February-July 1985 Semiannual Report
(This report was released to the Congress and to the press on September 6, 1985)

Treasury and Federal Reserve Foreign Exchange Operations

During the period under review many observers of the foreign exchange markets were uncertain about the sustainability of the global economic expansion, now into its third year. The vigorous upswing in the United States had faltered in the third quarter of 1984, and market participants were anxious for evidence whether domestic demand would remain strong enough to support renewed increases in production and employment in 1985. Doubts developed about other countries' ability to continue to expand should U.S growth remain subdued, since exports to the United States had been the major source of stimulus abroad.

Meanwhile, inflation had decelerated in almost all of the industrial countries, but the scope for making further progress in the fight against inflation was seen as more limited at this stage of the business cycle. At the same time, market attention was focused on concerns about the imbalances in the structure of the current recovery—imbalances reflected in a large U.S. fiscal deficit, unprecedented disparities in the current account positions of the largest industrialized countries, interest rates at levels that appeared high relative to current inflation rates, and persistent unemployment problems abroad.

With the major money and capital markets of the world increasingly integrated through progressive liberalization of exchange controls and other regulations, shifts in sentiment about these uncertainties were associated with sizable movements in dollar rates. During the six months February through July, the dollar briefly continued its four and one-half year climb, advancing strongly to hit record levels in the floating rate period. Thereafter it depreciated, at times quickly, to close the period much lower.

A report by Sam Y Cross, Executive Vice President, Federal Reserve Bank of New York and Manager of the Foreign Operations of the System Open Market Account Officers of the Foreign Exchange Function, together with Richard F Alford, Elizabeth A Goldstein, Thaddeus D Russell, and Elisabeth S Klebanoff contributed to its preparation

The dollar's continued rise: February to early-March

The dollar was buoyed early in the period by an improving outlook for the U.S. economy and the implications for U S. monetary policy. Data being published at the time pointed to a significant rebound in the fourth quarter that had been unanticipated just months before, and economic forecasters were beginning to present reassuring projections of moderate growth for 1985. An accelerating expansion of monetary aggregates was seen as limiting the scope for any further easing of U.S. monetary policy and might even suggest some tightening. As a result, there was a perception in the market that the decline in U.S. interest rates, which had brought short-term deposit rates down more than three percentage points in about six months and was marked by two half percentage point cuts in Federal Reserve discount rates, was not likely to continue. As this shift in expectations occurred, market rates for long-term as well as short-term instruments backed up somewhat during February and into early March.

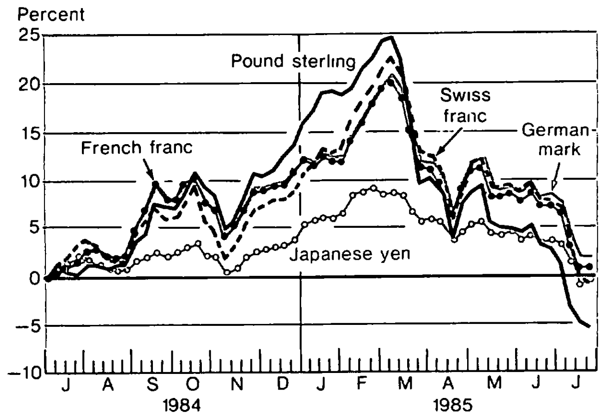
The economic outlook abroad was more guarded. The performance of many of the European economies had not been sufficient to dispel concerns about their longer-term growth potential. Industrial production statistics for the first quarter, while hard to interpret because of temporary disruptions associated either with labor disputes or an unusually severe winter, pointed to declines in output in many large countries Also, business opinions and press commentary appeared to reflect a lack of confidence in most countries that domestic demand could revive sufficiently to ensure a continued expansion should U.S. growth be subdued. Fiscal policies abroad were regarded as being almost universally restrictive, as the authorities sought further progress in achieving their medium-term goal of reducing fiscal deficits as a proportion of national income. Monetary policies were also generally restrained.

Thus, few market observers thought that foreign central banks would welcome pressures emanating from either a renewed firming of interest rates in the United States or a continuing decline in their currencies to tighten monetary policy any more. Yet the impact on domestic prices of the progressive decline in these countries' currencies against the dollar was showing through, at least in Germany where import prices were rising more quickly. Market participants therefore became wary of the possibility that the authorities there, as well as in other countries, might use intervention in an effort to stop the currency depreciations.

The full range of these international issues had already been discussed at a G-5 meeting late in January. Moreover, the May 1983 Williamsburg agreement to undertake coordinated intervention as necessary was reaffirmed at that meeting and visible foreign exchange market operations had subsequently been undertaken by the authorities of several countries. Market partici-

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 July 2-6, 1984 Figures calculated from New York noon quotations

Chart 2

U.S. Interest Rates

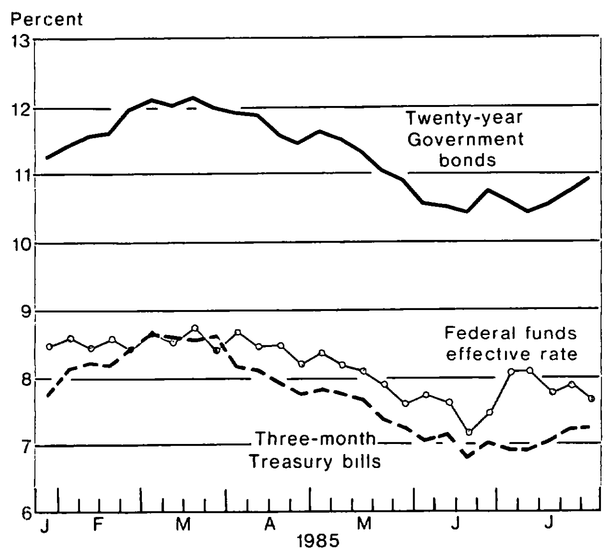
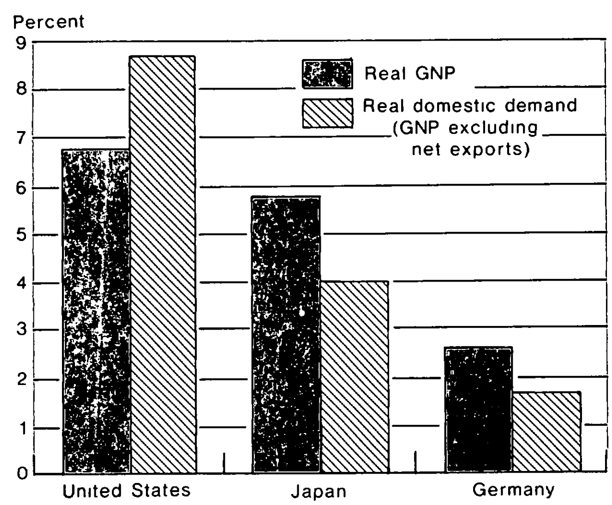


Chart 3

Real GNP and Real Domestic Demand Growth

In 1984



Source Organization for Economic Cooperation and Development, 1984 pants perceived the central banks to be more willing to intervene than before But they were uncertain about the circumstances in which the central banks would judge intervention to be appropriate

At the same time dealers remained impressed by the strength of demand for dollars in the exchange market Enthusiasm spread about the degree of interest coming from abroad in the Treasury's February refunding operations. Commercial entities were frequently seen as buyers of dollars, presumably to hedge future commitments in light of the improving outlook for the dollar As sentiment toward the dollar became increasingly bullish, the dollar rose through levels at which, in earlier months, some central banks had intervened and previously provided resistance The dollar's rise then gained momentum, markets became one-sided, and dollar rates moved quickly to successive highs against several European currencies By February 26, the dollar had risen nearly 10 percent against major European currencies while rising 3 percent against the Japanese yen At this point the dollar was at its highest level of the six-month period under review, trading around DM3.48 and $1 03 against the German mark and British pound, respectively.

