August 1984-January 1985 Semiannual Report
(This report was released to the Congress and to the press on March 8, 1985)

Treasury and Federal Reserve Foreign Exchange Operations

During the six months ended in January, the dollar rose to its highest levels of the floating-rate period against the German mark and to record levels against the British pound and most other European currencies The dollar's advance largely occurred in two steps—first around mid-September and again from early November to mid-January. In all, the dollar rose some 8 percent against the currencies of Continental Europe and 15 percent against the pound sterling It advanced by a substantially smaller $3^1/_2$ percent against the Japanese yen and by about 1 percent in terms of the Canadian dollar In trade-weighted terms the dollar rose some 8 percent over the six-month period.

The dollar continued to rise despite a shift in the prospects for the U.S. economy and for U S. interest rates, which began to occur in the summer For the past couple of years, the dollar's strong performance had been associated with exceptionally vigorous U.S economic growth, contrasting with slower recoveries elsewhere. Relatively high U.S interest rates had also been viewed as supporting the dollar. But indications emerged in August that the U.S. expansion was slowing in the third quarter, while economic activity abroad was picking up. Private economic forecasters tended to scale back their projections of U.S. output gains for late 1984; some even speculated that the United States might experience a growth recession in the coming quarters At the same time, long-term U.S. interest rates were progressively declining By early autumn, evidence accumulated that the narrowly defined monetary aggregate was no longer expanding and short-term interest rates began to fall back. By late January, interest rates on long-term U.S. government bonds had eased one and a half percentage points. Short-term interest rates had dropped even more, the decline accompanied by two half-percentage-point cuts in the Federal Reserve's discount rate to 8 percent. For the period as a whole, the rate for three-month Eurodollar deposits had declined by more than three percentage points, and interest differentials *vis-à-vis* the German mark, for example, though still favorable to the dollar, had been cut just about in half.

Under these circumstances, expectations developed that the dollar would weaken during the latter part of 1984, but these expectations failed to materialize. Each time the dollar started to move lower, it quickly recovered. The dollar was buoyed by an easing of inflationary fears in the United States that implied U.S. real interest rates were still attractive, even at lower nominal levels Forecasts that price pressures would reappear, made when the U S expansion was stronger early in 1984, had not been borne out. Inflation con-

A report by Sam Y Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account Richard F Alford and R Spence Hilton were primarily responsible for the drafting of this report, assisted by Elisabeth Klebanoff tinued moderate, and confidence grew that the U S. economy might experience reasonable price stability for some time This confidence gained support from continued declines in world commodity prices, most particularly crude petroleum.

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility January 31, 1984
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Swiss francs-dollars	600
Other authorized European currency-dollars	1,250
Total	30,100

Table 2

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
First quarter 1984	-0-	-0-
Second quarter 1984	−17 7	−21 4
Third quarter 1984	-0-	-0-
Fourth quarter 1984	-0-	-0-
January 1985	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1985*	−$1,380 7	−$900 6

Data are on a value-date basis

*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 valuation losses reflect the dollar's appreciation since foreign currencies were acquired

The strength of the dollar reflected as well a continuing preference on the part of both residents and nonresidents to invest in dollar-denominated assets. Since the last recession, economic growth was considerably greater in the United States than in most other industrialized countries many of which were still facing near-record levels of unemployment The United States and its currency continued to be well-regarded on grounds of relative political stability The flexibility of its labor and product markets compared favorably with those of other countries, some of which had been experiencing unusually protracted labor disputes. The weakness of precious metals and other commodity prices tended to underline the attractiveness of financial assets in general and of dollar assets in particular Investors, still reacting to the credit problems of recent years, attempted to be more selective. They tended to place a greater premium on security in making investment decisions, and the dollar provided an outlet for much of these investments. Portfolio managers as well remained attracted to dollar markets These markets seemed to provide the flexibility needed to adjust investment strategies quickly in the face of shifting interest rate expectations, and the liquidity to cover the currency exposure if the dollar should drop

Thus, capital inflows continued to be attracted to the United States at a pace greater than needed to finance a large current account deficit at prevailing exchange rates During the third quarter, heavy inflows came through the banking sector, as banks in the United States pulled back funds previously placed in the Eurodollar market. As inflationary expectations in the United States continued to moderate, as long-term interest rates fell, and as expectations of a decline in the dollar faded, a larger portion of the inflows subsequently took the form of portfolio investments in dollar-denominated securities. In November and December, the U S bond market in particular attracted attention at least partly because of relatively attractive yields and prospects for capital appreciation.

As these developments unfolded during the six months, market participants focused on the economic consequences and the possible policy implications of the dollar's continued advance. For the United States, while a strong currency helped to moderate price pressures at a time of vigorous economic growth, it imposed major strains on the U.S competitive position. The current account deficit was building up close to $100 billion, largely as the result of sharp increases in imports of consumer and investment goods For other countries, market participants noted the competitive boost being given to their exports, the leading source of stimulus to otherwise relatively modest economic recoveries But they believed the authorities would prefer a broader-based recovery and, therefore, would seek to keep interest rates as low as possible, particularly since inflationary expectations were subdued

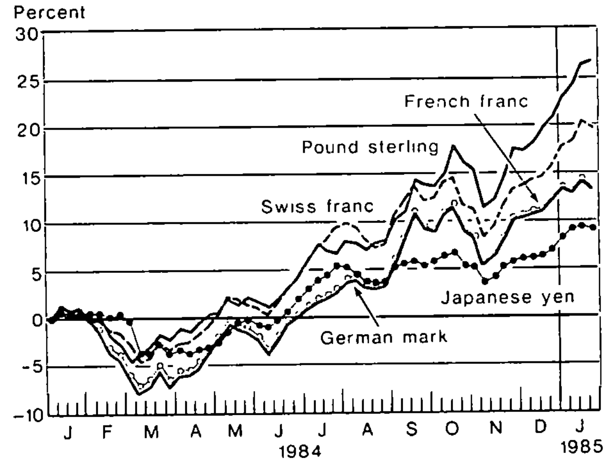
Thus, market participants concluded that the authorities would be reluctant to use monetary policy to resist the dollar's rise For a time early in the period, dealers were skeptical that even intervention would be used But market sensitivity to intervention increased, after the Bundesbank sold dollars aggressively in the exchange market late in September, in the first of several, highly visible operations The U S authorities, having intervened on one occasion earlier that month, again entered the market on four days following the Bundesbank's late September operation Central banks of some other countries also intervened to sell dollars during late September and early October Later in the period, when the dollar resumed its advance, market professionals again expected the authorities would try to moderate the move with intervention Expectations of central bank resistance, along with the intervention operations that actually took place, for a time kept the dollar's rise in check

