Treasury and Federal Reserve Foreign Exchange Operations August 1975—January 1976

By ALAN R. HOLMES AND SCOTT E. PARDEE*

Following the dollar's sharp recovery against the major continental European currencies early last summer, during which the Federal Reserve was able to repay in full its swap drawings arising out of operations in late 1974-early 1975, the exchange markets settled into better balance in August and early September. The dollar then came into renewed heavy demand in response to further favorable news on the United States economic recovery and to expectations that interest rates here would continue to firm ahead of interest rates in most other industrial countries, where recovery was lagging. By September 22-23, dollar rates against major European currencies had been bid up by some 4-5 percent above end-of-July highs. To moderate the day-to-day rise, foreign central banks sold sizable amounts of dollars in their respective markets. The Federal Reserve took the opportunity to purchase moderate amounts of German marks, adding $59.3 million equivalent to balances in August-September, and to buy $6 million of Belgian francs to hold against the remaining swap indebtedness outstanding since 1971.

By then, however, the long-brewing controversy on how to resolve New York City's fiscal difficulties was beginning to weigh on market psychology toward the dollar. Moreover, in early October, United States interest rates turned down once again amidst scattered indications that the pace of the recovery might have slowed, while more favorable signs of a near-term pickup of some European economies raised the prospect of a hardening of interest rates abroad. In this uncertain atmosphere, the dollar lost buoyancy and dollar rates dropped off sharply in sporadic bouts of selling pressure. In an effort to maintain order and to resist the decline, several foreign central banks entered the market as buyers of dollars, on some days in sizable amounts. The New York market also turned unsettled on occasion in early October, and the Federal Reserve, operating on four days between October 1 through October 15, sold a total of $50.1 million equivalent of marks from balances. Thereafter, the dollar leveled off around 4-5 percent below late-September highs against the major European currencies.

Over subsequent weeks, dollar exchange rates still fluctuated widely on a day-to-day basis. Although European central banks continued to buy dollars on balance when the dollar came under pressure in their markets, the New York market was generally quiet and there was no further need for the Federal Reserve to sell foreign currencies. In fact, as the elements of a compromise solution on New York City's finances gradually emerged, the dollar regained some of its earlier buoyancy and firmed by 1-2 percent into early December. Thereafter, through the year-end, the dollar traded fairly narrowly. The Federal Reserve intervened on two occasions to steady the market, selling $9.1 million of marks out of balances. Otherwise, the System took a number of opportunities to acquire mark balances, buying some $60.6 million equivalent in the market and from correspondents from October through the year-end.

Meanwhile, the heads of government of the six major industrial countries meeting at Rambouillet, France, on November 15-17, 1975 affirmed their intention "to work for greater stability in underlying economic and financial conditions in the world economy. At the same time, our monetary

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authorities will act to counter disorderly market conditions or erratic fluctuations in exchange rates." Reports of this agreement were well received in the exchanges.

Coming into 1976, the markets were fairly optimistic toward prospects for the dollar. The United States continued to make progress toward reducing inflation. Our competitive position remained strong with the trade balance still in sizable surplus. The latest economic indicators suggested that the slowing of the United States recovery in late 1975 had been only temporary and that, if anything, our recovery was more solidly based than the incipient upturns in other industrial countries. Thus, although United States interest rates continued to drift downward, the decline was expected to be temporary. In this atmosphere, consequently, the dollar was shielded from the variety of tensions which developed in markets for other currencies in early 1976.

By that time, divergent price and productivity performances among European countries had led many market participants to expect that exchange rate adjustments might again be necessary, both by those within the Economic Community (EC) "snake" arrangement and by other European countries whose trade is closely linked to that group. Early in January the Swiss franc came into strong demand and rose further to new highs against the German mark before heavy intervention by the Swiss National Bank helped to steady the market. Then, in the context of a prolonged cabinet reorganization in Italy, the lira came under heavy selling pressure and, after extensive support operations, the Bank of Italy withdrew from the market on January 21 to conserve its cash reserves. Over subsequent days the lira dropped away by 6¾ percent against the German mark and, as rumors spread that further exchange rate moves were imminent, other currencies also came under selling pressure, including particularly the French franc and the Belgian franc. These essentially speculative selling pressures were strongly resisted by the authorities of the respective countries. Since the dollar figured heavily in these flows—both as a vehicle currency for many market participants and as an intervention currency for central banks—the dollar also occasionally came on offer, particularly late in the month when a broader speculative demand built up for German marks, Dutch guilders, and Swiss francs. By the month end, the dollar had slipped some 2 to 3 percent against these currencies from early-December levels. During January, to avoid a disorderly decline of dollar rates, the Federal Reserve offered marks in New York on four different days, selling a total of $47.3 million equivalent. These sales were out of balances and were partly offset by $29.8

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

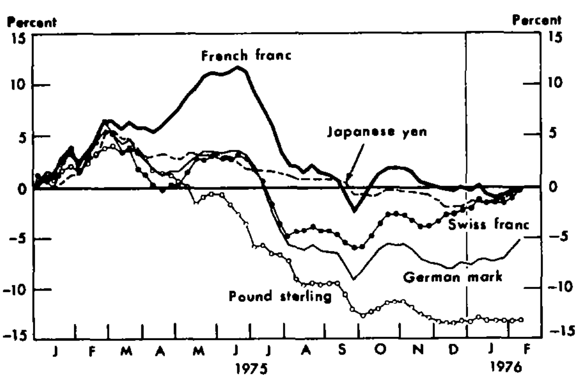
In millions of dollars

Institution	Amount of facility January 31, 1976
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	2,000
Bank of Italy	3,000
Bank of Japan	2,000
Bank of Mexico	360*
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	1,400
Bank for International Settlements:	
Swiss francs-dollars	600
Other authorized European currencies-dollars	1,250
Total	20,160*

* Increased by $180 million effective August 29, 1975.

Chart I

SELECTED EXCHANGE RATES *



*Percentage deviations of weekly averages of New York noon offered rates from New York noon offered rates on January 2, 1975.

million of purchases from correspondents during the month.

The strains on European currencies continued into February. But, after further strong official statements that underlying economic conditions did not justify any realignment of EC currencies, as well as sustained central bank intervention complemented by domestic monetary actions, the markets began to settle down once again by midmonth.

The more effectively coordinated intervention through late 1975-early 1976 and the expanded consultations among the central banks were facilitated by various international agreements over the past year, including those among the Federal Reserve, the German Federal Bank, and the Swiss National Bank in London in February 1975, between the United States Treasury and the French Finance Ministry in Rambouillet, and by the Interim Committee of the International Monetary Fund (IMF) in Jamaica in January 1976.

In December the dollar countervalues of the Federal Reserve's Swiss franc and Belgian franc swap commitments incurred prior to August 1971 were adjusted upward to take into account the dollar devaluations of December 1971 and February 1973. At the same time, Belgian franc commitments were lowered to reflect the franc's December 1971 revaluation. As a result, the dollar equivalent of outstanding indebtedness in these currencies was increased, respectively, by $196 million to $1,167.2 million and by $54 million to $315.8 million. Following these formal adjustments, the Federal Reserve began to acquire modest amounts of these currencies in the market or through correspondents to make progress toward liquidating that debt. Specifically, in addition to the $6 million of Belgian francs acquired in September, the System bought a further $68.4 million equivalent in the market and from a correspondent during December 1975-January 1976, of which $62.9 million equivalent was used to repay swap drawings in that currency. As a result, Belgian commitments were reduced to $252.9 million of francs by the end of January. In December-January the System acquired $16.3

Table II

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 1, 1975	Drawings (+) or repayments (—)					System swap commitments, January 31, 1976
		1975				1976	
		I	II	III	IV	January	
National Bank of Belgium	261.8	+ 16.7	+ 13.1 — 29.8		+ 54.0* — 18.1	—44.7	252.9
Bank of France	-0-		+ 45.6 — 5.1	— 40.5			-0-
German Federal Bank	218.7	+644.1 — 25.0	+ 63.4 —487.7	—413.5			-0-
Netherlands Bank	3.2	+ 49.0	+ 47.3 — 90.6	— 8.8			-0-
Swiss National Bank	378.5	+152.1	—159.4		+196.0†		567.2
Bank for International Settlements (Swiss francs)	600.0						600.0
Total	1,462.2	+861.9 — 25.0	+169.4 —772.7	—462.8	+250.0 — 18.1	—44.7	1,420.1

Note: Discrepancies in totals are due to rounding.

