Treasury and Federal Reserve Foreign Exchange Operations August 1974–January 1975

By CHARLES A. COOMBS AND SCOTT E. PARDEE*

Through the late summer of 1974 the dollar showed considerable buoyancy in the exchange markets but, from October on, became subject to continuing selling pressure. By late January, the dollar had fallen from its highs by some 27 percent against the Swiss franc and 17 percent against the German mark and other currencies in the European monetary bloc. Dollar quotations had also declined by some 3 to 4 percent against sterling, the Italian lira, and the Japanese yen.

The dollar's strength in August and September reflected primarily the pull of unusually high interest rates in New York and the Euro-dollar market, reinforced by expectations that surplus oil revenues would flow into the United States financial markets after saturating investment outlets elsewhere. With the dollar in demand, the Federal Reserve was able to buy sufficient marks in the market not only to repay the remaining $64.6 million equivalent of drawings on the Bundesbank outstanding from earlier in the year, but also to build up balances to finance intervention should selling pressure suddenly erupt. On one such occasion, on August 8 and 9, the Federal Reserve sold $20.8 million of marks from balances, $5.3 million of Dutch guilders drawn on the swap line with the Netherlands Bank, and $2.5 million of Belgian francs of which $0.8 million was from balances and $1.7 million drawn under the swap line with the National Bank of Belgium; the swap drawings in guilders and francs were quickly repaid out of market purchases of these currencies. Again, on September 3, the Federal Reserve sold $16.2 million of marks from balances to check an abrupt decline of the dollar. Otherwise, the Federal Reserve abstained from intervention until early October.

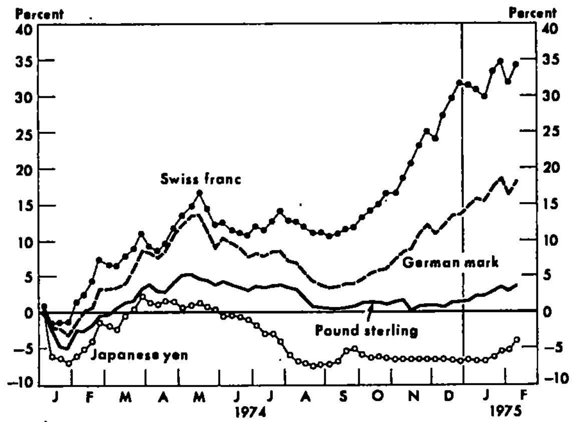
By that time, an improving trend in United States exports, up 40 percent from the year before, was cutting into the sizable trade deficit caused by the $17 billion jump in our 1974 oil import bill. Nevertheless, in early October, the exchange markets were showing signs of nervousness over the onset of a sharp decline in dollar interest rates and over reports that surplus oil revenues were beginning to be shifted out of dollars and sterling into continental European countries. Short bursts of selling pressure occurred in October. The Federal Reserve intervened on six days, selling a total of $165.7 million equivalent of marks, of which $62.1 million equivalent was from balances and $103.6 million equivalent was drawn under the swap line with the Bundesbank. The German central bank bought similar amounts of dollars in Frankfurt. Late in the month, when the dollar firmed somewhat following discount rate cuts in Germany and the Netherlands, the Federal Reserve began to acquire in the market moderate amounts of marks against outstanding swap indebtedness.

By early November, however, market sentiment toward the dollar turned bearish. Mounting evidence of an economic recession in the United States, more severe than in most other countries, suggested to the market that interest rates would fall faster here than abroad. That possibility in turn reinforced fears of large-scale shifts of funds out of dollars by some oil-producing countries,

*On February 19, 1975, Mr. Coombs resigned as Special Manager of the System Open Market Account and Mr. Pardee was appointed Deputy Manager for Foreign Operations. Alan R. Holmes, Manager of the Open Market Account, has assumed Mr. Coombs's responsibilities for supervision of foreign operations. The Federal Reserve Bank of New York acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

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, 1974.

as did the ever-present risk of renewed hostilities in the Middle East. At the same time, Germany's continuing strong trade performance rekindled revaluation rumors for the mark, and Switzerland, having lifted barriers to short-term capital inflows, experienced a new influx of funds which bid up the franc rate sharply. The rise of the franc and the mark tended to be mutually reinforcing and set off a general upsweep of currency rates against the dollar. On several occasions, the dollar rebounded in response to concerted intervention by the Federal Reserve and European central banks and the introduction of new curbs on capital inflows by the Swiss authorities. Nevertheless, the vigorous public debate over economic policies here and in Europe kept the market on edge, and the dollar continued to slip through late November.

The Federal Reserve intervened, at times forcefully, on seven days during November. In total, $187.9 million equivalent of marks was sold, of which $164.3 million equivalent was drawn under the swap line with the Bundesbank and the rest from balances. In addition, the System sold $28.5 million equivalent of Dutch guilders drawn under the swap line with the Netherlands Bank, $10.8 million of Belgian francs, of which $10.4 million was drawn under the swap line with the National Bank of Belgium and the rest from balances, and $12.5 million equivalent of Swiss francs purchased outright from the Swiss National Bank.

Late in November and early December, the pressures on the dollar eased, as United States interest rates leveled off. The Federal Reserve was able to purchase marks in the market and repaid $82.8 million equivalent of swap drawings on the Bundesbank. The System also purchased sufficient amounts of guilders and Belgian francs to liquidate in full the November drawings in these currencies.

From mid-December to late January, the exchange markets were subject to an almost unremitting diet of bearish news for the dollar, and market forces drove dollar rates lower almost every day. The economic downturn and the slide of interest rates in the United States reinforced expectations of a further widening of interest differentials already adverse to the dollar. Gloomy forecasts emerging in the debates over economic and energy policies in Washington further depressed the market. With individual oil-producing countries reportedly growing restive over the dollar's depreciation, market fears of an accelerated diversification of oil proceeds to other currencies intensified. In such an atmosphere, the market ignored any favorable news for the dollar, such as the underlying improvement in the United States trade balance and the slackening in our rate of inflation.

To cushion the dollar's decline, the Federal Reserve intervened on seventeen of the twenty-eight business days

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Institution	Amount of facility January 31, 1975
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
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	19,980

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 (—)					System swap commitments, January 31, 1975
		1974				1975	
		I	II	III	IV	January	
National Bank of Belgium	261.8			+ 1.7 — 1.7	+ 13.2 — 13.2		261.8
German Federal Bank	-0-	+255.0 — 3.7	+130.4 —122.8	—258.8	+301.5 — 82.8	+164.0 -0-	382.7
Netherlands Bank	-0-			+ 7.6 — 7.6	+ 38.0 — 34.8		3.2
Swiss National Bank	565.0	—193.8			+ 13.3 — 5.9	+ 19.3 -0-	397.8
Bank for International Settlements (Swiss francs)	600.0						600.0
Total	1,426.8	+255.0 —197.6	+130.4 —122.8	+ 9.4 —268.1	+366.0 —136.7	+183.3 -0-	1,645.4

Note: Discrepancies in totals are due to rounding.

from mid-December through January 24. Over that stretch, operating jointly with the Bundesbank, the System sold a further $134 million equivalent of marks, of which $103 million was drawn under the swap line and the rest from balances. The Federal Reserve also intervened in Swiss francs in December-January, and the Swiss National Bank resumed spot intervention in Zurich on January 6. The System's sales of Swiss francs amounted to $51.1 million equivalent, of which $32.5 million was drawn under the swap line with the Swiss National Bank and the rest purchased outright from that bank. In addition, the Federal Reserve sold $9.6 million equivalent of Dutch guilders and $2.9 million equivalent of Belgian francs drawn on the swap line with the respective central banks. Of these swap commitments, $5.9 million of Swiss francs, $6.4 million of Dutch guilders, and the full amount of Belgian francs were repaid through market acquisitions.

As the depreciation of the dollar continued, European exporters became increasingly concerned over an emerging undervaluation of the United States dollar that would leave them at a competitive disadvantage in world markets. By late January, this potential problem was also recognized by European government officials, who publicly noted that the dollar had fallen to unrealistically low levels in the exchange markets. Against this background, the Federal Reserve, together with the Bundesbank, began during the last week in January to intervene more forcefully to resist the erosion of dollar rates. Operating on four of the five days, the Federal Reserve sold a further $94.6 million of marks, drawn on the swap line, and the Bundesbank purchased a roughly equivalent amount of dollars.

