February-July 1981 Semiannual Report
(This report was issued to the Congress, and to the press on Thursday, September 3, 1981.)

Treasury and Federal Reserve Foreign Exchange Operations

The United States dollar advanced strongly against all currencies during the period under review in response to a variety of economic and political factors in the United States and abroad. In the United States, the current account remained in surplus. The domestic economy showed considerable resilience. The demand for money and credit continued strong, and United States interest rates remained high. Also, price indexes published during the period pointed to a significant decline in the inflation rate. Moreover, the already favorable market sentiment toward the Reagan administration was strengthened by its apparent resolve and effectiveness in translating from plan to action its major fiscal program designed to deal with inflation while revitalizing the United States economy.

The performance of major industrial countries abroad was less favorable. The current accounts of several countries, notably Germany, were in substantial deficit. Inflation was accelerating in most countries other than Japan. Economic activity abroad was generally sluggish. In many countries, the weakness of domestic demand was seen in the markets as constraining the authorities from raising interest rates sufficiently to attract capital inflows for financing current account deficits at prevailing exchange rates or to curb inflation. Market participants focused on the policy challenges facing many governments abroad and were concerned that policies would not be adopted to deal with these problems effectively. Moreover, political developments in Eastern Europe and in the Middle East added to uncertainties for the outlook, especially for Europe, and left traders and investors with the view that the United States was a relatively attractive outlet for investment.

In this environment, the market perceived little downside risk for the dollar in the exchange markets. Consequently, the dollar fluctuated higher over most of the period under review. Early in February, the selling pressures against other currencies focused mostly on the German mark, which not only declined against the dollar but also was weak within the joint float arrangement of the European Monetary System (EMS). After midmonth, the Bundesbank took strong action to defend the mark, and before long increases in short-term interest rates in Germany were followed by rising interest rates in many other financial markets on the Continent. At the same time, interest rates in the United States eased somewhat. As market participants moved to cover short currency positions, the mark rebounded and other currencies also strengthened by mid-March.

From April to mid-May, there was renewed upward pressure on short-term United States interest rates and the dollar resumed its advance. By midspring this tendency was reinforced, as the markets attempted to assess the implications of renewed

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unrest in Poland, the change of government in France, and political developments in several other European countries Moreover, United States statistics for the first quarter highlighted the unexpected strength of the domestic economy. As market participants began to adjust their expectations concerning the near-term outlook for the economy and for interest rates, the dollar advanced strongly.

Coming into the summer, market participants took an increasingly bearish view of the outlook for Europe. A debate over monetary and exchange rate policies had emerged in the press, intensifying with the approach of the July 19-20 Ottawa summit. Market participants focused on complaints by foreign governments that the high level of United States interest rates was complicating their efforts to encourage economic recovery and to avoid further depreciations of their currencies. At the same time, evidence suggested that the United States economy had lost its upward momentum. Inflation figures continued to show improvement, while the growth of the narrow monetary aggregates had moderated. Expectations developed that United States interest rates might ease from their near-record highs. In these circumstances, the dollar remained in demand but fluctuated more irregularly than before.

After mid-July the demand for credit in the United States was stubbornly strong in the face of high interest rates and the broader monetary aggregates continued to be buoyant. The market was impressed by Chairman Volcker's reaffirmation of the Federal Reserve's commitment to restrain monetary expansion. In addition, the market was becoming concerned about the impact of the United States government's near-term financing requirements on United States financial markets. In this environment, interest rates remained high, disappointing expectations of near-term declines. Moreover, as the Administration's economic proposals gained Congressional approval, market participants compared the breadth of support for the new policy directions in the United States with the continuing debates on a full range of policies in many countries abroad. As a result, market sentiment toward the dollar became bullish The dollar closed the period, advancing strongly across the board. The extent to which the exchange rates for individual currencies moved against the dollar depended in large part on economic and political factors in their respective countries. But, overall, the dollar ended the period up 22¼ percent against sterling, up 16½ percent against the Japanese yen, and up 16¼ percent against the German mark.

In their operations in the exchange market, the United States authorities intervened to settle a volatile market on nine trading days in February, when the dollar was rising sharply. The equivalent of $610.0 million net of marks was purchased in the market and an additional $168.4 million of marks was bought from correspondents. The proceeds of these market and correspondent purchases were split evenly between the Federal Reserve and the Treasury and were added to their respective balances.

On March 30, when trading in the exchange markets faltered amidst the uncertainties following the assassination attempt on President Reagan, the Trading Desk intervened to reassure the markets. A total of $74 4 million equivalent in marks was sold from balances, again split evenly between the Federal Reserve and the Treasury. On the following day, exchange markets quickly returned to more orderly conditions.

The Treasury indicated in April that, after study and consultation with officials of the Federal Reserve, the United States had adopted a minimal intervention approach to intervene only when necessary to counter conditions of disorder in the exchange market. On May 4, Treasury Under Secretary Sprinkel set forth the rationale for this approach in testimony before the Joint Economic Committee of the Congress.

The United States did not intervene on its own account through the remainder of the period under review. The Trading Desk continued to cooperate with other central banks by intervening as their agent from time to time in the New York market Over the six-month period, such operations were conducted in German marks, French francs, Japanese yen, and the Canadian dollar. In their own markets, central banks of other countries continued to intervene, operating heavily at times, mostly to limit the decline of their currencies against the dollar.

In April, the Swedish Riksbank repaid, prior to maturity, the $200 million drawn in January under the swap arrangement with the Federal Reserve, following a heavy reflow of funds into the Swedish krona. In May a $200 million increase in the arrangement that had been agreed upon for one year lapsed and the swap line reverted to the earlier $300 million amount.

On July 27 the United States Treasury paid off the first maturing tranche equivalent to $744.5 million of its Swiss franc-denominated securities. These securities were issued with the cooperation of the Swiss authorities in connection with the dollar-support program of November 1978. After this redemption the Treasury had outstanding $5,692.1 million equivalent of foreign currency notes, public series, of which $5,233.6 million is denominated in German marks and $458.5 million is denominated in Swiss francs. These securities mature between September 1, 1981 and July 26, 1983.

Table 1

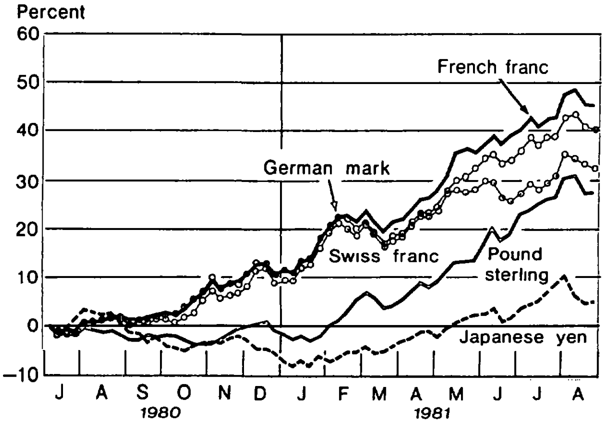
Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility January 1, 1981	Decrease effective May 23, 1981	Amount of facility July 31, 1981
Austrian National Bank	250		250
National Bank of Belgium	1,000		1,000
Bank of Canada	2,000		2,000
National Bank of Denmark	250		250
Bank of England	3,000		3,000
Bank of France	2,000		2,000
German Federal Bank	6,000		6,000
Bank of Italy	3,000		3,000
Bank of Japan	5,000		5,000
Bank of Mexico	700		700
Netherlands Bank	500		500
Bank of Norway	250		250
Bank of Sweden	500	200	300
Swiss National Bank	4,000		4,000
Bank for International Settlements			
Swiss francs-dollars	600		600
Other authorized European currencies-dollars	1,250		1,250
Total	30,300	200	30,100

Chart 1

The Dollar Against Selected Foreign Currencies

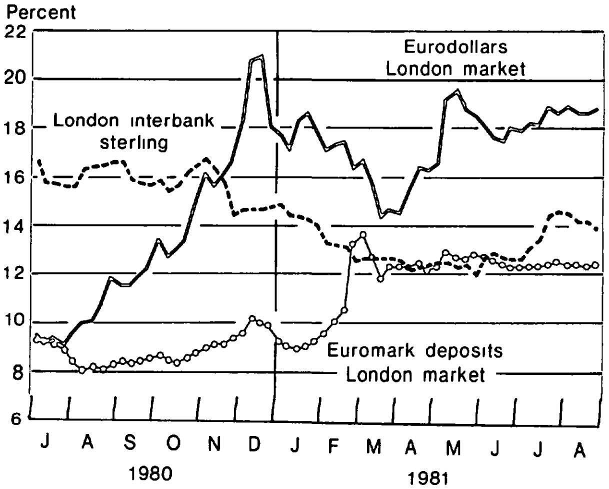


Percentage change of weekly averages of bid rates for dollars from the average rate for the week of June 30-July 6, 1980 Figures calculated from New York noon quotations