* Amount by which the dollar countervalue of the Federal Reserve's pre-August 1971 Belgian franc commitments, adjusted for the Belgian franc revaluation of 1971, was increased to reflect the two United States dollar devaluations of 1971 and 1973.

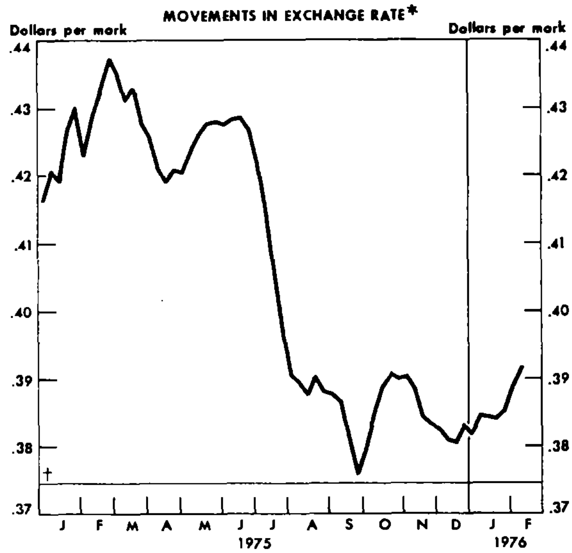
† Amount by which the dollar countervalue of the Federal Reserve's pre-August 1971 Swiss franc commitments was increased to take account of the two United States dollar devaluations of 1971 and 1973. This increase is reflected entirely in the System's position with the Swiss National Bank because of a transfer of Swiss franc commitments from the Bank for International Settlements to the Swiss National Bank sufficient to keep Federal Reserve commitments to the BIS within the $600 million swap facility.

million of Swiss francs in transactions with correspondents, which was held in balances against the outstanding debt in that currency.

In sum, during the August 1975-January 1976 period, the Federal Reserve purchased a total of $240.4 million equivalent of foreign currencies and sold $106.5 million equivalent. Operations in German marks accounted for $149.7 million equivalent of total purchases and all of the sales. The remaining purchases were $74.4 million of Belgian francs and $16.3 million of Swiss francs.

In other operations, the swap line with the Bank of Mexico was increased from $180 million to $360 million in August. The full amount was subsequently drawn by the Bank of Mexico in September and October to meet temporary needs and was fully liquidated prior to maturity in December. In addition, on January 20, the Bank of Italy drew $250 million under its swap arrangement with the Federal Reserve.

Chart II
GERMANY
MOVEMENTS IN EXCHANGE RATE*



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

+Central rate established on June 29, 1973.

GERMAN MARK

Unlike the United States, Germany remained in recession at midyear, with the economy not yet responding to the expansionary fiscal and monetary policies pursued since late 1974. Export demand was still weak as a result of the deeper than anticipated recession in Europe, and a sharp jump in the German savings rate, in response to the deteriorating economic climate at home, kept domestic demand in check. During the summer, therefore, the German authorities took further steps to stimulate the economy. In July-August the Federal government revealed plans for an expanded public works program to begin in the fall, coordinated with similar programs in France. In mid-August the Bundesbank announced its fifth cut in the discount and Lombard rates for the year to 4 percent and 5 percent, respectively. It followed up earlier moves to release reserves by reducing requirements on nonresident deposits to the level applicable to domestic liabilities. In addition, to ease the strains on German capital markets that resulted, at least in part, from the swollen borrowing requirements of the German government, the Bundesbank embarked upon large open market purchases of Federal bonds, thereby injecting further liquidity into the money market.

As a result, German short-term interest rates fell even further below those in the Euro-dollar market and banks placed large amounts of funds abroad. These outflows, reinforced by large-scale unwinding of nonresident investment in German portfolio securities and an unfavorable shift of leads and lags, more than offset a continuing but much reduced surplus on current account. Thus, market psychology shifted decidedly against the mark and, with some dealers moving to take up short positions, the German mark was pushed down by almost 10 percent from June to trade around $0.3900 early in August. As the mark declined, the Federal Reserve had acquired sufficient marks to repay by late July all remaining swap drawings on the Bundesbank incurred in market operations since October 1974 and, in early August, began building up a small balance.

Meanwhile, German capital markets remained strained and long-term interest rates showed no tendency to ease in response to the steady drop in short-term rates. Consequently, the German authorities moved further to provide assistance to these markets, while also offsetting some of the capital outflows, by announcing a relaxation of controls on foreign purchases of German securities. In this connection, prohibitions on interest payments for nonresident deposits were eliminated and the authorities extended through September their recent one-month ban against the flotation of new foreign bond issues in Germany.

Following these actions, the German mark steadied, trading with little day-to-day fluctuation until mid-September. At that point, the Bundesbank eased monetary policy further by reducing its discount and Lombard rates another ½ percentage point and increasing banks' rediscount quotas. At the same time, however, United States interest rates firmed again, and these divergent trends triggered a renewed rise of the dollar across the board. The mark came heavily on offer, extending its slide a further 4½ percent to a nineteen-month low of $0.3728 by September 23. The Bundesbank sold a large amount of dollars to moderate the decline. The Federal Reserve also purchased marks to add to its balances, acquiring since early August $59.3 million equivalent.

As reports of concerted European intervention to assure orderly markets circulated, market expectations of further sharp declines in the mark rate subsided. Dealers then started to cover the short positions that they had built up while the mark was weakening. Moreover, by this time the earlier capital outflows from Germany began to taper off. German banks reduced their placements abroad to meet growing demand for credit at home from both the private and public sectors. At the same time, public authorities, taking advantage of the leeway provided by the easing of controls on capital inflows, began to import funds from abroad. Thus, within days the mark rebounded almost to the levels of early September, and this rapid turnaround inserted a note of caution in the market.

Meanwhile, the dollar was coming on offer, as dealers focused increasingly on the widespread press coverage of New York City's fiscal difficulties and as United States money market rates turned down. At the same time, Germany was recording a pickup of consumer demand and a modest revival of foreign orders. These early signs of recovery, plus expectations that the Bundesbank would soon suspend its support for the bond market, led many market participants to anticipate an early firming of German interest rates.

Consequently, demand for marks was building up when a sizable shift of funds out of sterling into marks as well as French francs on October 1 sparked heavy bidding for marks. As trading grew progressively more nervous, the mark began to swing more widely and the Bundesbank and Federal Reserve both resumed intervention to maintain orderly trading conditions. Operating on four days between October 1 and October 15, the Federal Reserve sold a total of $50.1 million equivalent of marks from balances. Thereafter, although the rate remained volatile and the Bundesbank continued to intervene in Frankfurt, trading activity in New York was subdued and there was no further need for sales of marks by the Federal Reserve. During periods of dollar buoyancy in October, however, the System was able to purchase $36 million equivalent of marks for future contingencies. By late October the mark had leveled off at around $0.3900, up 4½ percent from its mid-September lows.

By November, market fears of a cumulative decline in dollar rates had quieted. The actual suspension of the Bundesbank's support program for the domestic bond market was taken in stride by the German capital markets,

Table III

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS AND THE BANK FOR INTERNATIONAL SETTLEMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding January 1, 1975	Drawings (+) or repayments (—)					Drawings on Federal Reserve System outstanding January 31, 1976
		1975				1976	
		I	II	III	IV	January	
Bank of Italy	-0-	-0-	-0-	-0-	-0-	+250.0	250.0
Bank of Mexico	-0-	-0-	-0-	+180.0	+180.0 —360.0	-0-	-0-
Bank for International Settlements (against German marks)	-0-	+45.0 —45.0	+1.0 —1.0	+125.0 —125.0	+ 19.0 — 19.0	-0-	-0-
Total	-0-	+45.0 —45.0	+1.0 —1.0	+305.0 —125.0	+199.0 —379.0	+250.0	250.0

with little impact on bond yields. Progress toward a compromise resolution of New York City's fiscal problems, culminating in President Ford's announcement of temporary Federal aid to the city on November 26, reassured the markets. Moreover, the finance ministers attending the Rambouillet summit meeting pledged to work for greater stability in economic and financial conditions and to act to counter disorderly market conditions or erratic fluctuations in exchange rates. Reports of this agreement were generally well received in the exchanges. As a result, speculative demand for marks subsided, and the mark moved down toward levels of early September. A leveling-off of United States interest rates, as well as news of an eighth consecutive large United States trade surplus in October and of a smaller than expected German surplus for that month, helped sustain the decline. Thus, by mid-December the mark had dropped back 3 percent from its late-October highs to $0.3792. As the mark eased, the Bundesbank sold most of the dollars it had taken in during October while the Federal Reserve took the opportunity to purchase $24.6 million equivalent of marks to add to balances.

