August 1983-January 1984 Semiannual Report
(This report was released to the Congress and to the press on March 7, 1984.)

Treasury and Federal Reserve Foreign Exchange Operations

During the period from August 1983 through January 1984, the dollar rose strongly on balance against the European currencies but was little changed against the Japanese yen. As the period began, the dollar was moving sharply higher and reached a 9½-year high against the German mark in mid-August. The dollar then declined gradually through early October, before it gained renewed strength and surpassed its earlier highs, ending the period 5 to 9 percent higher on balance against the European currencies.

At the beginning of August the U.S. economy was recovering more vigorously and inflation declining more rapidly than expected by many observers. At the same time, the U.S. authorities were perceived as willing to allow the demand pressures to be reflected in higher interest rates. In many other industrial countries, by contrast, economic recovery was more modest, unemployment was near peak levels or declining only slowly, and the monetary authorities were perceived as reluctant to tighten monetary policies. Under these circumstances, the dollar was quickly bid higher in unsettled trading as the reporting period opened. The U.S. monetary authorities and foreign central banks intervened in coordinated operations during one limited period, which helped restore order in the market.

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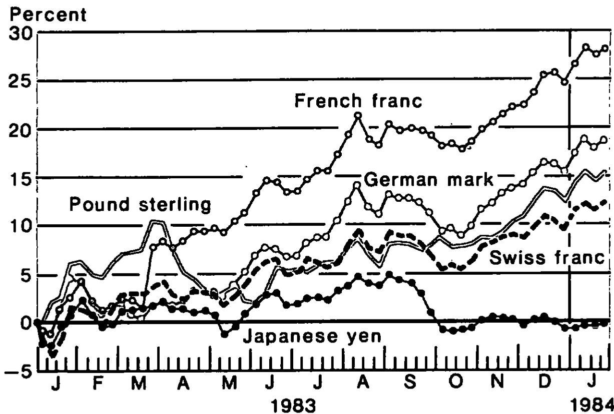
Market participants soon began to question whether the dollar could maintain the high levels reached in early August. New data pointed to a considerable slowing of economic growth in the United States, and evidence suggested that upward pressure on U.S. interest rates might be dissipating. M-1 growth had also decelerated and the inflation rate remained low, leaving market participants with little reason to expect a firming in interest rates and some room to hope for an easing. Moreover, private credit demands were appearing less strong than expected just months before, and estimates of the government's quarterly financing needs were revised downward. These developments triggered a rally in U.S. credit markets, with short-term interest rates dropping about 1 percentage point by early October. They also were seen as increasing the scope for monetary authorities abroad to take a more accommodative policy stance, without risking the inflationary impact of a depreciating currency. Under these circumstances the dollar declined through October 7, about 4½ percent on a trade-weighted basis and about 6½ percent against the German mark from its August peaks.

In early October, however, it became clear that U.S. growth had remained strong in the third quarter. Consequently, projections of the GNP gain for the full year—by both the Administration and market participants—were revised upward as much as a percentage point from those made as recently as July. The evidence of robust growth quickly stopped the decline in U.S. interest rates and again overshadowed the more modest economic recoveries of several European countries. The U.S. expansion once again became more evident,

Chart 1

The Dollar against Selected Foreign Currencies

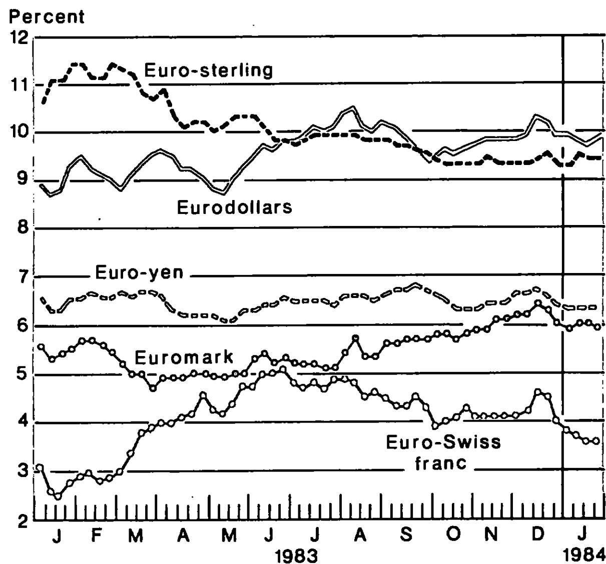


Percentage change of weekly average bid rates for dollars from the average rate for the week of December 27-31, 1982. Figures calculated from New York noon quotations.

Chart 2

Selected Interest Rates

Three-month maturities*



*Weekly averages of daily rates.

encouraging expectations of rising private credit demand. At the same time, market concern grew over the lack of action to reduce current and prospective fiscal deficits and, by mid-December, short-term interest rates had moved back up near the levels of early August.

In addition, optimism spread that the U.S. economy might be on the threshold of a lengthy period of strong but noninflationary expansion, with high productivity growth. The unemployment rate plummeted. Many attributed aggressive business hiring programs to growing confidence that earlier efforts to deregulate the economy, improve labor market flexibility, and adjust the corporate tax structure to spur investment were all beginning to bear fruit. In this environment the dollar developed upward momentum in the exchanges, climbing with each new economic statistic that suggested stronger expansion. There were also reports of substantial foreign interest in U.S. investments, based on expectations of improving corporate profits and yields on equity investments, as well as the continued attraction of comparatively high yields on fixed-income securities. As a result, the exchange markets showed little reaction to projections for the 1983 current account deficit of roughly $40 billion.

The dollar also benefited from "safe haven" considerations prompted by events that heightened international tensions, such as intensified fighting in Lebanon and escalation of threats in the Iran/Iraq conflict. Episodes of increased political and financial uncertainty in Europe also led to bidding for dollars.

After mid-December, U.S. interest rates eased off but only slightly. The dollar dipped briefly toward the year-end but then resumed its climb. It hit a ten-year high of DM 2.8505 against the mark on January 10 and set records against most other European currencies before again easing back somewhat by the close of the period.

Over the six-month period, the U.S. authorities intervened in the exchange markets on five occasions to calm disorderly markets. Two of these occasions were described in previous reports. The first of these involved operations on four business days between July 29 and August 5, which were coordinated with foreign monetary authorities. The U.S. authorities purchased $182.6 million equivalent of German marks and $71.5 million equivalent of Japanese yen during that period. The second occurred on October 31 and November 1 when the U.S. authorities entered the market to purchase a total of $29.6 million equivalent of Japanese yen. The remaining three instances, one in December and two in early January, involved purchases of German marks and totaled $193.4 million equivalent. All intervention during the six-month interval was split evenly between the Federal Reserve and the Treasury.