On three occasions during the first three weeks of February, the U.S. authorities intervened, selling a total of $242 6 million against marks, $48.8 million against yen, and $16.4 million against sterling to counter disorderly market conditions in operations coordinated with foreign central banks Between February 27 and March 1, the U S authorities sold another $257 4 million against marks in the New York market in a concerted intervention. These operations brought the total of U S intervention sales of dollars, between the January 21 G-5 meeting and March 1, to $659 million

As for the central banks of most other G-10 countries, they intervened much more heavily between February 27 and March 1 than before, selling dollars, buying German marks and other currencies, or doing both For all G-10 countries as a group, the total of dollars sold during the five weeks between January 21 and March 1 was about $10 billion This series of operations constituted one of the biggest dollar interventions during the floating rate period. The sales of dollars by G-10 countries other than the United States was large enough to cause a sizable drop in their official foreign currency reserves

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility July 31, 1985
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

The decline: mid-March to end-July

Even after the large interventions of late-February to early-March, the dollar traded close to its late February highs for about two weeks But the intervention had resulted in an accumulation of dollar-denominated assets in private hands. Talk had begun to spread earlier that portfolio managers were gearing up to provide more currency diversification to customers' portfolios, taking advantage of assets that appeared undervalued at current exchange rates and capitalizing on the possibility of future currency appreciation. Then, around mid-March, a more pessimistic reassessment of the outlook for the U S economy and a shift of view about interest rates began to weigh on the currency.

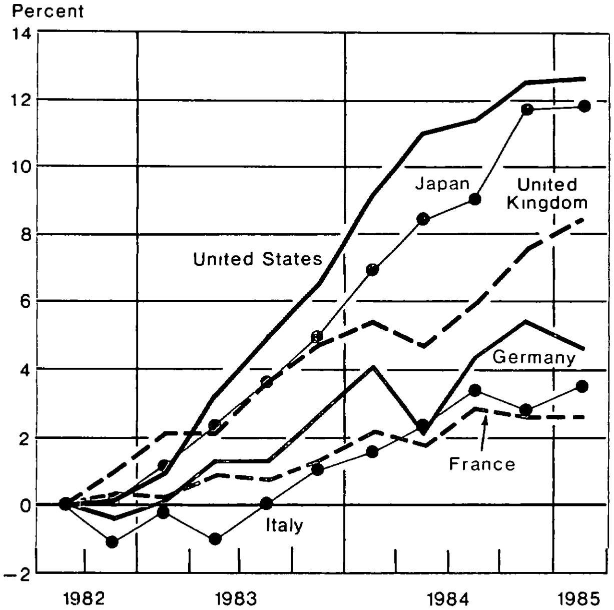
By mid-March, a variety of statistics were indicating that economic activity in the United States was proceeding only at a relatively slow pace While final demand remained buoyant, the demand for labor and growth of production in the manufacturing sector were much weaker than had been assumed in most forecasts earlier in the year Market participants came to realize the extent that demand was being diverted away from U.S -produced goods, thereby jeopardizing the sustainability of economic expansion here.

At the same time, signs of strain in U.S financial markets became more prominent, raising the risk that financial as well as economic dislocations would intensify. The failure of three secondary government securities dealers, though constituting a very small part of the market, imposed losses for a number of customers, including several local governments and thrift institutions The repercussions of these incidents revealed weaknesses in private deposit insurance systems and

Chart 4

Cumulative GNP/GDP Growth

Quarterly data



led to large deposit outflows from state-insured thrifts, particularly in Ohio, before the governor of that state temporarily closed the affected institutions. Pictures displayed prominently by the media of queues of depositors unable to withdraw their funds heightened concern about the authorities' ability to deal adequately with problem situations. Since difficulties had already been identified in energy, real estate, and agricultural portfolios, this weakness was perceived as having potentially far-reaching implications.

Against this background, market participants adjusted their assessments of the outlook for U.S. monetary policy and interest rates. Dealers were sensitive to the implications of the imbalances in the economy for the industrial sector and the prospects for sustained growth. Money as measured by M1, though remaining well above target, was growing somewhat more slowly on a month-to-month basis. Inflation rates were still low, a renewed weakness in oil prices helped keep inflationary expectations at bay, and signs of Congressional action to reduce the fiscal deficit lent some relief to the bond market.

Thus, most observers came to expect the Federal Reserve to give priority to supporting the economy and providing assistance to the domestic financial system. Market interest rates of all maturities started to decline in a trend that was to last about three months, while expectations developed that the Federal Reserve would announce a series of cuts in its discount rates By mid-June short-term interest rates had fallen two percentage points or more, with the Federal Reserve lowering its official rates just once—by half of a percentage point, effective May 20. Long-term rates also declined, but more slowly As a result of these declines, most U.S. interest rates were below levels prevailing at the depth of the 1982 recession.

As these developments began to unfold, the dollar fell substantially in the exchange markets. Many market participants were concerned for a time about the magnitude of any drop in the dollar, if foreign investors tried to liquidate dollar assets accumulated during previous years. Indeed investors acted to protect the value of their portfolios, mostly by selling dollars in the forward market but also by shifting into assets denominated in other currencies. Commercial customers postponed dollar purchases in the expectation of being able to buy later at more attractive rates. Bank dealers and speculators on organized exchanges also sought to sell the dollar and to establish short positions. Under these circumstances the dollar moved lower. As it fell through levels at which resistance had previously been expected, the pace of the decline quickened From its peak in late-February to the middle of April, the dollar dropped 20 percent against sterling, 15 percent against the continental currencies, as well as 6½ and 4 percent against the Japanese yen and Canadian dollar, respectively.

Late in April, however, the dollar firmed and then traded relatively steadily through the end of June. Market participants perceived that foreign investors had not liquidated their dollar holdings in large scale so that fears of an early and precipitous fall in the dollar faded. Instead, inflows of new funds were continuing, especially from Japan at the beginning of that country's new fiscal year in April, as well as from countries suffering from serious inflation problems. Also, persistent strains in the U.S. financial sector were being well contained. Interest yields on dollar investments were still relatively attractive. The scope for hedging the currency risk should the dollar decline had been demonstrated. And profits realized from earlier hedging operations increased the overall rate of return on dollar portfolios sufficiently to protect against even significant future declines in the dollar. In effect, the dollar retained its stature as the principal medium for investment.

Meanwhile, the currencies that traditionally benefit from a shift of investor preference out of dollars, the German mark and Japanese yen, had appreciated relatively modestly as the dollar had declined. The U.S. economy had still outperformed those of most other industrialized countries and talk continued of a renewed acceleration of U.S. growth in the second half of 1985. The only currency to challenge the dollar as an investment alternative was pound sterling. With the outlook for economic growth in the United Kingdom brighter than for most other countries and interest rate levels there comparatively high, sterling-denominated assets provided an attractive outlet for investors reluctant to accept declines in yields elsewhere. Thus by the end of June, the dollar was trading above its mid-April lows against all currencies except sterling.