Chart 2

Selected Interest Rates

Three-month maturities *



* Weekly averages of daily rates

In the seven months through July 1981, the Federal Reserve had gains of $4 9 million on its exchange market operations, while the Exchange Stabilization Fund lost $4 5 million The Treasury's general account lost $82 7 million, reflecting losses of $144 3 million as a result of annual renewals at current market rates of the agreement to warehouse with the Federal Reserve Swiss franc proceeds of Treasury securities and gains of $61 6 million on the reacquisition of Swiss francs in connection with the redemption at maturity of Swiss franc-denominated securities As of July 31, valuation losses on outstanding balances were $571 1 million for the Federal Reserve and $1,807 2 million for the Exchange Stabilization Fund The Treasury's general account had valuation gains of $1,313 5 million related to outstanding issues of securities denominated in foreign currencies

German mark

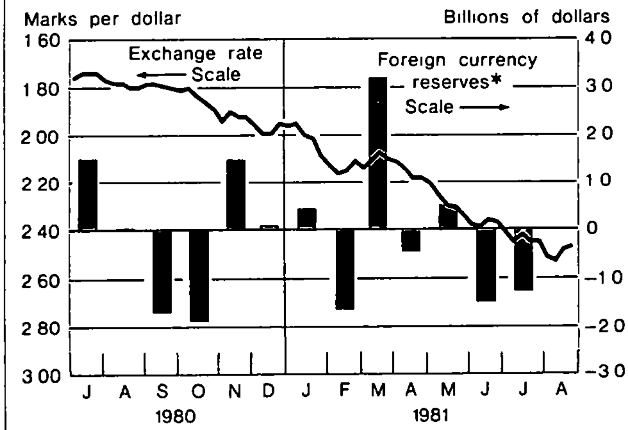
Early in 1981 Germany's current account deficit showed no signs of contracting despite continued stagnation of the domestic economy Though import demand had weakened and export orders had picked up from earlier depressed levels, these initial improvements were more than offset by the adverse impact on Germany's terms of trade of the sharp depreciation of the mark At the same time, growing tourism, interest, and dividend payments led to a further deterioration in services The authorities had hoped to correct the current account deficit gradually by a shift of resources toward investment and exports and, in the interim, to finance the deficit by a combination of private and official capital inflows But the protracted nature of the deficit exerted a negative impact on sentiment toward the mark, and private capital flowed heavily out of Germany instead Meanwhile, domestic demand remained exceptionally weak Central bank money was growing in the upper half of the 4-7 percent annual growth range, and short-term domestic interest rates at 9 percent were the subject of domestic debate—criticized for being too high to permit a recovery of domestic economic activity but too low to defend the mark from downward pressures in the exchange market

By February the outflow of funds from Germany accelerated sharply Market participants were deeply concerned about the lack of resolution within Germany over the appropriate role for monetary policy in dealing with the weakness of the external sector and about security issues raised by persistent tensions in Poland At the same time, there was growing confidence in the policies and leadership of the new United States administration under President Reagan, which had already established a clear direction for the United

Chart 3

Germany

Movements in exchange rate and official foreign currency reserves



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

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

States in economic and military matters With interest rates in Germany relatively low compared with those in the United States and some other industrial countries, funds flowed heavily out of marks, principally into dollar assets but also into sterling and higher yielding currencies of the EMS By midmonth the mark had plummeted to DM 2 25 against the dollar for a decline of 5½ percent from end-January levels and some 20 percent from the previous September Within the EMS the mark was trading at or near the floor of the joint float *vis-à-vis* the French franc The Bundesbank intervened in dollars and, together with the Bank of France, also in French francs to preserve the limits of the EMS Largely reflecting these operations, Germany's foreign exchange reserves declined to $42 7 billion at end-February, down $1.7 billion from the level outstanding on January 31. Meanwhile, during February the United States authorities intervened to settle trading conditions which were frequently one way The authorities bought $610 0 million equivalent of marks net in the market and $168 4 million equivalent from correspondents which were added to balances of the Federal Reserve and the United States Treasury.

The sharp and prolonged decline of the mark posed serious problems for the German authorities The depreciating mark boosted domestic currency prices of oil and other dollar-invoiced imports relative to export prices, thus magnifying the current account deficit The rising cost of imports fed directly into domestic producer and consumer prices ahead of important spring wage negotiations and thereby threatened to provoke new domestic cost pressures The mark's decline also complicated efforts to finance the external deficit and generated some uneasiness on the part of official mark holders On February 19 the Bundesbank temporarily closed the Lombard window, suspended the traditional fixed-rate facility, and announced that Lombard credits would henceforth be made available at its discretion and at rates determined on a day-to-day basis Bundesbank President Poehl stated that the immediate aim of these measures was to tighten German monetary policy in order to safeguard the stability of the mark Thereafter, German short-term interest rates shot up and call money temporarily reached 20-30 percent before settling back to trade around 12-13 percent.

Exchange market participants reacted positively to the tightening of German monetary policy As interest differentials adverse to the mark either narrowed sharply or disappeared completely, previously adverse commercial leads and lags were unwound and nonresidents repaid earlier mark-denominated borrowings This reflow of short-term funds into marks, principally out of French and Belgian francs, strengthened the mark dramatically within the EMS, and the mark traded after mid-February at the top of the joint float arrangement. The Bundesbank was therefore able to begin purchasing EMS currencies in the market to repay debt to the FECOM (European Fund for Monetary Cooperation), incurred earlier while the mark was at the bottom of the EMS Meanwhile, with United States interest rates also coming off near record highs, the mark rebounded against the dollar to trade around DM 2 09-2 12 through early April For their part the United States authorities limited their intervention to one occasion, on March 30, following the assassination attempt on President Reagan, when they sold $74 4 million equivalent of marks out of balances

During the spring the Bundesbank maintained its essentially restrictive monetary policy stance Officials stated that there was no basic conflict between internal and external policy considerations Short-term stimulus to the economy, whatever the temporary benefits to growth, would be counterproductive since it would increase domestic consumption and inflation at the expense of longer term needs such as capital formation, efficient economic decision making, and productivity gains The authorities therefore kept a tight rein on liquidity mainly through open market operations and foreign currency swaps These operations convinced exchange market participants that the Bundesbank would not allow interest rates to ease. But the occasionally highly charged domestic debate over monetary policy also suggested that the authorities would not be in a position to increase short-term interest rates in the face of continued recession and substantial unemployment

Meanwhile, in the United States, demands for money and credit pressed against a restrained supply of bank reserves and exerted upward pressure on short-term United States interest rates from April through mid-June The rise in United States interest rates was not matched by increases in German money market rates, so that interest differentials adverse to the mark widened from 2 percent in March to 6 percent by early June In the credit markets, however, yields on German bonds increased by more than yields in the United States These pressures on the German bond market spilled over into the exchanges, as foreigners liquidated some of their mark-denominated assets to limit capital losses In these circumstances, the mark was again under downward pressure and had dropped to DM 2 25 before May 10, when Francois Mitterrand was elected President of France Then a wave of French franc selling pulled the mark and other EMS currencies even lower in the exchanges To maintain the intervention limits of the joint float, the Bundesbank along with the Bank of France sold large amounts of marks against French francs through end-May before tough French exchange controls helped bring the market into better balance The Bundesbank also sold large amounts of dollars in the market to absorb part of the mark liquidity created by the EMS intervention and to moderate the steep fall of the mark against the dollar, which declined further to nearly DM 2 33 by the month end Part of these dollar sales occurred through the agency of the Trading Desk at the Federal Reserve Bank of New York operating on behalf of the Bundesbank However, the Desk did not intervene in the exchanges on behalf of the Federal Reserve or the United States Treasury.

In mid-June, selling pressures on the mark abated By this time, United States economic activity had turned sluggish, inflation figures had improved, and growth of the monetary aggregates moderated In these circumstances, United States interest rates had begun to soften and were widely expected to register sustained declines, thereby narrowing interest differentials adverse to the mark. But the market had become increasingly pessimistic over the outlook for Europe. Major political and security issues were of concern, as underlined by persistent tensions in Poland and by new questions about the framework of Western European relations raised by changes in several governments With respect to Germany, there were open disputes in Germany's governing coalition over a broad range of issues Germany's trade figures had not yet shown much evidence of improved competitiveness resulting from the substantial real depreciation of the mark Consumer price inflation was also accelerating, and there was little prospect for a near-term reduction of price pressures, given the rise in labor compensation negotiated in the spring.