In other operations during the six-month period, Mexico fully repaid the remaining portion of its special combined credit facility. As noted in a previous report, Mexico prepaid on August 15 outstanding swaps of $100.8 million to the Treasury and $54.3 million to the Federal Reserve. Drawings of $395.3 million and $214.8 million were repaid to the Treasury and the Federal Reserve, respectively, upon maturity on August 23, and the facility then expired. This facility had originally consisted of $600 million from the Treasury and $325 million from the Federal Reserve. It was provided in cooperation with other central banks, which together with the United States extended credit to the Bank of Mexico totaling $1.85 billion.

During 1982 and 1983, the Treasury participated, along with authorities from other nations, in providing liquidity support to the Bank for International Settlements for credit facilities the BIS provided to the Central Bank of Brazil and to the National Bank of Yugoslavia. This support took the form of the Treasury, through the Exchange Stabilization Fund (ESF), agreeing to be substituted for the BIS as a creditor in the event of delayed repayments. In November, both Brazil and Yugoslavia completed all repayments under these facilities, and all contingent Treasury commitments expired following these repayments to the BIS.

On December 23, the Treasury entered into a swap agreement of $50 million with the Central Bank of Jamaica in support of Jamaica's negotiations on an economic adjustment program with the International Monetary Fund (IMF). On December 29, Jamaica drew $10 million on this facility.

Also on December 29, the ESF sold $345.5 million of Japanese yen and $345.5 million equivalent of German marks to the Treasury general account for the purpose of financing a portion of the increase in the U.S. quota subscription to the IMF.

In the period from August through January, neither the Federal Reserve nor the Treasury general account realized any profits or losses from exchange transactions. As a result of the sale of currencies to fund the subscription payment to the IMF, the ESF recorded a transactions loss of $204.8 million, reflecting the shift of a valuation loss, which was previously recorded in the published ESF balance sheet, into the category of transactions loss. As of January 31, cumulative unrealized valuation, or bookkeeping, losses on outstanding foreign currency balances were $979.2 million for the Federal Reserve and $673.0 million for the ESF. Both the realized ESF loss and the unrealized valuation losses reflected the fact that the dollar had strengthened since the foreign currency balances were acquired.

The Treasury and the Federal Reserve invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity. Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve has invested some of its foreign currency resources in securities issued by foreign governments. As of January 31, the Federal Reserve held the equivalent of $1,545.2 million in these securities, while the Treasury's holdings were equivalent to $1,978.3 million.

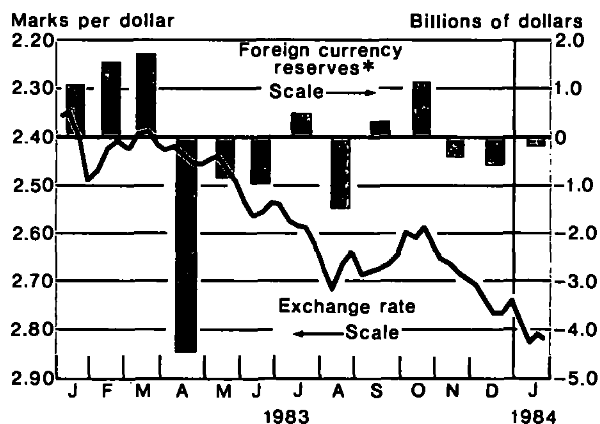
German mark

Early in August, the German mark fell to a 9½-year low of DM 2.7440 against the dollar, then reversed course to recover about 6½ percent by early October. This turnaround coincided with a perceived improvement in German economic growth prospects, a firming of interest rates, and a subsiding of the large outflows of long-term private capital that had persisted since 1980. Although its recovery against the dollar proved to be temporary, in August the mark began a gradual and sustained rise

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.

against most Continental currencies, as Germany's low inflation rate and current account surplus continued to compare well with the performances of its main trading partners.

By mid-August, German business confidence was reviving as prospects for economic expansion improved. Increased construction, inventory, and investment spending had spurred economic activity, and later reports confirmed the strong GNP growth in the second quarter. The long decline in employment came to a halt, and export orders began to increase despite the revaluation of the mark within the EMS earlier in the year and weak growth in Europe and most developing countries.

As the economic outlook brightened, market participants speculated that, to avoid renewed mark depreciation and the consequent inflationary pressures, the Bundesbank might raise interest rates in response to increases that had recently taken place abroad. In addition, money supply growth remained above the Bundesbank's 4-7 percent target range. Under these circumstances, market interest rates in Germany moved back up over the summer. Then, effective September 9, the Bundesbank raised its Lombard rate by 1/2 percentage point to 51/2 percent, citing the need to reduce central bank money growth, to strengthen confidence in the mark, and to limit domestic inflationary pressures. Following this move, money market rates did not rise further, interest rate differentials *vis-à-vis* dollar assets narrowed as U.S. rates eased back, and Germany's bond market joined the rally then taking place in bond markets abroad.

Against this background, portfolio capital shifted back into Germany, and the mark rose against the dollar to DM 2.5620 on October 7, its highest level during the period under review. The German currency also strengthened within the EMS, rising steadily from the bottom to the top of the band by early October. The Bundesbank intervened as part of coordinated operations with the United States in early August, and Germany's foreign exchange reserves declined $1.1 billion by end-September to $37.1 billion.

At that point the mark turned lower against the dollar, in a trend that continued through the remainder of the period under review. The mark began to decline as events in the United States challenged the view that the U.S. expansion was weakening substantially and that dollar interest rates would decline.

But, at the same time, negative sentiment began to reemerge toward the German economic and political situation. It became clear that the momentum the economy developed in the second quarter had not been maintained. Third-quarter industrial production stagnated, presaging the modest growth of GNP later published, and progress was slow in reducing unemployment. Demand for German exports did pick up, but rising imports kept the external sector from providing a net stimulus. The German current account in fact moved into a small deficit in the third quarter, and projections of the surplus for 1983 were revised downward.

Market participants concluded that, with the German recovery appearing to lose strength, the Bundesbank would not strongly resist a renewed decline in the mark by raising German interest rates, even if rates abroad were to increase. The government continued to emphasize its goal of reducing Germany's fiscal deficit, and the burden of economic stimulus was thought to rest on monetary policy. Central bank money growth was now decelerating toward its target range, and the earlier pickup in domestic prices had not continued. Market participants also noted that official spokesmen and business leaders pointed to the potential benefits of mark depreciation for stimulating exports.

Consequently, the decline of the mark against the dollar, which started early in October, continued through mid-January. International political tensions and domestic controversies also had an adverse effect on the mark during this period. At times, market participants sold marks in response to fears that the escalation of military conflicts in the Middle East and elsewhere might stimulate renewed "safe haven" flows into the United States. The mark also weakened against the pound and the yen but eased only slightly against other Continental currencies. By January 10, the mark had fallen to DM 2.8505 against the dollar, 11 percent below its October high, and had declined 10 percent against the Japanese yen over the same period.