By the turn of the year, the outlook for the U S economy was progressively improving Published data revealed quicker growth in the fourth quarter for the United States than had been anticipated Also, an accelerating expansion of monetary aggregates late in the year was seen as narrowing the scope for any further easing of U S monetary policy Economic performance in several European countries, though also improving, was still viewed by market professionals as not so vigorous as to require greater monetary restraint As sentiment toward the dollar became even more bullish early in January, the dollar's rise against all currencies gained increasing momentum The market noted the dollar's approach to levels against the German mark where the Bundesbank had been seen intervening several months before, as well as intense selling pressure against the British pound In a few European countries, domestic interest rates were tending to firm in response to concerns that the dollar's continued rise would eventually be reflected in increased domestic inflation

With the approach of a scheduled meeting of G-5 finance ministers and central bank governors, market professionals anticipated that this might be an occasion for monetary authorities to plan a large and concerted exchange market operation The officials discussed a range of international economic and financial issues In their announcement of January 17, they reaffirmed their commitments to promote a convergence of economic

Chart 1

The Dollar against Selected Foreign Currencies

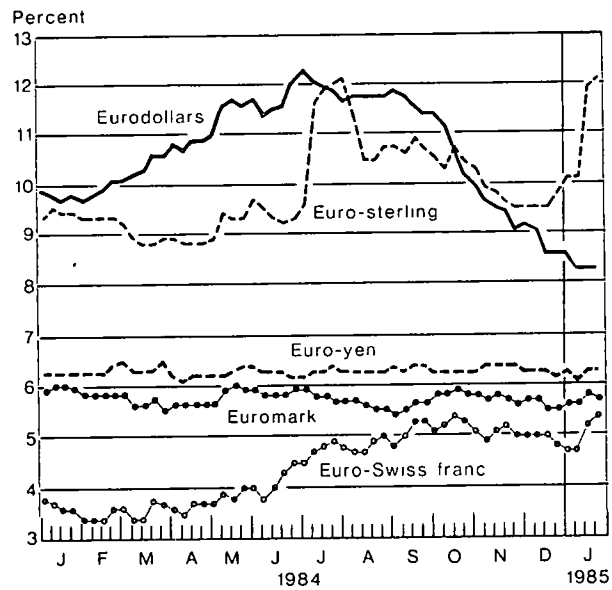


Percentage change of weekly average bid rates for dollars from the average rate for the week of December 26-30, 1983 Figures calculated from New York noon quotations

Chart 2

Selected Interest Rates

Three-month maturities*



*Weekly averages of daily rates

performance and stressed the importance of removing structural rigidities in their economies. They also reaffirmed the May 1983 Williamsburg agreement to undertake coordinated intervention as necessary.

After the G-5 meeting, visible foreign exchange market operations were in fact undertaken by several countries. Most central banks in Europe and the Bank of Japan operated on occasion to sell dollars during the rest of January. The U.S. authorities, in coordination with the others, also intervened on two occasions late in January to sell dollars against marks.

These operations reinforced market perceptions that the central banks were more willing to intervene than before. At the end of the month, however, market participants were still uncertain of the extent to which the authorities were prepared to intervene and of the circumstances in which the central banks would judge intervention to be appropriate or helpful. Dealers remained impressed by the steady stream of commercial and investment-related orders for dollars coming into the market. Under these circumstances the dollar steadied but did not fall back appreciably from mid-January levels.

In summary, during the six months under review, the U.S. authorities intervened in the exchange markets on seven occasions, selling dollars and buying marks in each instance. They bought $50 million-equivalent of marks on one day early in September, $229 million on four occasions between September 24 and October 17, and $94 million on two days late in January. The total, $373 million-equivalent of marks, was shared equally between the U.S. Treasury and the Federal Reserve.

In other operations, the Treasury Department announced on October 12 that it had joined with the Bank of Japan and the Bank of Korea in arrangements to provide short-term financing to the Central Bank of the Philippines, totaling $80 million in support of the Philippine economic adjustment program which had been agreed upon with the management of the International Monetary Fund (IMF). The Treasury, through the Exchange Stabilization Fund (ESF), agreed to provide $45 million, the Bank of Japan $30 million, and the Bank of Korea $5 million. The full amount of the facility was drawn on November 7. The drawing occurred after the Managing Director of the IMF confirmed that the IMF had received assurances of the availability of adequate financing in support of the Philippine economic adjustment program and that he had formally submitted the Philippine request for a standby arrangement to the Fund's Executive Board. The drawings were repaid on December 28, after the Philippines drew on its standby arrangement with the Fund.

On December 3, the U.S. Treasury agreed to provide a $500 million swap facility to the Central Bank of the Argentine Republic as bridging credit in support of the Argentine economic adjustment program, which had been agreed upon with the IMF. The full $500 million was drawn on December 28. On that day the IMF Managing Director indicated that the IMF had assurances of adequate financing from commercial banks in support of the Argentine Government's economic program. Argentina's requests to draw on a standby arrangement and on the Compensatory Financing Facility (CFF) were then approved by the Fund's Executive Board. The drawing was repaid in the amounts of $270 million on January 3, 1985, and $230 million on January 15, 1985, after the Argentine Government's drawings from the IMF under the CFF and its standby arrangement, respectively.

The Federal Reserve and the ESF invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity. Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve had invested $870.1 million of its foreign currency holdings in securities issued by foreign governments as of January 31. In addition, the Treasury held the equivalent of $1,573.8 million in such securities as of the end of January.

German mark

During the period under review, the mark fell 8.5 percent against the strongly rising dollar and eased relative to all other major currencies except sterling, ending the period near the bottom of the EMS. The mark's decline against the dollar was interrupted only temporarily—between late September and early November.

