Treasury and Federal Reserve Foreign Exchange Operations

During the six-month period under review, the exchange markets were faced with a shifting configuration of payments balances at a time when the United States economy was expanding much more rapidly than those of other major industrial countries.

Several countries that had been in serious current account deficit were making clear progress, mainly through stabilization programs, in reducing domestic inflation and restoring international balance. Growing evidence of improvement helped bolster market confidence in their currencies—particularly the pound sterling, the Italian lira, and the French franc—stimulating reversals of earlier capital outflows and previously adverse leads and lags. With these currencies now in demand, the respective central banks took the opportunity to buy dollars in the market and to rebuild their international reserves. The stabilization measures in these countries remained in force into the summer, and domestic growth slowed significantly.

Major countries that had been in current account surplus made little progress, however, toward their stated objective of reducing those surpluses. In particular, Japan's already massive current account surplus widened even further in early 1977 and set the stage for a sharp rise in the yen in the exchanges. Germany's current account surplus, while narrowing somewhat, remained large. But, since it was roughly offset by capital outflows, the mark, which had already appreciated by 9 percent since last summer, traded in a narrow range against the dollar through late spring. In general, the authorities of surplus countries faced sluggish demand at home and, although they sought to promote more rapid expansion, they were reluctant to press too hard for fear of refueling inflation.

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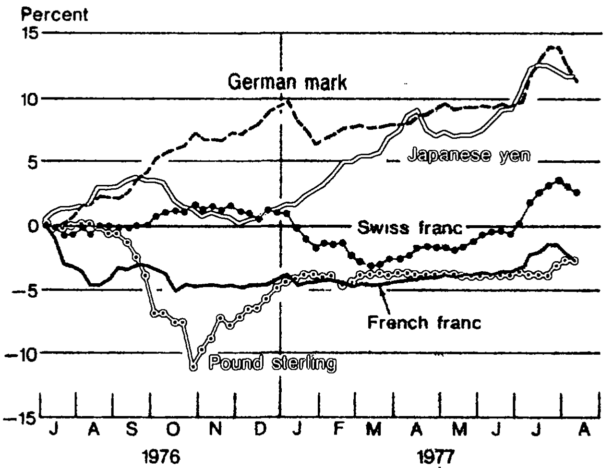
Meanwhile, the United States economy had moved into high gear in the early months of 1977. Our demand for foreign goods thus rose sharply at a time when foreign demand for American goods was growing only slightly. Consequently, our trade and current account deficits which emerged last year deepened further. Inflationary pressures also picked up in the United States, although this partly reflected temporary factors like the cold weather last winter. Even so, market sentiment toward the dollar remained generally positive. Dealers responded to a continuing flow of favorable news about the underlying expansion of the American economy. In addition, the market came to expect that short-term United States interest rates would be firming while rates elsewhere were flat or easing.

By the spring, however, the magnitude of the United States trade deficit, which reached $30 billion at an annual rate in the first half of 1977, was becoming a matter of broader concern. In part, the deficit reflected the increasing dependence of this country on foreign sources of oil, and the Administration's energy proposals making their way through the Congress were partly designed to slow the growth of oil imports over the longer term. But the deficit also reflected special

Chart 1
Selected Exchange Rates*



*Percentage deviations of weekly averages of New York noon offered rates from the average rate for the week of July 5-9, 1976

Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility July 31, 1977
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	360
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	$20,160

circumstances in other goods markets. In the context of a growing tendency toward trade restrictions abroad, the size of the deficit contributed to protectionist sentiment in many United States industries and labor unions. The Administration resisted this approach to curbing the deficit. At the same time, it began to urge countries with large current account surpluses to contribute more to the international adjustment process. In this effort, the Administration put forward a broad range of possible approaches the others could take, including more rapid expansion of their economies, the opening-up of their domestic markets to foreign competition, and the elimination of controls or administrative practices which might distort currency relationships In these discussions, it was stressed that exchange rate appreciation for the currencies of countries in current account surplus would contribute to international equilibrium. In the context of these discussions, the yen, in particular, staged its advance in the spring.

The markets for European currencies also responded nervously to comments on exchange policy by European or American officials. But these tensions largely subsided following the London economic summit in early May, since exchange rates were not mentioned in the communiqué. In late June, however, senior government officials meeting at the Organization for Economic Cooperation and Development (OECD) stated their agreement that countries with current account surpluses should allow their currencies to appreciate. In subsequent interviews with the press, government officials in various countries were pressed on their interpretation of this agreement and on their views of the appropriateness of the current constellation of exchange rates. The responses of the United States authorities were framed in the context of the broad policy objective to achieve further payments adjustment but, as their remarks were reported, the impression developed among dealers that a concerted effort was under way to lead the market.

By early July, the dollar was coming heavily on offer not only against the currencies of countries in surplus but against nearly all major currencies. As before, the central banks of the United Kingdom, Italy, and France mopped up dollars offered against their currencies, thereby limiting the rise in their exchange rates. Other currencies were bid up sharply, however, and to counter disorderly conditions several central banks, including those of Japan, Germany, and Switzerland, also bought dollars. The Federal Reserve intervened on several occasions in the New York market. After late June, the yen advanced by 3½ percent before leveling off. In Europe, the mark and the currencies linked to it rose by 3-5 percent through late July.

In the highly speculative atmosphere which developed, United States Treasury officials at first sought to avoid further comment on exchange rates but as market participants continued to respond to what had already been said, or was thought to have been said, it became necessary to dispel the impression that the authorities had been deliberately talking the dollar down. The effort to clear the air began in late July, when Federal Reserve Chairman Burns and Treasury Secretary Blumenthal in several statements stressed their belief in the importance of a strong dollar for the United States and the world generally. These statements sparked a turnaround in market psychology. Moreover, interest rates in the United States began to firm, and by the end of July dollar rates were being bid up from their latest lows against several major currencies.

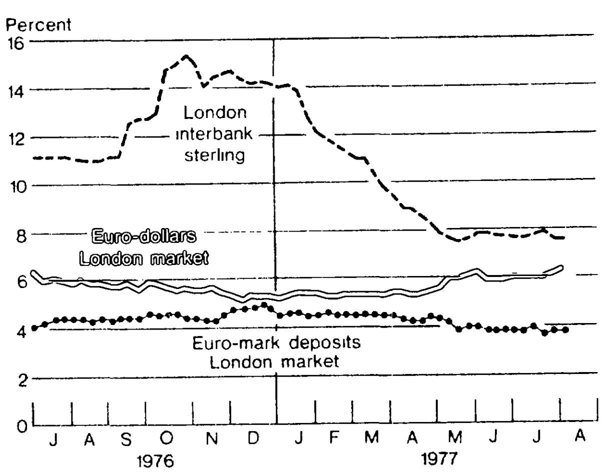
In market intervention during the February-July period, the Federal Reserve sold a total of $209.1 million of German marks, of which $173.7 million was financed from balances and $35.4 million from swap drawings on the Bundesbank, which were outstanding as of July 31. Total Federal Reserve purchases of marks from correspondents and in the market for balances amounted to $142.2 million equivalent. The System also sold $3.3 million of Dutch guilders out of balances and purchased $8.5 million equivalent from correspondents.

In addition, during the period the Federal Reserve repaid a further $287.1 million equivalent of special swap indebtedness in Swiss francs and the United States Treasury redeemed $171.7 million equivalent of franc-denominated securities. By July 31, the Federal Reserve's special swap debt to the Swiss National Bank had been reduced to $705.4 million equivalent, while the Treasury's Swiss franc-denominated obligations had been lowered to $1,341.5 million equivalent.

Chart 2

Selected Interest Rates

Three-month maturities*



*Weekly averages of daily rates

As reported in June, from last year's operations, the Bank of Mexico repaid in February a $150 million swap drawing on the Federal Reserve and prepaid in April $150 million drawn under the Exchange Stabilization Agreement with the Treasury.