Many market observers had supposed that the authorities abroad would have taken advantage of the decline in U.S interest rates that occurred during the spring to ease their own monetary policies. But in Germany and Japan the authorities appeared reluctant to cut short-term interest rates until they were more confident about the exchange market situation. In the other countries, the authorities were cautious about letting interest rates at home get too far out of line with those of their closest trading partners. To varying degrees, foreign central banks instead took advantage of the decline in the dollar to rebuild their foreign currency reserves. The authorities in several countries acquired sizable amounts of both dollars and German marks, currencies that could be used in future intervention operations to support their own currencies. By the end of June the G-10 countries as a group had largely recovered the reserves lost in the early months of the year.

In July the dollar resumed its decline. During the spring, the gap had continued between strong growth of U.S. domestic demand and weak expansion of domestic production. As a result, the regular flow of economic statistics had presented conflicting signals. By early July, however, it again became clear that U.S. economic activity had not increased as much as most observers had expected An acceleration of real GNP growth in the second quarter was more moderate than anticipated, and anecdotal information for July suggested that the third quarter was getting off to no better a start. The mounting U.S. trade and current account deficits were increasingly perceived by market participants as a drag on the domestic economy. Noting an increase in protectionist pressures, they considered the possibility that the Administration might welcome a further decline in the dollar to help restore external balance. At the same time, disappointment developed over the prospects for meaningful reduction of the fiscal deficit, as efforts in the Congress to adopt a compromise budget resolution appeared to falter.

During the month, interest rate developments tended to move in the dollar's favor In the United States, interest rates started to firm. Market participants here came to expect the Federal Reserve would not be more accommodative until it could assess more fully the implications of the drop in interest rates that had already occurred and of a renewed acceleration in M1 growth. In Europe, interest rates began to ease more rapidly. The central bank in Germany began to provide liquidity at progressively lower interest rates and, at least for a time, central banks in other continental countries moved in a similar direction. Thus, interest differentials actually moved in favor of the dollar during the month.

Nonetheless, sentiment toward the dollar had become cautious. Market professionals had already begun to set up positions in anticipation that the dollar might resume its decline Thus, when others came into the market to sell, dollar rates moved down through the end of the month, dropping well below the lows of mid-April. Sterling continued to lead the rise in foreign currencies against the dollar. After mid-July, however, when a

Table 2

Drawings and Repayments by the Argentine Central Bank Under Special Swap Arrangements with the U.S. Treasury

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

Drawings on the United States Treasury	Outstanding September 31, 1984	1984-IV	1985-I	1985-II	Outstanding July 31, 1985
$500 million	*	+500	−230 −270	-0-	-0-
$150 million	*	*	*	+75 +68	+143

Data are on a value-date basis

*Not applicable

realignment within the European Monetary System (EMS) drew attention to the mark's potential for revaluation in that arrangement, the German currency also began to strengthen more rapidly than before. During the entire February-July period under review, the dollar had fallen on balance 20 percent against sterling to $1.4135, 12 percent against the mark to DM2.7850 and by approximately similar magnitudes relative to most other continental currencies, and by 8 percent against the Japanese yen to ¥236

Meanwhile, during late June and July, progress was being made in some of the largest Latin American countries to deal with the serious imbalances in their economies. In Argentina, the government came to an agreement with the International Monetary Fund (IMF) on a stabilization program that entailed currency and wage/price reform designed to brake the country's rapidly accelerating inflation Upon completion of an agreement by the IMF to provide a standby, the U S Treasury and 11 other monetary authorities acted to facilitate the provision of a $483 million bridge financing facility for Argentina, of which the U.S. portion was $150 million. Argentina made two drawings of roughly equal size on this facility, on June 19 and on June 24, for a total of $460 million. The Treasury's portion of these drawings was $143 million Argentina is scheduled to repay the drawings in two installments after the period. In Mexico, the government tightened fiscal policy, liberalized trade policy, and made major changes in the structure of its exchange market. These actions were undertaken in order to align Mexico's cost and price structure more closely with world markets and aid in bringing inflation down to targeted levels

In the period February through July, the Federal Reserve and the Exchange Stabilization Fund (ESF) realized no profits or losses from exchange transactions. As of July 31, cumulative bookkeeping or valuation losses on outstanding foreign currency balances were $871 million for the Federal Reserve and $578 million for the Treasury's Exchange Stabilization Fund. These valuation losses represent the decrease in the dollar value of outstanding currency assets valued at end-of-period exchange rates, compared with the rates prevailing at the time the foreign currencies were acquired

The Federal Reserve and the ESF invest foreign currency balances acquired in the market as a result of their foreign 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 $1,009 2 million equivalent of its foreign currency holdings in securities issued by foreign governments as of July 31 In addition, the Treasury held the equivalent of $1,756.0 million in such securities as of the end of July.

Table 3

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

In millions of dollars

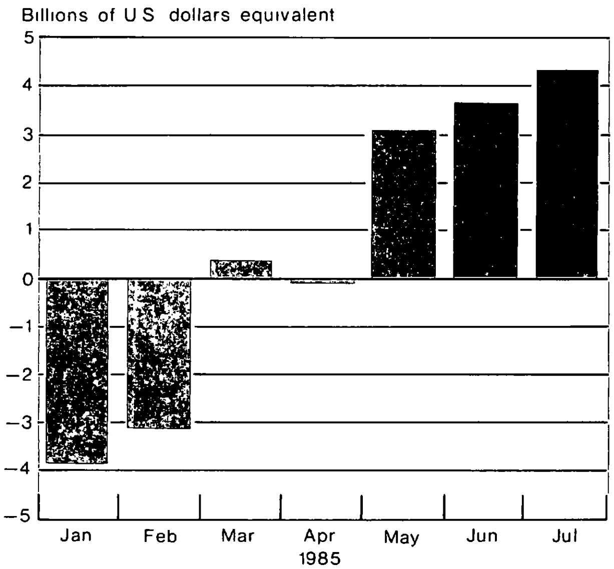
Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
February 1 - July 31	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1985	−871 1	−578 3

Data are on a value-date basis

Chart 5

Changes in Currency Reserves of G-10 Countries

Excluding United States



Foreign currency reserves shown in this and the following charts are drawn from IMF data published in International Financial Statistics

Adjustments for gold and foreign exchange swaps against European currency units done with the European Monetary Fund are incorporated

European currencies

Coming into the six-month period, progress appeared to stall in resolving the economic problems facing European countries. During the months of severe winter weather, growth in several countries slowed, unemployment in some continued to drift upward, and a deceleration in inflation petered out. At the same time the trend toward greater convergence of economic performances started to dissipate, notwithstanding the fact that governments in almost all of these countries continued to be committed to common goals for economic policy: reducing government deficits and containing inflation. Under these circumstances, there were some adjustments among the relationships of all European currencies as they declined and then rose against the dollar.

