February-July 1983 Semiannual Report
(This report was released to the Congress and to the press on September 7, 1983.)

Treasury and Federal Reserve Foreign Exchange Operations

During the February-July period under review, the dollar advanced against most major foreign currencies, offsetting by varying degrees the substantial declines in dollar rates that had occurred during the months just prior to the period The dollar's rise took place at a time when the world recession was giving way to expansion and inflation generally was decelerating But all economies were still operating far below capacity, and there was some question as to how strong the recovery might be Also, the pace of expansion among the industrialized economies was uneven, unemployment stayed well above the levels of recent recessions, and the decline of interest rates from the high levels of mid-1982 was losing momentum In some nations, pressures therefore remained on policymakers to take action to support economic growth and create jobs Under these circumstances, the currencies that showed the strongest performance in the exchange markets were those of countries already pulling out of recession, like the United States, and of countries seen in the market as relatively less vulnerable to such pressures In addition to the dollar, these currencies included the Canadian dollar, pound sterling, and Japanese yen.

At the outset the dollar showed little of the strength that was later to characterize this period Questions remained about the durability of the economic upturn here, the outlook for U S interest rates, and the possible implications for the dollar of a prospective deterioration in the U S current account Economic expansion in the United States appeared to be proceeding, as expected, more moderately than previous postwar recoveries and to be limited to interest-sensitive sectors of the economy, such as housing. The current account was widely forecast to drop into deep deficit, reflecting an additional drag on domestic output At the same time, the outlook for inflation improved further in response to evident productivity increases and weak commodities prices, particularly for oil Moreover, as the number of developing countries negotiating debt reschedulings grew, the uncertainties about how the international financial structure would withstand the working-out of these problems continued to cloud the outlook for world economic recovery Therefore, market participants held to the view that, for a number of domestic and international reasons, dollar interest rates would soon resume their decline after a short reversal around early February and thus expected the dollar to ease back as well This view was reinforced in mid-February when the Federal Reserve announced its monetary growth targets for 1983, which were interpreted as allowing room for both a moderately paced recovery and a further gradual decline in interest rates.

Contrary to expectations, U S trade figures for the early months of the year showed a smaller deficit than had been recorded during the last part of 1982 Also, short-term interest rates did not decline below mid-January levels, and the Federal Reserve kept its discount rate at $8^{1/2}$ percent as established in December 1982 But the improving outlook for prices and for growth contributed to a further easing in long-term interest rates and buoyed the market for equities

A report by Sam Y Cross Mr Cross is Executive Vice President in charge of the Foreign Group of the Federal Reserve Bank of New York and Manager for Foreign Operations of the System Open Market Account

Long-term yields moved down in two stages—first during February and again in April—while record highs were being registered for major stock price indexes

The dollar held relatively steady through mid-May, notwithstanding the strains surrounding difficult negotiations leading up to an agreement of the Organization of Petroleum Exporting Countries (OPEC) on new oil prices and production quotas as well as a major speculative attack against the currency relationships within the European Monetary System (EMS). Many market professionals, while impressed by the dollar's apparent firmness, still expected the dollar's medium-term trend to be downward because of the outlook for interest rates and current accounts Also, talk spread for a time that the major industrial countries might be preparing to discuss a coordinated intervention effort at the Williamsburg summit Thus, interbank dealers in foreign exchange and speculators on futures exchanges were prepared to sell dollars regularly By contrast, press reports of substantial foreign interest in U S stock and bond markets at times bouyed sentiment toward the dollar.

By May, reports of large boosts in employment and in output signaled that recovery in the United States was gaining momentum Looking ahead, a considerable improvement in consumer sentiment, the impact on spending of increasing values of financial assets, and the prospect of new tax cuts in early July, all suggested that the upswing would be far more robust than anticipated just a few months previously and might match the strength of earlier recoveries. At the same time, expectations faded that a compromise would soon be reached to cut the government's large fiscal deficits for the coming years. Moreover, the government was having to borrow an unusually large amount for a second quarter, a time when tax revenues are seasonally heavy Also, there was mounting concern about the rapid growth of the monetary aggregates, particularly the narrowly defined aggregate, M-1 Incoming data showed that the rate of growth of M-1, after slowing in early April, had rebounded Under these circumstances, U S interest rates of all maturities began to rise Interest rates in other countries were, by comparison, relatively steady, holding on to the declines that had been achieved over the past several months. As a result, interest rate differentials against most currencies moved more decidedly in favor of the dollar during late May and the adverse differential against sterling was eliminated by mid-June

During May and early June the dollar was pushed up again by strong professional bidding U S. interest rates were rising, there were no signs of coordinated intervention in the immediate aftermath of the Williamsburg summit, and after that meeting there appeared to be less foreign pressure on the United States to modify its policy mix In addition, the increasing attractiveness of yields on government securities drew a growing amount of investment from nonresidents Thus, the dollar's rise continued without interruption until mid-June

After a short period of consolidation around the quarter

International Agreements on Exchange Market Intervention Policy

Excerpt from Annex to the Williamsburg Declaration (May 30, 1983)

3. Exchange Rate Policy We will improve consultations, policy convergence and international cooperation to help stabilize exchange markets, bearing in mind our conclusions on the Exchange Market Intervention Study.

Excerpt from "Statement on the Intervention Study" (April 29, 1983)

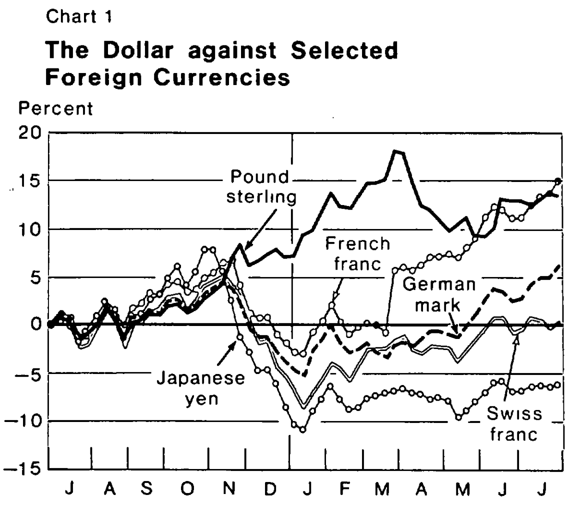
We have reached agreement on the following

A. The achievement of greater exchange rate stability, which does not imply rigidity, is a major objective and commitment of our countries.

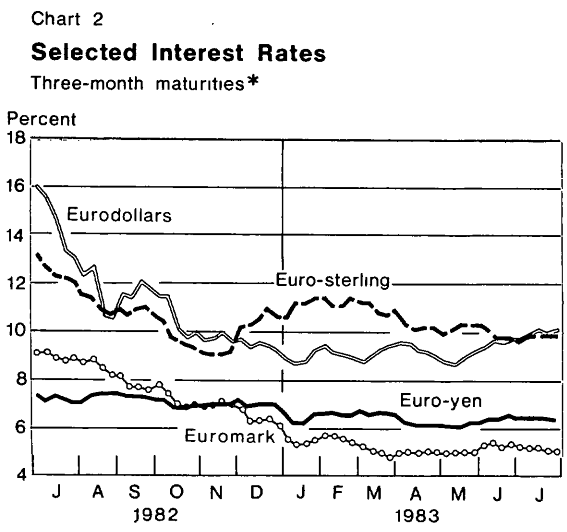
B. The path to greater exchange rate stability must lie in the direction of compatible mixes of policies supporting sustainable noninflationary growth This will be the primary objective of a strengthened multilateral surveillance as agreed in Versailles

C In the formulation of our domestic economic and financial policies, our countries should have regard to the behavior of our exchange rates, as one possible indication of need for policy adjustment Close attention should also be given to the interactions and wider international implications of policies in each of our countries

D Under present circumstances, the role of intervention can only be limited. Intervention can be useful to counter disorderly market conditions and to reduce short-term volatility Intervention may also on occasion express an attitude toward exchange markets Intervention will normally be useful only when complementing and supporting other policies. We are agreed on the need for closer consultations on policies and market conditions, and, while retaining our freedom to operate independently, are willing to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful



Percentage change of weekly average bid rates for dollars from the average rate for the week of June 28-July 2,1982 Figures calculated from New York noon quotations



*Weekly averages of daily rates

end, the dollar's advance resumed during July By this time, the vigor of the industrial rebound and perceived readiness of U.S authorities to allow demand pressures to show through in higher interest rates were seen in increasing contrast to situations abroad, most particularly in continental Europe In this atmosphere, even the publication of the largest monthly U S trade deficit in history for May appeared not to have dampened demand for the dollar. Instead, the dollar ratcheted upward at an accelerating rate, the movement most pronounced with respect to the German mark Once again, professional bidding added momentum to the dollar's rise as it passed its earlier highs for the year and then surpassed its peaks of November 1982 against several major currencies. Corporations also bought dollars to cover needs which had been postponed earlier in the year

By late July the dollar's upward movement had taken on a self-sustaining character in increasingly unsettled trading Rate movements were sharp and sudden as market participants became reluctant to take positions, causing trading to become thin and the market to become disorderly The U.S monetary authorities and foreign central banks intervened in coordinated operations, which had a calming effect on the market and helped reestablish order at the time These operations, which the U S authorities initiated on Friday, July 29, on a small scale, were continued during the early days of August In total, the Trading Desk operated on four occasions during the six business days, July 29-August 5, to buy $254 1 million equivalent of German marks and Japanese yen The operations involved purchases of $182 6 million equivalent of German marks and $71.5 million equivalent of Japanese yen, shared equally by the U S. Treasury and the Federal Reserve.