Finally, in February, the United States Treasury established short-term credit facilities for Portugal totaling $300 million. The Bank of Portugal subsequently drew the full amount of these facilities and repaid $85 million by August 1.

German mark

Early in 1977, prospects for continued expansion of Germany's economy were uncertain. The worldwide lull in demand for capital goods, the deflationary measures taken in several of Germany's principal European markets, and the appreciation of the mark during 1976 had clouded the outlook for a further strong expansion in exports. At home, investment demand remained soft and unemployment remained worrisomely high. Even so, a new round of wage negotiations had paved the way for pay increases above the government's target, and the authorities were reluctant to provide additional economic stimulus lest it be viewed as inflationary.

Meanwhile, with the relaxation of last year's tensions in the exchange markets, a flow of capital out of Germany was well under way, keeping the mark near the bottom of the European Community (EC) snake following the October 1976 realignment and on offer against many other currencies. The market nevertheless remained acutely sensitive to changing interest-rate relationships—especially between Germany and the United States in view of the broader importance of the mark-dollar relationship in the international monetary system. During February, signs of congestion in the German capital market, generating expectations of a rise in German interest rates, coincided with concerns over the economic implications of the harsh winter in the United States. Thus, the mark came into demand and rose from $0 4157 on February 1 to as high as $0.4190 by the month end. To cushion the mark's advance, the Bundesbank bought modest amounts of dollars in Frankfurt, while the Federal Reserve intervened on three days when trading became unsettled in New York, selling a total of $20.9 million equivalent of marks from balances.

In early March, expectations of a further rise in German interest rates receded, after the Bundesbank announced an increase in its commercial bank rediscount quotas. But concern over an unexpectedly sharp rise in the United States trade deficit, compared with Germany's continuing trade surplus, kept dealers cautious. The mark settled around end-February levels against the dollar and remained near the lower limit of the EC band through end-March. Then, on Friday, April 1, when incomplete reports of an EC snake realignment reached the New York market after the European close but ahead of the official announcement, trading became confused. The mark was abruptly bid up to as high as $0.4204. The Federal Reserve entered the market with moderate offers of marks, selling $15.3 million equivalent from balances.

While the immediate nervousness surrounding the snake realignment soon passed, the market had been reawakened to the possibility of further exchange-rate adjustments within Europe and elsewhere. In addition, rumors began to circulate in the market that the question of exchange rates, particularly relating to the mark and the yen, would be pursued at the economic summit meeting in London on May 7-8. With the yen having already advanced in recent weeks, the late-April announcements of a sharp widening of the United States trade deficit in March and an increased German trade surplus for that month reinforced expectations of a near-term rise in the mark rate as well.

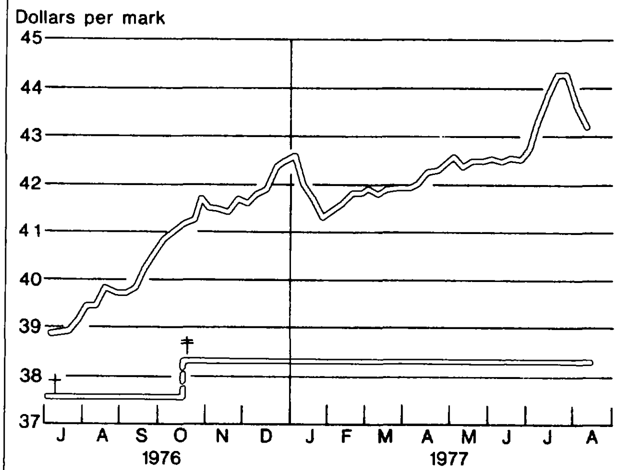
Consequently, demand for marks against sales of dollars gathered momentum in late April and carried over into early May. Moreover, strong bidding for Dutch guilders at the top of the EC snake exerted an upward pull on the mark. As the Bundesbank and the Netherlands Bank provided substantial support for the mark at its lower intervention limit against the guilder, the spot rate advanced to as high as $0.4266 in Frankfurt on May 5 just ahead of the summit. To counter disorderly conditions in New York, the Federal Reserve intervened on four trading days over April 15-May 4. In all, the System sold $34.8 million equivalent of marks. Since the mark was at the bottom of the EC snake at the time, and the guilder at the top, the Federal Reserve supplemented its operations in marks with offers of guilders, selling $3.3 million equivalent of that currency.

The broad scope of the joint communiqué issued from the London summit meeting, containing no reference to exchange rates, relaxed previous market concerns. Consequently, although Germany's trade surplus remained strong reflecting continued strength in German exports and a slowing of imports, the market's attention shifted back to an assessment of the relative economic performance and interest rate outlook for Germany and the United States. German short-term rates remained soft after the Bundesbank reduced commercial bank reserve requirements and raised rediscount quotas effective June 1 to help tide the money market over a period of anticipated seasonal tightness. By comparison, United States interest rates had firmed following Federal Reserve actions to counter a sharp rise in the United States monetary aggregates in April.

Chart 3

Germany

Movements in exchange rate*



*Exchange rates shown in this and the following charts are weekly averages of New York noon offered rates

†Central rate established on June 29, 1973

‡New central rate established on October 18, 1976

Thus, the market generally came into better balance during May and June. On May 12, however, the wire services highlighted one aspect of a speech by International Monetary Fund (IMF) Managing Director Witteveen stating that countries in a strong balance-of-payments position will have to permit their currencies to appreciate. These reports triggered a burst of demand for marks which unsettled the New York market and the Federal Reserve intervened, selling $33.5 million equivalent of marks. Again on May 26, the announcement of another sizable United States trade deficit for April generated an abrupt bidding-up of the mark, and the Federal Reserve sold $6.4 million equivalent to steady trading. But, apart from these two brief episodes, the mark traded quietly through mid-June at around $0.4240, some 2 percent above early-February levels, without intervention by either the Federal Reserve or the Bundesbank. During May and June, the Trading Desk bought from correspondents moderate amounts of marks to add to working balances.

In the weeks that followed, a number of press reports appeared which many market participants interpreted as implying that the United States government was attempting to talk the dollar down. On June 24, when trading had thinned out after the European close, the New York market was suddenly upset when the international news services reported, from the OECD ministerial meeting in Paris, that member countries with strong external positions were ready to see a weakening of their current account positions and an appreciation of their currencies in response to underlying market forces. This statement was viewed by the market as going beyond the results of the May summit and sparked an immediate rise in the mark as well as the yen. The demand gathered force once market professionals were free of their quarter-end positioning requirements, and by early July each successive advance of the yen in Tokyo was matched by a strong bidding-up of the mark rate in Europe as traders built up long positions in the German currency. By July 7, the mark had advanced over 2¼ percent to $0.4340, with the Bundesbank returning to the market for the first time since March to buy dollars

Following these operations and reports of forceful intervention by the Bank of Japan in Tokyo, the mark temporarily eased back. But market participants were soon caught up again in a crossfire of statements over the news services and editorial comment on the worsening of the United States trade deficit, the decline of the dollar, and the Administration's attitudes toward these developments. As this process was unfolding dealers saw little immediate downside risk for the mark rate, with the result that demand for marks progressively intensified. In this speculative atmosphere, the market largely ignored the Bundesbank's announcement on July 14 that it was reducing its Lombard rate by ½ percentage point to 4 percent and that it would be prepared to continue purchasing trade bills on a repurchase basis at a rate of 3¾ percent. Instead, as generalized selling of dollars persisted, the mark was bid up to a four-year high of $0.4455 by July 26 in trading that became increasingly disorderly. In response, the Bundesbank gradually stepped up its intervention, with significant dollar purchases at the daily fixings in Frankfurt. For its part, the Federal Reserve intervened in New York on nine trading days between July 8 and July 26, selling $94 7 million equivalent of marks. The System financed these sales from existing balances and from $35.4 million equivalent of drawings under the swap line with the Bundesbank.

