Treasury and Federal Reserve Foreign Exchange Operations*

By CHARLES A. COOMBS

Over the six-month period, February-July 1974, covered by this report, the exchange markets were buffeted by turbulent crosscurrents. Dollar rates against European currencies and the yen swung over a broad range in response to shifting market appraisals of the impact of the oil crisis and inflation on relative currency values, while episodes such as the Herstatt Bank failure also had major effects on market activity and sentiment.

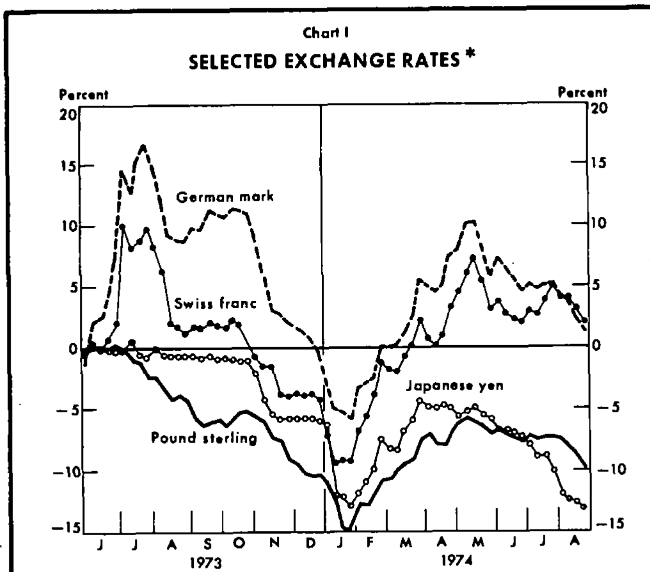
At the beginning of the year the dollar was moving up strongly against some currencies to levels prevailing before the February 1973 devaluation. The market's bullish appraisal of the dollar mainly derived from the favorable trends in the United States payments balance that had emerged during 1973, and the judgment that this country could better cope with the damaging consequences of the oil crisis than most other industrial countries. Late in January, however, exchange market sentiment abruptly shifted against the dollar, with selling pressures continuing until mid-May.

This adverse shift of market sentiment coincided with the complete elimination of United States capital controls on January 29 and the subsequent easing of European barriers against capital inflows. Moreover, United States interest rates had already begun to fall sharply while rates abroad held firm, and this swing in interest rate differentials temporarily provided a further strong inducement to outflows of United States funds into foreign markets. Foreign demand for dollar credit mounted, as many countries rushed to launch medium-term borrowing programs to meet anticipated balance-of-payments deficits. As a result, claims on foreigners reported by United States banks ballooned by a record increase of well over $9 billion during the four months, February through May. Even more importantly, the energy crisis threatened to provoke a more rapid and pronounced deterioration in our trade balance than originally expected, while Germany showed a continuing trade surplus of surprising strength.

As this picture unfolded, dollar rates against most European currencies fell steadily during February to levels more than 10 percent below the January highs. Such recurrent declines in dollar rates threatened to generate speculative pressures and disorderly trading, and the Federal Reserve accordingly resumed intervention on February 22. By the month end, the Federal Reserve had sold $91.2 million equivalent of marks financed by drawings on the swap line with the German Bundesbank, of which $3.7 million was repaid with market purchases early in March. In addition, this Bank sold $6.8 million equivalent of Belgian francs from System balances, as well as some $8.9 million equivalent of German marks and $15.8 million equivalent of French francs from Treasury balances.

Meanwhile, the divergent trend between the United States weakening trade position and the continued strength of Germany's export surplus had kindled renewed speculation on a revaluation of the German mark. During March the Federal Reserve intervened intermittently but in sizable amounts to sell a further $225.5 million equivalent of German marks, financed by additional drawings on the swap line with the Bundesbank. These operations were conducted in close coordination with the Bundesbank, which also supplied marks on a substantial scale both by buying dollars outright and by intervening in the European Community (EC) "snake" arrangement. In other operations during March, this Bank sold $10 million equivalent

*This report, covering the period February through July 1974, is the twenty-fifth 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.



*Percentage deviations of weekly averages of New York noon offered rates from New York noon offered rates on June 1, 1973.

speculation against the dollar. Reports of this agreement appeared on the news tickers on May 14 and immediately brought about a scramble to cover short dollar positions. By the following day, the German mark and Swiss franc rates against the dollar had fallen off by 4½ percent.

The subsequent recovery of the dollar during the late spring and summer months was solidly based on improving trends in the United States payments position. United States trade figures for April and again for June showed unexpected strength despite the burden of higher oil prices, while the German trade surplus leveled off and then declined. A pronounced tightening of credit conditions and sharply higher interest rates in New York also exerted a stronger pull on international capital funds, while United States bank lending abroad subsequently slackened. As the oil-producing countries progressively saturated the capacity of the major Euro-dollar banks to handle short-term placements, flows of Organization of Petroleum Exporting Countries (OPEC) funds into the United States credit markets grew in volume and revived earlier market anticipations that such investment flows would strengthen

of Belgian francs from System balances and $17.9 million equivalent of French francs from Treasury balances.

By April, interest rates in the United States had turned around and began to move upward sharply while rates abroad were on an easing trend, thereby progressively reversing earlier interest-arbitrage differentials adverse to the United States. Moreover, trade figures for March showed a more modest United States deficit than generally expected in the market and a slightly reduced surplus for Germany. Nevertheless, the market remained fearful of a possible revaluation of the German mark or disbanding of the EC snake. In addition, publication of first-quarter figures, showing a drop in United States output and a distressing acceleration of domestic inflation, prompted gloomy market reassessments of United States business and foreign trade prospects. Market sources also cited new disclosures in the Watergate affair as having a depressing effect on the dollar. As the dollar fell still further, the Federal Reserve continued to intervene and sold $51.6 million equivalent of marks in April, financed by further drawings under the swap line with the Bundesbank.

Speculative overtrading against the dollar continued until mid-May, at which point the dollar had fallen 21 percent below its January high against the mark. Against this background, Swiss, German, and United States officials attending the May meeting of the Bank for International Settlements (BIS) reached agreement on the desirability of concerted exchange market operations to counter excessive

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Institution	Increases during the period (February 1 through July 31,1974)	Amount of facility July 31, 1974
Austrian National Bank		250
National Bank of Belgium		1,000
Bank of Canada		2,000
National Bank of Denmark		250
Bank of England	1,000*	3,000
Bank of France		2,000
German Federal Bank		2,000
Bank of Italy	1,000†	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	2,000	19,980

* Effective date March 26, 1974.
† Effective date February 1, 1974.

Table II

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 1, 1974	Drawings (+) or repayments (—) 1974 I	II	July	System swap commitments, July 31, 1974
National Bank of Belgium	261.8				261.8
German Federal Bank	—0—	+255.0 — 3.7	+130.4 —122.8	—194.2	64.6
Netherlands Bank	—0—			+ 2.3 — 2.3	—0—
Swiss National Bank	565.0	—193.8			371.2
Bank for International Settlements (Swiss francs)	600.0				600.0
Total	1,426.8	+255.0 —197.6	+130.4 —122.8	+ 2.3 —196.6	1,297.5

Note: Discrepancies in totals are due to rounding.

the dollar relative to other currencies unable to provide comparable investment facilities.

Early in June, the dollar experienced temporary selling pressure and the Federal Reserve made a further drawing of $17.1 million on the Bundesbank swap line, lifting total mark debt outstanding to a peak of $381.7 million. Thereafter, the Federal Reserve steadily accumulated mark balances, of which $122.8 million was used to reduce outstanding swap debt with the Bundesbank to $258.9 million equivalent. The dollar came under some selling pressure, however, following announcement on June 25 of a poor trade performance in May, and on the following day Bankhaus I. D. Herstatt was closed. As a stabilizing measure, the Federal Reserve sold $24.2 million of mark balances on June 28 and July 2.