During the six months to end-July, the dollar rose by more than 7 percent against the German mark and by larger amounts against the other EMS currencies The dollar rose less against other currencies, by 5¾ percent in terms of the Swiss franc and by less than 1 percent against the Japanese yen and pound sterling The dollar was down marginally against the Canadian dollar In trade-weighted terms the dollar rose several percentage points, setting records for the floating rate period on many indexes

In other operations during the six-month period, the U.S monetary authorities continued to have credits outstanding to Mexico and Brazil On February 1 the Central Bank of Brazil repaid $280 million of the $730 million outstanding on facilities made available to it earlier by the Treasury The remaining $450 million facility was repaid on March 3 On February 28, the Treasury agreed to provide Brazil with two additional swap facilities of $200 million each in anticipation of Brazil's drawings under a compensatory financing facility and an extended fund facility of the International Monetary Fund (IMF) These swaps were drawn on February 28 and March 3 and were repaid by March 11 Thus, at that point

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility July 31, 1982	Bank of Mexico special facility effective August 30, 1982	Amount of facility July 31, 1983
Austrian National Bank	250		250
National Bank of Belgium	1,000		1,000
Bank of Canada	2,000		2,000
National Bank of Denmark	250		250
Bank of England	3,000		3,000
Bank of France	2,000		2,000
German Federal Bank	6,000		6,000
Bank of Italy	3,000		3,000
Bank of Japan	5,000		5,000
Bank of Mexico			
Regular facility	700		700
Special facility	-0-	325	269*
Netherlands Bank	500		500
Bank of Norway	250		250
Bank of Sweden	300		300
Swiss National Bank	4,000		4,000
Bank for International Settlements			
Swiss francs-dollars	600		600
Other authorized European currency-dollars	1,250		1,250
Total	30,100	325	30,369

*Size of facility was reduced as repayments were made

Brazil had repaid in full all Treasury swaps made available to it since October 1982 In December, the Bank for International Settlements (BIS), acting with the support of the U S Treasury and the monetary authorities of other nations, provided the Central Bank of Brazil with a $1 2 billion credit facility, which was subsequently increased to $1 45 billion As part of a liquidity-support arrangement for the BIS provided by the participating monetary authorities, the Treasury through the Exchange Stabilization Fund (ESF) agreed to be substituted for the BIS for $500 million of the credit facility in the event of delayed repayment by the Central Bank of Brazil

Funding for Mexico was provided through the Bank of Mexico's regular swap facility of $700 million with the Federal Reserve and also through special swap facilities totaling $1 85 billion in cooperation with other central banks through the BIS The U S portion of the latter facility consisted of $600 million by the Treasury and $325 million by the Federal Reserve In February, Mexico drew the remaining portion of the special facility, receiving $44 3 million from the Treasury and $25.8 million from the Federal Reserve. On February 28, the Bank of Mexico fully repaid the remaining $373 million outstanding under the Federal Reserve's regular reciprocal currency arrangement, which had been drawn last August before other arrangements had been put in place On May 31, Mexico prepaid outstanding swaps under the special facilities, of which $104 million was paid to the Treasury and $56 million to the Federal Reserve Drawings of $496 million and $269 million were outstanding from the Treasury and the Federal Reserve, respectively, as of July 31 but were subsequently repaid upon maturity late in August

In April, the BIS, acting with the support of the U S Treasury and the monetary authorities in other countries, agreed to participate in an international financial support package for Yugoslavia. The Treasury, through the ESF, as part of a liquidity-support arrangement for the BIS provided by the participating monetary authorities, agreed to be substituted for the BIS for $75 million in the event of delayed repayment by Yugoslavia By the end of the period, partial repayments on this facility had reduced the Treasury's contingent commitment to $57 million

On May 12 and on July 26, the U S Treasury redeemed at maturity the last two German mark-denominated securities equivalent to $667 9 million and $607.3 million, respectively These represented the final redemptions of foreign currency notes, public series, which had been issued in the Swiss and German markets with the cooperation of the respective authorities in connection with the dollar-support program of November 1978

In the period from February through July, the Federal Reserve realized no profits or losses from exchange transactions The ESF and the Treasury general account gained $17 0 million and $128 2 million, respectively, in connection with redemptions of German mark-denominated securities As of July 31, cumulative bookkeeping, or valuation, losses on outstanding foreign currency balances were $803 3 million for the Federal Reserve and $850.8 million for the ESF (Valuation gains and losses represent the increase or decrease in the dollar value of outstanding currency assets and liabilities, using end-of-period exchange rates as compared with rates of acquisition.) The above losses reflect the fact that the dollar strengthened since the time the foreign currencies were purchased

The Federal Reserve and the Treasury have invested foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of investments that yield market-related rates of return and have a high degree of quality and liquidity Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve invested some of its own foreign currency resources in securities issued by foreign governments As of July 31, the Federal Reserve's holdings of such securities were equivalent to $1,328 1 million In addition, the Treasury held the equivalent of $2,046 5 million in such securities as of the end of July

German mark

The German mark had participated in the generalized rise in currencies against the dollar around the turn of the year and had firmed within the EMS By the beginning of February, however, the mark had eased back across the board, trading at DM 2 4735 against the dollar, as expectations of a continued decline of the dollar weakened Within the EMS, it drifted down to the middle of the narrow band, as speculative buying of marks in anticipation of a realignment subsided pending early-March elections in Germany and France Nevertheless, the sharp swing in Germany's current account back into surplus and further deceleration of inflation during the past year had generated expectations in the markets that the mark would again be revalued in an imminent change in EMS currency relationships

Soon after the opening of the six-month period, speculative pressures reemerged as the election dates approached, and the mark again came into strong demand By mid-February it had moved to the ceiling of the EMS after opinion polls predicted that the five-month-old Kohl government would get a mandate from the electorate and have sufficient control of Parliament to pursue its conservative economic policies In early March, when the election results confirmed the predictions of the polls, the demand for marks increased With the currency at the top of the EMS, both the Bundesbank and other participating central banks had to intervene heavily to keep the mark within its upper limits As the pressures intensified, several other EMS countries whose currencies were pinned to the bottom of the EMS supplemented market intervention with other actions to discourage speculation. Thus, speculative bidding for the mark against non-EMS currencies intensified, lifting the mark some 4 percent against the dollar to its high for the period of DM 2 3685 by March 14 and by similar amounts against other major non-EMS currencies. In the realignment of March 21, the mark's central rate was adjusted upward by 5.5 percent. Other EMS currencies were revalued by smaller amounts or devalued, with the result that, in terms of the bilateral central rates, the mark was revalued by about the same amount on a trade-weighted basis

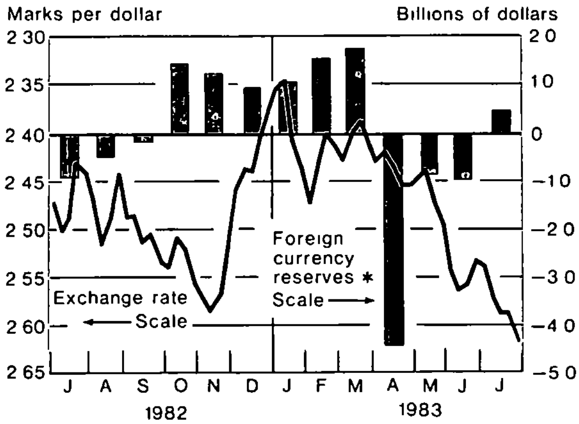
Meanwhile, Germany's recession had bottomed out late in 1982 and business confidence was improving, but the pace of recovery was still expected to be insufficient to curb a continuing rise in unemployment The government was committed to fiscal restraint to achieve a long-standing German objective of reducing the size of the fiscal deficit relative to GNP Already the government had made some progress in imposing cuts in social expenditures.

Under these circumstances, the Bundesbank had taken advantage of the drop in inflation and the improvement in the current account to ease monetary conditions Early in the year it had acted out of concern over a possible reversal of the downtrend of interest rates abroad and the risk that the mark's recovery had stalled, providing liquidity through open market operations and increasing banks' rediscount quotas but not lowering interest rates Effective March 18, however, it took the more visible step of cutting its discount and Lombard rates by 1 percentage point, to 4 percent and 5 percent, respectively, to signal its intention to lend support to the economy But, by this time, the domestic money market had become quite liquid and short-term market rates had declined, partly because of the liquidity effects of the heavy foreign exchange intervention before the realignment Moreover, the scheduled transfer of Bundesbank profits to the federal government in April was also going to inject liquidity Consequently, the Bundesbank tempered its interest rate action with some cutback in banks' rediscount quotas German interest rates nonetheless continued to ease, both absolutely and relative to those in the United States Thus, by end-March the adverse interest differential in the Euro-

Chart 3

Germany

Movements in exchange rate and official foreign currency reserves



Exchange rates shown in this and the following charts are weekly averages of noon bid rates for dollars in New York Foreign currency reserves shown in this and the following charts are drawn from IMF data published in International Financial Statistics

*Foreign exchange reserves for Germany and other members of the European Monetary System, including the United Kingdom, incorporate adjustments for gold and foreign exchange swaps against European currency units (ECUs) done with the European Monetary Fund

markets for three-month maturities, for example, had widened to almost 4½ percentage points, a level not seen since July 1982

After the realignment, the mark moved to the bottom of the new EMS band and also fell back to early-February levels against the dollar Speculative inflows and commercial leads and lags were unwound In addition, capital was attracted abroad Although interest rates in other EMS countries and the United States were temporarily easing, interest differentials were still adverse to the mark and no longer offset by the prospect of early exchange rate appreciation Also, there was talk of possible liquidation of some OPEC investment in marks to meet current payments Thus, EMS central banks bought large amounts of marks to keep the German currency within its lower intervention limits In addition, with the mark declining against most non-EMS currencies, the Bundesbank sold dollars By end-April, Germany's foreign currency reserves dropped more than they had risen during the previous two months to show a net $1 1 billion decline from January's $40 6 billion level