In summary, in exchange market intervention during the six-month period, the Federal Reserve sold a total of $742.3 million equivalent of German marks, Swiss francs, Dutch guilders, and Belgian francs. Of this, $619.2 million equivalent was in German marks, $465.5 million drawn under the swap arrangement with the Bundesbank, and the rest from balances acquired in the market. Liquidation of debt in marks, including the $64.6 million outstanding on August 1, amounted to $147.4 million equivalent, with the result that commitments in marks stood at $382.7 million equivalent on January 31. Intervention in Swiss francs amounted to $63.6 million equivalent, of which $31.1 million was purchased directly from the Swiss National Bank and the remaining $32.5 million was financed by swap drawings. With $5.9 million of Swiss francs having been repaid, some $26.6 million equivalent of those drawings remained outstanding on January 31. Of the guilders, $43.3 million equivalent was sold in the market, all financed by swap drawings, of which $3.2 million equivalent was outstanding at the end of January. The $16.2 million of Belgian franc intervention was financed out of $1.2 million equivalent of balances and $15 million equivalent of swap drawings, all of which had been repaid by the end of the period.

Also during the period, on August 21, the Bank of Mexico drew the full $180 million available under the swap arrangement with the Federal Reserve to cover a temporary shortfall in reserves. This drawing was repaid in November, prior to maturity.

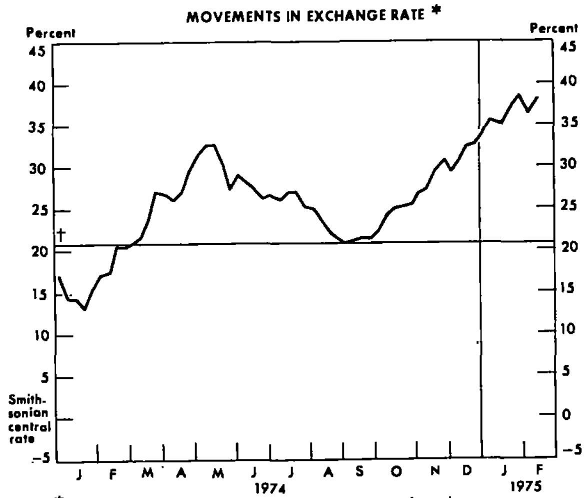
As described in the December 1974 interim report, on September 26 the Federal Reserve Bank of New York, after consulting with the Board of Governors of the Federal Reserve System, the United States Treasury, and other Government agencies, acquired the foreign exchange commitments of the Franklin National Bank. This action was greeted with relief by market participants here and abroad, and the subsequent news of Franklin's insolvency was taken in stride by the market with no adverse impact on dollar rates. This Bank quickly balanced the Franklin book and has met the forward commitments on maturity. By the end of January, nearly $400 million of the original $725 million of contracts had been liquidated.

GERMAN MARK

During 1974 the German economy turned increasingly sluggish, leading to a slackening of import demand and a freeing of productive capacity for export. For a time, the more buoyant economies of Germany's major trading partners provided continuing demand for German exports. But even after new demand weakened in the face of the spreading worldwide recession, the huge backlog of foreign orders received during previous years supported a high level of production for shipment abroad. Thus, although Germany like other industrial countries faced a sharply increased oil bill—up $8 billion for 1974 as a whole—the combined weakness of import demand and rapid growth of exports widened Germany's trade surplus especially in the early months of the year. The surprising strength of Germany's trade position fostered a speculative demand for the mark, which rose to as high as $0.4188 in mid-May and turned around only after reports that the Federal Reserve, the Bundesbank, and the Swiss National Bank had agreed on a concerted intervention plan to counter speculation against the dollar. A reflux of funds out of marks then developed, as nonresidents liquidated some of their large mark investments of previous years, as German enterprises lent heavily abroad to finance exports, and as the banking sector responded to the rise in dollar interest rates relative to those in Germany. Moreover, market nervousness following the June 26 closing of the Bankhaus I.D. Herstatt weighed on the mark. The spot rate eased and, after the mark slipped to the bottom of the European Community (EC) band, the Bundesbank began to sell substantial amounts of other EC currencies as well as dollars. The Federal Reserve was able to acquire sufficient marks to reduce its swap drawings from a peak of $381.6 million equivalent in early June to $64.6 million by the end of July.

In view of the domestic slowdown and severe strains in Germany's credit markets following the Herstatt collapse, the Bundesbank acted to maintain liquidity in the banking system by offsetting the outflows of funds abroad. The authorities had not yet abandoned their restrictive monetary policy, however, since Germany's inflation rate of 6 to 7 percent per annum remained high by recent historical standards although still far below the inflation rates of most of Germany's trading partners. In mid-August the Bundesbank announced a 10 percentage point reduction in reserve requirements on domestic liabilities, and interest rates in Germany held steady, while interest rates in the United States and elsewhere rose to unprecedented levels. The incentives for arbitraging funds out of marks and into dollars and other currencies therefore widened, and the mark eased in the exchange market. Consequently, in August the Federal Reserve was able to buy sufficient marks in the market to liquidate the remaining $64.6 million of its swap debt to the Bundesbank and to accumulate working balances as well.

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.

In two instances, however, the Federal Reserve found it desirable to intervene to restrain sudden selling pressure on the dollar. On August 8 and 9, when market uneasiness during the transition of presidential authority in the United States was compounded by release of discouraging United States wholesale price figures for July, the Federal Reserve sold $20.8 million of marks from balances, along with smaller amounts of Dutch guilders and Belgian francs. Again, on September 3, after the German authorities proposed to suspend their deposit requirement on German residents' borrowing abroad (the "bardepot"), the Federal Reserve sold $16.2 million of marks from balances to check an abrupt decline in the dollar.

Over the next few weeks, the mark leveled off at about $0.3735, 10 percent below its May peak. Meanwhile, interest rates in the United States and the Euro-dollar market were beginning to fall back sharply. Consequently, the major share of continuing flows out of Germany was deflected to other EC financial centers where interest rates were either unchanged or easing only slightly. Thus, while steady against the dollar, the mark continued to require support at the bottom of the EC band and depreciated significantly against the Swiss franc as well. By the end of September, German reserves had dropped by $1.9 billion from end-of-May levels. Meanwhile, the German authorities moved further to relieve the nervousness that remained in the market in the wake of the banking failures in Germany earlier in the summer. The Bundesbank and the German Banking Association established additional backstopping facilities for providing liquidity assistance to banks. The Bundesbank announced a further 8 percent cut in reserve requirements on September 26, and the government imposed comprehensive limits on banks' foreign exchange positions effective October 1.

In early October the balance in the exchange market began to tip in favor of the mark. As United States interest rates continued to decline and as fears of renewed hostilities in the Middle East resurfaced, the markets began to anticipate diversification of Organization of Petroleum Exporting Countries (OPEC) funds out of dollars and sterling into marks and other Continental currencies. Moderately heavy selling of dollars developed in early October, and the Federal Reserve resisted an excessive bidding-up of the mark rate by selling a total of $36.1 million equivalent of marks from balances on October 3 and 4. The rate steadied briefly, but on October 9, as the market assessed President Ford's anti-inflationary proposals, a large buy order for marks pushed the spot rate up sharply, setting off a generalized speculative selling of dollars. To maintain orderly market conditions, the Federal Reserve sold $104.4 million equivalent of marks, of which $26 million was financed from balances and $78.4 million was drawn on the swap line with the Bundesbank. In Germany the next day the Bundesbank followed up by buying an even larger amount of dollars and, to consolidate the ensuing improvement in the dollar rate, the Federal Reserve sold an additional $15.5 million of marks drawn on the swap line. The mark rate then steadied at about 4 percent above early-September levels.

The Federal Reserve intervened on only two other occasions in October when the dollar suddenly came under selling pressure against the mark—selling a total of $9.7 million equivalent on October 15 and 23, financed by swap drawings on the Bundesbank. Late in October, with evidence accumulating of a significant slowdown of the German economy, the Bundesbank shifted to a somewhat less restrictive monetary policy, cutting its discount and Lombard rates ½ percentage point. The mark then eased, permitting the Federal Reserve to buy moderate amounts of marks as cover against swap indebtedness, which amounted to $103.6 million at the end of October.

In early November, however, market sentiment turned even more bullish for the mark. In the United States, increasing evidence that a severe recession was under way, while promising to swing the United States trade accounts into a smaller deficit than expected, gave rise to expectations of an accelerated and abrupt decline of interest rates here. The German trade figures for September had shown a renewed large surplus, which—with another substantial surplus expected for October—rekindled speculation of a revaluation of the mark rate. In addition, a sharp advance of the Swiss franc, which had begun in October, was by November exerting an upward influence on the mark. The large-scale capital outflows that had persisted since the summer began partially to be met by offsetting inflows. German banks sold some DM 1 billion of German public authority notes to foreigners, of which one third was placed with OPEC countries. Moreover, some oil-exporting countries were arranging direct investments in German industrial enterprises.