Under these circumstances, senior United States financial officials sought to clarify United States exchange rate policy. On July 26, in answer to questions before the House Banking Committee, Chairman Burns stressed the need "to protect the integrity of our money" and observed that "depreciation of the dollar means higher prices domestically" while having "serious international repercussions". Secretary Blumenthal, in a speech in Louisville, Kentucky, emphasized that "a strong dollar is of major importance not only to the United States but also to the rest of the world". In response, dealers began to cut back their long mark positions. The dollar's recovery continued even after a record $2 8 billion United States trade deficit was announced for June. At the same time, moreover, United States interest rates had begun to firm as the Federal Reserve reacted to a sharp rise in the monetary aggregates in July. Thus, the mark began to move lower and reached $0 4378 by July 29, down 1¾ percent from its peak three days earlier but still up over 5 percent on balance for the six months In further operations in the New York market over the last days of July, the Federal Reserve sold $3.5 million equivalent of marks and purchased $14.8 million equivalent, on balance gaining partial cover for the earlier $35 4 million of swap drawings on the Bundesbank Germany's official reserves rose by $848 million in July, for a net increase of $685 million over the six-month period

Sterling

Late in 1976, the British government took further steps to curb Britain's inflation rate, which remained among the highest in Europe, to reduce its persistently large current account deficit, and to stabilize sterling following its protracted decline during much of the year. The Bank of England moved to restrict monetary expan-

Table 2

Federal Reserve System Drawings and Repayments under Reciprocal Currency Arrangements

In millions of dollars equivalent, drawings (+) or repayments (−)

Transactions with	System swap commitments, January 1, 1977	1977 I	1977 II	1977 July	System swap commitments July 31, 1977
German Federal Bank	14.9	−14 9	-0-	+35 4	35 4

sion, partly by raising its minimum lending rate to an unprecedented 15 percent and by reimposing an increasing marginal reserve requirement, the so-called "corset". The authorities sealed off a gap in exchange control regulations by prohibiting the use of the pound in financing third-country trade. And, in negotiating a $3.9 billion standby arrangement with the IMF, the government agreed to a package of fiscal restraint. As announced in December, this package included spending cuts, increased taxes, and the sale of part of the British government's holdings in British Petroleum—measures expected to reduce the public sector borrowing requirement as a share of gross domestic product from the existing 9 percent to 6 percent for the 1977-78 fiscal year. Meanwhile, the second, one-year phase of wage restraint, in place since July, was helping to slow the rise in labor costs.

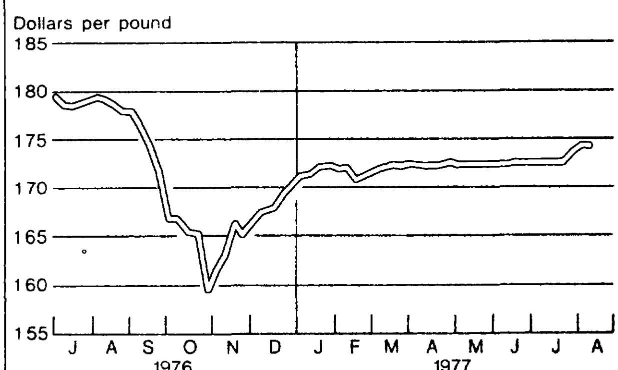
These various measures were combined with a substantial bolstering of Britain's reserve position. The $3.9 billion IMF standby was formally approved in early January 1977. Shortly thereafter, the United Kingdom authorities reached agreement with the main industrial countries over a plan, including a $3 billion backstop facility administered by the Bank for International Settlements (BIS), to alleviate pressures on sterling from sudden shifts out of officially held balances and to reduce those balances over the near term. Late in January, the British government announced a new $1.5 billion Euro-currency loan from a commercial banking syndicate.

Against this background, sterling staged a dramatic turnaround in the exchanges. Beginning in late 1976, the very indications that new fiscal and monetary restraints and international credit facilities were under serious consideration had prompted bidding for pounds. With sterling recovering, the high cost of funds in London began to squeeze out short positions and to encourage the unwinding of adverse leads and lags which had built up during months of demoralization over sterling's prospects. The running-off of outstanding third-country sterling trade credits gave an added impetus to net demand for the pound well into early 1977. The growing reflux of funds into sterling thus propelled the spot rate from its record low of $1.55 in October 1976 to just under $1.72 by early February 1977. By then, the Bank of England was absorbing large amounts of dollars from the market to add to reserves and to prevent sterling from rising to levels which it judged might prove unsustainable once the immediate demand pressures eased.

As trading conditions gradually settled down, dealers began to focus on the positive factors for sterling. By early 1977, the flow of North Sea oil was beginning to reach sizable proportions, giving credence to forecasts that the oil would provide the basis for a swing of the United Kingdom current account into substantial surplus over the years ahead. Moreover, as the sterling rate stabilized, market participants came to expect an easing of British interest rates away from crisis levels. Each new issue of government debt was met with reports of sizable bidding, from foreign as well as domestic sources, to take advantage of the currently high coupon rates and the potential for capital appreciation. Consequently, the British authorities were able to sell large amounts of government debt at progressively lower rates, and sterling remained in demand in the early spring. Through April, the Bank of England was able to buy large amounts of dollars to replenish official reserves On balance, United Kingdom reserves rose by some $3 billion between end-January and end-April.

The movement of funds into sterling, while strong and persistent, was nevertheless interrupted by occasional outbursts of selling pressure. Thus, sterling came heavily on offer in mid-February, briefly falling to as low as $1.6920 against the dollar, after news of of a record trade deficit in January and widespread press coverage of trade union opposition to a third year of voluntary pay restraint. In mid-March, another temporary spasm of selling pressure was triggered by political uncertainties that arose before the government narrowly survived a Parliamentary vote of no-confidence. And, in April, signs of a stiffening of trade union opposition to continued wage restraint again spurred some selling of sterling. On each of these occasions, however, the Bank of England stepped in promptly to avoid a significant decline in the sterling rate. In the context of the government's

Chart 4
United Kingdom
Movements in exchange rate*



*See footnote on Chart 3

broader policy commitments, the market quickly stabilized. Consequently, by early May sterling continued to hold firm just below $1.72.

In the meantime, the persistent domestic and foreign demand for British securities had resulted in a progressive decline of interest rates in London. The authorities had acted to slow the decline in view of the continuing high rate of domestic inflation and the government's debt management objectives. Nevertheless, the drop was mirrored in successive reductions in the Bank of England's minimum lending rate to 8 percent by mid-May—fully 7 percentage points below the crisis level of October 1976. With United States interest rates rising at the time, yield differentials favoring sterling placements had narrowed considerably and the market found the scope for further capital gains on investments in British securities substantially reduced. Consequently, dealers became sensitive to the possibility of a sudden unwinding of previous capital inflows. Moreover, the market was also aware that reversals of adverse leads and lags and unwinding of third-country trade finance that had buoyed the pound in previous months were by now largely completed. With sterling more vulnerable to selling pressure, concerns over the outlook for inflation surfaced once again—particularly following news of a sharp rise in retail prices in April and of the trade unions' adverse reaction to the Labor government's proposed formula, stated in the March 29 budget address, for a third year of pay restraint.

In this more bearish atmosphere, the pound came under a burst of largely professional selling after mid-May, particularly on May 24. The Bank of England responded with forceful intervention to limit the decline in sterling, helping to relieve the immediate pressures. Then, when Britain's reserve figures for May were published early the next month, the implied scale of official support impressed the market that the United Kingdom authorities were prepared to use their now ample resources to keep the exchange rate steady over the near term.