By mid-May, business confidence in Germany had faltered On the one hand, the benefits of decelerating inflation were becoming more apparent A drop in the inflation rate to below 3½ percent had paved the way for a very moderate increase in the key pay agreement for metal workers and an even lower 2 6 percent average wage increase for public service employees In addition, publication of first-quarter figures confirmed there had been some revival in interest-sensitive sectors of the economy, such as investment goods and consumer durables On the other hand, exports—the sector that traditionally leads Germany out of recession—had shown almost continuous weakness since mid-1982 The trade figures for April revealed a significant drop both in exports and in the trade surplus, suggesting that the strength recorded for the first quarter reflected little more than a speedup of shipments to other EMS countries in anticipation of the EMS realignment Henceforth, export demand was seen as being depressed, not only by the weakness of markets among the developing countries and OPEC, as before, but also as a result of the larger than expected revaluation of the mark in the March realignment and the effects of new austerity measures in France Moreover, the scope for providing more impetus to the economy by further reducing interest rates was rapidly disappearing Central bank money growth was still running well above the Bundesbank's target range of 4-7 percent for the year, even after reversal of the foreign exchange inflows of February-March And, abroad, the outlook for interest rates in the United States was bringing into question hopes that the ten-month-long downswing in world interest rates would continue

Under these circumstances, the outlook for the mark became increasingly overshadowed by that of the dollar which was buoyed by prospects of a vigorous economic recovery, strong corporate profits, and increasingly attractive yields on fixed-income investments in the United States As interest rates in the United States moved up after mid-May, rates in Germany held generally steady, with the Bundesbank allowing German banks to borrow from its Lombard facility heavily and for long periods of time As a result, interest differentials adverse to the mark began to widen once more, surpassing the levels of late March by mid-June and increasing further throughout July In addition, a number of political factors weighed on sentiment toward the mark The Williamsburg summit passed without apparent agreement on European initiatives pertaining to interest rates and exchange rates Meanwhile, reaffirmation of the NATO decision to place Pershing II and cruise missiles in Germany underscored the potential for public debate over a variety of national security issues

Thus, the mark continued to decline against the dollar, falling by mid-July below its November 1982 low, and generally traded near the bottom of the EMS Market participants took little apparent note of newly published figures that pointed to a marked upturn in industrial production and improvement in Germany's trade and current account figures for June. Instead, at end-July the mark's drop accelerated, as trading became increasingly hectic, to touch a seven and a half-year low of DM 2.6600. Throughout the last two and a half months of the period, the Bundesbank regularly sold modest amounts of dollars at the fixing but was perceived in the market as not providing strong resistance to a further drop in the exchange rate against the dollar. Meanwhile, other EMS central banks bought marks either in compulsory interventions at the limits of the $2\frac{1}{4}$ percent band or to rebuild reserves.

By end-July, trading conditions had deteriorated considerably. As the mark's decline relative to the dollar cumulated and major market makers became less willing to take the positions needed to smooth the flow of orders coming into the market from their customers, the market became more subject to sudden rate movements and widening spreads between bid and offered rates. The U.S. authorities entered the market on July 29 to purchase marks as part of an intervention operation that continued into the subsequent week and was coordinated with other central banks. For its part, the U.S. authorities purchased a total of $182.6 million equivalent of marks during a period of six business days to counter disorderly trading conditions.

Primarily as a result of intervention operations, Germany's foreign currency reserves declined a further $1.4 billion after April. For the whole six-month period, they fell $2.5 billion to $38.1 billion. The mark ended the period at DM 2.6500 against the dollar, down on balance 7 percent from its early-February level. As measured by the Bundesbank's trade-weighted index, however, the mark appreciated by $\frac{1}{2}$ percent, mainly because of the mark's appreciation *vis-à-vis* other EMS currencies.

In mid-May and in late July, the U.S. Treasury repaid at maturity the final two German mark-denominated obligations issued in conjunction with the November 1978 dollar defense program. These repayments totaled $1.3 billion equivalent.

Japanese yen

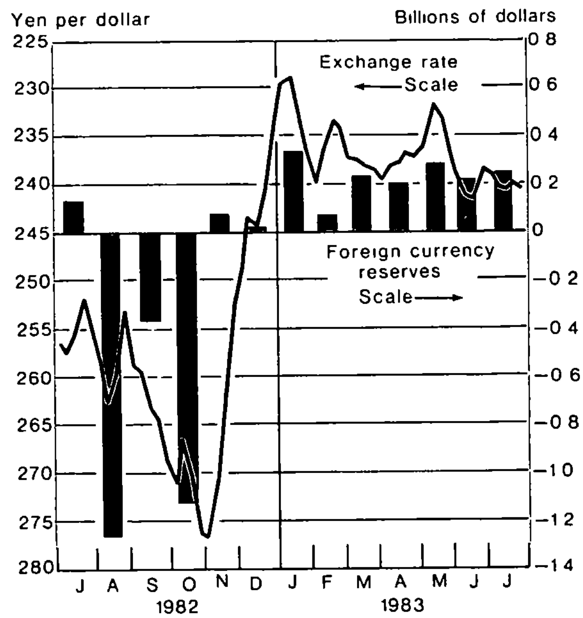
A recovery of the Japanese yen against the dollar, which had brought the currency up some 19 percent from its November 1982 low by early January, stalled just before the period under review. Although the yen remained firm as compared with European currencies, it eased back against the dollar to ¥240.90 at the beginning of February. As a result, market participants were again disappointed in their expectations that Japan's strong current account position, low inflation, and cautious economic policies would set the stage for the yen to recapture more of the ground lost against the dollar during the preceding two years.

For some time the yen's weak performance against the dollar had been regarded by the Japanese monetary authorities as substantially reducing their scope for responding to the weakness of domestic economic activity. Fiscal policy was felt to be constrained by concern over the budget deficit and a commitment to narrow the borrowing gap. Monetary policy was felt to be constrained by the risk that any further easing of interest rates in Japan might again stimulate outflows of capital which had been a major influence in the yen's weakness. The authorities wished to avoid adding pressure on the exchange rate at a time when international attention was focused on Japan's widening trade surplus. Japan had emerged with the largest current account surplus of the major industrialized countries, close to $7 billion in 1982. In the recessionary environment which many countries faced around the turn of the year, the prospect that Japan might experience a further sharp increase in its export penetration this year aggravated already severe trade frictions with its major trading partners. The Bank of Japan, therefore, chose not to lower its discount rate from the $5\frac{1}{2}$ percent level that had prevailed for

Chart 4

Japan

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3.

over a year, and Japanese market rates eased little even as interest rates in most other financial centers declined substantially after mid-1982.

During February and March, expectations about the near-term course of Japanese interest rates shifted frequently On numerous occasions, expectations developed that the official discount rate would be cut. Economic growth continued to slow, and output in Japan was slipping to relatively low levels of capacity Japan's low inflation, high real interest rates, and the outlook for modest wage increases in the spring labor offensive all suggested that there still might be scope for measures to stimulate domestic demand Nevertheless, the Bank of Japan repeatedly stated that the yen's exchange rate prevented it from lowering its lending rate With the outlook for interest rates uncertain and with Japan's economy looking stagnant as compared with the more vigorous performance of the U.S. economy, foreign investors became skeptical that Japan's stock and bond markets would make a strong showing relative to those abroad.

In addition, conditions in world oil markets and speculation surrounding the EMS realignment affected trading in the Japanese yen for the first three months of the period Although Japan was seen as benefiting from declining prices for its oil imports, market attention focused on the immediate, unfavorable impact on Japan's capital account of the possibility that OPEC nations might liquidate their holdings in Japanese capital markets Indeed, inflows of capital from OPEC countries were considerably diminished and contributed, along with substantial overseas investments by Japanese institutional investors, to an increase in Japan's net long-term capital outflow. The yen was also caught up at times in the EMS pressures around mid-March, since the yen was used to some extent as a vehicle for speculation against those currencies expected to be revalued

The yen, therefore, showed little trend against the dollar through late March Although at one point in February it rose to ¥231.20, by the quarter end the yen was trading back around ¥240. The yen declined about 3 percent against the mark just before the realignment of the EMS However, in the subsequent unwinding of speculative positions, the yen recouped most of that loss in just a few days.

At end-March, with the approaching close of the fiscal year and Parliamentary action on the budget, public attention focused increasingly on the continued sluggishness of the Japanese economy. Real growth had amounted to 3 3 percent in the fiscal year just ending—a disappointing figure by traditional standards—with the rate of growth decelerating noticeably throughout the year Export demand remained weak, reflecting the worldwide recession, increasing barriers to Japanese goods, and import cutbacks by developing countries Japan's current account surplus continued to widen, most importantly because imports were depressed by the low level of domestic demand The yen's earlier appreciation and weak commodities prices had contributed to an improvement in Japan's terms of trade. Although this helped strengthen the corporate sector's financial position, industry remained cautious about embarking on new investment projects as long as final demand was flagging Thus, loan demand remained weak and the Bank of Japan scaled back its projection for new lending by city banks for the coming quarter.

Under these circumstances, calls for an interest rate cut were increasingly heard from private as well as some government sources, and talk spread that the government would soon announce measures to support economic growth On April 5, the government presented an eight-point program, involving primarily a speedup in the disbursement of previously budgeted public works spending But the Bank of Japan still viewed the exchange rate as too weak to permit a discount rate cut and thus disappointed hopes that a drop in interest rates would reinforce the government's program

During April and into early May, the yen drew support from the prospect that Japanese interest rates would remain stable. In addition, the approaching release of a seven-nation intervention study and the upcoming Williamsburg summit focused attention on official exchange rate policies. Market participants interpreted statements by Bank of Japan Governor Maekawa and others as presaging a move to a more active international intervention policy They also anticipated that the Japanese government might choose to support its currency before the Williamsburg summit so as to defuse the trade issue.

By May 11, these factors helped boost the yen to a high of ¥230 35 against the dollar Speculation in favor of the yen on Chicago's International Monetary Market (IMM) became quite heavy at times and was an important component of the run-up in the yen, with open interest in yen contracts hitting successive records But the overhang of these positions soon became a source of concern, as fears arose that a sudden decline in the yen might be triggered by the need to cover them In addition, a renewed rise in U S interest rates and the completion of the Williamsburg summit without any obvious change in official foreign exchange operations exerted a drag on the yen, which dropped back to a low of ¥243 60 by mid-June. Nevertheless, the yen had shown a steady advance against the German and other Continental currencies, rising more than 6 percent *vis-à-vis* the mark during the prior two and a half months.

