August 1977-January 1978 Semiannual Report
(This report was released to the Congress and to the press on March 8, 1978)

Treasury and Federal Reserve Foreign Exchange Operations

During the six-month period under review, the United States dollar came under generalized selling pressure in increasingly disorderly exchange market conditions. By the end of January, the dollar had declined against a broad spectrum of major currencies, falling a net 21 percent against the Swiss franc, 10 percent against the Japanese yen, 8 percent against the German mark and currencies linked to it in the European Community (EC) "snake" arrangement, and 12 percent against the pound sterling. The decline was smaller against the French franc, by 3 percent, and the Italian lira, by 1½ percent. As exceptions, the dollar rose some 3½ percent against the Canadian dollar and 6 percent against the Swedish krona.

The depreciation of the dollar came in the context of deepening concern over the lack of progress in resolving serious economic imbalances among major industrial nations. The United States had swung into record trade deficit from $9 billion in 1976 to $31 billion in 1977 as a whole. Correspondingly, the United States current account deficit widened from $1 billion in 1976 to $19 billion in 1977. This deterioration reflected not only an increasing dependence on foreign oil to complement domestic energy sources but also the more rapid economic growth in the United States than abroad. By contrast, among the other industrial countries Japan's massive trade and current account surplus continued to mount partly for structural reasons and partly for the lack of sufficient domestic demand to boost imports. Germany, too, remained in substantial trade and current account surplus while experiencing a disappointingly slow pace of economic growth. While other European countries made progress in their efforts to curb previously high inflation rates and large payments deficits, real growth in their respective economies also tapered down.

As the size of these imbalances became apparent during the summer, market participants became increasingly apprehensive about the prospects for the dollar. Concern focused on the net supply of dollars coming on the market as a result of the current account deficit itself. With so many industrial countries suffering from a combination of high unemployment and low profits, protectionist sentiment became increasingly vocal, thereby underscoring the need for early action to redress these imbalances if an increasingly restrictive environment for trade was to be avoided. In the event other adjustment policies were not adopted here or abroad, dealers were fearful that exchange rates would ultimately emerge as the means of achieving adjustment.

Late in July, Chairman Burns and Secretary Blumenthal had stressed their belief in the need for a strong dollar for the United States and for the world generally. A healthy expansion of the United States economy was well under way. And, as United States authorities had pointed out, United States goods had generally retained their price competitiveness in interna-

A report by Alan R Holmes and Scott E. Pardee.
Mr. Holmes is the Executive Vice President in charge of the Foreign Function of the Federal Reserve Bank of New York and Manager, System Open Market Account. Mr. Pardee is Vice President in the Foreign Function and Deputy Manager for Foreign Operations of the System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

tional markets, and our inflation rate—while still uncomfortably high—was among the lowest in the world. To be sure, further action was still required in controversial areas. Legislation was before the Congress for an energy program that could reduce oil imports. United States officials continued their efforts to persuade other governments to promote more rapid growth of their economies and thereby to take on more of the burden of adjustment. Moreover, the Administration faced hard bargaining in containing protectionist pressures at home while seeking to negotiate a further reduction of restrictive trading practices abroad. But, on exchange rate policy, United States authorities, reaffirming the philosophy that dollar rates should move in line with economic fundamentals, felt assured that a strong, noninflationary domestic economy would help keep the dollar strong.

These assurances, and a firming of United States interest rates in early August, tended to settle the markets through the rest of the summer. This enabled the Federal Reserve to repay the modest amount of swap debt in German marks incurred in July. Otherwise, Federal Reserve operations in the exchange markets were minimal through late September.

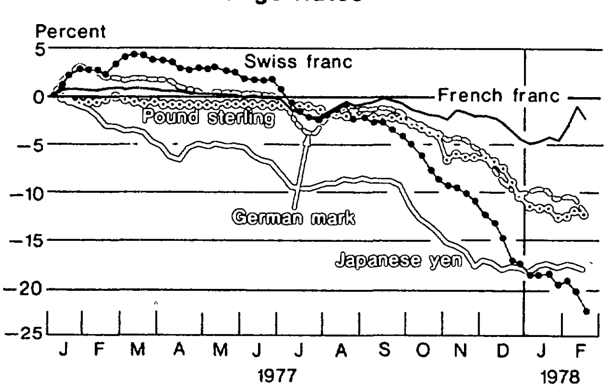
By that time, however, the energy bill had bogged down in the Congress. Moreover, recent indicators showed that economic growth had slowed in several foreign countries. Although new stimulative measures were announced in Japan, Germany, and elsewhere, they were expected to have little effect before 1978. And, taking those measures into account, many public and private forecasters saw little prospect for an early improvement for the United States trade deficit. These concerns came to a head during the annual meeting of the International Monetary Fund (IMF) and the World Bank, in late September, where financial officials thrashed out the whole range of economic policy issues but emerged with little apparent consensus on what to do next.

Reports from these meetings triggered an immediate reaction in the markets. In view of Japan's huge trade surplus, the yen came into renewed demand. The Swiss franc, the traditional haven in times of uncertainty, also came into heavy demand. The flow of funds into sterling, already huge throughout most of 1977, became even larger. Demand pressures soon spread to the German mark and other European currencies. Although circumstances varied for individual currencies, the dollar was generally on offer through most of the last three months of 1977.

With currencies being dealt around the clock in Asia, Europe, or North America, unsettled conditions in any one market tended to spill over into the others. The further the dollar fell, the greater was the shift out of dollars into other currencies through speculative positioning, commercial leads and lags, and hedging operations. In addition, traders were sensitive to recurring reports of substantial portfolio diversification by private and official dollar holders. Under such circumstances, the exchange market became increasingly one way and

Chart 1

Selected Exchange Rates*

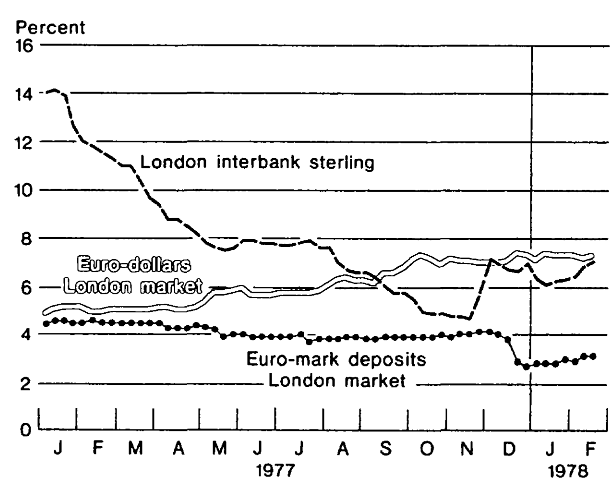


* Percentage deviations of weekly averages of New York noon offered rates from the average rate for the week of January 3-7, 1977.

Chart 2

Selected Interest Rates

Three-month maturities*



*Weekly averages of daily rates.

Table 1
Federal Reserve Reciprocal Currency Arrangements
In millions of dollars

Institution	Amount of facility January 31, 1978
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

unresponsive to economic fundamentals. Movements in exchange rates were abrupt, bid-asked spreads widened, and market professionals were increasingly unwilling to take dollars offered to them into their positions even for brief intervals. In response, foreign central banks continued to intervene in their respective currency markets. For its part, the Federal Reserve intervened frequently and on an increasing scale in the New York market.

