Treasury and Federal Reserve Foreign Exchange Operations

During the August 1976-January 1977 period under review, market participants remained sensitive to the possibility of further sharp rate movements for major currencies, as wide disparities in economic performance persisted among industrial countries. With the pace of economic expansion slowing in several countries during the summer and early fall, many traders became concerned that individual governments might not succeed in achieving greater price stability and payments equilibrium in the face of historically high unemployment rates and mounting political pressures to stimulate domestic demand. Consequently, as the market sought to anticipate both economic developments and possible policy changes, swings in sentiment generated large-scale shifts of funds into and out of some currencies. Among those that had weakened early in 1976, the pound sterling and the Italian lira came under renewed pressure, while other currencies—such as the Mexican peso and the Canadian dollar—were also heavily on offer at various times during the period. Meanwhile, speculation over a realignment within the European Community (EC) currency arrangement put the "snake" margins under renewed pressure And the Japanese yen was also subjected to reversals in market assessment.

The authorities of several countries moved to bring about internal and external balance in their economies and to restore order in the exchange markets. The United Kingdom authorities adopted a program of fiscal and monetary restraint tied to agreement on important medium-term credits. These included a $3.9 billion standby arrangement with the International Monetary Fund (IMF) and a $3 billion arrangement with the major central banks and the Bank for International Settlements (BIS) to deal with the official sterling balances. The governments in France and Italy also introduced broad-based stabilization programs, including fiscal and monetary measures and direct controls. In late October, the governments participating in the snake arrangement agreed on a parity realignment in which the German mark was adjusted upward by 2 to 6 percent against its partner currencies. Although many disparities in economic performance remained in early 1977, these various corrective measures were interpreted by the market to be steps in the right direction and therefore helpful in alleviating many of the tensions in the exchanges.

During the period, the dollar was again caught up in the crosscurrents affecting the European markets. But, in addition, sentiment toward the dollar shifted in response to the pause in the United States recovery, which spurred a gradual reassessment of the outlook for interest rates. As United States short-term interest rates declined while comparable rates elsewhere held steady or advanced somewhat, the narrowing in interest rate differentials prompted flows out of dollars. At times, other uncertainties—over the United States election, over our widening trade deficit, and over a potentially large Organization of Petroleum Exporting Countries (OPEC) price hike—had an adverse effect on market psychology. By early January 1977 the dollar had therefore declined by some 10 percent from late-

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July levels against the German mark and the other currencies linked to it. Much of the dollar's decline was gradual and trading in New York was generally orderly. But on those days when the market here became unsettled, the Federal Reserve countered with moderate offerings of marks to stabilize trading conditions. Thereafter, however, the market's attitude toward the dollar was buoyed by economic indicators that suggested the United States economy was picking up steam once again and by a reversal in interest differentials as United States rates firmed while those abroad eased. The dollar then came into demand and firmed against the main Continental currencies through end-January.

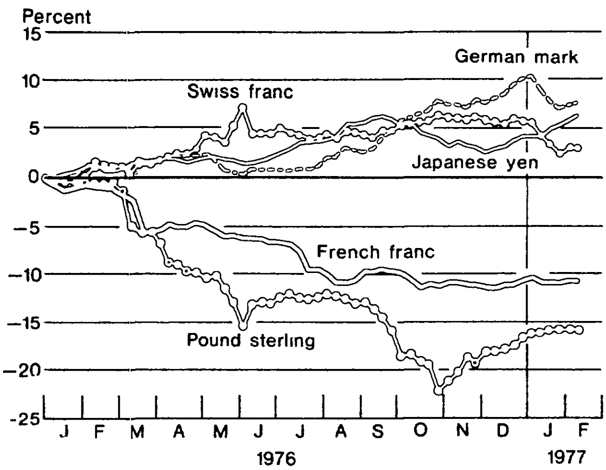
In exchange market intervention during the August 1976-January 1977 period, the Federal Reserve sold $175.6 million equivalent of marks, of which $160.7 million was from balances acquired before and during the period and $14.9 million was drawn in December under the swap line with the German Bundesbank. That swap drawing was quickly repaid in January when the dollar's buoyancy enabled the System, by purchases in the market and from correspondents, to rebuild balances once again. In all, the System bought $205.0 million of marks during the six-month period.

Moreover, pursuant to an agreement in late-October between the United States authorities and the Swiss National Bank for repayment in three years of Federal Reserve and United States Treasury debt in Swiss francs outstanding from August 1971, the System repaid $154.6 million equivalent and the Treasury repaid $86.1 million equivalent through end-January. Most of the francs were purchased directly from the Swiss National Bank against dollars. But, in addition, $7.9 million of Swiss francs was acquired from correspondents, while additional francs were bought from the Swiss National Bank against the sale of $48.1 million equivalent of German marks, $4.8 million of French francs, and $0.4 million of Dutch guilders. The marks and French francs came from balances acquired in the market during the period, while the guilders came from existing holdings. Finally, by November, using Belgian francs acquired from correspondents and in the market, the Federal Reserve liquidated the last $82.4 million equivalent of swap debt to the National Bank of Belgium outstanding since August 1971.

Also during the period the Bank of England drew in September a further $100 million each on the Federal Reserve and United States Treasury, which was in proportion to British drawings on other participants in the June 1976 standby credit facility. Total drawings on the System and the Treasury were thereby increased to $300 million each. These drawings were repaid in full at their maturity when the facility terminated on December 9, along with drawings on other participants. The Bank of Mexico repaid an earlier swap drawing of $360 million on the Federal Reserve and drew a further $150 million, which it arranged to repay at maturity in February. The Bank of Mexico also drew and

Chart 1

Selected Exchange Rates*



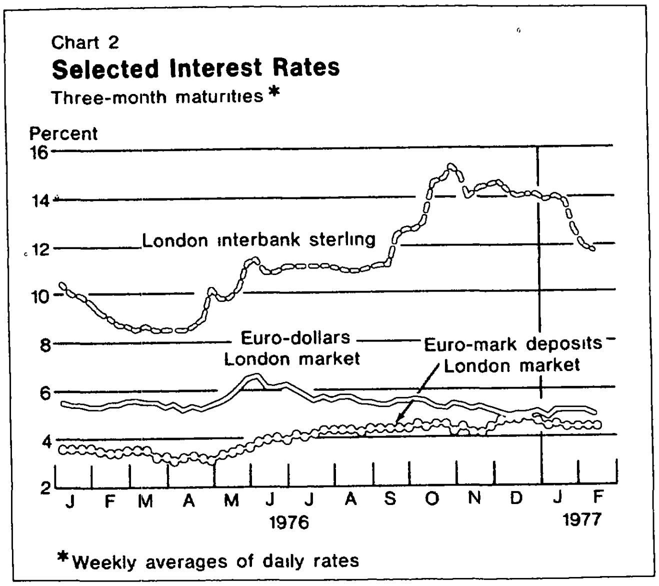
*Percentage deviations of weekly averages of New York noon offered rates from the average rate for the week of January 2-9, 1976

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility January 31, 1977
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



repaid a total of $365 million under a special short-term credit facility initiated in September with the United States Treasury. In addition, that central bank subsequently drew a further $300 million under the Exchange Stabilization Agreement, of which $150 million was outstanding at end-January 1977.

German mark

During most of early 1976 the exchange markets were bullish for the German mark. By that time, the economy was expanding smartly. Export growth continued strong enough to keep Germany's trade and current accounts in substantial surplus even though imports were on the rise. And Germany's rate of inflation, at around 5 percent per annum, remained one of the lowest among industrial countries and was continuing to moderate. This picture contrasted sharply with that for many of Germany's trading partners in Europe, where more rapid economic activity was leading to a deterioration in current account balances and upward pressure on wages and prices Although by early summer the markets had settled down somewhat after the strains of January-March, expectations remained that sooner or later the mark would appreciate against the currencies of other European countries with significantly higher rates of inflation. Thus, the mark held firm at the ceiling of the EC band while the other currencies in the arrangement remained clustered near the bottom.

Meanwhile, against the dollar, the mark leveled off below $0 3900 in the late spring and early summer, as the market considered the German and United States economies to be broadly in phase, even to the extent of entering the pause in growth at roughly the same time. Traders nevertheless remained concerned that changing money market conditions might at any time generate a reversal of the heavy volume of funds German banks had previously placed abroad in dollars and other currencies. Moreover, persistent expectations of a mark revaluation against the other EC currencies sometime before or after the German general elections in early October left traders poised to buy marks at the first sign that it was strengthening once again.

Against this background, market speculation over a realignment within the snake was quickly reignited when sizable orders to buy marks triggered a sharp rise in the spot rate late in July. The mark moved quickly to its upper intervention limit against several of the other snake currencies. There it came under recurrent waves of heavy demand during August, as dealers built up mark positions and commercial leads and lags shifted in Germany's favor. The Bundesbank and the other snake central banks intervened forcefully in one another's currencies to keep their exchange rates within the prescribed limits. At the same time the dollar again became caught up in the pressures of the snake and, as the mark strengthened, the Bundesbank purchased sizable amounts of dollars in Frankfurt. To maintain orderly conditions in New York, the Federal Reserve followed up by selling $15.9 million equivalent of marks from balances on August 16-17, the System's first intervention sales since March.