After mid-June the improvement in Japan's external sector began to receive more attention in the exchange markets A bottoming-out of exports, together with the continuing low level of imports, led to a widening of Japan's current account surplus to a seasonally adjusted annual rate of $20 billion for the first five months of 1983. In the meantime, the quickening pace of recovery in the United States, where the import of manufactured goods was forecast to rise significantly, suggested there would be a further expansion of Japan's exports. Moreover, political developments in Japan provided background support for the yen during this period, as the ruling party's victory in June Parliamentary elections confirmed that the government's international and economic policies would not be subject to major change.

Consequently, the yen moved up against the dollar during the latter half of June and held generally steady during July as the dollar advanced against the Continental currencies. But, when the yen became caught up in the pressures of a rapidly rising dollar at the month end, the Japanese authorities sold dollars as a coordinated intervention operation got under way in which the U S authorities bought $71 5 million equivalent of yen These purchases during the

Table 2

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

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

Bank drawing on Federal Reserve System	Outstanding July 1, 1982	1982 III	1982 IV	1983 I	1983 II	1983 July	Outstanding July 31, 1983
Bank of Mexico	200 0	+1,400 0 − 900 0	−217 4	−482 6	-0-	-0-	-0-
*Bank for International Settlements (against German marks)	-0-	-0-	+124 0 −124 0	-0-	-0-	-0-	-0-
Total	200 0	+1,400 0 − 900 0	+124 0 −341 4	−482 6	-0-	-0-	-0-

Data are on a value-date basis

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

Table 3

Drawings and Repayments by the Bank of Mexico under Special Swap Arrangements

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

Drawings on	Outstanding July 1, 1982	1982 III	1982 IV	1983 I	1983 II	1983 July	Outstanding July 31, 1983
United States Treasury special temporary facility for $1,000 million	*	+ 825 0 − 825 0	*	*	*	*	*
Drawings on special combined credit facility:							
†Federal Reserve special facility for $325 million	*	+ 89 8 − 43 8	+211 2	+ 67 8	− 56 0	-0-	269 0
†United States Treasury special facility for $600 million	*	+ 166 8 − 81 3	+392 2	+122 3	−104 0	-0-	496 0
Total	*	+1,081 6 − 950 0	+603 5	+190 0	−160 0	-0-	765 0

Data are on a value-date basis Because of rounding, figures may not add to totals

*Not applicable

†Size of facility was reduced as repayments were made during 1983

first days of August were shared equally between the Federal Reserve and the U S Treasury

Although the yen closed the six-month period at ¥242 90, near its low against the dollar, it registered a net decline of less than 1 percent since end-January With the yen relatively steady against the dollar, it showed an almost uninterrupted advance against other currencies after mid-March It ended July almost 7 percent higher on balance against the mark, thereby challenging its 1978 high against that currency The Japanese authorities intervened little in the exchange markets through the end of July, with the $1 25 billion increase in foreign currency reserves since January to $20 7 billion primarily reflecting interest receipts on their currency holdings

Swiss franc

Coming into the period under review, the Swiss franc was trading well above its previous-autumn levels against all currencies except the Japanese yen After leading the recovery of European currencies against the dollar that had begun in mid-November, it had held up better than others after the dollar's turnaround in early January to trade around SF 2 0250 against the dollar and about SF 0 82 in terms of the German mark

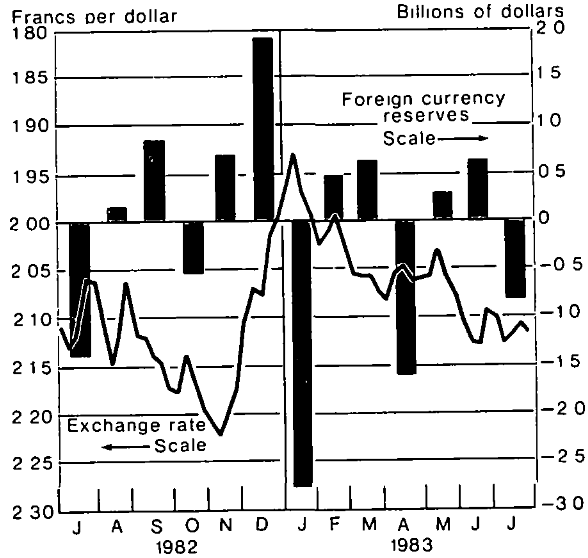
By February, there was a perception in the market that the Swiss authorities might not have the leeway that they had during much of the previous year to ease monetary conditions Inflation, at least at the consumer level, had receded less in Switzerland than in Germany, Switzerland's major trading partner and competitor in third markets The growth of central bank money had begun to rise, coming close to the central bank's 3 percent target for 1982, and the authorities had adopted the same target for the coming year Consequently, there was seen to be rather little scope for interest rates in Switzerland to decline from the very low levels of last fall, while interest rates abroad had dropped substantially As a result, the large adverse interest differentials that had fostered heavy capital outflows and had contributed to last year's weakness of the franc were narrowing considerably

There were other reasons as well why market participants anticipated that capital outflows from Switzerland might not be so large as in 1982 Foreign official and corporate borrowers, especially Japanese entities, continued to borrow in Swiss francs throughout the first half of 1983 The spot rate on occasion was pushed lower when the proceeds of new issues were converted into foreign currencies But, at the same time, the sheer size of earlier borrowings was seen as increasing the potential that the Swiss franc might come into strong demand sometime in the future If, for example, Swiss interest rates were to rise substantially more than rates in other markets or if the dollar were to decline, earlier borrowers might bid for francs to cover their liabilities Thus, the attitude of market professionals toward the Swiss franc had come to incorporate a decided sense of two-way risk

Chart 5

Switzerland

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

Sentiment toward the franc was also favorably affected by other factors The country's trade deficit had narrowed by $1 billion to yield a surplus on current account of $3 4 billion last year, and most forecasts called for a similarly sized surplus for 1983 The competitiveness of Swiss exports had actually improved somewhat, reflecting in part last year's decline of the franc relative to the German mark, which had not been fully reversed More importantly, the Swiss government's fiscal discipline compared favorably with that of other countries Thus, Switzerland appeared to have come through the difficult adjustments of recent years with fewer economic dislocations, as well as fewer political divisions, than most countries Moreover, Switzerland's traditional role as a safe haven and its relative political stability made the franc an attractive currency for investment, particularly when contentious political campaigns were under way in a number of neighboring countries

For a time during February and March, these favorable factors were overshadowed by intensified bidding for German marks in anticipation of an EMS realignment With the mark rising strongly across the board, the Swiss franc dropped steadily as it became one of the currencies against which long mark positions were established. In all, the franc declined nearly 6 percent against the mark to SF 0.8663 on March 14, its lowest level in one and a half years Against the dollar, the Swiss franc swung widely under the influence of active speculative trading in the interbank market and on Chicago's IMM before settling around the level of SF 2.0750 in mid-March

By late March, however, the Swiss franc had begun to move back up against the mark as positions taken prior to the March 21 realignment of the EMS were reversed Meanwhile, the franc's traditional interest rate disadvantage narrowed The Swiss National Bank lowered its official lending rates by 1/2 percentage point on March 17, in coordination with a larger reduction by the German central bank But Swiss money market interest rates actually rose during the second half of March, while those in most other centers were declining With some slowing of the previous rate of foreign borrowing in the Swiss capital market, the franc gained steadily against the German mark in a trend that was to continue

Against the dollar, the Swiss franc edged up more gradually through mid-May before declining in June, along with other foreign currencies The decline was in response to the renewed rise in U.S. interest rates and the revised outlook for U.S. economic recovery. Compared with other Continental currencies, however, the franc declined more modestly By then, short-term interest rates in the Swiss market had advanced almost to the levels prevailing in Germany, thereby eliminating the traditional negative spread between the two markets. The increased interest rates reflected market participants' wariness that the Swiss National Bank might tighten the supply of banking reserves in response to an apparent overshooting of its monetary target in the first five months of the year. Such speculation persisted even after central bank officials pointed out that the year-over-year rise in central bank money so far was a statistical anomaly that need not be offset later in the year and, furthermore, that the central bank would accept an overrun by as much as 1 percentage point.

The Swiss franc declined relative to the dollar as the dollar began its steep run-up late in July. It dropped to a low of SF 2.1530 on the last day of trading before closing at SF 2.1420, some 5 3/4 percent below the opening six months earlier. But, against the German mark, the franc continued rising to close 1 1/2 percent higher than at end-January and some 6 1/2 percent above its lowest point in mid-March. Trading at SF 0.8083, the franc was approaching levels that previously had brought into question the competitiveness of industry in Switzerland relative to that in Germany The Swiss authorities did not intervene in the exchange markets until after the end of the six-month period under review, although they continued to use foreign currency swaps to provide liquidity to the banking system. The country's foreign exchange reserves showed little change, easing back $400 million on balance to $11 8 billion at end-July.

Sterling

Sterling was affected during the period under review by developments in world petroleum markets and by uncertainties surrounding the United Kingdom's general election Prospects of potentially large drops in oil prices were seen as having considerable bearing on Britain's external and fiscal positions The current account surplus which had helped sustain comparatively high nominal and trade-weighted values of sterling during the previous two years had already dwindled, and the nonoil components were forecast to deteriorate sharply in the coming year—only partly because the immediate outlook for growth in the United Kingdom was somewhat better than for its European neighbors The government had recently provided some fiscal relief, largely to industry, at a time when the domestic economy was still struggling to emerge from three years of recession. A significant reduction of oil tax and royalty receipts would have raised the possibility that the government might exceed its target for public-sector borrowing, thereby undercutting progress toward the fiscal and monetary discipline that had been a hallmark of its strategy to curb inflation and to restore private initiative in the economy. Meanwhile, expectations had developed that the government might choose to hold an election before its mandated date in 1984. It was anticipated that economic policy in general and exchange rate policy in particular would be important campaign issues The government was expected to take credit for bringing inflation down to 4-5 percent. But, with the outlook for world trade pessimistic and the domestic economy not strong enough to bring the unemployment rate below 12 percent, there was already considerable concern about Britain's competitive position. A major opposition party was calling for a large devaluation of the pound, as well as for a sharp acceleration of public spending and substantially lower interest rates Talk spread that even the government might accept some modest easing of the exchange rate

By late January, the pound had eased against the dollar to $1 5210, while settling around 81 according to the Bank of England's trade-weighted measure. Sterling had fallen in late 1982, when debate on the competitive issue first flared up Selling pressure against the currency had been countered with sometimes forceful intervention by the Bank of England and some backing-up of interest rates that interrupted a pronounced downtrend over the preceding year Britain's foreign exchange reserves had declined for several months, reaching $9.8 billion by end-January.

