# Treasury and Federal Reserve Foreign Exchange Operations*

By CHARLES A. COOMBS

Over the six-month period, August 1973-January 1974, covered by this report, the dollar recovered strongly from the speculative attack that, during the first week of July, had driven down the dollar against the major European currencies to as much as 20 percent below official central rates. This sharp depreciation of dollar rates was unwarranted by the improving United States external position and threatened to magnify the impact of worldwide inflation on price levels here in this country. The speculative wave was abruptly broken on July 9 as reports circulated of an imminent resumption of exchange operations by the Federal Reserve, backed up by a major enlargement of the System's reciprocal lines of credit with foreign central banks. Subsequent Federal Reserve intervention in support of the dollar during the rest of July totaled $273.4 million, entirely financed by drawings on the swap lines with foreign central banks.

These swap credits taken down by the Federal Reserve during July were completely repaid by mid-August as dollar rates moved up. From late August through October, the exchange markets gradually settled down to more orderly trading conditions, with much narrower fluctuations in rates from day to day as well as during trading sessions. In this improved atmosphere, the market also showed greater resilience in absorbing the shocks of adverse political and economic news here and abroad. During this period, the Federal Reserve stood ready to intervene on numerous occasions, but operations were required only in five instances. These System operations, as detailed in the interim report appearing in the December issue of this *Review,* totaled $243.3 million, of which $238.9 million was drawn under the swap lines and repaid by the end of October 1973.

From November through late January, the dollar's recovery gained increasing momentum as evidence accumulated that the United States balance of payments was moving decisively into surplus. As United States exports soared, the trade account showed a dramatic turnaround, registering a sequence of monthly surpluses. Heavy foreign purchases of United States securities, foreign direct investments in the United States, and repatriations by United States companies of buoyant overseas earnings reinforced the demand for dollars. Set against the weakening payments positions of several major foreign countries, the general improvement in the United States position gave a strong boost to confidence in the dollar. As the oil crisis suddenly erupted, cutbacks in oil supplies and the successive steep price increases by the producing nations clearly threatened to have far-reaching effects on industrial output and employment, price inflation, and the balance of payments in the major industrialized countries. On each of these counts, the market took the view that the United States, far less dependent on imported oil than Europe and Japan, could better cope with the damaging consequences of supply restrictions and more readily absorb the payments burden of costlier oil. At the same time, it was widely anticipated that a major share of the oil producers' higher revenues would be attracted to dollar investments.

This favorable market assessment of United States prospects triggered a strong movement of short-term funds out of the major European currencies and the Japanese yen into dollars. Rising dollar rates were accelerated by a large-scale unwinding of long-standing speculative positions in

* This report, covering the period August 1973 through January 1974, is the twenty-fourth in a series of reports by the Senior Vice President in charge of the Foreign Function of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank acts as agent for both the Treasury and Federal Reserve System in the conduct of foreign exchange operations.

foreign currencies, and various foreign central banks sold dollars from their reserves to moderate the declines of their currencies. Nevertheless, by mid-January, the German mark and Swiss franc had fallen by roughly 23 percent against the dollar from their peak levels of early July 1973, while other major European currencies had also declined sharply. In late January, following the widespread dismantling of capital restrictions here and abroad, dollar rates topped off and a declining trend developed during February.

With the dollar rising steadily on its own from November through January, there was naturally no need for even temporary support operations by the System. As foreign currencies came on offer, however, both the Federal Reserve and the United States Treasury were able to make further progress in repaying foreign debt left outstanding at the time of closure of the gold window in August 1971. Beginning in August 1973, the Federal Reserve resumed modest daily purchases of Belgian francs in the market to repay swap drawings on the National Bank of Belgium incurred prior to August 15, 1971. By the end of January 1974, $128.2 million of those drawings had been repaid, leaving $261.8 million equivalent remaining (see Table II). In January 1974, the System also repaid through market purchases $193.8 million of Swiss franc debt incurred prior to August 15, 1971, thereby reducing the System's total Swiss franc debt to $971.2 million. As of January 31, therefore, System swap debt had been cut down to $1,232.9 million, compared with the peak of $3,045 million outstanding on August 15, 1971.

The Treasury also took advantage of the strengthening of the dollar to make net purchases during December 1973 and January 1974 of $186.5 million of German marks, French francs, Belgian francs, and Japanese yen, of which $132.9 million equivalent was subsequently used to pay down United States Treasury debt to the International Monetary Fund (IMF) to an end-of-January total of $1.3 billion. In addition, in October 1973 the Treasury had repaid at maturity the last of its German-mark-denominated securities with marks purchased from the Bundesbank. As a result, by end-January, the remaining Treasury medium-term foreign currency debt, all denominated in Swiss francs, totaled $1,587.9 million equivalent (see Table IV).

Effective February 1, the swap line between the Bank of Italy and the Federal Reserve was increased from $2 billion to $3 billion. In this connection, Chairman Burns noted that increases in other lines might be considered as needed.

Table I

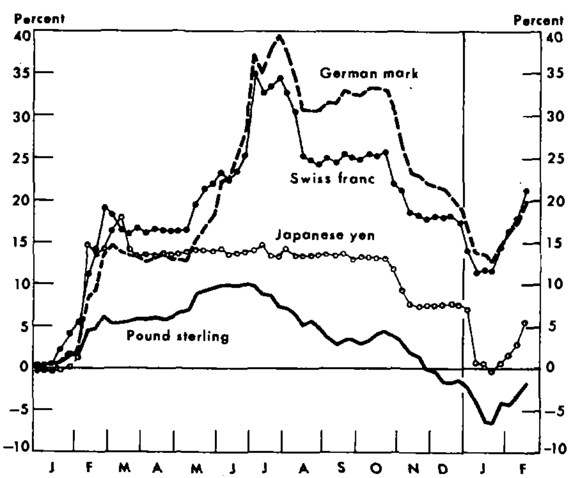
**FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS**

In millions of dollars

| Institution | Amount of facility February 1, 1974 |
|---|---|
| Austrian National Bank | 250 |
| National Bank of Belgium | 1,000 |
| Bank of Canada | 2,000 |
| National Bank of Denmark | 250 |
| Bank of England | 2,000 |
| Bank of France | 2,000 |
| German Federal Bank | 2,000 |
| Bank of Italy | 3,000 |
| Bank of Japan | 2,000 |
| Bank of Mexico | 180 |
| Netherlands Bank | 500 |
| Bank of Norway | 250 |
| Bank of Sweden | 300 |
| Swiss National Bank | 1,400 |
| Bank for International Settlements: | |
| Swiss francs-dollars | 600 |
| Other authorized European currencies-dollars | 1,250 |
| Total | 18,980 |

Chart I

SELECTED EXCHANGE RATES*



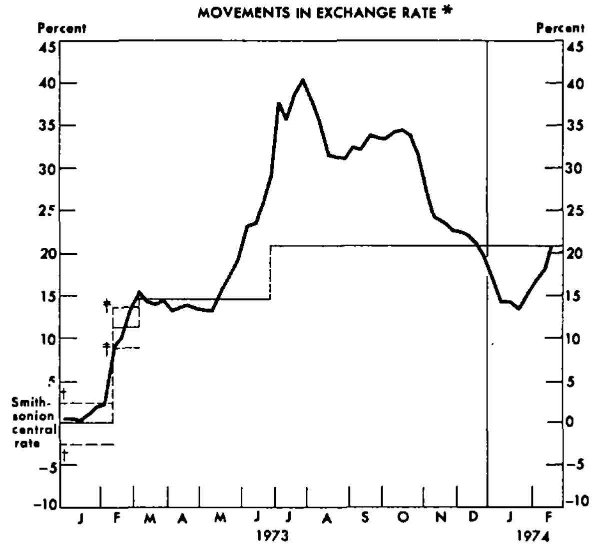

* Percentage deviations of weekly averages of New York noon offered rates from New York noon offered rates on January 2, 1973.