For some time the market had become increasingly concerned over reports of large foreign exchange trading losses by banks in various countries. The main impact of the Herstatt closure, however, was to highlight the fact that even a spot exchange contract involved a credit risk in which a bank might accept payment on a currency trade but be forced to close its doors before delivering the foreign exchange counterpart. As bank management throughout the world focused on this risk, traders severely limited new transactions to only those names they considered of the highest quality. Initially, foreign exchange trading was further sharply curtailed as New York Clearing House banks sought to make payments for their correspondents only after assurance that covering receipts were in hand. As this proved unworkable, the Clearing House then modified its procedures to permit all participating banks to recall payments made provisionally in anticipation of receipt of funds. These new arrangements facilitated a considerable recovery in trading volume, although complaints over the recall feature continued to be voiced abroad. Over subsequent weeks, trading in the spot exchange market gradually recovered, but activity in the forward market remained subdued. A more lasting consequence of the Herstatt affair was to compound the trading difficulties faced by small- and medium-sized banks, not only in the foreign exchanges but also in the Euro-dollar market, as a worldwide review of bank credit lines resulted in a tightening of credit limits for all but the very best names.

In the thin and sensitive markets that appeared in the wake of Herstatt, central banks tended to move more quickly than usual to check sharp exchange rate movements. On July 15-17, the Federal Reserve sold from balances $7.5 million equivalent of marks and $4.4 million of Belgian francs to cushion declining dollar rates. Then, on July 24, a sudden rash of rumors of a guilder revaluation exerted speculative pressure on the dollar, which intensified following ticker reports of the Supreme Court decision on the Watergate tapes. The Federal Reserve intervened forcefully that day and sold a total of $43.8

million of marks from existing balances, together with \$2.3 million of guilders financed by a drawing on the swap line with the Netherlands Bank. The dollar rate subsequently firmed up and gained increasing buoyancy with reports the next day of a reduction in the German trade surplus as well as an improved United States trade performance during June.

As the mark came on offer, the Federal Reserve again accumulated mark balances which were supplemented by a purchase of \$132.3 million of marks from the Bank of Italy. These mark acquisitions enabled the System to repay \$194.2 million of outstanding swap debt with the Bundesbank on July 31, leaving an outstanding commitment of \$64.6 million equivalent. In addition, the System acquired sufficient guilders to liquidate on July 30 the \$2.3 million drawing on the Netherlands Bank swap line.

In summary, during the period under review the Federal Reserve intervened in support of the dollar to the extent of \$527 million equivalent. Of this amount, \$139.3 million represented drawings on Federal Reserve and Treasury balances. The remaining \$387.7 million was financed by Federal Reserve drawings on its swap lines with the German Bundesbank and the Netherlands Bank.

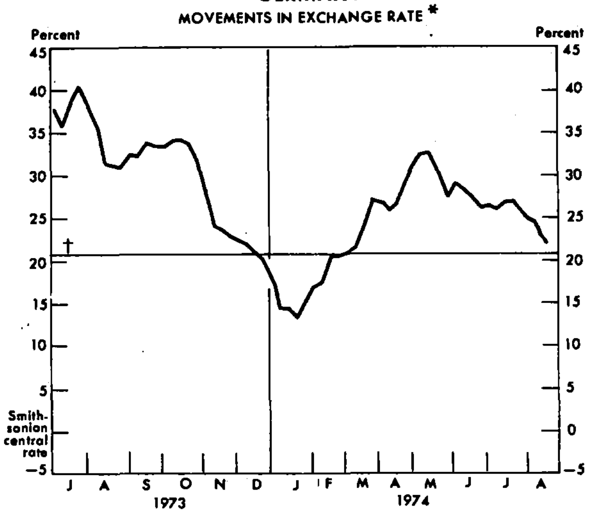
GERMAN MARK

In late 1973, the German mark led the decline of European currencies against the dollar. By early 1974, however, the market began to view the previous rush into dollars as having been overdone. A sharp bulge in demand for German exports, on top of an already high level of foreign orders, had added another \$1 billion a month to German exports, but the higher monthly cost of Germany's oil imports was estimated to be only half that amount. The market now expected, moreover, that the prospective sharp rise of the United States oil import bill would erode the recent surge back into surplus of the United States trade balance. Inflation in Germany was already leveling off just above 7 percent, while the rise in United States prices was continuing to accelerate. The market also anticipated that the Bundesbank would maintain its strongly restrictive monetary policy in an effort to reduce the inflation rate further. The interest rate disparity favoring Germany was widening at the time when United States controls on capital outflows were terminated on January 29. These developments, combined with a subsequent relaxation of German barriers to inflows, set the stage for a massive outpouring of funds from this country and reflows to Germany.

In late January and during February the German mark was bid up sharply against the dollar and EC currencies. The bidding for marks, with particularly heavy trading by a relatively small number of banks, unsettled the market and threatened to generate broader speculative pressures against the dollar. By February 22, the mark had advanced some 10 percent from its January lows and the Federal Reserve resumed intervention. The Desk was obliged to operate fairly forcefully on occasion to avoid the outbreak of disorderly conditions. By the month end, this Bank had sold a total of \$100.1 million equivalent of marks, \$91.2 million equivalent for the System financed by swap drawings on the Bundesbank and \$8.9 million for the Treasury from balances. Early in March the Federal Reserve purchased \$3.7 million equivalent of marks in the market and used them to repay part of the swap debt.

The rising German export surplus to almost \$1¼ billion in January had sparked renewed debate in that country over exchange rate policy, and press commentary suggested that the German government would welcome a rise or even revaluation of the mark. Official denials from the Bundesbank helped clear the air, but market talk of even more massive trade surpluses for Germany and deficits for other major industrial countries, including the United States, generated further strong demand for marks. In late March, German and United States February trade figures—a \$2 billion German surplus and a

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.

† Central rate established on June 29, 1973.

much-reduced $200 million United States surplus—set off a new surge of the mark. To maintain orderly conditions, the Federal Reserve intervened repeatedly, occasionally in sizable amounts. For March as a whole, System mark sales amounted to $225.5 million equivalent, all financed by additional drawings on the swap arrangement with the Bundesbank. The Bundesbank also purchased dollars on several days in Frankfurt and, with the mark pinned to the top of the EC band, provided marks for intervention against currencies of its partners in the snake as well.

By early April, interest rates in the United States were clearly moving upward while rates in Germany had eased, thereby reversing the previously adverse interest rate differentials against the dollar. Federal Reserve determination to maintain a firm monetary policy and the need for a strong dollar in the struggle against inflation were underscored by the April 4 testimony of Chairman Burns to the Congress. These developments gave only a temporary respite to the rise in the mark exchange rate. Expectations about the dollar rate soon soured on publication of United States gross national product (GNP) figures for the first quarter, showing an unexpectedly severe drop in real output and an acceleration of domestic inflation to a rate well above Germany's. Exaggerated market expectations of a German trade surplus as high as DM 7 billion for March prior to release of the data in late April renewed the revaluation fever. Growing uncertainties surrounding the impeachment proceedings in Washington as well as new disclosures in the Watergate affair exerted a further depressing influence on the dollar.

Heavy speculative demand for marks reemerged just after mid-April, swamping the effect of further increases in United States interest rates including on April 25 a ½ percentage point increase to 8 percent in the Federal Reserve discount rate. By mid-May, the spot mark had been ratcheted up to $0.42, fully 21 percent above its January low and just 6 percent below the peak reached in July 1973. This upsurge had pulled all the major European currencies up to levels that many traders considered to be unsustainably high. The Federal Reserve continued to intervene to guard against disorderly conditions. In April, sales of marks drawn on the swap line totaled $51.6 million equivalent. In Frankfurt, the Bundesbank made additional dollar purchases and continued to intervene in the EC snake arrangement. In the three months through mid-May, Bundesbank intervention had contributed to a $2.3 billion increase in German reserves.