The exchange markets became, therefore, even more sensitive to any developments likely to spur a further rise in the mark. Consequently, following news of a jump in United States unemployment, the mark was heavily bid up on November 6 and 7. Both the Federal Reserve and the Bundesbank intervened to moderate the rise, with the System selling a total of $49.2 million equivalent of marks, along with smaller amounts of Dutch guilders and Belgian francs. The mark sales were financed by a $25.6 million equivalent drawing on the swap line and by the use of balances. When the Swiss franc eased off toward midmonth, the mark followed suit and the Federal Reserve was able to acquire balances in the market.

Beginning on November 14, the mark itself became a renewed object of speculation in the market following press reports that the German government would not oppose a further rise in the mark rate. The spot rate was immediately bid up by almost 2 percent. The Bundesbank and the Federal Reserve both intervened on that day to resist the rise of the mark rate, the System selling $39.7 million equivalent drawn on the swap line. Speculation over a mark revaluation continued, however, and over the weekend the German government denied that it was considering measures to raise the mark rate. Following this clarification, on November 18 the Federal Reserve resumed forceful intervention not only in marks, selling $56.7 million equivalent drawn on the swap line with the Bundesbank, but also in Dutch guilders, Belgian francs, and Swiss francs. The Bundesbank and other European central banks followed up on the next day, and the Federal Reserve sold an additional $16.2 million equivalent of marks, again financed by a swap drawing. The revaluation talk did not die down completely, however, and the mark was bid up once again on November 22 and 25. The Bundesbank and the Federal Reserve again intervened to resist the rise in the rate, with the Federal Reserve selling a total of $26.1 million equivalent drawn on the swap line. Thereafter, the announcement of an unexpected trade surplus for the United States for October and a smaller than expected trade surplus for Germany, coupled with a firming of Euro-dollar rates, brought a brief respite. The mark eased, and the Federal Reserve was again able to buy marks to cover swap indebtedness. In early December, the Federal Reserve used these purchases, together with existing balances, to repay $82.8 million equivalent of swap debt, reducing the total outstanding to $185.1 million.

The exchange markets turned extremely thin during December, as traders sought to square their books before the year-end. The dollar came again on offer, as interest rates in the United States and Euro-dollar markets resumed their downtrend. For its part, early in the month the Bundesbank stated that it would seek a somewhat more rapid growth of the monetary base in the coming year and, on December 19, announced a further ½ percentage point cut in its discount and Lombard rates to 6 and 8 percent, respectively. Nevertheless, a further rise of the Swiss franc and the latest of a series of highly publicized OPEC investments in major German industrial firms dominated market psychology. The mark was gradually bid up and, to dampen the rise, the Federal Reserve intervened in modest amounts on seven business days between December 16 and December 30. These sales totaled $75.1 million, of which $31 million was from balances and $44.1 million was drawn under the swap line.

As the new year opened, the mark had already been bid up by some 11 percent from its September levels. Even so, discouraging news on the United States economy and the further drop in United States interest rates fostered bearish sentiment toward the dollar, while renewed revaluation rumors in Germany and the rising Swiss franc

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				1975	Drawings on Federal Reserve System outstanding January 31, 1975
		I	II	III	IV	January	
Bank of Mexico	-0-	-0-	-0-	+180.0	−180.0	-0-	-0-
Bank for International Settlements (against German marks)	-0-	+26.0 −26.0	+76.0 −76.0	+ 65.0 − 65.0	+129.0 −129.0	+45.0 −45.0	-0-
Total	-0-	+26.0 −26.0	+76.0 −76.0	+245.0 − 65.0	+129.0 −309.0	+45.0 −45.0	-0-

prompted further speculative demand for marks. Both the Bundesbank and the Federal Reserve intervened in modest amounts to limit the rise of the rate, but the mark advanced a further 4 percent by January 24. Through that day the Federal Reserve had intervened in marks on five occasions in January, for a total of $58.9 million equivalent financed by additional swap drawings. On January 27, the mark jumped by a further 1 percent to $0.4356, the highest level since July 1973. By that time, however, European government officials were expressing increasing concern over the unrealistic levels to which the mark had risen, and the Bundesbank and the Federal Reserve then began to intervene in heavier volume to check the mark's rise. During the week of January 27 the Federal Reserve intervened on four days, selling a total of $94.6 million equivalent of marks, drawn on the swap line, as the Bundesbank operated in similar magnitude in Germany. The market began to respond to this more forceful approach, and the mark eased by 2 percent from its highs to close at $0.4275. By the end of January, the System's swap commitments in German marks amounted to $382.7 million equivalent.

SWISS FRANC

In Switzerland during 1974, inflation was running at nearly 10 percent, even though economic activity was leveling off during most of the year. The Swiss National Bank, therefore, kept bank liquidity under close rein, while modestly easing reserve requirements and providing liquidity to the market through swaps from time to time in response to recurrent strains in Swiss capital markets. In the exchanges, movements of the Swiss franc continued to be dominated by hot-money flows and shifting speculative sentiment. In the general decline of the dollar from late January to early May, the franc had been ratcheted upward by 23 percent to $0.3588. At that point, a turnaround followed reports of agreement among the Federal Reserve, the Bundesbank, and the Swiss National Bank on a plan of concerted intervention to counter any further erosion in dollar rates. The unwinding of long positions in francs and further accommodation of liquidity needs in Switzerland extended the decline of the franc, which eased some 6 percent by the end of July. Its drop was more gradual than that of some other Continental currencies, however, since the market was concerned that large short franc positions arising from the foreign-currency losses disclosed during the preceding months might still have to be covered.

With the dollar buoyant in August and early September, the Swiss franc continued to ease in a generally quiet market, falling to as low as $0.3300 or some 8 percent below the May peak. Then, as dollar interest rates began to drop back more rapidly than the comparable rates for Swiss francs, the spot franc turned firm once again. The Swiss National Bank provided some $1 billion equivalent of liquidity assistance to the banks through both short-dated and three-month swaps during September, thus avoiding an even sharper run-up in the franc rate before the quarter end. Nevertheless, demand for Swiss francs continued to swell, partly on the covering of outstanding short positions and partly in expectation that the franc, like the German mark, would benefit from any significant diversification of OPEC funds out of dollars and sterling.

Following a further reduction in the banks' required reserves on October 8, the money market in Switzerland had become quite comfortable. The Swiss authorities, therefore, took advantage of this opportunity to dismantle yet another of their previously imposed barriers against inflows by lifting the ban on interest payments to nonresidents on October 16. By that time, however, traders were increasingly concerned over possible diversification of OPEC funds, and the franc was bid up sharply in a thin market. In addition, political uncertainties elsewhere in Europe and in the Middle East generated flows into francs. The spot franc then began to advance sharply not only against the dollar but also against the currency of Switzerland's largest trading partner, the German mark. This persistent rise posed a policy dilemma for the Swiss authorities, since intervention to halt the rise of the franc in the exchange market—and thus avoid further erosion of Switzerland's competitive position—would augment domestic liquidity and thereby undermine efforts to curb inflation. The market began to sift every statement by Swiss officials to anticipate the point at which the Swiss National Bank might intervene in the exchange markets. Consequently, the franc snapped sharply higher on November 7, following news reports from Switzerland that the National Bank was still unprepared to buy dollars, only to fall back nearly 2 percent over the following days simply on reports that the Federal Reserve, the Bundesbank, and the Swiss National Bank were prepared to intervene in a concerted manner.

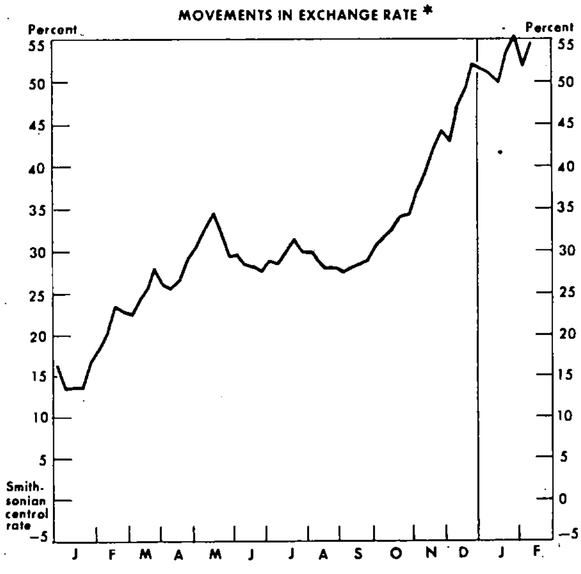
Just after midmonth, the franc came into demand once again in the backwash of speculation over a revaluation of the German mark. By November 18, the franc had risen about 16 percent against the dollar from its September lows and 5¾ percent against the mark. As part of a concerted intervention in marks, Swiss francs, Dutch guilders, and Belgian francs that day and on the following day, the Federal Reserve sold a total of $12.5 million of Swiss francs, which had been purchased directly from the Swiss National Bank. In response to this operation, the franc fell back by 6⅝ percent over the next two days. The Swiss National Bank followed up on November 20 by reimposing the negative interest charge, at 3 percent per quarter, and a ban on interest payments, each on the increase in nonresident deposits above October 31 levels. The central bank also obtained authority to monitor banks' forward sales to foreigners and to use swap transactions if necessary to enforce these new measures. These actions prompted an even further scramble in the market to unload francs, and the spot rate dropped a further 2 percent by November 21.