Meanwhile, officials were convinced that policies already adopted or soon to be put in place here and abroad would, in time, substantially reduce the imbalances that concerned the market. The pressing need was to deal effectively with the disorder in the exchange market and thereby to provide breathing room both for the measures to take effect and for market participants to take stock of fundamentals. In a statement on December 21, President Carter announced several measures to reduce United States imports of oil and to stimulate exports, and stressed that the United States authorities would intervene to the extent necessary to counter disorderly conditions. In early January, the United States authorities followed up with several measures to restore a sense of balance to the exchanges. On January 4, the Federal Reserve and the United States Treasury announced that the Treasury had entered into a new swap arrangement with the German Bundesbank and that this facility, together with the Federal Reserve swap network, would be actively utilized to check speculation and to restore order in the exchange market. Beginning that afternoon, the Federal Reserve's foreign exchange Trading Desk shifted to a more open and forceful approach to the market than it had used in previous months. On January 6, the Board of Governors of the Federal Reserve System approved a ½ percentage point discount rate increase, specifically on international considerations, and the Federal Reserve's domestic Trading Desk under instructions from the Federal Open Market Committee acted to firm money market conditions somewhat.

These steps, coming in the context of continuing debate on virtually all of the other issues that had troubled the exchange market for months on end, at first received a mixed reaction. Although the dollar staged a brief initial rally, it came heavily on offer again the following week. The New York Federal Reserve, in close consultation with the Bundesbank, continued to intervene forcefully. These mark sales were financed by drawings in equal amounts on the System and Treasury swap lines with the Bundesbank.

By mid-January, the intervention was beginning to take effect, and the exchange market gradually came into better balance. In fact, with the market settling into active two-way trading, the Desk did not intervene for several days running for the first time since November. And, thereafter, intervention was limited to modest amounts in German marks and, for the first time since 1975, in Swiss francs.

In sum, for the period August 1, 1977-January 31, 1978 covered by this report, the Federal Reserve sold a total of $1,310 5 million equivalent of marks. It repaid $35.4 million equivalent of previous drawings in marks on the Bundesbank and drew a total of $1,251.2 million equivalent to finance operations during the period. The remaining sales were financed from balances. United States Treasury sales of marks after January 4 amounted to $407 4 million equivalent, financed by drawings on its swap arrangement with the Bundesbank In addition, in intervention during the period, the Federal Reserve sold $18.9 million of Swiss francs drawn under the swap arrangement with the Swiss National Bank Otherwise, as detailed in the Swiss franc section, the Federal Reserve repaid $235 3 million equivalent and the Treasury repaid $223.5 million equivalent of Swiss francs from obligations remaining from August 1971.

German mark

In contrast to the solid economic expansion under way in the United States, the growth of output in Germany was losing momentum by midsummer 1977. New orders from abroad were lower, partly reflecting the generally slack conditions elsewhere in Western Europe and partly in response to the previous appreciation of the mark against most major currencies. In addition, German firms were reluctant to invest in new plant and equipment in view of uncertain prospects for sales, particularly in export markets, and because of postponements in the face of environmental protests of major public investment projects that had been intended to provide fiscal stimulus. Monetary policy remained fairly accommodative. The monetary aggregates were growing somewhat more rapidly than targeted, and bank lending expanded vigorously as interest rates declined. But by early August a public debate had emerged on the need for further fiscal impetus for the domestic economy. On the external side, Germany had been identified by its trading partners as a major current account surplus country that, it was hoped, would increase domestic demand, thereby boosting imports and helping relieve strains on the payments balances of other countries.

As talk about stimulative measures emerged in Germany during August and early September, exchange market participants turned generally cautious toward the mark. By that time, also, United States reassurances on exchange rate policy, along with a firming of United States interest rates, had contributed to an easing of the mark from the highs it had reached in late July. In all, the decline was some 4 percent to a low of $0.4268 in mid-August. The Federal Reserve took the opportunity to acquire marks in the market and from correspondents, which were used in part to liquidate the $35.4 million equivalent of swap drawings on the Bundesbank incurred when the market was unsettled in July. When the New York market turned nervous prior to the announcement of United States trade figures on August 24, the Federal Reserve sold $8 million equivalent of marks out of balances. Otherwise, the Federal Reserve refrained from intervening through August and most of September.

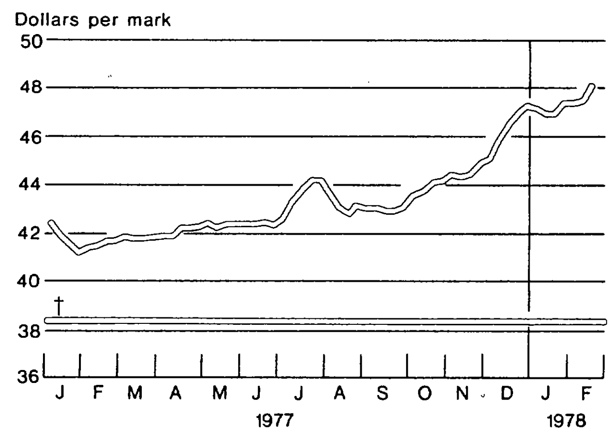
Meanwhile, the German authorities acted to give an additional boost to the economy. On August 25, the Bundesbank announced a reduction in commercial bank reserve requirements and higher rediscount quotas for the banks. In the context of a further firming of interest rates in the United States in late August and early September, these measures increased the interest differential to 1-2 percentage points per annum in favor of placements in dollars as against marks. Moreover, on September 14, the German government announced a package of measures designed to inject an additional DM 12 billion (nearly 1 percent of gross national product) into the economy through the end of 1978. This package included tax relief, particularly to encourage business investment, and increased public sector expenditures. Even so, current indicators were still revealing the extent to which the German economy had slowed, and many of the proposed measures were expected to have only a delayed impact.

Therefore, after the discussions at the late-September IMF-World Bank meetings in Washington over the difficulties in reducing the United States trade deficit, the German mark soon became caught up in the wave of dollar selling. At first, the rise in the mark lagged behind others. But, as the markets became increasingly unsettled, the demand for marks themselves intensified. The Bundesbank intervened, on occasion heavily, in the Frankfurt market. When pressure spilled into the New York market, the Federal Reserve intervened on eight trading days between September 30 and October 31 and sold $228.7 million equivalent of marks, of which $181.1 million equivalent was drawn on the swap line with the Bundesbank and the rest from balances. The generalized pressure against the dollar continued in November, although to a lesser extent. In that month the Federal Reserve intervened on five trading days, selling $80.9 million equivalent of marks financed by $77.3 million equivalent drawn under the swap arrangement with the Bundesbank and the remainder from balances. Nevertheless, the mark continued to advance, reaching $0.4502 by end-November for a rise of 4¾ percent since September.

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 October 18, 1976

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 III	1977 IV	1978 January	System swap commitments January 31, 1978
German Federal Bank	14.9	−14.9	-0-	+35.4 / −35.4	+800.1	+451.1	1,251.2
Swiss National Bank	-0-	-0-	-0-	-0-	-0-	+ 18.9	18.9
Total	14.9	−14.9	-0-	+35.4 / −35.4	+800.1	+470.0	1,270.1

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

Although economic growth in Germany resumed as the year-end approached, the exchange market remained sensitive to the possibility that foreign pressure would continue for Germany either to boost domestic demand or to find other ways to reduce its current account surplus which was widening once more. Amid uncertainty over these policy issues, the mark emerged in the forefront of market attention, rising more rapidly against the dollar than most other currencies in early December. But the German authorities, having put into place a stimulative package which would take effect mainly in 1978, were reluctant to adopt further measures for fear of rekindling inflationary pressures. As it was, the monetary aggregates were growing in excess of the Bundesbank's targets for 1977, partly as a result of the recent intervention in the exchange market. Nevertheless, the rise in the mark had already carried the rate to levels that the German authorities and many market participants considered to be excessive, particularly as compared with relative rates of inflation, and was regarded as likely to undermine chances for more rapid growth of the economy. And so, to reduce pressures on the mark, the Bundesbank on December 16 lowered its discount and Lombard rates by ½ percentage point each. Moreover, to discourage speculative inflows and to absorb some of the liquidity created by exchange market intervention, minimum reserve requirements on foreign deposits were increased and the existing ban on nonresident purchases of German bonds was extended to include securities with maturities of up to four years.