As the mark fell, the Bundesbank intervened regularly at the daily fixing in Frankfurt. It also operated forcefully in the market on several days in an effort to contain rapid declines of the mark against the dollar. On three occasions during December and January, the U.S. authorities intervened to purchase marks when market conditions became disorderly, operating in each case for the U.S. Treasury and the Federal Reserve equally. In total, the Trading Desk purchased a total of $193.4 million equivalent of marks.

The mark fluctuated widely against the dollar during the remainder of January, recovering somewhat to close the period at DM 2.8110. During January, both the dollar and yen had reached levels against the mark which some market participants doubted were sustainable, and data indicated some improvement in German economic performance as compared with the United States. Meanwhile, Germany's stock market strengthened, outperforming the U.S. market by a wide margin during January. Under these circumstances, market participants began to conjecture that international investors would increase the mark-denominated portion of their portfolios

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility January 31, 1983	Amount of facility, January 31, 1984
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:		
Regular facility	700	700
Special facility	325	*
Netherlands Bank	500	500
Bank of Norway	250	250
Bank of Sweden	300	300
Swiss National Bank	4,000	4,000
Bank for International Settlements:		
Swiss francs-dollars	600	600
Other authorized European currency-dollars	1,250	1,250
Total	30,425	30,100

*Facility, which became effective August 30, 1982, expired on August 23, 1983.

to restore a more traditional currency distribution. On several occasions in January, German officials publicly expressed the view that the dollar was becoming increasingly vulnerable to a decline.

During the six-month period, the mark declined 6 percent on balance against the dollar. It dropped 9½ percent against the Japanese yen and eased marginally against the Swiss franc. But the mark held on to its early gains within the EMS to close modestly higher against other member currencies. In effective terms, the mark appreciated about 1 percent over the six-month period under review. Germany's foreign exchange reserves posted little net change after September, closing the six-month period down on balance $1.1 billion at $37.1 billion.

Japanese yen

Over the month of August the yen declined about 2 percent against the dollar to a low of ¥247.50 in early September. The yen fell quite abruptly at first as the dollar climbed steeply against all currencies, but the decline moderated thereafter.

The yen's downward move through August in part reflected market concern that the Japanese economy had not yet emerged from a lengthy period of slow growth, leaving the outlook for higher profits and asset yields in Japan relatively limited. Many doubted that yen interest rates would be allowed to match any U.S. rate increases, since a rise in interest rates in Japan would dampen the still meager economic expansion. In this environment, Japan's long-term capital account deficit widened and in fact exceeded the current account surplus in August. The decline in the yen was resisted by Bank of Japan intervention during August, and the Japanese authorities joined with the United States in the coordinated intervention operation around the beginning of the month.

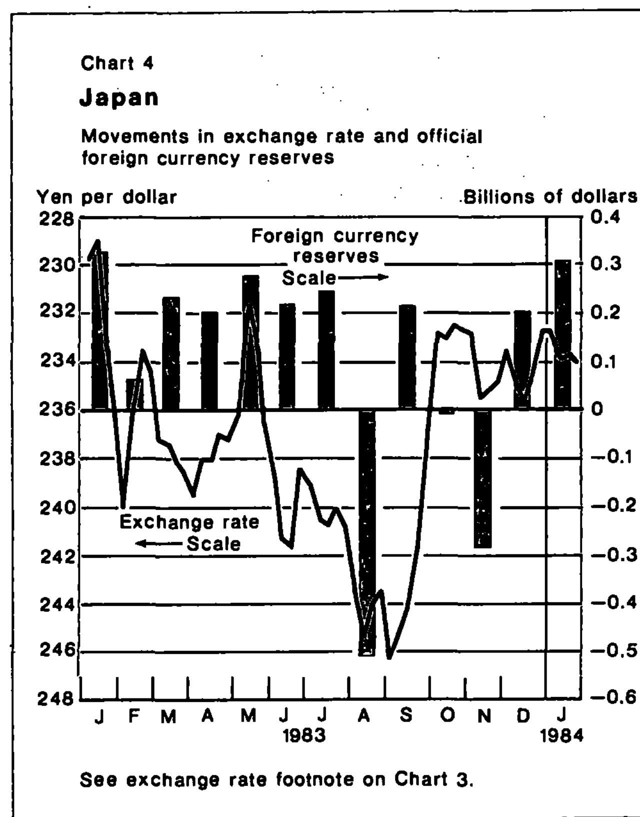
After the beginning of September the yen turned higher against the dollar, benefiting from evidence that the Japanese economy had begun to expand more vigorously. It was reported that GNP had grown at a 3.6 percent rate in the second quarter (later revised to 4.5 percent) and that industrial production and the index of leading indicators had risen strongly in August. Inflation remained very low, making it unlikely that the authorities would need to temper any acceleration of Japan's economy on these grounds. Japan's large current account surplus contributed to better market sentiment for the currency, despite the persistence of sizable long-term capital outflows. Against this background, the yen strengthened and quickly outpaced other currencies which had begun to rise against the dollar several weeks earlier. Over the five weeks through October 7 the yen appreciated more than 7 percent against the dollar to ¥230.10, and edged up against the European currencies as well.

During the remainder of the reporting period, the yen traded narrowly around the ¥234 level against the dollar, while it strengthened to record levels against most European currencies. Exchange market participants reassessed the outlook for the yen, especially against the mark and other Continental currencies, on the view that the yen had considerably greater scope to appreciate against those currencies than did the dollar, which had been in an uptrend since mid-1980.

The more robust performance of Japan's economy contrasted with the rather slow growth in Europe and was a major factor supporting the yen during this period. Japan's economy was seen as relatively innovative and dynamic, it had continued to expand—albeit slowly—during the recent worldwide recession, and profits were forecast to rise strongly. The Japanese inflation rate remained below even the best European price performance, and the country's higher savings and investment rates promised continued higher growth in the future.

Even though the economic outlook in Japan had improved during the autumn, expectations grew that there would be further government action to stimulate the economy. Such stimulus was expected to be aimed at raising imports to ameliorate the increasing worldwide trade frictions, especially prior to a visit to Japan by President Reagan scheduled for November. Then on October 21 the government announced a six-point program to boost economic activity, imports, and capital inflows. The package was accompanied, as expected, by a 1/2 percentage point cut in the discount rate to 5 percent. The Bank of Japan announced its readiness to counter any consequent downward pressure on the yen either by raising short-term interest rates or intervening in the exchanges. Although the stimulative impact of these actions was seen as relatively modest, they served to reinforce optimism about the durability of Japan's expansion.