Over the next weeks the market in Swiss francs was thinner and even more volatile than before, as dealers were sensitive to talk of new initiatives to discourage inflows. Under these circumstances, when mark revaluation rumors resurfaced, the franc advanced a full 6⅜ percent by November 26 before settling back. The Swiss National Bank then took further regulatory measures to limit the rise of the franc. On November 28 it reactivated the requirement that proceeds of foreign borrowings in Switzerland be converted immediately into foreign currency. Four days later it raised banks' reserve requirements against deposit liabilities to nonresidents. The National Bank also announced it would again assist the banks with their year-end positioning by providing swaps. Ultimately, the National Bank provided $1 billion of year-end swap assistance and did an additional $500 million of one- and three-month swaps outside the usual quotas to influence market conditions. Even so, the market continued to push the rate up during December. On December 17, after the franc rose especially sharply, the Federal Reserve again intervened in both German marks and Swiss francs, selling a total of $26.5 million equivalent of francs, of which half was purchased outright from the Swiss National Bank and half was drawn under the swap line with that bank. The franc eased over the next days, and the Federal Reserve purchased francs in the market to repay $5.9 million equivalent of the swap debt.

In the generally bearish atmosphere for the dollar, the Swiss franc continued to advance even after year-end positioning passed. On January 6, the Swiss National Bank resumed outright intervention in the spot market in Zurich, confirming its operation "to maintain orderly exchange market conditions". The Federal Reserve followed up with similar intervention in New York, as part of its concerted intervention in both francs and German marks. These joint interventions continued over the following days, and at first the Swiss franc dropped back. The demand for francs soon picked up again, however, after it was reported that failure of a financial subsidiary of an Italian company would leave a major Swiss bank short of francs. As the market anticipated a large demand to cover a substantial volume of this subsidiary's contracts maturing early in 1975, a more generalized speculation in favor of the Swiss franc developed. The franc was heavily bid up to new record levels, while the Swiss National Bank continued to intervene, at times quite heavily. The Swiss authorities then resisted further upward pressure by severely tightening recently imposed curbs on inflows of foreign funds. In particular, the ban on interest payments was widened to apply to all nonresident balances, the negative interest charge was raised to 10 percent per quarter, banks were required to balance all foreign exchange positions daily, and provision was made whereby the National Bank could block Swiss franc liquidity resulting from dollar intervention.

These new measures at first drew a strong market response, and the franc fell back. But, as the market grew doubtful that these measures could prevent a further rise in the franc as long as short franc positions overhung the market, the Swiss franc turned around and was soon outpacing other European currencies. By January 27, it had reached a new record of $0.4195, some 27 percent

Chart III
SWITZERLAND
MOVEMENTS IN EXCHANGE RATE *



* See footnote on Chart II.

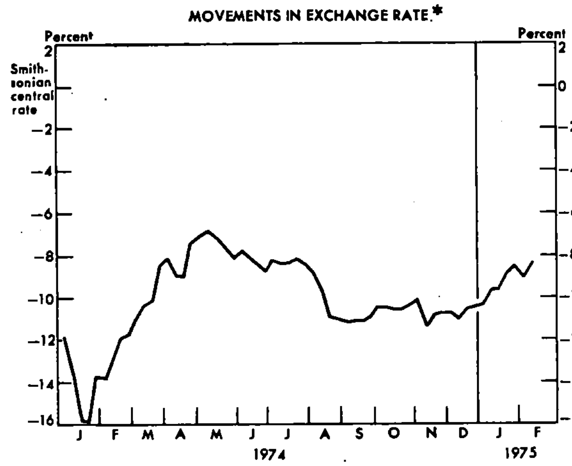
above last summer's lows. The Swiss National Bank then tightened its November regulation, limiting Swiss banks' sales of Swiss francs to nonresidents.

By this time, the immediate demands for Swiss francs had slackened and the dollar had begun to recover in other markets. Consequently, pressure in favor of the Swiss franc let up, and the franc eased to $0.4014 by the end of January. During the month the Federal Reserve, operating on six different occasions, sold a total of $24.6 million equivalent of francs. Of this amount, $5.3 million was purchased outright from the Swiss National Bank and $19.3 million was drawn under the swap line. Consequently, System drawings in Swiss francs were increased by $26.6 million equivalent as a result of the December-January operations, bringing total Swiss franc indebtedness including that outstanding since 1971 to $997.8 million equivalent by the end of January.

Chart IV

UNITED KINGDOM

MOVEMENTS IN EXCHANGE RATE*



* See footnote on Chart II.

STERLING

Last summer, the United Kingdom was faced with severe financial, economic, and balance-of-payments strains. Industry was caught between high wage, raw material, and financing costs, on the one hand, and statutory limits on prices, on the other. The ensuing squeeze on profits and corporate liquidity was restricting inventories, investment, and output. With industrial production not fully recovered from the disruption of the three-day workweek earlier in the year, the new cutbacks threatened a more prolonged stagnation and a rising unemployment rate while domestic inflation continued at a rapid rate. Meanwhile, the trade deficit had swelled to over $6 billion in the first half of the year, of which close to $3 billion reflected costlier oil imports. At the same time, the worldwide slowdown of economic activity cast a shadow on export prospects.

Although the exchange market sentiment remained bearish toward sterling, the pound depreciated on a trade-weighted basis only slightly during August and September while slipping against the dollar some 2 percent to around $2.33. Oil-related and other capital inflows roughly offset the United Kingdom's large current-account deficit and helped bolster the spot rate. During the third quarter, oil-exporting countries invested a net $2.2 billion in relatively high-yielding sterling assets. Oil companies also accumulated sterling, both spot and forward, in anticipation of future tax and royalty payments and for investments in North Sea exploration. The Bank of England operated on both sides of the market in August and September to smooth the impact of oil-related transactions.

By early October, however, the inflow of oil-related funds tapered off, as concern over Britain's economy continued and short-term sterling interest rates suddenly declined. In addition, there was some temporary nervousness ahead of the October 10 general election. The pound therefore tended to weaken against many of the Continental currencies while holding roughly steady against the dollar. The market soon came into better balance, however, as new demand for relatively large October oil payments in sterling counterbalanced continuing sales by oil producers diversifying out of sterling. Following the trend of other European currencies more closely, the spot pound firmed to $2.35 by early November.

Meanwhile, adverse economic developments led to some apprehension ahead of the November 12 budget message. The worsening inflation had triggered successive rounds of threshold wage increases, and recently negotiated wage settlements had cast doubt on the effectiveness of the government's "social contract" to achieve a voluntary pay restraint. Prospects of rising unemployment were increasingly underscored by news of further layoffs and business failures. The market was somewhat reassured by new budget proposals to alleviate corporate liquidity strains without having an excessive overall stimulative impact as many market participants had feared. Moreover, the extension of the Bank of England's supplementary deposits scheme to allow the banks to help provide sufficient corporate financing without encouraging a more rapid growth of the money supply was also viewed positively.

The market was caught by surprise, however, by an accompanying announcement from the Chancellor of the Exchequer that the United Kingdom's guarantee arrangements on official holdings of sterling would be allowed to expire in December. As these guarantees did not apply to the large accumulation of sterling holdings since September 1973, the market had taken in stride Australia's announced withdrawal from its arrangement in September 1974. But, since some dealers saw total abolition of guarantees as possibly stimulating accelerated diversification out of sterling, heavy selling pressure quickly materialized and the spot rate dropped below \$2.30. After substantial Bank of England support, as well as renewed oil-related demand for November royalty payments, the market steadied and sterling moved narrowly against the dollar through early December. Nevertheless, with other currencies advancing against the dollar, sterling lost further ground against the currencies of Britain's major trading partners. During October and November, half of the government's \$2.5 billion Euro-dollar loan and \$400 million of the British Water Council's loan from Iran were taken into foreign exchange reserves, which increased on balance about \$650 million for the two months.