Despite such intervention, the market continued to verge on disorder. Accordingly, representatives of the Bundesbank, the Federal Reserve, and the Swiss National Bank agreed at the monthly BIS meeting in Basle, Switzerland, on a concerted plan of intervention in marks and Swiss francs to counter excessive speculation against the dollar. The Federal Reserve was prepared to operate forcefully in the New York market, drawing further on the swap line with the Bundesbank, while the Bundesbank and the Swiss National Bank were prepared to buy dollars in their own markets. Reports of this agreement reached the news services on May 14 and had an electrifying effect on dollar trading. Dealers holding long mark and short dollar positions scrambled for cover. In twenty-four hours the mark rate plummeted nearly 4½ percent. As conditions in the exchanges settled down, dealers began to respond to the interest incentive favoring the dollar, and the mark's decline continued through the month end. As the mark declined, the Federal Reserve purchased modest amounts of marks to cover its swap indebtedness.

Revaluation jitters reappeared during the June 1-2 French-German summit meeting, and the mark was once again bid upward. To moderate the rise of the mark rate, the Federal Reserve sold $17.1 million equivalent drawn on the swap line, thus raising outstanding drawings to a peak of $381.7 million equivalent. Moreover, the Bundesbank was again obliged to provide marks against EC snake currencies. The mark subsequently resumed a gradual decline through most of June. By June 25, the mark had dropped over 7 percent from its mid-May high to $0.3881 and had receded from the top of the EC snake. The Federal Reserve took advantage of this situation to purchase sufficient marks to reduce its swap drawings to $258.9 million by the end of the second quarter.

Throughout the spring, reports that several banks in various countries had incurred large foreign exchange losses generated growing market concern about the extent of speculative overtrading. Against this background, the June 26 closing of Bankhaus I. D. Herstatt, a major German private bank, by the German banking authorities had a far-reaching market impact. The bank was closed partly in consequence of large foreign exchange losses and left many banks both in Germany and abroad with unsatisfied claims on Herstatt. Throughout the world, bank managements moved to reassess their own foreign exchange positions and their dealing relationships with other banks. Trading in marks was virtually paralyzed in New York and in European markets; the large German banks in particular were reluctant to deal through brokers or to participate in the daily fixing. Under these strained trading conditions, small- and medium-sized banks found it difficult to raise needed funds either in the exchange or Euro-dollar markets to meet current obligations. To ease this situation, the Bundesbank expanded Lombard and other credit facilities to provide additional liquidity on a selective basis to German banks.

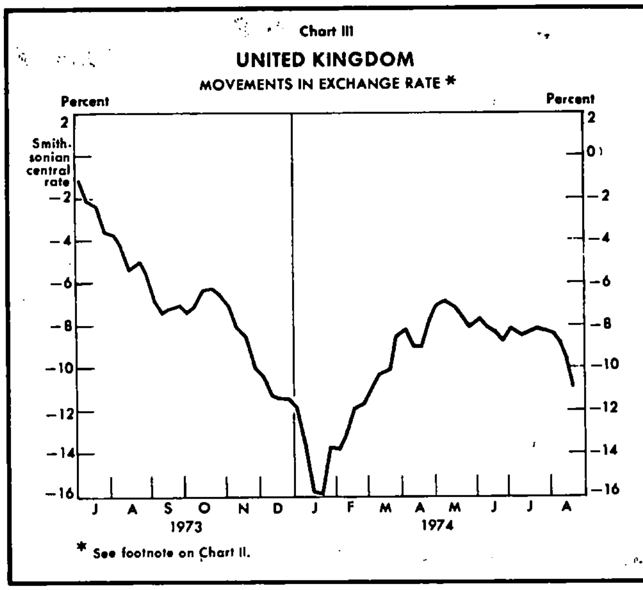
The mark initially declined under the impact of the Herstatt collapse, then leveled off in extremely limited interbank dealing. In this situation of unusual market sensitivity, however, the central banks were prepared to intervene more promptly, and the Federal Reserve sold a total of $31.7 million equivalent of mark balances from late June through mid-July.

Shortly after midmonth a news report that the International Monetary Fund (IMF) had recommended a revaluation of the Netherlands guilder prompted a speculative run-up in the guilder. The selling of dollars soon spilled over into other markets, and the mark also began to advance. Such speculation intensified on July 24, when the Supreme Court's decision on the Watergate tapes was announced. The Federal Reserve responded by intervening forcefully, through sizable offers of marks as well as guilders. By the end of that day, total sales of marks had reached $43.8 million equivalent.

The subsequent recovery of the dollar was reinforced by news of a halving of Germany's June trade surplus to around $1 billion and of a cut by two thirds in the United States June trade deficit. Rapidly moving political developments in Washington kept the market on edge, but expectations of renewed intervention by the Federal Reserve provided a steadying influence. By the month end, the mark had declined to $0.3865, about 8 percent below its May peak, and had fallen to the bottom of the EC band. During July the Federal Reserve took advantage of the stronger dollar to accumulate additional mark balances through the market. Moreover, the System arranged to purchase $132.3 million equivalent of marks from the Bank of Italy. Italy had obtained the marks from a multicurrency drawing on the IMF. Using these resources the System repaid a further $194.2 million equivalent of swap drawings on the Bundesbank, leaving $64.6 million equivalent outstanding on July 31.

STERLING

Early in 1974 the United Kingdom faced an unusually difficult economic situation. Despite wage-price restraints and tight monetary policy, accompanied by historically high interest rates, prices were rising at a 15 percent annual rate and the rise was accelerating. The trade balance was registering a nearly $1 billion monthly deficit and was expected to worsen as the full impact of higher oil prices was felt. Real economic growth had fallen off sharply, and financial strains were apparent, especially among



the smaller banks and in home-mortgage financing. A three-day workweek was imposed to conserve the nation's fuel supply, which had been sharply reduced by a confrontation between the miners and the government. This dispute heightened political tensions and tended to crystalize trade union opposition to wage and price controls. In early February, following the miners' decision to strike, an election was set for February 28.

Sterling came under periodic bouts of selling pressure, which drove it down to a low of $2.15¼ in mid-January and kept it relatively weak through early February. The pound therefore depreciated substantially against the continental European currencies, which were then advancing strongly against the dollar. By mid-February, however, the attraction of unusually high short-term interest rates in London, together with the persistent and expanding needs for sterling by oil companies to meet tax and royalty payments to oil-exporting countries, began to strengthen sterling. The rate then tended to follow other European currencies in their rise against the dollar, moving up nearly to $2.31½ just before the election.

The establishment of a minority Labor government was greeted with some caution by the market. After the government quickly moved to restore a normal workweek and resolve the trade union conflicts, however, the market atmosphere improved. Moreover, the renewal of exchange rate guarantees—this time against the weighted average of a number of currencies—on official overseas-sterling-area balances held in London was seen as forestalling large-scale switching into other currencies. With money remaining tight in London, first-quarter inflows amounted to over $1½ billion. Thus, sterling continued to rise along with most other European currencies against the dollar through much of March, reaching $2.36 after midmonth.

The market nevertheless remained concerned over sterling's prospects. The previous dislocations of production coupled with the vastly increased oil import bill aggravated Britain's large foreign trade deficit, and inflation threatened to erode once again Britain's international competitiveness. The March 26 budget message, announcing new fiscal measures largely neutral on aggregate domestic demand as well as substantial new credit lines to bolster Britain's reserves, helped reassure the market. The new credit lines included an increase of $1 billion, to $3 billion, in the swap line between the Bank of England and the Federal Reserve and arrangement of a $2.5 billion Euro-dollar loan—the largest single Euro-currency loan ever contracted—to be taken down as needed. These lines would supplement the almost $3.5 billion previously borrowed by Britain's public authorities. Sterling retained some buoyancy in the exchanges and, when speculative selling of dollars developed just before the month end, the pound was briefly swept up to $2.42½, before settling back to just below $2.40 early in April. The pound also gained ground against the currencies of Britain's EC partners.