Following these measures, interest differentials in favor of dollar placements over mark placements widened to 2-3 percentage points per annum. But, in the generally bearish atmosphere for the dollar that was emerging, considerations which were favorable to the dollar were ignored as participants jumped to protect themselves from any further rise in the mark. Thus, the demand for marks became broad based, reflecting a combination of professional positioning, portfolio shifting, commercial leads and lags, and corporate hedging of balance-sheet items before the year-end.

In this atmosphere, trading became increasingly one way. Any news report or rumor which could be considered adverse to the dollar, or favorable to the mark, triggered a further rush into marks. Moreover, the mark had become firmly established at the top of the EC snake, generating renewed speculation that a realignment within that group of currencies would soon be inevitable. As a result, the mark came into additional heavy demand against other participating currencies. In response, there was sizable intervention by the Bundesbank and its EC partners in both snake currencies and dollars to maintain the limits in the joint float.

In all, the mark rose by a further 6 percent against the dollar in December to $0.4767 at the year-end. Both the Federal Reserve and the Bundesbank continued to intervene virtually daily to avoid even greater disorder. In December, the Federal Reserve sold a total of $545 million of marks in the New York market, drawn on the swap line with the Bundesbank, raising total drawings outstanding by the year-end to $803.4 million equivalent. Germany's external reserves rose by $2.9 billion in December, for an increase of $5.2 billion over the last three months of 1977.

Exchange market disorder carried over into early 1978, as professional demand pushed the mark up a further 2½ percent to a peak of $0.4885. Additional intervention by the Bundesbank and the Federal Reserve, which sold another $40.1 million equivalent on January 3, was scarcely noticed. Instead, commentary in the market and in the press focused on what was considered an apparent reluctance of the Federal Reserve to intervene.

On January 4 the Federal Reserve and the United States Treasury issued a joint statement:

> The Exchange Stabilization Fund of the United States Treasury will henceforth be utilized actively together with the $20 billion swap network operated by the Federal Reserve System. A swap agreement has just been reached by the Treasury with the Deutsche Bundesbank and is already in force. Joint intervention by the Treasury, the Federal Reserve, and foreign central banks is designed to check speculation and reestablish order in the foreign exchange markets.

When this statement came across the news services early that afternoon, the Federal Reserve's foreign exchange Trading Desk followed up with simultaneous offers of marks to several banks in the New York market. This prompted a quick scramble for cover by some professionals who were short of dollars, and the mark dropped back by some 4 percent that afternoon without the Desk actually having sold any marks. Some further short covering during the next morning in Frankfurt pushed the mark even lower to $0.4640. But, with many other uncertainties overhanging the dollar, some dealers began to doubt that the central banks could halt the dollar's disorderly decline through intervention alone. Once it became clear that the monetary authorities were not seeking to push dollar rates up or to hold them at any particular level, dealers sought to regain the initiative through renewed heavy bidding for marks. This bidding, over the next two days, was concentrated in the hours toward the European close, after the Bundesbank had ceased its own dealings. The Desk countered forcibly, dealing both directly with banks and through agents, and sold a total of $253 million equivalent of marks over the two days. The Desk's sales were split evenly between the Federal Reserve and the Treasury, financed by drawings on their respective swap arrangements with the Bundesbank.

These exchange operations were followed by a hike in Federal Reserve discount rates, announced on January 6, and by the action of the domestic open market Trading Desk to promote somewhat firmer conditions in the United States money market. By the following Monday, January 9, the exchange market came into better balance, and the Desk did not intervene on that day.

Even so, the market remained sensitive to the wide range of policy issues that were still under debate at the time. Over the next two days, bearish sentiment toward the dollar was reinforced by reports of a division of opinion within the United States over the latest monetary policy actions and by suggestions that foreign central bankers had been critical of the United States in the monthly Bank for International Settlements (BIS) meeting in Basle. (Actual participants at the meeting subsequently made clear that the United States policy actions had in fact been warmly received.) Moreover, routine public statements by government officials in Germany and in the United States essentially repeating their positions on broader economic policy issues were taken as an additional sign of disagreement. In this atmosphere of seeming policy discord, many market participants concluded that the United States intervention approach had only grudging support in Washington and elsewhere and might be abandoned at any time. The dollar, therefore, came under renewed heavy selling pressure. Over the four trading days, January 10-13, the mark was bid up to as high as $0.4782. The German and United States authorities, while not holding the mark rate at any particular level, continued to intervene forcefully. On those days, mark sales by the United States authorities amounted to $509.9 million equivalent, split evenly between the Federal Reserve and the Treasury and financed by drawings on their respective swap lines with the Bundesbank.

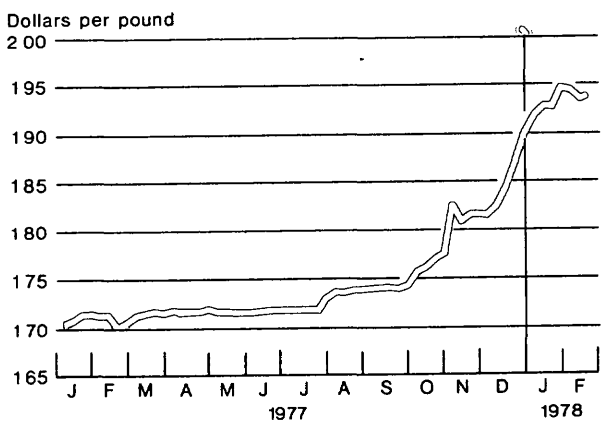
This show of force by the authorities made its point. By that Friday, dealers began to gain a feeling of two-way risk in the market, and natural buyers of dollars began to appear. In the following week, January 16-20, the market in fact came into rough balance with good two-way dealing, providing the first five-day stretch since last November in which the Federal Reserve did not intervene at all. The Desk subsequently entered the market on three occasions through the month end and sold $52.1 million equivalent of marks. In all, mark sales by the United States authorities after January 4 amounted to $815 million equivalent. On January 31, Federal Reserve swap debt to the Bundesbank amounted to $1,251.2 million equivalent of marks while the United States Treasury drawings were $407.4 million equivalent. By the month end the mark was trading quietly at $0.4740, some 3 percent below the January 4 peak.

Sterling

By midsummer 1977 the measures the British government had adopted during the previous year to curb inflation, to contain Britain's current account deficit, and to stabilize sterling were strongly taking hold. The government's two-year policy of voluntary pay restraints had succeeded in bringing the rate of wage increases far below the rate of price inflation. Although its strategy was modified in July in the face of stiff opposition to any continued limit on negotiated wage increases, the government had obtained union agreement to space out pay negotiations over the next twelve months and to limit wage increases within the public sector. Strict cash limits on government spending and increased government receipts combined to cut sharply the public sector borrowing requirement to well below the levels anticipated in Britain's standby arrangement with the IMF. The authorities had also acted to slow the decline in short-term interest rates from the crisis levels of late 1976, in part by large sales of government securities outside the banking sector. In this situation, nonresidents joined in the bidding for attractively priced gilt-edged securities, shifting large amounts of foreign funds into sterling-denominated assets.