## GERMAN MARK

In the massive speculation against the dollar, which erupted last spring and carried into early summer, the German mark spearheaded the rise of European Community (EC) currencies. By early July 1973, the mark rate had been pushed to as high as \$0.4525, some 31 percent above its February central rate. The Federal Reserve had then resumed intervention in the exchanges, beginning on July 10. Such intervention initially encountered considerable market resistance, as a severe liquidity squeeze in Frankfurt touched off renewed heavy bidding for marks. By the end of July, the Federal Reserve had sold a total of \$220.5 million equivalent of marks financed by drawings under the swap arrangement with the Bundesbank. The Bundesbank also had intervened in Frankfurt.

Late in the month the Bundesbank succeeded in relieving the immediate domestic liquidity squeeze and, with interest rates rising in the United States at the same time that this country's trade outlook was improving, the dollar began to stage a generalized recovery in the exchanges. Consequently, in early August, the mark came heavily on offer. As the mark rate declined, the Federal Reserve took the opportunity to acquire marks in the market. Some \$4.2 million equivalent of these balances was sold in the market on August 7 when there was a brief run-up of the mark rate, but the decline in the rate quickly resumed. By mid-August, the Federal Reserve had repaid through market purchases the \$220.5 million equivalent of swap drawings on the Bundesbank. Meanwhile, the Bundesbank had sold some of the dollars it had purchased during the coordinated intervention of July.

Chart II
GERMANY
MOVEMENTS IN EXCHANGE RATE *




* In this and the following currency charts, movements in exchange rates are measured as percentage deviations of weekly averages of New York noon offered rates from the middle or central rates established under the Smithsonian agreement of December 18, 1971.

† Upper and lower intervention limits established in December 1971.

† Upper and lower intervention limits around new central rate established on February 13, 1973 following devaluation of United States dollar. Limits suspended on March 1, 1973.

Over subsequent weeks, even as favorable trade and balance-of-payments figures were released for the United States, new uncertainties about price trends and political developments in this country surfaced from time to time. With the dollar still vulnerable, the Federal Reserve reentered the market to resist excessive movements of market rates. Thus, on August 20-21, when there was a resurgence of demand for marks ahead of the release of German trade figures, the Federal Reserve offered marks on those two days and again briefly later in the month. In the two episodes the System sold a total of \$54.5 million equivalent of marks drawn under the swap line with the Bundesbank, while the German central bank made modest purchases of dollars in Frankfurt. Then, in early September, just ahead of the official announcement of United States wholesale prices for August, the dollar again came under some pressure against the mark, and the Federal Reserve sold \$8.2 million equivalent of marks, of which \$3.9 million was drawn under the swap line and the remainder came from balances on hand. In all of these instances, however, the dollar recovered quickly, and the Federal Reserve was able to liquidate its swap drawings within a matter of days with marks purchased in the market. Apart from these occasions, exchange market conditions tended to improve and day-to-day fluctuations in the mark rate narrowed significantly as the dollar consolidated its earlier gains.

The relative calm in the exchanges was suddenly shaken by the unexpected revaluation of the Netherlands guilder on September 15, which immediately raised expectations of further central rate changes in the EC currency arrangement. Renewed speculative demand for marks appeared, pushing up the mark rate and pulling the other currencies in the EC band up in its wake. The Federal Reserve stepped in, in coordination with the Bundesbank, to moderate the rise in the mark. Between September 17 and 26 the Federal Reserve sold \$156.7 million equivalent of German marks drawn under the swap line, while the Bundesbank intervened in Frankfurt by buying nearly \$140 million. This forceful intervention, together with complementary action in other EC countries, effectively stemmed the speculative outburst.

By late September, the mark rate had steadied once again and, with underlying trade and investment flows tending to strengthen the dollar, the Federal Reserve was subsequently able to purchase sufficient marks to repay $86.1 million equivalent of the outstanding swap debt to the Bundesbank. In mid-October, the improvement in the dollar was again temporarily interrupted by a sharp fall in United States interest rates, the outbreak of war in the Mideast, and the resignation of Vice President Agnew. When news of the resignation hit the markets, demand for marks suddenly intensified. To guard against disorderly trading conditions, the Federal Reserve made unusually large offers of marks in the New York market, of which $21 million equivalent was sold.

Late in October, the market atmosphere was dramatically transformed when United States trade figures, showing an unexpectedly large $873 million surplus for September, confirmed to the market that the long-awaited turnaround in the United States trade position was clearly under way. The mark, in particular, came under heavy selling pressure, and the Federal Reserve purchased sufficient marks to repay the remaining $91.5 million equivalent of swap debt then owed to the Bundesbank. By early November, when the unfolding oil crisis was becoming the focus of attention in the exchange markets, the cutback of Arab oil deliveries was seen as threatening severe dislocations for the German economy. The mark's decline was accelerated by the unwinding of earlier favorable leads and lags and the cutting-out of entrenched long positions in marks. In occasionally very heavy dealing, the mark plunged by 7 percent against the dollar in November and a further 1¼ percent by mid-December. The mark dropped also to the lower range of the EC "snake" and required support during nearly all of November.

While the cutbacks of oil to Europe were eased over the December 22 weekend, the simultaneous doubling of oil prices in the Persian Gulf, followed by even higher prices on the part of Libya, sent new shock waves through the market. The general view was that these prices would jeopardize the balance-of-payments positions of all industrialized countries but that the United States would be in a better position than European countries to withstand the added cost. The mark, therefore, came heavily on offer along with other European currencies in late December and the Bundesbank intervened in the exchanges, fairly substantially on some days. Beginning in late December, this Bank also began to purchase marks in New York. An initial $23.7 million purchased for Treasury account and $24.3 million purchased for System account in early Janu-

**Table II**

**FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS**

In millions of dollars equivalent

| Transactions with | System swap commitments on December 31, 1972 | Drawings (+) or repayments (—) 1973 I | 1973 II | 1973 III | 1973 IV | 1974 January | System swap commitments on January 31, 1974 |
|---|---|---|---|---|---|---|---|
| National Bank of Belgium | 415.0 | − 25.0 | | + 6.0<br>− 52.0 | − 82.2 | | 261.8 |
| Bank of France | | | | + 47.0<br>− 47.0 | | | —0— |
| German Federal Bank | | +104.6<br>−104.6 | | +435.6<br>−278.9 | + 21.0<br>−177.7 | | —0— |
| Netherlands Bank | | | | | + 2.9<br>− 2.9 | | —0— |
| Swiss National Bank | 570.0 | − 5.0 | | | | −193.8 | 371.2 |
| Bank for International Settlements (Swiss francs) | 600.0 | | | | | | 600.0 |
| **Total** | 1,585.0 | +104.6<br>−134.6 | —0— | +488.6<br>−377.8 | + 23.8<br>−262.8 | −193.8 | 1,232.9 |

Note: Discrepancies in totals are due to rounding.

Table III

**DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS AND THE BANK FOR INTERNATIONAL SETTLEMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS**

In millions of dollars

| Banks drawing on Federal Reserve System | Drawings on Federal Reserve System outstanding December 31, 1972 | Drawings (+) or repayments (—) | | | | | Drawings on Federal Reserve System outstanding January 31, 1974 |
|---|---|---|---|---|---|---|---|
| | | 1973 | | | | 1974 | |
| | | I | II | III | IV | January | |
| Bank for International Settlements (against German marks) | —0— | +11.0<br>—11.0 | +23.0<br>—23.0 | +36.0<br>—36.0 | +46.0<br>—46.0 | +2.0<br>—2.0 | —0— |
| Total | —0— | +11.0<br>—11.0 | +23.0<br>—23.0 | +36.0<br>—36.0 | +46.0<br>—46.0 | +2.0<br>—2.0 | —0— |

ary were largely resold to the Bundesbank against dollars. Further purchases were then made to build up mark balances of the United States Treasury.

The downward momentum of the spot mark nevertheless continued, and by mid-January the rate had declined to $0.3462, a further 8 percent from mid-December levels and its lowest level in nearly a year. At that point, it stood just ½ percent above its February 1973 central rate and fully 23½ percent below its peak of July 1973.