During February and March, sterling again came on offer, after the failure of OPEC's January meeting to produce agreement on oil prices and production quotas left open the question whether the widely anticipated oil price drop would be limited and proceed in an orderly fashion The pound fell irregularly on various reports of the protracted OPEC negotiations, as well as of the British National Oil Company's own price negotiations Even after a mid-March agreement by OPEC on prices and production ceilings, the market remained skeptical that the details of the agreement would be adhered to

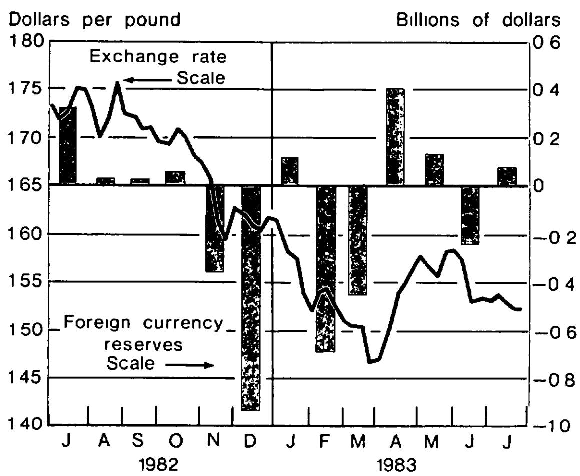
Adding to the pressures on sterling at times were the activities of trading professionals and their customers in anticipation of a realignment of the EMS With the pound already vulnerable to selling pressure and the sterling market unencumbered by exchange controls, the British currency was sold against those viewed as sure to be adjusted upward within the European currency arrangement As a result, large short sterling positions began to be established against the German mark by early March in a pattern that continued until the EMS realignment was announced on March 21.

The Bank of England was seen in the market as cushioning but not resisting this decline, which was regarded as reflecting largely external developments Moreover, outflows from sterling were not mirrored as before in a rise in British interest rates In fact, by mid-March, money market interest rates in the United Kingdom had actually fallen somewhat.

Chart 6

United Kingdom

Movements in exchange rate and official foreign currency reserves



See footnotes on Chart 3

The clearing banks took advantage of a temporary firming of sterling exchange rates in mid-March to cut their base lending rates by 1/2 percentage point, and the Bank of England immediately followed with similar reductions of its money market intervention rates

The sterling market remained generally unsettled through the end of the first quarter in response to the continuing uncertainties about oil prices, pressures within the EMS, and newspaper speculation that the government was unconcerned about the exchange rate It fell to its low for the period of $1 4508 against the dollar on March 28 and to 77.9 on the Bank of England's index At these levels, the pound was some 15 percent below its mid-November value both against the dollar and in effective terms Against the German mark, the pound had declined nearly 44 percent in over two years to a record low of DM 3 53 on March 24 Meanwhile, Britain's foreign exchange reserves declined a further $1 1 billion during February and March

At end-March, sterling turned around as signs of adherence to the OPEC arrangements were accumulating The British National Oil Company had announced its own price reductions, which were more modest than some predictions and which did not give rise to competitive action by OPEC producers of closely comparable qualities of crude oil Soon there began to be a reversal of many of the large short sterling positions that had been established during the previous two months, and some commercial entities also moved to cover sterling payments that had been delayed.

During April and early May, other factors also contributed to a further strengthening of sterling Britain's economic recovery appeared to become more assured, with evidence of further rises in domestic sales and production Reported inflation fell to its lowest rates in fifteen years And the current account stayed in modest surplus during the first quarter Under these circumstances, talk that the government might decide to hold a general election as early as June was viewed as increasingly favorable for sterling Thus, the pound continued to benefit from the reversing of professional short positions, from new positioning in favor of the currency, and from shifts into sterling-denominated securities by international investors It proceeded to advance, albeit more slowly after May 9 when the announcement of June general elections focused market attention on the immediate uncertainties of an election campaign On the last day of May, sterling reached the highest level of the six-month period at $1 6145 against the dollar and 88 0 on a trade-weighted basis before easing to around $1 51 and 84 0, respectively, by mid-June

From mid-June to late July, the sterling market became more settled with the spot rate about in the middle of the range over which it had traded during the preceding couple of months The election results assuring continuity in the economic and financial policies of the Thatcher administration and a firming of world oil prices suggesting that the new price structure would hold dispelled the principal uncertainties that had clouded sterling's prospects early in the period The pound's retreat from its late-May highs reduced concern that it was at levels incompatible with Britain's ability to compete and to maintain the momentum of its economic recovery

Meanwhile, the investment flows that had bolstered the pound at times during the spring also tapered off Money market interest rates in the United Kingdom had eased somewhat further which, together with the firming of U S rates since mid-May, left sterling assets without an interest rate advantage over U S investments The Bank of England had endorsed the decline in British interest rates by reducing its intervention rates on two occasions—mid-April and mid-June—for a total of approximately 1 percentage point, and the clearing banks had followed with similar reductions of their base lending rates For a time, market participants anticipated that rates might be lowered further But, after the government reaffirmed its resolve to control inflation and after new evidence showed monetary aggregate growth to be accelerating, the view became accepted that no more cuts in rates were in the offing

Sterling held relatively steady against the dollar during July, when the dollar rose against most other currencies As the period closed, the pound was trading at $1 5150, 1/2 percent lower than its level at the beginning of February In trade-weighted terms, it was 5 percent higher than six months earlier at 85 4 on the Bank of England's index, against the German mark, sterling had gained nearly 6 1/2 percent to trade at DM 4 018 Britain's foreign exchange reserves rose on balance after March to close the six-month period down $800 million from end-January levels at $9 0 billion

French franc

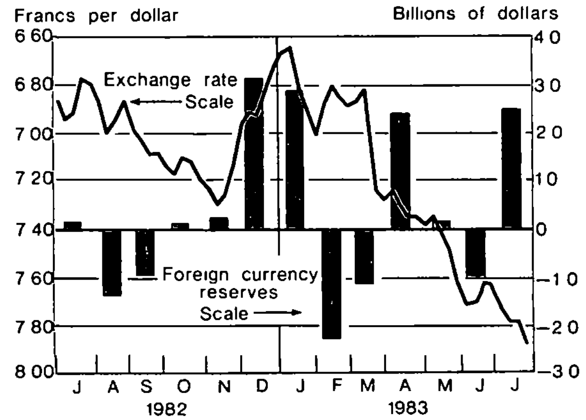
Early in 1983, France's relatively high rate of inflation, wide government deficit, and large current account deficit weighed heavily on market sentiment toward the French franc Even after a temporary freeze on wages and prices, the year-to-year increase in consumer prices had not fallen much below 10 percent and inflationary expectations remained unfavorable The government was struggling to hold to its target for the central government deficit of 3 percent of gross domestic product (GDP) And the current account deficit had more than doubled to $12 billion for the whole of 1982

The French authorities had adopted several measures during the preceding months to deal with these problems But market participants were skeptical that much progress would be achieved, particularly if it should require an undercutting of earlier efforts to curb unemployment and to stimulate economic growth In spite of the need for restraint, the French authorities introduced several measures during the fall and winter to spur investment and employment and acted to lower domestic interest rates as soon as exchange market conditions permitted Concern deepened that the

Chart 7

France

Movements in exchange rate and official foreign currency reserves



See footnotes on Chart 3

economic performance of France was diverging in important ways from that of many other European countries, where inflation was down sharply and current accounts were moving back toward surplus

Under these circumstances, market participants had come to expect that a new EMS realignment would occur soon after the elections in France and Germany scheduled for early March For several months the franc traded close to its parity against the German mark and generally in the upper half of the EMS band The franc was supported by intervention of the Bank of France and by sales of foreign currency which French enterprises borrowed abroad Such borrowing was estimated by Finance Minister Delors to have been $8 8 billion during 1982 By end-January the French franc stood at FF 7 0100 against the dollar and FF 2 83 against the mark France's foreign currency reserves were $17 6 billion at end-January, and the government had arranged a $4 billion syndicated loan in the Euromarket

During much of February the franc edged up against the dollar and moved along with the mark toward the top of the EMS band The pressure against the franc, while offset in the spot market by Bank of France intervention, was nevertheless showing through. Nonresidents speeded up their sales of French francs, which were increasingly financed by borrowing in the Euro-franc market and were reflected in a widening of the discount on the franc in the forward market Meanwhile, expectations of a downward adjustment of the franc rate also contributed to a heavy buildup of imported goods inventories by French enterprises and a deterioration in France's trade account

In early March, pressure against the French franc intensified. News of a sharply wider trade deficit for January, together with the results of the first round of municipal elections in France and the decisive victory for the new government in Germany's national elections, prompted further selling of francs On March 7 the Bank of France allowed the franc to fall to the floor of the EMS. At the same time the cost of overnight financing in the Euro-franc market was bid up to several thousand percent per annum, causing some speculators to close out short positions against the franc. Although the Bank of France was then able to scale back its intervention in the spot market, the accumulated support provided had been substantial, as is partially reflected in the $3.4 billion decline in French foreign currency reserves for February-March.