Consequently, sterling had come into strong demand in the exchanges. For some time the Bank of England had intervened heavily to hold the rate around the $1.72 level, thereby rebuilding Britain's reserve position in the process. But, as the dollar's decline had persisted during July, the Bank of England shifted to an intervention approach keyed to a weighted index of major currencies, and the spot rate rose to $1.7385 by early August. Meanwhile, Britain was winding down its inflation rate in response to the easing of wage pressures, the renewed strength of the pound, and the decline in commodity prices worldwide.

Chart 4
United Kingdom
Movements in exchange rate*



*See footnote on Chart 3

The improvement in Britain's financial position and prospects for inflation had been achieved, however, at the cost of continued sluggishness in production and a high level of unemployment. For the time being, the prolonged stagnation in the domestic economy was continuing to depress British imports, while manufactured exports were benefiting from the previous year's slide in the pound. Moreover, North Sea oil was beginning to bolster the balance of payments. Thus, Britain's current account had shifted from large deficit to solid surplus, and this turnaround provided a continuing source of commercial demand for sterling in the exchanges. Looking ahead, the market came to expect that the government would soon take advantage of its room to maneuver, within the specified limits for monetary expansion and public sector borrowing, to provide some needed stimulation to the domestic economy.

Against this background, the Bank of England's decision in August to allow two successive ½ percentage point reductions in its minimum lending rate to 7 percent was well received in the market. This move revived expectations of still further declines in British interest rates and of renewed potential for near-term capital gains on British securities. Meanwhile, the yields on longer term securities remained attractive relative to those on comparable securities elsewhere. As a result, the inflow of foreign funds again built up and the strength of the demand soon led the market to believe that the British authorities would have to permit an additional appreciation of sterling in the market This expectation was further fueled during September by news of a large $1 4 billion reserve gain in August, release of favorable economic indicators, and a strong vote upholding the twelve-month rule on wage increases at the Trade Union Congress. The Bank of England met the demand for sterling with large purchases of dollars almost every day. In its other operations, it attempted to mop up the excess liquidity generated by these dollar purchases and to slow any further drop in interest rates. But during September the minimum lending rate was again lowered in two steps to 6 percent, as short-term British interest rates fell significantly below comparable United States rates for the first time since December 1969.

Early in October, the rush into sterling intensified. With the dollar then on offer generally in the exchanges, dealers expected the spot pound would rise

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 III	1977 IV	1978 January	System swap commitments January 31, 1978
1,051.0	−148.4	−143.6	−143.6	−108.9	−36.4	470.1

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

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 III	1977 IV	1978 January	Outstanding January 31, 1978
Bank of Mexico	150.0	−150.0	-0-	-0-	-0-	-0-	-0-
Bank for International Settlements* (against German marks)	-0-	-0-	+35.0 −35.0	-0-	-0-	+147.0	147.0
Total	150.0	−150.0	+35.0 −35.0	-0-	-0-	+147.0	147.0

* BIS drawings and repayments of dollars against European currencies other than Swiss francs to meet temporary cash requirements.

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 III	1977 IV	1978 January	Amount of commitments January 31, 1978
1,545.7	−84.6	−85.8	−85.8	−120.5	−50.9	1,118.0

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 January for value after the reporting period.

at least partly in line with other currencies. In addition, in the discussions at the IMF-World Bank annual meetings on the need to counter disappointing economic performance worldwide, Britain had been identified by some as one of the countries that could now contribute by providing some stimulus to the domestic economy. In response to this expression of confidence, the flow of funds pouring into London's financial markets swelled to massive proportions and the authorities found it increasingly difficult to neutralize the impact of these inflows on domestic money markets. British short-term interest rates continued to ease, with the Bank of England's minimum lending rate dropping to a six-year low of 5 percent on October 17. The Chancellor's proposals for mild fiscal stimulus immediately and further tax cuts in the spring were, by the time they were announced on October 26, well within what the market had come to expect. But the market had also anticipated new measures to stem the inflows of foreign funds, which were beginning to jeopardize the authorities' target for monetary expansion. When no measures were announced, the rush into sterling continued. By October 28, the pound had risen some 2¼ percent above early-August levels to $1.7780. The Bank of England continued to intervene to limit the rise in the effective exchange rate index which had edged up only marginally since early August to 62.6 percent of its 1971 Smithsonian level. The heavy dollar purchases of the central bank accounted for the bulk of the nearly $7 billion increase in British reserves over the three months.

To protect the money supply from the expansionary effect of further large inflows, the authorities ended on October 31 their policy of intervening to prevent a rise in sterling's effective exchange rate. As a British Treasury statement acknowledging a change in official intervention policy flashed over the news services, the pound was pushed up in a wave of speculative demand to a high of $1.8625 the following day in London. But suddenly the market turned around when that same day British mine workers unexpectedly voted down a management proposal for a labor settlement and resubmitted demands for a 90 percent pay raise. At the same time, large sections of the country were subjected to brief electrical blackouts, as power station workers staged an official "work to rule" in support of claims for improved fringe benefits. Immediately, funds flowed from sterling into marks and the pound plunged back as much as 3½ percent to $1.7960 by November 3.

Trading in sterling quieted as the market adopted a more guarded attitude toward the pound's immediate prospects. On the one hand, Britain's rate of inflation continued to fall toward single-digit levels. Moreover, the external position was showing further improvement: the trade account had been in solid surplus for three consecutive months, and the overall current account had been in sizable surplus already by the third quarter. On the other hand, renewed labor disputes threatened to undermine the government's policy for wages. Also, the large-scale rise in reserves of previous months left the market uncertain over the outlook for monetary expansion in the near future. As the market weighed these considerations, the pound settled in around $1.82 until early December while, on a trade-weighted basis, it fluctuated narrowly around 63.5. In general, sterling was bolstered by continuing commercial demand. Although occasionally the pound showed a slight offered tendency, intervention was quite modest.

By that time, however, the caution that had overshadowed sterling was dissipating. The government had made substantial progress in sidestepping the highly visible claims of a few unions for pay increases significantly above a norm of 10 percent per annum. Uncertainties about a rise in interest rates that might prompt sizable withdrawals of foreign funds were cleared away after the Bank of England announced a hike in the minimum lending rate by 2 percentage points to 7 percent on November 25. Furthermore, domestic activity was showing signs of picking up and, with balance-of-payments considerations now placing less of a constraint on growth than at any time since World War II, the British economy was expected to begin a sustained upturn during 1978.

Consequently, when the dollar again began to weaken early in December and market professionals turned their attention to the strong Continental currencies, the pound was carried along in the generalized upsurge against the dollar. News of the abolition of the rule requiring surrender of 25 percent of investment currency premium proceeds from sales of foreign securities and the relaxations of some other restrictions on outflows had no impact on trading. Instead, pulled up by the rise in the mark and Swiss franc and bolstered by year-end commercial demand, the pound rose to $1.92 by December 30. Then in the new year the pound was bid up in heavy professional demand, joining the Swiss franc in leading the rise in foreign currencies against the dollar. By January 4 it had soared to as high as $1.9932, 14¾ percent above early-August levels.

The market then turned around and the pound fell 6 percent to $1.8750 after the announcement by the Federal Reserve and the United States Treasury of a more active United States intervention approach. But sterling remained buoyant against both the dollar and the mark through the rest of January. Signs that monetary growth was back within the targeted range reassured the market, and foreign funds were again attracted into sterling, especially just prior to a ½ percentage point reduction to 6½ percent in the Bank of England's minimum lending rate. The spot rate thus moved back up against the dollar to end the period at \$1.95—12¼ percent above early-August levels. Sterling also rose 4 percent against the mark during the six-month period and, on a trade-weighted effective basis, advanced some 7¾ percent to 66.5 During November-January official reserves increased a further \$947 million to a record \$21 4 billion on January 31.