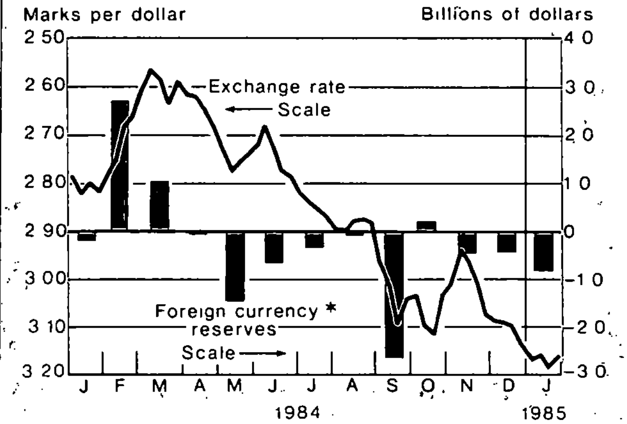
At the start of the period, international investors' attention was deflected to dollar-denominated securities. A rally in the U.S. bond market had just gotten underway. A much talked-about elimination of U.S. withholding tax on interest payments to non-residents was finally approaching. And talk spread that the U.S. Treasury would soon issue securities targeted especially for foreign investors. Meanwhile, the mark continued to suffer from comparison between the recoveries in Germany and in the United States. Under these circumstances, the mark was trading at DM2.9170, near 11 and a half-year lows against the dollar early in August. Its margin over other currencies within the EMS had also been significantly reduced.

After trading steadily in seasonally thin markets for several weeks, the mark again began to decline as the dollar rose early in September. As the mark's fall progressed, market participants questioned whether the German authorities would act to stop the decline. The economic justification for doing so was unclear. Addi-

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

tional stimulus to Germany's export sector—already the driving force to economic recovery—was seen in the market as a welcome boost to the economy and a spur to employment Meanwhile, depreciation was not generating any evident pickup in inflationary pressures, partly because of the weakness of world commodity prices Moreover, market participants were unsure what policy tool the authorities might use if they chose to act against the mark's decline The Bundesbank had emphasized before, when the mark was also declining against the dollar, that it did not intend to tighten monetary policy As for official intervention, remarks of Bundesbank officials pointed to its limited effectiveness in resisting fundamental market trends

In fact, the Bundesbank had been intervening regularly at the Frankfurt fixings and on occasion at other times in the open market These operations, at least during August, just about offset interest earnings and other inflows into Germany's reserves, so that the foreign exchange reserves showed little net change from end-July's $38 billion level When the dollar's rise accelerated, pulling the mark rate down to DM3 1765 on September 21, the Bundesbank intervened more aggressively Its actions, followed by other European central banks, helped the mark to bounce back up immediately For several days thereafter, market participants were extremely wary of possible further dollar sales by the Bundesbank, and rumors of other large operations circulated widely For the month of September, Germany's foreign exchange reserves fell $2 7 billion

The U S authorities had purchased $50 million-equivalent of marks on one occasion early in September After the Bundesbank's action of September 21, they purchased a total of $135 million-equivalent of marks during three days from late September to early October to counter disorderly markets These purchases were shared equally between the Federal Reserve and the Treasury

Immediately after the central bank interventions the mark traded generally between DM3 00 and DM3 10 In early October the mark received a further lift when the cabinet announced repeal of Germany's 25 percent withholding tax on German securities held by non-residents, retroactively to August 1, sparking renewed foreign interest in German bonds But soon thereafter, the mark began to drift lower against the dollar and to a lesser extent most other currencies In mid-October, when the mark was approaching the lows of September and trading at DM3 1575, the Bundesbank again intervened The U S authorities also bought $95 million-equivalent of marks on one occasion to counter a renewed outbreak of disorderly market conditions

The mark then rallied Market participants had become impressed that the Bundesbank and others were resisting the generalized rise of the dollar Furthermore, the economic environment appeared to have shifted in Germany's favor since mid-summer Statistics were released indicating that the economy had revived strongly during the summer Exports continued to be the principal boost to output and earnings But for the first time the export boom appeared to be spilling over to other sectors, as reflected in increased domestic new orders for capital goods U S interest rates of all maturities were declining, so that the market no longer perceived the Bundesbank as having to resist a gradual decline in German rates to obtain a narrowing of adverse interest differentials to strengthen the mark Under these circumstances, market professionals began to build up long positions in marks in the expectation that a major adjustment in the dollar-mark relationship was about to occur The bidding for marks pushed the spot rate up 9 percent to DM2 90 in the first week in November

But after November 7, the mark changed direction and

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements with the U.S. Treasury

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

Drawings on the United States Treasury	1984 III	1984 IV	1985 January	Outstanding January 31, 1985
Central Bank of the Philippines	-0-	+45 −45	-0-	-0-
Central Bank of the Argentine Republic	-0-	+500	−230 −270	-0-

Data are on a value-date basis

declined as the dollar strengthened for the balance of the period under review At first the selling of marks appeared to be dominated by corporations and others that had postponed dollar purchases required before the year-end in hopes of taking advantage of the expected rise in the mark. Before long the selling of marks broadened as expectations of a generalized decline in dollar rates diminished. Speculators in the futures markets and dealers in commercial banks liquidated much of their long mark positions by year-end More-over, international investors, no longer as concerned that a decline in the dollar would erode their total return on dollar-denominated securities, came back to U S. securities markets in size. With investors attracted by the remaining interest differentials favoring the dollar and the prospect of profits as U S. interest rates continued to decline, the dollar quickly came to overshadow the mark in the exchange markets. By January 11, the mark had been pulled down to a record low for the floating rate period of DM3 2020.

The Bundesbank had continued to operate in the exchange markets to sell dollars. These operations contributed to a $950 million decline in Germany's foreign exchange reserves during the three months October to December. But German authorities were also attempting to modify their money market management to ensure that German banks not have permanent recourse to large amounts of Lombard loans at the central bank, and they were concerned that larger dollar sales might complicate this endeavor Accordingly, by January, central bank money was increasingly being provided through security-based repurchase agreements, sometimes at interest rates slightly below the Bundesbank's Lombard rate Foreign exchange market operators at times misread the central bank's actions as signaling a desire for short-term interest rates to ease. In fact, the Bundesbank had announced that its monetary growth targets for 1985 would be lower than for the previous year, at 3 to 5 percent Bundesbank officials pointed to the impact of the mark's continued decline on import prices, thereby suggesting there was little scope for easing monetary policy Yet the market's misinterpretation of the Bundesbank's intentions for money market rates was not fully dispelled until the Bundesbank announced it would raise the Lombard rate half a percentage point, to 6 percent, effective February 1.

In any case, by the time the mark hit its mid-January low, market attention was focused more on the rise of the dollar than the decline of the mark. Other currencies, too, were weakening sharply, most especially the pound As a result, when market participants became aware that a G-5 meeting of finance ministers and central bank governors was to take place in Washington on January 17, they began to expect a concerted intervention operation. Between the middle of January and the close of the period, there were joint intervention operations in which the U S monetary authorities purchased $94 million-equivalent of marks. These operations, like those earlier in the period, were shared equally between the Federal Reserve and the Treasury and were conducted to resist a renewed rise in the dollar

At the end of January the mark was above its lows, trading at DM3 1670 against the dollar. But it was 9 percent below its high reached in early November and 8½ percent below end-July levels. Germany's reserves declined a further $821 million in January to close the period at $34 billion.