The decision of the French authorities on January 19 to float the French franc independently from the other currencies within the EC snake caught dealers by surprise. The German mark, which had recovered from its lowest point, suddenly came on offer along with other currencies remaining in the snake as dealers awaited the outcome of negotiations over the future of the EC monetary arrangement. As this pressure persisted, even after announcement by EC officials that the band arrangement would be continued on a more limited scale, this Bank again purchased marks in the New York market for United States Treasury account in an effort to avoid an even further decline in the spot rate. These purchases raised the Treasury's net acquisitions of marks to $112.5 million, and $105.2 million of the Treasury's accumulated balances was used in a repayment to the IMF on January 28.

Once the initial shock effects of the floating of the French franc had passed, the market began to reappraise the outlook for the dollar. By that time, there were reports that the oil embargo would be lifted or that oil prices would be rolled back, leading some dealers to believe that the previous rush into dollars had perhaps been overdone. Moreover, interest rates in the United States had begun to decline relative to rates abroad. Then, on January 29, the United States Government announced the termination of its controls on capital outflows. The dollar quickly came on offer and, since Germany's strong trade balance and very substantial international reserves were seen as helping that country meet the added payments burden of the higher oil prices, the German mark in particular began to rise sharply. Subsequently, the German authorities also relaxed many of their controls against inflows, lifting restrictions against nonresident purchases of long-term German securities and direct investments, allowing residents to borrow abroad without prior official approval and reducing the "bardepot" deposit requirement from 50 percent to 20 percent. These developments stimulated further bidding for marks, and by the end of January the spot rate had advanced by 4¼ percent from the lows reached earlier in the month.

## STERLING

Despite an abrupt slackening in the rate of growth last summer, the British economy remained gripped by severe inflation. The government responded by providing stimulus through fiscal policy, while seeking to decelerate the wage-price spiral by moving to a longer term "Stage III" control mechanism. Meanwhile, however, the willingness of the trade unions to accept continuing restraint on wages was being undermined by the persistent run-up of prices. Inflationary pressures were exacerbated by external factors. The worldwide rise in commodity prices and the substantial depreciation of sterling since June 1972—to which the trade accounts had not yet responded—had seriously inflated Britain's import bill and ratcheted domestic prices even higher. To help curb these pressures and to bolster sterling, the Bank of England had tightened monetary policy considerably. By early August, interest rates had moved up to historic highs and the bank's minimum lending rate had advanced to 11½ percent. Partly as a means of reinforcing Britain's reserves, the authorities had also encouraged public-sector borrowings in the Euro-currency markets, and over $1 billion of these borrowings had been announced. Protected by London's relatively high interest rates, sterling declined less rapidly than other currencies in August, falling back from $2.50 to around $2.46 as the dollar generally strengthened.

Early in September, however, the pound suffered a sudden sell-off on growing concern over the prospects for the British economy and on rumors that the United Kingdom would allow the sterling-balance guarantees with former sterling-area countries to lapse when they expired on September 24. Speculation quickly fed on itself and in just three days the pound plunged more than 7 cents, to a low of $2.38 in London on September 6. At that point the Bank of England stepped in with strong support, and the government announced its decision to extend the sterling guarantees for another six months at $2.4213, prompting a rebound in sterling to around that level. In subsequent weeks, trading remained nervous as the market awaited signs of progress in the final negotiations among government, labor, and employers over the ultimate shape of the Stage III controls. Spot sterling, therefore, did not participate in the rise in Continental currencies following the revaluation of the Netherlands guilder. Instead, the rate held fairly steady through early October and showed little response to the British government's announcement of Stage III guidelines, as the market deferred judgment on the effectiveness of the new controls until the trade unions' response could be weighed.

The October 6 war in the Mideast then became the dominant factor in the exchanges. Funds were initially shifted out of dollars into sterling, attracted by the relatively high interest rates available in London. As a result, sterling rose as high as $2.46 at one point in mid-October, even as the Bank of England purchased dollars to moderate the rise. Later that month, however, announcement of the huge United States trade surplus for September and of cutbacks in Arab oil production exerted a drag on sterling. But as the immediate impact of differential supply cutbacks was viewed as less damaging to the United Kingdom than to many of the industrialized countries, sterling fell off less sharply than other currencies.

Nevertheless, the longer run implications for sterling of the unexpectedly steep rise in oil prices in October were worrisome, as they portended an escalation of the inflationary pressures and a worsening of the trade balance —already at a record deficit of £364 million in October. Moreover, a confrontation between labor and government was shaping up as the coal miners, in particular, dramatized their objections to the new wage guidelines in mid-November by banning overtime and weekend work. With this action threatening cutbacks in electricity production and posing serious implications for the economy as a whole, market sentiment toward sterling turned bearish.

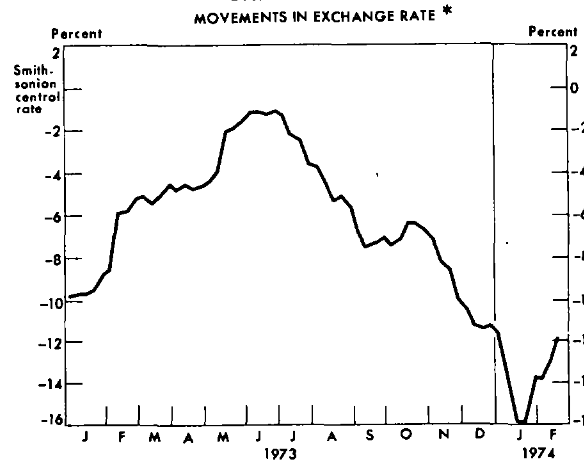
The Bank of England then moved to keep the money market firm by hiking its minimum lending rate to 13 percent and by calling for additional special deposits. The tighter money market conditions held sterling in line with other European currencies, but against the dollar it dropped sharply after midmonth, with renewed speculative overtones, to as low as $2.30½ by December 11. The Bank of England provided increasing support for the pound in the exchange market, while allowing a money market squeeze to increase the interest cost of maintaining short positions in sterling.

As the conflict of the miners' union and the government hardened and coal supplies dwindled, the government announced on December 13 a draconian electricity-saving plan, including a three-day workweek. This was followed by a new restrictive budget, designed to reduce aggregate demand in line with production cutbacks and to improve the balance of payments. At the same time,

Chart III

UNITED KINGDOM

MOVEMENTS IN EXCHANGE RATE *




* See footnote on Chart II.

the Bank of England took further steps to curb excessive credit expansion, introducing new reserve requirements to supplement existing credit control arrangements. Dealers saw these measures as marking an end to the government's long-standing commitment to rapid growth, while at the same time limiting Britain's capacity to export. Even so, the attraction of continuing high interest rates in London kept the pound near $2.31 through the end of the year.

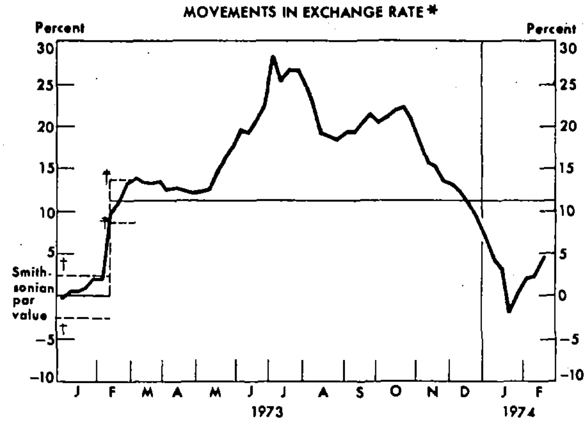
With sterling already in a vulnerable position, the doubling of oil prices in late December, potentially raising Britain's import bill by several billion dollars, triggered a sharp fall for the pound against the dollar. At first, the movement was roughly in line with the decline of other major European currencies. But, as talk spread of an early general election to resolve the continuing confrontation between labor militants and the government, sterling came even more heavily on offer. In extremely tense and nervous trading especially in the aftermath of the French decision to float the franc, the spot rate plunged by January 21 to a record low of $2.15¼ in London. This represented a drop of some 7 percent below the end-of-December level and 17⅜ percent below the Smithsonian central rate.