During the rest of December, trading in marks was generally orderly and the Federal Reserve intervened on only two occasions. On December 19, European currencies were suddenly bid up against the dollar following erroneous reports from the Group of Ten Paris meeting that the Bank for International Settlements (BIS) would be willing to auction IMF gold to central banks. The Federal Reserve entered the market with modest offerings of marks, selling $6 million equivalent from balances. Late in the month, when some large commercial purchases of marks provoked sharp increases in the mark rate in otherwise thin holiday markets, the Bundesbank and the Federal Reserve again intervened, with the System selling $3.1 million equivalent from balances.

By the turn of the year, prospects for the German economy brightened considerably. Evidence of recovery continued to mount, with a reported gain in gross national product (GNP) and increases in export orders. In addition, Germany's trade balance had widened again. Thus, when the exchanges reopened for the first full day of trading on January 5, the mark was easily pulled up in the wake of a renewed sharp rise in the Swiss franc. Following up on coordinated central bank intervention in Europe, the Federal Reserve sold that day $23.1 million of marks from balances. Thereafter, in the aftermath of the Jamaica agreement on monetary reform, trading quieted. The spot mark gradually settled back against the dollar through mid-January, with the Federal Reserve selling only a further $3.8 million equivalent from balances to resist a sudden rise in the mark on January 14. Otherwise, the System added $29.8 million equivalent to balances through purchases from correspondents.

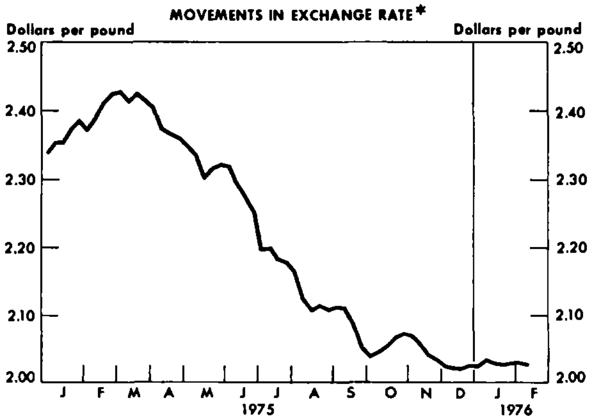
Late in January, however, divergent pressures among the European currencies, enveloping first the Italian lira, then the French franc and the Belgian franc, began to spill over into the market for German marks. At first, in the nervous trading following the suspension of official support for the lira, the mark slipped back to $0.3823. But, as some of the funds coming out of those European currencies that were weakening were shifted into marks, the mark rate moved up steadily against these currencies and then against the dollar as well. On two days when trading threatened to become disorderly, the Federal Reserve sold a total of $20.4 million equivalent of marks to steady the market, financing these sales from balances. By January 30, the mark reached a rate of $0.3868, some 3¾ percent above its September low.

STERLING

In the first quarter of 1975, sterling remained steady in terms of its "effective" trade-weighted change since December 1971 at a depreciation of 21.5 percent. As the dollar weakened against all main currencies at this time, sterling showed a modest gain in dollar terms. Nevertheless, markets had become increasingly discouraged over the prospects for sterling. As elsewhere, the British economy had slipped into serious recession. But, in contrast to other industrial countries, inflation in the United Kingdom was approaching runaway proportions, fueled by wage increases of as much as 30 percent per annum. Aside from the potential strains on the domestic social fabric, the inflation threatened to erode the clear progress Britain had made in narrowing its previously massive current-account payments deficit. That deficit nevertheless remained uncomfortably large, and traders had become doubtful that it could be fully financed since United Kingdom public sector borrowings abroad had slowed, and new OPEC (Organization of Petroleum Exporting Countries) investments in sterling assets began to taper off as OPEC surpluses declined. Consequently, sterling had become vulnerable to selling pressure, and in the three months to the end of June it had dropped some 10 percent against the dollar and to an "effective" depreciation since December 1971 of 28.9 percent.

By that time, however, the United Kingdom government had begun to negotiate with labor and management a voluntary arrangement to limit wage increases to £6 per week over the next year. This arrangement,

Chart III
UNITED KINGDOM
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.

backed up by a program of price restraint, was designed to bring the inflation rate down to 10 percent by the end of 1976, comparable to levels then prevailing in most of the leading European countries. In addition, short-term British interest rates were increased, thereby restoring the differential in favor of the pound which had been partially eroded by firmer United States interest rates. These measures took some of the immediate pressure off sterling. It therefore continued to trade around $2.15½, even as the dollar strengthened sharply against the main Continental currencies, thereby narrowing its trade-weighted depreciation to 26.2 percent at the end of July.

Until the voluntary restraint could be tested, the market nevertheless remained skeptical that this new approach would slow Britain's inflation significantly. Thus, when end-of-July demand for oil royalty payments passed, traders cautiously rebuilt some of their short sterling positions and, as the dollar continued to strengthen, the spot rate dropped off to a low of $2.0975 on August 11. Sterling then steadied, as an increasing number of British trade unions voted to accept the pay limits under the new anti-inflation plan. Moreover, early in September Chancellor Healey's denial at the IMF annual meetings of any government intention to seek a new depreciation of the pound helped to reassure the market.

Britain's trade deficit had begun to widen once again, however, as imports for development of the North Sea oil fields increased sharply. The announcement in mid-September that the government would propose plans to alleviate unemployment triggered exaggerated fears of a general reflationary package, and the pound began a sharp decline. Details of the government's proposals showed a more modest package of selective employment measures than had been expected. Nevertheless, sterling continued to fall off under heavy selling until early October, when it reached $2.0262 for an effective depreciation of 29.7 percent. The Bank of England intervened flexibly to smooth the decline.

By early October the problems of New York City were beginning to weigh on the dollar, and when United States interest rates suddenly declined the pound joined other European currencies in a generalized rise against the dollar. Moreover, on October 6 the Bank of England raised its minimum lending rate by 1 percentage point to 12 percent in a move widely interpreted in the market as reflecting the authorities' intention to maintain favorable short-term interest differentials in order to discourage outflows of funds. Consequently, a steady demand for pounds developed, including a trimming of some of the numerous short positions which had been built up previously. The pound thus recovered gradually to $2.0820 by early November, with the Bank of England taking the opportunity to recoup some of its previous reserve losses. Then, to supplement its resources further, the British government announced on November 7 that it would apply for a total of $2 billion in drawings on the IMF, including $1.2 billion from the IMF oil facility.

This recovery was short-lived, however, as the easing of exchange market concerns over New York City's finances soon buoyed the dollar at a time when the market was reacting to a spate of pessimistic forecasts for the United Kingdom in 1976. Sterling dropped off in dollar terms through most of November, reaching a new low of $2.0132 on November 28, before leveling off once again in early December, but eased only gently in effective terms to a 30.1 percent depreciation.

Beginning in December, some of the extreme exchange market pessimism toward sterling started to lift. The voluntary wage restraint program was effectively dampening wage increases, with clear evidence that inflation was receding. There were also early indications that the British recession was reaching bottom. Recovery was expected to be slow in coming, but the government, having announced a shift in priorities toward stimulating certain key industries and away from broad social welfare programs, had reassured the market that it would strive to maintain Britain's competitiveness over the near term. This firmer undertone for sterling continued through the year-end and into early 1976, with the pound buoyed by further covering of previous short positions, a pickup of commercial demand, and the large interest rate differential in favor of the United Kingdom. With inflation slowing, the British authorities allowed domestic interest rates to follow the easing of interest rates in the United States and elsewhere. The improved market atmosphere helped shield sterling from being drawn into the heavy speculation which erupted in markets for continental European currencies in late January. Having traded in the \$2.02-\$2.04 range since early December, sterling held at around \$2.0275 at the end of January, for a net decline of nearly 6 percent against the dollar and 4 percent on a trade-weighted basis since last July. In January, the Bank of England cash reserves were bolstered by the \$1.2 million drawing on the IMF oil facility.

SWISS FRANC

During early 1975, the Swiss economy was also dragged into recession by the sharp downturns in its major markets abroad. At the same time, recurrent financial, speculative, and hedging demand pushed up the Swiss franc in the exchanges, thereby threatening to weaken further the competitive position of Switzerland's already strained export industries. To counter recessionary tendencies in the domestic economy without reversing progress already achieved in lowering inflation, the Swiss authorities took selective fiscal measures. In addition, the Swiss National Bank cut its discount rate 1 percentage point in two steps to 4½ percent by May 19 and reduced reserve requirements. The authorities also took a variety of actions to contain a further strengthening of the Swiss franc and discussed with members of the EC currency arrangement the possibility of establishing a link with the snake as a means of stabilizing the franc against the other European currencies. By midsummer, prospects of an early association with the EC snake dimmed, however, and the Swiss franc was again gaining ground against the EC currencies even as it eased back against the dollar to \$0.3720 by early August.