Within the EMS, the mark's attraction as an investment vehicle for private-sector investors weakened in relation to other EMS currencies, as well as to the dollar. Economic performance and macroeconomic policies among EMS countries were showing growing convergence Other European countries were adopting more market-oriented policies. Against this background, the persistence of wide, unfavorable interest differentials at a time when inflation differentials were narrowing and prospects for a new currency realignment were appearing remote led virtually all the EMS currencies to strengthen relative to the mark. The authorities of other EMS countries took advantage of this development to buy substantial amounts of marks in the market to add to reserves.

Sterling

At the beginning of the period under review, a five-month decline of sterling against the dollar was ending, with the currency trading around $1.30 and between 78 and 79 according to the Bank of England's trade-weighted index. After mid-October, however, the pound became increasingly vulnerable to selling pressure, and by December it was falling across the board. The downward pressure continued in January. For the period as a whole, the pound fell 15 percent against the dollar and 9 percent in terms of the Bank of England's trade-weighted index.

In August and September, sterling traded steadily against other European currencies, even though all were declining against the dollar. The British authorities' resolve to adhere to their medium-term financial plan calling for cuts in monetary and public-sector borrowing growth had recently been reaffirmed. The Bank of England ratified a substantial increase in short-term British interest rates, that restored an interest rate advantage for the pound relative to the dollar. Although the pound declined 8½ percent against the dollar to $1.22 as the dollar advanced generally, it did not move below 76.6 on the trade-weighted index. The overall steadiness of sterling and an apparent moderation in the growth of British monetary aggregates permitted staged reductions in short-term sterling interest rates during August totaling one and a half percentage points. With these cuts the interest differentials favoring sterling were more than eliminated.

Notwithstanding the pound's steadier tone in the exchange markets, a number of factors undermined market confidence that the British authorities would hold to their anti-inflation policies. Britain's economy, in its third year of expansion, was showing signs of losing momentum while unemployment was still rising. No progress was being made in bringing inflation down below 5 percent or in slowing the rise of unit labor costs, by then increasing more rapidly than in other industrial countries. Meanwhile Britain's current account position was deteriorating, despite a pickup in demand in major export markets, because of a sharp jump in imports. A lengthy strike by coal miners was having an adverse effect on production, as well as the balance of payments since imported oil was being substituted for domestically-produced coal. Moreover the oil sector, which had been accounting for more than half of the economy's recent growth and had kept Britain's current account in surplus, was no longer seen as a reliable source of strength. With predictions that North Sea oil production would peak in the next couple of years, the stimulative effect of the oil sector on the economy was expected to wane. In the meantime the contribution of net oil exports to Britain's balance of payments was expected to be undercut if an apparent weakness in oil markets led to any significant drop in petroleum prices.

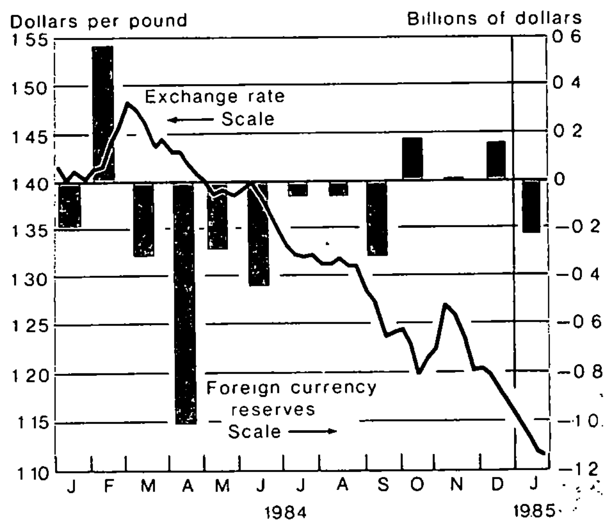
Britain's domestic economy and external position were thus perceived to be in precarious balance. Market participants paid close attention to any development thought capable of forcing the government to have to choose between supporting further growth and employment or dealing with pressures on prices, costs, and the exchange rate. Thus, prospects of a possible spreading of the coal miners' strike and of a reduction in oil prices set the stage for an abrupt but limited drop in the exchange rate around mid-October. Within a week, the pound slid below $1.20 against the dollar and to 74.0 against the trade-weighted index.

For about two months, the pound then steadied. The coal miners' strike failed to widen and downward pressure on oil prices was being contained as long as OPEC

Chart 4

United Kingdom

Movements in exchange rate and official foreign currency reserves



See footnotes on Chart 3

discussions on ways to deal with weak oil prices continued. The pound traded within a range of 74 to 76 according to the trade-weighted index. Against the dollar it moved in line with other European currencies, rising during late October and early November before falling back below $1.21 early in December. With the pound again trading more steadily, British short-term interest rates continued to ease largely in line with the decline in Eurodollar rates. By mid-December, the British clearing banks had cut their base lending rates from the mid-summer highs by a total of 2½ percentage points to 9½ or 9¾ percent.

From December on, sterling began to fall sharply against all currencies, setting successive new lows in terms of both the dollar and the trade-weighted index. Selling of sterling was stimulated by the expectation that OPEC would have difficulty reaching an effective agreement on price differentials. In addition, the market's underlying concern intensified that the authorities were shifting their priorities for economic policy toward spurring output. Growth of public-sector borrowing was turning out well in excess of the government's target, only partly because of strike-related expenditures. Credit extended to the private sector also showed signs of accelerating. The monetary aggregates remained near the top of their official target ranges. Admittedly, the monetary aggregates were distorted in December by a stock issue. But market participants, interpreting the evidence at hand, concluded that the Bank of England would be reluctant to see a reversal of the interest-rate declines of the past several months even to stem a fall in the exchange rate. Market participants also came to doubt the authorities were prepared to use intervention to resist a renewed decline in sterling Official declarations and actions suggested the authorities were willing to let the pound fall if dictated by market forces

Under these circumstances the pound dropped steadily, falling most precipitously in mid-January when the OPEC negotiations appeared to be under particular strain. The pound touched a low against the dollar of $1.1015 in Far Eastern trading on January 14 and of 70.6 against the trade-weighted index at the opening in London that same day. As the exchange rate fell, the authorities did not resist a rise in money market interest rates. The Bank of England at one point seized the initiative to push interest rates up further, to the levels of mid-summer. In the end, sterling interbank rates rose even more—for a total increase of 4½ percentage points to 14 percent At that point interest rate differentials were again strongly in favor of the pound, reaching a level of 3½ percentage points for three-month deposits relative to the dollar.