Late in October the yen briefly moved lower against the dollar following a military flare-up in the Middle East, and the Bank of Japan came into the market to support the currency. The U.S. authorities joined with the Japanese central bank in intervention, purchasing a total of $29.6 million equivalent of yen for the Federal Reserve and Treasury accounts on October 31 and November 1.



See exchange rate footnote on Chart 3.

During November and much of December the yen steadied against the strongly rising dollar and continued to set records against most European currencies. The yen remained firm even when Prime Minister Nakasone on November 28 dissolved the Diet and called for elections to be held three weeks later. Elections had been anticipated by the exchange markets, but few saw much chance of major changes in economic policy as a result. In the event, the governing Liberal Democratic party lost more seats than expected, threatening its parliamentary majority and triggering steep but temporary declines in the yen and the Tokyo stock and bond markets. Both the yen and Japanese stock and bond prices quickly rebounded when it became clear that Prime Minister Nakasone would be able to retain control of the Diet and to sustain the basic thrust of Japan's economic policies.

From mid-December into January, optimism about the Japanese economy gathered more momentum, reflected in both a rising yen and soaring stock prices in the Tokyo market. It was reported that Japan's third-quarter real GNP growth had climbed to 6.2 percent, industrial production had risen sharply in November, and projections of 20 percent increases in corporate profits for 1984 were published. Meanwhile, Japan's monthly trade surpluses remained at near-record levels and the consumer price index fell in December to just 1.8 percent above its year-earlier level. In this context, the yen climbed to a record ¥81.94 against the German mark on January 10, after which some profit taking on cross positions against the European currencies brought the yen back slightly from its highs.

At the same time, the yen remained nearly unchanged against the dollar throughout January despite the dollar's surge against the European currencies. At the close of the six-month period the yen, at ¥234.60, was 3 1/2 percent higher against the dollar and up 9 1/2 percent against the German mark. Over the same period, Japan's foreign exchange reserves remained virtually unchanged and stood at $20.7 billion at end-January.

In early November, at the conclusion of President Reagan's November 9 visit to Tokyo, Treasury Secretary Regan and Finance Minister Takeshita issued a Joint Press Announcement which contained a number of measures designed to liberalize further Japan's capital markets, internationalize the yen, and allow the yen to more fully reflect its underlying strength. The announcement also reported that the Japanese Ministry of Finance and the U.S. Treasury Department would establish a joint ad hoc group of financial authorities on yen/dollar exchange rate issues. This group, co-chaired by Secretary Regan and Finance Minister Takeshita,

would monitor progress in implementing the measures and develop and implement additional steps toward the agreed objectives of liberalizing Japan's capital market and internationalizing the yen.

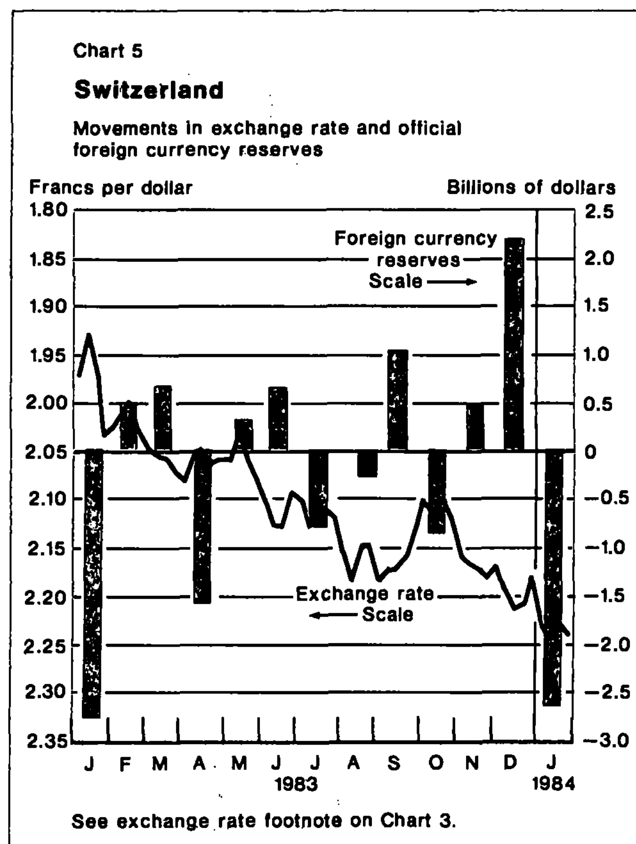
Swiss franc

The Swiss franc was in a rising trend against the other European currencies as the period opened. In fact, by mid-August the franc had climbed about 7½ percent against the German mark since March to around SF 0.80. The franc benefited from a narrowing of the usual interest disadvantage of Swiss-franc assets, as Swiss interest rates rose on market expectations that the Swiss authorities would act to reverse the overshooting of the monetary growth target earlier in 1983. Other factors also lent some support to the franc. The inflation rate had declined further to the lowest level in 4½ years, unemployment remained low compared with that in most countries, and the current account surplus continued to run at an annual rate of about $3.5 billion.

But even as the franc rose against the mark in early August, market participants began to question the franc's scope for further appreciation. Approach of the franc toward the franc-mark rate of SF 0.80 had in the late 1970s prompted action by the authorities to protect the competitiveness of Swiss industry within its main markets in Europe. Indeed, Swiss officials were beginning publicly to voice concern over the franc's appreciation relative to other European currencies. In early August, the Swiss National Bank announced that it had intervened in the foreign exchange market, acting in concert with several other central banks and purchasing German marks against both dollars and Swiss francs. Central bank officials also stated that they would not offset the resulting addition to liquidity in the Swiss banking system.

Also during August, market participants came to the view that Swiss monetary policy was being eased slightly, as Swiss interest rates declined along with those in the United States. In early September the Swiss National Bank did not join the German and Dutch authorities in raising official lending rates, and the gap between Swiss and German interest rates widened by about 1½ percentage points by early October to almost 2 percentage points at the three-month maturity. In these conditions, the Swiss franc lagged behind the German mark's sharp recovery against the dollar in August and then stabilized just above the SF 0.81 level against the mark for the next two months.

In early November the Swiss franc began to appreciate gradually against the German mark and other European currencies even as it fell against the dollar, gaining slightly on a trade-weighted basis. The franc benefited in part from Switzerland's political and economic stability. An improvement in the Swiss economy, although modest, supported the franc through this period. Growth resumed in the third quarter of 1983 and was forecast to reach over 1 percent in 1984. Swiss inflation continued to subside, falling to a twelve-month rate of 1.4 percent in October, below the rate of Switzerland's main trading partners. At the same time, interest in Swiss-franc-denominated investments remained strong, allowing the continued large offerings by foreign borrowers in the Swiss market to be easily absorbed without placing noticeable pressure on franc interest rates or the exchange rate.