Meanwhile, recent statistics had revealed that Britain's current account was improving more rapidly than had been expected. The domestic economy remained depressed, leading to a leveling-off of imports. But also, increased North Sea oil production and sharp rises in tourist receipts and other visible earnings had brought the current account into near balance by the second quarter. Moreover, capital inflows had resumed, as interest yields again looked attractive to foreign investors, compared with placements elsewhere. The British government's June 27 sale of a portion of its British Petroleum holdings, which in the end was nearly five times oversubscribed, also drew in sizable amounts of funds from abroad. These factors contributed to an increasingly bullish atmosphere for the pound, which remained in demand. Consequently, when the dollar came on offer against other major currencies in late June and early July, market participants began to shift into sterling as well. In meeting this hot money inflow, the Bank of England allowed the spot rate to edge above $1.72 but continued to absorb most of the excess demand through heavy purchases of dollars.

Table 3

Federal Reserve System Repayments under Special Swap Arrangement with the Swiss National Bank

In millions of dollars equivalent

System swap commitments January 1, 1977	1977 I	1977 II	1977 July	System swap commitments July 31, 1977
1,051 0	−148 4	−143 6	−53 6	705 4

Data are on a value-date basis with the exception of the last two columns, which include transactions executed in late July for value after the reporting period

By early July, opposition within the trade unions to a third year of wage restraint had built up to the point where there remained virtually no hope of winning voluntary support for a limit on negotiated wage increases for another year. The Labor government modified its wage restraint strategy to seek union agreement to space out pay negotiations over twelve months, while obtaining moderate wage increases within the public sector. This outcome led to only a brief bout of selling pressure. Instead, as the dollar continued on offer, these concerns receded into the background and the movement of funds into sterling gathered renewed momentum.

As before, the Bank of England resumed purchases of dollars to avoid a rise in sterling, but the effect of this approach was to allow the pound to depreciate along with the dollar against the currencies of other major trading partners. Consequently, on July 27, the Bank of England shifted to an intervention approach keyed to a weighted average of major currencies. As soon as market participants learned that the Bank of England was abandoning its strategy of holding the pound around the $1.72 level, there was an enormous rush to buy sterling, not only out of dollars but out of other currencies as well. The pound advanced to as high as $1.7420 against the dollar, for a net rise of about 1¼ percent over early-1977 levels, and recouped part of its recent depreciation against other currencies. The Bank of England made heavy purchases of dollars to limit the rise. Mainly as a result of these and earlier acquisitions by the central bank, Britain's external reserves rose $3.6 billion during June-July to a record $13.6 billion at end-July, for an overall rise of $6.4 billion over the six-month period

Swiss franc

Last winter the Swiss economy was pulling out of recession only slowly. The continued weakness of domestic demand was reflected in a further moderation of inflation and a trade surplus—the first in twenty years—which together with large interest earnings from abroad had boosted Switzerland's current account surplus close to $3 5 billion for 1976. To stimulate a revival of business activity while also avoiding any upward pressure on the Swiss franc that might inhibit export demand, the Swiss National Bank had provided a more accommodative monetary policy. Also, to encourage a continuing outflow of capital, the authorities reinforced their capital export conversion program, whereby the proceeds of new foreign bond issues in Switzerland are immediately converted into foreign currencies at the central bank. As Swiss monetary conditions eased, interest rates moved to levels well below those in other major countries, prompting sizable outflows of capital from Switzerland. This process was magnified by a large-scale reversal of much of the hot money inflows of previous months, when funds had been shifted into Swiss francs out of those currencies—sterling, the French franc, and the Italian lira—that had been under pressure during 1976. Consequently, the Swiss franc had begun an across-the-board decline that continued well into early 1977.

In February, the market's view hardened that low interest rates would be maintained after the Swiss National Bank provided support to an undersubscribed Swiss government bond issue while releasing commercial bank minimum reserves and sterilized deposits. Foreign investors therefore continued to shift funds out of low-yielding franc assets into other currencies, now more stable and offering significantly greater rates of return. Private forecasts of a sharply lower Swiss franc over the medium term touched off further selling of francs. As a result, the Swiss franc dropped back to as low as $0 3893 by March 1, down by 2½ percent against the dollar since end-January and by 7¼ percent from its record highs of June 1976. In the meantime, the franc also lost further ground against the German mark, for an overall decline of 15 percent since the June 1976 peaks.

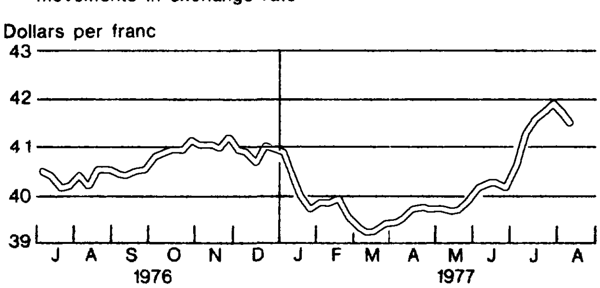
In fact, however, the Swiss economy had begun hesitantly to respond to the stimulus of rising Swiss exports and the government's economic policies. Moreover, the Swiss monetary aggregates were growing faster than targeted. To avoid an excessive monetary growth, the National Bank absorbed domestic liquidity through net dollar sales under its capital export conversion program. Early in March, it took the opportunity to sell a small amount of dollars in the exchange market. Then, as the quarter-end approached, the central bank annouced that it would provide only limited swap assistance to the commercial banks to satisfy window-dressing needs. In response, interest rates in Switzerland turned around toward the month end, capital outflows tapered off, and the Swiss franc began to firm in the exchanges. As it did, the Swiss National Bank resumed dollar purchases in the market to moderate the rise.

In April, demand for Swiss francs gathered strength as traders reacted to reports that countries, like Switzerland, with large current account surpluses were being urged to let their currencies appreciate in response to market forces. With concern also deepening over the widening trade deficit and potential for renewed inflation in the United States, the franc continued to move up. The rise in the franc was briefly interrupted in an initial reaction to news in mid-April that the Swiss Credit Bank had sustained substantial losses at its Chiasso branch in connection with irregularities in the handling of fiduciary deposits from Italy. Concerned that this news, together with closure of two small private banks in Switzerland, might cloud the reputation of Swiss banking, the authorities and the major banks worked out an agreement by early June on practices for accepting funds and on bank secrecy. In the meantime, the major Swiss commercial banks resumed their bidding for francs to improve their liquidity positions, both in the wake of the Chiasso affair and also in response to further signs of a somewhat more restrictive monetary stance by the Swiss

Chart 5

Switzerland

Movements in exchange rate*



*See footnote on Chart 3

authorities. As Swiss interest rates were bid up and German interest rates drifted lower, dealers covered their long mark-short franc positions. Consequently, the franc advanced against both the mark and the dollar, reaching $0.4029 in Zurich on June 6 before the immediate demand for franc balances began to subside and Swiss money market rates eased.

In late June, the Swiss franc was caught up in the general advance of European currencies against the dollar. Initially, after release of the OECD communiqué on June 24, it moved abruptly higher and then continued to rise during much of July, although at a somewhat slower pace than the mark. As the rate advanced, foreign companies with franc-denominated liabilities moved to acquire francs to prepay existing loans. To moderate the rise in the franc, the Swiss National Bank bought substantial amounts of dollars in the market, more than offsetting dollar sales under the capital export conversion program. Also, on July 14, the Swiss authorities cut both the discount rate and the Lombard rate by ½ percentage point each to 1½ percent and 2½ percent, respectively—a move that was timed to coincide with the Bundesbank's ½ percentage point reduction in its Lombard rate. Even so, the franc advanced to a record high of $0.4207 in European trading on July 26. Then, with the change in market sentiment toward the dollar that emerged and the firming of United States interest rates, the franc began easing back with other European currencies. It closed on July 29 at $0.4162, almost 7 percent above its March low, for a net rise of 4¼ percent since January 31.