After lengthy negotiations over the March 18 weekend, the franc's parity was devalued 2.5 percent as part of an overall realignment of EMS currencies. The franc was, in effect, devalued by 8 percent against the mark, 6 percent against the guilder, 5 percent against the Danish krone, and 4 percent against the Belgian franc. It remained unchanged *vis-à-vis* the Italian lira and was effectively revalued 1 percent against the Irish pound The French government announced that, to reduce the trade deficit and to help bring down inflation, it was prepared to adopt further austerity measures. In addition, it would seek a large, medium-term loan from the European Community (EC). On March 25 the French government announced the details of a new program which aimed at reducing domestic demand by FF 65 billion (about 2 percent of GDP). The program included a mandatory loan to the government based on income and wealth taxes paid in 1982, an income tax surcharge to reduce the deficit of the social security system, a special gasoline tax to compensate for declining oil prices and other revenue-raising measures, as well as a limitation on the amount of foreign currency French tourists may take abroad In addition, the money supply growth target for 1983 was lowered from 10 percent to 9 percent. The government projected that, as a result of the program, economic growth for the year would be reduced to nearly zero and inflation cut to 8 percent

The French franc had been pulled up by other EMS currencies before the realignment and was trading on March 18 at around FF 6.90 against the dollar. When the exchange markets opened the following Monday, the EMS currencies as a group fell sharply against the dollar, and the French franc settled around FF 7.25. Nevertheless, the franc emerged firmly at the top of the newly aligned EMS band, where it was to trade through late April. The exchange markets were impressed by the scope and decisiveness of the government's measures, in particular the decision to pass its program by decree rather than going the more lengthy route of legislation. As a result, speculative positions were unwound and commercial leads and lags swung quickly back in favor of the franc These reflows were reflected, in part, in a sharp drop in Euro-franc interest rates to their lowest rates since the start of the year. Moreover, with the franc now at its upper intervention point in the EMS, the Bank of France bought large amounts of other EMS currencies, thereby rebuilding official reserves. At end-April, French reserves had climbed $2 5 billion to $16.7 billion.

By May, the reflows back into the French franc were largely completed while hurdles still had to be surmounted to meet the government's economic objectives. Efforts to curb inflation were being undercut to some extent as the franc dropped against the dollar, since France received none of the benefit of declining oil prices on its domestic price structure. Some disappointing trade figures had already made it clear that the target recently set for the 1983 external deficit would be difficult to achieve On the domestic side, the austerity program was still being met by political opposition.

Under these circumstances the Bank of France was careful about letting interest rates ease, and by summer they were still sufficiently high to attract deposits from investors abroad. The monetary authorities operated on both sides of the market, adding on balance small amounts of foreign currencies to reserves The government went ahead with its plan to borrow ECU 4 billion from the EC's balance-of-payments facility in a series of transactions undertaken in June and July Moreover, the political leadership reaffirmed on a number of occasions the need for rigorous economic policies this year and next.

Thus, by the end of July, the franc was still trading in the upper half of the EMS band and at FF 3.00 against the mark. It continued to decline along with the mark against the dollar, closing the period some 14 percent down from end-January levels at FF 7.9900. But France's foreign currency reserves increased further during the last half of the six-month period to close the period at $18.5 billion, up $900 million from end-January levels and $4.2 billion from their low point of end-March.

Italian lira

Coming into 1983, the economic situation in Italy was showing modest improvement, there had been some progress in bringing down inflation and containing the growth of imports. But these results had been achieved at the cost of a sharp drop in output, and the prospects for further improvement were still unclear. Inflation differentials *vis-a-vis* most of Italy's trading partners had actually widened since the modest scaling-back in Italy's rate of inflation could not match the more sizable reductions of inflation in most other industrialized countries. Export volumes had declined by more than could be explained by contractions in Italy's major export markets Efforts to contain rapidly growing fiscal deficits were being frustrated both by recession at home and repeated failure to get Parliamentary approval for increased taxes and revenues The overshooting of the government deficit contributed to a rapid expansion of total domestic credit which had significantly exceeded its target for 1982 Under these circumstances, the Bank of Italy concluded that it had no room to ease monetary policy and was one of the few central banks not to lower the official discount rate after August 1982 As a result, interest rates in real terms had actually increased somewhat

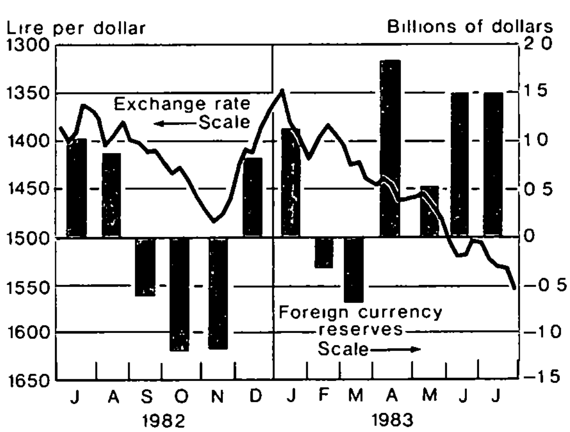
The attraction of relatively high interest rates kept the lira trading firmly near the top of the narrow EMS band, a position it was to keep through February The Bank of Italy took advantage of this relative strength to rebuild its foreign currency reserves to a level of $13 7 billion at end-January 1983 Against the dollar the lira was trading at Lit 1,418 00 by the opening of the six-month period

Early in March, when a realignment of the EMS arrangement appeared to be imminent, market participants came to expect that the Italian authorities might seek to protect the competitiveness of the country's exports by negotiating a downward adjustment of the lira's central rate should the French franc be devalued Between March 3 and March 10 the lira came on offer as commercial leads and lags turned quickly against the currency The spot rate

Chart 8

Italy

Movements in exchange rate and official foreign currency reserves



See footnotes on Chart 3

dropped from the top of the 2¼ percent band to a position well below the narrow band, using the greater leeway available to the lira The Bank of Italy supported the currency with sales of dollars and, to a lesser extent, of EMS currencies These operations are partly reflected in a $700 million decline in the country's foreign exchange reserves for March Meanwhile, the lira had also declined somewhat against the dollar to Lit 1,424 00

On March 21, as part of the overall realignment, the lira's central rate within the EMS was adjusted downward 2½ percent, leaving the parity unchanged relative to the French franc and with adjustments similar to those for the franc against the other EMS currencies In the exchange market, the lira moved to trade well above the new narrow band maintained for the other currencies Following the realignment, there were sizable flows into lire as leads and lags were unwound, seasonal inflows began to show through, and Italy's relatively high interest rates became attractive again once a devaluation was not a near-term prospect The Bank of Italy took advantage of the lira's comfortable position within the joint float to recoup more than earlier losses of foreign currency reserves, contributing to a rise of nearly $2 billion in foreign exchange reserves for the month of April

Soon after the realignment, market interest rates in Italy began to ease Although output had stabilized, it remained at a low level There was little expectation of an early economic recovery, and unions and employers pushed aggressively for lower interest rates Commercial banks cut their prime rates twice during the spring by a total of 1¼ percentage points to 18¾ percent, and there were similar reductions of Treasury bill auction rates But the news on price performance was still disappointing The consumer price index was rising at an annual rate of about 16 percent during the first quarter, well above the government's goal of 13 percent or less The Bank of Italy did not join other EMS central banks in reducing official rates during March But on April 8 it lowered the discount rate by 1 percentage point to 17 percent

Even so, interest differentials remained strongly in favor of the lira Moreover, Italy's current account was strengthening further Italy's trade deficit narrowed considerably during the first half of 1983, compared with the same period of 1982 Increasing tourist receipts and declining service costs on Italy's external debt were expected to generate further gains for the Italian current account balance during 1983 These developments helped buoy the lira even as prospects for action to bring Italy's public-sector deficit under control faded The government collapsed in early May before all the measures to contain the deficit could be passed by Parliament, and it was unclear whether a new coalition government would take strong measures either to cut spending or to raise taxes in the current depressed economic environment

Table 4

Drawings and Repayments by the Central Bank of Brazil under Special Swap Arrangements with the United States Treasury

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

Drawings on United States Treasury special facilities for	Outstanding July 1, 1982	1982 III	1982 IV	1983 I	1983 II	1983 July	Outstanding July 31, 1983
$500 million	*	*	+ 500 0 − 500 0	*	*	*	*
$280 million	*	*	+ 280 0	− 280 0			
$450 million	*	*	+ 450 0	− 450 0	*	*	*
$250 million	*	*	+ 250 0 − 104 2	− 145 8	*	*	*
$200 million	*	*	*	+ 200 0 − 200 0	*	*	*
$200 million	*	*	*	+ 200 0 − 200 0	*	*	*
Total	*	*	+1,480 0 − 604 2	+ 400 0 −1,275 8	*	*	*

Data are on a value-date basis

*Not applicable

The lira continued to trade above the EMS narrow band through July while moving down with other European currencies against the dollar The easing of pressures on the external account permitted the Italian authorities to build up their foreign currency reserves and to increase the amount of foreign exchange Italian tourists may export. By end-July the lira was trading at Lit 1,573.00 against the dollar, down almost 11 percent over the six-month period under review and down 3½ percent against the German mark Meanwhile, Italy's foreign exchange reserves stood at $18 6 billion, up $4 8 billion over the period.

European Monetary System

The currencies of the EMS were trading steadily against each other at the beginning of February, but in a configuration which reflected widespread market expectations that continued divergence in economic performance among the member countries made another realignment inevitable. These expectations were based on observations that, in most cases, differentials in inflation and current account performance had increased slightly since the realignment of June 1982 Inflation had decelerated more sharply in Germany and the Netherlands than in other EMS countries. At the same time, German and Dutch current accounts had moved strongly into surplus, while other countries, even those whose current accounts had improved, remained in sizable deficit.