With sterling thus on a better footing in the exchanges, the British authorities felt in a position to relieve some of the tensions which had built up in domestic financial markets as a result of the sharp run-up of interest rates over previous months. The Bank of England reduced its call for special deposits from 4½ percent to 3 percent and successively cut its minimum lending rate from 12½ percent to 12 percent. Market interest rates in the United Kingdom also fell back from their historically high levels before leveling off. Meanwhile, interest rates in the United States and Euro-dollar markets were advancing, tending also to narrow interest differentials in favor of sterling. The spot pound turned somewhat easier through mid-April. As the dollar then came under generalized speculative pressure, sterling moved moderately higher once more, gaining nearly 2 percent against the dollar between mid-April and mid-May.

When the speculative surge of European currencies was suddenly broken, following press reports of possible concerted central bank intervention in support of the dollar, sterling declined against the dollar much less sharply than other European currencies. From mid-May, the depressing effect of a huge current-account deficit on the sterling rate was nearly offset by an increasing demand for sterling for tax and royalty payments to the OPEC members. In turn, these countries were investing the major share of their sterling accruals in high-yielding sterling instruments. In addition, reports that potential British North Sea output of gas and oil would greatly exceed earlier forecasts lifted some of the market's pessimism about the outlook for British trade. The pound settled near $2.40 in early summer in the reduced and cautious trading that followed the closing of the Herstatt Bank in Germany.

Thereafter, the British government continued to grapple with strong inflationary pressures and a worsening trade position, on the one side, and, on the other, a weakening trend of real output and income. Monetary policy was kept relatively firm, while on July 22 the government announced

Table III

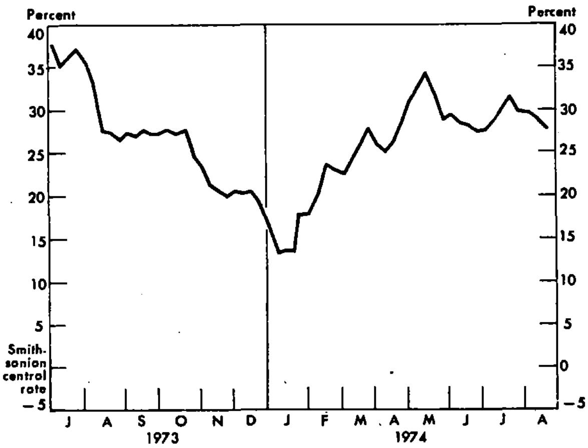
DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS AND THE BANK FOR INTERNATIONAL SETTLEMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding January 1, 1974	Drawings (+) or repayments (—) 1974: I	II	July	Drawings on Federal Reserve System outstanding July 31, 1974
Bank for International Settlements (against German marks)	—0—	+26.0 —26.0	+76.0 —76.0	+5.0 —5.0	—0—
Total	—0—	+26.0 —26.0	+76.0 —76.0	+5.0 —5.0	—0—

a moderately stimulative package of fiscal measures, including a cut in the value-added tax to boost private spending. This combination of policies, less reflationary than some had feared, helped maintain a firm undertone for sterling. News that Iran had agreed to lend up to $1.2 billion to British industry over the next three years and the continuing demand for sterling by oil companies also helped buoy the pound. By the end of July, sterling, at $2.38½, was still almost 7 percent above its early-February lows. During the six-month period under review, the Bank of England intervened in the market intermittently to moderate exchange rate movements and to avoid the emergence of disorderly trading conditions.

Chart IV
SWITZERLAND
MOVEMENTS IN EXCHANGE RATE *



* See footnote on Chart II.

SWISS FRANC

Early in the year, inflation in Switzerland rose to 10 percent per annum under the impact of higher oil prices. To curb inflationary pressures, the Swiss authorities relied primarily on a restrictive monetary policy, including incremental reserve requirements against domestic and foreign liabilities, credit ceilings, and noninterest-bearing penalty deposits against loan growth above the prescribed 6 percent limit. This policy, supported by the Swiss National Bank's abstention from intervening in the foreign exchange market, had resulted in a marked tightening of bank liquidity and an accompanying firming of Swiss and Euro-Swiss franc interest rates. To moderate the ensuing strain on Swiss financial markets, the Swiss National Bank at the end of January reduced required reserves by 20 percent and reduced limits on nonresident borrowings in Switzerland. Joining in the widespread dismantling of capital controls, the Swiss authorities lifted the prohibition on nonresident investment in Swiss securities and mortgages.

The lifting of controls opened the way for an influx of funds, and the Swiss franc rate led the sharp rise of Continental currencies against the dollar. By late February, the spot rate had risen to $0.3280, some 12 percent above mid-January lows. Strong demand for the Swiss franc, reinforced by a spillover from the rapidly rising German mark, continued in March, lifting the Swiss franc a further 3 percent.

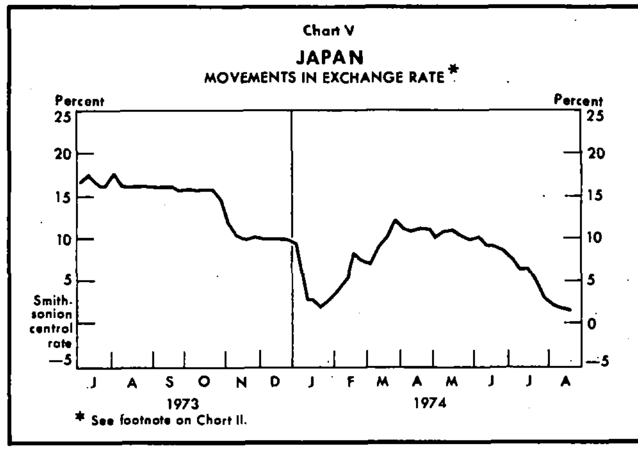
Meanwhile, Swiss credit markets were tightening drastically. Short-term Swiss and Euro-Swiss franc rates firmed almost to mid-January levels, drawing funds away from longer term placements. To alleviate this pressure, the Swiss National Bank provided temporary liquidity beginning April 3 by arranging dollar swaps with the commercial banks, a technique ordinarily employed only at month or quarter end. The National Bank injected more permanent liquidity by reducing minimum reserves on both domestic and foreign bank liabilities. The central bank also raised the ceiling on the growth of bank credit for the period to July 1974 by 1 percentage point, to 7 percent per annum, while easing the burden of penalty deposits on excess lending. Although Swiss interest rates turned lower in response, speculative demand for francs continued strong. The franc followed the continuing rise of the mark in early May, as political uncertainties elsewhere in Europe and in the United States stimulated flows into the franc. By May 14 the spot rate had been swept up to $0.3588, more than 20 percent above its January lows.

In the highly charged speculative atmosphere that had developed, the report of an agreement among the Federal Reserve, the Bundesbank, and the Swiss National Bank on intended concerted intervention to prevent a further erosion in dollar rates prompted an immediate reversal of market psychology. The spot franc came heavily on offer, tumbling 4¾ percent in twenty-four hours. As dealers continued to cut out long positions, the rate eased another 2 percent to $0.3360 by the end of May.

Liquidity pressures remained a matter of official concern in Switzerland. To reduce the strain on the longer term markets, on May 21 the authorities temporarily closed the Swiss capital market to issues of foreign bonds. The following week, they also agreed to extend growth limits on bank lending to guard against an excessive rise in short-term interest rates. As liquidity tightened toward the quarter's end in June, the National Bank again entered into dollar swaps and cut minimum reserve requirements further. These actions helped prevent a further tightening of liquidity, and the franc moved generally in line with other European currencies during June.