Thereafter, sterling began to rally, as tax payments and the massive overhang of short positions combined to produce an unprecedented liquidity squeeze in the London money market. This upturn was reinforced when the announcement of the termination of United States capital controls raised expectations of sizable inflows into high-yielding sterling investments. By the end of January, the spot rate had been bid back up to $2.27, for a rise of 5½ percent from the January 21 low.

Chart IV

FRANCE

MOVEMENTS IN EXCHANGE RATE*




* See footnote on Chart II.

† Upper and lower intervention limits established in December 1971.

‡ Upper and intervention limits as of February 14, 1973. Limits suspended on March 2, 1973.

### FRENCH FRANC

In the various exchange market upheavals over the first seven months of 1973, the French franc had been bolstered by the solid surplus in France's trade account as well as by occasional speculative inflows. The franc rate had been pushed as high as $0.2626 in early July, some 21 percent above its February central rate. In the subsequent resumption of exchange market intervention by the United States during July, the Federal Reserve had sold some $47 million equivalent of francs in the market, financed by drawings under the swap line with the Bank of France. As the dollar improved across the board in early August, the Federal Reserve readily acquired in the market sufficient francs to repay those swap drawings.

As elsewhere, inflationary pressures had mounted in France, and to protect the franc's position the authorities had gradually stiffened monetary policy. Thus, to keep pace with the escalation of interest rates in other major centers, in early August the Bank of France raised its discount rate by 1 percentage point to 9½ percent. Even so, money market rates in Paris failed to match the even higher levels reached in other financial centers, and a subsequent liberalization of exchange controls led to some outflows of funds. The franc thus remained near the bottom of the EC band and required occasional central bank support during August and early September.

The market generally considered the French trade surplus modest, compared with the massive trade surpluses of some of France's trading partners in the EC snake, and the unexpected revaluation of the Dutch guilder led to an outbreak of speculation over further adjustments, including a possible devaluation of the franc. Offerings of French francs against German marks and Belgian francs—the currencies at the top of the EC band—soon swelled to massive proportions, and the Bank of France and other EC central banks intervened heavily in support of the franc. In addition, the French authorities hiked the discount rate to 11 percent, the highest in one hundred years, raised bank reserve requirements, and tightened credit ceilings, while also asking the banks to refrain temporarily from lending French francs to nonresidents.

By September 24, these actions had blunted expectations of an imminent devaluation. At the same time, the heavy intervention of the previous week had created an unprecedented squeeze for franc balances, raising the cost of financing speculative short positions in francs, and some dealers moved to cover their positions. As a result, the franc edged off the bottom of the snake. The authorities soon lifted the restraint on lending to nonresidents but also announced a far-reaching dismantling of those banking regulations adopted in March 1973 to deter capital inflows. The commercial banks quickly began to offer positive yields to nonresidents once again. These measures provided a firmer tone to the market through late October, although there was occasional moderate intervention to support the franc at the lower limit of the EC band. Then, as the dollar came into widespread demand after announcement of the United States huge September trade surplus, other European currencies were depressed even more than the franc, with the result that no further intervention was required.

In early November, the market's focus suddenly shifted to the potentially serious effects on European countries of cutbacks of crude oil supplies from the Mideast. This led to a generalized demand for dollars, but at the same time the market took the view that France would suffer relatively less than other European countries from the differential cutbacks of oil deliveries. Additional anti-inflationary measures by the French authorities, including selective price controls and some tightening of both monetary and fiscal policies, also buoyed the franc. Thus, while dropping progressively lower against the dollar throughout November and early December, the franc declined less steeply than the other EC currencies. Indeed, by December, the franc was at the top of the EC band and there were moderate official sales of francs at the upper limit.

By mid-December, however, the market was shifting to the view that the oil crisis might also have a disruptive effect on the French economy. Then, the subsequent hike of Mideast oil prices came as a severe blow and, by adding substantially to the prospective import bill, threatened to turn France's trade position into sizable deficit. The franc declined precipitously against the dollar in occasionally heavy selling and once again dropped to the bottom of the EC band. The Bank of France intervened at first in other EC currencies and then also in dollars to keep the franc within the limits of that band. In conjunction with these operations, this Bank began in early January to purchase francs in New York for the United States Treasury, accumulating a total of $33.1 million equivalent. The pressures on the franc nevertheless remained intermittently heavy through midmonth, and by January 18 the spot rate had fallen over 8 percent from its mid-December level against the dollar.

On January 19, the French authorities announced that France would withdraw from the EC currency arrangement and allow the franc to float independently for six months, explaining that prospects of a massive oil-induced deterioration in their balance of payments made immediate

**Table IV**

**UNITED STATES TREASURY SECURITIES**
**FOREIGN CURRENCY SERIES**

In millions of dollars equivalent

| Issued to | Amount outstanding December 31, 1972 | Issues (+) or redemptions (—) 1973 I | II | III | IV | 1974 January | Amount outstanding January 31, 1974 |
|---|---|---|---|---|---|---|---|
| German Federal Bank | 306.0 | —153.0 | | | —172.4 | | —0— |
| Swiss National Bank | 1,232.9 | | | +63.6 | | +127.3 | 1,587.9 |
| Bank for International Settlements* | 170.9 | | | —62.2 | | —127.3 | —0— |
| Total | 1,709.8 | —153.0 | —0— | +63.6<br>—62.2 | —172.4 | +127.3<br>—127.3 | 1,587.9 |

Note: Valuation changes account for numerical discrepancies, as well as for different dollar values in the third quarter 1973 which involved refinancing by the Swiss National Bank of a Swiss-franc-denominated security held by the Bank for International Settlements.

* Denominated in Swiss francs.

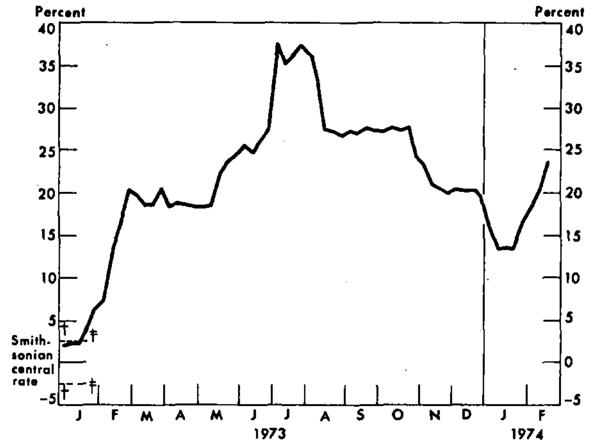
action necessary to protect French reserves and employment. The French authorities simultaneously moved to protect the currency by banning franc loans to nonresidents once again and by adjusting other banking regulations. The decision to float independently came as a shock to the market. Consequently, when trading resumed on Monday, January 21, the franc came under selling pressure, and the Bank of France stepped in to support the rate through dollar sales. The pressure nevertheless was such that the franc dropped by about 6 percent to $0.1894 in Paris. Over subsequent days, trading remained exceptionally nervous, and the Bank of France continued to intervene to moderate rate movements, not only in Paris but also in New York through the agency of the Federal Reserve Bank of New York.

Late in January, the franc was bolstered by reports of an imminent $1.5 billion Euro-dollar borrowing by the French government, along with other borrowings being arranged abroad by official French institutions, since these borrowings were seen as reinforcing reserves for future support of the exchange rate. The franc then joined in the general advance of European exchange rates against the dollar following the termination of United States capital controls, and the Bank of France bought modest amounts of dollars, again partly through this Bank, to moderate the rise. By the end of January the spot franc had advanced 4½ percent from its low of the previous week.

Chart V

SWITZERLAND

MOVEMENTS IN EXCHANGE RATE *




* See footnote on Chart II.

† Upper and lower intervention limits established in December 1971.

‡ Intervention limits suspended on January 23, 1973.

