FEDERAL RESERVE BANK OF NEW YORK

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Contents

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Through the late summer of 1974 the dollar showed considerable buoyancy in the exchange markets but, from October on, became subject to continuing selling pressure. By late January, the dollar had fallen from its highs by some 27 percent against the Swiss franc and 17 percent against the German mark and other currencies in the European monetary bloc. Dollar quotations had also declined by some 3 to 4 percent against sterling, the Italian lira, and the Japanese yen.

The dollar's strength in August and September reflected primarily the pull of unusually high interest rates in New York and the Euro-dollar market, reinforced by expectations that surplus oil revenues would flow into the United States financial markets after saturating investment outlets elsewhere. With the dollar in demand, the Federal Reserve was able to buy sufficient marks in the market not only to repay the remaining $64.6 million equivalent of drawings on the Bundesbank outstanding from earlier in the year, but also to build up balances to finance intervention should selling pressure suddenly erupt. On one such occasion, on August 8 and 9, the Federal Reserve sold $20.8 million of marks from balances, $5.3 million of Dutch guilders drawn on the swap line with the Netherlands Bank, and $2.5 million of Belgian francs of which $0.8 million was from balances and $1.7 million drawn under the swap line with the National Bank of Belgium; the swap drawings in guilders and francs were quickly repaid out of market purchases of these currencies. Again, on September 3, the Federal Reserve sold $16.2 million of marks from balances to check an abrupt decline of the dollar. Otherwise, the Federal Reserve abstained from intervention until early October.

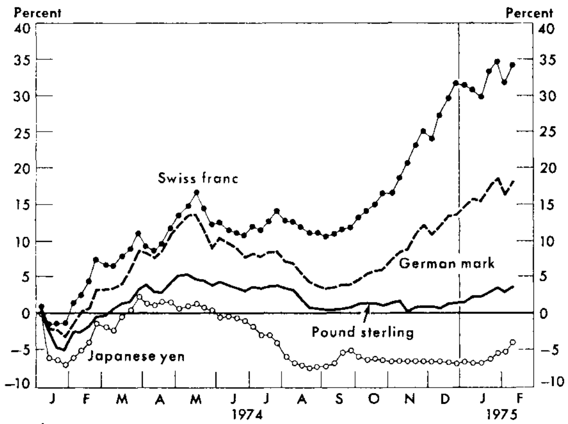
By that time, an improving trend in United States exports, up 40 percent from the year before, was cutting into the sizable trade deficit caused by the $17 billion jump in our 1974 oil import bill. Nevertheless, in early October, the exchange markets were showing signs of nervousness over the onset of a sharp decline in dollar interest rates and over reports that surplus oil revenues were beginning to be shifted out of dollars and sterling into continental European countries. Short bursts of selling pressure occurred in October. The Federal Reserve intervened on six days, selling a total of $165.7 million equivalent of marks, of which $62.1 million equivalent was from balances and $103.6 million equivalent was drawn under the swap line with the Bundesbank. The German central bank bought similar amounts of dollars in Frankfurt. Late in the month, when the dollar firmed somewhat following discount rate cuts in Germany and the Netherlands, the Federal Reserve began to acquire in the market moderate amounts of marks against outstanding swap indebtedness.

By early November, however, market sentiment toward the dollar turned bearish. Mounting evidence of an economic recession in the United States, more severe than in most other countries, suggested to the market that interest rates would fall faster here than abroad. That possibility in turn reinforced fears of large-scale shifts of funds out of dollars by some oil-producing countries,

*On February 19, 1975, Mr. Coombs resigned as Special Manager of the System Open Market Account and Mr. Pardee was appointed Deputy Manager for Foreign Operations. Alan R. Holmes, Manager of the Open Market Account, has assumed Mr. Coombs's responsibilities for supervision of foreign operations. The Federal Reserve Bank of New York acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

Chart I

SELECTED EXCHANGE RATES*



*Percentage deviations of weekly averages of New York noon offered rates from New York noon offered rates on January 2, 1974.

the market and repaid $82.8 million equivalent of swap drawings on the Bundesbank. The System also purchased sufficient amounts of guilders and Belgian francs to liquidate in full the November drawings in these currencies.