The June 26 closing of Germany's Bankhaus Herstatt had a considerable psychological impact on the Swiss market. Amidst rumors that other banks might be afflicted with large foreign exchange losses, trading dropped off precipitously. Swiss banks sought to improve their liquidity positions beyond normal levels and reassessed the risks of exposure to their correspondents. Some banks were left with open positions following the Herstatt closing and had to find cover by bidding for francs. These added demands put upward pressure on Swiss and Euro-Swiss franc interest rates. The authorities responded with further swap assistance to keep Swiss franc interest rates in line with corresponding Euro-dollar rates to avoid sizable shifts of funds out of long-term markets.

Late in July, the Swiss franc moved up on rumors of a Dutch guilder revaluation and rose still further when the dollar came more generally on offer following the Supreme Court's Watergate tapes decision. In line with other European currencies the Swiss franc subsequently dropped back to $0.3378, about 6 percent below its May highs.



JAPANESE YEN

Dependent on imported oil for over 70 percent of its energy needs, Japan was particularly vulnerable to the economic impact of the energy crisis. Already suffering from a sharp upsurge of domestic inflation and a massive adverse swing in both trade and capital accounts, the higher cost of oil was expected to exacerbate the rise in production costs and to add significantly to Japan's import bill. The yen thus had come under increasing speculative pressure late in 1973. The authorities responded with a series of measures. They stiffened monetary policy, applied direct measures to conserve oil and electricity supplies, and shifted the pattern of capital controls to encourage inflows and slow outflows. In addition, the Bank of Japan intervened to moderate the continuing erosion of the yen rate, which reached levels that prevailed before the yen was floated by mid-January.

These actions, together with the termination of United States capital controls at the end of January, turned the tide, as Japanese banks stepped up their borrowings in the United States and Euro-dollar markets to finance Japanese imports of oil and other commodities. In addition, Japanese residents sold dollars to comply with new restrictions on their foreign-currency holdings. Consequently, the yen recovered 4 percent by late February and strengthened another 4 percent in March in response to a seasonal buildup of export receipts. Late in March the Bank of Japan intervened by purchasing dollars in small amounts for the first time since February 1973.

During the spring and early summer, Japanese banks continued to expand their net foreign borrowings. Also, in response to foreign exchange controls, long-term investment abroad slowed to $1 billion in the second quarter, compared with $1½ billion three months before. Japan's trade balance, which had sunk to a seasonally adjusted $1¼ billion deficit in the first quarter, moved back into surplus by June, as both imports and exports responded to a slowdown in the domestic economy.

Despite this improvement in Japan's balance of payments, settlement of import bills, representing payments for goods shipped into the country in previous months, strengthened the demand for dollars in Tokyo. The yen consequently eased gradually by some 3 percent to $0.003520 by the end of June. The yen's decline accelerated in July, however, as rumors circulated that the Japanese banks were approaching their credit limits abroad. The Japanese authorities requested the banks to refrain from excessive foreign borrowings and, to help the banks repay their dollar borrowings, placed additional official deposits with them. Nevertheless, the volume of import payments continued to swell, and by the month end the spot yen had dropped back to around its January lows. To resist the decline, the Bank of Japan resumed occasional support of the yen through moderate sales of dollars. Further adjustments in Japanese exchange control provisions relieved much of the selling pressure, and by mid-August the yen rate had stabilized.

FRENCH FRANC

The precipitous rise in Mideastern oil prices late last year threatened a $5 billion deterioration in France's trade account and a near doubling of France's rate of inflation. To protect reserves and employment in the face of such an adverse shift in the balance of payments, the French authorities temporarily withdrew from the EC monetary arrangement and allowed the French franc to float independently on January 19. Initially, the franc dropped by about 5 percent. After the initial impact of this decision had dissipated, however, and reports circulated that the government was arranging a $1.5 billion Euro-dollar borrowing to augment official reserves, the market gradually moved back into better balance. Following the termination of United States capital controls late in January, the franc joined in the general upsurge of European currencies.

The franc's advance continued into the early spring, although France's current account was rapidly moving into substantial deficit. Helping to buoy the spot rate were reports of additional French public-sector borrowings, totaling over $1 billion. In addition, the French authorities announced in March new measures to contain pressures on capacity and to bolster the balance of payments. They also terminated the two-tier exchange market. In response, the franc occasionally outpaced other European currencies that were also gaining strongly against the dollar. On these occasions, this Bank stepped in to provide resistance to an excessive rate movement, selling for the United States Treasury $15.8 million equivalent of francs on February 27 and similarly $17.9 million on March 20. By March 28 the franc was trading around $0.21, over 10 percent above its mid-January lows.

In early April the franc eased, as the death of President Pompidou on April 2 and prospects of new Presidential elections weighed on market psychology. In addition, expectations of a mounting German trade surplus became an increasingly depressing influence on the French franc as well as the dollar. The franc's decline was cushioned by the steady conversion of Euro-dollar borrowings by private- and public-sector enterprises. Nevertheless, by May the franc had dropped over 4 percent to $0.2020, while sliding over 8 percent against the mark and other snake currencies. After the election of President Giscard d'Estaing, the franc again began to move more closely with EC snake currencies, and by May 14 the spot franc had recovered against the dollar almost to its late-March levels.

In late May, rumors that a return of the franc to the EC snake was imminent circulated with increasing frequency. Traders particularly expected the June 1-2 French-German summit talks to produce an economic package designed to adjust intra-EC trade imbalances and to smooth the way for a return of the franc to the snake without a franc devaluation. Consequently, the franc held relatively firm through late May. When the franc

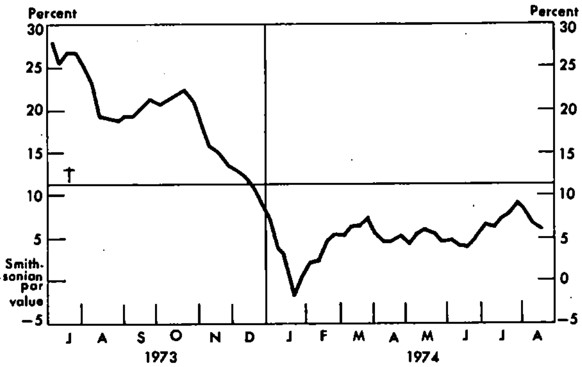
Table IV
UNITED STATES TREASURY SECURITIES
FOREIGN CURRENCY SERIES
In millions of dollars equivalent

Issued to	Amount outstanding January 1, 1974	Issues (+) or redemptions (—) 1974: I	II	July	Amount outstanding July 31, 1974
Swiss National Bank	1,459.2	+127.3			1,599.3
Bank for International Settlements	127.3	—127.3			—0—
Total	1,586.4	{+127.3 {—127.3	—0—	—0—	1,599.3*

Note: Swiss-franc-denominated security issued to the Bank for International Settlements was reissued to the Swiss National Bank at its maturity in January 1974.

* Increase in amount outstanding reflects valuation changes upon renewals of maturing securities.

Chart VI
FRANCE
MOVEMENTS IN EXCHANGE RATE *



* See footnote on Chart II.
† Central rate established on February 12, 1973.

did not rejoin the EC arrangement after the summit talks, however, the franc's buoyancy faded and the spot franc, too, slipped back early in June.

Meanwhile, spiraling oil costs had pushed the rate of inflation almost to 15 percent, and the trade balance (on a customs basis) had swung into a deficit of $750 million in May. The government responded by announcing a broad stabilization program on June 12, including increased corporate and personal income taxes, continued restraints on credit growth and petroleum consumption, and incentives for personal savings. A week later, the Bank of France followed up by hiking its discount rate a full 2 percentage points to 13 percent. As market interest rates in France then climbed to record levels, short franc positions were quickly covered. In contrast to other European exchange markets, trading in the Paris market remained active following the Herstatt closure. As some French traders repatriated funds from Germany, the franc strengthened and the Bank of France bought dollars to moderate the rise. In July, the franc was pulled up further in the generalized speculative run-up of European exchange rates following rumors of the guilder revaluation, and the Bank of France continued to purchase dollars to moderate the upswing. After this speculative outburst, the franc declined only slightly against the dollar, in contrast to other European currencies, as an improvement in France's trade figures together with a sharp fall in the German trade surplus for June raised hopes that European trade was moving into better balance. By the month end, the franc was trading near $0.2140, its highest level since December 1973.