With these various concerns depressing sentiment toward the mark, the German currency weakened still further against the dollar in late June and July, when United States interest rates firmed up rather than declining as expected Continued bearish sentiment toward the mark also hampered progress in financing the current account. For several months, long-term private capital had remained in deficit, although the pace of net outflows had slowed. By June the previous inflow of short-term capital was being reversed. Partly for this reason the Bundesbank announced that German interest rates would remain high and that the growth of central bank money would be held in the lower half of the annual target range. At the same time, the federal government continued to borrow heavily abroad in order to finance the sizable current account deficit, amounting to DM 29 billion at an annual rate in the first six months of the year. Between January and June the public authorities raised about DM 14 billion in foreign credits, with a large share coming directly from Saudi Arabia

During July, as the exchange market focused on fiscal policy developments in Germany relative to those in the United States, the mark came more heavily on offer In Germany, increasing government expenditures threatened to raise the public-sector deficit in 1981 to 4.5 percent of gross national product (GNP) from under 3 percent of GNP only two years earlier Although containing the upward trend in

Table 2

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

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

Bank drawing on Federal Reserve System	Outstanding January 1, 1981	1981 I	1981 II	1981 July	Outstanding July 31, 1981
Bank of Sweden	-0-	+200 0	−200 0	-0-	-0-

Data are on a value-date basis

Table 3

United States Treasury Securities, Foreign Currency Denominated

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

Issues	Amount of commitments January 1, 1981	1981 I	1981 II	1981 July	Amount of commitments July 31, 1981
Public series:					
Germany .	5,233 6	-0-	-0-	-0-	5,233 6
Switzerland	1,203 0	-0-	-0-	−744 5	458 5
Total	6,436 6	-0-	-0-	−744 5	5,692 1

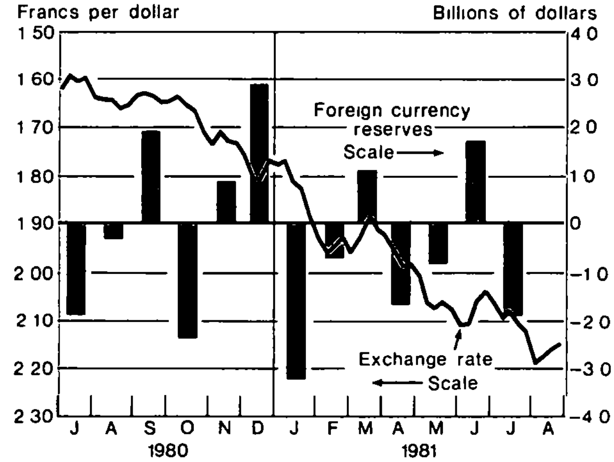
Data are on a value-date basis
Because of rounding, figures may not add to totals

spending had become a priority, measures to reduce expenditures in the 1982 budget were drafted in the midst of heated public debate, raising some questions whether the final budget proposal would be approved by the Parliament Meanwhile, the Reagan administration gained Congressional support for major expenditure cuts and tax reductions, marking an important shift in fiscal policy that was aimed at reducing inflation and providing greater incentives to the private sector. The exchange market assessed the new direction of United States fiscal policy favorably. There were still concerns that defense outlays and tax cuts might in combination swell rather than reduce the budget deficit But growing confidence that the Federal Reserve would keep the growth of bank reserves and the monetary aggregates under firm control helped alleviate inflationary fears and also reinforced expectations that United States interest rates would remain high The market's generally positive reaction to the Reagan administration's economic program, coupled with the attraction of high yields on dollar placements, led to a surge of dollar bidding during July. In these circumstances, the mark dropped sharply lower in frequently heavy trading to DM 2 4770 by the month end for a net 16½ percent decline over the six months under review. Meanwhile, Germany's foreign exchange reserves increased $647 million from February levels to stand at $43 4 billion on July 31, 1981. The rise in reserves mainly reflected sizable intervention purchases of currencies within the EMS after March, mostly French francs but also Belgian francs, which offset intervention sales of dollars in the final months of the period

Chart 4

Switzerland

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

Swiss franc

Coming into 1981 the Swiss economy was continuing to show greater momentum than those of most other industrialized countries At the same time, the pace of consumer price increases had accelerated sharply in response to resilient consumption demand and to the progressive decline in the Swiss franc during much of 1980 The Swiss authorities were anxious to combat these emerging inflationary pressures while mindful of the risks of precipitating a downturn for Switzerland in view of the sluggishness of the international economy As a result, the Swiss National Bank announced it would leave its monetary base growth target for 1981 unchanged from that of 1980 at 4 percent.

At that time, interest rates in Switzerland were well below those in all other major industrial countries, and the differential *vis-à-vis* the United States had again widened to 10 percentage points In response, many corporate entities, governments, and other official agencies borrowed francs domestically or in the Euro-Swiss franc market, where many borrowers had options allowing them to switch loan currency denominations on rollover dates In addition, with developments in Eastern Europe seen in the market as casting a cloud over all the Continent, the Swiss franc had lost some of its traditional attraction as a refuge for capital As a result, inflows of funds were insufficient to offset the buildup of interest-sensitive capital outflows, and during January the Swiss franc continued to weaken both against the dollar and other European currencies. By the beginning of the period, the Swiss franc had declined about 16 percent from its 1980 highs to a three-year low of SF 1 9270 against the dollar and was trading at SF 0.90 against the German mark Swiss foreign exchange reserves stood at $12 1 billion.

On February 3 the National Bank of Switzerland raised its discount and Lombard rates ½ percentage point to 3½ percent and 4½ percent, respectively, the first change in these rates in nearly a year. The actions were taken to support the franc in the exchanges and to adjust official rates to tightening domestic money market conditions But interest rate differentials unfavorable to the Swiss franc remained wide, and the franc continued to decline against a generally strengthening dollar. As the franc eased, the National Bank sold dollars to support the rate but operated in more modest amounts than many other central banks.

Following a change in the administration of Germany's Lombard facility, which precipitated a sharp rise in German money market interest rates, the Swiss National Bank announced a second round of interest rate increases On February 20 the discount and Lombard rates were raised to 4 percent and 5½ percent, respectively, and the National Bank also conducted foreign currency swap operations—its major tool for monetary control—so as to tighten further money market conditions By mid-March, money market rates had risen to about 9 percent, levels not seen since the mid-1970s Also, dollar interest rates eased somewhat and the adverse interest differentials narrowed sharply, helping the franc strengthen in the exchanges to a level of SF 1 8530 on March 18

By this time it had become clear that the Swiss economy, rather than weakening as expected, continued to expand in the first quarter of 1981, in sharp contrast to the sluggishness in Germany and elsewhere. Increases in employment, though slowing from the strong 1980 pace, remained sufficient to enable Switzerland to avoid the rising unemployment so troublesome to many industrial nations. Domestic consumption and construction activity had remained buoyant even in the face of mortgage rates which soared to levels not seen since 1975. These pressures had contributed to an acceleration of the inflation rate to about 6 percent which, though high by historical standards for Switzerland, was nevertheless still among the lowest rates in the world. In the United States the unexpected strength of the economy renewed monetary growth and put considerable upward pressure on dollar interest rates, which was sustained over the remainder of the period. As the dollar again came into demand, the franc fell in the exchanges

With the economy robust, the Swiss authorities had leeway to pursue policies intended to push the inflation rate back down. Beginning in late April and continuing through May, the Swiss National Bank fostered tighter money market conditions by allowing liquidity-providing foreign currency swaps to run off On May 11, the National Bank again raised the discount and Lombard rates, this time to 5 percent and 6½ percent, respectively, and shortly thereafter announced a willingness to see the monetary base fall below its annual target range In response, Swiss interest rates moved even higher, including the politically sensitive mortgage interest rate and other long-term interest rates.

These developments coincided with the presidential elections in France and, as all European currencies initially dropped against the dollar, the Swiss franc fell further to a low of SF 2.0790, down 12 percent from its March highs. Thereafter, however, Switzerland came to be seen as a politically stable and economically sound investment outlet and the Swiss franc began to regain some of the status of a "safe haven" currency. In the context of this improving exchange market psychology, speculative and investment flows turned in favor of the franc. Funds also flowed in from Germany to repay franc borrowings, which had become nearly as expensive as mark credit. Through the end of June the franc firmed slightly against the dollar and climbed against the mark to SF 0 85, thus breaking out of the narrow range around SF 0 90 which had held for about two years.

Through July the franc declined against the dollar in line with other currencies and against the mark, mainly in response to growing market expectations of an EMS realignment that was thought likely to benefit the mark. By the end of the month the franc had declined to SF 2.15 against the dollar and to SF 0.87 against the mark, down about 11¾ percent against the dollar and up 4 percent against the mark for the six-month interval. For the period overall, Swiss foreign currency reserves fluctuated modestly, largely in response to foreign currency swap operations conducted to influence growth of the Swiss monetary base. At the close of the period, Swiss reserves stood at $9.9 billion, down $2.2 billion from the end of January.

On July 27 the United States Treasury redeemed the first maturing tranche of its Swiss franc-denominated securities in the amount of SF 1.2 billion issued in July 1979, with the cooperation of Swiss authorities in connection with the dollar-support program of November 1978. To neutralize the liquidity effects of the note transactions, the Swiss National Bank allowed a portion of maturing foreign currency swaps to run off, thereby absorbing liquidity injected by the retirement of the notes. As a result, the money markets remained generally steady over the month end.