#### SWISS FRANC

In midsummer of last year the Swiss banking system was relatively liquid despite the restrictive monetary policy introduced in 1972. As a result, when the dollar strengthened across the board in early August, the Swiss franc declined more rapidly than many other currencies. Once the dollar's advance was established, entrenched long positions in francs began to be unwound, adding to the immediate demand for dollars. By August 23, the spot franc had dropped 13½ percent against the dollar from its July peak level of $0.3774 while also depreciating 3 percent against the currency of its principal trading partner, Germany.

Exchange trading then turned quieter, and the Swiss franc joined in the general firming of European exchange rates against the dollar later in August and in early September. Concern also arose early in September over possible liquidity pressures at the quarter end, but the Swiss National Bank announced that it again stood ready to provide assistance through short-dated swaps (of which it ultimately did $900 million). As a result, dealers felt reassured that the authorities were intent on maintaining balanced conditions in the Swiss money market at least for the time being. Against this background, the Swiss franc traded narrowly, with only modest fluctuations at the time of the guilder revaluation in September and again at the outbreak of the Mideast war. The authorities took advantage of these improved market conditions to reduce to zero the 2 percent per quarter negative interest charge on excess nonresident Swiss franc balances and to lift the restriction that the banks maintain balanced foreign exchange positions on a daily basis. But even such a substantial relaxation of controls had only a transitory impact on the market.

During this period of relatively quiet trading from late August through mid-October, the Swiss franc, while holding steady against the dollar, was losing some further ground against the German mark. The cumulative, adverse shift in Switzerland's terms of trade threatened to boost the already disturbing rate of domestic inflation. Moreover, the authorities were becoming concerned about the quickening pace of credit expansion since the summer. Thus, when in late October the release of strong United States trade figures for September touched off a vigorous advance of dollar rates throughout Europe, the Swiss authorities took advantage of their room to maneuver to tighten monetary policy. Accordingly, the National Bank raised minimum reserve requirements on foreign funds by 25 percent, while imposing a 10 percent marginal reserve requirement on domestic Swiss franc and foreign currency time deposits above March 1972 levels. In addition, the requirement that a fraction of foreign capital issues in Switzerland be converted at the central bank was reimposed with a conversion ratio of 10 percent. These measures, together with the market's assessment that the Swiss economy was less vulnerable than most of Europe to the immediate effects of oil-production cutbacks, contributed to the strengthening of the Swiss franc against the other European currencies. Consequently, even as the franc fell by some 6 percent against the dollar in the five weeks to November 23, it advanced more than 3 percent against the German mark as some dealers switched funds out of marks and into Swiss francs.

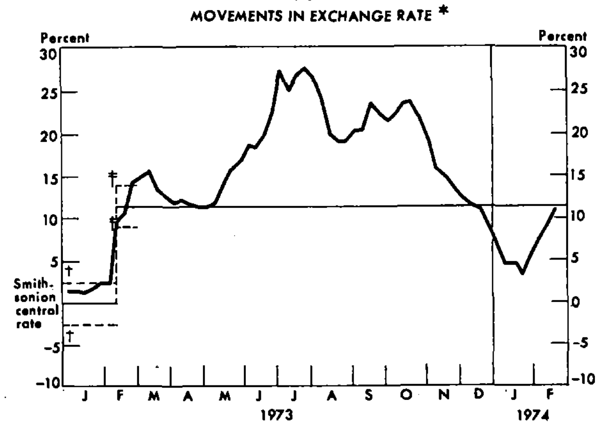
The franc moved more nearly in line with other European currencies until early December, when liquidity conditions in Switzerland tightened as banks began to seek funds for normal end-of-year requirements. Since the National Bank, in an attempt to keep a tight rein on domestic monetary expansion, provided only part of the banks' needs through dollar swaps and a temporary release of minimum reserves, the Swiss banks turned to the exchange market. At first they sold dollars forward in order to leave their spot positions intact at a time when the dollar was strengthening sharply against all other currencies. But, as the year-end approached, the scramble for funds became unexpectedly heavy and spilled over into the spot market. Thus, while other European currencies began to decline sharply against the dollar in late December, the Swiss franc held relatively firm.

Once trading for the year-end was completed, however, the Swiss franc also came under heavy selling pressure, falling more than 7 percent against the dollar by early January, and the Swiss National Bank occasionally sold dollars to moderate the decline. Moreover, as the Swiss franc declined, the Federal Reserve began a program of regular purchases of Swiss francs in the market, using the francs to repay remaining indebtedness to the National Bank incurred prior to August 15, 1971. Over the next three weeks, the System thereby repaid a total of $193.8 million equivalent of swap commitments, reducing its overall Swiss franc indebtedness to $971.2 million equivalent. Meanwhile, the Swiss authorities sought to avoid an imminent liquidity squeeze by canceling the recall of minimum reserves that had been delayed at the end of the year and by reducing required reserves another 20 percent. The Swiss banks nevertheless remained extremely cautious as the month end approached and began to bid for francs, with the result that interest rates in Switzerland and on Euro-Swiss francs started to advance. The franc was thus on a firming trend when the termination of United States capital controls was announced on January 29, prompting a further sharp rise in the Swiss franc, along with other European currencies. For their part, the Swiss authorities also eased controls further, lifting the prohibition on foreign purchases of Swiss securities. At the end of January, the Swiss franc traded at $0.3060, up 5 percent from its early-January low and 17½ percent above its Smithsonian central rate.

## BELGIAN FRANC

The continuing demand for Belgian exports, while maintaining Belgium's already strong trade position, exerted increasing pressure on productive capacity, thereby contributing to the buildup of inflationary pressures in the Belgian economy. To contain these pressures, the National Bank of Belgium, in early August, began to tighten its monetary policy by raising its discount rate and limiting access to central bank credit. Initially, these actions brought Belgian interest rates more in line with other EC interest rates, and the Belgian franc thus held in the middle of the EC snake as the joint float moved down against the dollar. Taking advantage of the improvement in the dollar rate, the Federal Reserve acquired sufficient francs to repay in full the $6 million of swap debt in Belgian francs incurred during the July support operations. When, in late August and early September, Belgian interest rates again fell behind rising rates elsewhere and capital outflows from Belgium resumed, the commercial rate

Chart VI
BELGIUM
MOVEMENTS IN EXCHANGE RATE *




* See footnote on Chart II.
† Upper and lower intervention limits established in December 1971.
‡ Upper and lower intervention limits around new central rate established on February 14, 1973. Limits suspended on March 1, 1973.

settled to the bottom of the 1½ percent Benelux band, where it was supported against the Netherlands guilder, and to the lower range of the EC arrangement. Meanwhile, the Federal Reserve began to purchase small amounts of Belgian francs on a daily basis to cover remaining pre-August 15, 1971 swap commitments to the National Bank of Belgium. By mid-September, the System had repaid $43 million of this debt, reducing remaining commitments to $347 million equivalent.

Following the September 15 revaluation of the Dutch guilder, the Belgian franc became a target of speculation, as the market focused on the close link between the two currencies and noted that Belgium, like the Netherlands, had a sizable current-account surplus. The commercial rate was quickly pushed to the top of the EC and Benelux bands, and substantial official sales of Belgian francs against both French francs and Dutch guilders were needed to hold the rate within its upper intervention limits. It also rose against the dollar, reaching $0.027800, some 12 percent above the February 1973 central rate. The Belgian authorities announced that they would not revalue the franc and acted to curb speculative inflows by reimposing the ¼ percent per week charge on excess nonresident franc holdings, imposed in March but removed in early September, and by requesting the banks to cut their foreign liability positions by 25 percent. These firm measures broke the speculative wave, and by mid-October, as relative interest incentives had again turned against Belgium, the Belgian franc had begun to ease against the dollar while settling back to trade near the bottom of the Benelux band and in the middle of the EC joint float. The Federal Reserve, therefore, resumed its purchases of Belgian francs and by early November repaid a further $85.2 million equivalent of swap indebtedness, reducing outstanding debt to $261.8 million equivalent.