Early in the period, with the dollar strengthening across the board, the continental currencies as a group fell about 10 percent. The Swiss franc dropped to SF2 9405, the lowest level in more than 10 years, and the German mark posted a low for the floating-rate period at DM3.4780 The Dutch guilder, the French and Belgian francs, and the Italian lira dropped to record lows of NG3.9430, FF10.6300, BF69.90, and LIT2167, respectively. Sterling, which had been the target of especially heavy selling pressure just before the period, declined somewhat more slowly against the dollar during February. Nevertheless, by February 26 it had declined nearly 9 percent and also recorded a record low of $1.0370.

Meanwhile, authorities in Germany and the United Kingdom were concerned that inflation was picking up as a result, at least in part, of the impact on import prices of the continuing strength of the dollar In the United Kingdom, inflationary expectations were also stimulated by concerns over the priorities of the government's economic policy and above-target growth of money But the British authorities had acted to address these concerns prior to the period by permitting an abrupt and sharp increase in short-term interest rates. In Germany, where the pressures were far less acute, market rates also tended to firm. But market participants perceived the German authorities to be resisting the rise out of concern that significant increases in interest rates were not appropriate to the domestic economic situation. These developments had disappointing implications for other countries that had been maintaining favorable interest rate differentials relative to Germany The central banks in France, Italy, and Belgium, for example, saw the opportunity for them to lower interest rates in response to earlier improvements in their price performance as quickly slipping away.

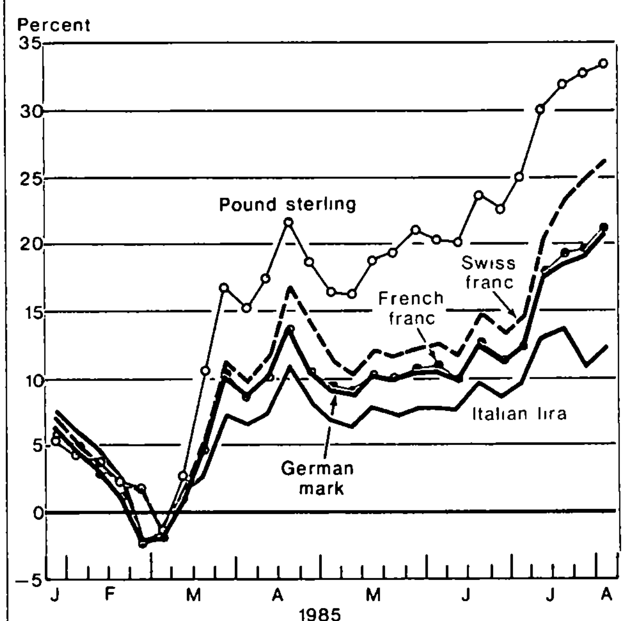
Following the G-5 meeting in January most European central banks participated in the coordinated interventions that took place through early March. All of those participating sold dollars, at times in sizable amounts Some supplemented their dollar sales with purchases of marks and a couple of other currencies, either against dollars or their own currencies.

From mid-March, when the dollar began to decline, to end-June, sterling was the currency that rebounded most strongly to lead the rise in European currencies against the dollar. The Swiss franc also benefited more than many others, while the German mark was not particularly buoyant

This pattern of exchange rate changes surprised market observers who had anticipated that, once the dollar started to fall, the mark would reassert itself as the principal alternative for investment But as it turned out, the currencies to benefit most from the dollar's initial decline were, for the most part, those with assets yielding relatively high interest rates. Foreign capital was drawn into sterling, enticed by high yields on gilts and other fixed income securities as well as the breadth and liquidity of London's financial markets Residents in high

Chart 6

Selected Foreign Currencies against the Dollar



Percentage change of weekly average bid rates for selected foreign currencies from the noon rates on February 28, 1985 Figures calculated from New York noon quotations interest rate countries borrowed abroad where the cost of funds was lower to finance trade and domestic expenditures. The Swiss franc firmed against many other currencies, even though Swiss interest rates remained relatively low, because the impression spread in the markets that monetary policy in Switzerland was not likely to be eased. In Germany, interest rates were also lower than in most other countries, and economic indicators for the first quarter were being interpreted in the market as disappointing. Expectations developed that the Bundesbank would cut interest rates as soon as exchange market conditions permitted and U.S. interest rates declined.

Although the upward pressure on European interest rates subsided as the dollar declined during the spring, the European monetary authorities were slower to reduce interest rates than many market observers had expected.

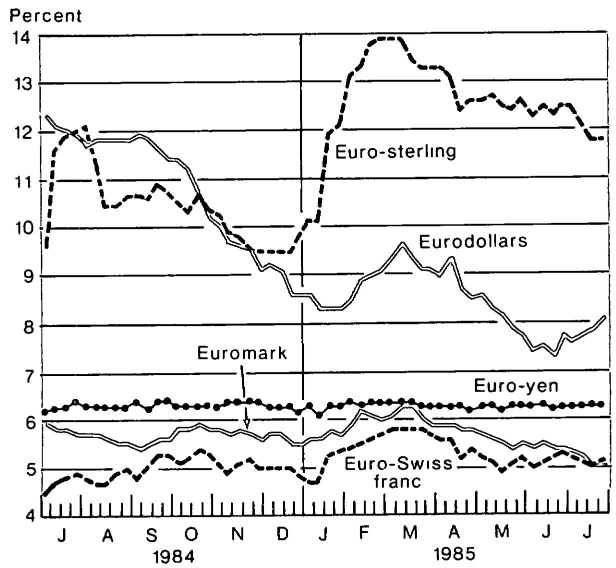
In the United Kingdom, the authorities were intent on reassuring markets of their commitment to strict financial policies. A cautious budget, presented in March, called for both a drop in the public sector borrowing requirement and reductions of growth targets for Britain's two monetary target variables, M0 and M3. As interest rates in the United States declined and capital inflows into sterling exerted upward pressure on the pound, the Bank of England allowed interest rates to ease somewhat. But the authorities were perceived as acting to slow the decline—an approach that appeared reasonable as long as the economic outlook for the United Kingdom was more optimistic than for most other countries. By late June, short-term interest rates were still above 12 percent and differentials *vis-à-vis* dollar interest rates were even wider than they had been early in February.

In Germany, also, the Bundesbank did not judge the domestic situation as warranting a change in the course of monetary policy. The central bank saw the underlying trend of economic activity still pointing upward. Central bank money stock was growing close to the top of its target path, buoyed by an acceleration of domestic credit growth early in the year. The public sector in particular was temporarily having an expansionary impact on monetary growth. And by late spring a public debate had emerged over accelerating proposed tax cuts. The Bundesbank did not wish to suggest that an easing of policy was appropriate by announcing reductions of its official rates. But it was willing to provide sufficient liquidity to the banking system mainly through repurchase agreements. These operations reduced banks' use of Lombard credit and guided day-to-day money rates cautiously lower. By the end of June, three-month money rates had eased 75 basis points from

Chart 7

Selected Interest Rates

Three-month maturities*

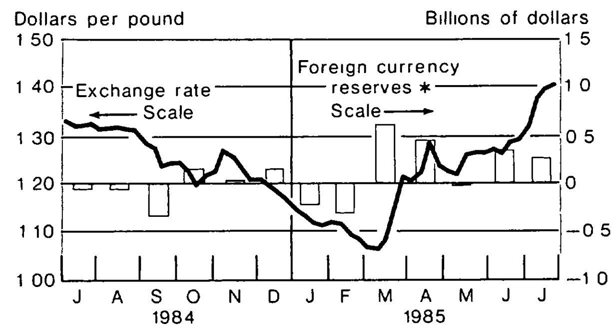


*Weekly averages of daily rates

Chart 8

United Kingdom

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 exchange reserves for the United Kingdom and other members of the EMS, including Germany, incorporate adjustments for gold and foreign exchange swaps against European currency units done with the European Monetary Fund levels of end-February, less than half the decline for comparable rates in the United States