Meanwhile, the Federal Reserve and the United States Treasury continued with the program agreed to last October for an orderly repayment of pre-August 1971 franc-denominated liabilities. The Federal Reserve repaid $287.1 million equivalent of special swap indebtedness and the Treasury redeemed $171.7 million of Swiss franc-denominated securities by end-July. Most of the francs for these repayments were acquired directly from the Swiss National Bank against dollars. But the Federal Reserve also bought francs from the National Bank against the sale of $58.9 million equivalent of German marks and $40.3 million equivalent of French francs, which were in turn either acquired in the market or drawn from existing balances. In addition, the System purchased $24.9 million equivalent of Swiss francs in the market or from other correspondents mostly in late February-early March, when the franc was weakening in the exchanges. By end-July, the Federal Reserve's special swap debt to the Swiss National Bank had been reduced to $705.4 million equivalent while the Treasury's Swiss franc-denominated obligations had been lowered to $1,341.5 million equivalent.

French franc

Following recurrent bouts of selling pressure on the French franc through much of last year, the market for francs came into better balance by early 1977.

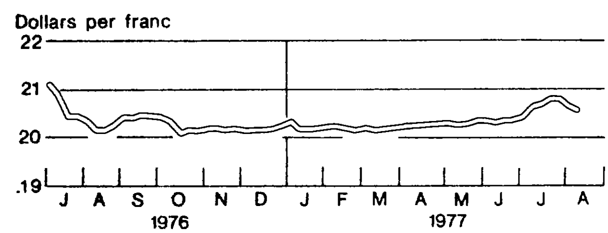
Last September, the French government introduced a wide-ranging stabilization program to deal with the underlying payments imbalance and with the adverse market psychology that had weighed on the franc. Presented by newly designated Premier Barre, the plan represented a shifting of priorities away from immediate economic stimulus toward a concerted effort to curb inflation and stabilize the exchange rate. Specific measures included a three-month price freeze, a call for wage restraint, curbs on bank lending, and a 1 percentage point hike in the Bank of France's discount rate to 10½ percent.

The market's initial response was hesitant in view of the controversial nature of some of the measures. But by early winter the pace of price and wage increases in France had slowed markedly and the trade deficit began to narrow. Also, tensions in markets for other major European currencies were easing, and traders became less fearful that a spillover of pressures from other currency markets would disrupt trading in francs. Consequently, as the market's previous extreme pessimism gradually lifted, market participants began bidding for francs to cover short positions or to reverse commercial leads and lags built up against the franc in previous months. The spot franc held firm around $0.2010 against the dollar through mid-February, while strengthening some 1½ percent against the German mark and other currencies in the EC snake. In the meantime, the Bank of France took advantage of the opportunity to buy dollars to add to foreign currency reserves

Chart 6

France

Movements in exchange rate*



*See footnote on Chart 3

Nevertheless, dealers were sensitive to political developments in France before the general elections in early 1978. With the approach of municipal elections in March, for which public opinion polls projected a swing in favor of the opposition parties of the Left, the market turned cautious and the franc again came on offer. To avoid a buildup of speculative pressures, the Bank of France resumed intervention in support of the franc, selling moderate amounts of both dollars and German marks, and operated to keep French interest rates firm in the domestic money market. Against the dollar, the spot franc eased about ½ percent from mid-February levels almost to $0.2000, while against the German mark and other EC snake currencies it declined about 1 percent. Once the immediate uncertainties surrounding the municipal elections had passed, market nervousness receded and the franc gradually regained its previous buoyancy.

In the spring, France's underlying payments position was clearly improving. Confidence in the country's external position was bolstered by the further favorable swing in the French trade account that nearly halved the late-1976 deficit and by expectations of a further moderation of inflation despite lifting of the price freeze. In this context, the high interest rates in France, compared with lower or declining interest rates elsewhere, attracted sizable inflows of interest-sensitive funds. Also, French public and private corporations continued to borrow abroad. At the same time, however, industrial production leveled off and unemployment rose somewhat. Toward the end of April, the market began to expect some easing of monetary policy and the franc softened somewhat in the exchanges Although the authorities introduced programs to increase employment in specific areas, these were to be financed by borrowings in the market, and interest rates were kept relatively firm. The franc quickly recovered and remained in strong demand through May and most of June The spot rate edged up gradually against the dollar to $0.2025 by late June, with the Bank of France continuing to take dollars into reserves.

When the dollar came under generalized selling pressure in the exchange markets beginning in late June, the franc joined in the upswing of major European currencies. It was bid up a further 3 percent to a late-July peak of $0.2086, some 3¾ percent above early-February levels, even as the Bank of France continued to buy sizable amounts of dollars to moderate the rise of the franc rate. But, as the franc did not keep pace with the continued advance of the German mark, the French central bank also sold modest amounts of marks to cushion the decline in the franc rate against the German currency. Toward the end of July, however, the franc began to settle back against the dollar following statements by United States officials emphasizing the need for a strong dollar and Premier Barre's remarks that the dollar had become undervalued *vis-à-vis* the French franc and other European currencies. As a result, by the month end the franc rate had eased to $0.2050, to close the six-month period up 1⅞ percent on balance against the dollar. Against the German mark, the franc regained some of the ground it had lost but still closed the period some 3½ percent lower on balance.

Italian lira

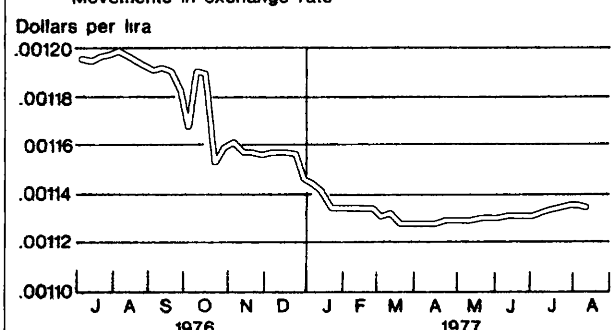
By early 1977, Italy's minority government had gathered sufficient support to implement many elements of its comprehensive stabilization program. Steps had been taken to bring the public sector deficit under control through spending cuts, tax increases, and higher prices for public services. The Bank of Italy had reinforced its restrictive monetary policy by raising its discount rate to 15 percent and by imposing limits on bank lending. Even so, the authorities' efforts to negotiate modifications in Italy's wage indexation system—wages had risen over 25 percent in 1976, as against price rises of some 21 percent—gained little headway. Consequently, negotiations with the IMF over a new stand-by arrangement, which would provide Italy with $530 million of new IMF credit and assure the availability of a further $500 million from the EC, were delayed until more of the government's anti-inflationary package was in place.

At first the lira had been stabilized by strict exchange controls as well as by a repatriation of funds in response to an amnesty on previous illegal outflows by Italian residents. Gradually the tight credit condi-

Chart 7

Italy

Movements in exchange rate*



*See footnote on Chart 3.

Table 4

Drawings and Repayments by Foreign Central Banks and the Bank for International Settlements Under Reciprocal Currency Arrangements

In millions of dollars; drawings (+) or repayments (—)

Banks drawing on Federal Reserve System	Outstanding January 1, 1977	1977 I	1977 II	1977 July	Outstanding July 31, 1977
Bank of Mexico	150.0	—150 0	-0-	-0-	-0-
Bank for International Settlements (against German marks)	-0-	-0-	+35 0 —35 0	-0-	-0-
Total	150 0	—150 0	+35 0 —35 0	-0-	-0-

tions in Italy and the greater stability of the rate following the 25 percent depreciation in 1976 also tended to encourage flows into the lira. As demand for lire mounted, the spot rate leveled off around $0.001134 (Lit 882). The Italian authorities took the opportunity to buy dollars in the market to rebuild their foreign exchange reserves to $3.3 billion by end-January.