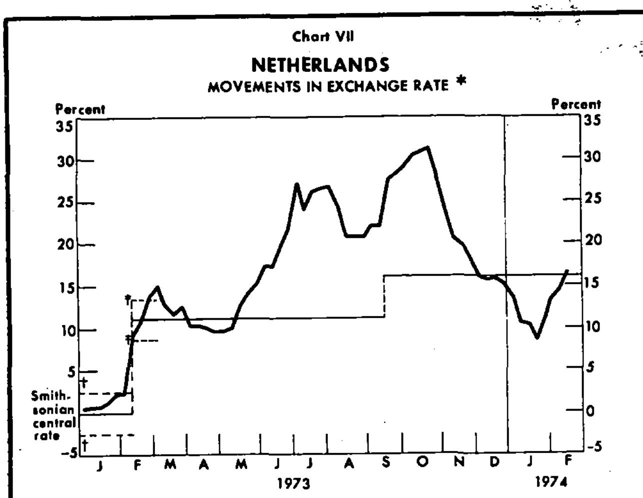
When the dollar strengthened against the European currencies in late October following announcement of the large United States September trade surplus, the Belgian franc declined more gradually than other EC currencies. The relative strength of the franc reflected a sudden tightening of liquidity in Brussels which was later reinforced by successive increases in the National Bank of Belgium's discount rate to 7¾ percent. Thus, as the entire EC bloc of currencies dropped sharply against the dollar in November with the unfolding of the oil crisis, the commercial franc held briefly near the top of both the EC and the Benelux bands, requiring moderate official sales of Belgian francs against marks and Dutch guilders to maintain the prescribed limits. Thereafter, the commercial franc remained near the middle of the EC band when, with concern over the differential oil supply cutbacks weighing on the market, the Dutch guilder weakened. As a result, some intervention was required to maintain the Benelux arrangement. By mid-December the commercial rate had fallen 10½ percent against the dollar from its October highs, and it subsequently eased below its February 1973 central rate.

Toward the turn of the year, when the oil price hikes shifted the focus of market attention from supply to price, the effect on the Belgian payments position was judged to be relatively severe. The franc therefore came on offer, weakening against the dollar as well as against some other EC currencies during the last week of December. Effective January 1, the Belgian authorities removed again the ¼ percent per week charge on excess nonresident franc holdings. The Belgian franc then moved up within the EC band until the floating of the French franc led to a new dip in the Belgian franc, both against the dollar and within the snake. During the month this Bank purchased francs in the market on behalf of the United States Treasury. A total of $36.2 million equivalent of francs was acquired, of which $23 million was used in a repayment to the IMF.

Late in January, in the wake of the termination of United States capital controls, the Belgian authorities lifted the prohibition of interest payments to nonresidents and abolished the 100 percent marginal reserve requirement on nonresident accounts. These actions were expected to induce inflows into Belgium, and the Belgian franc firmed to $0.023800 by the month end, some 4¾ percent above its January low and 4 percent below its February 1973 central rate.

### NETHERLANDS GUILDER

As with most other industrial countries the Netherlands had suffered an upsurge of inflation, but real economic growth remained sluggish during much of the year. Lagging domestic demand had contributed to a widening of the already sizable current-account surplus in the Dutch payments balance but, at the same time, had constrained the authorities from using monetary policy in an all-out fight against inflation. Consequently, interest rates remained lower in the Netherlands than in most of its major trading partners, and outflows of interest-sensitive funds exerted a strong drag on the guilder in the exchanges. The spot rate moved in line with other EC currencies against the dollar but held at or near the bottom of the 2¼ percent EC band in the late spring and early summer. The guilder had also peaked against the dollar in early July, at $0.4000, some 16¾ percent above its February 1973 central rate.




* See footnote on Chart II.

† Upper and lower intervention limits established in December 1971.

† Upper and lower intervention limits around new central rate established on February 14, 1973. Limits suspended on March 1, 1973.

By late summer, however, the employment picture had brightened somewhat, and the improved domestic situation allowed the Dutch authorities to employ some monetary restraint in an effort to curb inflation. The Netherlands Bank accordingly introduced liquidity ratios for the commercial banks in mid-July and progressively raised its discount rate, with the result that by early August Dutch interest rates had moved up into line with rates in other major centers. As the outflow of interest-sensitive funds slowed, the guilder became more buoyant in the exchanges. Although the guilder followed the general decline of European currencies against the dollar in early August, it now moved to the top of both the EC and the Benelux bands, requiring occasional moderate intervention at the upper limits of those bands by early September.

On September 15 the Dutch authorities announced that the guilder would be revalued by 5 percent *vis-à-vis* special drawing rights (SDRs) as part of a package of measures aimed at curbing domestic inflation and stimulating employment. This action caught the market by surprise and was followed by substantial speculative flows into German marks and Belgian francs and out of French francs—and out of dollars as well—to hedge against the risk of further exchange rate adjustments within the EC snake. Concerted central bank action soon helped quell these fears and, after trading erratically for several days when the guilder required support in the Benelux band, it settled at around $0.3930, 9¼ percent above its new central rate and near the middle of the EC band.

By late September the Amsterdam money market was tightening substantially, partly on seasonal factors, and interest rates were rising sharply. As the liquidity squeeze intensified, the Netherlands Bank moved to relieve some of the pressure by selling guilders spot in the exchange market while simultaneously repurchasing them forward. Despite substantial swap assistance, however, the Dutch banks remained short of liquidity and, early in October, the guilder was driven once again to the top of the EC band, where moderate daily intervention was required. On October 15 the Netherlands Bank announced a further increase in its discount rate to 7 percent, and pressure on the guilder at the top of the EC band intensified. Then, as rumors began to circulate that the guilder would again be revalued, intervention under the EC arrangement grew even more substantial. Against the dollar, the spot rate rose to as high as $0.4081, over 13 percent above its September central rate. On October 23, along with heavy intervention in EC currencies, the Netherlands Bank also began to purchase substantial amounts of spot dollars to curb the rise of the guilder. This intervention had a useful effect, and the Federal Reserve, after consultation with the Netherlands Bank, followed up by offering guilders in New York, selling $2.9 million equivalent drawn under the swap line with the Dutch central bank. Over subsequent days, the guilder joined other currencies in dropping sharply against the dollar in response to news of the huge United States September trade surplus. As the spot guilder fell, the Federal Reserve acquired in the market sufficient guilders to repay its swap commitment.

By early November the market's attention shifted to the vast new uncertainties associated with the oil crisis. Although the Netherlands was the only EC country faced with a total Mideast oil embargo, there was little overt exchange market reaction until early November. Then, the ban on Sunday driving in the Netherlands highlighted the potentially grave consequences of the embargo to the Dutch economy. The guilder came on offer, dropping sharply against the dollar and falling to the bottom of both the EC and the Benelux bands. This pressure continued through succeeding weeks, and by early December the spot rate had plunged some 13 percent from its October highs against the dollar to trade below its new central rate. At the same time, the Netherlands Bank and other EC central banks were obliged to intervene forcefully in support of the guilder at the lower limits of the snake. This sizable intervention, which contributed to a further tightening of the Amsterdam money market, helped check the speculative pressures, and the spot rate began to recover in mid-December. The guilder then came off the bottom of the EC band, leaving room for the Netherlands Bank to provide money market relief by further dollar swaps and by easing commercial bank access to central bank credit.

Following the doubling of Arab oil prices late in December, the guilder joined in the general decline of European currencies against the dollar, falling to $0.3367, 6⅜ percent below its central rate, before leveling off. By mid-January, the immediate concern over the energy situation in the Netherlands had eased and the guilder declined more gradually than other EC currencies. In the aftermath of the floating of the French franc, the Dutch authorities agreed with the remaining EC participants to maintain the snake arrangement. At first the guilder dipped against the dollar, but it soon began to recover. In reaction to the lifting of United States controls on capital outflows later in the month, the recovery gathered pace. At that time, the Dutch authorities took the opportunity to eliminate the separate exchange market for purchases of Dutch securities, the so-called obligation guilder. By the end of January the guilder had advanced to $0.3470, just 3½ percent below its central rate.