See exchange rate footnote on Chart 3.

During the same period, Swiss fiscal and monetary policies appeared to market participants to be shifting more toward restriction. The Swiss government proposed a budget for 1984 aimed at further reducing Federal financing requirements to 0.6 percent of GNP, while the monetary authorities were seen as placing more emphasis on price stability than on tempering the franc's rise against the mark. Market participants took special note that the central bank did not intervene to cushion the franc's rise against the German mark as the cross rate again approached the SF 0.80 level in late

November. Senior central bank officials spoke publicly of the need to give priority to the fight against inflation and announced that the target for central bank money growth would be kept at 3 percent in 1984. This growth rate, if attained, would be 1/2 percentage point less than the growth actually achieved during 1983.

Thus, while dropping to a low against the dollar of SF 2.2655 on January 10, the Swiss franc reached its highest level against the German mark of SF 0.79. The franc ended January at SF 2.2455 against the dollar, down nearly 5 percent over the six-month period, while in terms of the German mark the Swiss currency rose 1 1/4 percent on balance to close at SF 0.7988. Switzerland's foreign exchange reserves were little changed from six months earlier at $11.7 billion, with fluctuations within the period mainly reflecting foreign currency swap operations to adjust liquidity in the Swiss banking system.

Sterling

Sterling was seldom the focus of attention in the exchanges and was virtually unchanged on balance through mid-September. Thereafter, it declined gradually to end the six-month period 8 percent lower against the dollar and down by modest amounts against most other currencies. The primary influence on the exchange rate during the August-January interval was developments in world oil markets. Expectations of lower British interest rates gave rise to some pressure on sterling in late September and early October, but this factor then became relatively unimportant.

As the dollar rose strongly through mid-August, sterling held up better than most currencies. British money market rates declined and widened the dollar's interest rate advantage. But inflation in the United Kingdom had also dropped below 5 percent by early 1983, even as Britain's economy was in its third year of slow recovery. In addition, sterling was supported by firm world oil prices as the earlier glut in world oil supplies dissipated and was replaced by concern over supply shortages should the war between Iran and Iraq disrupt shipments from the Persian Gulf. The shift of view in the oil market improved prospects for Britain's current account and budget through higher government tax and royalty income from North Sea oil production. These factors continued to provide support for the currency through late September, and sterling generally remained close to $1.50 against the dollar and 85 on the Bank of England's trade-weighted index.

But, in late September, new data showed some deceleration of monetary growth and market participants began to suspect that the government might lower interest rates to stimulate the economy and to lower the exchange rate. Substantial progress had already been made in regaining Britain's international competitiveness—the inflation rate had been cut in half in the last year, sterling had fallen almost 20 percent in effective terms from its peak in early 1981, and labor productivity had begun to improve. But most observers felt that production costs in the United Kingdom were still relatively high, especially for manufactured goods and especially in comparison with the Continent. Concern about competitiveness was underlined by release of data showing that output growth was sluggish, much of the growth of consumption was being met by imports, and exports remained depressed even though the economies of some of Britain's major trading partners on the Continent had begun to expand somewhat more vigorously.

On October 3 the Bank of England cut its money

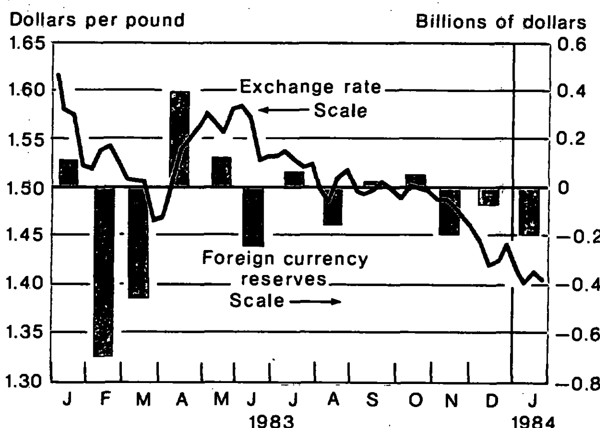
Table 2

Drawings and Repayments by the Bank of Mexico under Special Combined Credit Facility

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

Drawings on	Outstanding January 1, 1983	1983 I	1983 II	1983 III	Outstanding January 31, 1984
Federal Reserve special facility for $325 million	257.3	+ 67.8	− 56.0	−269.0	*
United States Treasury special facility for $600 million	477.8	+122.3	−104.0	−496.0	*
Total	735.0	+190.0	−160.0	−765.0	*

Data are on a value-date basis. Because of rounding, figures may not add to totals.
*Facility, which became effective August 30, 1982, was fully repaid and expired on August 23, 1983.



See footnotes on Chart 3.

market intervention rate by 1/2 percentage point. Sterling fell sharply in response, quickly declining nearly 3 percent against the mark to about DM 3.85 and below $1.48 against the dollar. The Bank of England exchange rate index fell to 82.4. Sterling then recovered somewhat and fluctuated narrowly during the balance of October.

Oil market developments, which had been a consistent support to sterling through late summer, had a mixed influence on the currency between October and January. Sterling benefited when the conflicts in Lebanon and the Persian Gulf flared up, raising the specter of restricted oil supplies and higher prices. But, at other times, evidence of ample supplies and an easing of spot oil prices in the Rotterdam market undermined sterling. In late December, one element of uncertainty was eliminated when the British National Oil Company announced that it would hold prices at current levels through the first quarter of 1984.

Monthly United Kingdom trade data had some influence on exchange rates from time to time, but without any significant effect on balance. Though the figures were erratic, the current account remained in surplus and appeared to improve somewhat at the year-end.

From mid-December to end-January, sterling declined slightly in effective terms and traded steadily against the German mark but fluctuated widely against the dollar. Against the dollar sterling closed the six-month interval down 8 percent at $1.4035. On balance, sterling declined 2 percent against the German mark and about 4 1/4 percent on the Bank of England effective index. Over the six-month period, Britain's foreign exchange reserves declined almost $500 million to $8.5 billion.

French franc

As the period opened, market participants were awaiting evidence that the French government's austerity program, announced after the EMS realignment in March, had begun to reduce inflation and to narrow the current account deficit. The program sought a 2 percent reduction of domestic demand through contractionary fiscal policy and more restrictive monetary growth targets and was expected to reduce economic growth nearly to zero for 1983. While it was clear at midsummer that the economy had slowed, there was little apparent progress toward the program's main goals of cutting inflation substantially and achieving balance in the current account. Without evidence of such progress, traders questioned the sustainability of the franc's position near the top of the EMS, and some expected exchange rate pressure to emerge as soon as early fall. Benefiting from reflows after the March realignment as well as an ECU 4 billion loan from the European Community, France's foreign currency reserves stood at $18.5 billion at the beginning of the period.