The relative stability of interest rates in Germany was a factor limiting the scope for interest rate declines in other European countries The authorities there had accepted that domestic interest rates would remain considerably higher than those in Germany because inflation rates were higher and current account positions were not as strong Yet their currencies were being buoyed relative to the mark by the inflow of interest-sensitive capital. Under the circumstances, these central banks also looked to relatively subtle techniques to ease money-market rates gradually, so as not to suggest that a change in policy was underway. The Bank of France, for example, lowered its money market intervention rate, acting cautiously by moving in several small steps In this way, short-term interest rates in France declined somewhat more than in Germany. A more substantial change in technique occurred in Belgium where the National Bank decided to adopt a more flexible and market related practice for fixing the discount rate Henceforth the discount rate was to be linked to the rate on three-month Treasury certificates As a result, a decline that had already occurred in market rates was acknowledged and rates continued to ease modestly through the end of June

Against this background, the authorities in many European countries also chose to respond to the favorable exchange market environment for their currencies by acquiring foreign currency reserves During the second quarter a number of central banks were active buyers of dollars either in the market or from customers. They also purchased substantial amounts of other currencies, especially the German mark, because it is a currency frequently used for intervention within the EMS and is of increasing importance in the reserve holdings of other European countries As a result of these operations, many countries restored the reserves lost during their intervention operations in late January through early March. France and Italy had among the largest increases in reserves Germany's increase was the greatest, even though it refrained from intervening for much of the period

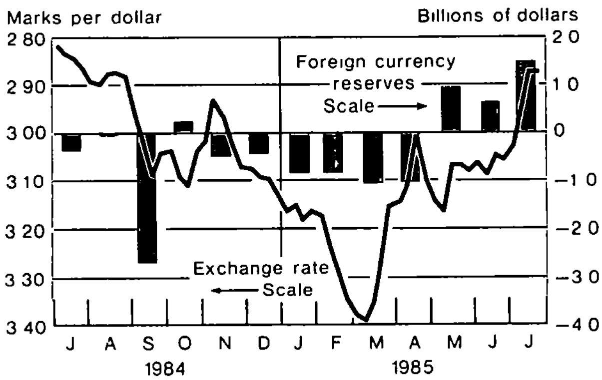
Meanwhile, the Italian lira had broken stride with the other European currencies During February it had risen against the dollar more slowly than the others As a result, it had moved from the top to the bottom of the narrow EMS band between early February and mid-March and then traded consistently about 1½ percent below the bottom-most currency in the narrow band during the second quarter Fiscal policy in Italy had been expansionary, with the government deficit expected to grow to 17 percent of GDP in 1985 Moreover, Italy's inflation remained high relative to that of other countries and successive increases in wage settlements eroded the country's competitiveness all the more Accordingly, the current account had deteriorated, with imports of capital goods quickening Under these circumstances, market participants came to anticipate that the Italian authorities might welcome a decline in their currency.

Sentiment toward the lira was briefly buoyed in May and June when the government's position strengthened with a defeat of a referendum reinstating wage index-

Chart 9

Germany

Movements in exchange rate and official foreign currency reserves

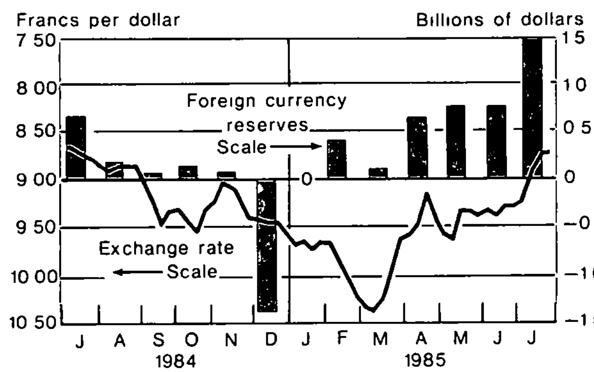


See notes on Chart 8

Chart 10

France

Movements in exchange rate and official foreign currency reserves



See notes on Chart 8

ation and a smooth transition to a new presidency. But by July the lira had resumed its slide toward its lower EMS limit This depreciation helped to offset the competitive disadvantage resulting from accumulated inflation differentials but removed room for movement of the exchange rate within the wide band available to the lira in the EMS arrangement The Italian authorities therefore decided to seek a realignment of the lira's central rates Thus, after the lira dropped to its existing lower limit in hectic trading on Friday, July 19, the authorities closed the foreign exchange markets in Italy after the fixing That weekend the EMS countries agreed to a realignment that took the form of a 7 8 percent devaluation of the lira's bilateral central rates against all other active EMS members As a result, the lira's European currency unit central rate fell by 7.7 percent while the others rose by 0 15 percent.

The July realignment of the EMS served to focus market attention on the risks of further adjustments in the exchange rate relationships among European currencies Market operators began to hedge their borrowings in low interest rate currencies and their investments in high interest rate currencies. The monetary authorities in countries like France and Belgium found the scope for letting interest rates ease or for adding to official reserves more circumscribed than before At the same time the Bundesbank found that the exchange rate environment, together with a reaffirmation of the government's policy of fiscal consolidation, afforded an opportunity to let short-term interest rates decline more quickly. A similar development occurred in the Netherlands

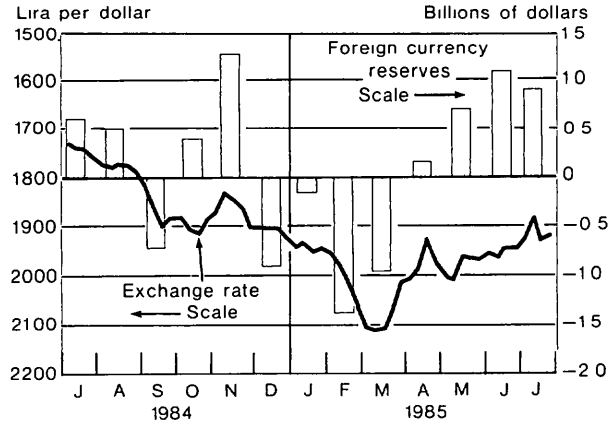
About the same time in July sentiment toward sterling began to soften as well The pound had risen progressively against the mark to levels that brought into question Britain's competitive position *vis-à-vis* its European trading partners. Moreover, the earlier optimistic assessment of the country's economic prospects gave way to a more guarded outlook in the face of a weakening flow of new orders and a flattening of output growth Market participants came therefore to expect the Bank of England to permit a more rapid decline in interest rates, even if the pound were to weaken as a consequence Indeed, during the month, money market rates in London declined toward the 11 percent level and favorable interest rate differentials relative to the dollar narrowed by about one and one-half percentage points In response, sterling gave up some of its gains *vis-à-vis* the mark late in the month.