By September, in the wake of the large-scale official intervention and monetary measures taken in Europe, the immediate pressures within the snake had temporarily tapered off. But sentiment toward the mark remained bullish. News of increased foreign orders on top of an already large trade surplus for July provided an optimistic outlook for Germany's future trade performance. In addition, reports suggesting a continued pause in the United States recovery generated expectations of a protracted decline in United States money market rates, while German rates were expected to hold steady or rise somewhat. Moreover, as sterling dropped sharply in the exchanges early in September, the shift of funds out of sterling into marks magnified the demand for the German currency all the more. Consequently, the market remained fearful that speculation could resurface at any time and that Germany's exchange rate policy might once more emerge as a campaign issue in the final days of a close contest for the upcoming general elections. As a result, trading remained nervous, the Bundesbank made further large purchases of dollars, and the Federal Reserve sold a further $16.3 million equivalent of marks in New York on two days, September 16 and 24.

With the approach of the October 3 German elections, the mark came into renewed speculative demand late in September. The snake again became fully extended and the Bundesbank intervened heavily, along with other participating central banks, to maintain the limits. As these tensions resurfaced, the mark also advanced against the dollar following news of another large United States trade deficit and a decline in leading economic indicators for August. After the election, no parity changes were announced but the market was kept on edge by the possibility of a mark revaluation. Thus, the mark remained in demand through midmonth —advancing to $0.4117, over 6 percent above the levels of late July. The Federal Reserve sold an additional $20.9 million equivalent of marks from balances when trading became unsettled in New York on October 5-6. Meanwhile, the Bundesbank purchased dollars to moderate the mark's rise. Intervention in snake currencies and in dollars was largely responsible for the $2.8 billion increase in German reserves during the three months, July-October.

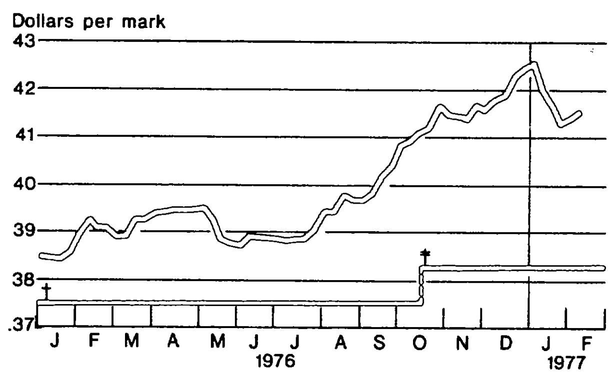
On Sunday, October 17, the EC finance ministers and central bank governors meeting in Frankfurt agreed on a realignment of parities within the joint float to avoid a repetition of the speculative pressures of previous months. The German authorities announced a 2 percent revaluation of the mark which, together with the parity changes by Scandinavian members of the EC monetary arrangement, resulted in a parity adjustment of 2 percent to 6 percent between the mark and other snake currencies. After some initial hesitancy in the market, the mark soon dropped to the bottom of the realigned joint float and, against the snake currencies, it began to trade below levels prevailing before the realignment was announced. By end-October a substantial unwinding of commercial leads and lags was under way. The other central banks participating in the EC monetary agreement quickly took advantage of these reflows to buy marks in the market to repay their indebtedness stemming from previous interventions. These official purchases of marks also had the effect of absorbing some of the liquidity created in Germany as a result of the huge currency inflows of preceding months. To bring the pace of monetary expansion back closer to the target levels for 1976 as a whole, the Bundesbank reinforced the process by selling large amounts of German government securities in the open market.

As a result, the mark did not ease against the dollar as it did against other snake currencies but rose to around $0.4150. In general, though, trading was well-balanced from the time of the EC realignment to mid-November. Only infrequently did particularly large demands for marks come into the market in a way that put pressure on the mark during the New York trading day. In particular, the mark became well bid on October 19 and 26, in response to heavy shifts out of sterling, and on November 22 following publication of disappointing economic indicators for the United States. On these occasions of market unsettlement, the Federal Reserve offered marks, selling a total of $22.9 million equivalent from balances. At other times the Trading Desk was able to purchase modest amounts of marks for System balances mostly from correspondents but also in the market when trading was quiet.

Over the rest of the year, however, the market became increasingly sensitive to the relative progress of the economic recoveries in Germany and the United States. Reports of a steep rise in German industrial output in October gave rise to expectations that money market conditions in the two countries would continue to diverge. To the market, these expectations seemed to be confirmed by the ¼ percentage point cut in Federal Reserve discount rates on November 19 and a technical reduction in reserve requirements announced on December 17. These moves contrasted with the Bundesbank's announcement of an 8 percent target for the growth of central bank money in 1977—a target interpreted as restrictive in view of the much more rapid growth of the preceding months. As a result, interest differentials favorable to the dollar were squeezed out by early December. At the same time, the possibility of a sizable hike in oil prices at the upcoming OPEC talks weighed on the dollar.

Thus, the mark was in demand throughout December, and this demand intensified as German banks

Chart 3
Germany
Movements in exchange rate



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

†Central rate established on June 29, 1973

‡New central rate established on October 18, 1976

sought to satisfy year-end needs by acquiring marks in the exchange market. Most of this bidding for marks was concentrated during the European trading day and, to provide resistance to a cumulative rise in the mark rate, the Bundesbank bought substantial amounts of dollars in Frankfurt. When these pressures spilled over into the New York market, the Federal Reserve followed up with sales of marks on four days during December, for a total of $74.5 million equivalent. Of this, $59.6 million equivalent was financed from System balances and $14.9 million equivalent was drawn under the swap arrangement with the Bundesbank. Nevertheless, the mark had firmed to $0.4249 by the end of the year, a rise of 3½ percent since the snake realignment of October.

With the dollar declining, dealers had tended to ignore several recent reports pointing to a pickup in United States economic activity—a substantial increase in November's leading economic indicators, a surge in durable goods orders, and strong Christmas retail sales. Instead, after the passing of the year-end and particularly in the light of the mark's recent strength, market professionals began building new long mark-short dollar positions on the expectation that United States interest rates would go still lower and that the United States trade deficit would worsen this year while Germany's trade surplus would increase. Consequently, the mark extended its advance against the dollar, reaching $0.4274 in Europe on January 4, fully 10¼ percent above late-July 1976 levels. To avoid an even sharper rise, the Bundesbank made sizable dollar purchases. The Federal Reserve followed up by selling $7.3 million equivalent of marks out of balances before the market turned around.

The shift in sentiment in favor of the dollar followed wire service reports of a 1 percent fall in German industrial production in November. In addition, after the liquidity pressures of the year-end had passed, German short-term interest rates began to ease. Consequently, the mark began to move back on some professional covering. The decline soon gathered momentum as United States interest rates edged somewhat higher, the market reacted favorably to the incoming Carter administration's fiscal stimulus proposals, and substantial amounts of funds flowed out of marks back into sterling. By late January the mark eased back 4 percent to $0 4101. In cushioning the mark's decline, the Bundesbank sold modest amounts of dollars in Frankfurt while the Federal Reserve bought $90.1 million equivalent to repay in full its recent swap drawing and to replenish System balances. On January 31, however, widespread publicity about the disruptive economic effects of severe winter conditions in the United States triggered a burst of demand for marks and other European currencies, and the Federal Reserve sold $17.8 million equivalent of marks from balances to stabilize trading conditions. The mark thus closed the period at $0.4157, some 7¼ percent above late-July 1976 levels. Meanwhile, by end-January 1977 German reserves had fallen $1.3 billion from end-October 1976 for a net rise of $1.5 billion since July 1976.

Sterling

For some time the British economy has been plagued by one of the highest inflation rates in Europe, disappointingly slow economic growth, and a persistently large deficit in its balance of payments. To address these underlying problems, during the spring of 1976 the authorities successfully secured trade union agreement to a second, one-year phase of wage restraint in exchange for some tax relief. For the longer term, the government announced a shift in priorities toward stimulating key industries and away from broad social welfare programs, while seeking to restrain both public and private consumption to make room for export growth. But the delicate balance upon which the government's strategy for gradually achieving economic stability rested was brought into question last spring. Between March and early June, the pound fell by more than 15 percent to $1.7065 against the dollar and nearly 12 percentage points to 41.9 percent below the December 1971 Smithsonian agreement level on an effective basis against the major currencies. This drop left the market badly shaken. Following announcement of a $5.3 billion package of standby credits from the Group of Ten countries plus Switzerland and the BIS, the pound recovered some 4 percent from its June low to trade between $1.77 and $1.78. The market nevertheless remained volatile, and the British authorities continued to intervene at times in sizable amounts. To replenish reserves, the Bank of England drew late in June $1.03 billion on the standby facility, including $200 million under the Federal Reserve swap line and $200 million from the United States Treasury's Exchange Stabilization Fund.