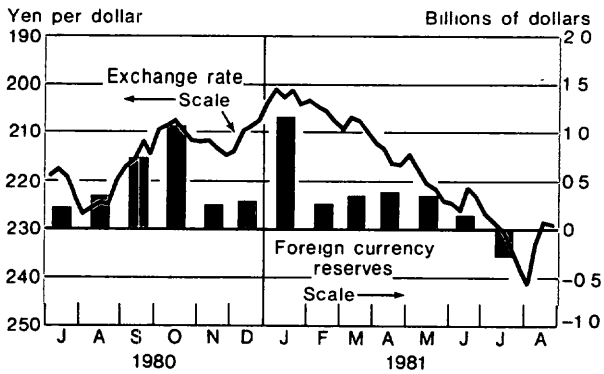
Japanese yen

Early in 1981 the yen continued to benefit in the exchanges from the rapid adjustment of Japan's economy to the second oil shock. Restrictive monetary and fiscal policies had successfully curtailed domestic demand, limited the buildup of inflationary expectations and, together with moderate wage settlements, contained the impact of oil price increases on domestic costs. At the same time, changes in production processes under way since the mid-1970s had made industry less dependent on imported raw materials, particularly oil. These developments, together with the impact of the 1979-80 depreciation of the yen, led to a marked improvement in the current account, which swung from deep deficit to virtual balance. They also impressed international investors sufficiently to attract

Chart 5

Japan

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

massive inflows of funds, particularly from Organization of Petroleum Exporting Countries (OPEC) investors eager to increase the share of yen-denominated assets in their portfolios. As a result, the yen rebounded in the exchanges to ¥ 206.10 in New York on January 31, up 21 percent against the dollar and 27 percent against the German mark from its lows of April 1980. The government proceeded to liberalize substantially exchange controls on international capital transactions. Also, Japan's foreign exchange reserves rose to $22.7 billion by end-January.

Meanwhile, however, domestic demand had stalled and, with the improvement in Japan's external position, the authorities had begun to relax the tight stance of policy after mid-1980. Yet, by early 1981, consumption and residential construction continued to falter and business fixed investment, previously the only domestic source of strength, was also decelerating rapidly. The growth of the monetary aggregates had slowed, and yen money market rates softened. Inflationary pressures had eased, partly reflecting the dampening impact on import prices of the yen's appreciation, so that wholesale price inflation had dropped from a year-on-year rate of 24 percent in the spring of 1980 to about 5 percent in early 1981. Meanwhile, in the exchange market the rising dollar had eroded the yen's earlier buoyancy, but the rate nonetheless remained relatively stable around ¥ 208 through mid-March. Against the currencies on the Continent, the yen held up relatively well even while those currencies benefited from a sharp rise in their interest rates. In these circumstances, domestic pressures on the authorities intensified during February and March to adopt reflationary measures including a reduction of interest rates.

On March 17 the government introduced a fiscal package which accelerated budgeted public-works expenditures and provided low-cost financing to promote housing construction, to aid small companies, and to boost exports of industrial plants. These measures were generally thought to be modest so as not to compromise materially the goals of reducing the budget deficit in the fiscal year ending March 1982 and of easing the burden on the markets of financing the central government's large requirement. At the same time, the Bank of Japan lowered its discount rate 1 percentage point to 6¼ percent for the third cut in less than a year, reduced banks' reserve requirements, and then followed up by substantially relaxing window-guidance ceilings on the growth of bank lending

But the authorities were also concerned that the large interest differentials adverse to the yen might trigger volatile capital outflows. Japan's interest rates were the lowest among the major industrial countries. The liberalization of Japanese exchange controls also provided greater opportunities for capital outflows. Among other things, the Bank of Japan introduced a new lending arrangement similar to the special Lombard facility in Germany, enabling the central bank to charge more than the official discount rate on its lending to commercial banks whenever necessary to counter potentially excessive capital outflows or downward pressures on the yen.

In the event, sentiment toward the yen in the exchanges turned more cautious during the spring. Though market participants were still confident in the thrust of Japan's economic policies and the overall performance of the economy, there were reasons to question whether the rapid improvement in the current account would continue. The likelihood of trade restrictions against Japan's automobile exports dimmed prospects for future export earnings, as did self-imposed export restraints by Japanese manufacturers in industries faced with growing protectionist sentiment abroad. Spreading recession in major overseas markets clouded export prospects even further. Consequently, the trade surplus was thought unlikely to widen sufficiently to cover rising interest payments on nonresident yen deposits and tourism outflows which were significantly boosting Japan's traditional services deficit.

In these circumstances, large interest differentials adverse to yen-denominated assets began to show through. Japanese resident institutions and individuals —already in the process of adjusting to newly liberalized foreign exchange controls—stepped up their export of capital as interest differentials favoring the dollar widened from about 7 percentage points in March to over 11 percentage points in May and early June. In particular, life insurance companies, pension funds, and bank trusts took advantage of access to overseas investments by establishing a presence in the United States capital markets at yields more attractive than those available in Japan As a result, the yen declined along with other major foreign currencies against the dollar, dropping 7¾ percent from mid-March levels to ¥224 by early June

These developments put pressure on Japan's capital markets, complicating the authorities' efforts to bolster domestic growth and to finance the large government deficit at current yields. The authorities were concerned that raising the national bond coupon, a key indicator of overall long-term interest rates in Japan, would lead to higher lending rates throughout the economy. Reluctant therefore to increase new issue rates as rates in the secondary market rose, the government had difficulty arranging the June issue of ten-year bonds and had to withdraw the July issue altogether. In the exchange market, concern developed that these strains in the capital market would spill over into the currency markets, as foreign investors decelerated their purchases of Japanese assets or even began selling off some of their holdings Moreover, the growing perception that the authorities would find it difficult to support the yen by raising Japanese interest rates contributed to a further decline in the yen to ¥228 by end-June

Table 4

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

In millions of dollars

Period	Federal Reserve	United States Treasury: Exchange Stabilization Fund	United States Treasury: General account
First quarter 1981 . .	+ 6.2	− 0 7	−144 3
Second quarter 1981	− 1 4	− 3 8	-0-
July 1981	+ 0 1	-0-	+ 61 6
Valuation profits and losses on outstanding assets and liabilities as of July 31, 1981	−571 1	−1,807 2	+1,313 5

Data are on a value-date basis

These pressures against the yen intensified considerably during July, as the long-awaited decline in United States interest rates failed to materialize With little prospect that large interest differentials adverse to the yen would narrow and that the currency would soon rebound against the dollar, a broad range of participants accelerated their sales of yen in an effort to limit losses At the same time, foreign corporations stepped up short-term yen borrowings to meet financing needs in other currencies, while commercial leads and lags also shifted against the yen As the flow of funds gathered force, the decline of the yen began to outpace the fall of the European currencies against the rapidly strengthening dollar

To cushion the yen's decline, the Bank of Japan intervened in Tokyo substantially on occasion and in New York through this Bank as agent However, Bank of Japan Governor Mayekawa explained that, while intervening to smooth erratic rate movements, the Bank of Japan did not consider it necessary to adopt exceptional measures to stop the yen's slide. The authorities asserted in numerous public statements that the yen had depreciated by more than was justified in terms of economic fundamentals and was therefore likely to move back up over time Consumer price inflation was abating rapidly and, given the moderate outcome of the wage round negotiated in the spring, could be expected to remain the lowest among the major industrial countries. Meanwhile, exports were proving stronger than earlier anticipated, despite negotiated export restrictions and were contributing to a modest surplus on the current account The authorities also noted that short-term bank flows were still positive, even while Japan's long-term capital account had moved into deficit This result largely reflected the fact that the covered cost of borrowing dollars was often less than local yen financing, creating incentives for both Japanese banks and nonbanks to borrow abroad.

But, in the exchange market, the yen continued dropping sharply to close at ¥240 35 on July 31, down 16¾ percent against the dollar over the six-month period under review but unchanged against the German mark on balance. Exchange market intervention by the authorities contributed to a $278 million decline in Japan's foreign exchange reserves during July Nonetheless, at end-July Japan's reserves stood at $23 9 billion, up $1 2 billion on balance, mostly reflecting interest receipts on Japan's reserve holdings

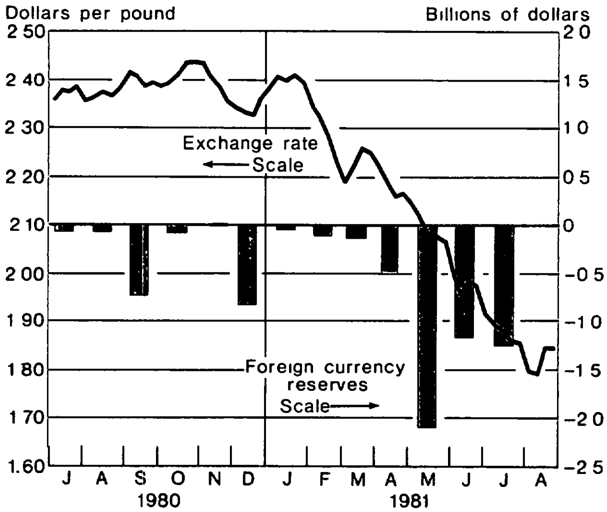
Sterling

By early 1981 the British economy had shown substantial improvements in both price and current account performance. Inflation had fallen back for several months to single-digit rates from the 20 percent or

Chart 6

United Kingdom

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

more level of a year earlier. The current account moved into a surplus of $6.6 billion for 1980, making the year-on-year improvement of $10 billion the largest of any industrial country and in sharp contrast to the general experience. These considerable achievements reflected a continued expansion of North Sea oil exports and an improvement in the nonoil terms of trade. They also reflected a sharp slashing of inventories which was but one feature of the severe recession that had gripped the economy for more than a year. Indeed, with corporate profits squeezed by persistently high interest rates, wages, energy prices, and a strong pound, British companies had also been forced to reduce fixed investment and to lay off workers in order to restore their liquid asset positions Even so, the growth of sterling M-3 remained well above its target range, reflecting the continuing demand for bank credit, the unexpectedly large public-sector borrowing, and the ending of the supplementary special deposit scheme in June 1980. The Bank of England, therefore, kept monetary policy restrictive, and British interest rates had been slow to decline.