Just before mid-December, it was reported that Saudi Arabia had informed the Aramco group that it wished all future oil payments to be made exclusively in dollars. The subsequent liquidation of sterling previously acquired by Aramco members and prospects of even more diversification of OPEC funds largely into Continental currencies triggered new selling pressure on the pound. The Bank of England resisted the rate decline with substantial support. Thereafter, Saudi Arabia reaffirmed publicly that it would continue to invest in sterling assets, and other Middle East sterling holders followed up with similar reassuring statements. The market then steadied and, when a severe squeeze developed in the Euro-sterling market, the pound benefited from some covering of short sterling positions. Over the remainder of the year, the spot rate traded narrowly around \$2.34 and the trade-weighted value of sterling recovered from the record low set on December 12.

During January, sterling once again lagged behind the strong advance of the major continental European currencies against the dollar. New fears about corporate solvency in Britain and about possible diversification of sterling balances exerted a drag on sterling. Later in the month, the favorable impact of improved trade figures for December was more than offset by successive reductions in the Bank of England's minimum lending rate to 11 percent and corresponding declines in London money market rates. Consequently, the pound weakened further against major Continental currencies although rising somewhat against the dollar to \$2.38 by the month end. The Bank of England provided further moderate support to check the erosion. Over the two months of December and January, official dollar sales, together with other foreign-currency payments, were partly offset by additional drawings on the United Kingdom government's \$2.5 billion Euro-currency loan, but Britain's reserves nevertheless declined by about \$1 billion.

Table IV

UNITED STATES TREASURY SECURITIES FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding January 1, 1974	Issues (+) or redemptions (—)					Amount outstanding January 31, 1975
		1974				1975	
		I	II	III	IV	January	
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-	-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 through April 1974.

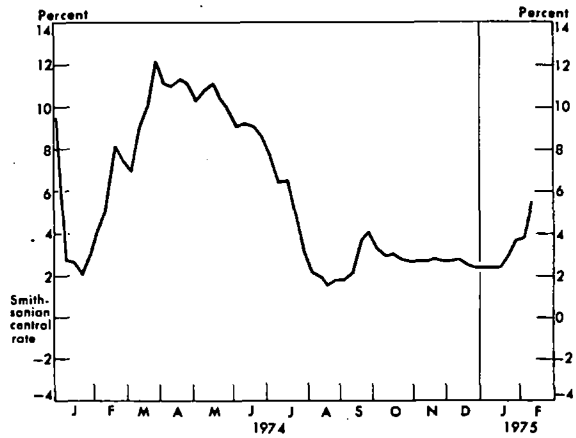
JAPANESE YEN

A $6 billion increase in Japan's oil import bill in the first half of 1974 and sharply higher commodity prices had driven Japan's current account into deep deficit early in the year. This was largely financed by heavy short-term borrowings by Japanese banks, both in the Euro-dollar market and in the United States. By midsummer, however, with the Euro-markets under unusual strains, some Japanese banks were reportedly approaching credit limits and facing increasing costs of funds there. The Japanese authorities requested the banks to refrain from excessive borrowing, and then the demand for spot dollars in Tokyo increased. By August 22, the yen had fallen over 10 percent from its late-March 1974 peak to $0.003294, its lowest point since it was floated in February 1973. The Bank of Japan from time to time intervened in the market to avoid wide fluctuations in the yen rate, providing support through moderate sales of dollars. The authorities also took a series of steps in August and early September to relax impediments to inflows of foreign funds to Japan. Controls were eased on net conversions of dollars into yen by foreign banks, on prepayments for Japanese exports, and on nonresident investments in certain Japanese securities. In addition, reserve requirements on nonresident "free yen" deposits were reduced to zero. These measures helped relieve the pressure, and the yen rate steadied above its lows.

Meanwhile, Japanese economic activity remained sluggish after a sharp decline early in the year. Upward pressure on wholesale prices abated, but consumer prices continued to rise rapidly. Therefore, the Japanese authorities maintained their highly restrictive monetary policy. With domestic sales sagging and inventory financing becoming increasingly burdensome, Japanese companies placed greater emphasis on exports. As shipments abroad surged, Japan's trade balance, after a $2.7 billion first-half deficit, swung decisively into surplus by late summer. Successive reports of this turnaround contributed to the improvement in market sentiment in September. After mid-September, wire service reports that a $1 billion loan had been arranged between an oil-producing nation and Japan sparked active bidding for yen. Later in the month, figures were released showing a current-account surplus for August—the first since the escalation of oil prices the winter before—and the yen was bid up further to a level 3 percent above its August lows.

By early October the yen had steadied around $0.003333, but market uncertainties persisted and the yen came under some renewed pressure in late October. Trading then came into better balance during November and early December, as the Japanese authorities further relaxed restrictions on capital inflows from abroad. The Ministry of Finance permitted Japanese corporations to use the proceeds of certain foreign bond issues for domestic purposes, and several companies quickly moved to arrange new issues abroad. The Bank of Japan also asked Japanese banks to reduce as much as possible the additional cost of their borrowings in the Euro-dollar market.

Chart V
JAPAN
MOVEMENTS IN EXCHANGE RATE *



*See footnote on Chart II.

Continuing market concern over prospects for the yen resurfaced in late December and early January. Pressure on the yen gradually eased, however, as dealers reacted to news of Japan's strong export performance in December and as new Japanese corporate foreign borrowings were converted into yen. Moreover, the market responded favorably to the Bank of Japan's reaffirmation of its policy of restraint, until prices had stabilized, and to the generally anti-inflationary thrust of the government's draft budget. By late January, the yen had begun to advance in sympathy with the sharp rise of European currencies against the dollar, reaching $0.003363, some 3 percent above the August low.

FRENCH FRANC

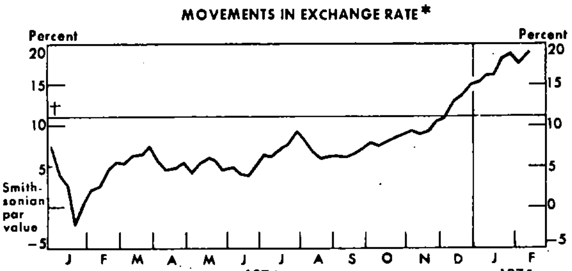
In contrast to many other industrial countries, France enjoyed real economic growth and relatively low unemployment during the year. On the other hand, the inflation rate remained relatively high, compared with price trends in Germany and neighboring countries.

Moreover, the trade account, which had been in moderate surplus throughout 1973, swung into deep deficit by May. In part, this deterioration was in response to relatively buoyant domestic demand. More importantly, it reflected a $6 billion increase for 1974 in France's oil import bill, as well as the adverse shift in French terms of trade following the downward float of the franc early in the year.

To counter the worsening inflation and the weakening trade position, the French government imposed progressively more stringent economic policies. In June, the government adopted a new anti-inflation program containing credit, tax, price control, and energy-saving measures. In September, it followed up by renewing ceilings on credit growth (except on credits to finance export production) and announcing a stringent $11 billion limit on oil imports for 1975. Meanwhile, around midyear, the Bank of France had hiked its discount rate to a record 13 percent, stiffened penalties for banks exceeding official credit ceilings, and maintained a severely tight money market. As monetary policies in other countries were gradually relaxed, substantial interest rate differentials in favor of the French franc emerged. In response, short franc positions—built up before the floating of the franc and the French presidential elections in May—began to be covered and French enterprises stepped up their borrowings abroad.