ITALIAN LIRA

The steep rise in oil prices at the end of 1973 had very serious implications for Italy which depends on imported oil for about 80 percent of its energy needs. The oil crisis threatened to add another $5 billion to a trade deficit already running at $4 billion in 1973 and to accelerate domestic inflation still further. These economic fears combined with serious political and social uncertainties generated large speculative capital outflows. The lira came under renewed selling pressure in January, plunging to $0.001480, and lost ground *vis-à-vis* other European currencies as well.

Concerned that a further weakening of the lira and a corresponding deterioration in Italy's terms of trade would aggravate domestic inflationary pressures, the Italian authorities intervened heavily in support of the spot lira. Such intervention was financed from the proceeds of foreign borrowings by Italian public enterprises as well as new Bank of Italy swaps with the commercial banks. To bolster reserves, several new public-sector borrowings were arranged. Moreover, the swap line between the Bank of Italy and the Federal Reserve was increased by $1 billion to $3 billion, effective February 1, and after midmonth the Italian authorities announced that negotiations were under way for a $1.2 billion IMF standby credit. Although news of additional credit facilities was well received in the market, pessimism over Italy's domestic economic situation and trade performance remained deeply entrenched, and the Bank of Italy intervened heavily to keep the lira in line with the other EC currencies as they firmed against the dollar in February. Later that month, pressure on the lira intensified as a division over economic policy led to the dissolution of the cabinet on March 1.

The prompt formation of a new government under Premier Rumor was followed by a sequence of counter-inflationary measures that temporarily firmed the lira rate. Monetary policy was tightened, as the Bank of Italy imposed a one-year ceiling on the growth of most categories of bank lending and raised its basic discount rate 2½ percentage points to 9 percent. These actions triggered an immediate escalation of private borrowing and lending rates. The government moved to increase the value-added tax on nonessential consumer goods to discourage imports, raised prices for some government services, and strengthened income tax provisions. New regulations on the export and import of lira bank notes were also imposed, and on March 22 the two-tier foreign exchange market was abolished in favor of a uniform market for commercial and financial transactions. These various measures were initially welcomed in the exchange markets but, as traders began to question their effectiveness, the selling of lire was resumed. The authorities continued to provide substantial support to the lira to keep it generally in line with other EC currencies, which were rising sharply against the dollar. By the end of March, official support for the lira had swelled since the beginning of the year to over $3 billion. The intervention was financed in part by new foreign borrowing including EC short-term support. By the quarter end, the total of Italy's medium-term Euro-dollar borrowing came to about $9 billion.

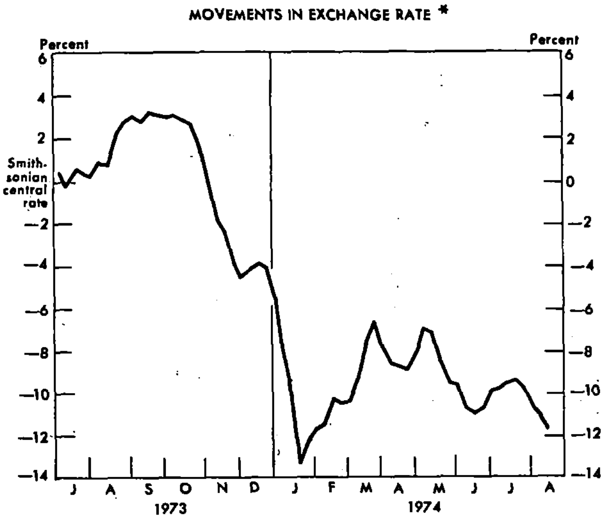
In April, Italy's trade deficit, running at $1 billion a month, continued to weigh on the market, and the lira required almost daily official support. The Italian authorities moved at the end of April to reinforce their earlier monetary restraints by imposing a 50 percent import-deposit requirement on most categories of imports. This measure, implemented early in May, gave a lift to the lira, which in any case was marked up somewhat in the general resurgence of speculation against the dollar that peaked toward mid-May. Even before the dollar's mid-May recovery, however, continued uncertainties had begun to weaken the lira rate against other European currencies. The market became increasingly unsettled after new figures showing the extent of the balance-of-payments deterioration were released. Moreover, grim appraisals of the Italian economy by responsible leaders inside and outside the government underscored the seriousness of the situation. As the debate over economic policy provoked a cabinet crisis in early June, the lira dropped to as low as $0.001531.

The cabinet was quickly reestablished, however, and additional stabilization measures were adopted, including a renewed effort to bring government expenses under control. At the same time, the monetary restraints in force since March began to bite, leading to a tightening of liquidity and a consequent reversal of capital outflows. The lira therefore improved in June and remained steady in the atmosphere of cautious dealing that developed in all markets after the Herstatt Bank failure. During July, the Bank of Italy was a net buyer of dollars in the market. By the month end, the spot rate had settled near $0.001555, some 5 percent above its mid-January lows.

Chart VII

ITALY

MOVEMENTS IN EXCHANGE RATE *



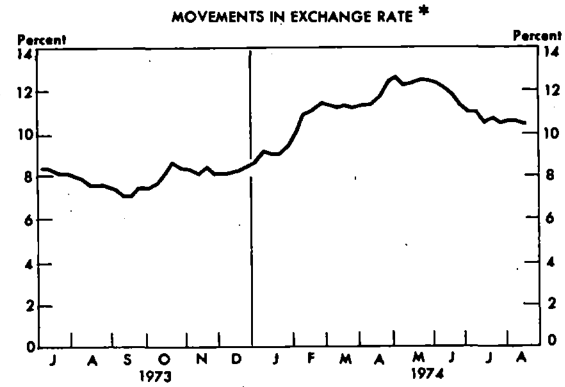
* See footnote on Chart II.

CANADIAN DOLLAR

The prospects of a continuing surplus in Canada's trade balance provided a firm undertone to the Canadian dollar early in 1974. A major exporter of raw materials and industrial commodities, Canada was expected to benefit from the historically high commodity prices. Moreover, as Canada is largely self-sufficient in oil, its trade position was seen as unaffected by the sharp hike in oil prices that was swelling the import bill of other developed countries. The positive market assessment for the Canadian dollar was further reinforced in January when United States interest rates dropped off sharply, Canadian rates held steady, and interest differentials shifted in favor of Canada. With this shift stimulating substantial short-term inflows, the Canadian dollar enjoyed a broad-based advance that was sustained by both strong commercial and professional demand late in January. Positioning ahead of conversion of provincial borrowings abroad, outright forward purchases of Canadian dollars, and cuts in United States prime rates provided further impetus to the upswing through February. By the month end, the Canadian dollar had climbed almost 3 percent to above $1.03¼. In moderating the rise, the Bank of Canada had purchased sizable amounts of United States dollars, thereby contributing to the $429 million increase in reserves for the first two months of the year.

From March to mid-April the Canadian dollar steadied, fluctuating narrowly around $1.03 in response to actual or prospective interest rate incentives. Then, on April 15, the Bank of Canada raised its discount rate a full percentage point to 8¼ percent to temper the strong demand for domestic credit and to bring it in line with higher interest rates abroad. The commercial banks soon followed by raising their prime rates and, as Canadian interest rates

Chart VIII
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.

rose, demand for Canadian dollars swelled. The spot rate soon was pushed above its February peak, to just below $1.04½ on April 25 even as the Bank of Canada again purchased dollars to moderate the advance. Concern that the Liberal government might lose a confidence vote on its upcoming budget proposals led to a brief downturn in the Canadian dollar early in May. Although an election was eventually called, the spot rate held firm as a further rise in interest rates and a second increase in the Bank of Canada's discount rate to 8¾ percent continued to attract short-term funds from abroad. By May 23 the Canadian dollar was again trading near $1.04.