Britain's improving external position and relatively high interest rates had combined to push sterling up to a six-year high against the dollar and to rise even further against the Continental currencies. By end-January, however, the pound eased back to trade around $2.3630 against the dollar and was at 104.4, according to a new trade-weighted index adopted by the Bank of England on February 2. Meanwhile, the British authorities had taken advantage of the strength of sterling to repay prior to maturity a number of international loans taken up in the mid-1970s. As a result, British foreign exchange reserves were down from their 1980 highs but still stood at $18.7 billion.

By early February, the pace of capital outflows had accelerated, as United States interest rates had become unexpectedly firm and the dollar was strong generally in the exchanges. Although nonresidents continued to add to their sterling balances, there was increasing evidence that British residents were taking advantage of the elimination of exchange controls to diversify their investment portfolios into other currencies. Moreover, the protracted recession in the United Kingdom was weighing more heavily on market psychology. The persistent strength of sterling had generated bitter complaints from British industrialists over narrowing profit margins and declining product market shares. The rate of unemployment was rising more quickly and headed toward 10 percent. Also, a government decision to modify its plans for closing uneconomic coal mines, following an outburst of strikes by the nation's coal miners, was interpreted in the press as indicating the government's willingness to ease stringent policies aimed at making the economy work more efficiently. As a result, expectations developed in the market that the United Kingdom authorities might take advantage of the improvements both in inflation and in the current account to soften the restrictive policy stance and to provide some stimulus to the domestic economy

Therefore, as the market awaited the March 10 budget, talk circulated that the authorities would cut the minimum lending rate by perhaps as much as 3 to 4 percentage points and allow a downward adjustment in the exchange rate as a means of stimulating economic activity In this environment, the pound eased back against the dollar in line with other European currencies. But after mid-February, when interest rates in a number of other European currencies were sharply increased, commercial leads and lags moved heavily against sterling and some OPEC members shifted funds out of the pound. As a result, by early March the pound broke stride with the currencies of the Continent and fell against the dollar some 8 percent to as low as $2.1750.

For their part the authorities remained concerned over the possibility of a resurgence in monetary growth and inflation and over the persistence of a large public-sector borrowing requirement. In his March 10 budget speech, Chancellor Howe reiterated the government's determination to maintain a restrictive policy stance until inflation came under control and called for increases in indirect taxes to reduce the projected public-sector borrowing requirement by £3 billion to £10½ billion. This tightening of fiscal policy was coupled with a 2 percentage point reduction of the central bank's minimum lending rate to 12 percent per annum as well as with a lowering of the target for sterling M-3 growth to a 6-10 percent annual range. The lowering of the minimum lending rate had already been discounted in the money and exchange markets. After the uncertainties about the budget had been cleared away, sterling moved up along with other European currencies as United States interest rates eased back from earlier highs. Thus, the pound recovered to $2.2960 around mid-March on a reflow of capital and a reversal of previously adverse commercial leads and lags. Against the dollar, sterling was a net 3 percent lower from end-January levels Against other European currencies, it was also lower by about 7 percent, so that in effective terms the pound was trading about 100.2, a decline of 4 percent.

By April, British interest rates had settled around levels similar to those in Germany. Anecdotal information suggested that the economy was leveling off. But actual economic and financial trends were unusually difficult to monitor. A civil servants' strike had the effect both of delaying tax payments to the Exchequer and of impeding the collection of key trade and financial statistics. The Bank of England was proceeding with its plans to change operating techniques for monetary control so as to increase the role of market forces in determining short-term interest rates. And, as each step of the process was announced, the markets were somewhat unsure of the near-term implications The pound eased along with other currencies against the dollar throughout the spring. By late May, it was about 10 percent lower at around $2 07. In effective terms, it was trading at 98.8

During June the focus of market attention shifted to sterling For some time, the energy situation had shielded the pound from a number of adverse factors. These included Britain's loss of competitiveness arising from earlier high rates of inflation and a strong exchange rate, a seriously deteriorating economy, and a weakening of political support for the government's continuing restrictive policies Thus, when an increasing oversupply of oil internationally prompted a significant cut in the price of North Sea crude, an important element of favorable market psychology was shattered and the vulnerability of sterling began to show through.

The pound, therefore, came under heavy selling pressure during June and July, dropping through the psychologically important level of $2.00. Market participants were doubtful that the government would support the rate through a large increase in interest rates in view of the continuing recession. Talk circulated in the markets that exchange controls might be reimposed, prompting even further selling of sterling.

Thereafter, sterling stabilized, as British interest rates rose after the Bank of England began providing funds to the money market above rather than at the minimum lending rate. Also, following the resolution of the civil servants' strike, a pickup in tax collections was expected to tighten liquidity even more. The abatement of civil disturbances gave an additional lift, while Prime Minister Thatcher's proposal of a modest spending program to encourage private-sector hiring of young people was not viewed as a significant departure from past restrictive policies and thus tended to reassure the exchange markets. As a result, sterling traded around $1 84 on July 31 for an overall decline of 22¼ percent against the dollar for the six-month period. In effective terms, the pound declined 11¼ percent to 92 5 at the end of July.

Meanwhile, over the six-month period the Bank of England maintained its policy of intervening lightly on both sides of the market to smooth out sharp fluctuations in the rate. Accordingly, during the period under review, the United Kingdom external reserves were affected mainly by the repayment and prepayment of loans Britain's foreign exchange reserves declined $5 1 billion over the six-month period to $13 6 billion on July 31.

French franc

By the beginning of the period under review, the French economy had moved into a recession that was to prove deeper and more protracted than many of the slowdowns then taking place elsewhere on the Continent. Industrial production was down 10 percent from the level of the previous year, and unemployment had risen in line with the growth of the labor force to 7.3 percent. At the same time, the sharp increase in oil prices of recent years and lagging productivity growth had contributed to a weakening of France's external position and a worrisome deterioration in its price performance. France's current account had swung back into a deficit of $7 billion, and inflation had accelerated above the two-digit level once more to a rate of 13 percent.

Faced with these setbacks to the five-year program of economic stabilization, the French authorities remained committed to the priorities of curbing inflation and maintaining the strength of the French franc. Whatever stimulus that had been provided to the economy in 1980 and again in late February 1981 was modest in size and was intended to contribute eventually to export competitiveness Monetary policy remained restrictive. The Bank of France had reduced its growth target for M-2 for 1981 to 10 percent, and the already tight limits on banks' credit growth were lowered 1 percentage point on average Interest rates in France remained high relative to interest rates in most other countries on the Continent In addition, the government continued to encourage large enterprises in France to take advantage of capital markets abroad to finance on a long-term basis large investment projects at home

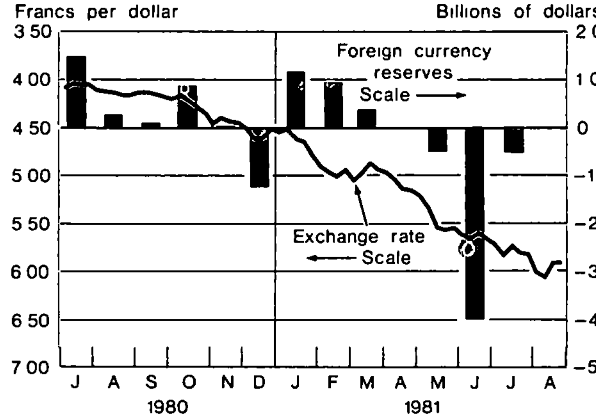
In the exchange markets, the current account deficit continued to be more than offset by capital inflows, reflecting the attraction of interest-sensitive funds from abroad and efforts of domestic residents to meet local financing needs in foreign currencies In addition, the market's attitude toward the French franc was generally more positive than for other European currencies France's current account deficit, though a source of concern, was considerably smaller than for Germany, its principal trading partner. The government's fiscal deficit, though greater than the preceding year, was only 1½ percent of overall GNP, so that financing the deficit was not as much of a burden as in many other countries France's traditionally good relations with Middle Eastern countries were generally thought in the market to make it easier for France to attract funds from investors seeking an alternative to the dollar These long-standing ties were also thought to help protect the nation from short-run disruptions in oil supplies, while France's commitment to the development of nuclear energy was seen as providing a more secure energy source in the longer run. Moreover, with the approach of presidential elections later in the spring, market participants believed that the government would take extraordinary steps if necessary to bolster the franc should it come under selling pressure. Meanwhile, France's foreign exchange reserves had swelled to an impressive $26 5 billion by January 31.