While many of these demands for lire continued into February and March, the unwinding of a 50 percent import-deposit scheme and dismantling of other exchange controls imposed in 1976 exposed the lira to occasional selling pressures. In late-March, following the outbreak of student rioting over government policies and of workers' strikes over proposed changes in the wage-indexation system, the spot rate declined by about ½ percent to $0.001127 (Lit 887). To contain these pressures the Bank of Italy intervened forcefully. Its official dollar sales were partly reflected in a decline of about $300 million in exchange reserves through end-March.

By this time, the Italian government had come closer to reaching agreement with the IMF on the terms of a letter of intent to support Italy's request for a standby facility. In this connection, the authorities extended commercial bank lending ceilings through March 1978, gained trade union and legislative approval for a compromise proposal for amending the wage indexation system, and raised indirect taxes to finance a reduction in employers' social security contributions. As released on April 14, the IMF letter of intent also projected further cuts in public spending to reduce the budget deficit, a lowering of the inflation rate to 13 percent by March 1978, and a swing into current account surplus next year.

This reinforcement of Italy's stabilization effort was welcomed in the market. In late April and May, reversals of previous outflows resumed. With domestic interest rates remaining high and regulations still in force encouraging Italian exporters to seek foreign sources of finance, Italian banks and companies increased their borrowings abroad. In addition, the net reflux of hot money increased sharply following disclosures by Swiss banks of irregularities in dealings with Italian residents' funds. The passing of the period of seasonal weakness in current payments gave additional buoyancy to the market. Taken together, these forces generated substantial bidding for lire. The spot rate rose only slightly, however, as the Bank of Italy continued on balance to buy substantial amounts of dollars to add to reserves.

By early June, the stabilization measures were clearly taking hold. The rate of inflation had moderated. The current account deficit had narrowed significantly, albeit at the expense of a considerable slowdown in the domestic economy. Moreover, tight controls on bank credit had kept domestic lending in check. Consequently, the Bank of Italy was able to begin easing domestic interest rates from crisis levels by cutting its discount rate by 2 percentage points to 13 percent. Interest differentials nevertheless remained favorable for Italy, and a net inflow of short-term funds continued. By then, the possibility of further declines in Italian interest rates was prompting some Italian residents to repatriate funds in anticipation of capital gains on new issues of Italian Treasury bills and notes.

Beginning in late June, demand for lire swelled further, partly on the seasonal rise in tourist receipts but also in connection with the general strengthening of European currencies against the dollar. The lira rate advanced only to $0.001135 (Lit 881), however, as the Bank of Italy continued to absorb dollars. In all, from April through July, Italian exchange reserves rose by $4.1 billion to $7.1 billion, even with a repayment in July of previous drawings from the IMF.

EC snake

Following recurrent episodes of heavy speculation throughout 1976, the countries participating in the European currency arrangement—Germany, the Benelux countries, Sweden, Denmark, and Norway—agreed in October on a realignment of exchange rate parities whereby the German mark was adjusted upward by 2 percent while the Scandinavian currencies were adjusted downward by 1 to 4 percent. These readjustments to offset disparities in relative inflation rates and economic performance among the participating countries relieved market tensions and triggered a reversal of the earlier speculative flows. As a result, the German mark fell to the bottom of the EC snake and through March 1977 the member currencies traded comfortably within the snake's 2¼ percent limits without any particular strains.

By that time, however, the Swedish krona had eased to near the bottom of the band in response to Sweden's still relatively high inflation rate and deepening current account deficit. As part of a program that the Swedish authorities adopted to reverse the decline in export competitiveness and to avoid an outbreak of speculative selling of Swedish kronor, a new realignment was agreed upon, implying a 6 percent devaluation of the krona within the joint float. The Danish and Norwegian kroner were also devalued, each by 3 percent, as part of the realignment. When reports of this realignment leaked out on Friday afternoon, April 1, ahead of the official announcement, traders in New York were taken by surprise and became reluctant to make markets in these currencies until details of the parity changes were made available. Once trading resumed on Monday, April 4, however, the market easily adjusted to the new rate relationships. The Swedish krona, after depreciating somewhat less than the change in its central rate, began to benefit from inflows of funds and traded firmly near its new upper intervention limit against the mark, which remained at the bottom of the band. The Danish krone and Norwegian krone also stabilized in the upper half of the realigned band, pressing at times on their upper limits against the mark when conversions of external borrowings buoyed their exchange rates.

Market participants nevertheless remained sensitive to further possible changes in exchange rate relationships within the snake. As the May 7-8 London economic summit drew closer, dealers came increasingly to believe that a readjustment might emerge as part of a more comprehensive agreement to allow currencies bolstered by strong current accounts to appreciate. Market attention focused on the Dutch guilder which had traded near the top of the joint float since the previous autumn and was generally expected to firm in the exchanges. The guilder came into increasingly intense demand, frequently reinforced by foreign purchases of Dutch securities which offered yields that were relatively favorable in comparison with those available in Germany. By late April, the guilder was being pressed at its upper intervention limit against the mark, even as the mark itself was rising against the dollar. To maintain the EC snake limits, the Netherlands Bank and the German Bundesbank bought sizable amounts of marks against sales of guilders in their respective markets. The Dutch central bank also bought a large amount of dollars in Amsterdam. Trading in New York became unsettled at times and, on May 4, the Federal Reserve supplemented its intervention in marks by selling $3.3 million equivalent of guilders from balances.

On the following day, the Netherlands Bank responded to the buildup of speculative demand for guilders by announcing a 1 percentage point cut in its discount rate to 3½ percent, a move immediately interpreted in the market as a signal of Dutch commitment to present snake currency relationships. Consequently, the pressures within the band began to recede. When the London summit meeting ended without any changes in exchange rate relationships, the guilder backed away from its upper intervention limit against the mark. Later on, figures were released showing that the Netherlands' large current account surplus had virtually disappeared during the first quarter of 1977. Signs of some acceleration of Dutch inflation also diminished bullish market sentiment toward the guilder. Thus, as short-term interest rates in the Netherlands continued to decline to levels well below comparable rates in Germany, the guilder eased against the mark and the entire band contracted.

Tensions reemerged within the snake during June

Table 5

United States Treasury Securities
Foreign Currency Series
Issued to the Swiss National Bank

In millions of dollars equivalent, issues (+) or redemptions (−)

Amount of commitments January 1, 1977	1977 I	1977 II	1977 July	Amount of commitments July 31, 1977
1,545.7	−84 6	−85 8	−33 7	1,341 5

Because of rounding figures do not add to totals.

Data are on a value date basis with the exception of the last two columns which include transactions executed in late July for value after the reporting period and July, however. Following the outcome of protracted wage negotiations in Sweden, talk intensified of a further devaluation of the krona to offset the impact of rising unit labor costs on price competitiveness. Fairly heavy selling of the Swedish krona and other Scandinavian currencies built up, especially before each weekend. The sharp rise in the German mark against the dollar that quickly gathered momentum in late June and early July exceeded that of the other joint float currencies, and the mark soon moved up to the top of the band. The guilder and the commercial Belgian franc, pulled up by the mark's rise, traded comfortably within the EC snake. But the Scandinavian currencies, while still rising against the dollar, lagged behind. To keep their currencies above the lower limit of the snake, the central banks of Sweden, Denmark, and Norway therefore continued to intervene, principally through sales of dollars in the market. Nevertheless, these pressures persisted, leading ultimately to Sweden's withdrawal from the snake and a further realignment of the remaining currencies late in August.