In mid-June, however, the Canadian dollar began gradually to weaken. Canadian interest rates were now lagging behind the uptrend of United States rates. In addition, Canada's trade account had weakened and, by June, dropped into deficit. The spot rate continued to slip, even after a clear-cut victory for the Liberal government in the July elections cleared away political uncertainties and the Bank of Canada raised the official discount rate further to 9¼ percent. By the end of July, it had dropped below $1.02¼ and the Bank of Canada had intervened to moderate the steady erosion. Over the course of the two-month slide the Canadian reserves declined some $200 million.

NETHERLANDS GUILDER

In late 1973, the Mideast oil embargo on the Netherlands and the sharp rise of oil prices had initially prompted pessimistic assessments for the Dutch economy. By mid-January, however, such fears had begun to lift. The nation's strong underlying payments position, a $1¾ billion surplus in 1973, provided ample room to withstand the estimated $1¼ billion in higher oil costs, and revenues from the Netherland's natural gas exports were expected to benefit strongly from the energy shortage.

Following the widespread relaxation in early 1974 of capital controls, high Dutch interest rates stimulated some reflow of funds to the Netherlands. In late January and February, the guilder rose more rapidly against the dollar than most European currencies, climbing 10 percent from mid-January lows to $0.3635 in late February.

Meanwhile, in response to signs of a slackening of domestic economic activity, plans were announced to provide moderate stimulus through tax reductions and higher government expenditure. In addition, the Netherlands authorities remained concerned over an undue tightening of money market conditions. As earlier official swaps with Dutch commercial banks matured, they were rolled over or replaced with outright purchases of spot dollars by the central bank. Furthermore, the cost of central bank credit was reduced during February and early March. As a result of these actions, Dutch interest rates eased somewhat so that by mid-March the guilder, while holding relatively firm against the dollar, had eased against other EC currencies.

Later in March, rumors of a possible revaluation of the mark led to bidding for guilders, reflecting expectations that the guilder would follow a mark revaluation. The guilder at first kept pace with the mark, climbing to $0.3738 even as the Netherlands Bank purchased dollars to moderate the advance. As speculation focused more and more on the mark, however, the guilder dropped to the floor of the EC band, where it was supported by the Dutch and German central banks. To relieve such pressure on the guilder, the Netherlands Bank tightened domestic liquidity by allowing maturing swaps with the commercial banks to run off. This operation had the desired effect, and by May 14 the guilder had fluctuated sharply higher with the mark to $0.3983.

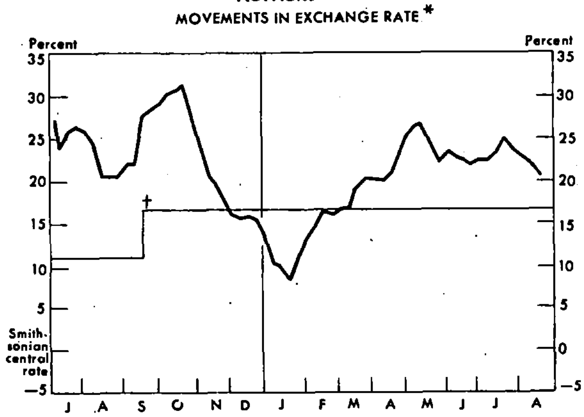
Following reports from Basle on May 14 that concerted central bank intevention had been planned to support the dollar, the guilder fell off from its peak levels. A temporary easing of the Amsterdam money market accentuated the decline. By late May, the guilder had again fallen to the bottom of the EC snake, as well as to the floor of an almost fully extended Benelux band where it traded with only brief interruption through late June.

The closing on June 26 of the Herstatt Bank brought both spot and forward trading in Amsterdam virtually to a halt. Trading recovered only hesitantly over succeeding days. The covering of short positions in guilders left exposed by the Herstatt collapse gave some buoyancy to the guilder rate by mid-July. Some interest-induced inflows and nonresident purchases of guilder-denominated securities also contributed to the rise. The firming tendency was also in part the result of a more positive market outlook for the Dutch payments position that emerged after termination of the oil embargo on July 10.

Circulation in the Amsterdam press on July 23 of a report that an IMF study group had recommended a guilder revaluation touched off a scramble for guilders. Although the report was officially denied, the guilder nevertheless rose to the top of the snake, while a more generalized speculative movement against the dollar developed. The Supreme Court's decision on the Presidential tapes led to further dollar selling on July 24. That day the Federal Reserve placed sizable offers of guilders in the New York market. This was done in coordination with the Netherlands Bank, which had purchased dollars outright in the Amsterdam market and sold guilders against other EC currencies. The market backed away from the Federal Reserve offerings, and only $2.3 million equivalent of guilders was actually sold. The Federal Reserve financed these sales by a swap drawing with the Netherlands Bank. The guilder closed the day at $0.3895, some ½ percent off its high.

Wire service reports late on July 24 of Federal Reserve intervention in guilders and marks had a steadying effect on the market the next day. The Netherlands Bank reinforced this effect with additional dollar purchases early

Chart IX
NETHERLANDS
MOVEMENTS IN EXCHANGE RATE *



* See footnote on Chart II.
† New central rate established on September 17, 1973.

in the morning. After the New York opening, a categorical official Dutch denial of any revaluation plans led to further easing of the guilder against the dollar and movement of the guilder to well below the top of the snake. With the guilder's easing, the Federal Reserve was able to purchase the $2.3 million equivalent of guilders needed to liquidate its swap debt.

The guilder's decline was subsequently accelerated by announcements of a greatly reduced United States June trade deficit and of a swing of the Dutch position into deficit for May. By the end of July the spot rate had fallen back to $0.3810, over 4¼ percent below its May high.

BELGIAN FRANC

By the end of 1973, Belgium's restrictive monetary policy had contributed substantially toward holding the inflation rate just under 7 percent. Domestic restraint permitted strong export demand to widen the current-account surplus to $1½ billion for the year as a whole. The sudden hike in oil prices, however, threatened to erode the current-account surplus for 1974 by an estimated $1¾ billion and to set back earlier progress toward bringing inflation under control. In late 1973, the Belgian franc weakened sharply against the dollar and settled to the bottom of the EC band.

In early 1974 the Belgian franc participated in the general strengthening against the dollar. Joining other countries in relaxing capital restrictions, Belgium lifted the prohibition on interest payments to nonresidents and the 100 percent reserve requirement on nonresident accounts. To bring Belgian interest rates more in line with other EC countries, the National Bank raised its discount rate by 1 percentage point to 8¾ percent on February 1. After this move, the Belgian commercial franc advanced more rapidly against the dollar than most European currencies and rose to the top of the EC snake. The rate reached $0.025100 by February 22, over 10 percent above its mid-January lows.

At this point, the Federal Reserve intervened with offers of Belgian francs along with other currencies. The Federal Reserve sold $6.8 million equivalent from balances accumulated earlier in the month when the franc was still weak within the EC snake. The Belgian franc was again pulled up against the dollar in the wake of speculative pressures on the German mark. The Desk intervened on March 20 with sales of $10 million equivalent of Belgian francs, also from balances. Rumors of a German mark revaluation persisted, and the Belgian franc soon dropped to the bottom of the EC band where it required intervention peri-

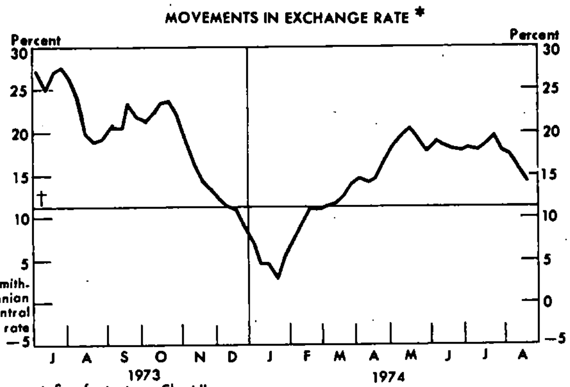


Chart X
BELGIUM
MOVEMENTS IN EXCHANGE RATE *

* See footnote on Chart II.
† Central rate established on February 12, 1973.

odically throughout April and early May. Against the dollar, the spot franc was dragged up by the mark to a high of $0.027235 on May 14, almost 20 percent above its January lows.