From mid-December to late January, the exchange markets were subject to an almost unremitting diet of bearish news for the dollar, and market forces drove dollar rates lower almost every day. The economic downturn and the slide of interest rates in the United States reinforced expectations of a further widening of interest differentials already adverse to the dollar. Gloomy forecasts emerging in the debates over economic and energy policies in Washington further depressed the market. With individual oil-producing countries reportedly growing restive over the dollar's depreciation, market fears of an accelerated diversification of oil proceeds to other currencies intensified. In such an atmosphere, the market ignored any favorable news for the dollar, such as the underlying improvement in the United States trade balance and the slackening in our rate of inflation.

To cushion the dollar's decline, the Federal Reserve intervened on seventeen of the twenty-eight business days

as did the ever-present risk of renewed hostilities in the Middle East. At the same time, Germany's continuing strong trade performance rekindled revaluation rumors for the mark, and Switzerland, having lifted barriers to short-term capital inflows, experienced a new influx of funds which bid up the franc rate sharply. The rise of the franc and the mark tended to be mutually reinforcing and set off a general upsweep of currency rates against the dollar. On several occasions, the dollar rebounded in response to concerted intervention by the Federal Reserve and European central banks and the introduction of new curbs on capital inflows by the Swiss authorities. Nevertheless, the vigorous public debate over economic policies here and in Europe kept the market on edge, and the dollar continued to slip through late November.

The Federal Reserve intervened, at times forcefully, on seven days during November. In total, $187.9 million equivalent of marks was sold, of which $164.3 million equivalent was drawn under the swap line with the Bundesbank and the rest from balances. In addition, the System sold $28.5 million equivalent of Dutch guilders drawn under the swap line with the Netherlands Bank, $10.8 million of Belgian francs, of which $10.4 million was drawn under the swap line with the National Bank of Belgium and the rest from balances, and $12.5 million equivalent of Swiss francs purchased outright from the Swiss National Bank.

Late in November and early December, the pressures on the dollar eased, as United States interest rates leveled off. The Federal Reserve was able to purchase marks in

Table 1

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Institution	Amount of facility January 31, 1975
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	2,000
Bank of Italy	3,000
Bank of Japan	2,000
Bank of Mexico	180
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	1,400
Bank for International Settlements:	
Swiss francs-dollars	600
Other authorized European currencies-dollars	1,250
Total	19,980

Table II

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 1, 1974	Drawings (+) or repayments (—)					System swap commitments, January 31, 1975
		1974				1975	
		I	II	III	IV	January	
National Bank of Belgium	261.8			+ 1.7 — 1.7	+ 13.2 — 13.2		261.8
German Federal Bank	-0-	+255.0 — 3.7	+130.4 —122.8	—258.8	+301.5 — 82.8	+164.0 -0-	382.7
Netherlands Bank	-0-			+ 7.6 — 7.6	+ 38.0 — 34.8		3.2
Swiss National Bank	565.0	—193.8			+ 13.3 — 5.9	+ 19.3 -0-	397.8
Bank for International Settlements (Swiss francs)	600.0						600.0
Total	1,426.8	+255.0 —197.6	+130.4 —122.8	+ 9.4 —268.1	+366.0 —136.7	+183.3 -0-	1,645.4

Note: Discrepancies in totals are due to rounding.

from mid-December through January 24. Over that stretch, operating jointly with the Bundesbank, the System sold a further $134 million equivalent of marks, of which $103 million was drawn under the swap line and the rest from balances. The Federal Reserve also intervened in Swiss francs in December-January, and the Swiss National Bank resumed spot intervention in Zurich on January 6. The System's sales of Swiss francs amounted to $51.1 million equivalent, of which $32.5 million was drawn under the swap line with the Swiss National Bank and the rest purchased outright from that bank. In addition, the Federal Reserve sold $9.6 million equivalent of Dutch guilders and $2.9 million equivalent of Belgian francs drawn on the swap line with the respective central banks. Of these swap commitments, $5.9 million of Swiss francs, $6.4 million of Dutch guilders, and the full amount of Belgian francs were repaid through market acquisitions.