Japanese yen

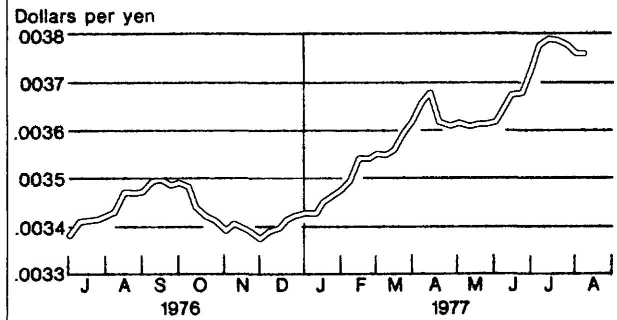
By early 1977, Japanese exports were again rising strongly as a result of the reacceleration of economic growth in the United States and buoyant demand elsewhere for Japanese products. However, demand within Japan remained generally weak. Business investment was particularly sluggish as Japanese industrialists, still trying to come to grips with the severe dislocations of recent years, viewed the longer term outlook for economic growth with unusual caution. The actual and expected weakness in domestic demand, in turn, exerted a powerful drag on Japanese imports The combination of strong exports and stagnant imports produced a further widening of Japan's trade and current account surpluses, already at record levels last year.

The Japanese authorities had moved to stimulate the economy, through some easing of fiscal policies, but they had proceeded with caution in view of the continuing high rate of domestic inflation, and the Bank of Japan had kept its discount rate at 6½ percent. Once uncertainties in December over Japanese elections and the magnitude of a new OPEC oil price rise passed, market sentiment in the exchanges turned increasingly bullish toward the yen. Bolstered by the large current account surplus and inflows of interest-sensitive funds from abroad, the yen rebounded sharply from its December lows. After having intervened forcefully to support the yen in its previous decline, the Japanese authorities refrained from intervention as the rate rose by about 3 percent against the dollar to $0.003470 (¥288) by end-January.

Chart 8

Japan

Movements in exchange rate*



*See footnote on Chart 3

By early February, the magnitude of Japan's current account surplus was attracting international attention. Statements by Japanese government officials, as well as by economists and officials abroad, had already focused on the need for global adjustment of current account imbalances. In addition, the press reported that some countries were taking steps to limit imports of specific Japanese products. In this environment, dealers moved to lengthen yen positions and commercial leads and lags shifted more heavily in Japan's favor on expectation of a further rise in the yen. As a result, the yen advanced strongly, breaking through the ¥280 level following the March 19-20 weekend meeting between Prime Minister Fukuda and President Carter. Further public statements by Japanese officials assured the market that the authorities would continue to intervene only to counter erratic fluctuations in the exchange rate. Consequently, the yen was bid up further, to as high as $0.003700 (¥270.3) by April 12, even as the Bank of Japan intervened increasingly forcefully.

With the yen now at a three-year high, dealers became increasingly cautious. At that time, the United States Customs Court ordered the Treasury to impose import duties on Japanese electronic products (a decision which was appealed) and the British government imposed a provisional tariff on certain types of steel from Japan. Moreover, the boost of the Japanese economy provided during the first quarter by the buoyant export sector had failed to spark a broadly based and self-sustaining recovery. Consequently, when the Bank of Japan acted to provide further impetus to the economy by cutting the discount rate for the second time in two months to 5 percent, effective April 19, dealers began to take profits on their yen positions. The subsequent lowering of short-term money market rates and commercial bank prime rates reduced incentives for further short-term flows into Japan. Commercial leads and lags were reversed, and Japanese borrowings abroad tapered off. Thus, the yen eased to as low as $0.003593 (¥278.3) on April 26, while the Bank of Japan sold dollars to moderate the decline. The yen firmed slightly ahead of the May 7-8 London summit. Thereafter, with United States money market rates now having risen somewhat, the yen settled back in subdued trading through late May.

In June the Japanese Finance Ministry announced a gradual liberalization of Japanese exchange controls governing flows both in and out of Japan. With respect to inflows, the authorities eased limitations on conversions of foreign funds and increased the accessibility of the Japanese money market to foreign investors. With respect to outflows, controls were lifted on short-term overseas lending by Japanese banks and Japanese resident purchases of foreign-currency bonds. The amount of foreign currency Japanese tourists may take abroad was raised. Also, regulations governing foreign bond issues in Tokyo were liberalized. Initially, the market's response to the changes in capital controls was muted. But, by mid-June, Japanese interest rates had begun edging back up from the lows reached in May while United States short-term interest rates had leveled off. Thus, as the yen began to move up again, the market came to the view that the liberalization of exchange restrictions would permit larger inflows of capital to Japan.

Against this background, the OECD meeting and subsequent communiqué on June 24 provided the catalyst for a renewed surge in the yen rate. Reports that the finance ministers had agreed that countries with current account surpluses were ready to see an appreciation of their currencies in response to underlying market forces triggered immediate demand for yen. Subsequent statements by government officials in the United States and Japan were interpreted as confirming this view. In addition, rumors circulated in the Tokyo market that Japan might accept the United States Treasury's suggestion at the OECD meeting and sell its interest earnings on existing reserves in the exchanges. Propelled by professional and commercial demand from around the world, the yen continued to advance through late June and early July to as high as $0.003800 (¥263) on July 11. By that time, however, Japanese businessmen were expressing concern over the rise in the rate. Moreover, the Bank of Japan had reentered the market to purchase a substantial amount of dollars to check a further sharp appreciation of the yen. Thereafter, the yen rate settled back in quieter trading to $0.003754 (¥266.4) by the month end, for a net rise of 8 percent over the six-month period and 11¾ percent from its lows of last December. Japanese official reserves rose by some $1¼ billion to a level of nearly $18 billion between end-January and end-July.

Canadian dollar

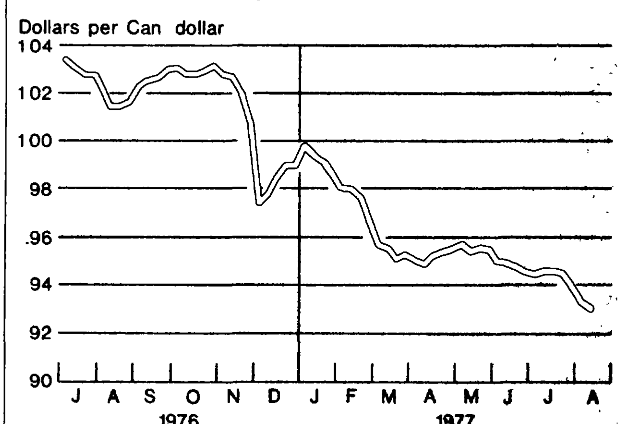
Throughout 1976, Canadian economic policy had been directed at curbing inflationary pressures, while permitting expansionary forces to work through the economy gradually. By early 1977, broad monetary and fiscal restraint, together with a wage-price control program, had helped to bring the underlying rate of inflation down toward the declared target of 6 percent. But opposition to the government's wage-price program was gathering strength in both business and labor circles, and the immediate prospects for a further reduction in the inflation rate were clouded by sharply rising food prices. At the same time, economic recovery in Canada had come to a virtual standstill. As a result, the rate of unemployment had begun to edge up again, particularly in areas like Quebec and the Maritime Provinces. Moreover, the growth in monetary aggregates had fallen below the Bank of Canada's targets and short-term interest rates were progressively lowered, narrowing the favorable interest rate differential relative to the United States. Successive cuts in the Bank of Canada's discount rate to 8 percent by February 1 were viewed as confirming the downtrend in Canadian short-term interest rates.

In addition, the election last November of a separatist party government in Quebec, committed to establishing independence for the province, raised doubts about the receptiveness of new Canadian, particularly

Chart 9

Canada

Movements in exchange rate*



*See footnote on Chart 3.

Quebec, issues in international capital markets. Foreign placements had been expected to reach levels that would more than offset Canada's continuing current account deficit of some $4 billion per annum. But, in early 1977, the two major bond-rating agencies in the United States were reassessing their evaluations of certain Quebec borrowers. In the interim, some scheduled Canadian issues in the New York bond market were either withdrawn or postponed. With the prospects for conversions of borrowing proceeds correspondingly scaled down, the Canadian dollar became vulnerable to adverse swings in market sentiment.