During the summer the sterling market was in better balance, with the spot rate still above $1.77, until latent uneasiness about Britain's economic prospects resurfaced in late August. The immediate catalyst for reassessment was the highly publicized water shortage in Britain, resulting from a record drought, which raised the possibility of production and employment cutbacks in several parts of the country. And by then the evident pause in other industrial economies had dimmed hopes that the United Kingdom would be pulled out of recession by rising export demand. At home the economy was stagnant, unemployment was

Table 2

Federal Reserve System Drawings and Repayments under Reciprocal Currency Arrangements

In millions of dollars equivalent; drawings (+) or repayments (−)

Transactions with	System swap commitments, January 1, 1976	1976 I	1976 II	1976 III	1976 IV	1977 January	System swap commitments, January 31, 1977
National Bank of Belgium	297 6	−86 5	− 83 7	−100 0	− 27 4	-0-	-0-
German Federal Bank	-0-	+133 9 − 26.4	−107 5	-0-	+ 14 9	−14 9	-0-
Netherlands Bank	-0-	+ 19 6 − 19 6	-0-	-0-	-0-	-0-	-0-
Swiss National Bank	567 2	+600 0* − 20 0	-0-	-0-	−1,147 2†	-0-	-0-
Bank for International Settlements (Swiss francs)	600.0	−600 0*	-0-	-0-	-0-	-0-	-0-
Total	1,464 8	+753 5 −752 6	−191 2	−100 0	+ 14 9 −1,174 6	−14 9	-0-

Discrepancies in totals are due to rounding

* Consolidation of Swiss franc debt

† The Federal Reserve repaid the outstanding $1,147 2 million equivalent of its pre-August 1971 Swiss franc swap indebtedness and took down the same amount on the newly created special swap line designed to refund the short-term obligation into a medium-term obligation, which is being reduced as drawings are repaid over a three-year period (see Table 3).

Table 3

Federal Reserve System Drawings and Repayments under Special Swap Arrangement with the Swiss National Bank

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

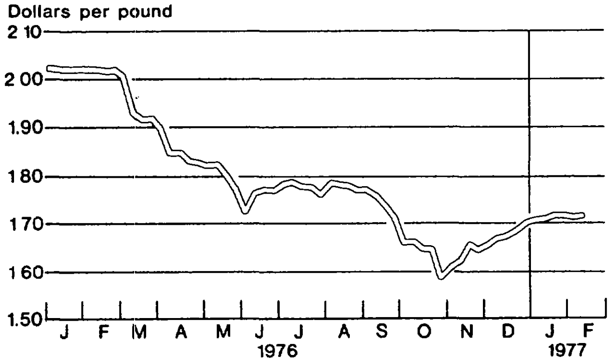
Transactions with	System swap commitments, January 1, 1976	1976 I	1976 II	1976 III	1976 IV	1977 January	System swap commitments, January 31, 1977
Swiss National Bank	-0-				+1,147 2 − 96 2	−58.4	992 5
Total	-0-	-0-	-0-	-0-	+1,147 2 − 96 2	−58 4	992 5

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

Chart 4

United Kingdom

Movements in exchange rate*



*See footnote on Chart 3

still increasing, and the inflation rate was beginning to edge upward again, in large part because of spiraling import costs. In addition, the market focused increasingly on the size of Britain's large public sector deficit —even after the government's announcement in July of planned cutbacks in government expenditures for the next fiscal year—as well as on the potential threat of a ballooning in money supply should the debt not be financed through sales of government bonds. The aggregates already had increased rapidly in July, and this was seen not only as a potential source of inflation but also as an indication of large-scale British financing of adverse leads and lags against sterling.

In the face of these various uncertainties, the pound came on offer again in late August. Market sentiment soured further over subsequent weeks on reports of strikes and wage demands beyond the bounds of the government's incomes policy, as well as in reaction to official figures showing a £905 million reduction in foreign official holdings of sterling balances in the second quarter. In response, sizable commercial selling (including outflows to finance third-country trade), several large sell orders thought to have been from the Middle East, and outright dealer positioning against sterling weighed heavily on the pound. At first, the Bank of England provided substantial support to keep the pound around the $1.77 level. But, when the selling pressure persisted, the authorities cut back on intervention to conserve official reserves. Instead, the Bank of England hiked its minimum lending rate by 1½ percentage points to 13 percent, issued a call for special deposits to drain bank liquidity, and announced a new long-term government bond issue yielding close to 15 percent.

Nevertheless, heavy commercial and professional selling continued, and by late September the pound had been pushed down nearly to $1.70. At that point, the Labour Party's annual conference provided a platform for sharp criticism of the government's planned public expenditure cuts as well as for demands for import controls to protect British jobs. Following widespread press coverage of these disputes, the pound came under further pressure and was driven below $1.70. Once the rate moved through this bench mark without meeting any market resistance, the slide quickly gathered momentum, and by September 28 it had plunged to a low of $1.6320 before steadying somewhat.

To "buy time for the market to give a more positive assessment of government economic policy", Chancellor Healey announced on September 29 that Britain intended to apply for $3.9 billion in further credits from the IMF to repay borrowings under the June $5.3 billion standby credit facility scheduled to expire December 9. Also, to offset recent reserve losses, the British authorities again drew on the standby facility, obtaining another $100 million each from the Federal Reserve and the United States Treasury—amounts which were in proportion to drawings on other countries participating in that facility. Shortly thereafter, the authorities moved further to tighten liquidity and to drive up the cost of financing short sterling positions. The Bank of England raised the minimum lending rate another 2 percentage points to an unprecedented 15 percent, called a second round of special deposits to absorb additional liquidity, and operated forcefully in the market for short-dated swaps.

These policy initiatives drew favorable comments both in the market and from foreign government officials In addition, the resulting squeeze in the domestic and Euro-sterling money markets helped the pound to steady around $1.65 during early October. Nevertheless, sterling's 7 percent depreciation from the $1.77 level left the market fearful that pressure could reemerge at any time. In addition, a disagreement within the Labour Party over the degree of restrictiveness the government should accept in negotiating terms and conditions of the IMF loan introduced another layer of uncertainty into the market.

In this atmosphere, a London newspaper article—alleging that the IMF and the United States Treasury had proposed that the pound be allowed to depreciate to $1.50 as a precondition for IMF credit—touched off widespread selling of sterling as soon as markets opened on Monday, October 25. Even though the report was firmly denied by IMF, United States, and British officials, the pound dropped precipitously, declining almost 5 percent in early trading. In an attempt to restore order in the market, the Bank of England intervened forcefully. But this quick and unprecedented plunge in the rate left the market thoroughly confused over the appropriate level for sterling and kept the pound vulnerable to every rumor or press report about the IMF loan conditions. Thus, when reports came over the news services that the Labour Party National Executive had voted to oppose further public spending cuts, the pound fell to an all-time low of $1.5550 on the morning of October 28. At this level, the pound had sunk some 13 percent below end-July levels and to 48.8 percent on a trade-weighted average basis. Meanwhile, during the three months to end-October, reserves dropped over $600 million, even after the $515 million of drawings on the June standby facility and the receipt of more than $500 million in public sector borrowings abroad.

By early in November, however, the pound had bounced back above $1.60, following the first reports that negotiations might be under way with Germany, Japan, and the United States for major new credits to deal with the problem of official sterling balances. The pound then advanced to the $1.65 level by midmonth in a turnaround that was partly triggered by new moves by the government to curb outflows and credit expansion. In particular, on November 19, the authorities sealed off a gap in exchange control regulations, through which sizable amounts of funds had flowed out during the summer, by restricting the use of the pound in financing third-country trade—a measure expected to generate a substantial reflow over the subsequent six months. In addition, the Bank of England reintroduced the supplementary deposit scheme—the so-called "corset" regulation—whereby banks place with the central bank a rising proportion of the increase in interest-bearing deposit liabilities above specified levels.

The pound's turnaround in November also reflected growing market expectations that the government was reaching an accommodation over the terms of a new IMF package, even if that were to involve severe fiscal restraints. As the market awaited the announcement of new budgetary measures, these expectations solidified and sterling advanced to $1.6857 by December 15, while the Bank of England bought dollars in the market to moderate the rise. In the budget message that day, the Chancellor announced public spending cuts over the next two fiscal years, increased indirect taxation, and the sale of part of the British government's holdings in British Petroleum—measures expected to reduce the public sector borrowing requirement as a share of gross domestic product from 9 percent to 6 percent for the 1977-78 fiscal year. The Chancellor also revealed targets for domestic credit expansion over the next three years that would meet IMF conditions for keeping a tight rein on monetary expansion. In addition, to prefinance IMF drawings, he announced standby swap facilities of $350 million with Germany and of $500 million with the United States (of which the Federal Reserve and the Exchange Stabilization Fund would each provide $250 million). Finally, he indicated that there was a general desire among the major countries to achieve a satisfactory arrangement

Table 4

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

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

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding January 1, 1976	1976 I	1976 II	1976 III	1976 IV	1977 January	Drawings on Federal Reserve System outstanding January 31, 1977
Bank of England	-0-	-0-	+200.0	+100.0	−300.0	-0-	-0-
Bank of Italy	-0-	+500.0	-0-	−500.0	-0-	-0-	-0-
Bank of Mexico	-0-	-0-	+360.0	-0-	+150.0 −360.0	-0-	150.0
Bank for International Settlements (against German marks)	-0-	-0-	+14.0 −14.0	+37.0 −37.0	-0-	-0-	-0-
Total	-0-	+500.0	+574.0 −14.0	+137.0 −537.0	+150.0 −660.0	-0-	150.0

Table 5

United States Treasury Securities, Foreign Currency Series

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

Issued to	Amount of commitments January 1, 1976	1976 I	1976 II	1976 III	1976 IV	1977 January	Amount of commitments January 31, 1977
Swiss National Bank	1,599 3				—53 6	—32 6	1,513 1
Total	1,599 3	-0-	-0-	-0-	—53.6	—32 6	1,513 1

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

for the sterling balances.