As the depreciation of the dollar continued, European exporters became increasingly concerned over an emerging undervaluation of the United States dollar that would leave them at a competitive disadvantage in world markets. By late January, this potential problem was also recognized by European government officials, who publicly noted that the dollar had fallen to unrealistically low levels in the exchange markets. Against this background, the Federal Reserve, together with the Bundesbank, began during the last week in January to intervene more forcefully to resist the erosion of dollar rates. Operating on four of the five days, the Federal Reserve sold a further $94.6 million of marks, drawn on the swap line, and the Bundesbank purchased a roughly equivalent amount of dollars.

In summary, in exchange market intervention during the six-month period, the Federal Reserve sold a total of $742.3 million equivalent of German marks, Swiss francs, Dutch guilders, and Belgian francs. Of this, $619.2 million equivalent was in German marks, $465.5 million drawn under the swap arrangement with the Bundesbank, and the rest from balances acquired in the market. Liquidation of debt in marks, including the $64.6 million outstanding on August 1, amounted to $147.4 million equivalent, with the result that commitments in marks stood at $382.7 million equivalent on January 31. Intervention in Swiss francs amounted to $63.6 million equivalent, of which $31.1 million was purchased directly from the Swiss National Bank and the remaining $32.5 million was financed by swap drawings. With $5.9 million of Swiss francs having been repaid, some $26.6 million equivalent of those drawings remained outstanding on January 31. Of the guilders, $43.3 million equivalent was sold in the market, all financed by swap drawings, of which $3.2 million equivalent was outstanding at the end of January. The $16.2 million of Belgian franc intervention was financed out of $1.2 million equivalent of balances and $15 million equivalent of swap drawings, all of which had been repaid by the end of the period.

Also during the period, on August 21, the Bank of Mexico drew the full $180 million available under the swap arrangement with the Federal Reserve to cover a temporary shortfall in reserves. This drawing was repaid in November, prior to maturity.

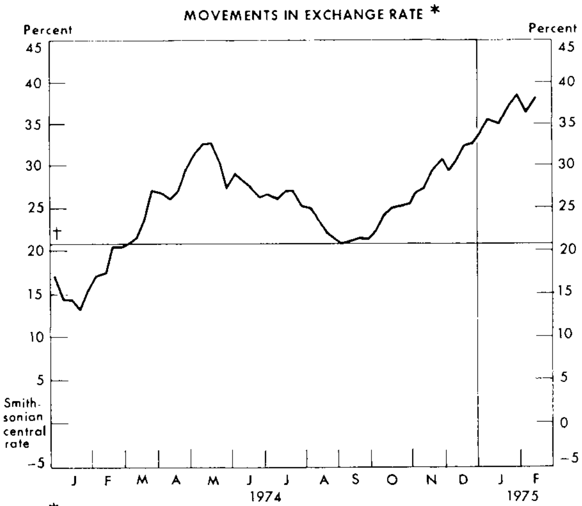
As described in the December 1974 interim report, on September 26 the Federal Reserve Bank of New York, after consulting with the Board of Governors of the Federal Reserve System, the United States Treasury, and other Government agencies, acquired the foreign exchange commitments of the Franklin National Bank. This action was greeted with relief by market participants here and abroad, and the subsequent news of Franklin's insolvency was taken in stride by the market with no adverse impact on dollar rates. This Bank quickly balanced the Franklin book and has met the forward commitments on maturity. By the end of January, nearly $400 million of the original $725 million of contracts had been liquidated.