Thus, the decline in the dollar in July came to be reflected in a somewhat more rapid rise in the German mark than before Even so, at the end of the six-month period under review, the pound had still risen from the February lows against the dollar by more than the other

Chart 11

Italy

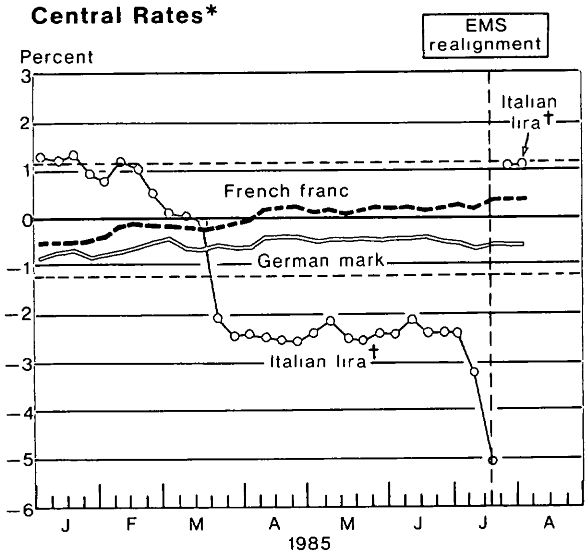
Movements in exchange rate and official foreign currency reserves



See notes on Chart 8

Chart 12

Percent Deviation of Selected 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

European currencies It closed the period up 38 percent from the end-February lows at $1 4350 The mark rose 25 percent during the same period to DM2 7800, with the Swiss franc and most EMS currencies moving roughly in line with the mark The lira rose 18 percent to LIT1872

Japanese yen

The yen generally moved in line with European currencies against the dollar during the six-month period, but its fluctuations were narrower As the period opened, market sentiment toward the yen was relatively positive An annualized 9 percent rise in GNP in the fourth quarter of 1984 and optimistic projections for calendar 1985 compared favorably with the experience and outlook of other countries Inflation remained low, with the effect of the yen's depreciation against the dollar offset by its rise against other currencies and by the weakness of world commodity prices, particularly petroleum Japan's current account surplus had grown to a record $35 billion in 1984 Thus the yen did not fall as rapidly against the dollar as the European currencies during February

Japanese fiscal policy continued to be one of gradually reducing the government's fiscal deficit as a proportion of GNP The Bank of Japan maintained its accommodative monetary stance, but the central bank refrained from reducing its official lending rates, citing as its main reason the need to support the yen in the exchange markets

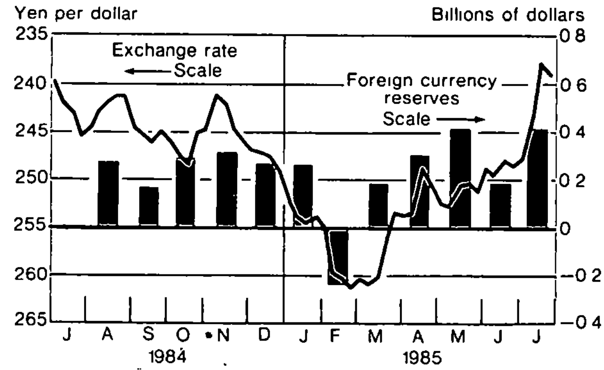
After March the yen did not rise as rapidly as other currencies against the dollar Attention was often focused on Japan's huge long-term capital outflows—which had reached $50 billion in 1984—as a major potential source of unpredictable pressure against the yen At times during the period, the yen's performance in the exchange market—as well as credit market developments in both Japan and the United States—was influenced temporarily by reports and rumors about possible changes in rules or preferences governing Japanese investment abroad In any case, the yen did not benefit, as did the European currencies, from a favorable shift of capital flows late in the period under review Long-term capital outflows, as measured in Japanese net purchases of foreign bonds, actually grew larger to set new records in June and July But since a greater proportion of the outward investment by Japanese residents than before was thought to be hedged through forward foreign exchange transactions and short-term dollar borrowings, the resulting pressures against the yen were substantially mitigated

Rising foreign protectionist threats against Japan, and demands that the Japanese government step up its actions to reduce the trade imbalance, also attracted attention in exchange markets at times as a potentially negative background factor for the yen Generally, however, such pressures did not have immediate exchange-rate influences Announcements in April and June of new Japanese government programs to open domestic markets by reduced tariffs, liberalized investment rules, and administrative reforms had little apparent impact on the yen rate at the time

Chart 13

Japan

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 8

By the end of the period, Japanese foreign currency reserves had risen by almost $1 2 billion to $2.38 billion, largely reflecting interest earnings

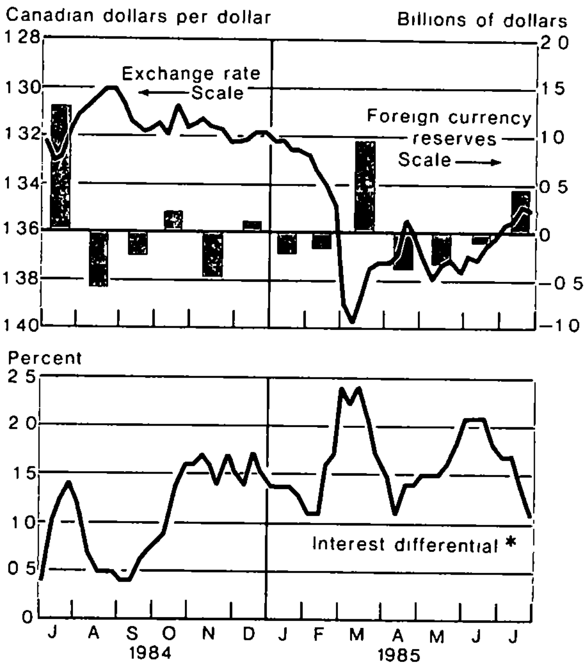
Canadian dollar

The Canadian dollar, like other currencies, weakened considerably against the U S dollar early in the period The rise in U S interest rates during January and February fanned renewed debate over priorities for monetary and fiscal policies in Canada Inflation in Canada had stabilized under 4 percent on a year-on-year basis but the unemployment rate had recently moved back over 11 percent Market participants, noting that Canada's traditional interest rate advantage had dwindled to about one percentage point by early February, questioned the willingness of Canadian authorities to permit increases in interest rates comparable to those in the United States. Moreover, uncertainty developed as to whether Canada's newly elected government would deal decisively with its plan to reduce the budget deficit and improve the investment climate At the same time unease developed surrounding potential capital outflows related to the acquisition by Canadians of foreign-owned assets in the petroleum sector