Late in January, the high level of sterling interest rates made selling the pound short expensive. In addition, OPEC had demonstrated an ability to work out a limited agreement on pricing differentials, and spot oil prices firmed Thus, the immediate pressures against the currency abated. In addition, sterling benefited from market talk of stepped-up central bank intervention following the mid-January G-5 meeting in Washington Although the pound remained subject to sporadic pressure through the end of the month, it traded without clear direction. The pound closed slightly above its low at $1.1275 and 71.5 in terms of the Bank of England's trade-weighted index

British foreign exchange reserves were little changed on balance between end-July and the end of December Then for January, they dropped $233 million to $6.73 billion as of the end of the period.

On December 18, the Chancellor of the Exchequer, in reply to questions in Parliament, stated that the Bank of England would no longer request foreign monetary authorities to restrict sterling balances to working levels, thereby ending formally an agreement the government felt was no longer appropriate to the current international monetary setting. The announcement did not cause any visible impact on exchange rates at the time

Japanese yen

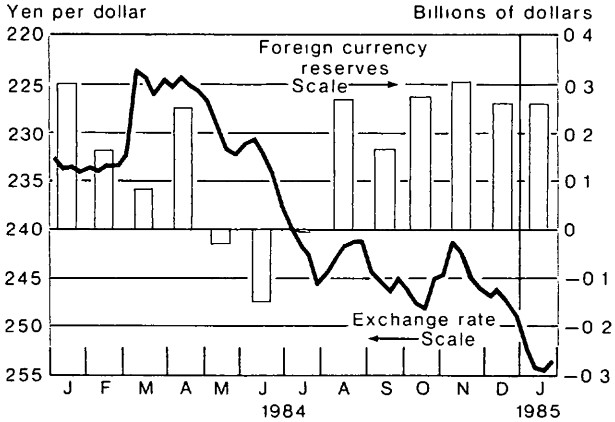
Over the six-month period under review, the Japanese yen eased against the dollar but appreciated against the European currencies A record-breaking pace of long-term capital outflows continued to be a source of downward pressure on the currency against the dollar Outflows of Japanese resident capital were attracted in part by relatively high interest rates abroad. They also reflected the continuing diversification of financial assets by Japanese investors and increased yen lending to foreign borrowers. Meanwhile, some non-residents that had been among the largest investors in Japanese securities several years ago continued to liquidate their holdings at maturity, largely to meet payment needs. The net long-term capital outflows swamped Japan's large and growing current account surplus, which was reaching $35 billion for the year At times, however, favorable shifts in commercial leads and lags gave a boost to the yen against all currencies *Vis-à-vis* the European currencies, Japan's large current account surplus and robust domestic economy was an important source of strength

At first, the yen got some respite from the full brunt of the capital outflows that had helped to push the spot rate down to ¥246 45 by the start of the six-month period The outflows subsided in August as foreign investment in Japanese equities resumed during a late-summer rebound in the Tokyo stock market Also, Japanese investors slowed their net purchases of foreign securities ahead of the end of the financial half-year in

Chart 5

Japan

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

September. Thus, the yen advanced to ¥242 early in August and traded steadily against the dollar at that level for several weeks.

During September and October, the yen also received a lift from a favorable swing in commercial transactions The yen started to ease against the dollar which had become well-bid across the board. But market participants expected this weakness to be short-lived, anticipating that the dollar would soon decline in response to declining U.S. interest rates. Thus, as the yen fell through the lows of late July-early August and toward the ¥250 level, Japanese exporters stepped up their selling of dollars to take advantage of the current dollar rate Meanwhile importers postponed their currency purchases. At the same time, Japan's imports of oil slowed so that the net export balance was unusually favorable

With these trade transactions favoring the yen and capital outflows temporarily subdued, the yen's decline against the dollar was more gradual than the decline of the European currencies during September and early October The yen did touch a two-year low of ¥250 45 on October 17, but it gained 7 percent against the German mark to trade near a record high *vis-à-vis* that currency. Moreover, the yen recouped its losses against the dollar during late October when the dollar eased back. By early November the yen was again trading near the ¥240 level against the dollar and reached a high for the six-month period of ¥239.40 on November 7

Meanwhile, the changing economic environment abroad had several implications for Japan. The slowdown of the U.S economic expansion in the third quarter of 1984 seemed to show up almost immediately in a sharp deceleration of Japan's export growth As a result, Japan's external position actually had a negative impact on GNP the same quarter In addition, the decline in U S interest rates, widely expected to be further encouraged by cuts in the Federal Reserve's discount rate, contributed to a substantial easing of long-term interest rates in Japan Japanese enterprises shifted their expectations about immediate financing requirements and the future costs of funds. Credit demand softened and corporate borrowing increasingly took place at shorter maturities.

Against this background, there was discussion in the fall that a reduction of the Bank of Japan's official interest rates could entail large potential benefits and low risks for the Japanese economy, given Japan's restrictive fiscal policy, low inflation, and the more restrained economic growth outlook. Bank of Japan officials were concerned, however, that any further drop in Japan's relatively low short-term rates would put further pressure on the yen exchange rate at a time when the size of Japan's current account surplus was threatening to provoke protectionist reactions in major export markets It therefore kept its discount rate at the 5 percent level established a year earlier with the result that short-term interest rates remained steady.

As a result of these interest rate developments, the interest differentials adverse to the 'yen narrowed somewhat for long-term rates and declined even more for short-term rates. But market operators began to waver in their expectations that the yen would strengthen further in response to this narrowing of interest differentials, because the dollar generally had eased relatively little from its highs of October.

Thus, the allure of the remaining interest differentials favoring the United States and of prospects of significant further capital appreciation on dollar-denominated bonds began once again to weigh on the Japanese yen Toward the end of the year Japanese investment in foreign securities mounted. The December U.S. government issue targeted at foreign investors, as well as the offering of British Telecom shares, were well received in the Tokyo market. Thus, net capital outflows jumped up in November and December to $5 billion and a record $8 billion, respectively In the year as a whole net long-term capital outflows from Japan rose to $50 billion At the same time, market participants noted that foreign private borrowers rushed to take advantage of the opening of the Euro-yen market to them, effective December 1, to place yen issues. To the extent these issues were purchased by Japanese residents the transactions contributed to Japan's capital outflows

Commercial leads and lags also began to shift against the Japanese yen. When expectations of a decline in the dollar faded, importers who had postponed their currency purchases came to fear that exchange rates would become even more unfavorable if they waited any longer. Meanwhile, exporters had already converted some of their foreign currency proceeds ahead of schedule.