To be sure, the authorities in several participating countries had implemented policies during 1982 to reduce inflation and to improve current accounts, but the effects were only beginning to show through The Belgian government, using emergency powers, had imposed a broad austerity program to slash government spending, wage costs, and the trade deficit In Denmark a new government had abolished wage indexation and reversed a stimulative fiscal policy, while the central bank had kept interest rates relatively high In Ireland, the authorities had in place restrictive fiscal and monetary policies and the exchange rate had appreciated against sterling, the currency of Ireland's major trading partner. In France, however, and to a lesser extent in Italy, progress toward achieving better balance in the economy was not yet sufficient to relieve concern in the markets about the currencies' near-term outlook

In all EMS countries, unemployment was high and generally still rising, reaching levels of over 16 percent in some countries. To varying degrees in all countries the authorities were embarked on medium-term efforts to reduce large and persistent structural fiscal deficits But recession was adding to the difficulties of achieving planned budgetary savings Pressure therefore was on monetary policy to provide support to the domestic economies, and the question remained among market participants whether the general move toward restraint could be sustained long enough to produce more uniform economic performance.

Under these circumstances, the Dutch guilder stayed virtually at the top of the $2^1/_4$ percent narrow band early in February, with the German mark and the Danish krone close behind The French franc was held close to its bilateral central rate relative to the mark, while the Irish pound fluctuated below the middle, and the Belgian franc remained at or near its lower intervention point. Except for the French franc, there was only modest intervention in support of the currencies within the narrow EMS band The Italian lira, buoyed by relatively high interest rates in Italy, was fluctuating within the wider limits available to that currency to trade slightly above the $2^1/_4$ percent intervention limits of the others.

During February, however, the currency relationships came under increasing pressure, as speculation grew that a realignment might occur soon after early-March elections in France and Germany. The mark and guilder became pinned to their upper intervention points The French franc moved along with the mark until March 7, when the French franc was permitted to drop to its lower intervention point By this time, other currencies, too, had come under pressure The Danish and Irish currencies fell to the bottom of the EMS band, and the Italian lira traversed the whole width of the narrow band to trade about 2 percent below it. To defend the Belgian franc, the Belgian National Bank raised official interest rates by $2^1/_2$ percentage points, effective March 9,

Table 5

United States Treasury Securities, Foreign Currency Denominated

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

Issues	Amount of commitments July 1, 1982	1982 III	1982 IV	1983 I	1983 II	1983 July	Amount of commitments July 31, 1983
Public series:							
Germany	3,171 3	−1,231 9	−664 1	-0-	−667 9	−607 3	-0-
Switzerland	458 5	-0-	-0-	−458 5	-0-	-0-	-0-
Total	3,629 8	−1,231 9	−664 1	−458 5	−667 9	−607 3	-0-

Data are on a value-date basis Because of rounding, figures may not add to totals

Table 6

Net Profits (+) or Losses (−) on United States Treasury and Federal Reserve Current Foreign Exchange Operations

In millions of dollars

Period	Federal Reserve	United States Treasury: Exchange Stabilization Fund	United States Treasury: General account
Third quarter 1982	-0-	− 2 3	+89 4
Fourth quarter 1982	-0-	+ 4 3	+16 0
First quarter 1983	-0-	+ 0 5	+38 3
Second quarter 1983	-0-	+ 17 0	+58 1
July 1983	-0-	-0-	+70 1
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1983	−803 3	−850 8	-0-

Data are on a value-date basis

and then on March 14 the authorities significantly tightened exchange controls, particularly affecting commercial leads and lags Meanwhile, a sudden and sharp increase in short-term Euro-French franc interest rates effectively curtailed speculation by nonresidents selling the French franc short.

In response to these developments, the focus of speculative activity shifted toward those currencies expected to be revalued. Bidding for marks and guilders quickly intensified against both dollars and other non-EMS currencies, with the result that the upward pressure on the stronger currencies lent support to the EMS as a group against the dollar. The central banks in Germany and the Netherlands took advantage of the strength of their currencies, as well as the improvement in their current accounts and in their price performance, to lower interest rates and thereby to lend support to their domestic economies. By March 18, the Netherlands Bank dropped its official lending rates in two stages for a total of 1 percentage point, and the Bundesbank lowered its official interest rates that day by 1 percentage point as well As a result of these and earlier declines in interest rates, short-term market rates had eased in the two countries to their lowest levels since early 1979 Dutch interest rates had declined even more rapidly than German rates over the preceding year and were as much as 1 percentage point below those for comparable maturities in Germany

Meanwhile, the EMS central banks intervened heavily, both in EMS currencies and in dollars In fact, total EMS intervention in the six weeks through March 18 considerably exceeded that for any comparable period since the inception of the currency arrangement Countries whose currencies were under the heaviest pressure suffered sizable reserve losses and established large debtor positions in the European Fund for Monetary Cooperation (FECOM), while Germany had the opposite experience.

On March 21 the seventh realignment became effective Four currencies were revalued—the mark by 5 5 percent, the guilder by 3 5 percent, the Danish krone by 2.5 percent, and the Belgian franc by 1 5 percent—and three were devalued—the French franc and the lira by 2 5 percent and the Irish pound by 3 5 percent In effect, these changes left the trade-weighted values of the Danish krone and the Belgian franc about unchanged and offset an earlier appreciation of the Irish pound against sterling, leaving that currency at about its 1982 level overall. Pursuant to the realignment, the French government indicated it would adopt austerity measures to restore external equilibrium

Immediately after the realignment, speculative positions were reversed and commercial leads and lags were unwound These reflows out of marks and guilders helped drag the entire EMS down *vis-à-vis* non-EMS currencies, with the result that several of the devalued currencies hit new lows against the dollar Within the EMS, however, the reflows pushed the French, Irish, and Danish currencies all close to the top and the Italian lira moved well above the narrow band With the mark and guilder now at the lower limit of the new band, most participating central banks had an opportunity to reconstitute reserves and reduce FECOM debt, most of which was repaid by end-April

As the reflows proceeded, policy adjustments were possible in a number of countries which could then catch up with the generalized decline in interest rates The authorities in Italy, Belgium, Denmark, and Ireland permitted an easing in domestic interest rates, confirmed in most cases by cuts in official lending rates Among the largest declines were those in Belgium, where the central bank lowered its lending rates by 5 percentage points in four steps, and in Denmark, where the central bank lowered its discount rate twice for a total of 2½ percentage points. In addition, foreign exchange controls were relaxed in Belgium and Denmark. The Belgian authorities removed one of the restrictions imposed prior to the realignment requiring Belgian enterprises to convert promptly foreign currency receipts from current account transactions. The Danish authorities eased some long-standing exchange restrictions on capital transactions By contrast, the German and Dutch authorities stemmed the earlier downtrend in their interest rates. In fact, market rates in the Netherlands backed up sharply to levels above those in Germany Then, effective May 3, the Netherlands Bank validated part of the increase by raising its discount rate by 1 percentage point back to the level that had prevailed at the start of the six-month period.

Following these actions, the Belgian franc and Danish krone eased in the EMS toward the bottom and the middle, respectively, while the guilder edged up toward the middle But the other currencies were little changed during the four and a half months after the March realignment, with the German mark staying close to its lower intervention point against either the French franc or the Irish pound at the top The adjustments in currency relationships that did occur took place without strain through end-July, the continued improvement in trade accounts and inflation figures lending credibility to the 1982 austerity programs in both Belgium and Denmark Against the dollar, however, the EMS currencies as a group moved lower, closing the six-month period under review down 7 to 14 percent on balance. For the EMS countries as a whole, foreign currency reserves changed little on balance over the period Within the group, however, reserves of Italy, France, and to a lesser degree Belgium rose while those of Germany and the Netherlands declined

Canadian dollar

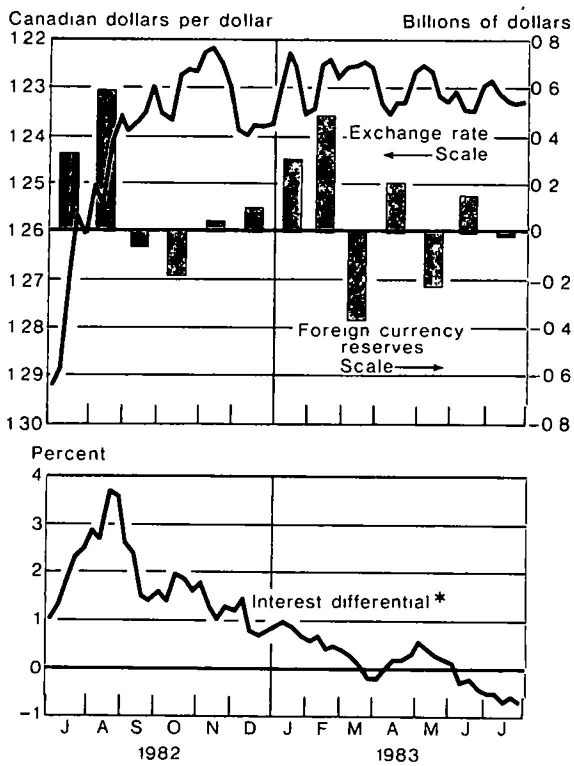
Early in 1983, the Canadian economy was just beginning to emerge from recession. For Canada the drop in output had been deeper than for most other industrialized countries and the unemployment rate was still near its peak of 12.8 percent. In addition, the downturn in inflation had come later than for most countries, with the annual rate of increase for the consumer price index edging just below double-digit levels by the turn of the year

Although the severity of the adjustments taking place in Canada had given rise to an active debate over the appropriate priorities for economic policy, the Canadian authorities remained committed to the need to promote cost and price stability A public-sector wage and price restraint program had been implemented Fiscal policy remained cautious Initiatives by the government during the winter to boost employment and to stimulate investment had been matched largely by cuts in planned expenditures elsewhere, although the financing requirements of both the federal and provincial governments had increased mainly for cyclical reasons In addition, monetary policy continued to be aimed at exerting continuous downward pressure on inflation to provide a basis for sustained economic growth In the conduct of this policy, the Bank of Canada had announced in November 1982 that it was withdrawing the target range for the expansion of the specific monetary aggregate, M-1, since the aggregate's relationship to interest rates and total spending was no longer sufficiently reliable In the meantime, the monetary authorities indicated they would look at other financial and economic variables, including the value of the Canadian dollar