Swiss franc

By the summer of last year, the Swiss economy was expanding faster than anticipated. At the same time Switzerland's inflation rate, at slightly above 1 percent per annum, remained lowest among industrial countries, partly as a result of the previous substantial appreciation of the Swiss franc. This incipient recovery was fueled in part by a modest rise in consumption and investment In addition, with many Swiss firms starting to take advantage of the low inflation rate to maintain their competitive position, exports were particularly buoyant. The growth of the Swiss economy prompted an even faster rise in imports than exports, so that Switzerland's trade account shifted back into deficit. But the current account remained in sizable surplus, bolstered by Switzerland's traditionally large earnings on overseas investments

Thus, sentiment in the exchange markets toward the Swiss franc had become increasingly bullish by late summer. The franc remained in demand, even after the German mark and the Japanese yen eased back amidst uncertainty over the implications of new stimulatory measures being planned in those countries By end-September, the franc had risen over 2 percent against the dollar to \$0.4260 and 4 percent against the German mark from end-July levels. To counter this pressure, the Swiss National Bank intervened forcefully in Zurich and in New York through the agency of the Federal Reserve Bank of New York. On September 27, the Swiss authorities also imposed an immediate ban on the sale to nonresidents of forward francs with a maturity of less than one month, to prevent evasion of a negative interest charge on nonresident deposits through use of these short-dated swaps with Swiss commercial banks. By this time, the cumulated intervention in Swiss francs was beginning to add more liquidity to the domestic money market than was called for by the National Bank's target for monetary growth of 5 percent for the year. The central bank continued to absorb some of this liquidity by selling dollars to nonresident borrowers of Swiss francs under the official capital export conversion requirement. But, in addition, it began to sell dollars in the market on a three-month swapped basis which, in effect, temporarily absorbed domestic funds until they would be needed for year-end purposes.

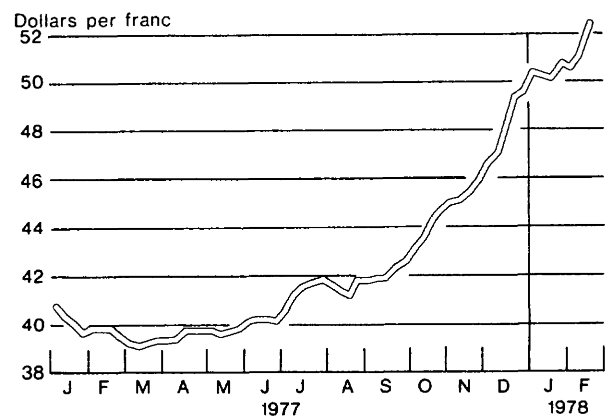
With concern heightening after the late-September IMF-World Bank meetings over the implications for the exchange markets of the persistent trade imbalances among major nations, exchange dealers and investors around the world again began to move into Swiss francs. Despite the limited availability of convenient instruments for investing in Swiss francs, low interest rates, and the barricade of controls created by the Swiss authorities to inhibit hot money inflows, the rush to acquire francs in whatever form led to a cumulative bidding-up of the franc rate. Both commercial and professional interests bought francs on the expectation that the rate would rise, shifting funds mainly out of dollars but, on occasion, out of currencies such as the pound sterling and the German mark as well. Corporate borrowers that had previously financed short- and long-term credit needs in Switzerland now hastened to buy francs to limit exchange losses on their liabilities. Speculation in the form of foreign acquisition of Swiss franc currency notes intensified. In this highly dynamic exchange market situation, the franc at times led the rise in other currencies against the dollar while at other times the rise in other currencies prompted an additional bidding-up of the franc.

On balance, however, the franc rose more rapidly

Chart 5

Switzerland

Movements in exchange rate*



*See footnote on Chart 3

than most other major currencies. By end-November, the rate had surged another 9 percent above late-September levels to $0.4637 and advanced 4¼ percent against the mark. The Swiss National Bank continued to try to contain the franc's rise, buying substantially more dollars in the spot market than it sold directly to nonresident borrowers of francs under the capital export conversion program. It had also acted to prohibit prepayment clauses in new foreign loan contracts. But heavy demand for francs persisted. Prepayments on outstanding loans were unaffected by the new prohibition. Also, the authorities had indicated their concern about the continued injection of new liquidity by announcing their intention to issue sterilization notes and by providing only limited liquidity assistance over the month end.

Even so, as trading conditions deteriorated generally in December, the franc continued to rise in sporadic bursts of demand. In the exchange market this further upward movement became overshadowed for a few days by the surge in demand for German marks. But within Switzerland businessmen, reacting to the uncertainties generated by the appreciation of the franc, began to curtail investment spending plans. Domestic output flagged, the rise in imports stalled, and the trade balance swung back into surplus, partly reflecting changes in the valuation of Swiss imports and exports. To prevent year-end needs for francs by Swiss commercial banks from buoying the rate even more, the Swiss authorities reversed an earlier decision to scale down the volume of their customary assistance and announced they would provide unlimited temporary year-end liquidity at favorable rates. But the franc was still swept up in heavy demand from both commercial and professional interests. From early December to January 4, the franc rose to $0.5270, up a further 13½ percent against the dollar and 5 percent against the mark.

Following the announcement of a more active intervention policy by the United States authorities, the franc rate immediately dropped back by 8 percent to as low as $0.4844 on January 5. Subsequently, as the market sought to test the authorities' resolve to avoid a renewed rise in the rate, the Swiss franc was bid upward again. Even when the markets settled down more generally after mid-January, the franc remained subject to bouts of buying that threatened to trigger broader unsettlement in the markets. Consequently, on January 24, the Federal Reserve resumed intervention for its own account in Swiss francs in New York. On that day, the Federal Reserve sold $18.9 million of francs drawn under the swap line with the Swiss National Bank, in addition to the francs sold by the Desk that day on behalf of the Swiss National Bank. By the month end the franc was trading more steadily at $0.5043, for a net rise of 21 percent against the dollar and 13 percent against the mark for the six-month period.

During the period, the Federal Reserve and the United States Treasury continued with the program agreed to in October 1976 for an orderly repayment of pre-August 1971 franc-denominated liabilities. The Federal Reserve repaid $235.3 million equivalent of special swap indebtedness, while the Treasury redeemed $223.5 million equivalent of Swiss franc-denominated securities by the end of January. Most of the francs for these repayments were acquired directly from the Swiss National Bank against dollars. However, the Federal Reserve also bought francs from the National Bank against the sale of $76.3 million equivalent of German marks and $61.3 million equivalent of French francs, which were in turn either covered in the market or drawn from existing balances. By end-January, the Federal Reserve's special swap debt to the Swiss National Bank stood at $470.1 million equivalent, while the Treasury's Swiss franc-denominated obligations had been reduced to $1,118.0 million equivalent.

French franc

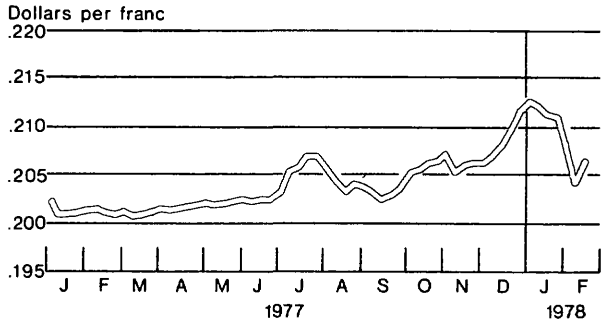
During the first half of 1977, the French economy had begun to respond to the government's concerted efforts to curb inflation and to stabilize the French franc. The pace of wage increases had slowed, inflationary pressures at the wholesale level were moderating considerably, and the rate of increase in consumer prices had stayed just below 10 percent even after a temporary price freeze had been allowed to lapse. At the same time, France's trade account was moving into surplus for the first time in two years and the current account deficit was narrowing considerably. In addition, interest rates had declined more slowly in France than elsewhere, and French residents including public and semipublic entities had accelerated their borrowing activities abroad during the summer months. Thus, the French franc had joined in the rise in European currencies against the dollar to trade around $0.2050 in early August, even as the Bank of France had taken in reserves from time to time in moderating the rise.