The franc remained relatively firm during the late summer and early fall. Although it eased from its early-August levels as the dollar strengthened around midmonth, its decline was less pronounced than for most currencies. Favorable interest rate incentives, together with news of more bank failures and large exchange losses elsewhere in Europe, prompted further repatriations of funds and a building-up of franc balances by nonresidents. By the

Chart VI
FRANCE
MOVEMENTS IN EXCHANGE RATE*



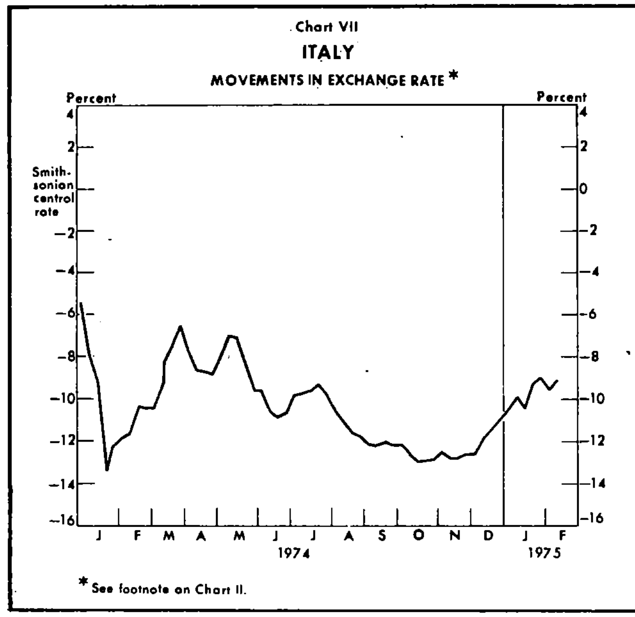
* See footnote on Chart II.
† Central rate established on February 12, 1973.

end of August, the franc had resumed an uptrend which gained momentum after mid-September, when discussions of multilateral proposals and direct deals for financing European oil deficits helped to dispel some of the market's concern over France's large oil deficit. The franc at times outpaced the German mark and other European currencies in the general upswing of currencies against the dollar, rising 4 percent to $0.2145 by November 7. To moderate the rise of the franc, the Bank of France made increasingly heavy purchases of dollars, thereby contributing to the $600 million increase in French reserves during the three months to end-October.

Meanwhile, the economic climate in France was deteriorating. The high rate of inflation generated growing labor unrest, and by early November a number of strikes erupted that threatened to disrupt production. At the same time, the government's austerity measures were beginning to bite, causing an abrupt slowing of output and a jump in unemployment. Against this uncertain background, the rise in the franc faltered. Indeed, while holding steady against the dollar through much of November, the franc dropped to its lowest levels against the German mark and other Continental currencies in five months. Following reports of large-scale layoffs and short hours, the labor strikes ended and pressure against the French franc eased. Late in the month, market tone improved further after President Giscard d'Estaing relieved growing concern over unemployment by promising renewed economic expansion for 1975 and providing special assistance to industries most vulnerable to the slowdown.

By early December the franc was again in demand. French interest rates remained near their peak levels with the three-month Euro-franc rate some 8 percentage points above the corresponding Euro-dollar rate. Moreover, France's trade deficit was narrowing far more rapidly than had been forecast, as imports slackened in the face of weakening domestic demand and lower energy requirements. In addition, news of a $1 billion loan agreement with Iran and other successful Middle East negotiations promised to bolster France's external position in the coming year. The franc climbed sharply, therefore, again outpacing other currencies as the dollar declined in December. The Bank of France resumed intervention, buying dollars regularly to keep the franc's rise in line with other currencies.

After the first week in January, the French government began gradually to relax its restrictive monetary policy. The Bank of France cut its discount rate 1 percentage point to 12 percent on January 9. In addition, minimum reserve requirements were reduced on January 21, and the regulation of bank credit was made more flexible. Nevertheless, French interest rates remained well above those in most other markets and the French franc continued to advance. Boosted further by news of a trade surplus in December—the first monthly surplus since 1973—the franc moved up to $0.2349 just before the end of January to trade nearly 14 percent above its mid-August lows.



ITALIAN LIRA

Midsummer 1974 marked a significant turning point in Italian economic and balance-of-payments trends. During the first half of 1974, inflation was continuing at a rate two to three times faster than in most other major industrial countries, as sharply higher costs for imported oil and other commodities, production bottlenecks in some industries, and an expanding government budget deficit helped perpetuate the inflationary spiral. The current-account deficit had more than doubled under the weight of a $6 billion increase in oil imports for 1974, exerting persistent pressure on the lira in the exchanges. The authorities had intervened heavily to prevent a substantial depreciation of the lira from worsening domestic inflation. The bulk of this intervention had been financed by new foreign borrowings, including EC short-term assistance, and by midyear Italy's medium-term indebtedness to the Euro-dollar market stood at $8 billion. Meanwhile, to eliminate the nonoil deficit, contain inflation, and rein in public spending, the authorities progressively stiffened monetary and fiscal policies and imposed an import-deposit scheme.

By midyear these measures were beginning to take hold. A sudden weakening of domestic demand was narrowing the nonoil component of the trade deficit, and declines in world commodity prices promised an unexpected further improvement. The severe tightening of domestic liquidity was stimulating a substantial influx of short-term funds, as Italian commercial banks borrowed heavily in the Euro-dollar market to finance domestic lending. Conversions of these borrowings had a steadying effect on the Italian lira in the exchanges, and the Bank of Italy had been able to add to its reserves.

By late July, the Italian authorities had become concerned that the rapid growth of bank borrowing abroad would frustrate the extremely restrictive monetary policy and might aggravate existing strains in the international capital markets. Therefore, the authorities instructed banks to limit their net foreign indebtedness to July 19 levels, and the net inflow of funds began to taper off in early August. Then, after Italy's severe liquidity crunch eased somewhat with the exemption of all agricultural products from the import-deposit scheme, the repayment of foreign borrowings picked up and continued throughout the next several weeks. By the end of September, Italian banks had reduced their net foreign indebtedness by almost $1 billion. As these repayments coincided with the normal seasonal slackening of tourist receipts, the lira periodically came under some selling pressure during August and early September. The Bank of Italy provided occasional moderate support for the lira rate to prevent it from weakening too rapidly against other European currencies.

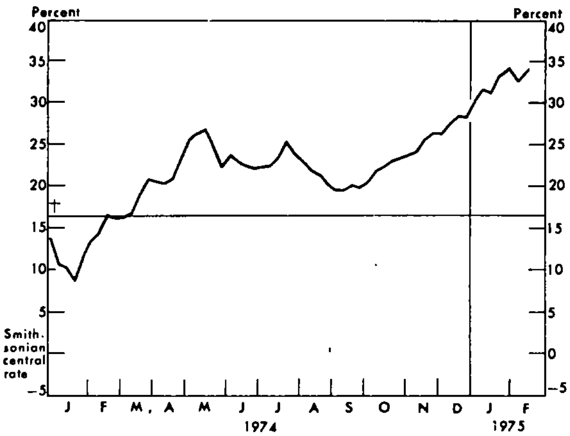
In the meantime, Italy obtained new official credits to cover its current-account deficit. In early August, the Italian authorities drew a total of $622 million equivalent from the International Monetary Fund (IMF) against its gold tranche and the first tranche of its $1.2 billion standby. Later in the month, the Bank of Italy obtained $2 billion by way of a reciprocal gold-dollar deposit with the Bundesbank. (In that transaction, the gold was valued at 80 percent of average recent market prices or about $120 per ounce.) Then, in mid-September, Italy borrowed $315 million from the IMF oil-financing facility and renewed its European Monetary Cooperation Fund credit of $1,885 million. The government also announced a second takedown of $540 million equivalent from Italy's IMF standby credit. The new borrowings, which were taken into official reserves over the two months through the end of September, helped improve market sentiment, and the lira held about 3 percent below its late-July levels until early October.

Meanwhile, the Italian economy had markedly slowed down, with industrial output falling sharply. Domestic price inflation continued to worsen, however. As Cabinet disagreement over continuation of the government's austerity program surfaced, leading to Prime Minister Rumor's resignation on October 3, outflows of funds put renewed pressure on the lira. The exchange rate slipped about 1 percent against the dollar and 4 percent against other EC currencies, while the Bank of Italy provided heavy support in the first half of the month to moderate the lira's decline. Although selling pressures temporarily subsided toward the end of October, the lira remained relatively weak and did not participate in the general upsurge of European currencies in November. By the end of that month, the lira had depreciated by a further 1 percent against the other EC currencies while holding steady against the dollar. Over the two months, intervention sales of dollars were mainly responsible for a $1.2 billion decline in official reserves.

Market sentiment improved considerably in December, as the new government under Premier Moro moved swiftly to implement its economic program. Monetary policy was kept restrictive, although the Bank of Italy made a modest cut in its historically high discount rate. In addition, measures to discourage crude oil imports were adopted and plans for expanded capital investments in energy, agriculture, and public works were proposed. In the exchanges, a significant reflow of funds, which had been moved out of the lira at the height of the Cabinet crisis, was reinforced by continuing tight money market conditions. Furthermore, the slowdown of economic activity was dampening import demand. Thus, the lira rate firmed almost 2½ percent during December.

After the year-end, however, the lira again came on offer. The Bank of Italy relaxed its restrictive stance somewhat further and, as liquidity strains in Italy eased during January, short-term reflows slowed. In addition, although Italy's nonoil trade was improving, a seasonal weakening in the trade balance and a bunching of oil payments depressed the rate. As on other occasions, moreover, pressure on the dollar occasionally spilled over onto the lira, and it lost substantial ground against the EC currencies. The Bank of Italy again provided support, and by the month end the immediate pressures had lifted. On January 31, the lira rate stood at $0.001564, about 1 percent higher than at the outset of the reporting period.