Chart 14

Canada

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



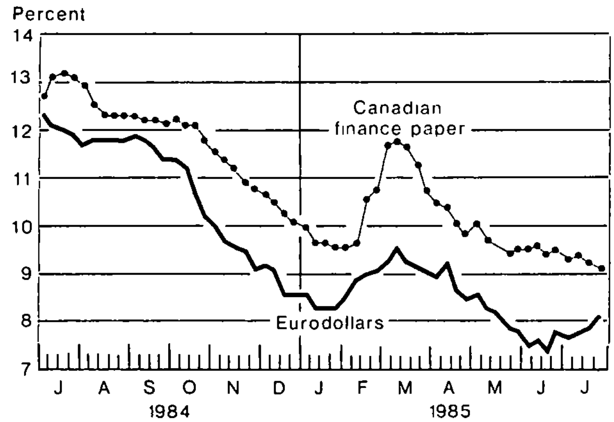
See exchange rate footnote on Chart 8

*Canadian finance paper minus Eurodollars Weekly average of daily rates

Chart 15

Interest Rates in Canada and the Eurodollar Market

Three-month maturities*



*Weekly averages of daily rates

Against this background, sentiment toward the Canadian dollar deteriorated sharply Speculative selling and an adverse shift in commercial leads and lags put pressure on the exchange rate which fell to an all-time low of Can $1 4070 ($0 7107) early in March, a decline of 6 percent from the end of January. The authorities intervened heavily to moderate the decline, financing their dollar sales by drawing on the government's credit lines with commercial banks and borrowing in the Eurodollar market Moreover, the Bank of Canada allowed interest rates to rise more sharply than U S rates, and the currency's interest rate advantage widened to 2½ percentage points

These developments helped to convince market participants that the authorities' approach to the exchange rate had not been changed In addition, the Canadian government announced plans for tax increases and expenditure cuts to reduce the fiscal deficit together with legislation to remove impediments to foreign investment in Canada, thereby reducing uncertainty further. Moreover, a strong external performance, signs of a pickup in the domestic economy, and low wage settlements provided a more encouraging outlook for the currency

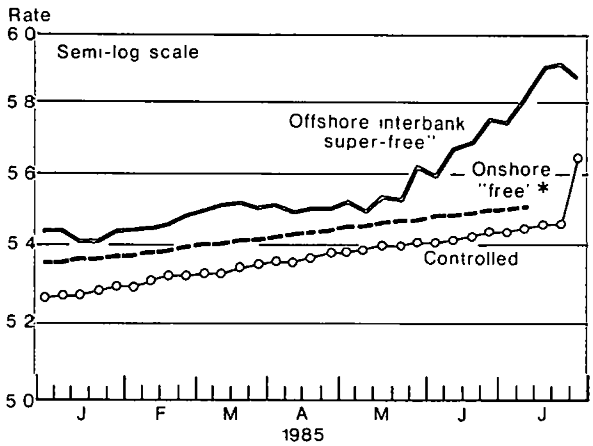
Thus, the Canadian dollar recovered after mid-March most of the ground it lost earlier in the period to close at Can $1 3539 ($0 7386), down only 2 percent on balance over the six months Under these circumstances, interest differentials eased back to fluctuate around 1½ percentage points over the remainder of the period. The Bank of Canada made net dollar purchases as its currency rose, which it used to repay debt on its commercial bank credit lines and bolster reserves In addition, a further U S dollar borrowing in the U S market served to boost the level of foreign exchange reserves. By the end of July, foreign exchange reserves were up $498 million over the period under review at $2 1 billion.

Selected Latin American currencies

During the six months under review, two major Latin American countries, Mexico and Argentina, introduced new economic packages that included, among other measures, reforms to their respective foreign exchange systems In the case of Mexico, this package was designed to get its stabilization efforts of the past three years back on track In the case of Argentina, the task was to embark on major reforms to reverse long festering economic imbalances that were being reflected in spiraling inflation rates

Chart 16

Mexican Peso Rates



*Abolished July 11, 1985

Mexico

Mexico had posted a significant improvement in its trade account, which had swung from a deep deficit into surplus in 1983 and 1984. However, the surplus had subsequently narrowed. During the first four months of this year, the weakening of Mexico's external position was being accentuated by a nearly 10 percent fall in total exports. Oil shipments dropped in the face of weakening prices elsewhere, the competitiveness of non-oil exports declined with a real appreciation of the "controlled" exchange rate, and the pressures of increasing internal demand deflected production to the home market. Under these circumstances, Mexico's current account surplus for all of 1985 was also expected to diminish, notwithstanding the reduction of interest payments stemming from declining interest rates.

Meanwhile, Mexico's fiscal deficit through June rose to well above target levels. The budget overrun reflected the lower-than-anticipated oil revenues and increased government spending resulting partly from higher-than-expected inflation and greater internal interest payments.

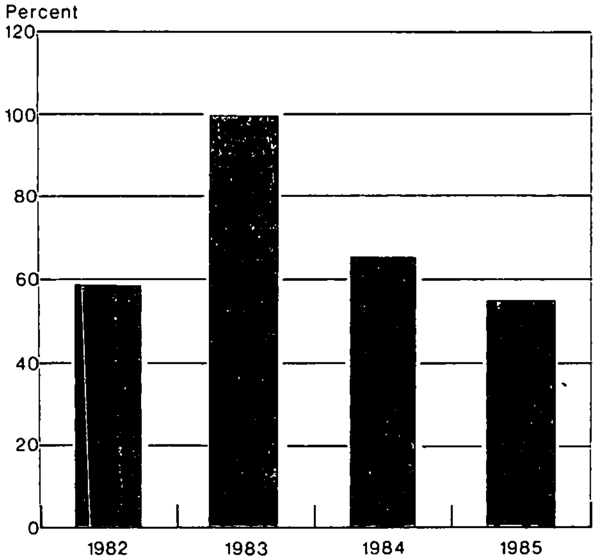
In response to these pressures, beginning in late May the discounts widened between Mexico's "controlled" exchange rate for licensed transactions and the two free market rates—the internal "free" rate and the "super-free" rate across the Mexican border. Thus, the improvement in the foreign exchange position of the Mexican peso, which had occurred in late March and in April following announcement of new understandings with the IMF on 1985 economic policies and the signing of the first phase of Mexico's multi-year rescheduling, quickly dissipated. By late spring the external market was subject to recurring rumors of an impending peso devaluation, an increase in the daily rate by which the authorities adjusted the crawling "controlled" rate, and cuts in oil export prices. By mid-July, the gaps between exchange rates for the peso were increasingly large. Exporters had the incentive to delay or divert revenues required to be converted in the "controlled" market to either the domestic "free" market or the external, "super-free" market. Also, the volume of trading in the internal "free" market diminished substantially. Thus, the widening gap of peso rates was a source of growing concern to the authorities.

To deal with this situation, the Mexican authorities adopted a series of measures, starting in mid-June. Under Mexico's procedures for licensing imports, exporters were granted certificates of importation rights (called "DIMEX"), permitting them to import without license a range of raw materials and inputs to make their operations more efficient. Effective June 28, Mexican banks were allowed to operate in the foreign exchange market at the "super-free" rate by establishing trading houses designed for this purpose. After the Mexican banks were able to participate in the "super-free" market via their trading houses, they became major intermediaries in that market. Then, on July 11, the Mexican banks, supported by the monetary authorities, decided to stop trading at the internal "free" rate. As a result transactions were switched from the "free" market, where the peso was trading at 247.3 pesos per dollar the day before, to the "super-free" market, where the peso was at 312.0 pesos per dollar before the announcement of this change. This switch constituted a 26 percent devaluation for transactions not eligible for the "controlled" rate. Then on July 25, the Mexican government announced additional economic reforms including:

- A 17 percent devaluation of the "controlled" exchange rate, from 232 to 279 pesos per dollar.
- The introduction of a "regulated float" to replace the earlier crawling system involving a fixed, daily slide of the peso against the dollar for the "controlled" market.
- Elimination of import permits on goods accounting for about 37 percent of its imports, thereby making a total of over 60 percent of Mexican imports subject to tariffs rather than non-tariff barriers, and a further enlargement of the "DIMEX" arrangements.
- A cut in current government expenditures,