By this time, the market was focusing increasingly on the relationship between the Swiss franc and the German mark, the currency of Switzerland's major trading partner. The recession in Germany was already deeper and more prolonged than expected, while the economic slowdown in Switzerland was viewed as correspondingly less severe. As the market expected a further easing of liquidity in Germany throughout the late summer and fall, therefore, the Swiss franc continued to rise against the mark. To moderate the franc's advance, the Swiss National Bank made frequent purchases of dollars on the exchanges. Since these purchases were offset by continuing dollar sales to foreign borrowers under the capital export conversion program, they resulted in little net change in reserves. Against the dollar, the franc drifted somewhat lower as the dollar gained generally in the exchanges, slipping 2 percent to \$0.3643 by September 23.

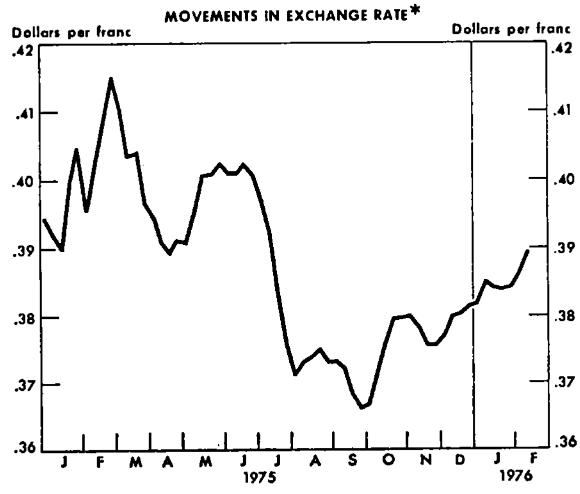
Subsequently, however, as uncertainties surrounding the New York City financial crisis and the trend of United States interest rates weighed generally on the dollar, the franc led the rebound of European currencies against the dollar. Under these circumstances, the National Bank stepped up its intervention. Also, to reduce Swiss interest rates further, it lowered the official discount and Lombard rates three times, to five-year lows of 3 percent and 4 percent, respectively, by October 29. Moreover, to dampen speculative activity, the central bank further tightened existing limitations on forward Swiss franc transactions with foreigners. Nevertheless, the franc continued to advance to a peak of \$0.3817 by late October, while gaining another 2 percent against the German mark from August levels. By early November, the National Bank's intervention had helped to reassure the market and, once a resolution to New York's financial crisis appeared to be in sight, the franc joined in the general retreat of European currencies. The franc eased back more gradually than other currencies, however, slipping 2 percent to \$0.3733 and rising another ½ percent against the German currency.

By December, market sentiment toward the franc

Chart IV

SWITZERLAND

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.

Table IV

UNITED STATES TREASURY SECURITIES
FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding January 1, 1975	Issues (+) or redemptions (—)					Amount outstanding January 31, 1976
		1975				1976	
		I	II	III	IV	January	
Swiss National Bank	1,599.3						1,599.3
Total	1,599.3	-0-	-0-	-0-	-0-	-0-	1,599.3

became even more bullish than before. By then, Swiss consumer price inflation was down to a rate of 3.4 percent per annum, well below rates elsewhere. The Swiss trade account had swung into a surplus. Moreover, an early link with the EC snake was formally ruled out and, with the franc already having moved through parity with the Dutch guilder, the market soon came to expect it would close in on the German mark as well. A number of market participants with recent and long-standing debts in Swiss francs therefore began to cover their exposure. In addition, commercial banks and private corporations moved actively to unwind short franc positions against marks. Then, with the onset of demand for Swiss francs for year-end window dressing, bidding soon escalated. As a result, the franc rose strongly against both the European currencies and the dollar.

To counter the upward pressure on the franc, the Swiss National Bank provided substantial temporary liquidity to the Swiss banks through a total of $1.8 billion of dollar swaps over the year-end. It also intervened heavily in the spot market, purchasing dollars to moderate the rise in the spot rate. Although trading conditions were kept generally orderly, the franc rate continued to firm and reached $0.3823, its highest level in five months. In addition, it strengthened to above parity with the German mark, while increasingly pulling up other currencies along with it against the dollar.

When the Swiss foreign exchange market reopened on January 5 after the New Year holiday, however, a bunching of orders to buy Swiss francs triggered a further sharp rise in the Swiss franc rate. Professional traders, concerned about the liquidity-tightening effects of the substantial repayment of year-end swaps, were reluctant to provide much resistance to this increase. Thus, the advance picked up momentum, as more corporations rushed to hedge their long-term Swiss franc borrowings and as funds flowed into Switzerland from Italy where the lira had come under heavy selling pressure. On that day alone, the Swiss franc rate jumped 1⅛ percent to $0.3863. Then, and over subsequent days, the Swiss National Bank provided forceful resistance to a further rise by large-scale dollar purchases, both in Zurich and through the Federal Reserve in the New York market. In the first week of trading in January, the Swiss central bank took in over $400 million and, as the market became aware of the magnitude of its intervention, trading conditions gradually settled down.

Thereafter, the franc eased back, and the market was further reassured by the announcement of another cut in the official discount rate to 2½ percent on January 12. Moreover, the monetary authorities issued new regulations to monitor more closely the Swiss banks' open foreign currency positions. Therefore, late in the month, the franc lagged behind the rise of the mark as pressure within the EC snake built up. Nevertheless, by the end of January, the Swiss franc at $0.3844 was 3½ percent higher than six months before.

In December, the Federal Reserve, the Swiss National Bank, and the BIS agreed to adjust the System's pre-August 15, 1971 remaining swap commitments to take account of the December 1971 and February 1973 dollar devaluations. As a result, the total dollar countervalue of the commitments was increased by $196 million. Since the swap line with the BIS was already fully drawn, a portion of Swiss franc commitments with the BIS was transferred to the Swiss National Bank, so that the entire increase was reflected in the System's outstanding commitments to that bank. Total System indebtedness to the Swiss National Bank was, therefore, raised to $567.2 million. In December-January, the Federal Reserve bought $13.2 million equivalent of Swiss francs from the Swiss National Bank against sales of various foreign currencies that the System had acquired either in the market or from correspondents and an additional $3.1 million equivalent from other correspondents. The total $16.3 million equivalent of Swiss francs was held in balances against outstanding swap debt in that currency.

FRENCH FRANC

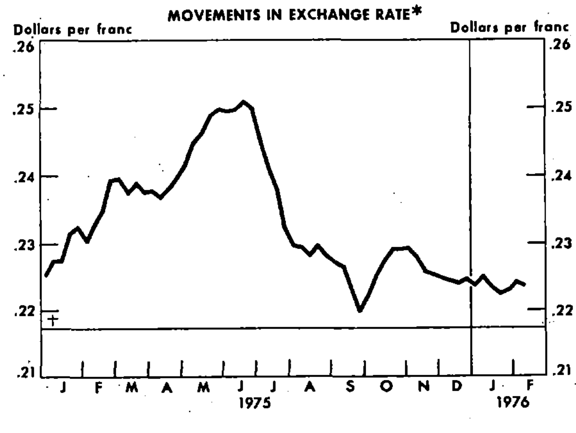
During the first half of 1975 a massive turnaround in France's external position had progressively bolstered market sentiment toward the French franc. Trade prospects had been brightened by announcement of substantial export contracts from OPEC, while heavy liquidation of inventories, reduced energy requirements, and a severe recession at home had cut into imports. Thus, the trade balance swung from a $3.9 billion deficit in 1974 to a $1.6 billion surplus by midyear, sufficient to eliminate France's oil-inflated deficit on current account. Meanwhile, monetary policy was kept relatively restrictive in order to combat France's still high rate of inflation. Interest rates, therefore, moved further above those in most other countries, stimulating sizable inflows of funds from abroad, and French companies were encouraged to borrow some $1.3 billion abroad.

As a result, the franc gained strongly in the exchanges not only against the dollar but also against other European currencies. By midyear, the spot rate had appreciated almost 20 percent from its low of August 1974 to be again in reach of its central rate against the German mark and other EC currencies. Meanwhile, the Bank of France had intervened to moderate the franc's rise, and its dollar purchases were partially reflected in the $2 billion increase in foreign exchange reserves over the same period. On July 10 the franc rejoined the EC snake at its existing central rate and, thereafter, the Bank of France resumed purchasing moderate amounts of dollars. From $0.2288 on August 1, the franc moved up with the other European currencies before easing back in late August, even as the Bank of France intervened to dampen upward pressure on the franc and keep it in the middle of the EC snake.