In this positive psychological climate, the franc had traded at or near the top of the EMS for almost two years, even as it declined against the generally rising dollar to FF 4 90 by end-January. Early in February, the franc continued to decline more slowly against the dollar than did the other EMS currencies, falling some 4½ percent to FF 5.1150 by midmonth Within the EMS, it remained at its upper intervention limit and the French, German, and Belgian central banks intervened to keep the franc within its 2¼ percent band. In late February, however, the French franc fell below the German mark in the EMS following action by the Bundesbank to raise interest rates

Chart 7

France

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

in Germany. With French interest rates increasing not as rapidly as elsewhere, funds shifted out of francs and commercial leads and lags swung from francs to marks Thus, by early March the franc had settled about ¼ percent below the mark in the EMS Against the dollar, it fluctuated in line with other European currencies, recovering by the end of March to early-February levels Nevertheless, France's foreign exchange reserves continued to strengthen, rising $1.3 billion over February-March to $27 8 billion reflecting in part intervention within the EMS.

Within France, the performance of the economy was becoming a matter of increasing public debate. Output had stabilized, but there was little evidence of an upturn. Unemployment was rising even more rapidly than before Inflation remained high. And the current account deficit showed no sign of narrowing. In the exchange markets the franc continued to be bolstered by relatively high nominal interest rates through mid-April. Thereafter, as the electoral contest went through the first round of a two-stage voting procedure and forecasters indicated that the outcome would be close, some international investors began moving funds out of the franc. But, with the Bank of France now intervening to keep the franc from slipping within the EMS, the rate continued to hold steady against the mark In this manner, the franc declined 8¼ percent against the dollar to FF 5.3950 by May 8, just prior to the second round of voting

Mitterrand's election came as a surprise to the exchange markets. With the Paris stock market plummeting, massive amounts of funds began to be moved out of the franc. These flows largely took the form of commercial leads and lags but also represented withdrawals of deposits and liquidations of investments. These selling pressures quickly pushed the franc from the middle to the floor of the joint float and to FF 5.5875 against the dollar late in May.

The authorities responded quickly to contain these selling pressures. The Bank of France intervened heavily to keep the franc within its 2¼ percent band against the mark. Effective May 14, the central bank raised reserve requirements on sight deposits and eliminated the special reserve requirement on nonresident deposits that had been imposed to curtail capital inflows late in 1980. Also, it raised the discount rate on seven-day Treasury bills by 4½ percentage points to 18 percent, while day-to-day rates in the money market jumped from 13½ percent to 16 percent At the same time, leading economic advisers to the new president reaffirmed France's commitment to the EMS arrangements

Once in office the new government took further action to stabilize the franc by tightening exchange controls. With respect to trade financing, it reduced the scope for leading and lagging commercial payments and receipts to one calendar month (retroactive to May 1) Regarding portfolio investment in foreign currencies, residents were required as of May 22 to purchase the exchange from other residents, thereby establishing a separate market for these transactions and removing them as a source of pressure on the exchange rate For its part, the Bank of France hiked its discount rate on seven-day Treasury bills another 4½ percentage points to 22 percent and day-to-day interest rates moved up as high as 20 percent.

In response to these stringent moves, the franc came into demand as exporters scrambled to convert foreign-currency receipts ahead of the month end. By end-May, therefore, the franc was off its lows against both the mark and the dollar. Thereafter, the new exchange control measures were expected to generate a continuing reversal of leads and lags well into the summer. Also, the tightening of credit conditions and the sharp rise in Euro-French franc interest rates to around 25 percent helped discourage nonresident outflows. Thus, the franc soon settled in around the middle of the EMS, a position it was generally to maintain through end-July.

As a result, the franc traded comfortably within the EMS during the June 21 Parliamentary elections that provided a sufficient majority to the new government to implement its economic program. By July, the authorities were proceeding with their program to reduce unemployment by expanding the economy and increasing its productive potential, while also carrying through a long-standing plan to nationalize key sectors of the economy. In particular, they announced plans to increase social benefit expenditures, raised the minimum wage, and announced plans for new education, housing, and industrial retraining programs. Even with tax increases to generate more revenue, the fiscal deficit was expected to double for 1981. The government also moved forward with plans to nationalize eleven industrial groups. Commercial bank lending ceilings were raised and minimum reserve requirements lowered to allow greater expansion of bank lending.

With the exchange markets now more settled, the Bank of France was also able to permit short-term interest rates to decline gradually, so that by end-July the central bank's discount rate on seven-day Treasury bills was down to 18½ percent and day-to-day rates had eased to 17¾ percent. Even so, the market remained pessimistic over the outlook for the franc, since France had adopted strongly stimulative policies while other countries were still emphasizing restraint. With the dollar rising across the board, the franc eased by the month end to FF 5.8775, down 20 percent on balance for the six-month period. Even within the EMS the market found reason to contrast the recent reflationary measures of the French government with the budget-cutting efforts taking place in Germany, especially after the Ottawa summit Even so, the franc held its own around the middle of the joint band to close the period trading at FF 2.3728 against the German mark, down 3¼ percent on balance over the six-month period. Meanwhile, France's foreign exchange reserves, which had dropped $4 5 billion during May-June, declined only another $558 million to $22.6 billion, to register a net decline of $3.8 billion over the February-July period.

Italian lira

The Italian lira was under considerable downward pressure coming into the period as the market responded to a swing in Italy's current account back into heavy deficit, the persistence of relatively high inflation at home, and the lack of progress in containing government expenditures and curbing the public-sector deficit. The $15 billion deterioration in Italy's current account over 1980 to a $10 billion deficit had reflected in part an adverse turn in Italy's terms of trade resulting from the sharp increase in dollar prices for energy and other imported products. It reflected as well the weakening demand in Italy's principal export markets In addition, the rapid pace of inflation, at 20 percent by late 1980, had brought into question the competitiveness of Italy's export sector, especially in those countries participating in the fixed exchange rate arrangements of the EMS Moreover, the large and growing public-sector deficit that amounted to 11 percent of gross domestic product (GDP) further clouded the prospect for reducing inflationary pressures in the near term That deficit reflected a number of deep-seated problems including the high level of wage settlements, the pervasiveness of a wage indexation system, and the lagging productivity growth and weakening capital structure of Italy's large government-enterprise sector.

These problems had come into focus early in 1981 in the absence of progress in improving price or trade performance at a time when industrial output had rebounded from earlier depressed levels The government had proposed a medium-term program intended to cut current spending, to stimulate investment, and to finance the increased investment spending abroad But the pace of public spending had quickened and monetary growth had accelerated In this environment, the lira had fallen against the dollar to a record low in New York trading of LIT 1,004 50 by the end of January Within the EMS, the lira had required steady intervention support by the Bank of Italy to hold its position. Even so, Italy's foreign currency reserves stood at a relatively high $20 5 billion

Meanwhile, the task of controlling inflation and supporting the lira in the exchanges had fallen on the Bank of Italy, which acted on January 31 to tighten control over expansion of money and credit Ceilings on bank lending were extended to include loans under LIT 130 million and foreign currency loans, both previously excluded from limitation The new ceilings were made effective March 31, at which time loans coming under the new controls were to be reduced to end-December levels and then subject to a new and lower set of growth limits for the remainder of the year Credit extensions above the limits were made subject to a 50 percent deposit requirement in non-interest-bearing accounts at the central bank As before, foreign currency loans to exporters were excluded These actions improved exchange market sentiment toward the lira early in February. Though the lira eased against the dollar, which was strengthening at the time, it kept generally in line with other currencies in the EMS.

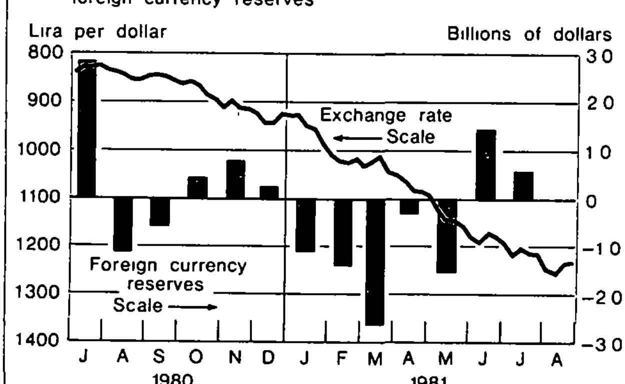
During February, however, the most recent information suggested a further widening of the trade and current account deficits and intensification of domestic inflationary pressures As a result, the lira failed to recover late in the month by as much as the currencies of other Continental countries, which were being bid up in response to sharp increases in short-term interest rates in their domestic markets By mid-March the lira had slipped nearly 4 percent against the German mark and was thus requiring intervention support to hold its position within the EMS As the March 31 deadline approached for cutting back on foreign currency loans under the new credit ceilings, importers and other residents came into the market as buyers of foreign currency These transactions added to the pressure against the lira, which fell through Italy's divergence threshold within the EMS even as the Bank of Italy stepped up its intervention support. These operations contributed to a $4 billion decline in Italy's foreign currency reserves during February-March

In response to these exchange market pressures, a series of actions were taken to support the lira over the weekend of March 21-22 They included a 6 percent downward adjustment of the lira's central rate within the EMS, which was reflected in the market by a 2½ percent depreciation against the dollar Also, to absorb liquidity the Bank of Italy hiked reserve requirements from 15¾ percent to 20 percent above end-February levels on both resident and nonresident lira-denominated bank deposits It also raised the discount rate by 2½ percentage points to 19 percent, the first change in this rate since September 29, 1980 In addition, the government announced its intention to propose measures to Parliament to offset the potential effect on the government deficit of several budgetary amendments passed by Parliament in preceding weeks The proposals focused on cuts in current

Chart 8

Italy

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

spending in line with those announced during the winter which, when approved by Parliament, would be sufficient to bring the projected 1981 government deficit back to the LIT 37.5 trillion level originally envisaged.