Chart 17

Mexican Inflation Rate



Sources International Monetary Fund, International Financial Statistics, and Banco de Mexico, Informe Anual

amounting to 150 billion Mexican pesos during 1985, that entailed a 20 percent cut in budgeted expenditures on goods, the elimination of several highly visible government positions, and major cutbacks in expenditures by public enterprises

The purpose of these reforms was twofold First, they were expected to relieve demand pressures in the economy coming from the public sector Second, they were intended to improve competitiveness by adjusting the exchange rate and by opening the domestic market to lower-priced imports for raw materials, intermediate products, and capital goods

During the period between the announcement of the abolition of the internal "free" market and the rest of the economic reforms, the peso weakened sharply as Mexican residents rushed to buy dollars in anticipation of a further devaluation. By July 24, the market rate in Mexico and abroad had fallen a further 20 percent to 374 pesos per dollar, and the discount relative to the "controlled" rate widened to more than 60 percent But by the end of July, the peso recovered to 354 50 pesos per dollar, and the discount from the "controlled" rate narrowed to about 27 percent

Argentina

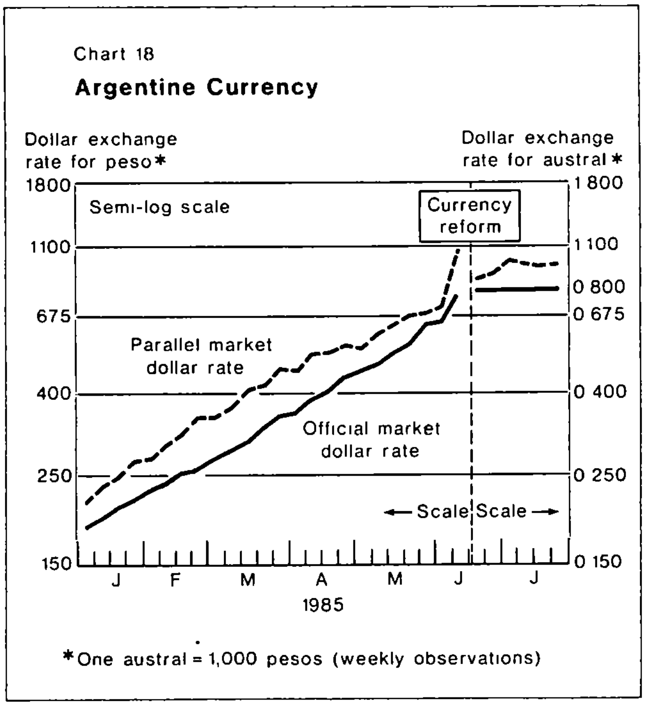
In Argentina a newly constituted democratic government had been attempting to grapple with a debilitating wage/price spiral without jeopardizing promised increases in real incomes But the domestic economy was in severe disequilibrium The central bank had monetized years of oversized fiscal deficits. It found that, with public sector wage increases and fiscal policy stimulating demand, efforts to restrict excessive bank lending through interest rate ceilings and credit allocation schemes led to a diversion of financing to an informal inter-company market

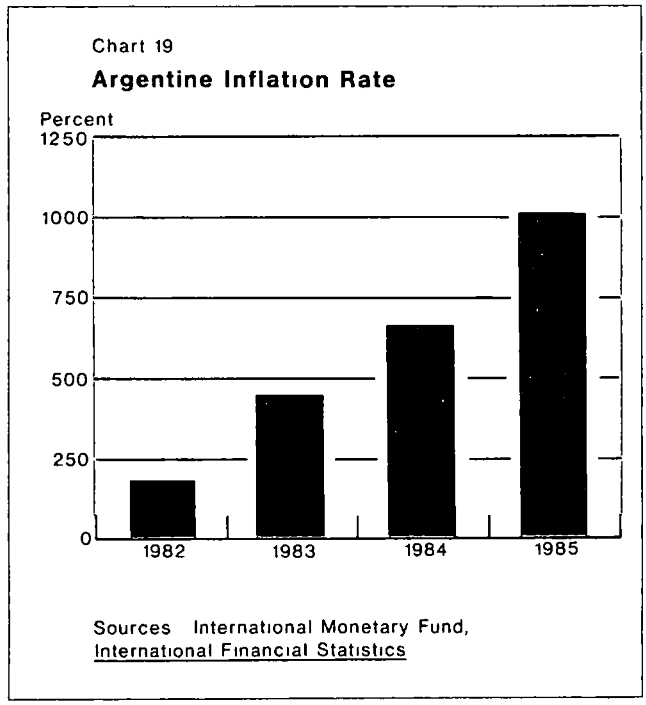
Argentine officials had repeatedly spoken of the need for programs to stabilize the economy over time by tightening monetary and fiscal policies. As recently as December 1984, Argentina had announced a 15-month standby arrangement with the IMF. But the country was from the start not in compliance with the standby provisions and the rise in Argentina's inflation rate continued to accelerate In the process, the strategy of gradual adjustment had lost credibility By early 1985 the internal chaos wrought by an economy reeling toward hyperinflation provoked political demands for a new approach that promised quicker results, even if the approach involved immediate sacrifice

Thus, in March President Alfonsin, with a new economic team, began to adopt a series of new measures to achieve rapid adjustment and a radical restructuring of the economy First, regulated deposit rates were raised to levels comparable to the monthly inflation rate Interest rates were deregulated on some bank liabilities to attract funds back into the banking system where the authorities could exert more control on credit creation Public utilities also raised prices significantly to increase revenue.

On June 11, the government announced an 18 percent devaluation of the Argentine peso in the official market Previously, the government had implemented "mini-devaluations" rarely exceeding 4 percent, and averaging about 1 percent per day to adjust for the inflation differentials between Argentina and other countries Following this action, and amid rumors of dramatic economic measures, the premium which Argentine residents had to pay for dollars in the parallel market widened to 35 percent

Then on June 14, President Alfonsin announced a package of bold economic reforms, centering on a further, substantial cut in the fiscal deficit and a pledge to stop monetizing the deficit The deficit, which had fluctuated in the range of 10 to 12 percent of GDP since the end of 1983, was to be slashed to only 2 5 percent for the second half of this year In support of this plan, price and wage ceilings were frozen—actions described as interim steps toward eliminating the country's price and wage indexation system that





was perpetuating Argentina's inflation problem

In addition, currency reform was instituted to replace the Argentine peso with a new currency, the austral, at a rate of 1000 pesos to 1 austral Effective June 16, the austral was given a fixed parity of 80 austral cents to the U S dollar

On the basis of these measures the government was able to shore up Argentina's external financing position and reduce cash flow problems It completed negotiations for reactivating the IMF program, which was approved on August 9 It also took steps to reduce interest arrears on public sector debt, using funds from official reserves and drawing upon a multilateral bridge financing facility backed by the monetary authorities of the United States and 11 other participating countries The government's actions also set the stage for completion of a rescheduling agreement and a new lending program with commercial banks

The announcement of the government's adjustment program was generally well received in Argentina In the exchange market, too, the Argentine currency appeared to have gotten a steadier footing by late July Capital inflows began to materialize, taking the form at least in part of a reversal of commercial leads and lags