In the meantime, the domestic economy continued to weaken and unemployment was still rising rapidly. In early September, President Giscard d'Estaing announced a major fiscal package, which would provide substantial stimulus through an investment tax credit and through large-scale expenditures on social infrastructure investments and transfer payments. At the same time, the Bank of France's discount rate was reduced by 1½ percentage points to 8 percent. In addition, reserve requirements on demand deposits were lowered from 11 percent to 2 percent to inject additional liquidity into the banking system, and credit regulations were eased to stimulate construction and consumer spending. This expansionary package first gave pause to the market but, after a temporary decline in the franc rate, strong commercial demand reappeared and the franc eased back less than other EC currencies when the dollar advanced across the board after mid-September.

Thus, by late September, the French franc had emerged near the top of the EC band, a position it was to hold through the year-end. It continued to benefit from relatively high interest rates, conversions of foreign borrowings, and inflows of funds following renewed tensions in the Middle East. In addition, by comparison with other countries in the EC, France appeared more likely to enjoy a modest economic recovery than those more dependent on a revival of demand in export markets. Consequently, the franc joined in the rebound of European currencies in late September and October, as the dollar generally weakened in response to concern over New York City and to an easing of United States interest rates. Bidding for

Chart V
FRANCE
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.
†Central rate established on February 12, 1973.

francs was frequently heavy and, despite large dollar purchases by the Bank of France to avoid pressures within the snake, the spot rate strengthened to a high of $0.2306 by the end of October. Thereafter, as the dollar regained buoyancy generally, the spot franc settled back some 3 percent against the dollar during November and December. Although the Bank of France's dollar intervention tapered off, it began to purchase small amounts of German marks to keep the franc off the top of the snake. The central bank intervention was partly reflected in French official exchange reserves, which had swelled by over $2 billion in the six months through the end of December.

Shortly after the new year, however, market sentiment toward the franc suddenly turned bearish. With the French economy picking up some momentum, the trade balance was moving into deficit, prompting dealers to reassess the outlook for the franc. As French credit conditions improved, French companies repaid some of their previous foreign borrowings. At the same time, the government reaffirmed that new foreign borrowings would be strictly limited and, with fewer approved issues still in the pipeline, demand from conversions tapered off. Against this background the franc came heavily on offer in mid-January, after a leading French commercial bank predicted a large 1976 trade deficit and called for a slight downward exchange rate adjustment. Substantial commercial selling of francs, including bidding for dollars by French oil companies to meet midmonth payments, sustained the decline. By January 20, the franc rate had slipped to $0.2230 and had also weakened against other EC currencies despite moderate resistance by the Bank of France.

Thus, the franc was already vulnerable in the exchanges, when news of the suspension of official intervention in Italy on January 21 quickly unsettled the market. In response, dealers scrambled to unload long French franc positions and leads and lags shifted against the franc, pushing the spot rate down ½ percent against the dollar and ¼ percent against the German mark. The Bank of France sold large amounts of dollars and smaller amounts of German marks to keep the franc from falling to the bottom of the EC snake. Selling pressure nevertheless remained intense, as rumors began to circulate of a possible downward adjustment of the franc. These rumors were forcefully denied by French Finance Minister Fourcade and Foreign Trade Minister Barré. On the last days of January, the balance of speculative forces in the market began to tip in favor of the mark. Thus, the French franc, while still generally on offer, bottomed out at $0.2219 and traded around $0.2236 at the month end, some 2¼ percent below early-August levels.

ITALIAN LIRA

Through early summer 1975, following a period of severe monetary restraint, Italy had cut back domestic inflation significantly. It had also achieved a drastic turnaround in its current-account payments position, from a $7.5 billion 1974 deficit to near balance in the first half of last year. Italy's previous payments difficulties had led to about a 25 percent weighted-average depreciation of the lira since early 1973 and to a large accumulation of foreign debt by private and state-owned enterprises. The Italian authorities still sought greater wage and price stability, which could strengthen the current account further and bring the overall payments account into equilibrium. Nevertheless, the progress thus far in 1975 had been at the cost of a severe drop in output and rise in unemployment. At the same time, although many Italian exports were clearly competitive in world markets and Italy's recession was deeper than elsewhere, the protracted weakness in foreign demand had frustrated prospects for the kind of export-led recovery which was considered essential for the lira's longer term stability in the exchange markets. Through most of early 1975, the lira had moved more narrowly than other EC currencies against the dollar, rising by 4 percent through the end of May and falling by 6 percent in June and July to $0.001505. While the lira eased against the dollar in the early summer, its improvement against other EC currencies had enabled Italian public authorities and Italian banks to repay substantial foreign debts.

Late in July, to deal with the deepening recession, the Italian government announced a $5¼ billion equivalent reflationary package. The lira came under some selling pressure in early August, dipping below $0.001500, and the Bank of Italy intervened to moderate the decline. The immediate nervousness soon passed, however, and the cumulation of seasonal demands, largely receipts from tourism, buoyed the lira through early September. The Bank of Italy was thus able to recoup part of its earlier sales, while also taking into reserves the proceeds of Italy's $930 million drawing on the IMF on September 4.

In September, while following the general decline against the dollar through late month, the lira began to ease against other European currencies as well. In a further step to stimulate the economy, the Bank of Italy cut its discount rate on September 15 for the second time in 1975, from 7 percent to 6 percent, and adjusted its other lending rates by a similar margin. With interest rates generally steady elsewhere, Italian importers repaid commercial credits granted in 1974 and Italian banks moved to liquidate more of their foreign currency liabilities. Consequently, outflows of short-term funds began to weigh on the spot rate, and the lira followed only part way in the general rise of European currencies against the dollar in late September and early October, even as the Bank of Italy resumed support of the spot rate through dollar sales.

By late fall, Italian industrial activity was showing only tentative signs of recovery as sectoral bottlenecks blunted the impact of the fiscal and monetary stimulus that had been provided. Meanwhile, the financing of an increased budget deficit—estimated at nearly 10 percent of GNP—and the continuing release of funds held under the import deposit scheme contributed to a rapid expansion of the monetary base. Against this background, imports began to pick up sharply as some firms restocked depleted inventories. Thus, the trade balance deteriorated sufficiently to erode the surplus that had emerged by midyear. With renewed capital outflows developing, selling pressure on the lira began to build up in the exchanges, and the Bank of Italy had to provide heavy support to keep the lira in line with other European currencies. By the year-end, these losses had reduced official exchange reserves to $1.3 billion.

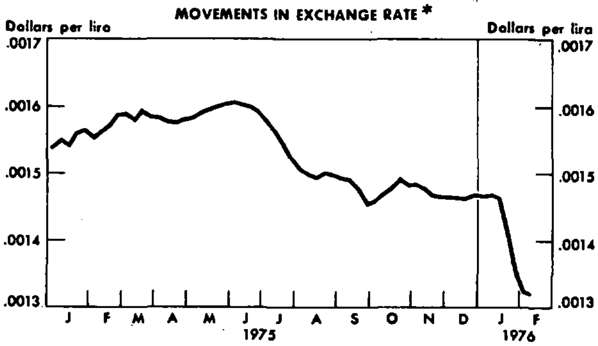
Shortly after the new year, a cabinet crisis precipitated by the withdrawal of Socialist Party support for the minority coalition culminated in the resignation of the government. As efforts went forward to strike a new political compromise on which a viable cabinet could be formed, selling pressure on the lira grew heavy. At first, the outflows were readily met with forceful intervention by the Bank of Italy, and the market was in better balance by January 9. Nevertheless, the substantial reserve losses by the Italian authorities had become a matter of discussion in the press and of concern in the market. Moreover, uncertainties over the lira's prospects were compounded when loans to Italian institutions were mentioned in the spate of allegations appearing in the United States press over the condition of United States banks, and renewed heavy selling pressure soon erupted. By January 20, the Bank of Italy had sold more than $500 million since the beginning of the year and, to add to its cash balances, on that day drew $250 million under the swap line with the Federal Reserve.