After these measures and as a result of its new EMS parity, the lira moved from the bottom to near the top among the EMS currencies. Also, the expansion of money and credit began to slow in response to the tightening of monetary policy. Skepticism remained, however, over the fiscal situation. As a result, the lira soon began to ease toward the middle of the EMS and the Bank of Italy intervened on occasion to limit any slippage.

During April and May, as United States interest rates had again turned higher, short-term funds were drawn increasingly from Italy. Thus, the lira became more vulnerable to downward pressure. Moreover, at home Italy's inflation problem had again become a major focus of public debate. Exchange market participants took note that the Parliament had not yet acted on either the short-term austerity measures proposed by the government in March or the three-year program under discussion for months. In addition, a major political controversy diverted attention away from economic matters. When it reached a crisis in late May that brought down the Forlani government, any chance of near-term action on policy initiatives evaporated. Moreover, by end-May, Italy's foreign exchange reserves had dropped a further $2 billion to $14.5 billion.

To address the immediate pressures in the exchange and financial markets, the Forlani government—acting in a caretaker capacity—imposed an austerity program by decree that included increases in certain public charges and cuts of 5 to 10 percent in some categories of government spending. These actions were intended to reduce the government deficit by about 7½ percent in 1981 if approved by Parliament within sixty days. The government simultaneously imposed an import deposit scheme, also by decree, which required that all purchasers of foreign exchange place with the Bank of Italy a ninety-day, noninterest-bearing deposit equal to 30 percent of the exchange transaction. These deposits had the effect of increasing the cost of payments in foreign currency as well as cutting into credit available for domestic purposes.

After these actions, the lira traded more comfortably within the EMS, enabling the Bank of Italy progressively to scale back its intervention support of the currency. Against the dollar, the lira continued to decline but, in contrast to preceding months, no more rapidly than other Continental currencies. During July the formation of a new government under the Republican Giovanni Spadolini and the onset of seasonal inflows from tourism gave additional support to the lira. The Bank of Italy then became a sizable net buyer of dollars for the first time during the period under review. By the end of July, the lira was trading at LIT 1,227.50, down on balance 22¼ percent against the dollar and down 5 percent against the German mark. Meanwhile, Italy's foreign currency reserves rose $2.0 billion after end-May to $16.5 billion at end-July for a $4.0 billion decline over the six-month period under review.

Other currencies within the European Monetary System

In early 1981 the countries whose currencies are members of the EMS joint floating arrangement faced similar problems. Most were dependent on capital inflows to finance current account deficits. Fiscal deficits had grown and were exerting increasing strains on domestic capital markets, and inflationary pressures appeared to be accelerating even as the domestic economies were weakening. Although monetary policies were generally restrictive, slowdowns in the domestic economies and rising unemployment were seen in the market as constraining the authorities from increasing interest rates further to maintain the currencies' attractiveness to international investors and portfolio managers. Some countries had been able to attract substantial amounts of private funds, and others looked to government-arranged loans from abroad as a means of achieving external balance and stabilizing their currencies within the joint float. But, in either case, the EMS currencies were vulnerable to capital outflows attracted by relatively high interest rates in other countries and to an increasingly bullish sentiment toward the dollar. As a result, these currencies were continuing to decline as the six-month period under review opened.

Within the EMS, there were also considerable strains and the 2¼ percent band for all but the Italian lira was fully stretched. Requiring persistent support at the bottom of the band was the Belgian franc, along with the German mark. The Belgian franc was weighed down by concern over a domestic economy that was undergoing difficult structural adjustment, experiencing rising unemployment, and suffering from a fiscal deficit that had mounted to more than 10 percent of GNP. The current account deficit also was large, and both deficits were being financed to a large extent through government-arranged loans denominated mostly in dollars and other Eurocurrencies. Close behind the French franc at the top of the band was the Dutch guilder. It was helped by the relatively favorable current account position of the Netherlands and interest rates that were high enough to continue to attract nonresident investment in long-term guilder-denominated bonds. The Danish krone and Irish pound fluctuated around the middle of the band, and the Danish and Irish authorities relied heavily on conversions of foreign borrowings to keep their currencies trading comfortably within the joint float.

This configuration of currencies changed abruptly in mid-February, when the German authorities reacted to intensifying selling pressure against their currency by tightening monetary policy. German interest rates rose considerably, especially rates on call money, and the mark snapped up within the EMS, rising from the bottom to the top of the joint float. As the mark advanced within the EMS, the French franc and Dutch guilder came under modest selling pressure against the mark. But these pressures were soon contained, and the currencies stayed in the upper half of the European Community (EC) band after the Bank of France and the Netherlands Bank, following quickly on the Bundesbank's measures, raised their own interest rates by 1 to 1½ percentage points. The Danish krone and the Irish pound eased into the lower half of the joint float but were kept from falling further by modest intervention.

This changing configuration of currencies within the EMS left the Belgian franc all the more exposed at the bottom of the joint float. Belgium's fiscal and current account deficits continued to deteriorate. The authorities were reluctant to raise domestic interest rates because the economy was still weak and labor unrest was already festering in some of the most depressed industries. The coalition government was having difficulty agreeing on a program of expenditure cuts and other measures to reduce the fiscal deficit. And the prolonged negotiations on economic policy were casting doubt in the exchange markets about the government's ability to deal with the country's economic problems.

Against this background, the Belgian franc remained pinned to its lower intervention point as the EMS group of currencies gained against the dollar late in February. In March, following a downward adjustment of the Italian lira which put it in the upper half of its new band, the franc was exposed to even greater selling pressure. Heavy support had to be provided for the Belgian franc mainly by sales of German marks and French francs. The Belgian National Bank increased its official lending rates in stages over the month. By March 26, its discount rate was up 1 percentage point to 13 percent and its Lombard rate was up 3 percentage points to 15 percent. Also during the month, the government announced parts of its program to cut the fiscal deficit by BF 30 billion. However, the pressures against the Belgian franc remained intense as continuing shifts in commercial leads and lags aggravated the exchange market impact of the large current account deficit. On March 30 the government resigned, and immediately thereafter the National Bank hiked its discount and Lombard rates another 3 percentage points. It also imposed measures to ensure that financial institutions would not restore their liquidity by unloading government debt and would not add to outflows of capital by extending credits to the private sector. To restore confidence in the franc, a one-month freeze on wholesale and retail prices was imposed effective April 2. These new initiatives helped ease the immediate pressures against the Belgian franc.

During April and early May, trading became more comfortable within the EMS, which nevertheless declined progressively against a generally strengthening dollar. The mark remained at the top of the band, providing the Bundesbank an opportunity to improve its position within FECOM by acquiring small amounts of other EMS currencies in the market and by having its currency used in intervention to support other EMS currencies. The Belgian franc gradually came into better balance, moving off the floor of the EMS in a favorable reaction to the recent tightening of monetary policy. The Dutch guilder, by contrast, declined into the middle of the band as the market reacted to the failure of Dutch interest rates to keep pace with those abroad and to uncertainties ahead of Parliamentary elections. The Danish krone also eased slightly within the joint float, while the Irish pound stayed near the bottom of the band. Intervention by the central banks of Belgium, the Netherlands, Denmark, and Ireland was modest and conducted mostly in dollars to stabilize the position of their currencies in the EMS. As the French presidential elections moved through the first round of balloting, by contrast, official purchases of francs against both marks and dollars became heavy as the Bank of France acted to steady the franc in the middle of the joint float.

Later in May, the announcement of Mitterrand's victory in the French presidential elections brought the French franc under immediate pressure in the EMS and generated skepticism in the market over the commitment of a new French government to the EMS institutions. The French authorities soon acted to support their currency by tightening exchange controls and by raising interest rates sufficiently to trigger some reversal of leads and lags. In addition, to reassure the markets, both President Mitterrand and Chancellor Schmidt publicly reaffirmed their intention to cooperate in upholding the EMS arrangements. Meanwhile, the Dutch guilder, aided by fairly moderate but persistent intervention by the Netherlands Bank, managed to maintain its position in the upper half of the joint float.

Also, the Danish krone and the Irish pound remained stable within the EMS.

During June and July the Belgian franc came under renewed selling pressure as the market reacted to a progressive lowering of domestic interest rates and to the new government's lack of progress in reducing the fiscal deficit. The central banks met this pressure with forceful intervention, however, and by late July the franc had stabilized within its EMS band Nevertheless, the market remained concerned about the prospects for EMS countries, individually and collectively With sentiment toward the dollar becoming increasingly bullish during the summer, the EMS currencies as a group weakened further. By the end of July, the EMS currencies had declined against the dollar by 16¼ percent to 22¼ percent on balance over the six-month period.