GERMAN MARK

During 1974 the German economy turned increasingly sluggish, leading to a slackening of import demand and a freeing of productive capacity for export. For a time, the more buoyant economies of Germany's major trading partners provided continuing demand for German exports. But even after new demand weakened in the face of the spreading worldwide recession, the huge backlog of foreign orders received during previous years supported a high level of production for shipment abroad. Thus, although Germany like other industrial countries faced a sharply increased oil bill—up $8 billion for 1974 as a whole—the combined weakness of import demand and rapid growth of exports widened Germany's trade surplus especially in the early months of the year. The surprising strength of Germany's trade position fostered a speculative demand for the mark, which rose to as high as $0.4188 in mid-May and turned around only after reports that the Federal Reserve, the Bundesbank, and the Swiss National Bank had agreed on a concerted intervention plan to counter speculation against the dollar. A reflux of funds out of marks then developed, as nonresidents liquidated some of their large mark investments of previous years, as German enterprises lent heavily abroad to finance exports, and as the banking sector responded to the rise in dollar interest rates relative to those in Germany. Moreover, market nervousness following the June 26 closing of the Bankhaus I.D. Herstatt weighed on the mark. The spot rate eased and, after the mark slipped to the bottom of the European Community (EC) band, the Bundesbank began to sell substantial amounts of other EC currencies as well as dollars. The Federal Reserve was able to acquire sufficient marks to reduce its swap drawings from a peak of $381.6 million equivalent in early June to $64.6 million by the end of July.

In view of the domestic slowdown and severe strains in Germany's credit markets following the Herstatt collapse, the Bundesbank acted to maintain liquidity in the banking system by offsetting the outflows of funds abroad. The authorities had not yet abandoned their restrictive monetary policy, however, since Germany's inflation rate of 6 to 7 percent per annum remained high by recent historical standards although still far below the inflation rates of most of Germany's trading partners. In mid-August the Bundesbank announced a 10 percentage point reduction in reserve requirements on domestic liabilities, and interest rates in Germany held steady, while interest rates in the United States and elsewhere rose to unprecedented levels. The incentives for arbitraging funds out of marks and into dollars and other currencies therefore widened, and the mark eased in the exchange market. Consequently, in August the Federal Reserve was able to buy sufficient marks in the market to liquidate the remaining $64.6 million of its swap debt to the Bundesbank and to accumulate working balances as well.

Chart II
GERMANY
MOVEMENTS IN EXCHANGE RATE *



* In this and the following currency charts, movements in exchange rates are measured as percentage deviations of weekly averages of New York noon offered rates from the middle or central rates established under the Smithsonian agreement of December 18, 1971.

† Central rate established on June 29, 1973.

In two instances, however, the Federal Reserve found it desirable to intervene to restrain sudden selling pressure on the dollar. On August 8 and 9, when market uneasiness during the transition of presidential authority in the United States was compounded by release of discouraging United States wholesale price figures for July, the Federal Reserve sold $20.8 million of marks from balances, along with smaller amounts of Dutch guilders and Belgian francs. Again, on September 3, after the German authorities proposed to suspend their deposit requirement on German residents' borrowing abroad (the "bardepot"), the Federal Reserve sold $16.2 million of marks from balances to check an abrupt decline in the dollar.

Over the next few weeks, the mark leveled off at about $0.3735, 10 percent below its May peak. Meanwhile, interest rates in the United States and the Euro-dollar market were beginning to fall back sharply. Consequently, the major share of continuing flows out of Germany was deflected to other EC financial centers where interest rates were either unchanged or easing only slightly. Thus, while steady against the dollar, the mark continued to require support at the bottom of the EC band and depreciated significantly against the Swiss franc as well. By the end of September, German reserves had dropped by $1.9 billion from end-of-May levels. Meanwhile, the German authorities moved further to relieve the nervousness that remained in the market in the wake of the banking failures in Germany earlier in the summer. The Bundesbank and the German Banking Association established additional backstopping facilities for providing liquidity assistance to banks. The Bundesbank announced a further 8 percent cut in reserve requirements on September 26, and the government imposed comprehensive limits on banks' foreign exchange positions effective October 1.

In early October the balance in the exchange market began to tip in favor of the mark. As United States interest rates continued to decline and as fears of renewed hostilities in the Middle East resurfaced, the markets began to anticipate diversification of Organization of Petroleum Exporting Countries (OPEC) funds out of dollars and sterling into marks and other Continental currencies. Moderately heavy selling of dollars developed in early October, and the Federal Reserve resisted an excessive bidding-up of the mark rate by selling a total of $36.1 million equivalent of marks from balances on October 3 and 4. The rate steadied briefly, but on October 9, as the market assessed President Ford's anti-inflationary proposals, a large buy order for marks pushed the spot rate up sharply, setting off a generalized speculative selling of dollars. To maintain orderly market conditions, the Federal Reserve sold $104.4 million equivalent of marks, of which $26 million was financed from balances and $78.4 million was drawn on the swap line with the Bundesbank. In Germany the next day the Bundesbank followed up by buying an even larger amount of dollars and, to consolidate the ensuing improvement in the dollar rate, the Federal Reserve sold an additional $15.5 million of marks drawn on the swap line. The mark rate then steadied at about 4 percent above early-September levels.