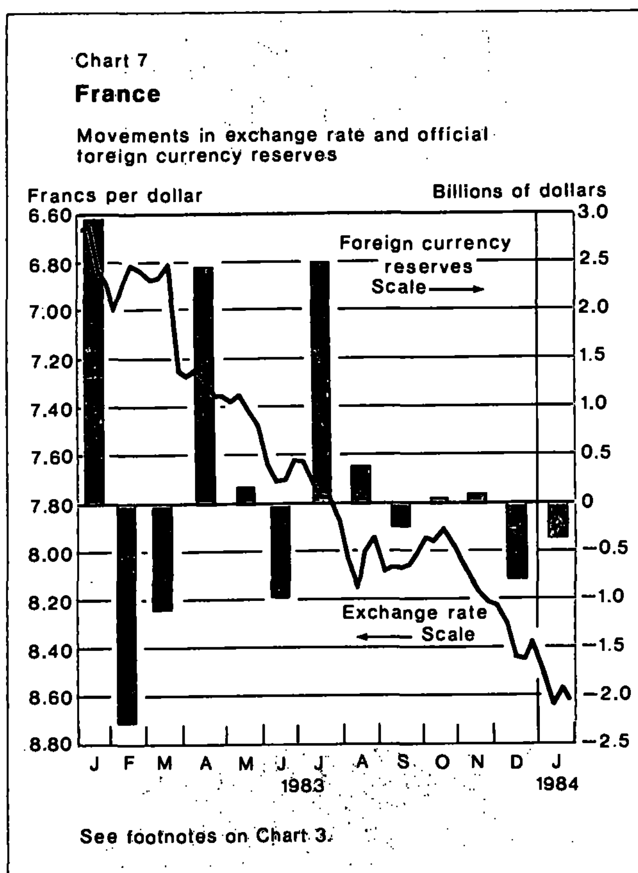
In early August the franc remained firm at the top of the EMS but declined sharply against the strongly rising dollar. The franc reached a record low of FF 8.2450 versus the dollar on August 11, and during that period the Bank of France intervened to support the franc as the dollar rose across the board. Thereafter the franc, along with other EMS currencies, turned higher against the dollar in a trend that continued through early October, and the franc held firm at the top of the EMS through early autumn. One reason for this strength was that the restrictive fiscal policy had by then slowed the growth of income and thereby reduced imports. Also, on the monetary side, M-2 growth had slowed to its reduced 1983 target of 9 percent, helping keep interest rates firm and bolster the franc. But, while franc interest rates held steady, Germany raised its Lombard rate in September, narrowing interest rate differentials favorable to the franc. Moreover, the French inflation rate had not yet begun to decline, and a large inflation differential persisted between France and Germany. Thus, even though the franc remained near the top of the EMS, there was at times considerable selling pressure on the franc against the mark, which by early October had risen to join the franc near the top of the EMS.

From late October through December, more evidence accumulated that progress was being made toward some of the main goals of the austerity program. The French external accounts improved strikingly. The first monthly trade surplus since 1979 was registered in

September, followed by news of a current account surplus for the third quarter as a whole (later revised to a small deficit). Shortly thereafter, the government partially relaxed the strict foreign exchange controls imposed earlier in the year and announced plans to reduce substantially its foreign borrowing.

Also, the government reaffirmed its commitment to a policy of reducing inflation through 1984. The government budget for 1984 limited the increase in spending to 6.3 percent in nominal terms, or about zero growth after adjustment for inflation. Also, the authorities called for average wage increases of no more than 6 percent in 1984. The growth target for M-2 was lowered to 5.5-6.5 percent, compared with a 9 percent target for 1983. The reaffirmation of the government's commitment to curb inflation, together with the continued improvement of France's trade performance, tended to reinforce confidence in the franc. Consequently, there was little exchange market reaction to labor unrest in December and January, which underscored the difficulties in achieving the government's stabilization program.

In this environment the franc traded firmly at the top of the narrow EMS band through the end of January. Franc interest rates remained relatively high, attracting non-resident demand for franc investments. The franc closed the period at FF 3.0591 against the German mark, slightly above its midpoint. The franc, along with its partner currencies, fell back to a record low of FF 8.7020 against the dollar in mid-January, but subsequently recovered somewhat to end the period 7½ percent lower at FF 8.5990. France's foreign currency reserves fell about $700 million over the six-month period and stood at $17.7 billion at end-January.



Throughout the period, French entities continued to borrow abroad, although the government did not arrange any new large-scale foreign credits. In January, Finance Minister Delors stated that France's external debt had reached $53 billion at the end of 1983, compared with $44 billion at the end of 1982.

Italian lira

The lira traded in the upper portion of its wide EMS band from the beginning of August to mid-October, although several brief flurries of pressure during this period brought the lira somewhat lower in the EMS.

Supported by high Italian interest rates, the lira had remained well above the top of the narrow EMS band since the March realignment. Money market interest rates of 17 percent and higher reflected the Bank of Italy's continuing efforts to narrow the gap between inflation rates in Italy and elsewhere in Europe. By August, some progress on inflation was becoming evident as a result of the restrictive monetary policy, the decline in economic activity, and the January modification of the *scala mobile* (wage indexation system). As the reporting period opened, the lira was also drawing support from a narrowing of Italy's trade deficit as declining domestic demand depressed imports.

During August and September, however, there were several episodes of pressure on the lira within the EMS, in part reflecting market participants' concern that the apparent improvements in Italy's trade and price performance might prove temporary or insufficient to match the progress in other European economies. In particular, deceleration in inflation was seen as threatened by the Italian government's continued difficulty in containing the fiscal deficit. In fact, many industrialists argued that the lira's devaluations within the EMS in recent years had not fully compensated for Italy's higher inflation rate and that Italy's prospects for expanding exports might therefore be limited even if economic growth in other European economies picked up sharply.