After some initial hesitancy in the market, the pound was then buoyed by an extreme shortage of funds in the London money market that was only partially alleviated by the Bank of England. As settlements for the growing sales of British government gilt-edged securities drained liquidity from the banking system just before the year-end, the banks bid for balances in the exchanges. In addition, some fairly sizable commercial orders came into the market, also for year-end purposes or for covering open positions taken up earlier in the year. Accordingly, the rise in the pound gradually accelerated during December, and the rate reached $1.7080 by the month end, some 10 percent above its late-October low. Meanwhile, the Bank of England repaid, upon maturity, its drawings of $300 million each on the Federal Reserve and the Exchange Stabilization Fund as part of its total $1.545 billion repayment of outstanding credits on the standby facility Partly as a result, British reserves fell to $4.1 billion by the year-end, their lowest level in six years

In early January, announcement of the IMF's official approval of the $3.9 billion standby facility for Britain further reassured the market. Moreover, following discussions in Paris and Basle, the central banks of the major industrial countries reached agreement on a plan to deal with the sterling balances. Under this plan, eleven countries (the United States, Germany, Japan, Switzerland, Belgium, the Netherlands, Canada, Austria, Sweden, Norway, and Denmark) would provide up to $3 billion to the BIS to back up British drawings for financing net reductions in official sterling holdings below December 1976 levels. Of this, the Federal Reserve and the United States Treasury would provide $1 billion. For their part, the British authorities would offer medium-term foreign-currency-denominated securities to official holders to fund part of the total sterling balances and to achieve an orderly reduction in the reserve currency role of the pound. The Managing Director of the IMF was also requested to assist in the implementation of the agreement.

Announcement of these agreements early in January triggered a sharp jump in the sterling rate to as high as $1 7350, before it subsequently leveled off at about $1.7150. Then, the long process of reversing previously adverse commercial leads and lags and of unwinding sterling credits used in third-country trade financing generated a steady demand for sterling. At the same time, British interest rates moved progressively lower, as reflected in the six cuts in the Bank of England's minimum lending rate from the 15 percent level of mid-November to 12¼ percent on January 28. In addition, the central bank scaled back its earlier calls for special deposits. Under these circumstances, prospects of capital gains spurred some flows of foreign funds into British securities. Late in the month the authorities announced a $1.5 billion Euro-dollar loan with a syndicate of European and North American commercial banks, which gave a further boost to the pound. As a result, spot sterling traded firmly during January while the Bank of England took the opportunity to buy dollars in the market and to rebuild its official reserve position At $1.7149 by the month end, the pound was up 10½ percent from its October low and only 4 percent below late-July 1976 levels. On a trade-weighted average basis, sterling's depreciation since the 1971 Smithsonian agreement had narrowed 6 percentage points from the record reached in October to 42 8 percent, compared with 38.8 percent at end-July 1976 Meanwhile, the Bank of England's large-scale purchases of dollars in January had, along with the initial takedown on Britain's IMF standby, contributed to a $3.1 billion increase in reserves for the month. As a result, Britain's foreign exchange reserves stood at

$7.2 billion on January 31, $1.8 billion more than six months before.

Swiss franc

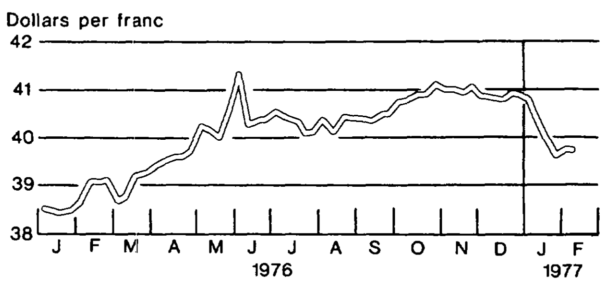
During the first half of 1976, the Swiss franc was propelled progressively higher against all major currencies Switzerland's inflation rate declined to about 3½ percent, the lowest among the industrial countries, while an unprecedented trade surplus swelled the Swiss current account surplus to nearly 10 percent of GNP. Moreover, large amounts of funds were drawn into francs as market participants sought protection against the severe uncertainties plaguing many other European currencies at the time. At home, however, the Swiss economy was stagnant, with overall economic activity only a little higher than at the trough of the 1975 recession. While the appreciation of the franc helped to reduce import costs significantly, it also led to a deterioration of profitability in Switzerland's export industries and in turn exerted a drag on investment.

Consequently, the Swiss authorities moved to limit the franc's rise in the exchanges. They intervened to buy large amounts of dollars, both in Zurich and through this Bank in New York, offsetting enough of these purchases with sales to foreign borrowers—required to convert the proceeds of their borrowings in Switzerland at the central bank—to avoid jeopardizing the monetary target for the year. Moreover, the Swiss authorities imposed additional exchange controls, restricting the importation of large foreign bank notes in April and adopting quotas in June to curtail forward sales of Swiss currency to nonresidents while entering into a gentleman's agreement whereby Swiss banks would refrain from accepting franc deposits abroad. In addition, the Swiss National Bank reduced its discount and Lombard rates to the lowest levels in ten years to bring down domestic interest rates, and it

Chart 5

Switzerland

Movements in exchange rate *



*See footnote on Chart 3

indicated a willingness to continue to provide temporary liquidity through dollar swaps with the commercial banks to maintain a comfortable money market

By late July, these various measures had begun to take effect. The Swiss franc eased back 5¼ percent from its peak levels of early June to $0.3981, while slipping some 5½ percent lower against the German mark. In contrast to previous periods of turbulence in the exchanges, trading in Swiss francs remained relatively quiet as renewed tensions built up in the EC snake during August Now that interest rates in Switzerland were well below those elsewhere in Europe and were expected to decline further as the Swiss authorities pursued their accommodative monetary policy, funds flowed increasingly back out of francs into marks. In addition, a move into deficit in the trade accounts during the summer led some market participants to question whether Switzerland would continue to show the unusually strong trade performance of recent months As a result, the franc gradually dropped back against the mark throughout the fall, declining by some 4 percent between end-July and late November. Against the dollar, however, the franc was pulled up by the rise in the mark to trade around $0.4100 through late November, with the National Bank intervening frequently to moderate daily movements in the rate.

By late 1976, the Swiss economy was still failing to show any signs of expansion. The continued softness in domestic demand was reflected in a further reduction in inflation to just 1 percent at an annual rate, its lowest since the mid-1960's The current account remained in large surplus, totaling some $3.5 billion for the year as a whole. In the absence of any upward pressures on domestic prices and with growth of the monetary base lagging, the Swiss authorities stepped up their efforts to provide liquidity to the banking system. While continuing to accommodate the banks' temporary needs with large amounts of dollar swaps, the National Bank announced that they were prepared to inject substantial Swiss francs on a permanent basis through dollar purchases in the exchange markets. Over November-December, these outright purchases amounted to nearly $2 billion, well in excess of the dollar sales under the capital export conversion program As a result, the Swiss franc continued to drop back further against the German mark and other European currencies while trading narrowly against the dollar. Then in January 1977, with economic stagnation in Switzerland contrasting sharply with the improved outlook emerging in the United States, the franc eased back in the generalized decline of European currencies against the dollar to end the period at $0.3990. At this level, from the record highs of June 1976, the franc had declined by a net 5 percent against the dollar and fully 11¾ percent against the mark.

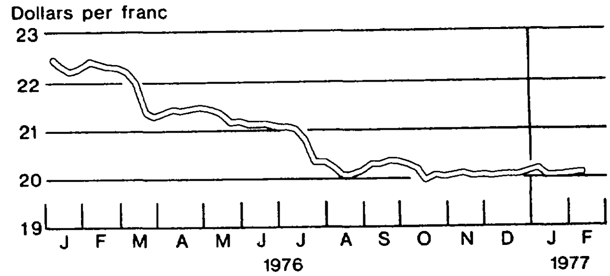
In October, the Federal Reserve and the United States Treasury reached agreement with the Swiss National Bank on an orderly procedure to repay over three years the Swiss franc indebtedness remaining from August 1971. This included $1,147.2 million equivalent of drawings under the Federal Reserve swap line, as well as the $1,599.3 million equivalent of United States Treasury Swiss franc-denominated notes. In this connection, the Federal Reserve's drawings on the original swap agreement with the National Bank were repaid on October 29, using Swiss francs drawn under a newly established special swap facility which, in turn, will be reduced as the swap is repaid over the three-year period. The System then began to liquidate its obligations in accordance with the new arrangement, primarily using francs purchased directly from the Swiss National Bank against dollars and other foreign currencies. By the end of the period, the Federal Reserve repaid $154.6 million equivalent, leaving $992.5 million outstanding as of January 31, 1977. During this same period, the United States Treasury purchased sufficient francs directly from the Swiss National Bank to repay $86.1 million equivalent of franc-denominated securities, leaving $1,513.1 million equivalent outstanding as of January 31.

French franc

Last year, the French authorities faced particularly difficult policy choices. Although domestic demand had recovered briskly from the recession of 1974-75, this pickup led to a greater rise in imports than in exports and a sharp widening of the current account deficit. At the same time, domestic inflation continued to hover at a rate of nearly 10 percent per annum, almost double that of countries such as Germany and the United States. Early in the year, the franc came under heavy selling pressure within the EC arrangement on the expectation that sooner or later it would have to be adjusted downward within the EC snake or otherwise depreciated against the currencies of countries that had lower rates of inflation. In mid-March, when the governments participating in the arrangement failed to agree on a realignment of parities, the French authorities decided to allow the franc to float independently. Although the franc rate initially dropped by some 5¼ percent, it subsequently settled at about 2 percent below its previous EC parity and traded around $0.2125 against the dollar through early summer.