As a result, the yen progressively weakened against the dollar, falling over 6½ percent from its early November high to ¥255 40 by the end of January At this level it was down 3½ percent on balance during the six months, although against the major European currencies, it rose nearly 5 percent

Throughout the six-month period the Bank of Japan intervened in the foreign exchange market in comparatively small amounts. Following the meeting of the G-5 in mid-January, the prospect of an increase in coordinated intervention made market participants wary of speculating too heavily against the yen. However, the concern was not sufficient to stem the yen's slide. In total, intervention sales of dollars offset only a fraction of Japan's interest earnings on its foreign exchange reserves, which rose $1 6 billion over the six-month period to close at $22½ billion.

European Monetary System

During the period under review, there was a growing convergence of economic performance among EMS countries Recovery had spread to all The countries showing the greatest improvement in 1984 were those that had still been in recession during 1983 Inflation was continuing to decelerate, with the countries showing the greater declines being those with the higher inflation rates a year before In general, current account positions were either stable or continuing to improve.

In all cases, the economic expansion proved insufficient to reduce historically high levels of unemployment. Yet fiscal and monetary policies were generally restrained Fiscal policies were aimed at reducing the size of the government deficit relative to GNP, with actual results varying depending on the burden of unemployment compensation and interest payments on government debt Monetary policy was generally unaccommodating Interest rates were allowed to ease only in response to declines in other countries or to improvements in inflation and fiscal deficit control at home

Under these circumstances, the exchange rate relationship within the EMS remained free from strain during the entire period under review Early on, most of the EMS currencies were clustered within 1 percent of their bilateral parity rates The only exception was the Italian lira, which started near the upper limit of the wider, 6 percent limit established for that currency. The German mark and the Dutch guilder alternated as the topmost currency within the narrow band against the Belgian franc at the bottom During the period, the German mark and Dutch guilder fell progressively, albeit unevenly, to the lower part of the band. The two currencies fell below the Danish krone and the Irish pound by early September, dropped below the French franc late in November, and approached the bottom of the narrow band to trade below the Belgian franc by early January.

The strength of other currencies *vis-à-vis* the mark presented many EMS countries with opportunities and policy choices. One option, chosen by the Belgian, French, and Italian authorities, was to take advantage of the lack of pressure to build their foreign currency reserves Prior to the period, the Belgian National Bank had been able to begin reducing its liabilities to the European Monetary Cooperation Fund (EMCF), using the proceeds of the government's external borrowings. During the six months under review, the Belgian central bank was able to continue this program, not only with proceeds of further borrowings, but also with foreign currencies acquired in the market By the end of the period, Belgium had fully restored its European Currency Unit (ECU) position in the EMCF and increased foreign currency reserves more than $500 million over the six months Before the period, the French and Italian authorities had already restored their foreign currency reserves to the levels prevailing before the last EMS realignment However, they continued to buy substantial amounts of marks along with some other currencies.

Another option, chosen in a small way by the French and Italian authorities, was to ease some of the exchange controls imposed during earlier periods of pressure against their currencies. On December 1, the French authorities announced a partial lifting of controls on the transfer of funds abroad by individuals and corporations and permitted Economic Community institutions to float ECU-denominated bonds in the French market On December 1, the Italian authorities announced reductions in the non-interest-bearing deposit required against residents' investment abroad and eased restrictions on foreign exchange accounts as well as on the means of payment to be used by Italians traveling abroad.

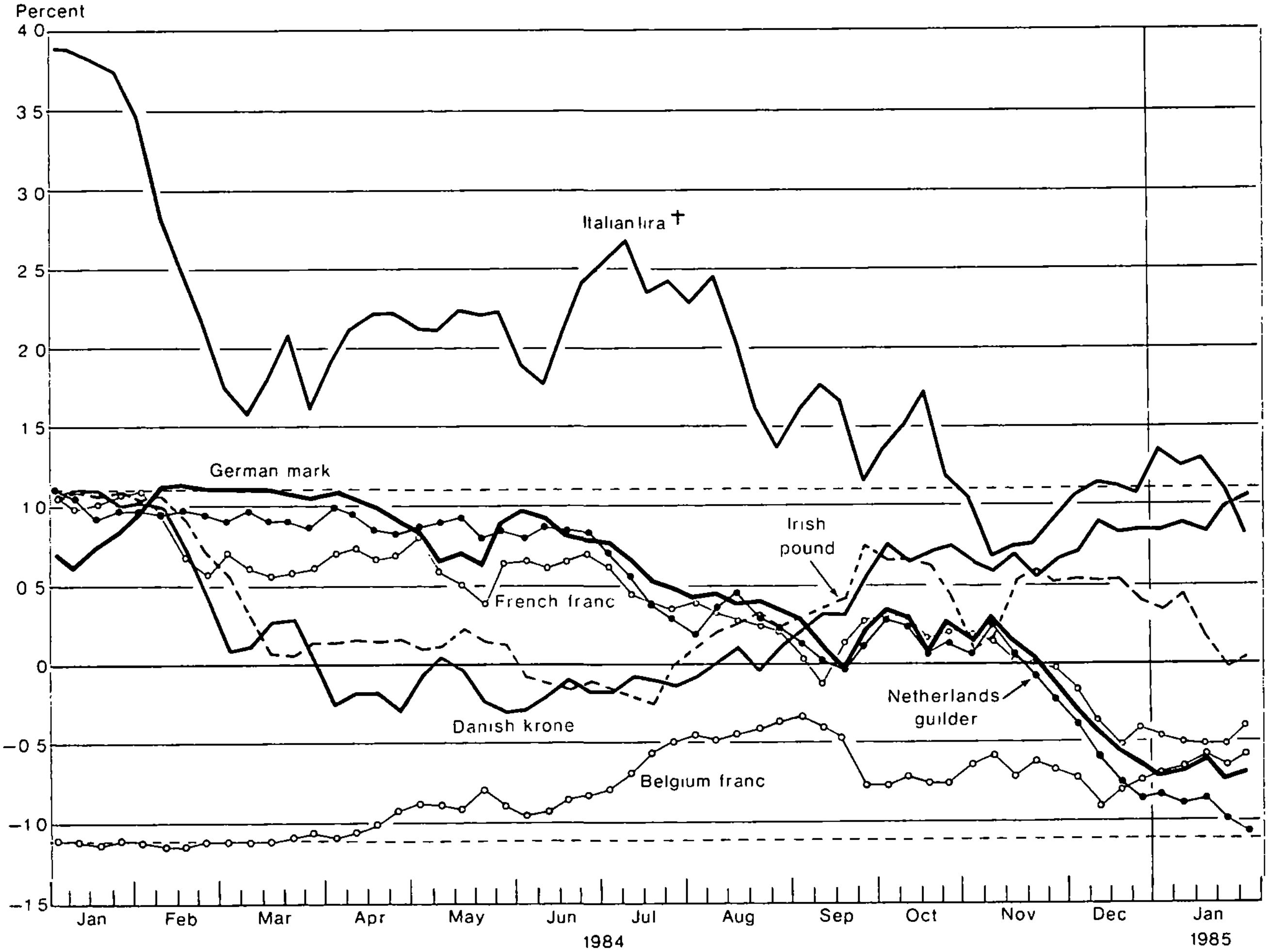
A third option was to take advantage of the relative strength of the currency to lower interest rates. In France and Belgium the authorities cautiously permitted an easing of interest rates once the foreign currency reserve position was restored and after inflation had shown clear signs of moderation. The French authorities also took advantage of moderating domestic credit demands to replace the strict guidelines on banks' credit, known as the *encadrement du credit,* with a more flexible credit control system