The Federal Reserve intervened on only two other occasions in October when the dollar suddenly came under selling pressure against the mark—selling a total of $9.7 million equivalent on October 15 and 23, financed by swap drawings on the Bundesbank. Late in October, with evidence accumulating of a significant slowdown of the German economy, the Bundesbank shifted to a somewhat less restrictive monetary policy, cutting its discount and Lombard rates ½ percentage point. The mark then eased, permitting the Federal Reserve to buy moderate amounts of marks as cover against swap indebtedness, which amounted to $103.6 million at the end of October.

In early November, however, market sentiment turned even more bullish for the mark. In the United States, increasing evidence that a severe recession was under way, while promising to swing the United States trade accounts into a smaller deficit than expected, gave rise to expectations of an accelerated and abrupt decline of interest rates here. The German trade figures for September had shown a renewed large surplus, which—with another substantial surplus expected for October—rekindled speculation of a revaluation of the mark rate. In addition, a sharp advance of the Swiss franc, which had begun in October, was by November exerting an upward influence on the mark. The large-scale capital outflows that had persisted since the summer began partially to be met by offsetting inflows. German banks sold some DM 1 billion of German public authority notes to foreigners, of which one third was placed with OPEC countries. Moreover, some oil-exporting countries were arranging direct investments in German industrial enterprises.

The exchange markets became, therefore, even more sensitive to any developments likely to spur a further rise in the mark. Consequently, following news of a jump in United States unemployment, the mark was heavily bid up on November 6 and 7. Both the Federal Reserve and the Bundesbank intervened to moderate the rise, with the System selling a total of $49.2 million equivalent of marks, along with smaller amounts of Dutch guilders and Belgian francs. The mark sales were financed by a $25.6 million equivalent drawing on the swap line and by the use of balances. When the Swiss franc eased off toward midmonth, the mark followed suit and the Federal Reserve was able to acquire balances in the market.

Beginning on November 14, the mark itself became a renewed object of speculation in the market following press reports that the German government would not oppose a further rise in the mark rate. The spot rate was immediately bid up by almost 2 percent. The Bundesbank and the Federal Reserve both intervened on that day to resist the rise of the mark rate, the System selling $39.7 million equivalent drawn on the swap line. Speculation over a mark revaluation continued, however, and over the weekend the German government denied that it was considering measures to raise the mark rate. Following this clarification, on November 18 the Federal Reserve resumed forceful intervention not only in marks, selling $56.7 million equivalent drawn on the swap line with the Bundesbank, but also in Dutch guilders, Belgian francs, and Swiss francs. The Bundesbank and other European central banks followed up on the next day, and the Federal Reserve sold an additional $16.2 million equivalent of marks, again financed by a swap drawing. The revaluation talk did not die down completely, however, and the mark was bid up once again on November 22 and 25. The Bundesbank and the Federal Reserve again intervened to resist the rise in the rate, with the Federal Reserve selling a total of $26.1 million equivalent drawn on the swap line. Thereafter, the announcement of an unexpected trade surplus for the United States for October and a smaller than expected trade surplus for Germany, coupled with a firming of Euro-dollar rates, brought a brief respite. The mark eased, and the Federal Reserve was again able to buy marks to cover swap indebtedness. In early December, the Federal Reserve used these purchases, together with existing balances, to repay $82.8 million equivalent of swap debt, reducing the total outstanding to $185.1 million.