During the summer, however, France was hit by a severe drought, which threatened to push up food prices, cut agricultural exports, and increase oil imports to compensate for lost hydroelectric power. By that time also, the domestic economic expansion had slowed and, with rates of unemployment and inflation remaining uncomfortably high, the debate over economic policy choices in France had heated up considerably. Consequently, market concern over the outlook for the franc resurfaced, and in late July and early August the franc came under renewed selling pressure. Although the authorities countered by sharply raising interest rates, the franc slipped back to a 2½-year low of $0.1986 by August 13, while easing a further 8 percent against the EC snake currencies. The spot rate then steadied after the government indicated it was working on a new economic stabilization program. Following a cabinet reshuffle in late August, the new Prime Minister, Raymond Barre, stressed his intention to give priority to curbing inflation and defending the franc. Consequently, trading quieted down and the rate rose to around $0.2030 through mid-September as the market awaited the new program.

Chart 6
France
Movements in exchange rate*



*See footnote on Chart 3

On September 22, Premier Barre announced a wide-ranging set of measures designed to balance the budget, to reduce the French inflation rate, and to restore equilibrium to the balance of payments. These measures included increases in income taxes to offset proposed reductions in value-added taxes and to finance aid to drought-stricken farmers. Moreover, to curb cost inflation, the government imposed a three-month price freeze on most goods other than oil and called upon trade unions to keep 1977 wage increases within the anticipated rise of retail prices. At the same time the monetary authorities lowered ceilings and reactivated reserve requirements on bank lending in order to achieve a 12.5 percent monetary growth target during the next year. Finally, to discourage further adverse shifts in commercial leads and lags while these longer term measures were taking hold, the Bank of France hiked its discount rate a further 1 percentage point to 10½ percent and imposed a modest tightening in foreign exchange controls.

The market's initial response was cautious, in part because of the potentially controversial nature of the tax increase and the call for wage restraint, and the franc was marked down somewhat. Over subsequent weeks, as strains emerged within France's ruling coalition of parties, the market atmosphere became more uncertain. In addition, talk of another large OPEC oil price increase in December raised concern that such a move would undercut France's domestic anti-inflationary effort and widen the trade deficit further. As a result, the franc came on offer during the late fall and early winter, with selling particularly strong at times of tension within the EC snake or pressures on sterling. The franc held generally above $0.2000 *vis-à-vis* the dollar but declined, in parallel with the dollar, a further 6 percent from mid-August against the mark and other EC snake currencies. To avert a steeper decline, the Bank of France kept a tight rein on domestic monetary conditions, thereby encouraging inflows of interest-sensitive funds by both nonresidents and French companies.

Late in the year, signs began to appear of an improvement in the French economic outlook. The trade deficit narrowed significantly in response to a sharp decline in French imports. The OPEC oil price increase was not so large as feared. Moreover, the domestic price freeze clearly was containing the rise in price indexes. Although market sentiment toward the franc remained cautious, the closing-out of positions taken earlier in the year and a reversal of previously adverse commercial leads and lags contributed to a 1 percent rise in the franc rate before the year-end.

In early 1977, the market atmosphere improved even further. Several of the strikes which had been threatened in response to the anti-inflationary measures failed to materialize. The release of retail price figures showing a slowdown in the inflation rate in December for the third consecutive month confirmed to the market that the government's price and wage restraints, resting heavily on voluntary compliance, were proving more effective than many traders had expected. Moreover, although interest rates in France eased somewhat, they did not decline as much as in other financial centers and the Bank of France did not join several other European central banks in lowering its official lending rate. Thus, the franc remained relatively firm throughout January, holding at $0.2012 against the dollar by the month end while recovering some 2-3 percent against the German mark and other Continental currencies. The Bank of France was therefore able to add to reserves, with the result that official exchange holdings rose a net $264 million during the August 1976-January 1977 period.

Italian lira

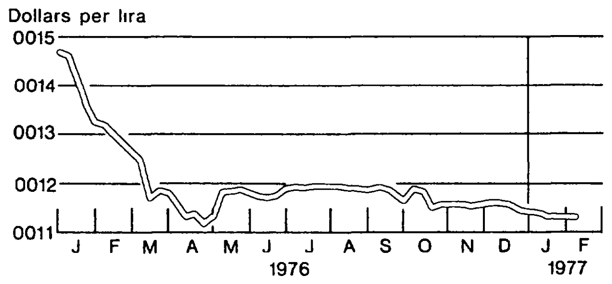
The Italian lira was under severe pressure from the beginning of 1976, dropping as much as 26 percent through early spring in response to deep-rooted economic and political strains in Italy. Recovery of the domestic economy, though still tentative, stimulated a rapid rebuilding of inventories which, together with the rise in raw materials prices, swelled Italy's import bill and turned the trade account into deep deficit. In the political impasse which developed, moreover, fiscal policy remained expansionary, threatening to blunt the effectiveness of the restrictive monetary measures adopted during the spring to support the lira. To halt the slide of the rate in early May, the authorities therefore resorted to a set of tough foreign exchange restrictions. The most important was a temporary 50 percent deposit requirement on the lira countervalue of virtually all foreign-currency purchases by Italian residents, which mopped up some $5 billion equivalent of domestic liquidity over the next three months and stimulated sizable capital inflows Meanwhile, as efforts to reach a political compromise to deal with Italy's economic and social problems evaporated, new elections were set for late June.

The outcome of those elections, a narrow but clear-cut plurality for the Christian Democratic Party over the Communist Party, gave an immediate boost to market sentiment. Delicate political compromises had to be struck, however, and several weeks passed before a minority government under Prime Minister Andreotti was formed and confirmed by the Parliament. Meanwhile, until broader policy measures could be taken, the authorities maintained a squeeze on

Chart 7

Italy

Movements in exchange rate*



*See footnote on Chart 3

domestic liquidity by extending the import deposit requirement for a further three months. This squeeze continued to draw funds in from abroad which, coupled with seasonally high tourist receipts and reversals of pre-election outflows, kept the lira firm around $0.001197 (Lit 835). The Bank of Italy took advantage of the lira's buoyancy to absorb large amounts of dollars in the market. Using these acquisitions, that bank not only repaid external indebtedness—including in late July the full $500 million drawn under the swap line with the Federal Reserve earlier in the year—but was able to add substantially to reserves. Although the pace of reflows began to slow late in August, the Bank of Italy was still able to repay $500 million of its $2 billion gold collateral loan with the Bundesbank, while extending the arrangement itself for another two years.

By mid-September, the Andreotti government had begun to negotiate the components of a stabilization program with various political factions. By that time, however, Italy's inflation rate was accelerating again, partly reflecting a surge in import costs. In response, the trade unions maintained their resistance to the government's efforts to slow wage increases by modifying or eliminating the cost-of-living indexation system. Meanwhile, the scheduled expiration of the import deposit requirement in November was approaching. The market was concerned that, as these deposits ran off, new liquidity would be injected into the money market at a time when the Italian Treasury was still borrowing heavily from the Bank of Italy to finance the public sector deficit. Also, with the tourist season over, many market participants were again expecting a deterioration of Italy's current account

In this uncertain atmosphere, a gradual buildup of commercial selling by Italian oil companies and other firms pushed the lira progressively lower in late September. In response, the Bank of Italy supported the lira in the market and the government arranged to phase out the import deposit requirement gradually over six months beginning in November. In addition, the authorities imposed a ½ percent levy on commercial bank deposits to reduce liquidity by Lit 550 billion Nevertheless, as speculative pressure in other European markets broadened to envelop the lira, the spot rate fell off to as low as $0.001146 (Lit 873), down 4¼ percent fom late July.

To check this pressure on the lira while the government completed negotiating its package of economic stabilization measures, the authorities imposed a temporary 10 percent tax, effective October 1-15, on most resident foreign currency purchases to supplement the import deposit requirement still in force. In addition, they hiked the discount rate a full 3 percentage points to 15 percent and raised cash financing requirements on exports invoiced in foreign currencies from 30 percent to 50 percent. In response, the spot rate was immediately marked up by as much as 4 percent to trade at $0.001190 (Lit 840).

On October 13 the government announced its proposals for increased taxes and sizable public spending cuts for 1977. In addition, regulated prices for gasoline and for many public services were increased, while cost-of-living-linked wage increases for certain high income groups were ordered to be invested in government securities. The market response was hesitant, however, as the limited change in wage indexation was interpreted as underscoring the government's difficulty in resolving this highly charged political issue. Thus, sentiment toward the lira remained bearish, and the authorities again found it necessary to tighten exchange controls in an effort to avoid an outburst of speculative selling when the special foreign exchange tax terminated on October 15. Ceilings on Italian banks' spot and forward positions were cut. Moreover, in a sweeping restriction, the authorities prohibited until further notice nearly all nonresident drawings on existing credit lines with Italian commercial banks. In addition, in order to bring credit growth back within the limits agreed with the EC, a ceiling on the growth of loans was reintroduced on October 15. Even after these measures were imposed, however, the removal of the foreign currency tax released a flood of pent-up foreign currency demand that drove the lira back down to $0.001147 (Lit 872). To cushion the decline in the rate, the Bank of Italy again had to intervene heavily. Consequently, in a matter of days the authorities reimposed the tax on foreign exchange transactions—this time at 7 percent for four months beginning in October—to bridge the period until the new economic measures could start to improve the balance of payments.