### ITALIAN LIRA

By midsummer 1973, a sharp recovery of Italian business activity, rising domestic inflation, and speculation in the commodity markets had swollen Italy's imports and seriously weakened the trade position. To bolster the lira in the face of heavy demand for foreign currencies, the authorities had reaffirmed their intention to provide support for the floating commercial rate, and had reinforced their reserves with new foreign borrowings by public enterprises, while also negotiating increased short-term credit facilities. In addition, the new coalition government had announced strong measures to come to grips with inflation, including a ninety-day price freeze, selective credit ceilings on the banks, and new exchange controls. The market responded favorably to these official initiatives, and in August, when other European currencies were weakening against the dollar, the lira was on an upswing, reaching as high as $0.001773 or some 3 percent above its Smithsonian central rate.

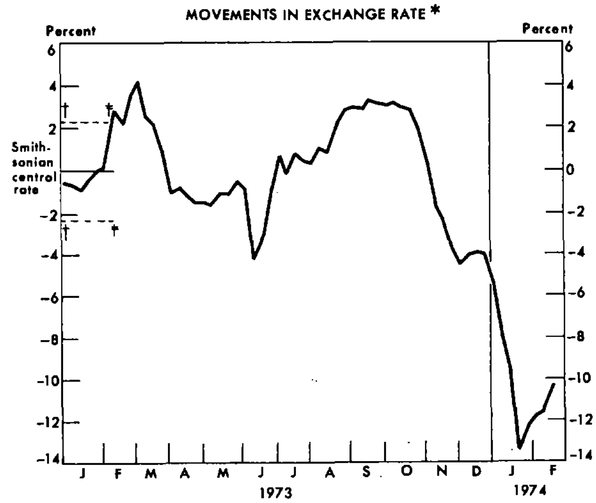
In September the lira's improvement faltered as a result of a further widening of Italy's trade deficit and concern over the outlook for the domestic economy after the temporary price freeze would expire. The Bank of Italy again intervened in support of the lira while repaying most of the remaining dollar swaps it had with the commercial banks. In addition, it tightened monetary policy by raising basic lending rates to a uniform 6½ percent and by unifying the system of penalty rates on repeated commercial bank borrowing at the central bank. Trading then quieted, and the lira held steady through mid-October.

The war in the Mideast and the subsequently announced cutbacks of oil supplies provoked a new burst of import demand, largely reflecting a precautionary buildup of inventories of petroleum products and other raw materials. Consequently, the lira once again came under selling pressure and the rate began to ease. The drop in the lira gained momentum with announcement of the huge United States trade surplus for September. Growing awareness of the seriousness of the oil situation with regard first to quantity and then to prices soon triggered an across-the-board decline for the lira as well as other European currencies. By mid-November, the lira's decline began to outpace those for other European currencies as the build-up of consumer-goods imports and the impact of higher oil prices caused a further deterioration in Italy's trade position. By early December, in progressively heavier trading, the commercial rate had plummeted roughly 8 percent from late-October levels to a little more than 5 percent below the Smithsonian level. The Bank of Italy intervened heavily to resist the erosion of the rate. By mid-December, selling pressures eased off somewhat although the market remained nervous and uncertain.

Chart VIII

ITALY

MOVEMENTS IN EXCHANGE RATE *




* See footnote on Chart II.

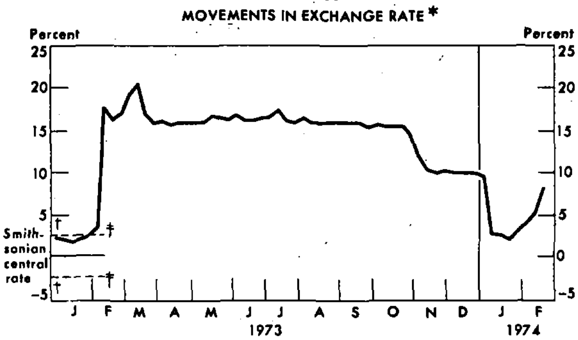
† Upper and lower intervention limits established in December 1971.

‡ Intervention limits suspended on February 13, 1973.

In view of Italy's already substantial trade deficit, the doubling of Persian Gulf oil prices in late December was seen as a further severe blow to Italy's payments position, and the lira came heavily on offer again in late December and early January. Against this unsettled background, the French decision to pull out of the EC snake arrangement, as the Italian authorities had done eleven months before, was a further shock to the market. Along with the newly floating French franc, the lira immediately began to drop precipitously. By January 23, the commercial lira had plunged to as low as $0.001480, a decline of nearly 10 percent since the beginning of the year and fully 14 percent below the Smithsonian central rate. The Bank of Italy continued to intervene in support of the lira, and late in January additional Euro-dollar borrowings by Italian public enterprises were announced, raising the total of such borrowings since mid-1972 to over $6 billion.

Following the termination of United States capital controls, the lira joined in the general advance of European currencies against the dollar, recovering by almost 3 percent to a level 11½ percent below its Smithsonian central rate. At the end of January, the Bank of Italy and the Federal Reserve agreed on an increase in their reciprocal swap arrangement from $2 billion to $3 billion, effective February 1.

Chart IX
JAPAN
MOVEMENTS IN EXCHANGE RATE *




* See footnote on Chart II.
† Upper and lower intervention limits established in December 1971.
‡ Intervention limits suspended on February 14, 1973.

#### JAPANESE YEN

When the Japanese yen was floated in February 1973, it quickly jumped up to some 20 percent above its Smithsonian level. Starting in March, however, and continuing through the spring and summer, the yen came on offer in the exchanges as importers and exporters unwound earlier leads and lags of payments in favor of the yen. Various measures to encourage capital outflows taken in the previous year led to a strong growth of direct and portfolio investments abroad and of Japanese banks' foreign lending. At the same time, Japan's massive trade surplus was shrinking. The rapid expansion of the Japanese economy stimulated strong import demand for raw materials and industrial commodities, while the worldwide escalation of commodity prices further magnified the country's total import bill. The result was a persistent demand for dollars, which was met by regular intervention by the Bank of Japan around the ¥ 265 level. Consequently, Japan's reserves fell by $4 billion from early March to the end of July and declined a further $375 million through September. The Bank of Japan then began to permit some easing in the spot rate. But, as the market became increasingly aware of the underlying weakening in the Japanese payments position, adverse leads and lags developed and the pressure on official reserves continued into October.

Later that month, the cutbacks of oil supplies and the sharp increases in posted oil prices announced by Mideastern countries intensified selling pressure on the yen. With over 70 percent of its total energy requirements met by imported oil, the Japanese economy was seen as particularly vulnerable to the energy crisis. As selling pressure on the yen built up, the Bank of Japan allowed the rate to decline in several steps to about ¥ 280 by mid-November. The Japanese authorities also began to shift the pattern of capital controls, banning Japanese purchases of short-dated foreign assets and relaxing certain capital inflow controls, and cut back their program of lending dollars for import financing. Speculation over a possible further fall in the yen continued to build up, however. The Bank of Japan provided firm support to maintain the ¥ 280 level through the rest of November and December, with the result that official reserves declined by a further $2.5 billion over the fourth quarter. In addition, in December, the authorities further tightened restraints on capital outflows and, to contain domestic inflation, increased the Bank of Japan's discount rate by a full 2 percentage points to 9 percent while cutting budgeted increases in government expenditures.

The late-December announcement of a doubling in the price of Persian Gulf crude oil set off an even greater wave of selling pressure against the yen. After a determined effort to hold the spot rate, on January 7 the Bank of Japan suspended its support of the ¥ 280 level and the yen dropped to ¥ 300, a 7 percent fallback almost to prefloat levels. To encourage inflows and discourage outflows of funds, the Ministry of Finance announced liberalized rules for prepayments of Japanese exports, a relaxation of regulations on foreign borrowings by domestic companies, new restrictions on foreign-currency bank loans to residents, used mainly for financing outward direct investments, and new constraints on Japanese purchases of foreign securities. The selling of yen moderated in response to these measures, but the Bank of Japan still had to intervene regularly to keep the rate from going beyond the ¥300 level.