Against the dollar, the lira, along with other EMS currencies, fell sharply in early August, and the Bank of Italy intervened with modest dollar sales. Subsequently, the lira lagged somewhat behind the other EMS

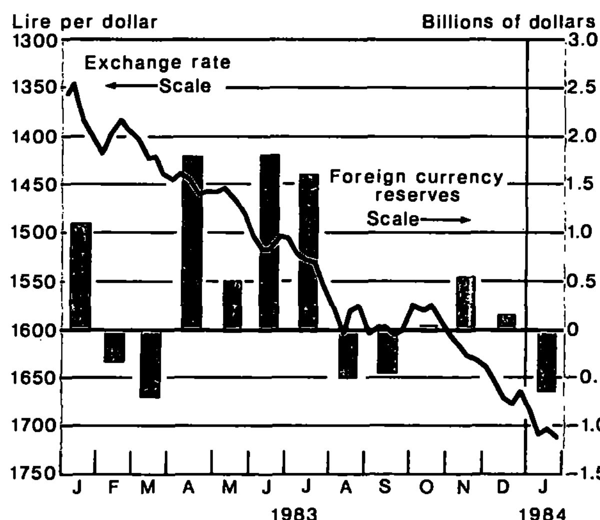
currencies when they turned higher against the dollar in a rise that lasted through mid-October. During those weeks, several brief spates of speculation and the usual tapering-off of summer tourist inflows brought the lira slightly lower within the EMS. The Bank of Italy intervened on several of these occasions to resist the lira's decline. By mid-October the lira's margin above the narrow EMS band had eased back about 1 percent and the lira was little changed on balance against the generally lower dollar. Against the German mark the lira had declined about 3 percent.

After mid-October, pressure on the lira subsided and the currency held its position comfortably above the narrow band through the end of the period under review. The Italian authorities took advantage of the lira's stability during this period to relax foreign exchange controls partially. In addition, the Bank of Italy was able to build up foreign exchange reserves, although there are typically reserve outflows in late fall. By the end of December, foreign currency reserves had risen $854 million from end-September to $18.5 billion. The relatively strong position of the lira reflected continued firm interest rates and some signs of improvement in inflation, economic growth, and the domestic policy situation.

The Bank of Italy maintained a restrictive policy stance through the fall and winter, while the government budget deficit continued to grow and the unemployment rate continued to establish postwar records. On October 23, Bank of Italy Governor Ciampi warned that "without effective curbs on pay and public borrowing there could be no relaxation of the highly restrictive monetary policy" and called for a comprehensive incomes policy to bring inflation down to the government's 1984 target of 10 percent. Italy's high money market rates declined somewhat during this period but by considerably less than did the inflation rate.

The progress on inflation that became evident over the fall and winter was the most significant for Italy in years. Consumer price increases fell from a year-on-year rate of 16.3 percent in the second quarter to 13.3 percent by October and hit 12.5 percent by January. Wholesale price increases fell below 10 percent in August for the first time in five years and then stayed below that level through the remainder of the period.

More broadly, signs emerged that the economy had begun to grow again in the third quarter, and in fact it turned out that real GDP had risen at a 3.6 percent rate. The external accounts continued to improve, leaving the 1983 trade deficit about a third smaller than that of 1982. In November the trade account actually registered a surplus, the first since October 1979. The current account for the first eight months of 1983 also turned around—to a surplus of Lit 1.0 trillion as compared with the Lit 5.4 trillion deficit in the same period a year earlier. At the same time, Prime Minister Craxi's government achieved modest success in getting action on its budget initiatives. The new coalition government which took power in August had proposed a strict austerity budget aimed at reducing the huge fiscal deficit and further reducing inflation and, in fact, obtained Parliamentary approval for the general outlines of its program by end-December—only the third Italian budget of the postwar period to be passed on schedule.



While progress was made on several fronts, it remained clear that Italy needed significant additional progress before its economic performance would be in line with those of its neighbors. Economic growth had revived, but unemployment in Italy continued to rise. And, while Italy's inflation decelerated over the period, by January consumer price inflation was still 10 percentage points above that in Germany and 4½ percentage points above that in France. In wholesale prices, however, the gap narrowed to 7 percentage points versus Germany, and for France the gap reversed sign; French wholesale price inflation exceeded that in Italy by 6 percentage points in the year to December.

While holding steady against the EMS currencies, the lira continued to fall to record lows against the dollar, reaching Lit 1,722.75 on January 12. It then recovered

Table 3

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

In millions of dollars

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund	United States Treasury General account
First quarter 1983	-0-	+0.5	+38.3
Second quarter 1983	-0-	+17.0	+58.1
Third quarter 1983	-0-	-0-	+70.1
Fourth quarter 1983	-0-	−204.8	-0-
January 1984	-0-	-0-	-0-
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1984	−979.2	−673.0	-0-

Data are on a value-date basis.

somewhat to close the period at Lit 1,713, down almost 9 percent on balance against the dollar.

European Monetary System

At the beginning of August the currencies within the EMS were trading in a pattern that had changed little since the last realignment on March 21, 1983. The Irish pound and French franc were at or near the top of the narrow band, and the Italian lira remained more than 3 percent above the top, within the wider bands allowed for that currency. The German mark remained at the band's lower limit and had been joined there by the Belgian franc, while the Netherlands guilder and the Danish krone had moved to the middle of the joint float.

In mid-August, as the dollar fell from its peaks, the German mark began to rise steadily within the EMS. The Netherlands guilder and Danish krone also moved higher, leaving the Belgian franc more isolated at its EMS floor. By early October the currencies of Germany, France, the Netherlands, Denmark, and Ireland were all clustered near the top of the narrow EMS band in a configuration that was generally maintained throughout the rest of the period. The Belgian franc required only modest support to keep it within its lower limit. Against the dollar, the EMS currencies declined 6 to 9 percent on balance over the August-January period despite sizable net intervention sales of dollars by the member central banks. At the close of the period, the EMS bilateral limits adopted in March 1983 had lasted longer than any other since those agreed upon in November 1979.

The stability in the EMS exchange rate relationships reflected growing convergence of economic performances among member countries at a time when the dollar was consistently strong against all EMS currencies and thus not straining the cross rates. The convergence, most apparent in trade and price developments, was in part a consequence of the austerity programs instituted by several member countries during 1982 and the spring of 1983. The March realignment also contributed to a narrowing of bilateral trade gaps between member countries.

The trade balance improvement was most dramatic in the case of France, but a combination of weak domestic demand and gains in competitiveness also narrowed the deficits or generated surpluses on the current accounts of Belgium, Denmark, Ireland, and Italy. In Germany and the Netherlands—the countries whose currencies were revalued the most in the last realignment—the external surpluses were little changed. There was a similar, although less pronounced, convergence of inflation rates as higher inflation countries experienced some moderation in price increases while others saw their inflation rates stabilize at low levels.

Success in trimming fiscal deficits was less visible during the period, as increased debt service costs and rising unemployment kept most countries' fiscal gaps from narrowing significantly despite serious budget-cutting efforts. Domestic opposition to tough austerity measures in several countries led to some questioning of the governments' ability to carry through their policies and temporarily brought individual currencies under pressure. In fact, the Danish government fell during the period, following debate over fiscal restraint which had been reflected briefly in pressure on the krone.

