
Weekly averages of daily rates

See exchange rate footnote on Chart 3

Chart 8

Interest Rates in Canada and the Eurodollar Market

Three-month maturities*



*Weekly averages of daily rates

ticipants perceived the Canadian authorities to be reluctant to allow interest rates to rise along with U.S rates

The Canadian currency was also subjected to other pressures during the spring Market participants thought that Canadian subsidiaries of some U S oil companies would be sold and the proceeds converted into U.S. dollars to finance large take-over bids involving the parent companies. Commercial leads and lags shifted against the Canadian dollar At the same time, market professionals sought to establish or increase short positions in the currency, adding further to the pressure.

Against this background, the Canadian dollar dropped off sharply in several waves of selling from March through July. The pressures were particularly intense in June and early July when a change in the leadership of the governing party and the prospect of national elections in September stimulated renewed debate on interest and exchange rate policy. During this episode the Canadian currency dropped to an all-time low of Can.$1.3368 ($0.7481). The Bank of Canada intervened in the exchanges to resist this decline

Meanwhile, Canadian money market interest rates ratcheted upward and the Bank of Canada's bank rate rose to a peak of 13.26 percent in the middle of July, even after U.S. money market rates had started to ease. These movements pushed interest rates on Canadian dollar assets significantly above those on U.S. dollar assets and buoyed the currency. Market sentiment was also encouraged by the waning of public debate over exchange rate and interest rate policy. As market participants' earlier concerns that the currency would depreciate lifted, the Canadian dollar recovered some of its earlier decline. It closed the period at Can $1.3094, down 5 percent on balance against the dollar over the period.

The Canadian authorities drew heavily on their reserve position to finance intervention to support the Canadian dollar from February to June, but they were able to buy back reserves in July. Their foreign currency reserves were supplemented as needed by borrowings of U.S. dollars on credit lines with Canadian and foreign banks, totaling $1.4 billion, as well as by net borrowings in other foreign currencies equivalent to $0 6 billion Canada's foreign currency reserves nevertheless declined from the end of January to the end of April, falling $1.1 billion to $1.7 billion before returning to $2.7 billion by the close of the period