The cost to France's domestic economy of its improved external position had been severe, however. Consumer demand was expanding more slowly than projected, investment demand and industrial production were both flat, and unemployment was rising. With the improvement in France's current account position now giving the government more room to maneuver, it followed up measures taken in the spring with selec-

Chart 6

France

Movements in exchange rate*



See footnote on Chart 3.

tive actions to improve the employment situation without abandoning its overall anti-inflationary stance. On August 31, the Bank of France cut the official discount rate by 1 percentage point to 9½ percent and interest rates on other money market instruments were allowed to ease in line with declining money market rates for other currencies. Early in September, the government announced a mild fiscal stimulus for the economy, introducing new measures to spend FF 5 billion (0.3 percent of GNP) in 1977. In the wake of these policy initiatives and in response to a slowdown in external borrowings, the franc tended to come on offer during September. But by the month end the franc had become caught up in the advance of European currencies against the dollar, rising 2¾ percent to as high as $0.2088 on November 1.

By this time, however, the market began to question whether the French franc could be expected to keep pace with the German mark's rapid rise against the dollar. As some market participants sought to hedge their mark commitments by selling francs against marks, the franc weakened in the exchanges. Moreover, rapidly rising agricultural prices in France were slowing the progress in reducing inflation. Premier Barre, in a televised speech on November 3, again warned about the dangers of inflation, and soon thereafter the government announced a freeze on a variety of retail food prices. But leaders of opposition parties argued that the continued rise in prices was indicative of the failure of the government's anti-inflation policies.

In an atmosphere of growing political sensitivity before the general elections scheduled for March 1978, the selling of francs gained momentum during early November. The franc thus eased back against the dollar to $0.2048 even as the dollar remained on offer against the other European currencies and the yen. To moderate the franc's fall, the Bank of France, which on occasion had sold both dollars and marks in the Paris market through the autumn, stepped up its intervention. Moreover, the central bank moved to tighten interest rates. Nevertheless, by early December the franc had weakened some 4 percent against the mark which was buoyed by a groundswell of speculative inflows out of dollars.

By the year-end, the economic indicators for the French economy were pointing to further improvement. The rise in the consumer price index was now slowing, and unemployment showed a small decline. The trade figures for December had registered a sizable surplus once again, after an unexpectedly large deficit the month before, and the Organization for Economic Cooperation and Development had forecast a narrowing of the current account deficit from $3 billion to $2 billion in 1978. As a result, the French franc, buoyed also by commercial month-end and year-end demand, rose sharply at the end of December. In fact, it kept roughly in pace with the German mark as it rose to $0.2178 on January 3. After the joint Federal Reserve-Treasury announcement the following day, the franc dropped back against the dollar somewhat less than other European currencies. But, as the month of January progressed, commercial leads and lags started shifting against the franc once more as uncertainties over the outcome of the March elections continued to overhang the market. By the month end the franc, trading at $0.2108, was 2¾ percent above early-August levels, while over the six-month period the franc had fallen 5½ percent against the mark. As of January 31, French foreign exchange reserves stood at $4.7 billion, little changed over the six-month period.

Italian lira

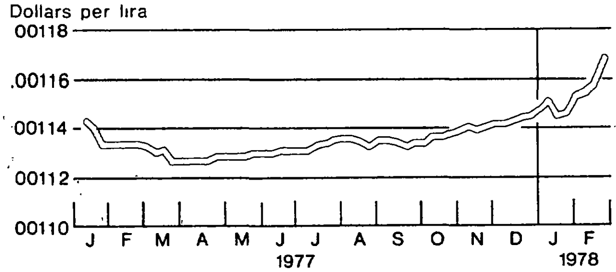
To curb inflation, to restore equilibrium in the balance of payments, and to stabilize the Italian lira, Italy's minority government had implemented by mid-April 1977 a comprehensive program that served as the basis for a new standby agreement with the IMF. As part of the three-point program, the public sector deficit was to be reduced through tax increases, spending cuts, and higher prices for public services. Monetary policy had been reinforced with a sharp hike in interest rates and strict controls to limit the extension of credit. And steps were undertaken to modify Italy's wage indexation system, with the view to bringing the rate of inflation down from 22 percent to 13 percent by spring 1978.

The completion of this program and the conclusion of a standby agreement had been welcomed in the

Chart 7

Italy

Movements in exchange rate*



*See footnote on Chart 3

market. It provided Italy with $530 million of new IMF credit and assured the availability of a further $500 million from the EC. In addition, it paved the way for more private external borrowing since—with the outlook for the lira now more assured and with availability of domestic credit greatly restricted—Italian banks and companies had a strong incentive to meet their financing needs abroad. Bolstered by these and other capital inflows, the lira had steadied around $0.001130 (Lit 885) through early summer. The authorities bought substantial amounts of dollars in adding to Italy's foreign exchange reserves, which rose to $7.1 billion by end-July.

By early August, the pace of these capital inflows had begun to slow as the tapering-off of seasonal tourist receipts left the market uncertain about the vulnerability of the lira to renewed downward pressure. But Italy's current account, now benefiting from the impact of the lira's 22 percent fall in 1976 and of the new austerity program, swung toward surplus. Therefore, continuing commercial needs kept the lira in demand throughout the late summer. The Bank of Italy again took in dollars, albeit at a more modest pace. The central bank also took advantage of the favorable climate in the exchange markets to cut the Bank of Italy's discount rate 1½ percentage points to 11½ percent in late August. The authorities made further repayments of credits to the IMF and, in September, repaid a $500 million tranche on a $2 billion gold-dollar swap the Bank of Italy had with the Bundesbank. Even with these repayments, Italy's foreign exchange reserves declined only $518 million during August-September.

By October the lira, too, had become caught up in the generalized advance against the dollar. Demand for lire intensified and, with the Bank of Italy acting to limit the rise in the rate, its purchases of dollars increased. The unpegging of sterling at end-October triggered even more favorable shifts in commercial leads and lags, as market participants came to expect the Italian authorities might follow suit. As a result, by end-November, Italy's foreign exchange reserves had risen $1.6 billion in two months while the spot rate had advanced to $0.001140 (Lit 877.2).

Meanwhile, Italy's current account had strengthened further, swinging from a $2.8 billion deficit in 1976 to a near $2 billion surplus in 1977. Moreover, the government's new austerity program had succeeded in bringing the inflation rate down toward 16 percent in just half a year. But these improvements resulted in a considerable slowing of the domestic economy. Industrial production had dropped off sharply to levels below those of the previous year. Unemployment rose and, with corporate profits squeezed by the high cost of borrowing funds, the prospects for an improvement in the labor market seemed dim. Pressure was mounting for new action to stimulate the domestic economy now that some progress had been achieved on the inflation and balance-of-payments fronts. At the same time, however, the public sector deficit had exceeded the limit specified in the standby agreement and subsequent discussions with the IMF. The minority government entered into a new round of negotiations with the opposition parties and the trade unions on new measures to increase public service prices and to reduce expenditures. But by this time the Communist Party and the trade unions were facing growing opposition from within their own ranks against the tacit support they were providing for government policies.