But by this time, in the absence of the formation of a new government, the Italian authorities were facing some hard choices. These were well described by Professor Paolo Baffi, Governor of the Bank of Italy, in an address to the Institute for Advanced Military Studies in Rome on January 15, 1976:

> I would say that the task of defending the lira at present may be likened to that of defending a fortress with insufficient supplies of food and ammunition and with the cordon of the besieging army closing further and further in every day. In this analogy the territorial inroads represent the progessive loss of purchasing power of the lira; the gradual exhaustion of supplies of food and ammunition corresponds to the erosion of the foreign exchange reserves and of Italy's credit standing abroad. In the conduct of economic policy, however, we find no counterpart for two fundamental imperatives in a state of seige, viz., food rationing and unity of command.
>
> The counterpart of rationing might be found in a genuine incomes policy for which there have been vain demands for more than a decade. The counterpart of unity of command would be a broad coordination of economic policy on the basis of a consistent set of objectives, one of which must be monetary stability.

On January 21 the Italian authorities announced that, to conserve reserves, the Bank of Italy would suspend official dealings in the exchange markets. This decision left the lira effectively floating freely in the exchanges and, as selling continued over the next few days, the spot rate plummeted by some 6¼ percent in occasionally disorderly trading. The lira continued to fluctuate widely over the rest of the month, closing on January 30 at $0.001321, some 10 percent below levels prevailing before the cabinet resignation. The proceeds of the $250

Chart VI
ITALY
MOVEMENTS IN EXCHANGE RATE *



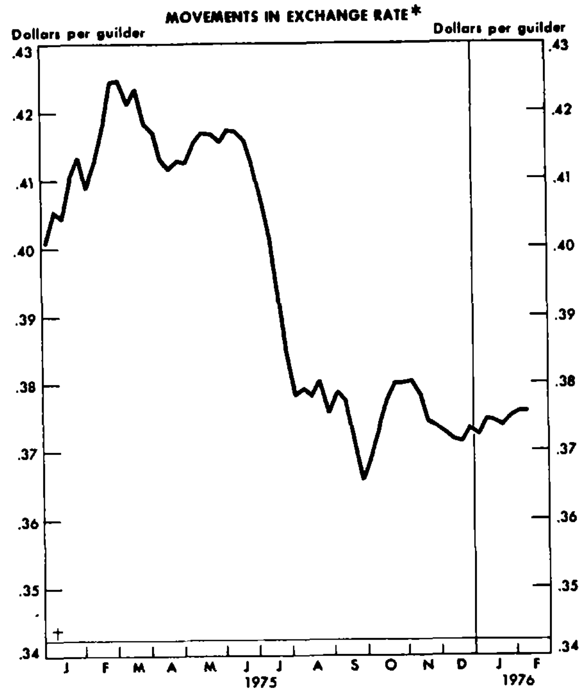
*See footnote on Chart II.

million swap drawing on the Federal Reserve remained unused but available for intervention by the Bank of Italy to maintain an orderly exchange market following resumption of official dealings, ultimately set for March 1. Treasury Minister Emilio Colombo reported to Parliament late in January that official intervention policy would be aimed at "assuring a normal development of international transactions, eliminating accidental oscillations in the lira rate due to purely speculative transactions, and orienting the lira toward a level indicated by medium-term underlying balance-of-payments trends".

NETHERLANDS GUILDER

To stimulate a still sluggish domestic economy, fiscal and monetary policy in the Netherlands continued to be relaxed throughout early 1975. As a result, monetary growth had accelerated and, although the Netherlands Bank temporarily absorbed some of the excess liquidity from time to time, Dutch short-term interest rates declined steadily to levels well below those in the United States, Germany, and Belgium. Thus, Dutch commercial banks had placed increasing amounts of funds abroad, both in the Euro-dollar market and in Continental financial centers. Moreover, long-term capital outflows, including several new Euro-guilder bond issues, remained substantial. Together, these flows more than offset the large Netherlands current-account surplus.

Chart VII
NETHERLANDS
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.
†Central rate established on September 17, 1973.

The guilder, therefore, had declined more steeply against the dollar than other EC currencies during early summer, contributing to a narrowing of the EC snake. In August, Dutch interest rates eased further, and the Netherlands Bank cut its discount rate by ½ percentage point to 5½ percent. Partly in response, the guilder drifted back to about $0.3775. Then, after holding fairly steady through mid-September, it dropped back another 4 percent to a nineteen-month low of $0.3629 as the dollar advanced across the board. But, toward the end of September, the guilder rebounded with other European currencies, as New York's fiscal crisis and declining United States interest rates weakened the dollar generally.

Meanwhile, the Netherlands current account had been further bolstered by growing foreign sales of Dutch natural gas. In addition, Dutch short-term interest rates bottomed out in response to seasonal factors. Although the Netherlands Bank took in dollars on a swap basis, providing guilders to prevent a tightening of liquidity from exerting strong upward pressure on the exchange rate, the guilder remained buoyant both against the dollar and the other EC currencies throughout the late fall. On those occasions when new developments in New York City's ongoing fiscal crisis unsettled the markets, the guilder was bid up strongly with other currencies and the Netherlands Bank bought small amounts of dollars to maintain orderly markets. Even so, by early November, the guilder had advanced 5¼ percent from its September lows to $0.3818.

Once elements of a compromise to New York's financial problems began to emerge late in November, the guilder eased back to trade through the year-end around $0.3728. Against other European currencies, however, it remained firm. Dutch current-account surpluses continued to cumulate, and prospects improved for further gains in manufactured exports as signs of a recovery of demand abroad, especially in Germany, started to appear. In addition, it was announced that the previous ban on interest payments to nonresidents would be lifted, effective January 1, 1976. By late December, the guilder was pushing against its upper limit within the Benelux currency arrangement, although at first only modest intervention by the Dutch and Belgian central banks was needed to maintain the 1½ percent margin between the two currencies.

By late January, however, demand for guilders was exerting greater upward pressure, not only against its partner in the Benelux band but against all EC currencies. Substantial payments for gas and refined oil exports, interest charges on outstanding Euro-guilder loans, and other month-end commercial demands combined to swell bidding for the Dutch currency. Then, on January 28, a press report that the Benelux band might be abandoned triggered large-scale speculative demand for guilders against sales of Belgian francs. Although this report was officially denied both in Amsterdam and in Brussels, the pressures intensified on the last two days of the month, as rumors of a realignment of parities among EC snake currencies—including a possible revaluation of the guilder—circulated in the market. To maintain the Benelux limits, the Netherlands Bank, intervening in coordination with the National Bank of Belgium, bought substantial amounts of Belgian francs as well as dollars. In a further effort to relax pressure on the guilder, the Netherlands Bank also announced on January 30 a ½ percent cut in its bank rate to 4 percent and a 1 percent cut in its other interest rates. Nevertheless, by the end of January the guilder had firmed to $0.3752, for a net rise of 3¼ percent since its mid-September low.

BELGIAN FRANC

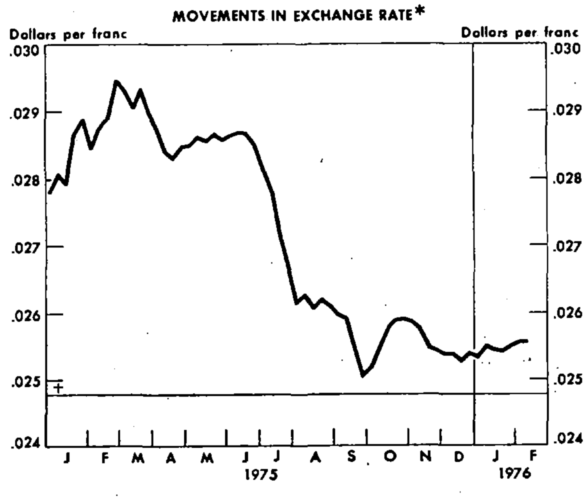
By midsummer 1975 the deepening recession in neighboring countries had exerted a serious drag on the Belgian economy, pulling industrial production down by over 10 percent and pushing the unemployment rate up to 6½ percent. But the rate of inflation remained persistently high and above the rates of some of Belgium's major trading partners. Faced with this dilemma, starting in May 1975, the government had imposed a selective price freeze to break inflationary expectations while gradually easing monetary conditions to stimulate the economy. By August 21, the National Bank of Belgium had cut its discount rate in two steps to 6 percent, generally in line with the easing of interest rates elsewhere on the Continent, and had released commercial bank reserves. Thus, the Belgian franc joined in the general downtrend of currencies against the dollar, easing to $0.026040 by early August while remaining in the upper half of the EC band.

During September the market became concerned that Belgium's inflation, fueled by a continued rise in price-indexed wages, was not slowing as rapidly as hoped in response to the price freeze. With the trade balance worsening in the face of depressed demand abroad and the implementation of a rather low interest rate policy, the commercial franc became vulnerable to selling pressures.