In the wake of the French decision to float the franc, the Japanese authorities closed the Tokyo market for two days, during which the yen fell as much as 2⅝ percent in New York. They nevertheless decided to hold firm at ¥300, and when trading resumed in Tokyo, on January 23, the Bank of Japan sold a massive amount of dollars at that level. After the close in Tokyo that day the yen again declined in foreign markets. Following consultations between United States and Japanese authorities, this Bank began to bid for yen in the New York market to bring the yen rate back to near the Bank of Japan's intervention level. These purchases, on behalf of the United States Treasury, totaled $4.3 million equivalent and were subsequently used for a United States repayment to the IMF. By the end of January the market was in better balance, with the yen having moved away from the intervention rate. But Japanese reserves had declined by a further $680 million in January, or by a total of $7½ billion since the floating of the yen in February 1973.

## CANADIAN DOLLAR

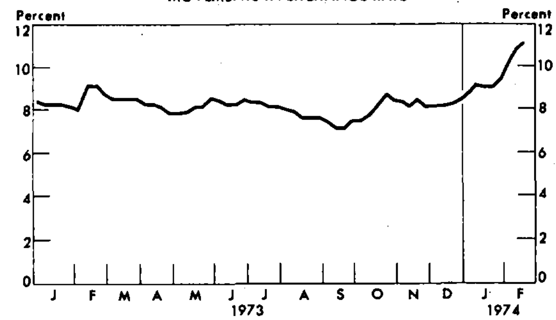
With Canada's underlying balance of payments remaining in small surplus during the late summer of 1973, movements in the Canadian dollar rate were mainly influenced by interest-sensitive flows of funds. The Canadian authorities, while careful not to brake the expansion of the domestic economy, had moved interest rates higher, with the Bank of Canada's discount rate reaching 7¼ percent in September. The gradual rise in Canadian market interest rates nevertheless had lagged behind earlier sharp rate increases in the United States and elsewhere, and the resulting outflows of funds tended to depress the spot Canadian dollar. Strikes on the Canadian railways and in some export industries also raised concern in the market, and the spot rate eased from about $1.00 in early August to just below $0.99 by mid-September, with the Bank of Canada providing support.

Later that month, a sharp decline in interest rates in the United States, with rates in Canada holding steady, led to a squeezing-out of the adverse interest differentials and stimulated some reflows into Canada. Moreover, there were sizable new foreign borrowings by Canadian provincial authorities. In late October, as Canadian banks sought funds for their end-of-fiscal-year needs, the influx of funds accelerated. Consequently, the spot rate moved up to as high as $1.00¾, while the forward rate was simultaneously driven to a discount for the first time since August 1972. Once the banks met their needs, the money market turned more liquid and the Canadian dollar rate edged down to the $1.00 level by early November.

Chart X

CANADA

MOVEMENTS IN EXCHANGE RATE*




*Measured as percentage deviations from the $0.92½ official parity established in May 1962. The Canadian dollar has been floating since June 1, 1970.

Through most of December the Canadian dollar held steady against the United States dollar. Consequently, it appreciated sharply against major European currencies, on the market's view that Canada's relative self-sufficiency in oil would protect the Canadian balance of payments from both supply shortages and higher costs.

By the turn of the year the market had taken an even more bullish view of the Canadian dollar's near-term prospects. Again, this partly reflected the expectation that Canada would weather the oil price increases better than other major countries. Moreover, the continued worldwide rush into raw materials and other commodities was expected to improve Canada's terms of trade and overall trade position even further. In addition, a bunching of long-term foreign issues by Canadian borrowers strengthened current and potential demand for Canadian dollars, while the downturn of United States interest rates after mid-January, with Canadian interest rates steady, stimulated short-term inflows to Canada as well. Consequently, the Canadian dollar appreciated sharply against all major foreign currencies and advanced to $1.01¼ by the month end, with the Bank of Canada intervening to moderate the rise. Canadian official reserves increased by $85 million in January after little net change in the closing months of 1973.

**EURO-DOLLAR**

The substantial improvement in the United States balance of payments and the marked erosion in the payments position of major foreign countries began to generate a significant shift in the flow of funds through international capital markets late last summer and early fall. As the dollar strengthened in the exchanges, earlier borrowings to finance speculative sales of dollars were repaid and dollars purchased against foreign currencies were placed in short-term Euro-dollar deposits. Meanwhile, as primary goods prices again shot up sharply, a large portion of the increased dollar receipts of commodity producers was invested in the Euro-dollar market. On the demand side of the market, in addition to the normal corporate borrowers, public entities of both industrialized and developing nations appeared increasingly as borrowers, encouraged by their governments to seek external credit.

Chart XI
INTEREST RATES IN THE UNITED STATES, CANADA, AND THE EURO-DOLLAR MARKET
THREE-MONTH MATURITIES*

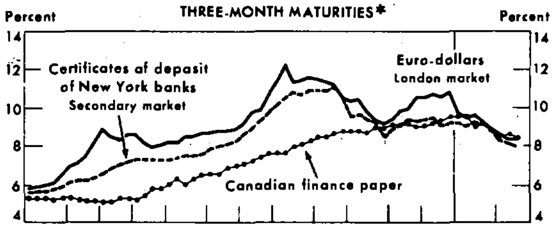
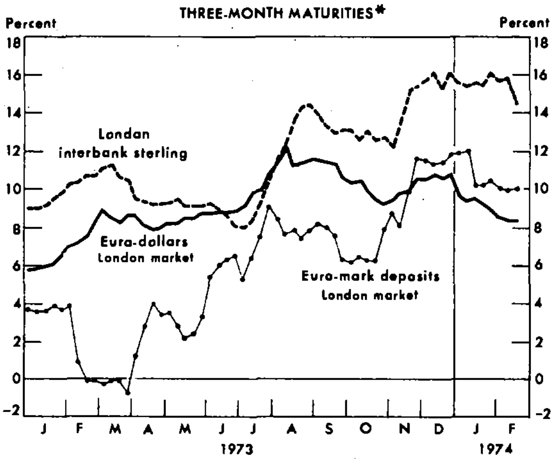



Chart XII
SELECTED INTEREST RATES
THREE-MONTH MATURITIES*




* Weekly averages of daily rates.

As investors remained reluctant to acquire fixed-interest securities in view of escalating world inflation and continued wide fluctuations in short-term interest rates, only a small fraction of all borrowers' needs was met through public offerings in the Euro-bond market. Instead, a larger and growing portion was financed through privately placed medium-term Euro-dollar loans, on which interest rates would be adjusted periodically to reflect changes in the lending banks' cost of funds.

Late in the year, the steep increases in world oil prices prompted a far-reaching reassessment of how the radically altered balance-of-payments prospects for the producing and consuming nations would affect the Euro-dollar market. On the one hand, it was widely expected that the producing nations would channel a significant portion of their higher revenues into the market. On the other hand, governments of oil-consuming countries indicated their intention increasingly to tap the market for funds to cushion their reserves. Although the market remained generally receptive to the expanding needs of public as well as private borrowers, some new loans met investor resistance.

Meanwhile, in response to the dollar's strong improvement in the exchanges, the governments of Germany and most other Continental countries had begun to relax their restraints on capital inflows. Effective January 1, the United States joined in this progressive easing of controls by reducing the interest equalization tax from ½ percent to ¼ percent, liberalizing the foreign direct investment program and raising bank lending ceilings under the Federal Reserve's voluntary foreign credit restraint program. Then, effective January 29, these control programs were terminated altogether, and other governments quickly responded by speeding up their own relaxation of controls.

During the period under review, Euro-dollar rates on three-month maturities moved more closely in line with United States domestic interest rates than with rates in the major European markets. At the same time, interest differentials between comparable Euro-dollar and United States deposit instruments narrowed significantly, except at the year-end when normal seasonal positioning in the Euro-dollar market provided a temporary buoyancy for Euro-dollar rates. Thus, by the end of January, three-month Euro-dollars and United States certificates of deposit were both quoted just slightly above 8½ percent; late last summer, by comparison, the rates were at about 11½ percent and 10½ percent, respectively.