But in general the authorities perceived the scope for lowering interest rates to be limited Faster or more substantial cuts in interest rates were judged to be inappropriate in view of the remaining inflation differentials *vis-à-vis* Germany, the continuing need to finance a large budget deficit, or the financing requirements of a current account deficit In both Italy and Ireland, interest rates were actually increased The Bank of Italy temporarily raised its discount rate one percentage point to 16 5 percent in September to curb growth in bank credit that was exceeding its target range When credit growth moderated, however, the Bank of Italy cut its discount rate back to 15 5 percent in recognition of the continuing progress in reducing inflation to below double-digit rates

Thus, interest differentials among EMS countries remained relatively wide and did not narrow as rapidly as, for example, the inflation differentials Residents in countries with still relatively high interest rates increased their borrowings in international markets, partly to finance domestic operations, while short-term capital movements through the banking sector also flowed to

Chart 6

Percent Deviation of EMS Currencies from their Bilateral Central Rates*



*Weekly averages of daily 9 a m rates

†The Italian lira may fluctuate ± 6 percent from its central rate with other participating currencies

the centers with higher rates. Judging these inflows to be potentially reversible, the central banks chose to resist a substantial appreciation of their currencies within the EMS through intervention.

Against the dollar, the EMS currencies fluctuated generally in line with the German mark, weakening most of the period under review with the only major reversal during October and November. By the end of January many of these currencies were trading at record lows against the dollar, and all were some 8 percent below end-July levels.

Although several of the EMS central banks at times intervened in dollars to limit the decline of their currencies against the dollar, total dollar sales by central banks other than the Bundesbank were moderate for the period as a whole. In any case, by end-January, the EMS central banks had purchased considerably more EMS and other currencies in the exchange market than they had sold dollars.

Swiss franc

As the period under review began, Swiss interest rates were under some upward pressure. Throughout 1984, the monetary authorities in Switzerland aimed at controlling inflation by monetary restraint, adhering to a targeted rate of growth of about 3 percent for the central bank money stock. They held to this goal even though economic recovery slowed during the second half of the year. The economic recovery, though moderate by historical standards, was sufficient to generate a modest pickup in credit demands and some increase in interest rates. In addition, domestic financial markets were somewhat unsettled by the decline of the Swiss franc from its peak in March that amounted to nearly 19 percent *vis-à-vis* the dollar and about 2 percent *vis-à-vis* the German mark by the end of July. These declines had brought the spot rate down to SF2.4745 and DM.8493 by the opening of the period.

During August the Swiss franc steadied. Although short- and long-term interest rates in Switzerland remained the lowest of any of the industrialized countries, the tightening of money market conditions in Switzerland combined with other factors to begin to reverse the decline in the Swiss franc. Interest rates in Switzerland were rising at a time when rates elsewhere were either steady or declining. Interest differentials, while still adverse *vis-à-vis* both the dollar and the German mark, narrowed. In addition, non-residents had significantly reduced their issuance of Swiss franc-denominated bonds. Also, there had been a particularly sharp drop in bond placements—and therefore in the ensuing conversion of bond proceeds into dollars—by Japanese firms whose ability to offer attractive terms on bonds with stock warrants became compromised by a poor performance of Japan's stock market during the second quarter. Nor did Swiss franc bonds offer as much prospect for capital appreciation to attract investors as did bonds denominated in currencies where interest rates were declining.

The Swiss franc therefore recovered irregularly against the dollar to reach its high of the six-month period of SF2.3650 on August 16. The franc recovered against the German mark for somewhat longer, moving to a level below DM0.82 after mid-September.

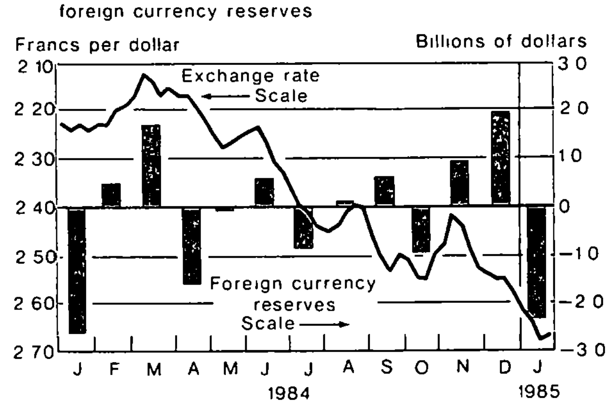
During late September and October, when European currencies were generally fluctuating widely *vis-à-vis* the dollar, the Swiss franc moved with the German mark, but not as widely. The Swiss franc was not the focus of selling pressures prior to September 21. Thereafter, it did not benefit as much from intervention. The Swiss authorities made it clear that they did not intend to intervene aggressively in the exchange markets out of concern that they might then have to deviate substantially from their domestic monetary policy objectives. When the dollar fell back in late October, the Swiss franc was again trading close to its highs for the period against both the dollar and the mark.