Chart VIII
NETHERLANDS
MOVEMENTS IN EXCHANGE RATE*



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

NETHERLANDS GUILDER

The Netherlands strong current-account surplus in 1974, together with expectations of further improvement in the balance of payments in 1975, kept the Dutch guilder strong against both the dollar and other European currencies during the reporting period. Prospects for increased natural gas exports blunted the impact of higher prices on oil imports, while port and shipping services were improving the net invisibles balance. Reports of a continuing large current-account surplus had spawned revaluation rumors in late July. Speculative demand for guilders had been countered by coordinated Netherlands Bank-Federal Reserve intervention, and the rumors were spiked by an official denial of any revaluation intentions. The guilder then turned lower, dragged down by the declining German mark, and substantial intervention against marks was required to maintain the limits of the EC band.

The only Federal Reserve intervention in guilders late in the summer came on August 9 when $5.3 million equivalent was sold along with other currencies, as markets were briefly unsettled during the period of transition of presidential authority in the United States and after release of disappointing United States wholesale price figures. The sale of guilders was financed by a drawing on the swap line with the Netherlands Bank and, as the guilder quickly resumed its decline, sufficient guilders were acquired to liquidate the swap commitment. By early September, the guilder had fallen 3¾ percent to $0.3663.

Money market conditions in Amsterdam then tightened, as seasonally heavy tax payments pushed up Dutch interest rates at a time when a cut in reserve requirements in

Germany was adding to liquidity in Frankfurt. In addition, the Dutch government announced, as part of its 1975 budget proposal, a steep increase in the price of natural gas, estimated to add $500 million to the Netherlands' 1975 exports. Consequently, the guilder was again bid up and, as the EC snake came under increased pressure, the Netherlands Bank stepped up its purchases of marks. The Dutch central bank also began to provide substantial amounts of guilders through one- to three-month dollar swaps with the commercial banks, lessening domestic liquidity strains. In the two months August-September, Dutch official reserves increased by about $1 billion.

In October, the guilder participated in the upward movement of continental European currencies against the dollar, with little reaction to a percentage point reduction in the Netherlands Bank's discount rate to 7 percent late in the month. In view of the relative positions of EC snake currencies in November, when the European currencies began to advance more sharply, the Federal Reserve supplemented its intervention against marks by offering guilders as well. The Federal Reserve sold $6.5 million equivalent of guilders on November 7 and a total of $22 million equivalent during the coordinated central bank intervention of November 18 and 19. The Netherlands Bank followed up in the Amsterdam market by purchasing moderate amounts of dollars. The System's sales were financed by drawings on the swap line and were repaid through market purchases when the guilder temporarily declined. Dutch reserves increased another $550 million during October and November, largely as a result of continued dollar swap transactions with the Dutch banks.

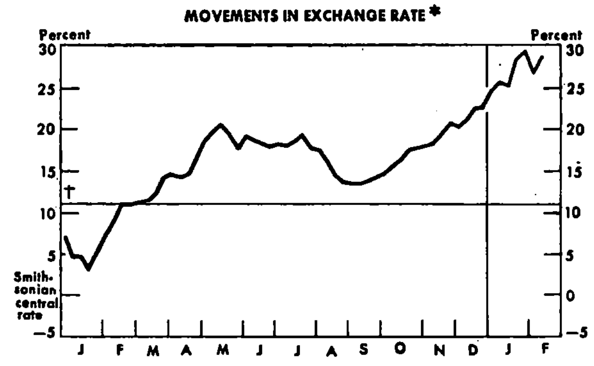
By early December, the guilder strengthened again to a level 6½ percent above its September low. Meanwhile, the Dutch government, increasingly concerned about rising unemployment and sluggish domestic economic activity, particularly in the construction industry, had announced new measures to stimulate the economy. Taxes on wages and salaries would be cut as of April 1, 1975, investment incentives were broadened, and private sector payments for social services were reduced. Together with the planned deficit in the September budget, these actions would provide substantial fiscal stimulus while monetary policy would remain moderately restrictive to counter inflationary pressures. Thus, Dutch interest rates held above those in some other financial centers and provided an incentive for funds to move into guilders as the dollar generally remained on offer in the exchanges in December. The Dutch authorities again provided liquidity through dollar swaps with commercial banks and also bought modest amounts of dollars outright in the spot market. For its part, the Federal Reserve also intervened in guilders in New York on December 17 and 27, selling a total of $9.6 million equivalent of guilders along with other currencies to cushion the decline in dollar rates. These sales were financed by additional swap drawings, of which all but $3.2 million was repaid through subsequent market purchases. The guilder nevertheless was pulled sharply higher in January by the speculative rise of the mark and Swiss franc. It reached a peak of $0.4175 on January 27—14 percent above its September low—before dropping back somewhat on subsequent days along with other currencies.

BELGIAN FRANC

The slowdown in Belgium's economy that set in around mid-1974 was more gradual than in most other industrial economies. The pace of domestic inflation, on the other hand, remained high relative to that for Belgium's principal trade partners. Consequently, the authorities maintained a restrictive monetary policy, with the result that Belgian interest rates rose to levels above those prevailing in most other Continental financial centers and remained relatively firm throughout the second half of the year. The pull of high yields in Belgium prompted both a reflux of previous outflows and inflows of new short- and long-term capital. These inflows, together with a current account that was still in surplus despite higher imported oil costs, provided a continuing buoyancy for the Belgian franc in the exchanges.

Accordingly, the Belgian franc declined more gradually

Chart IX
BELGIUM
MOVEMENTS IN EXCHANGE RATE *



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

against the dollar in August than most other European currencies, while holding just below the top of the EC band. The Federal Reserve sold \$2.5 million equivalent of Belgian francs, along with its sales of other currencies, to forestall a sudden slippage in dollar rates on August 9. Of this, \$1.7 million was financed by a drawing on the swap line with the National Bank of Belgium and the remainder was drawn from System balances. The swap commitment was promptly repaid as the Belgian franc was pulled down by the German mark. In early September, the commercial rate bottomed out at \$0.025275, almost 4 percent below early-August levels.

After mid-September, however, the franc began to rise again. Liquidity in Belgium was tightened further by tax payments and by higher reserve requirements on call deposits. Moreover, there was a shift of funds into francs out of German marks in response to a tightening of foreign exchange restrictions both in Germany and Luxembourg. In November, the rise of the Belgian franc accelerated as pressure on the dollar generally intensified. To dampen the franc's advance and avert a buildup of pressure within the EC snake, the National Bank of Belgium frequently made modest purchases of dollars in Brussels. In New York the Federal Reserve offered Belgian francs, along with other European currencies, to smooth the decline in dollar rates on November 7, 18, and 19 and December 17. Total sales of Belgian francs amounted to \$13.7 million equivalent, of which \$13.2 million was drawn on the swap line and subsequently was repaid through market purchases. The remainder was drawn from balances.

By the year-end the slowing pace of Belgian economic activity had induced an easing of credit demands, and Belgian interest rates turned down. Late in January, in view of domestic and international interest rate trends, the National Bank relaxed its credit policy by reducing the discount rate by ½ percentage point to 8¾ percent, raising ceilings on credit growth, and releasing reserves against bank time deposits. Nevertheless, the decline in Belgian interest rates lagged behind those elsewhere. The Belgian franc thus held at or near the top of the EC band, requiring the central bank to purchase moderate amounts of other participating currencies. As the European currencies generally strengthened against the dollar, therefore, the commercial franc advanced to \$0.028600 on January 31, and the National Bank purchased further small amounts of dollars to resist the rise. At this level, the commercial Belgian franc stood almost 13 percent above its September low. As of January 31, System swap commitments with the National Bank of Belgium totaled \$261.8 million equivalent of Belgian francs, all incurred prior to August 15, 1971.