Uncertainties over the outcome of these negotiations, which ultimately led to the resignation of Premier Andreotti's 1½-year-old government, overshadowed the market for lire during December and January. Flows into Italy slowed substantially, and the lira came on offer at times. But the pressure did not cumulate because the market remained aware of Italy's ample exchange reserves and the overriding concern at the time was the dollar's continuing decline. Nevertheless, the lira weakened against the other major currencies on the Continent, with the Bank of Italy selling dollars on balance during these two months. But against the dollar the lira rose to trade at $0.001153 (Lit 867.3) on January 31. Overall, it rose 1⅝ percent for the period while on balance Italy's foreign exchange reserves increased to $7.6 billion.

EC snake

During the period under review, most of the currencies within the EC snake were pulled up sharply by the rise in the German mark against the dollar. An exception was the Swedish krona which, after coming on offer throughout the summer in reaction to a continued deterioration in Sweden's trade and price performance, was withdrawn for the time being from the joint float on August 29. At that time, it was devalued by 10 percent in relation to a basket of currencies (weighted according to their importance in Sweden's foreign trade). This entailed a marking-down of the krona by 9 percent against the dollar, before it steadied on an unwinding of short positions and commercial leads and lags. Simultaneously, with this exchange rate adjustment by a major trading partner, Norway and Denmark each adjusted downward the intervention points of their currencies by 5 percent against the other members of the snake. Following this adjustment —the third in less than a year—the Danish krone and Norwegian krone moved into first and second position in the newly realigned joint float. The mark sank to the bottom, thereby affording the National Bank of Denmark an opportunity to take marks into its reserves.

Over the next two months, trading relationships were comfortable within the joint float. But by mid-November, the mark had moved back up to the top of the snake. In the increasingly unsettled climate which was developing, the market began once again to question the durability of the current rate relationships within the snake. As the mark surged further upward against the dollar, the remaining currencies became caught on the floor of a rising joint float. Rumors of another imminent realignment or breakup of the snake surfaced repeatedly. Each time, the selling of weaker currencies intensified, with the greatest pressures coming before weekends and during the December 5-6 EC summit meeting. In response, there was large official intervention in both dollars and marks, and several EC central banks tightened their domestic money markets to maintain the joint float intervention limits.

Following these initiatives, tensions within the EC snake eased in late December and market participants came increasingly to focus on the dollar generally. Thus, the currencies at the bottom of the joint float moved off the floor of the band, thereby enabling the respective central banks to relax monetary pressures and purchase marks in the exchange market to repay debt to the Bundesbank. For the most part, trading remained quiet in the joint float through the end of the period. But one currency, the Norwegian krone, continued to require official support from the Norges Bank and the Bundesbank to keep pace with the mark. In mid-February, to restore a more competitive relationship with its major trading partners, the Norwegian authorities announced an 8 percent downward adjustment of their currency against the other snake currencies.

Japanese yen

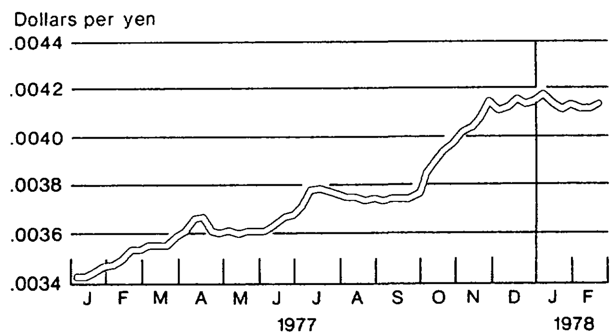
During the summer of 1977, economic growth in Japan was still far below the pace projected by the Japanese authorities. Fear of mounting layoffs in a country where the security of lifetime employment has been a tradition was becoming an increasingly important domestic issue. The government had acted, both through fiscal spending programs and a lowering of interest rates, to provide modest stimulation without aggravating the rate of inflation which was still running over 8 percent per annum. But the private sector had been slow to respond. Businessmen were reluctant to increase investment in new plant and equipment in view of the worsening squeeze on profit margins, the recent rise in the yen, and the fear of protectionist actions against Japanese goods abroad. The continued sluggishness of the Japanese economy had exerted a powerful drag on imports. Exports had continued to expand in line with more buoyant economic conditions elsewhere, particularly in the United States. As a result, Japan's current account had mounted to a massive $10 billion at an annual rate, generating considerable concern internationally.

As the exchange markets had responded to these developments, the yen had advanced 4 percent in the late spring and early summer. But then, as dealers came to expect the government to take stronger steps to bolster the domestic economy, the spot rate settled in the vicinity of ¥ 267 ($0.003745) through August. In early September, the government proposed a ¥ 2 trillion package of increased public expenditures, along with special programs to aid industry and to speed up raw materials imports. In addition, the Bank of Japan cut its discount rate by ¾ percent to 4¼

Chart 8

Japan

Movements in exchange rate*



*See footnote on Chart 3.

percent while also reducing reserve requirements to facilitate a sustainable economic recovery through a further decline of general interest rates. Market reaction to the measures was mild, since few of the provisions were expected to have an immediate effect. But the lowering of Japanese short-term interest rates, at a time when United States rates were rising, gave further incentive for Japanese companies to reduce their trade financing in dollars in favor of credits in yen. In addition, capital outflows, such as foreign borrowings in Japan, were encouraged. With these outflows offsetting to some degree the continuing current account surplus, the yen market remained in rough balance through mid-September.

Nevertheless, Japan was still cumulating massive trade surpluses each month, while the United States continued to run a trade deficit at an annual rate of $30 billion. Concerns over this continued imbalance remained strong, and in late September the market came to realize that both private and official forecasters were projecting an even larger United States deficit in 1978. Under these circumstances, Japanese officials attending the IMF-World Bank meetings in Washington were openly urged to take further steps to expand the Japanese economy and to open their markets more to foreign goods, or risk further protectionist measures in their major export markets. Within Japan itself a hot debate was also taking place over whether further reflationary measures were needed to revive the domestic economy.

In this atmosphere, a new wave of demand built up for the yen. As the spot yen rose, even broader demand came into the market on the expectation of higher yen rates to come. The forward yen also strengthened, thereby opening up an incentive for nonresident placement of funds, on a covered basis, in "free" yen deposits and investment in Japanese government securities. Most of the pressure on the yen was concentrated in the Tokyo market. But it also spilled into the European and United States exchange markets where, with the dollar generally on offer, the rise in the yen reinforced and was reinforced by the rise in other major currencies. Thus, in seven weeks through mid-November, the yen advanced by 9 percent to some ¥245 ($0.004080), even as the Bank of Japan intervened forcefully on occasion to slow the rise.

By that time, the rush into yen was far exceeding the surplus on either trade or current account. Inflows of speculative funds were accentuating the yen's sharp rise and threatening to disrupt the domestic money market. In response, the authorities announced on November 17 the suspension of public offerings of Japanese Treasury bills and the imposition of a 50 percent marginal reserve requirement on "free" yen deposits. On November 24, the Bank of Japan followed up with very heavy intervention, which settled the market with the yen trading at around the ¥240 ($0.004167) level. Reflecting in large part the Bank of Japan's intervention during October-November, Japan's reserves increased by $4.5 billion since end-July.

On November 28, Prime Minister Fukuda announced a reshuffling of his cabinet in an attempt to accelerate efforts to prepare a program to reduce the trade surplus while also stimulating the economy. These moves gave new impetus to bilateral trade negotiations between the United States and Japan in preparation for the Tokyo round of multilateral negotiations on reducing tariff and nontariff barriers to trade. In this more positive atmosphere, the yen fluctuated narrowly in the first half of December, even as the dollar was weakening against other major currencies.