Monetary policies remained generally restrictive, with changes in official interest rates corresponding closely to the respective currencies' positions within the EMS. Central bank lending rates were raised in Germany and the Netherlands early in the period when the mark and the guilder were in the bottom half of the band. The Belgian franc was at or very near the floor of the joint float throughout the six months, and in late November the National Bank of Belgium increased its interest rates by 1 percentage point to counter some speculative pressure on the exchange rate. By contrast, official interest rates were cut in Ireland and Denmark at times when the currencies of those countries were trading at or near the ceiling of the narrow band.

Canadian dollar

As August opened, the Canadian dollar was trading narrowly around Can.$1.23 ($0.8130) against the U.S.

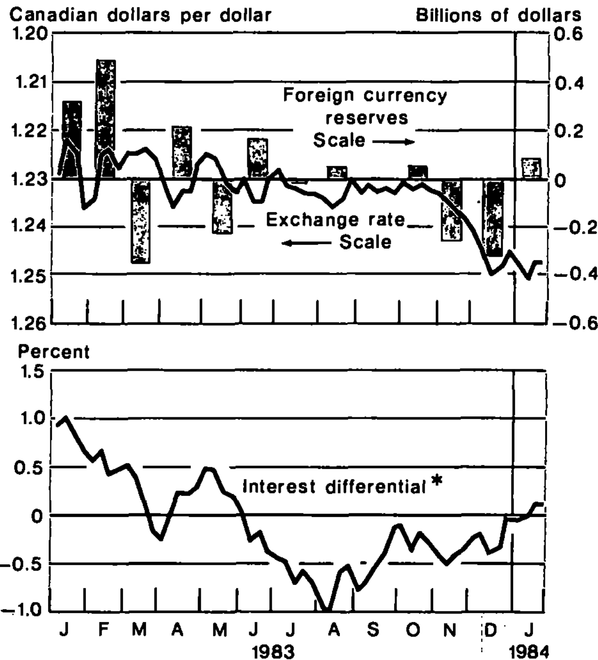


Chart 9

Canada

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

*Canadian finance paper minus Eurodollars. Weekly averages of daily rates.

See exchange rate footnote on Chart 3.

dollar, while both rose strongly against most other currencies. The Canadian currency had held steady since early summer even though interest rate differentials, which normally favor Canadian assets, had shifted in favor of the U.S. dollar by as much as a full percentage point.

The Canadian currency was buoyed by the remarkable improvement in Canada's economic performance. The country's severe 1981-82 recession had given way to an exceptionally strong rebound, spurred by vigorous domestic demand and by growth in the United States. While Canadian imports picked up in response to the boom at home, strong demand from the United States helped push Canada's trade surplus to near-record levels, keeping the current account in a surplus, unusual for Canada, through the first half of 1983. Canadian inflation, which had remained stubbornly high, plunged from double-digit levels in late 1982 to 5.5 percent in July, its best level in ten years.

Canadian fiscal policy had provided stimulus for the recovery, while a successful program for public-sector wage and price restraint had reinforced the effects of recession in bringing about the marked slowing in inflation. At the same time, monetary policy remained oriented toward a return over time to price stability. The Bank of Canada had earlier ceased to specify targets for domestic monetary aggregates in the implementation of monetary policy. Instead, it was monitoring a variety of economic and financial variables, including the exchange rate. The exchange rate was cited as a major influence on domestic prices, of particular importance at a time when the authorities were moving to consolidate the hard-won progress on inflation.

After the middle of August, U.S. interest rates turned lower, and by early October the interest differentials adverse to Canadian investments were nearly eliminated. Nevertheless, the Canadian dollar did not strengthen against the U.S. dollar along with the other foreign currencies during this period, in part because a rise in imports, spurred by robust domestic demand, was eroding the current account surplus.

After U.S. interest rates had begun to rise in October, market participants became concerned that Canadian interest rates would not match the rise. Despite the

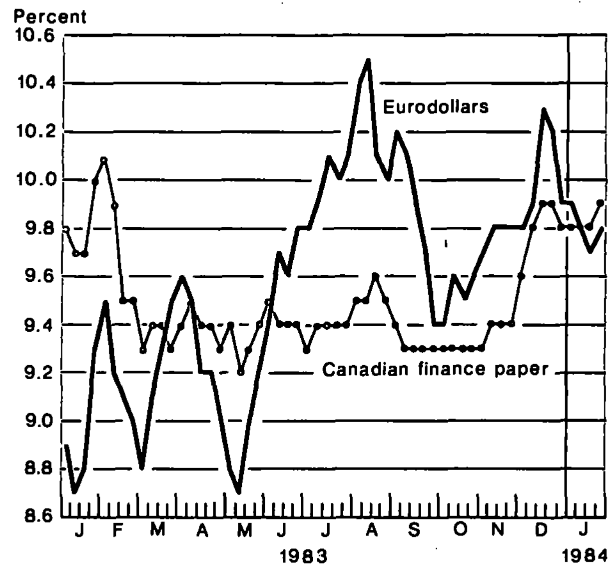


Chart 10

Interest Rates in Canada and the Eurodollar Market

Three-month maturities*

*Weekly averages of daily rates.

rapid growth of Canadian industrial production, output had still not regained its pre-recession levels and the unemployment rate remained above 11 percent. In this context and in view of the dramatic progress on inflation, market participants expected the Canadian authorities to limit interest rate increases. Canadian interest rates rose only slightly during November, and the negative interest rate gap widened once again.

The Canadian dollar thus began to decline early in November. The rate movement prompted some increase in trading in the currency, both in the interbank market and on Chicago's IMM, from the low turnover that had prevailed during its long period of stability. The Canadian currency continued to drop in December even after Canadian money market rates moved significantly higher for the first time in over a year. With U.S. rates also rising, differentials remained unfavorable to Canadian assets. In addition, the announcement that the current account had moved into deficit for the third quarter contributed to negative sentiment. The Bank of Canada entered the market at times to counter the pressure against the Canadian dollar, and Canadian foreign exchange reserves fell $570 million during November and December, mainly reflecting this intervention.

The Canadian dollar recovered in late December as U.S. interest rates turned lower, first narrowing and then eliminating the interest rate disadvantage of Canadian assets. After dropping to a low of Can.$1.2532 ($0.7980) in early January when the U.S. dollar rose strongly against all foreign currencies, the Canadian currency resumed its rise over the rest of the month as interest differentials began to favor Canadian dollar investments. In addition, the currency benefited from the publication of November trade statistics, showing that the trend of declining monthly surpluses since May had begun to reverse. The currency ended January at Can.$1.2482 ($0.8012), down 1½ percent from its level six months earlier. Over the period as a whole, Canadian foreign exchange reserves had declined $350 million to $2.8 billion.