Against this background, as the dollar advanced strongly in the exchanges just after mid-September, the franc fell away more rapidly than other European currencies. By September 23, the commercial franc had dropped 5 percent to $0.024730 and, to cushion the decline, the National Bank of Belgium sold moderate amounts of dollars. For its part, the Federal Reserve took this opportunity to resume purchases of Belgian francs against outstanding swap debt incurred before August 1971, acquiring $6 million equivalent over September 23-24. Pressures on the Belgian franc then subsided, and the commercial rate rebounded with other European currencies in late September and October. On a few occasions during this time, the National Bank made small purchases of dollars to maintain orderly market conditions in Brussels.

During November and early December the Belgian franc again drifted down against the dollar along with other EC currencies. Concern over Belgium's price performance continued especially after proposed government anti-inflationary measures ran into opposition from the labor unions and within Parliament. Consequently, the franc eased to near the bottom of both the EC snake and the separate Benelux band. The authorities were able, however, to stabilize the franc's position within those

Chart VIII
BELGIUM
MOVEMENTS IN EXCHANGE RATE*



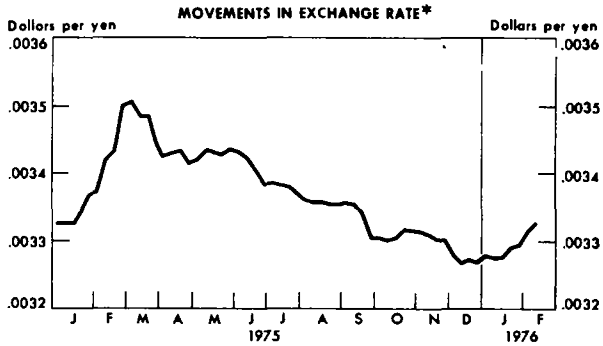
*See footnote on Chart II.
+Central rate established on February 12, 1973.

limits with only occasional modest dollar sales.

Meanwhile, on December 2, the Federal Reserve and the National Bank of Belgium implemented an earlier agreement to adjust commitments under outstanding Federal Reserve swap drawings, initiated prior to August 15, 1971. As a result of these adjustments, the System's debt in Belgian francs was decreased to take into account the 1971 Belgian franc revaluation and the corresponding assets of the National Bank of Belgium were increased by $54 million to $315.8 million to take into account the dollar devaluations of 1971 and 1973. Subsequently, the Federal Reserve resumed a program of regular market purchases of small amounts of Belgian francs and used these acquisitions to repay $18.1 million equivalent of outstanding debt before the year-end.

In December and early January, trading in commercial Belgian francs was fairly balanced but, with the Dutch guilder on a rising trend, the Benelux band was extended to its 1½ percent limit. Intervention was modest, though, until generalized speculation over European currency relationships emerged in late January. In particular, on Wednesday, January 28, the pressures on the Benelux band sharply intensified in response to newspaper reports that the Benelux currency arrangement might be disbanded. The reports were strongly denied by both governments, but the National Bank of Belgium and the Netherlands Bank were obliged to absorb large amounts of francs through sales of guilders to maintain the limits of the band. The National Bank supplemented this intervention with sales of dollars as well. Moreover, since much of the speculation was in the form of adverse shifts in leads and lags, the National Bank responded by raising interest rates on a variety of trade-related paper. The pressure against the franc then subsided, at least temporarily, with the Belgian franc trading on January 30 at $0.025470, 2¼ percent below the levels of six months before. Meanwhile, the Federal Reserve continued to make modest purchases of Belgian francs and repaid a further $44.7 million of swap debt. The remaining 1971 commitments in Belgian francs were thereby reduced to $252.9 million by the end of January.

Chart IX
JAPAN
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.

JAPANESE YEN

Japan had begun to pull out of recession ahead of most other industrial countries, but by midsummer the recovery was losing its initial momentum. Thus, the market expected the authorities would follow up their increasingly stimulative policies of the spring with additional reflationary measures and a further gradual easing of monetary policy. Meanwhile, the deep and long-lasting recession abroad had seriously clouded prospects for Japanese exports. Although Japan's trade account surplus had widened substantially earlier in the year, by the summer the market was increasingly concerned that export demand would prove insufficient to cover any growth in imports pulled in by the incipient recovery.

As a result, the yen had lost buoyancy in the exchanges and, as demand for dollars built up in Tokyo, the spot rate had slipped back 4¼ percent from early-March levels to ¥298 ($0.003356) by early August. As expected, the Bank of Japan on August 12 cut its discount rate by ½ percentage point to 7½ percent and indicated it would regulate various limits on bank credit expansion more flexibly. In addition, on September 17 the government announced another package of measures to aid the recovery, including increased public works expenditures and financial aid to medium- and small-size firms, while further relaxation of monetary policy was suggested as well. Meanwhile, many exchange dealers were worried over the possible deterioration of Japan's current balance, and news of the collapse of a major Japanese industrial corporation had caused concern over the financial position of Japanese companies. Thus, the yen remained on offer in sporadically heavy trading throughout August and September. The Bank of Japan intervened forcefully first at ¥298 and then, as the dollar gained strongly elsewhere in the exchanges, it moved the intervention level in two steps to ¥303 ($0.003300). The heavy intervention was reflected in a two-month decline of $1.4 billion in Japanese official foreign exchange reserves.

By late September a bunching of export bill conversions and the decline of dollar rates against the major European currencies helped to relieve the pressure on the yen. Thus, previously adverse leads and lags were reversed, providing support for the spot rate even as the current-account deficit widened. Moreover, net capital outflows through nonresident sales of Japanese securities slowed, as United States interest rates began to decline and OPEC interests made occasionally sizable investments in yen. In this improved atmosphere, there was little market reaction to announcement of a long-anticipated discount rate cut to 6½ percent on October 23. In fact, the yen traded below the ¥303 level from mid-October to mid-November.

Selling pressure on the yen soon reemerged, however, in reaction to a variety of events. Following the November 15-17 Rambouillet summit meeting, the Japanese press carried reports suggesting that the yen might be allowed to weaken further before the January 1976 Jamaica conference of the IMF. A public workers' strike also had an adverse effect, as did news of an increased Japanese current-account deficit in October and scaled-down estimates of the strength of the Japanese recovery. The Bank of Japan, while lowering its intervention level, again offered firm resistance to the yen's decline, and by mid-December the spot rate bottomed out at ¥306¾ ($0.003260), some 2¾ percent below early-August levels. Thereafter, bearish sentiment began to lift on a combination of positive factors, including an expected increase in January of the swap quotas for foreign banks in Japan and heavier than anticipated export bill conversions. Consequently, the exchange market came into better balance in quieter trading through the year-end.

By early 1976 the pendulum had swung back in favor of the yen. The outlook for the trade balance brightened, as economic recoveries elsewhere bolstered export prospects while the slowing of Japan's recovery dampened import growth. Moreover, in response to a renewed decline in United States money market rates, foreign purchases of Japanese securities picked up. Thus, traders began to cut back long dollar positions. By the month end, the yen was bid back up to ¥303⅝ ($0.003293), some 1 percent above December's low. Meanwhile, the Bank of Japan purchased dollars to moderate the yen's advance, contributing to a reserve gain of $338 million in January.

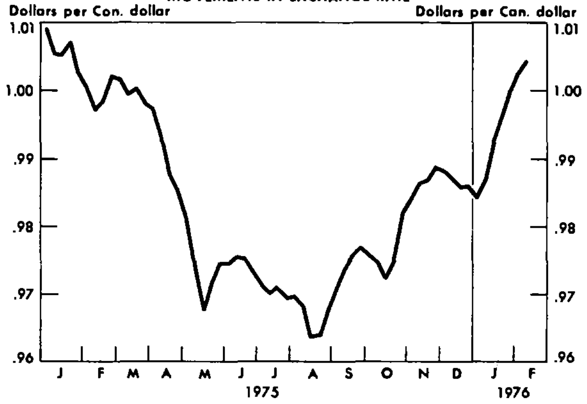
CANADIAN DOLLAR

In the spring and early summer of 1975, the markets had taken a bearish view of the outlook for Canada's payments position. Canada's current account had already swung into deep deficit. And, with Canada's eco-

Chart X

CANADA

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart II.

nomic downturn both milder and shorter than those abroad, imports were rising more rapidly than exports. Moreover, Canada's rate of inflation remained high, particularly compared with that of the United States. New labor settlements suggested that wage rates would continue to rise sharply, threatening further erosion of Canada's competitive position. To contain inflationary pressures, monetary policy had been tightened somewhat in the spring, and modest favorable interest rate differentials had emerged by May. But uncertainties over the economic outlook blunted any significant inflows of short-term funds, thereby leaving a potentially large payments gap to be filled by long-term Canadian borrowings abroad.