As a result of all the restrictions then in force, the lira again came into demand. To avoid incurring the deposit and tax requirements on spot purchases of foreign exchange, Italian importers sought additional short-term trade credits abroad At the same time, high domestic interest rates forced Italian commercial banks and other market participants to shift an increasing amount of their borrowing into the Euro-dollar market. Moreover, the risk of severe penalties on breaching nonresident credit limits prompted foreign banks to build up working balances in lire. In addition, the lira also benefited from a return flow of funds placed illegally abroad earlier in the year after the authorities extended their amnesty program to encourage further repatriations. On the strength of these various inflows of funds, the lira remained in demand through mid-

December, fluctuating narrowly around $0.001156 (Lit 865). The Bank of Italy took the opportunity to buy sizable amounts of dollars virtually every day, thereby rebuilding official reserves by some $1.4 billion during October and November. Early in December, the Bank of Italy repaid the $486 million portion of the EC credit provided by Britain, while borrowing an additional $236 million on its gold collateral loans with the Bundesbank

By late in the year, the Italian balance of payments was beginning to show signs of improvement as some of the restrictive measures adopted in October began to take effect. With the public sector deficit under more effective control, the government forecast a reduction in the Treasury's borrowing requirement for 1977. In addition, the authorities took the opportunity to reduce compulsory commercial bank investments in public sector securities, while at the same time the central bank was able for the first time since 1975 to sell Treasury bills in the open market to absorb commercial bank free reserves.

In this improved atmosphere, the government was in the position late in December to announce its decision to cut the currency tax in half, effective December 27, and to reduce the remaining levy in successive ½ percentage point cuts, phasing it out entirely by February 21, 1977. Initially, the lira was marked down, as Italian firms—especially oil companies—came into the market to satisfy postponed foreign currency needs. By December 28 the lira had slipped over 1 percent to $0 001143 (Lit 875) even as the Bank of Italy intervened to moderate the decline. With market participants still delaying their foreign currency purchases in anticipation of further relaxation of the restrictions, however, the lira steadied after that burst of selling pressure had passed. In January, the continuing domestic money squeeze stimulated further inflows from the Euro-currency market, which offset much of the demand for currencies that emerged as both the foreign currency tax and the import deposit requirement were progressively reduced. Thus, the lira eased only a further ¾ percent to $0.001134 (Lit 882) by the month end, a net decline of 5¼ percent for the six months since July 1976.

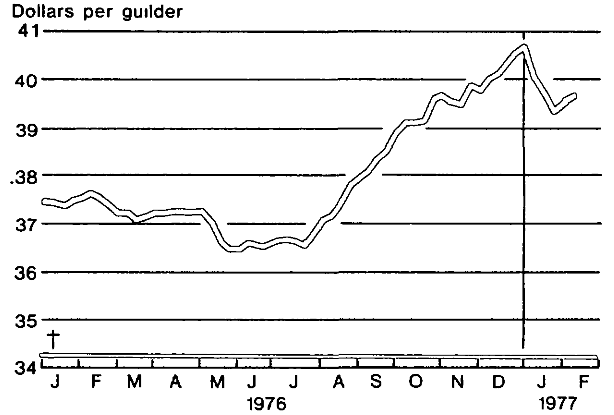
Netherlands guilder

During 1976 the Dutch guilder was caught up in wide swings in market sentiment. In the speculative atmosphere that emerged in European currency markets early in the year, the guilder was bid up on the expectation that it would be revalued along with the German mark Following a showdown over EC parities in March, however, the guilder came suddenly on offer when the market learned that the Dutch authorities

Chart 8

Netherlands

Movements in exchange rate*



*See footnote on Chart 3

†Central rate established on September 17, 1973

were unwilling to revalue. Subsequently, the market grew increasingly bearish toward the guilder. To be sure, the economy was moving gradually into recovery and the current account continued in substantial surplus. But the rise in domestic prices was still more rapid than in Germany, and the market questioned the prospects for any reduction of inflationary pressures. Thus, the guilder fell to near the bottom of the snake, where the central bank intervened heavily by selling dollars until a tightening of conditions in the Amsterdam money market helped bring the guilder market into better balance in early summer Meanwhile, the guilder had joined in the general decline against the dollar to trade around $0.3675 by end-July.

In early August, when speculation reemerged over a possible parity realignment within the EC snake, funds were shifted into marks and the guilder came under attack once again, dropping to the bottom of the EC band where heavy intervention by the Netherlands Bank was required. To demonstrate a determination to maintain the guilder within the EC snake at prevailing rates, the authorities brought about an intense squeeze in the money market by successively raising the discount rate to 7 percent by August 20 and by imposing increasingly stiff penalties on commercial banks' borrowings in excess of their quotas at the central bank. By late August, the combined effect of the heavy central bank intervention, the penal interest rates, and resident demand for balances to meet tax payments had sent overnight money rates in Amsterdam soaring to unprecedented levels. Dealers, faced with a sharply increased cost of financing short guilder positions, rushed for cover. Dutch commercial banks liquidated some of their short-term foreign assets to meet liquidity needs, while adverse commercial leads and lags dating back to the spring were reversed. As a result, the guilder snapped sharply higher in late August and then kept pace with the mark's rise against the dollar except for a temporary setback just prior to the October 3 German elections. The Netherlands Bank was therefore able to purchase sufficient German marks in September and early October to repay the remaining indebtedness resulting from its previous intervention.

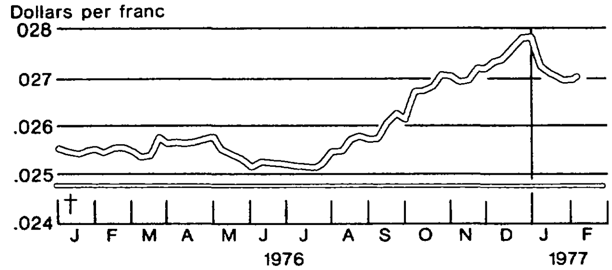
In the October 17 realignment of snake parities, the mark was adjusted upward by 2 percent against the guilder. As a substantial reflux of funds and unwinding of adverse leads and lags developed within the arrangement, the guilder remained in demand. In this atmosphere, the Netherlands Bank moved progressively to ease domestic liquidity. It continued its purchases of German marks and dollars in the exchanges, reduced penalty rates on commercial bank borrowings from the central bank, entered into swaps against dollars before the year-end, and lowered the official discount rate in two steps to 5 percent by January 7. In December the Dutch capital market, closed since the previous May, was reopened for selected foreign issues.

These various measures helped to keep the guilder just below the upper limit of the snake, where it followed the rising trend of the mark through the fall and early winter. By early January, the spot guilder reached an eighteen-month high of $0.4102. Thereafter, as United States interest rates firmed and sentiment toward the dollar improved, the guilder settled back to $0.3965 at the month end, for a net rise of 7 percent since end-July 1976. In the meantime, the sizable central bank purchases of marks and dollars since August 1976 had contributed to a substantial increase in official exchange reserves so that in the year from January 1976 external holdings declined only marginally on balance.

Chart 9

Belgium

Movements in exchange rate*



* See footnote on Chart 3

†Central rate established on February 12, 1973

Belgian franc

During the various episodes of exchange market turbulence in early 1976, the Belgian franc was vulnerable to selling pressures, partly on market concern over Belgium's relatively high rate of inflation. Whenever tensions flared up in the exchanges, the Belgian authorities vigorously defended the franc by raising short-term interest rates and squeezing domestic liquidity. At the same time, even though the economic recovery was slower than in most other countries, they took other anti-inflationary measures. The market expected only slow progress toward price stability, however, in view of Belgium's system of indexing wage increases to the rise in prices, and this concern became even stronger when the serious drought last summer threatened to push domestic food prices up sharply. Under these circumstances, when strains on the EC band resurfaced in late July and early August, adverse shifts in leads and lags put renewed pressure on the Belgian franc at the snake's lower limit. Therefore, the National Bank of Belgium was obliged to intervene in large amounts, along with the other participating central banks. But the generalized flow into marks was great enough to pull the franc up against the dollar to $0.025750 by mid-August.

Meanwhile, the Belgian authorities publicly reaffirmed their commitment to defend the franc's existing EC parity, expressing the view that a devaluation of the franc within the snake would have serious inflationary consequences while complicating the tasks of promoting economic recovery and reducing unemployment. Moreover, the authorities reimposed a severe credit squeeze, hiking the official discount rate in two steps to 9 percent, raising interest rates on other official advances and short-term Treasury certificates even more, and cutting back on commercial bank credit limits with the central bank.

As Belgian liquidity tightened early in September, dealers began to cover some of their now expensive short positions and pressure against the Belgian franc subsided. After mid-September the commercial franc moved away from the snake's floor and, apart from a brief speculative outburst before the German elections, the franc required only limited additional support against the mark through mid-October. In fact, on a few days, the franc firmed sufficiently within the joint float to enable the National Bank to buy small amounts of marks in the market to begin repaying the mark debt it had accumulated from earlier interventions.

Nevertheless, disparities in economic performance between Belgium and Germany continued to raise expectations of an eventual realignment between the currencies of the two countries. Thus, the market's initial reaction to the announcement on October 17 that the Belgian franc's snake parity—like the guilder's—would not be independently lowered in the realignment of the snake was one of disappointment, and the franc was marked down sharply the next day at the opening in Europe. But almost immediately thereafter the franc began moving back up against the dollar and within the snake.