Thereafter, however, the franc began to lose ground relative to both currencies. This weakness in the franc followed statistical releases confirming that inflation continued to be higher and growth lower than in Germany. Also, the franc did not benefit, as the mark did, from continuing expectations of central bank intervention. The National Bank, having kept its restrictive 3 percent target for growth of central bank money for

Chart 7

Switzerland

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

1985, was perceived as reluctant to add further upward pressure on domestic interest rates by intervening in the exchange markets. The franc declined more rapidly than the mark as the dollar strengthened across the board during late December and January The franc closed the period at SF2 6830, down 8½ percent relative to the dollar for the six months.

As the franc began again to decline in late 1984, market commentators started to attribute the move at least in part to a long-term loss of the franc's international appeal. They suggested the franc might be suffering from an erosion of its "safe haven" status in the face of worldwide reductions in inflation and the perception of an increasingly fragile political environment in Europe. Some also suggested that the transactions demand for the currency had diminished to the extent that the franc has lost attractiveness as a trading vehicle. As for foreign exchange dealing, the dollar/mark relationship was volatile enough to provide sufficient profit opportunities in markets larger in size and permitting bigger transactions. As a medium for investment, the franc was being overshadowed by other currencies, most especially the dollar.

The Swiss National Bank did not intervene in the exchanges during the August-January period Swiss reserves fluctuated as the central bank used currency swaps to adjust domestic liquidity, closing virtually unchanged from end-July levels

Canadian dollar

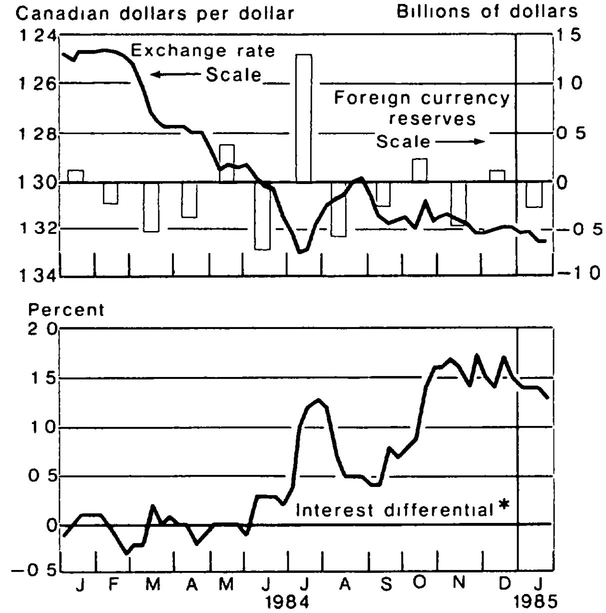
Just before the period opened, the Canadian dollar had shaken off the severe selling pressures of the earlier part of the year. In mid-summer, Canadian interest rates had moved up, restoring a positive differential in favor of the Canadian dollar. With money market rates well above corresponding U.S. rates at the start of August, the cost of short Canadian dollar positions had become expensive. Thus professional selling of the currency subsided and commercial leads and lags came into better balance. Also a public debate faded over whether economic policy should give priority to reducing unemployment or dealing with inflation The Canadian dollar rose from the historic low of Can.$1 3368 ($0.748) against the U.S. dollar reached in mid-July to Can.$1.3094 ($0.764) by early August

During the period under review, a number of factors supported the Canadian currency which, along with the U.S. dollar, rose relative to the other major currencies. Canada's current account was in surplus, buoyed by a strong export performance Canada's economy revived in the third quarter, catching up for slower growth earlier in the year. Meanwhile, inflation continued to moderate, falling to below 4 percent at an annual rate In addition, a change in government at the September national

Chart 8

Canada

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



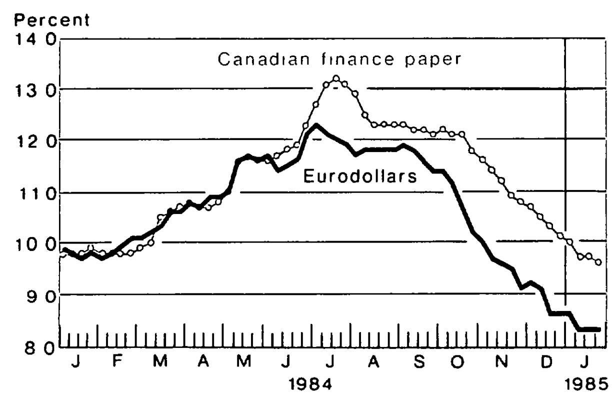
*Canadian finance paper minus Eurodollars Weekly average of daily rates

See exchange rate footnote on Chart 3

Chart 9

Interest Rates in Canada and the Eurodollar Market

Three-month maturities*



*Weekly averages of daily rates

elections encouraged market participants because of the new governing party's advocacy of policies to encourage foreign investment in Canada, to reduce governmental intervention in the economy, and to cut government expenditures These ideas were reaffirmed in November when the government gave a statement to Parliament of its intended legislative program.

Yet market confidence in the Canadian dollar was not fully restored The public debate preceding the election had left uncertain the priority any government would place between lower interest rates to stimulate the economy and higher rates to fight inflation By mid-winter there was also some doubt that the new government would be able to implement its program of fiscal restraint Moreover, large corporate transactions occasionally weighed on the market for Canadian dollars at times

Under these circumstances, the Canadian authorities moved cautiously to take advantage of the decline of U S. interest rates to avoid an outbreak of revived pressure against the currency. Canadian interest rates at first did not decline as quickly as U.S rates, and by mid-October the interest differentials *vis-à-vis* the U.S. dollar were even wider than in early August. Thereafter, Canadian interest rates did ease more in line with U.S interest rates, maintaining the wider differentials for the balance of the six-month period

Against this background, the Canadian dollar fluctuated without clear direction against the U.S. dollar, declining less than other currencies On balance it declined 1¼ percent to Can.$1 3258 ($0.754) by end-January The Canadian dollar thereby continued to appreciate against other currencies during the period under review, benefiting at least in part from high yields on Canadian assets and the currency's relative firmness against the U.S. dollar to attract sizable capital inflows from abroad.

Foreign exchange intervention by the Canadian authorities was aimed at smoothing out sharp movements in the currency Total foreign currency reserves fell by $1 2 billion, mostly in August and November, to stand at $1 5 billion at the end of the period. The declines primarily reflected repayments of outstanding foreign exchange drawings made earlier in the year on the government's credit lines with Canadian and foreign banks