During these months, Belgium's rate of inflation increased and reached an annual rate of 11 percent. The National Bank responded by progressively tightening its monetary restraints at a time when domestic liquidity was already being contracted by foreign exchange outflows. The National Bank cut commercial banks' discount quotas and stiffened reserve requirements against bank credit expansion, while reserve requirements on time deposits were eased. These new monetary restraints helped push Belgian interest rates above levels prevailing in other countries participating in the EC snake arrangement. Also tending to strengthen the franc was the formation in April of a new government under Premier Tindemans, which relieved the uncertainties of a three-month governmental crisis. In mid-May, once the speculative movement into marks tapered off and the snake moved lower against the dollar, the franc began to strengthen against other EC currencies. By early June the Belgian franc reemerged at the top of the EC band.

The Belgian authorities continued to tighten their anti-inflation program. In early summer the government announced a budgetary plan, providing for increases in taxes to ensure equilibrium in the 1975 budget. The National Bank replaced an expiring gentleman's agreement limiting commercial bank credit expansion with new legal rules. Based on this authority, it cut credit expansion limits for the next four months from 17 percent to 14 percent. Reinforced by these new restraints, the Belgian franc traded steadily around $0.026400 and remained firm within the EC and Benelux bands, while the German mark and certain other currencies fell from their speculative peaks. In late June and July the National Bank periodically bought EC currencies to keep the franc within the snake and Benelux limits and regularly purchased small amounts of dollars to assist in this effort. In mid-July the Federal Reserve supplemented its sales of marks with sales of $4.4 million equivalent of Belgian francs from balances to resist an excessive erosion of dollar rates. When speculation over a guilder revaluation triggered a generalized selling of dollars late in July, the franc rose temporarily, but dropped back by the month end to $0.026280, some 3½ percent below its May highs.

EURO-DOLLAR

During the period, the oil price escalation with its attendant balance-of-payments problems subjected the Euro-currency markets to heavy demands. In general, countries around the world depending on oil imports rushed to the Euro-market to finance their expected needs, attempting to extend the maturities out as far as possible. As the flow of funds to OPEC members subsequently swelled, they placed a large share of the excess over current expenditures in the Euro-currency market but mainly for very short-term maturities. Banks were thus faced with an increasingly difficult problem of reconciling the maturity differentials between their claims and liabilities. In addition, following disclosures of foreign exchange losses by several banks, bank managements reacted by strengthening their internal controls and by tightening their credit limits for all but the very best names. As a result, a multitiered rate structure emerged, and many smaller banks and even large banks of some countries had to pay premiums over rates at which prime banks could obtain funds. One consequence of this tiered rate pattern was that many banks at rollover dates for syndicated term loans were obliged to refinance their commitments at rates above the London interbank deposit rate on which the floating interest rates to be charged to borrowers are contractually based.

Despite the segmentation of the market, the Euro-currency market continued to expand at an impressive rate between February and July. During the early months of the year, official and semiofficial borrowers in the United Kingdom, Italy, and France obtained loan commitments of close to $10 billion in anticipation of mounting oil deficits. The market was also tapped by developing countries, especially in Latin America and Asia, by Eastern bloc borrowers, notably Yugoslavia, and by public-sector institutions in Spain and Greece. Among nonofficial borrowers, Japanese banks entered the market on a large scale and soon became heavy net debtors, reversing their net foreign creditor position built up during 1972 and 1973. In response to the heavy demands for funds in the Euro-currency market, interest rates were bid up, providing a further incentive for recycling into the market the rapidly growing oil revenues of the OPEC countries. In addition, the Euro-currency market received a strong boost following the removal in January of United States restraints on capital outflows. Through late spring, United States banks and other financial and nonfinancial institutions lent large amounts in the Euro-markets. During recent months, however, whenever Federal funds rates climbed above overnight Euro-dollar rates, head offices of United States banks stepped up their Euro-dollar takings from their overseas branches. Similarly, major foreign banks arbitraged on occasion sizable amounts of Euro-dollars into the United States money market.

More recently, market expansion has probably slowed. A somewhat larger portion of aggregate OPEC surplus fund accruals appears to have been placed in the United States money market, although investments of Mideastern oil-producing countries in the United States still represent only a fraction of that area's current surplus. Japanese banks became less insistent bidders under instructions of their government. To facilitate this policy, the Japanese Finance Ministry increased its dollar deposits with domestic banks. In addition, Italian banks have also reduced their borrowings.

Euro-dollar rates tended to move closely with money rates in the United States through May. They bottomed out in late February, when three-month Euro-dollar maturities were just above 8 percent, and thereafter climbed steadily until early May (see Chart XI). This rise was in contrast to interest rate declines in some European centers (see Chart XII). After pausing during May, Euro-dollar rates resumed their climb and reached unprecedented levels in the aftermath of the Herstatt collapse. Thus, rates on three-month maturities reached 14 percent in mid-July, rising well above comparable United States certificates of deposit rates. In the latter half of that month, rates generally fell back, but the July average rate as well as the mid-August rate for the three-month maturity was close to 13½ percent.

Because of limits imposed by customary capital-asset ratios, many major intermediaries have found it difficult to accept increasing amounts of OPEC deposits. Some major banks have refused to add to their Euro-currency footings; others have become more reluctant to accept very short-dated deposits and are quoting below the market to discourage such supplies. As a result, some of the OPEC countries have been willing to place funds at somewhat longer maturities. Still, the market remains confronted by the sharp divergence of maturities at which funds are placed and at which oil-importing countries wish to finance their balance-of-payments deficits. While the market has so far made a major contribution to the recycling of funds from oil-producing countries to those with balance-of-payments deficits, its capacity to continue such financial intermediation on a large scale may partly depend upon the availability of deposits at longer maturities. Finally, as recently noted by Federal Reserve Board Governor Wallich: "The problem of the weaker countries is obvious—they will sooner or later find it difficult to attract funds from the market as their debt burdens reach the limits which the market should and probably will place on their borrowing capacity."

Chart XI

INTEREST RATES IN THE UNITED STATES, CANADA, AND THE EURO-DOLLAR MARKET

THREE-MONTH MATURITIES *

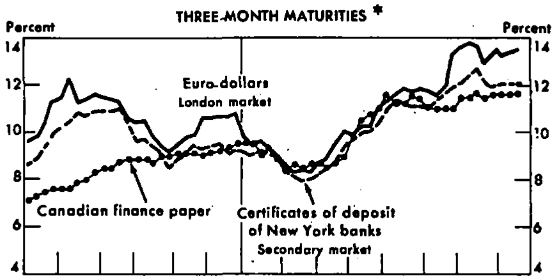
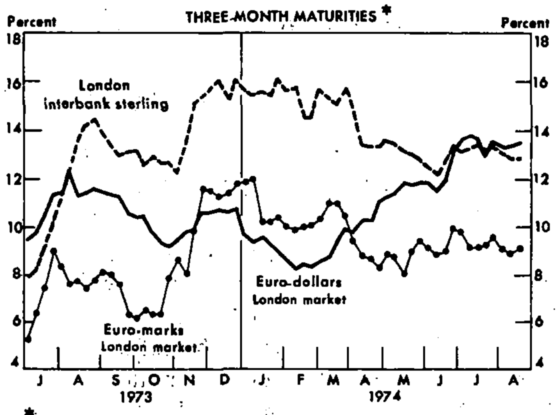


Chart XII

SELECTED INTEREST RATES

THREE-MONTH MATURITIES *



* Weekly averages of daily rates.