Then, as short positions and adverse commercial leads and lags built up since mid-July were progressively reversed, the franc joined the other EC currencies in a steady advance against the dollar which continued through the year-end. By early January 1977 the franc rate had firmed to $0.028000, 9½ percent above midsummer levels. During this period the National Bank occasionally purchased dollars to moderate the rise. At the same time, with the franc holding firm within the EC snake, the National Bank bought sizable amounts of German marks in the market, initially to repay the remaining mark debt and later to build up dollar reserves by converting mark purchases at the Bundesbank. As a result, Belgian reserves increased from end-October to end-December by about $700 million, enough to offset losses during the preceding three months. Meanwhile, the substantial injections of Belgian franc liquidity arising from the central bank's purchases of dollars and marks helped to ease strains in the Belgian money market, and the authorities followed up by lowering official lending rates on various advances and loans in line with the easing in market rates of interest.

By January, official figures showed that Belgium's current account had moved roughly into balance and that Belgium's inflation rate was moderating once again. Domestic economic activity remained slack, however, and the unemployment rate seasonally adjusted had risen to nearly 6.2 percent of the labor force. Under these circumstances and with the franc remaining steady within the EC snake, the Belgian authorities followed other European central banks in cutting domestic interest rates further. The National Bank reduced its discount rate for the first time since August to 8 percent, lowered a variety of other official lending rates by as much as 2 percentage points, and raised commercial banks' rediscount quotas to increase the availability of credit. During the remainder of January, the commercial franc eased back along with the mark against the dollar to $0.027040 by the month end, a net rise of 6 percent in the six months from end-July 1976.

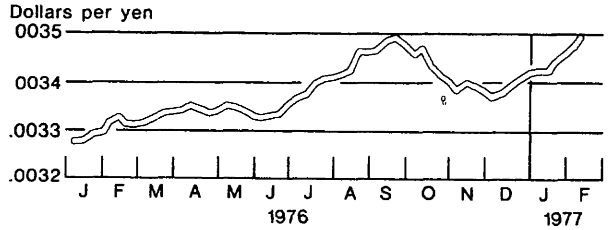
During the period under review, the Federal Reserve completed its program of regular purchases of Belgian francs to repay swap debt outstanding since August 1971, acquiring sufficient francs from correspondents and in the spot and forward market to liquidate the remaining $82.4 million of drawings by November 12.

Japanese yen

Following the economic dislocations of previous years—inflation, payments deficit, and recession—the Japanese authorities were seeking to revive the domestic economy through fiscal stimulus and accommodative monetary policy without rekindling domestic inflation. When early in the year, however, the United States and other industrial countries experienced a sharp expansion of demand, particularly in rebuilding inventories, Japanese exports surged without an immediate rise in imports and Japan's trade and current accounts moved into substantial surplus. This generated more positive expectations toward the yen which, combined with favorable interest arbitrage incentives, led to substantial capital inflows to Japan. Consequently, in the early months of 1976 the yen rebounded by some 2 percent from its lows of late 1975. Although the market came into better balance over the late spring, the possible persistence of a large trade surplus for Japan became a matter of official concern abroad and was one of the subjects discussed at the economic summit meeting among major nations in Puerto Rico in late June. Moreover, the Japanese press carried reports that, in the economic policy debate emerging in Japan, some leaders expressed a readiness to accept a gradual rise in the yen to contain domestic inflation.

As the market reacted to reports of these policy discussions, the yen came into heavy demand from late June through August. Foreign importers of Japanese goods advanced their yen purchases in the spot and forward markets to cover future needs, nonresident investors shifted funds into Japanese securities, and

Chart 10
Japan
Movements in exchange rate*



*See footnote on Chart 3

market professionals both in Tokyo and abroad shifted into long or longer yen positions. The spot rate reached a high of $0.003504 (¥285.4) by September 9, some 5¼ percent above midyear levels. To maintain an orderly market, the Bank of Japan bought moderate amounts of dollars in August-September before the yen eased back somewhat late in September.

In early October, however, the balance of market sentiment shifted back against the yen. Talk of a sizable OPEC oil price rise in December had become a major concern in view of Japan's dependence on oil imports for the bulk of its energy needs. With the approach of the national election in Japan in early December, political uncertainties also weighed on market psychology toward the yen. Moreover, the economic pause in the United States and Europe during the summer had been reflected in a deceleration of Japanese export growth which, coupled with a delayed rise in imports to rebuild stocks run down earlier in the year, had led to a narrowing of the trade and current account surplus. Since the Japanese economy was also sluggish, the market came to expect that interest rates in Japan might eventually decline, and market rates softened somewhat even as the Bank of Japan kept its discount rate unchanged.

In this atmosphere, the yen came increasingly on offer in the exchange market during October and November, as professional traders shifted out of yen and into dollars while previously favorable leads and lags were unwound. Selling pressures increased on the days before and after the December 5 election, in which the ruling Liberal Democratic Party almost lost its absolute majority in the lower house of the Diet. By December the yen rate slipped to as low as $0.003359 (¥297.7), some 4¼ percent below its September high, with the Bank of Japan by then intervening forcefully to maintain orderly market conditions.

Over the next few days, however, the market atmosphere improved markedly. The smooth transition of authority to a new government under Prime Minister Fukuda had a reassuring effect, particularly as the new administration in Japan reasserted the policy of cautious stimulus to the economy. In addition, the outcome of the OPEC meeting in midmonth with a smaller than expected increase in OPEC oil prices also came as a relief to the market. Consequently, the yen turned upward once again, bolstered by seasonal conversions of exports receipts.

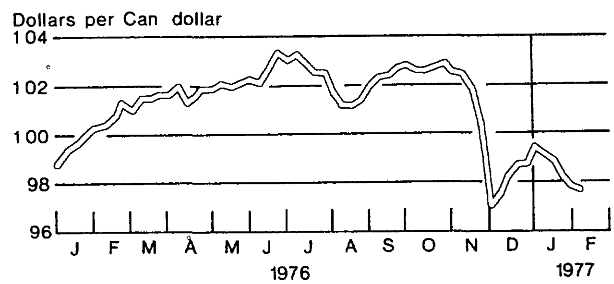
By early 1977, figures had been released showing an overall Japanese trade surplus of $10 billion for 1976 and a current account surplus of about $3½ billion, or nearly 1 percent of GNP. Moreover, the revival of demand in the United States and elsewhere was reportedly again generating a rise in Japanese exports which outpaced import growth. Amid renewed expression of concern over the size of Japan's trade and current account surplus, funds again began to flow heavily into Japan. The yen thus continued to advance through most of January, reaching a high at the month end of $0.003469 (¥288.3), some 3¼ percent above the early-December low, with only modest intervention by the Bank of Japan.

Canadian dollar

By midsummer 1976, the Canadian authorities had made significant progress in reducing inflation from the levels of 1974-75, partly as a result of a broad anti-inflationary program which included price and wage restraints as well as a restrictive monetary policy. At the same time, however, the pace of expansion of the domestic economy was sluggish, unemployment was still high, and Canada's current account remained in sizable deficit. During the first half of 1976, this deficit had been more than offset by Canadian borrowings abroad, amounting to some $4.5 billion. Thus, while the market remained hesitant about the longer term prospects, the conversions of these borrowings had pushed the Canadian dollar rate up strongly in the exchanges. The broader interest in the Canadian dollar that these borrowings had generated, together with the impressive rise in the rate, had attracted sizable professional position-taking that left the currency more exposed to volatile swings in market sentiment. When the pace of new borrowings and conversions slowed during midsummer, the Canadian dollar dropped about 3 percent from its June highs to below $1.01 early in August.

In August and September, however, several new foreign borrowings were announced that generated a reversal of professional positions and reportedly attracted renewed flows of OPEC funds into Canadian

Chart 11
Canada
Movements in exchange rate*



*See footnote on Chart 3

dollars. Buoyed also at times by seasonally strong commercial demand, the Canadian dollar advanced again to above $1.03 by late October. The Bank of Canada continued to intervene on both sides of the market to maintain orderly trading conditions, with the net result that by end-October Canada's official reserves were almost back up to end-June levels.

Meanwhile, some long-standing concerns over prospects for the Canadian economy began to weigh on market sentiment. Opposition was building up, within both the labor unions and the business community, to an extension of the government's year-old wage-price control program. Also, the latest economic statistics indicated a further slippage in the already disappointing pace of recovery, raising the possibility of higher unemployment especially in Quebec and the maritime provinces,. At the same time, the growth of monetary aggregates was slipping below the Bank of Canada's target range. Under these circumstances, the market became wary of significant declines in Canadian interest rates relative to those in the United States.

Thus, sentiment toward the Canadian dollar was already turning more hesitant when reports spread that the Separatist Party of Quebec might make severe inroads in the Liberal Party's majority in the upcoming November 15 elections for the Quebec provincial legislature. In response, the Canadian dollar came on offer and the spot rate began to soften even before the elections. Nevertheless, market participants were caught by surprise when the Separatist Party won by a sizable majority. In reaction, the Canadian dollar was marked down sharply in London the day after the election, before temporarily recovering somewhat in the New York and Canadian markets.

Over subsequent days, as the market tried to assess the broader political and economic implications of the election results in Quebec, the selling pressure gathered force. Professional dealers in both Europe and North America scrambled to cut back their Canadian dollar positions or to take up short positions. As the rate fell, commercial demand for Canadian dollars virtually dried up, United States corporations brought forward their normal year-end conversions of earnings by Canadian subsidiaries, and Canadian borrowers postponed their conversions of new foreign issues. Meanwhile, interest rates in Canada also began to ease. On November 19, after a ¼ percentage point cut in Federal Reserve discount rates, the Bank of Canada announced a reduction in its lending rate of ½ percentage point to 9 percent. With the Canadian dollar increasingly on offer, the spot rate tumbled through the $1.00 level over our Thanksgiving Day holiday and, in record turnover, continued to slide over the next few days. By Tuesday, November 30, it had reached $0.9587 in London, the lowest level since June 1970. The Bank of Canada provided substantial resistance to the sharp fall in the rate, and Canadian official reserves fell $759 million in November.