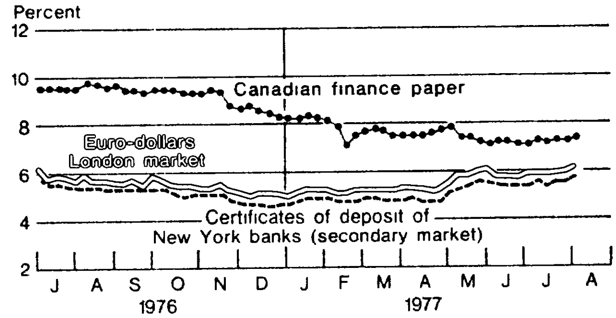
In this unsettled market atmosphere, the Canadian dollar, which had already dropped some 4¼ percent in just three months, again came on offer in late January and then fell off sharply during February. In the absence of any sizable conversions of foreign issues by Canadian borrowers, the decline met little resistance in the market. Thus, the downslide quickly accelerated as commercial leads and lags gradually shifted against the Canadian dollar, and market professionals built up substantial short positions against the currency. Concern that the government's April 1 budget would be expansionary to address the unemployment problem and publication of private forecasts suggesting a sharply lower Canadian dollar rate magnified the selling pressure even more. Consequently, the Canadian dollar dropped 4 percent, from $0.9825 at the end of January to as low as $0.9430 by April 1. The Bank of Canada intervened on both sides of the market to maintain orderly trading conditions, with official reserves declining by $585 million during February and March.

In April, market pessimism lifted somewhat as it became clear from the Federal budget that the government was not significantly loosening the restrictive tone of fiscal policy. By this time, too, Moody's Investors Service had announced that it was maintaining its current rating on Quebec bonds. In the wake of that announcement, indications of a pickup in foreign borrowings by Canadian provinces and public authorities began to emerge, including a $300 million credit raised by the Province of Quebec in the Euro-currency market. In addition, figures were released showing a strong trade surplus for Canada in the first quarter, as Canadian exports benefited from the vigorous expansion of the United States economy. Thus, the Canadian dollar market gradually came into better balance. The spot rate edged up to trade narrowly around $0.9535 through mid-May. The Bank of Canada therefore operated less heavily than before, taking in dollars on balance as reflected in the $137 million reserve increase during April-May.

Chart 10

Interest Rates in the United States, Canada, and the Euro-dollar Market

Three-month maturities*



*Weekly averages of daily rates

During the remainder of the period, however, underlying concerns over Canada's political outlook and economic performance dominated market psychology. Market participants followed closely the debate over the issue of Quebec separatism. At the same time, with the unemployment rate still hovering around 8 percent, the market expected the Canadian authorities to adopt more stimulative policies even though inflation was starting to pick up again. Interest differentials favoring Canada had by then narrowed significantly following another ½ percentage point Canadian discount rate cut and the run-up of short-term United States interest rates in early May. Moreover, estimates of the volume of new Canadian issues abroad were scaled down.

In this atmosphere, a gradual buildup of professional selling, combined with the end-June clustering of royalty and debt service payments to nonresidents, pushed the spot rate down to $0.9425 where it traded somewhat unsteadily through mid-July. In late July, the Canadian dollar again came on offer. By that time, United States short-term interest rates were beginning to rise. Moreover, on July 25, the Canadian government indicated that it now appeared that its 6 percent per annum target for inflation would not be met. In a renewed burst of commercial and professional selling, the spot rate fell to just above $0.9350. On balance, the Canadian dollar declined by some 4¾ percent between end-January and end-July, thereby extending the decline that had begun late in 1976 to 9 percent. Over the six months, Canadian reserves, declined by a net $670 million.

Mexican peso

By early 1977, Mexico was beginning to recover from the financial crisis of the previous autumn, which had resulted in a precipitous drop of the peso in the exchange markets. Following the inauguration of President López Portillo in December, the new administration sought to revive public confidence, pledging to reduce the government deficit and to encourage the growth of the private sector. An important agreement was struck with the trade unions, limiting the rise in wages in 1977. The Mexican authorities also ratified the October 1976 agreement with the IMF which could provide Mexico with more than $600 million in credits over a three-year period. These initial efforts were welcomed by the business and financial community in Mexico and abroad, leading to a reflux of funds into the peso. Nevertheless, the reversal was incomplete as many market participants awaited firmer evidence of improvement in the underlying situation. By early February the peso had settled at around $0.0450 in New York, some 44 percent below the prefloat level.

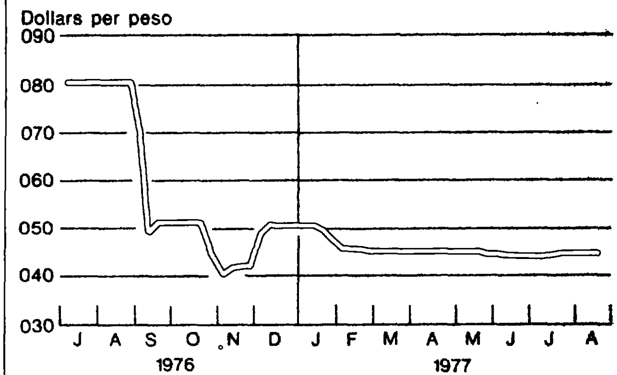
Coming into the spring, Mexico's economic indicators showed that the painful process of adjustment was under way. The burst of inflation of late last year, reflecting in part the sharp decline of the peso, was tapering down. Imports were at a lower level than before the peso depreciation, largely reflecting a contraction of industrial production and a slowdown in public investment spending. At the same time, export receipts were rising in response to the speedup of growth in the United States, the increasing flow of Mexican oil production into world markets, and higher coffee and other agricultural prices abroad. As a result, Mexico's trade and current account deficits narrowed markedly, reducing the need for new international borrowing by Mexican entities. With the market thus in better balance, the peso continued to move narrowly. The Bank of Mexico liquidated at maturity the $150 million drawn under the swap line with the Federal Reserve in November 1976. In April, it repaid the remaining $150 million in drawings under the Exchange Stabilization Agreement with the United States Treasury.

Through the spring and early summer, the Mexican authorities reinforced the stabilization program by means of a series of financial and administrative reforms to improve the efficiency of the banking system and to strengthen monetary control. In April, the structure of differential reserve requirements was simplified, with the effect of lowering the net reserve requirement and providing the commercial banks with increased lending capacity. In May, the previous system of administered interest rates was replaced by rate ceilings, which were set above the earlier levels, and the Bank of Mexico pledged to seek to encourage interest rate levels compatible with underlying economic forces. In July, the authorities began to introduce a program in which companies would be able to borrow pesos from Mexican commercial banks against the collateral of an interest-bearing dollar deposit with the lending bank. The central bank would impose a 100 percent reserve requirement on this deposit while rediscounting the peso loan. This program was thus a means of expanding credit to the private sector while replenishing international reserves.

Chart 11

Mexico

Movements in exchange rate*



*See footnote on Chart 3

Meanwhile, although market concerns over the outlook for the peso surfaced from time to time, the exchange rate held fairly steady. By summer, Mexico's economic performance continued to show signs of improvement, as industrial production was beginning to revive and exports remained strong. Moreover, a scaling-up of estimates of Mexico's proven oil reserves strengthened expectations that rising oil exports would substantially improve Mexico's current account position. As investor caution gradually receded, new Mexican foreign borrowings linked to the development of oil resources were well received in international capital markets. Thus by end-July, the peso held at $0.0437 for little net change over the six-month period. Reflecting the improving sentiment for the peso during that time, the discount on three-month forward pesos in New York narrowed from some 37 percent to 20 percent.