The exchange markets turned extremely thin during December, as traders sought to square their books before the year-end. The dollar came again on offer, as interest rates in the United States and Euro-dollar markets resumed their downtrend. For its part, early in the month the Bundesbank stated that it would seek a somewhat more rapid growth of the monetary base in the coming year and, on December 19, announced a further ½ percentage point cut in its discount and Lombard rates to 6 and 8 percent, respectively. Nevertheless, a further rise of the Swiss franc and the latest of a series of highly publicized OPEC investments in major German industrial firms dominated market psychology. The mark was gradually bid up and, to dampen the rise, the Federal Reserve intervened in modest amounts on seven business days between December 16 and December 30. These sales totaled $75.1 million, of which $31 million was from balances and $44.1 million was drawn under the swap line.

As the new year opened, the mark had already been bid up by some 11 percent from its September levels. Even so, discouraging news on the United States economy and the further drop in United States interest rates fostered bearish sentiment toward the dollar, while renewed revaluation rumors in Germany and the rising Swiss franc

Table III

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

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding January 1, 1974	Drawings (+) or repayments (—) 1974 I	1974 II	1974 III	1974 IV	1975 January	Drawings on Federal Reserve System outstanding January 31, 1975
Bank of Mexico	-0-	-0-	-0-	+180.0	—180.0	-0-	-0-
Bank for International Settlements (against German marks)	-0-	+26.0 —26.0	+76.0 —76.0	+ 65.0 — 65.0	+129.0 —129.0	+45.0 —45.0	-0-
Total	-0-	+26.0 —26.0	+76.0 —76.0	+245.0 — 65.0	+129.0 —309.0	+45.0 —45.0	-0-

prompted further speculative demand for marks. Both the Bundesbank and the Federal Reserve intervened in modest amounts to limit the rise of the rate, but the mark advanced a further 4 percent by January 24. Through that day the Federal Reserve had intervened in marks on five occasions in January, for a total of $58.9 million equivalent financed by additional swap drawings. On January 27, the mark jumped by a further 1 percent to $0.4356, the highest level since July 1973. By that time, however, European government officials were expressing increasing concern over the unrealistic levels to which the mark had risen, and the Bundesbank and the Federal Reserve then began to intervene in heavier volume to check the mark's rise. During the week of January 27 the Federal Reserve intervened on four days, selling a total of $94.6 million equivalent of marks, drawn on the swap line, as the Bundesbank operated in similar magnitude in Germany. The market began to respond to this more forceful approach, and the mark eased by 2 percent from its highs to close at $0.4275. By the end of January, the System's swap commitments in German marks amounted to $382.7 million equivalent.

SWISS FRANC

In Switzerland during 1974, inflation was running at nearly 10 percent, even though economic activity was leveling off during most of the year. The Swiss National Bank, therefore, kept bank liquidity under close rein, while modestly easing reserve requirements and providing liquidity to the market through swaps from time to time in response to recurrent strains in Swiss capital markets. In the exchanges, movements of the Swiss franc continued to be dominated by hot-money flows and shifting speculative sentiment. In the general decline of the dollar from late January to early May, the franc had been ratcheted upward by 23 percent to $0.3588. At that point, a turnaround followed reports of agreement among the Federal Reserve, the Bundesbank, and the Swiss National Bank on a plan of concerted intervention to counter any further erosion in dollar rates. The unwinding of long positions in francs and further accommodation of liquidity needs in Switzerland extended the decline of the franc, which eased some 6 percent by the end of July. Its drop was more gradual than that of some other Continental currencies, however, since the market was concerned that large short franc positions arising from the foreign-currency losses disclosed during the preceding months might still have to be covered.

With the dollar buoyant in August and early September, the Swiss franc continued to ease in a generally quiet market, falling to as low as $0.3300 or some 8 percent below the May peak. Then, as dollar interest rates began to drop back more rapidly than the comparable rates for Swiss francs, the spot franc turned firm once again. The Swiss National Bank provided some $1 billion equivalent of liquidity assistance to the banks through both short-dated and three-month swaps during September, thus avoiding an even sharper run-up in the franc rate before the quarter end. Nevertheless, demand for Swiss francs continued to swell, partly on the covering of outstanding short positions and partly in expectation that the franc, like the German mark, would benefit from any significant diversification of OPEC funds out of dollars and sterling.