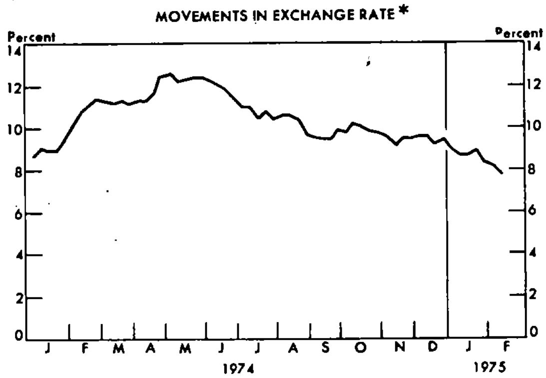
CANADIAN DOLLAR

The gradual decline of the Canadian dollar that had begun in June 1974 continued with only brief interruptions during the six-month period under review. The downtrend primarily stemmed from a progressive erosion of Canada's trade surplus during 1974 and an increasingly pessimistic market assessment of prospects for 1975. Export growth fell off sharply as a result of the severe slackening of United States demand and the break in world commodity prices that tended to weaken Canada's terms of trade. By contrast, the deceleration of economic activity in Canada was more moderate than elsewhere, with a still buoyant investment demand sustaining imports of capital goods. Consequently, many published Canadian forecasts showed the Can.\$706 million export surplus for the first half of 1974 swinging into deficit by early 1975. Whereas trade deficits in earlier years had been financed by large capital inflows, prospects for long-term inflows were now uncertain and short-term capital flows were largely responding to the shifting interest rate incentives between Canada and the United States.

In early August, when the near-record levels of dollar interest rates yielded strong disincentives against Canada, selling of Canadian dollars intensified as United States corporations repatriated funds to their home offices. Labor unrest in Canada further depressed the market. The spot rate fell almost 1 percent to a low of \$1.0109 by August 28. The Bank of Canada intervened to avoid too rapid a decline and, during August, Canada's reserves fell \$160 million. In September and October, as the retreat of United States short-term rates was underscored by declines in United States prime rates, the Canadian dollar recovered somewhat. Positioning by Canadian banks in anticipation of several conversions of foreign borrowings and of their October 31 fiscal year-end also temporarily spurred demand for the Canadian currency. But, by late October, the spot rate was again easing.

Meanwhile, the sharp production cutbacks in United States output were exerting an increasingly heavy drag on the Canadian economy. As demand for credit weakened, Canadian banks lowered their prime rates. In addition, the Bank of Canada cautiously eased the restrictive stance maintained during the first half of the year by reducing its discount rate to 8¾ percent, the first cut from the peak 9¼ percent level established in July. Shortly thereafter, chartered banks' secondary reserve requirements were lowered 1 percent to 7 percent. Then, on November 18, the government announced a somewhat more stimulative budget for the fiscal year beginning April 1975, featuring cuts in the personal income tax. These actions were largely

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.

in line with market expectations, and the Canadian dollar fluctuated narrowly between $1.01 and $1.0150 through mid-December.

Late in the month, however, market sentiment toward the Canadian dollar worsened again. News of a Can. $149 million trade deficit for November confirmed expectations of a continuing deterioration in Canada's underlying payments position, and the market was expecting another cut in the central bank discount rate. As Canadian banks added to their United States dollar positions and commercial leads and lags worsened, the Canadian dollar fell to a twelve-month low of $1.0004 on January 9. Several days later, the Bank of Canada, having reduced secondary reserve requirements by another percentage point in early January, lowered its discount rate by another ½ percentage point to keep it in line with the general decline of Canadian money market rates. Since exchange dealers had actually counted on a larger cut and there were substantial conversions of Canadian provincial foreign borrowings that boosted the spot rate, the Canadian dollar briefly rebounded to nearly $1.01. Once the conversions were completed, the rate turned lower again. After the final trade figures for 1974 were released, revealing a steep erosion of Canada's trade surplus to Can.$419 million for the year—little more than a fifth of the 1973 level—the Canadian dollar eased to $1.0008 on January 31. This represented a 2 percent decline against the dollar since August levels and a substantial depreciation against virtually all other major currencies.

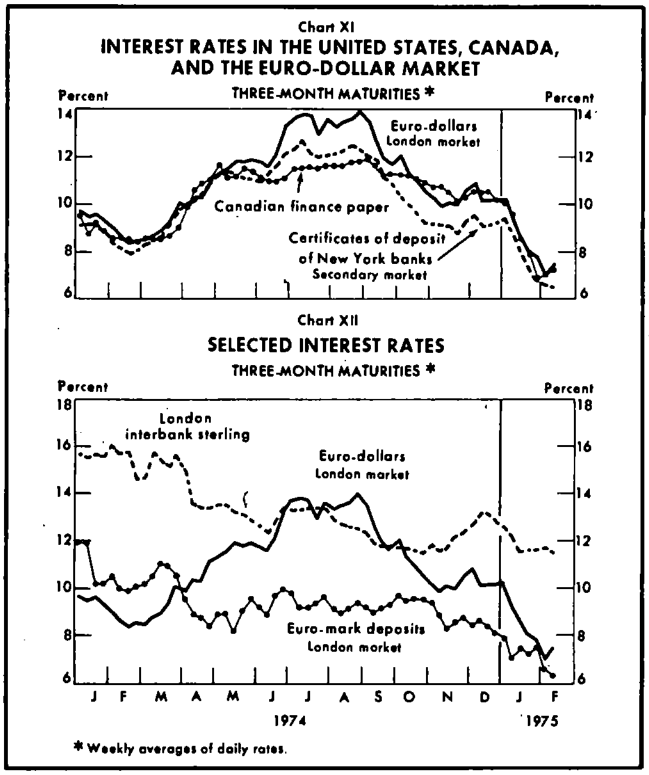
EURO-DOLLAR

The Euro-currency markets continued to suffer from the erosion of confidence that afflicted international banking following the failure of banks in several countries last year. Persistent nervousness in the market was reflected in new cuts last fall in credit lines to many market participants. In particular, smaller and even medium-sized banks and those of certain countries under balance-of-payments pressure remained subject to rather close and, in some cases, increasingly tight credit ceilings by their traditional suppliers. The multitiered rate structure that had emerged last spring and summer, therefore, persisted. The strains in the market gradually subsided, however, with the result that the differentials between the rates charged to different classes of banks narrowed and almost disappeared early in 1975.

The improved market tone owed much to an announcement by the Bank for International Settlements on September 10 that the central bank governors meeting at Basle, following a discussion of the problems of a lender of last resort in the Euro-markets, had concluded that means are available for the provision of temporary liquidity and will be used if and when necessary. The market was further reassured when consortium banks responded to the Bank of England's request for firm commitments from shareholders to support the banks' operations if they ran into problems at any time. Another boost to market confidence was given by an official statement that "the Federal Reserve is prepared, as a lender of last resort, to advance sufficient funds suitably collaterialized to assure the continued operation of any solvent and soundly managed member bank which may be experiencing temporary liquidity difficulties associated with the abrupt withdrawal of petrodollars—or any other deposits".

After a fairly steep decline in outstanding deposits last summer, the Euro-currency market resumed its expansion in the final quarter of last year, albeit at a much reduced rate. Its continued growth benefited greatly from renewed placements of sizable OPEC deposits, which brought the total for the year to an estimated $23 billion or 40 percent of OPEC countries' surpluses. Thus, the market remained the major receptacle for those funds that the oil-producing countries were unable to spend for goods and services and did not employ for grants-in-aid and loans to oil-importing countries. During the summer and fall, the market also benefited from sizable advances by United States banks to their branches, notably those located in the Bahamas, which then passed on these funds to a variety of bank and nonbank borrowers.

As OPEC and other major supplier countries added further to their Euro-currency holdings, overall liquidity in the market improved but the market continued to suffer from a maldistribution of liquidity. The very large banks in the market had ample funds at their disposal, often more than they desired in view of their capital and surplus positions. While the very large banks grew in strength and importance, the role of some of the medium-sized and smaller banks became stationary or diminished. A few banks unable to command the relatively attractive rates offered to their bigger competitors actually scaled down their operations.



It was the medium-term Euro-loan market that was most seriously affected by the strains in international banking. Last summer and fall, the rate of increase in the volume of medium-term loans slowed down considerably, as many syndicate participants no longer were able to secure funds at competitive interest rates. Consequently, the syndication of balance-of-payments and project loans carrying very distant repayment schedules diminished significantly. Reduced competition permitted lenders to widen the spreads of rates on loans over the rates they paid for funding these loans and to tighten other terms and conditions, including the shortening of average maturities for medium-term loans funded with short-term funds on a floating-rate basis. In more recent weeks, however, as money market conditions in many parts of the world became easier, spreads between loan and deposit rates were again narrowing somewhat.

Interest rates in the market, after rising to virtually unprecedented levels, dropped in September and October in response to sharp across-the-board declines in United States money market rates. The downtrend in Euro-dollar rates stalled toward the end of November, as the decline in United States domestic rates slowed and as year-end positioning prompted some bidding for dollar funds. Early this year, rates resumed their precipitous fall in response to actual and expected declines in United States prime rates and other interest rates. By end-January, three-month rates had dropped below 8 percent, almost one half of the peak levels reached last summer.