Consequently, the market for Canadian dollars was left vulnerable to shifting expectations over the extent to which Canadian borrowers could tap these markets. During the first half of the year, a heavy schedule of foreign public and private issues in other markets, particularly in the United States, had at times seemed to preclude additional large Canadian offerings. Thus, the Canadian dollar had been under recurrent selling pressure, declining by some 4 percent from $1.0100 in January to $0.9696 by the end of July. The pressure reappeared in early August, and the rate slipped to $0.9616, its lowest level in five years, by August 18.

Over the following weeks, the atmosphere began to improve in response to signs of an improved outlook for Canadian placements abroad as well as to reports of Soviet demand to finance large new grain purchases in Canada.

By September, new foreign borrowings by municipal and provincial agencies had been placed and a large number of Canadian corporate issues in the Euro-bond market were announced, as firms began to take advantage of the planned removal of withholding taxes on foreigners' holdings of long-term Canadian corporate securities. As proceeds of these various new issues were converted into Canadian dollars, the spot rate began to move up in the exchanges, reaching $0.9788 by September 23. Meanwhile, on September 3, the Bank of Canada had raised its discount rate by ¾ percentage point to 9 percent.

Late in September, the market for Canadian dollars took on a more hesitant tone especially when, in the backwash of the New York City fiscal crisis, a large issue by a Canadian municipal borrower received a mixed reception in the New York market. Then, since figures had just been released showing a widening of the trade deficit and a more rapid rise in wages and prices, the market was receptive to rumors that began to circulate in the exchanges on October 10 that the floating Canadian dollar would be devalued as part of an upcoming government package of new economic measures. An ensuing bout of selling pushed the rate back down to $0.9699, with the Bank of Canada intervening to steady the market.

On October 14 the government announced a major new initiative to curb accelerating domestic inflation. A three-year wage and price program was introduced, limiting annual wage increases covered by the plan to 10 percent in the first year. In addition, price increases were restricted to reflect cost increases only. Profit margins were frozen, and corporate dividends were fixed at current levels. Later on, Bank of Canada Governor Bouey stressed the bank's commitment to moderating the growth of monetary aggregates through higher interest rates if necessary. Meanwhile, major new foreign issues were undertaken by Canadian public and private borrowers both in the United States and in the Euro-currency markets, and prospects of large-scale conversions prompted further demand for the Canadian dollar. As a result, the Canadian dollar rallied in late October and continued to advance through most of November, reaching $0.9912 by November 28 or a rise of 2 percent in six weeks' time. In December, the rate eased back largely on seasonal factors, as short-term outflows to the United States increased ahead of the December 15 corporate tax date and as conversions of foreign borrowings tapered off temporarily.

In January 1976, the Canadian dollar came into renewed heavy demand. Canadian provincial authorities announced several substantial new foreign borrowings which, taken together, would more than offset the expected current-account deficit in the early months of the year. Moreover, United States interest rates were drifting downward while Canadian rates held firm, opening record interest rate differentials of as much as 4 percentage points in favor of Canada. By late January, the Canadian dollar had been bid above the $1.00 level, for a net rise of 3 percent over the six-month period. Largely reflecting the Bank of Canada's day-to-day intervention to moderate exchange rate movements, Canadian reserves rose by a net of $375 million from July 1975 through January 1976.

EURO-CURRENCY MARKETS

The Euro-currency markets grew increasingly active during the last half of 1975, after a marked slowdown of activity earlier in the year. The great bulk of new bank lending, however, continued to be concentrated with the nonindustrial countries. Nearly half of new syndicated medium-term credits went to the nonoil-producing less developed countries, which suffered from mounting payments imbalances in the wake of the severe contraction

Chart XI
INTEREST RATES IN THE UNITED STATES, CANADA, AND THE EURO-DOLLAR MARKET
THREE-MONTH MATURITIES*

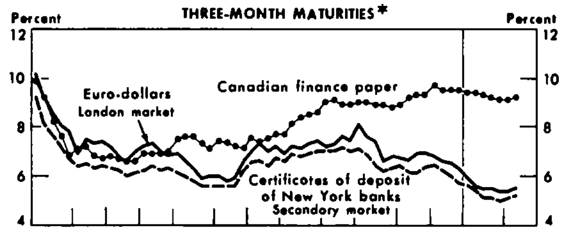
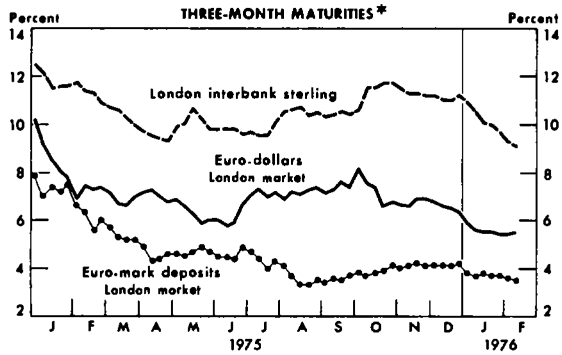


Chart XII
SELECTED INTEREST RATES
THREE-MONTH MATURITIES*



*Weekly averages of daily rates.

of world demand. In addition, several of the oil-producing countries that had launched ambitious economic development programs began to appear as substantial borrowers, as demand for oil declined and their imports escalated. Sizable amounts were also raised by Eastern European countries, although their share of total loans tended to decline somewhat.

In contrast, demand for loans by borrowers from the major industrial countries, while picking up here and there toward the year-end, remained slack. In the early stages of the economic recovery, private and semipublic corporations in these countries were still trying to rebuild liquidity and otherwise to strengthen their balance sheets. To reduce their dependence on sources of finance available only at variable rates of interest, many of these firms took advantage of favorable conditions in domestic and international bond markets to raise long-term capital at fixed interest rates. Thus, their reliance on bank lending in the Euro-currency markets correspondingly declined. Moreover, with the balance of payments of most industrial countries improving significantly during 1975, governments and other public authorities drastically scaled down their takings from the market. Substantial sums were raised, however, to finance exploration and development of new energy sources, particularly in the North Sea.

The growth of Euro-dollar lending was easily facilitated by a strong expansion of new supplies to the market. Unlike 1974, however, when OPEC countries were the principal source of additional deposits, the persistent easing of domestic monetary conditions in most industrial countries led to large-scale shifts of funds from their domestic money markets into the Euro-currency markets. Thus, the industrial countries became the major net provider of funds, while the scale of new OPEC placements tapered off significantly as these countries' combined external surplus deteriorated sharply.

By January 1975, market conditions were still clearly improving for prime-name borrowers. Loan spreads tended to narrow, amounts that could be syndicated increased, and maturities were lengthened. Over time, however, the major banks operating in the market had tended to view more cautiously the ability of some borrowers from developing countries to meet interest payments and redemption schedules on outstanding debt. In addition, outstanding loans to certain industries, especially for financing tankers, remained a continuing concern. As credit standards were tightened, there were increasing indications of a greater selectivity on the part of lenders to participate in proposed new loans by various borrowers. Thus, in January 1976, new syndicated medium-term bank credits tapered off, as the market attempted to digest the previous heavy volume of lending.

In the Euro-bond market, however, the rapid expansion of activity that accelerated during late 1975 carried over into the new year. With bond yields becoming increasingly attractive as short-term interest rates eased back much more sharply than long-term rates, institutional interest in new offerings of prime-name borrowers continued to be exceptionally high. Thus, public and private entities in many countries took advantage of favorable market conditions to place unprecedented amounts of new bond issues in international markets. Moreover, foreign issues in the New York capital market, which had swelled to a record \$7½ billion in 1975, remained heavy at \$500 million in January 1976. Most of the borrowers were from the industrial countries, although some issues of developing countries with relatively favorable balance-of-payments positions were also well received. In addition, international and regional organizations borrowed substantial amounts to finance their increased lending to many of the countries that found it impossible to raise funds in the market.

Short-term interest rates in the interbank Euro-dollar market tended to follow closely movements of domestic rates in the United States. The three-month Euro-dollar rate leveled off at around 7 percent per annum in August, but then moved upward again in September to a peak of 8¼ percent in early October. Thereafter, the rate began to decline sharply as United States monetary conditions turned easier and, after steadying around 6½ percent during November and December, the rate eased again to a three-year low of 5½ percent by the end of January, for a net decline of 1½ percentage points over the six-month period.