Following a further reduction in the banks' required reserves on October 8, the money market in Switzerland had become quite comfortable. The Swiss authorities, therefore, took advantage of this opportunity to dismantle yet another of their previously imposed barriers against inflows by lifting the ban on interest payments to nonresidents on October 16. By that time, however, traders were increasingly concerned over possible diversification of OPEC funds, and the franc was bid up sharply in a thin market. In addition, political uncertainties elsewhere in Europe and in the Middle East generated flows into francs. The spot franc then began to advance sharply not only against the dollar but also against the currency of Switzerland's largest trading partner, the German mark. This persistent rise posed a policy dilemma for the Swiss authorities, since intervention to halt the rise of the franc in the exchange market—and thus avoid further erosion of Switzerland's competitive position—would augment domestic liquidity and thereby undermine efforts to curb inflation. The market began to sift every statement by Swiss officials to anticipate the point at which the Swiss National Bank might intervene in the exchange markets. Consequently, the franc snapped sharply higher on November 7, following news reports from Switzerland that the National Bank was still unprepared to buy dollars, only to fall back nearly 2 percent over the following days simply on reports that the Federal Reserve, the Bundesbank, and the Swiss National Bank were prepared to intervene in a concerted manner.

Just after midmonth, the franc came into demand once again in the backwash of speculation over a revaluation of the German mark. By November 18, the franc had risen about 16 percent against the dollar from its September lows and 5¾ percent against the mark. As part of a concerted intervention in marks, Swiss francs, Dutch guilders, and Belgian francs that day and on the following day, the Federal Reserve sold a total of $12.5 million of Swiss francs, which had been purchased directly from the Swiss National Bank. In response to this operation, the franc fell back by 6⅝ percent over the next two days. The Swiss National Bank followed up on November 20 by reimposing the negative interest charge, at 3 percent per quarter, and a ban on interest payments, each on the increase in nonresident deposits above October 31 levels. The central bank also obtained authority to monitor banks' forward sales to foreigners and to use swap transactions if necessary to enforce these new measures. These actions prompted an even further scramble in the market to unload francs, and the spot rate dropped a further 2 percent by November 21.

Over the next weeks the market in Swiss francs was thinner and even more volatile than before, as dealers were sensitive to talk of new initiatives to discourage inflows. Under these circumstances, when mark revaluation rumors resurfaced, the franc advanced a full 6⅜ percent by November 26 before settling back. The Swiss National Bank then took further regulatory measures to limit the rise of the franc. On November 28 it reactivated the requirement that proceeds of foreign borrowings in Switzerland be converted immediately into foreign currency. Four days later it raised banks' reserve requirements against deposit liabilities to nonresidents. The National Bank also announced it would again assist the banks with their year-end positioning by providing swaps. Ultimately, the National Bank provided $1 billion of year-end swap assistance and did an additional $500 million of one- and three-month swaps outside the usual quotas to influence market conditions. Even so, the market continued to push the rate up during December. On December 17, after the franc rose especially sharply, the Federal Reserve again intervened in both German marks and Swiss francs, selling a total of $26.5 million equivalent of francs, of which half was purchased outright from the Swiss National Bank and half was drawn under the swap line with that bank. The franc eased over the next days, and the Federal Reserve purchased francs in the market to repay $5.9 million equivalent of the swap debt.

In the generally bearish atmosphere for the dollar, the Swiss franc continued to advance even after year-end positioning passed. On January 6, the Swiss National Bank resumed outright intervention in the spot market in Zurich, confirming its operation "to maintain orderly exchange market conditions". The Federal Reserve followed up with similar intervention in New York, as part of its concerted intervention in both francs and German marks. These joint interventions continued over the following days, and at first the Swiss franc dropped back. The demand for francs soon picked up again, however, after it was reported that failure of a financial subsidiary of an Italian company would leave a major Swiss bank short of francs. As the market anticipated a large demand to cover a substantial volume of this subsidiary's contracts maturing early in 1975, a more generalized speculation in favor of the Swiss franc developed. The franc was heavily bid up to new record levels, while the Swiss National Bank continued to intervene, at times quite heavily. The Swiss authorities then resisted further upward pressure by severely tightening recently imposed curbs on inflows of foreign funds. In particular, the ban on interest payments was widened to apply to all nonresident balances, the negative interest charge was raised to 10 percent per quarter, banks were required to balance all foreign exchange positions daily, and provision was made whereby the National Bank could block Swiss franc liquidity resulting from dollar intervention.