Chart 9

Canada

Movements in exchange rate, official foreign currency reserves, and interest differential



*Canadian finance paper minus Eurodollars
Weekly averages of daily rates

See exchange rate footnote on Chart 3

Against this background, the Canadian dollar held comparatively steady against the U S dollar during the six-month period under review, fluctuating generally within a 2 percent band around Can $1 2300, a level to which it had recovered during the fall of 1982 In effect, it also rose on balance against most other currencies

From the beginning of the six-month period, the Canadian dollar drew support from a marked improvement in Canada's current account position that had become evident in 1982 A sharp drop of imports, reflecting the slowdown in Canada's domestic economy, together with a modest expansion in exports, had combined during 1982 to swing the current account into significant surplus for the first time in more than a decade Trade figures early in the year suggested that Canada's net export position was strong enough to hold on to an overall current account surplus for the first quarter of 1983 At the same time there were a number of conversions by Canadian residents of funds borrowed in markets abroad where interest rates were lower than in Canada

As a result, the Canadian dollar rose on balance through early March and fluctuated to a high of Can $1 2210 The Canadian authorities, after having taken advantage of opportunities prior to the period to rebuild their foreign currency reserves to U S $2 9 billion, continued on balance to add to reserves In addition, short-term interest rates eased during February and then held generally steady during most of March even as rates for comparable maturities in U S dollars temporarily firmed As a result, Canada's traditionally favorable interest rate gap narrowed through most of March and, at the three-month maturity, actually turned negative for several days around the quarter end

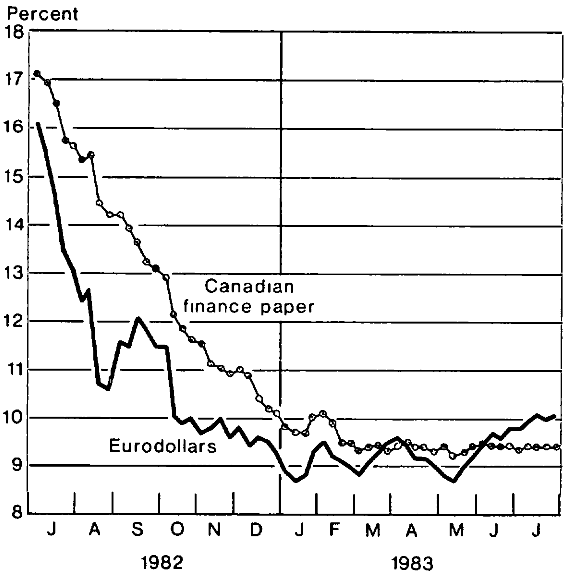
Early in April, sentiment toward the Canadian dollar briefly became more cautious With the erosion of Canada's normal interest rate differential and the domestic economy still operating far below capacity, market participants came to question whether the Canadian authorities would allow interest rates to back up if U S rates were to continue to rise In addition, there was uncertainty about the stance of fiscal policy to emerge from the budget, which was to be announced after midmonth, in view of the continuing pressures for stimulus and talk within the government of the need to create jobs

In the event, the Bank of Canada restrained the liquidity

Chart 10

Interest Rates in Canada and the Eurodollar Market

Three-month maturities*



*Weekly averages of daily rates

positions of Canadian banks, and short-term interest rates moved up slightly from late-March levels In the meantime, U S. interest rates resumed a downward course so that interest rate differentials came back in favor of the Canadian dollar. In addition, the government's announcement of its budget for the 1983-84 fiscal year was well received by the business community and the exchange markets generally It did include a Can.$4.8 billion medium-term recovery program to spur investments and to promote jobs, largely over the next two years. But the market was impressed by provisions that would offset most of the cost of the program, albeit with a delay, including a temporary increase in the federal sales tax in subsequent years when the economy is expected to be more robust. Following this announcement, the Canadian dollar moved off its mid-April low near Can.$1.2400

By late in the second quarter, the economic situation in Canada was clearly improving. Inflation was dropping steadily, with the year-on-year rate of increase in the consumer price index down to 5.4 percent by May and major wage settlements providing for the smallest increases in four years The current account balance remained in surplus, bolstered by strong demand for Canada's exports of agricultural products and automotive parts. These favorable developments occurred at the same time that the domestic economy was rebounding strongly, spurred by consumption and housing. By late June, forecasters were revising upward their growth projection for the current year In this climate, talk circulated in the exchange markets that foreign investment inflows into Canada had picked up

Under these circumstances, Canadian interest rates did not match the prolonged advance of U.S. interest rates after mid-May. Indeed, short-term interest differentials turned negative for the Canadian currency again by early June and widened progressively through end-July. Nevertheless, the Canadian dollar held up better than other currencies against the dollar, as the U.S. currency strengthened across the board during June and July. The Canadian dollar was sufficiently strong that the spot rate eased only modestly from its early-May levels to close the six-month period under review at Can.$1.2330, up slightly from the beginning of the period During this period, the Bank of Canada added to foreign currency reserves, which rose U S.$300 million over the six-month period to the relatively high level of U S $3.2 billion

Mexican peso

By February, Mexico's external financial crisis, which developed in 1982, was at a major turning point On the one hand, a number of actions had been taken to arrest further deterioration in Mexico's financial position. The newly elected de la Madrid government had begun to implement a stringent austerity program designed to redress the external imbalance, to curtail inflation, and to reduce sharply the huge government deficit. In December, the IMF had approved an extended fund facility for Mexico Negotiations were proceeding, although incomplete, with foreign banks on a $5 billion jumbo loan to help ease immediate liquidity strains and to cover the expected 1983 current account deficit. The rate of domestic economic activity had slowed, and the large current account deficit had begun to decline.

On the other hand, major problems and uncertainties remained. Inflation continued at around 100 percent per annum, clouding prospects for a deceleration of wages sufficient to break the wage-price spiral. Large spending cuts, needed to bring the public-sector deficit down from 17 percent of GNP in 1982, had only just begun to materialize. Although public-sector interest payments were current, a program had not yet been agreed upon for restructuring these debts. Meanwhile, no proposals had been made to deal with accumulated arrears that had developed in private-sector external debt service and import payments

Reflecting the progress already achieved, the Mexican peso was trading steadily in early February in the offshore interbank market at Mex.$148 50, close to the onshore "free market" rate established late in 1982 as part of a move to relax exchange controls. But soon thereafter uncertainty deepened and the peso, while remaining at Mex.$147 90 in the onshore "free market", declined to about Mex $171 in offshore interbank trading. The drop in world spot oil prices threatened to force OPEC to reduce oil prices, a move that would lead Mexico to follow suit, weakening the outlook for Mexico's oil export earnings. About the same time, progress stalled on the $5 billion bank financing. During February, the Bank of Mexico drew down the final amounts available on the $1.85 billion joint BIS-U S swap facility In this connection, Mexico received $44 3 million from the Treasury and $25 8 million from the Federal Reserve In addition, the Federal Reserve renewed until end-February the outstanding balance of $373 million on the regular Federal Reserve-Bank of Mexico swap facility, originally drawn in August 1982. The swap was then repaid on February 28

Beginning in late February, several important issues began moving toward resolution. The $5 billion jumbo loan agreement became a certainty on February 27, and $433.7 million in bridge financing was arranged for disbursement ahead of the signing of the jumbo loan in early March and the initial drawing under the jumbo agreement The Mexican authorities announced the first of five schemes to deal with short-term private-sector foreign credits, the foreign currency to be delivered later when available. This marked the first concrete step by the authorities on principal amounts of private-sector debt. Shortly thereafter, OPEC reached agreement on a new pricing and production structure, and prices of Mexican oil exports were lowered by $2.75 per barrel in line with the OPEC agreement. PEMEX oil shipments and earnings rebounded quickly, which, together with funds becoming available from the jumbo credit, eased the immediate strain on Mexican liquidity. In early May, the IMF informed the commercial bank group advising Mexico on its external debts that the country had come within the IMF's first-quarter limit on the current account deficit, despite the shortfall in oil revenues In fact, Mexico had a current account surplus in the first quarter, due mainly to severely depressed imports. In this environment, the peso strengthened in the offshore interbank market from late March into early May

For the remainder of the period under review, the peso traded firmly in the offshore interbank market close to the rate in the Mexican "free market" The latter remained unchanged at Mex $147 90 from January 24 through June 21 and was adjusted higher twice to Mex $147.60 at the end of the period The "controlled rate", established along with the "free rate" for foreign debt, trade, and other eligible transactions, was depreciated steadily over the period as planned to take account of inflation differentials *vis-à-vis* Mexico's major trading partners. It stood at Mex $123.83 at end-July

The steadiness of the peso reflected growing market perception that the government's adjustment program was on track and that Mexico's liquidity position was improving. Early in May, for the first time in more than a year, there were market reports that private capital transferred out of Mexico earlier was beginning to move back. Later in May, the IMF released the second extended fund facility tranche of $325 million, which was used to make an initial payment on the joint BIS-U.S swap facility And, on June 22, official creditors signed a multilateral agreement to reschedule interest arrears and medium- and long-term principal payments falling due through the end of 1983

More important was evidence of gains in areas thought to be most intractable. The current account improvement exceeded forecasts, and projections made in late June suggested the possibility of a modest current account surplus for 1983 as a whole. The government deficit had been reduced even more sharply than planned. In late July, the Bank of Mexico said it would soon begin disbursement under the private-sector short-term debt schemes set up in the spring and would announce later in the summer a scheme to deal with medium- and longer term private credits Significant progress was also made in the area of wages and inflation. Agreements in the spring wage negotiations limited increases to 15 percent, far below the 50 percent requested by union leaders to restore lost purchasing power Reflecting the moderation in wages and increasing slack in the Mexican economy, the rate of increase in consumer prices dropped from about 10 percent per month at the turn of the year to less than 4 percent in June. Thus, in major areas the Mexican adjustment program appeared to be well ahead of the schedule set eight months earlier. After the close of the period, on August 23, the Bank of Mexico repaid all remaining amounts due at maturity on the joint BIS-U.S. swap facility.