Canadian dollar

The Canadian government sought to harness Canada's rich natural resources to generate higher economic growth and to curb the deeply entrenched inflationary pressures. Its plans for achieving these objectives were embodied in proposals submitted late last year to Parliament for the 1981 budget and for a national energy program According to the budget, the federal deficit would be substantially reduced over several years with cuts, among other things, in transfers to the provinces in the context of the next federal-provincial review of financial arrangements in 1982. The largest contribution to cuts in the fiscal deficit, however, came from changes in taxation and subsidies proposed in the energy program. According to the proposed energy program, the federal government would unilaterally establish a single price for crude oil at levels, though higher than before, still well below international levels. Unification of domestic and imported crude oil prices would be achieved through new levies and a gradual elimination of the direct government subsidy on imported oil. Incentives for exploration and development would be provided in amounts varying largely with the degree of Canadian ownership and control of the enterprises concerned. A federal tax on oil and gas revenues, together with the increased levies, would considerably increase federal revenues.

In the exchanges, market participants questioned whether adequate incentives would remain to maintain the momentum of exploration and development and to continue to attract the sizable inflow of investment from abroad that had buoyed the currency over previous years. In addition, the pricing and revenue provisions, together with other elements of the budget, raised complex issues about the relationship between the federal and provincial governments. Late in the year, the Canadian dollar had come under selling pressure in the exchange markets, dropping to its lowest levels since the 1930s. The Bank of Canada had responded forcefully to these selling pressures by intervening heavily to cushion the Canadian dollar's decline and by raising short-term interest rates. As a result, the market had come into better balance and the spot rate had recovered somewhat. It was still trading, however, not far above its recent lows at Can.$1.1948 by the end of January. Meanwhile, Canada's foreign currency reserves stood at $1.4 billion, and the government of Canada's outstanding borrowings under its $3.0 billion credit line with foreign banks amounted to $300 million. Its $2 5 billion credit line with Canadian chartered banks remained fully available. (The latter credit line was increased to $3 5 billion in June 1981.)

By February a more positive attitude developed for the Canadian dollar. Canada's trade position had benefited from earlier shifts in the terms of trade and an improved competitive position. The trade surplus had climbed to an annual rate of $10 billion in the last quarter of 1980, swinging the current account into an uncharacteristic surplus at a time when most industrialized countries were in deep current account deficit. Also, the Canadian economy was particularly buoyant late in 1980, led by expanding exports. This pickup in activity contrasted with the developing slowdown in much of Europe and Japan.

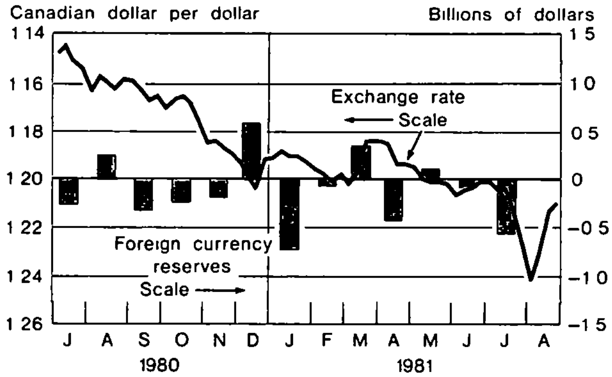
The unexpected pickup in economic activity and ensuing resurgence in M-1 provided the basis for the monetary authorities to put upward pressure on short-term interest rates. In addition, the persistently high level of interest rates in the United States and the potential for interest-sensitive outflows to put renewed selling pressure on the Canadian dollar, and thereby to exacerbate the inflationary situation, suggested the desirability of allowing Canadian interest rates to move gradually higher Thus, Canadian interest rates continued to increase in early March, even as United States interest rates subsequently edged lower, so that the usual pattern of interest rate differentials favorable to Canada was reestablished. Also, on February 13, the Bank of Canada, in announcing its monetary growth targets for the new year, cut the 1981 range for M-1 expansion 1 percentage point to 4-8 percent.

In response to these various factors, the Canadian dollar strengthened in the exchanges by about 1½ percent to around Can.$1.1783 by mid-March. The Bank of Canada, continuing to intervene to moderate short-run fluctuations in the currency, was a net purchaser of dollars in the exchanges, as is reflected in the

Chart 9

Canada

Movements in exchange rate and official foreign currency reserves

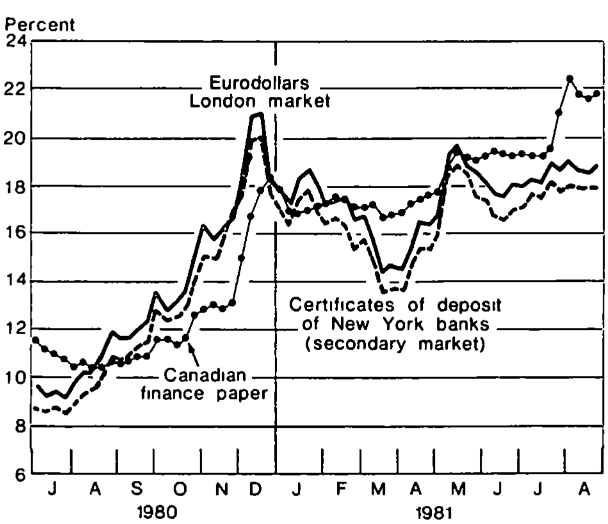


See exchange rate footnote on Chart 3

Chart 10

Interest Rates in the United States, Canada, and the Eurodollar Market

Three-month maturities*



*Weekly averages of daily rates

$378 million increase in foreign exchange reserves during February-March.

During the second quarter, however, the outlook for the Canadian dollar became more guarded. Negotiations to resolve disagreements over pricing of oil and gas were dragging on without clear results Pending resolution of these issues, the principal energy-producing province of Alberta had started to cut back oil production and these cutbacks were leading to a previously unexpected increase in Canada's oil-import bill as well as clouding prospects for the anticipated increase in federal government revenues Also, in the context of a federal government proposal to repatriate the Canadian constitution, a number of issues relating to the relationship between the federal and provincial governments were being reviewed by the courts Meanwhile, a first-quarter slackening of export demand, particularly to the United States, had cut into Canada's trade surplus, and the current account appeared to be returning to deficit Moreover, domestic inflation had accelerated, spurred partly by increases in energy prices, and the consumer price index was now rising at an annual rate in excess of 12 percent Also, wage settlements had failed to moderate, a number of industries were being hit by labor strikes, and difficult wage negotiations were approaching Partly for domestic reasons and partly in response to a renewed rise in United States interest rates, the Bank of Canada allowed Canadian rates to move up further. Initially, however, Canadian interest rates did not keep pace with those in the United States so that by mid-April the previously favorable interest differentials had eroded Thus, the Canadian dollar eased against the rapidly rising United States dollar through the spring But it continued to move higher against the other currencies which were weakening more rapidly against the United States currency

Nevertheless, Canada had headed back toward its traditional pattern of current account deficit financed by capital inflows. Canadian entities had significantly stepped up their borrowing activities in the United States. With the Canadian dollar still close to its historic lows against the United States dollar and with the monetary authorities having demonstrated determination to defend the rate, many borrowers took advantage of the relatively firm United States currency to borrow abroad and convert the proceeds to finance domestic needs At the same time, however, Canadian residents sought to make direct and portfolio investments abroad, both in the energy sector to take advantage of more rapid price increases than permitted at home and in other natural resource industries Canadian investors were also purchasing foreign-owned assets in Canada. In this connection, a few foreign-owned companies in Canada became targets of unsolicited takeover bids, and widely publicized fights for control drew attention to the impact of the new pricing and tax provisions favoring Canadian ownership in the energy sector. As market participants considered the implications for capital flows and debt servicing requirements of shifting ownership of the natural resource industries to Canadian ownership, the Canadian dollar became increasingly vulnerable in the exchanges.

Indeed, in July the Canadian dollar came under extreme downward pressure in a selling wave that was precipitated by a few large commercial orders. Once the decline began, market participants focused their attention on other factors that were also adverse for the Canadian dollar. With the United States dollar rising sharply against other currencies at the same time, the Canadian dollar fell further. To steady the market, the Bank of Canada bought Canadian dollars heavily in the market. It financed its intervention, in part, by drawing $700 million under its $3.0 billion facility with foreign banks, leaving its $3.5 billion standby facility with the Canadian chartered banks fully in place. Also, to support the exchange rate, the Bank of Canada moved to push interest rates sharply higher, and by the close of the period the rate on three-month Treasury bills had climbed to slightly over 20 percent, the highest in years. On July 29 the Ministry of Finance announced that it had obtained agreement from the major Canadian banks to curb loans to finance takeovers of foreign companies. This action helped bring the Canadian dollar market into better balance after the period under review. But in the interim the Canadian dollar dropped lower to Can.$1.2344, registering a decline of 3¼ percent for the six months between end-January and end-July. Also, at end-July, Canadian reserves stood at $748 million, down $600 million on balance.