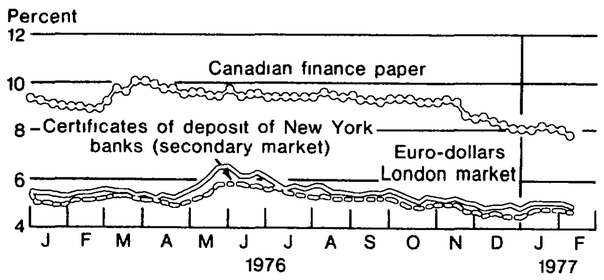
The Canadian dollar began a tentative recovery in early December, when some participants began to feel that the selling had been overdone. Reports of new foreign borrowings scheduled for early 1977 tended to provide some reassurance that, even after the Quebec election, Canadian borrowers could continue to tap the international credit markets. As the atmosphere improved, there were renewed borrowing conversions in the market, and some short positions were covered. In addition, reports circulated that the proceeds of Canadian wheat sales to China were being converted. Thus, even after the Bank of Canada cut its discount rate another ½ percentage point on December 21, the exchange rate was marked down only briefly, and by January 5 it had recovered to $0.9984, over 4 percent above its November 30 low. The Bank of Canada intervened about as heavily to moderate the rise as it had to cushion the decline, adding $764 million to official reserves during December

Nevertheless, the market remained cautious toward the Canadian dollar and the rate generally fluctuated lower during the rest of January. By this time, market participants held firm expectations of a further easing of short-term interest rates in Canada, while in contrast United States money market rates were tending to rise. Uncertainties over the timing of future borrowing conversions dampened professional bidding for Canadian dollars. In addition, the market reacted adversely to Quebec Premier Levesque's speech to businessmen in New York, in which he reaffirmed his party's objective of an independent French-speaking Quebec. By end-January, therefore, the Canadian dollar rate had

Chart 12

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

Three-month maturities*



*Weekly averages of daily rates

slipped back to $0.9825, for a net decline of 4¼ percent over the six-month period. During that time, Canadian official reserves declined by $115 million on balance.

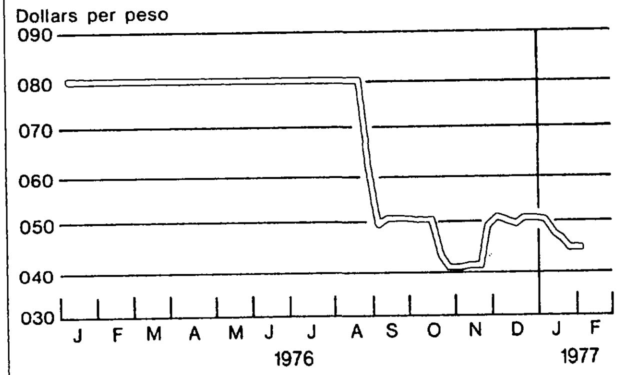
Mexican peso

For nearly two decades, Mexico's impressive economic growth largely reflected the authorities' efforts to mobilize domestic savings and attract funds from abroad to finance the development effort Externally, this approach resulted in a current account deficit which was normally offset by sufficient capital inflows to achieve at least overall balance and, in most years, to allow for some accumulation of international reserves. Throughout this period, the Mexican authorities successfully maintained a fixed rate of $0.08 to the peso, meeting with only occasional bouts of selling pressure. This stability nevertheless rested on a delicate balance of economic forces. Beginning in the early 1970's, ambitious social and economic programs at home led to growing fiscal deficits which eventually generated rates of inflation well above those in the United States and other major countries. At the same time, Mexico was caught up in the backwash of worldwide inflation, particularly after the oil price rise of 1973-74, and the subsequent recession in the United States and other industrial countries. The Mexican authorities managed to avoid an economic downturn in 1974-75, but at the expense of a sharp widening in the current account deficit that required even greater foreign borrowings than before. By early 1976, the authorities had recognized the need for restoring internal and external balance and had made a start toward that objective. Nevertheless, market participants remained cautious in view of the large economic imbalances which remained, the increasing wage demands of Mexican trade unions, and election-year uncertainties in Mexico.

Against this background, the Mexican peso came under heavy selling pressure on several occasions in early 1976. By April, rumors of a forthcoming devaluation of the peso had led to outflows of resident funds as well as to hedging by nonresidents of peso claims and receivables. To help finance its intervention at that time, the Bank of Mexico drew the full $360 million available under the swap arrangement with the Federal Reserve. Some reflows subsequently developed but not in sufficient volume for the Bank of Mexico to liquidate the swap drawing quickly, as it had with earlier drawings in 1974 and 1975.

The market remained edgy throughout the spring and early summer. After former Finance Minister López Portillo was voted to succeed President Echeverría in the July 4 election, many market participants ex-

Chart 13
Mexico
Movements in exchange rate*



*See footnote on Chart 3

pressed concern over the possible need for a change in the exchange rate either before or after the December 1 inauguration. Although Mexico's imports had steadied, the growth of exports was falling well below expectations, halting progress in reducing the current account deficit. Yet, the authorities were unable to step up the pace of foreign borrowings to offset fully both the widening current account deficit and the continuing hot money outflows. The Bank of Mexico continued to support the peso at the $0.08 level, but at a heavy loss of international reserves.

On August 31 the Mexican authorities announced that, as part of an overall strategy of economic adjustment, the peso would be allowed to float, with the Bank of Mexico intervening only to prevent "erratic and speculative fluctuations" in the spot rate. Other measures included steps to cut the public sector deficit, price controls on raw materials. and taxes on exceptional profits that exporters might receive from the peso's depreciation.

Immediately after these announcements, the spot peso was marked down almost 39 percent before recovering slightly in thin trading. To help steady the rate, official intervention was soon resumed and the peso traded around $0.0505 through late October. Meanwhile, in conjunction with these new policies, the Mexican government had entered into negotiations with the IMF. In that context, the United States Treasury and the Federal Reserve agreed to a special arrangement with the Bank of Mexico on September 20, making available to that bank up to $600 million of interim financing. On that basis, the Bank of Mexico drew early in October $365 million on the United States Treasury, an amount that was fully repaid when Mexico made its first drawing on $963 million in credits the IMF made available beginning in November. In October the Bank of Mexico also repaid the $360 million of swap drawings on the Federal Reserve outstanding for six months.

In the exchanges, however, the attitude toward the Mexican peso remained bearish. Although wage increases were substantially below levels originally demanded by the labor unions, domestic prices had nevertheless risen sharply following the floating of the peso. Moreover, the market had come to expect that implementation of new measures in connection with Mexico's eligibility for drawing on the Fund would have to await the installation of a new administration on December 1. In this atmosphere, a variety of rumors, of capital controls or freezes on resident bank accounts, began to appear in the market, triggering renewed movements of funds out of Mexico in early autumn. Later on, in mid-November, reports of seizures of privately held land in northern Mexico generated further uncertainty. In response, capital outflows intensified and Mexican residents rushed to convert more pesos into United States dollars, including dollar currency notes.

In an effort to maintain an orderly market for the peso, the Bank of Mexico at first stepped up its official dollar sales. But, after sustaining a further loss of reserves, the authorities permitted the peso to sink a further 25 percent to $0.0380 on October 27, before resuming support for the rate. Among other credits to augment reserves, the authorities drew in November $150 million on the swap line with the Federal Reserve and a total of $300 million under the Exchange Stabilization Agreement with the United States Treasury. Later that month, in the face of massive selling pressure on the peso and the likelihood of even more capital outflows before December 1, the authorities announced over the November 20-21 weekend that they were withdrawing temporarily from the market. To deter additional speculative selling of pesos, commercial banks and other credit institutions were prohibited from trading for their own accounts, except to cover existing commitments. Instead, stockbrokers were authorized to act as foreign exchange dealers for the purpose of executing essential transactions. Following these measures, the immediate selling of pesos stopped and a technical shortage of peso balances quickly developed in both Mexico and abroad. Thus, the peso bottomed out at $0.0345 on November 22—fully 57 percent below the prefloat level—and rose to as high as $0.0526 by December 1.

That day, in his inaugural address, President López Portillo called for national unity, austerity measures, and a productivity improvement program to strengthen the Mexican economy. The speech was well received in Mexico and abroad, and over the following days a substantial reflux of funds into pesos developed. Thereafter, the new administration began implementation of the policy measures embodied in the agreement with the IMF and gained agreement for more modest than expected wage increases in the January round of wage talks. Moreover, on December 20, the authorities lifted the prohibition against commercial bank trading for their own account. Even as more normal trading resumed, the peso held firm at around the $0.05 level through the year-end and into early 1977. When some selling pressure emerged briefly after mid-January, the rate dropped to as low as $0.0444 before firming in good two-way trading. By the month end, the peso was trading at $0.0463, some 42 percent below the prefloat level. Meanwhile, the Bank of Mexico's reserve position had improved sufficiently to repay in December $150 million of the $300 million drawn on the United States Treasury and to schedule repayment of the $150 million in swap drawings on the Federal Reserve at maturity in February.