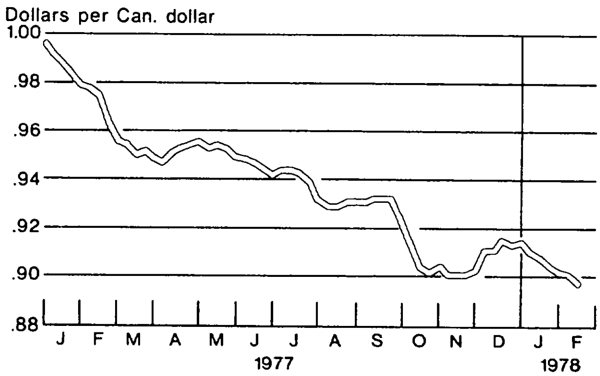
Nevertheless, most of the underlying problems affecting the Japanese trade imbalance remained. The uncertainties over the Japanese economic outlook generated by the yen's continued rise was keeping the domestic economy sluggish, lowering import growth, and preventing the leveling-off of export volume from cutting the trade surplus. In fact, the trade surplus was actually becoming somewhat wider as a result of the impact of the yen's appreciation on the terms of trade. For 1977 as a whole, the total surplus reached $17.5 billion, up $7.6 billion from 1976. In this context, dealers remained sensitive to public statements about the ongoing trade negotiations, indicating that a dramatic change in Japanese trade flows could not be expected in the short term. Moreover, as the year-end approached, the exchange markets for the dollar generally had become more disorderly. Consequently, the yen came into sporadic bouts of demand through the rest of December and into early 1978. The Bank of Japan continued to intervene forcefully in the Tokyo market and, beginning in late December, supplemented these operations by occasionally intervening in the New York market through this Bank. Even so, the yen continued to be bid up to reach a high of ¥236.5 ($0.004228) in New York on January 4.

Following the United States authorities' announcement of a more active intervention approach, the yen rate fell back some 2 percent. Thereafter, the yen moved more narrowly in a reasonably balanced market. Announcement of proposed budget changes gave promise of additional fiscal stimulation to the Japanese economy. Later in January, a joint statement by the Japanese and American trade negotiators also helped remove some of the tension in the market. By the month end, the yen was trading around ¥241.5 ($0.004140) for a net rise of 10¼ percent over the six-month period under review. During that time, Japanese

Chart 9

Canada

Movements in exchange rate*

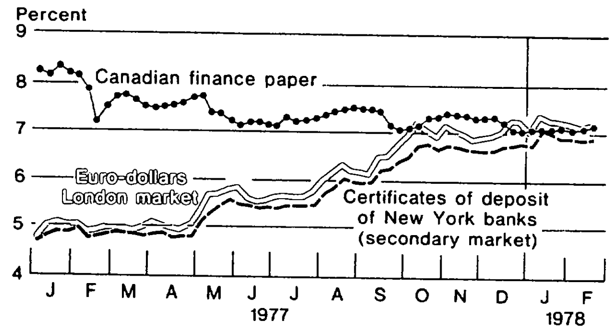


See footnote on Chart 3.

Chart 10

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

Three-month maturities*



*Weekly averages of daily rates.

reserves had risen, largely through official intervention purchases, by $5.7 billion to $23.4 billion.

Canadian dollar

For two years the Canadian authorities had in place broad monetary and fiscal restraints as well as income controls to curb the severe inflationary pressures that had afflicted the Canadian economy. Although these efforts had brought some early success, the authorities acknowledged last July that, with the increase in prices still hovering around a rate of 9 percent, their 6 percent target could not be achieved during 1977. Meanwhile, the slow pace of economic activity for the second quarter and the rise in unemployment—especially in Quebec and the maritime provinces—had become apparent. Political and social tensions generated by the presence in Quebec of a government committed over the long term to establishing the province's independence also introduced uncertainties that exerted a drag on spending by both businessmen and consumers. Many in the market, therefore, came to expect that the government would shift its priorities away from containing inflation toward stimulating an early rise in employment.

Externally, Canada's current account deficit remained above the $4 billion level at an annual rate. Unlike 1976, this deficit was not fully covered by capital inflows generated by long-term borrowing abroad. Instead, Canadian public authorities had postponed some of their financing until doubts over foreign capital market receptiveness to Canadian placements had been cleared up. Moreover, a decline in Canadian interest rates earlier in the year had already eroded interest incentives for short-term flows into Canada and, when United States interest rates started to firm after midyear, market participants expected these interest rate differentials to narrow further. In response, the Canadian dollar had already come heavily on offer in the exchange markets. From November 1976 through mid-August, it had dropped 9¾ percent to as low as $0.9269 before steadying somewhat to trade around $0.9320 through end-September.

By early October, however, bearish sentiment toward the Canadian dollar resurfaced. The calendar for new Canadian external borrowings over the near term appeared light, and conversions of previous borrowings tapered off. Looking ahead, some market participants were apprehensive that the government might announce substantial reflationary measures in an economic policy message scheduled for later in the month. Others concluded from official reaffirmation of Canada's floating exchange rate policy that the authorities were prepared for the rate to go substantially lower. Moreover, reports that the provincial government might "nationalize" certain key industries in Quebec, coming on top of an earlier move to adopt French as the official provincial language, further heightened market tensions. In this atmosphere, a wave of selling gathered momentum. Market professionals sold Canadian dollars short, commercial leads and lags shifted against the currency, and some United States corporations chose to repatriate funds ahead of the usual year-end date. The rate was thereby driven down late in October to a low of $0.8950. The Bank of Canada's intervention to maintain orderly markets under the circumstances resulted in sizable dollar sales in October, as reflected in a $605 million decline in external reserves for that month alone. This decline brought Canada's external reserves down to $4.2 billion by October 31, the lowest level for Canadian reserves since May 1970.

By this time, however, the Canadian economy was beginning to gain strength and Canada's trade account was starting to respond to the decline in the exchange rate. The government had presented its economic message, which contained only moderately stimulatory measures. Finance Minister Chrétien also had announced the dismantling of the wage-price control program, but gradually rather than immediately as some in the market had anticipated. For its part, the Bank of Canada had lowered its monetary growth target to continue to exert a moderating influence on inflation. Moreover, the Canadian authorities arranged a seven-year Euro-dollar standby credit of $1.5 billion with Canadian banks to replenish, if needed, official dollar reserves.

These developments helped steady the Canadian dollar during November-December. Dealers who had gone short Canadian dollars earlier in the year began to bid for the currency to square their positions before the year-end. Moreover, Canadian public authorities began again to borrow heavily in foreign capital markets and to convert the proceeds of these and recent issues into Canadian dollars. These demands more than offset whatever commercial year-end selling remained to meet debt servicing requirements and foreign dividend payments. Thus, the rate advanced to as high as $0.9202, some 2¾ percent above its October lows. In smoothing the rise, the Bank of Canada was a net buyer of United States dollars.

In January, however, renewed concern over the economic and political outlook contributed to more volatile trading in the Canadian dollar. Moreover, United States short-term interest rates had risen further to levels above comparable rates in Canada, and the calendar for new Canadian borrowings appeared to have thinned out. The spot rate thus fluctuated lower, and the Bank of Canada was again a net seller of United States dollars. The Canadian dollar had eased to $0.9031 by January 31, ending the period 3½ percent below its level at end-July 1977. Canada's external reserves stood at $4.4 billion, up $234 million from the low point reached last October but down $604 million from the level of six months before.