These new measures at first drew a strong market response, and the franc fell back. But, as the market grew doubtful that these measures could prevent a further rise in the franc as long as short franc positions overhung the market, the Swiss franc turned around and was soon outpacing other European currencies. By January 27, it had reached a new record of $0.4195, some 27 percent

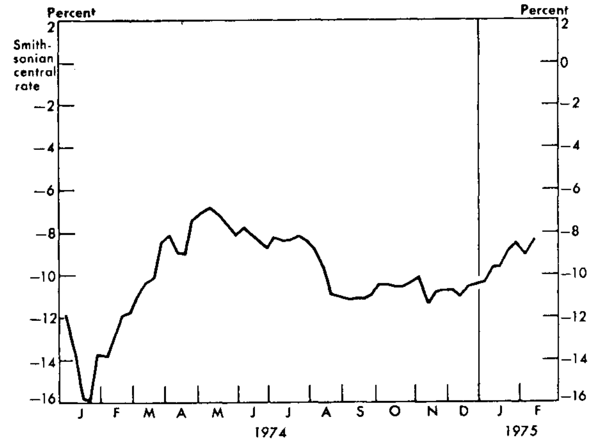
Chart III
SWITZERLAND
MOVEMENTS IN EXCHANGE RATE *

* See footnote on Chart II.

above last summer's lows. The Swiss National Bank then tightened its November regulation, limiting Swiss banks' sales of Swiss francs to nonresidents.

By this time, the immediate demands for Swiss francs had slackened and the dollar had begun to recover in other markets. Consequently, pressure in favor of the Swiss franc let up, and the franc eased to $0.4014 by the end of January. During the month the Federal Reserve, operating on six different occasions, sold a total of $24.6 million equivalent of francs. Of this amount, $5.3 million was purchased outright from the Swiss National Bank and $19.3 million was drawn under the swap line. Consequently, System drawings in Swiss francs were increased by $26.6 million equivalent as a result of the December-January operations, bringing total Swiss franc indebtedness including that outstanding since 1971 to $997.8 million equivalent by the end of January.

Chart IV
UNITED KINGDOM
MOVEMENTS IN EXCHANGE RATE*



* See footnote on Chart II.

STERLING

Last summer, the United Kingdom was faced with severe financial, economic, and balance-of-payments strains. Industry was caught between high wage, raw material, and financing costs, on the one hand, and statutory limits on prices, on the other. The ensuing squeeze on profits and corporate liquidity was restricting inventories, investment, and output. With industrial production not fully recovered from the disruption of the three-day workweek earlier in the year, the new cutbacks threatened a more prolonged stagnation and a rising unemployment rate while domestic inflation continued at a rapid rate. Meanwhile, the trade deficit had swelled to over $6 billion in the first half of the year, of which close to $3 billion reflected costlier oil imports. At the same time, the worldwide slowdown of economic activity cast a shadow on export prospects.

Although the exchange market sentiment remained bearish toward sterling, the pound depreciated on a trade-weighted basis only slightly during August and September while slipping against the dollar some 2 percent to around $2.33. Oil-related and other capital inflows roughly offset the United Kingdom's large current-account deficit and helped bolster the spot rate. During the third quarter, oil-exporting countries invested a net $2.2 billion in relatively high-yielding sterling assets. Oil companies also accumulated sterling, both spot and forward, in anticipation of future tax and royalty payments and for investments in North Sea exploration. The Bank of England operated on both sides of the market in August and September to smooth the impact of oil-related transactions.

By early October, however, the inflow of oil-related funds tapered off, as concern over Britain's economy continued and short-term sterling interest rates suddenly declined. In addition, there was some temporary nervousness ahead of the October 10 general election. The pound therefore tended to weaken against many of the Continental currencies while holding roughly steady against the dollar. The market soon came into better balance, however, as new demand for relatively large October oil payments in sterling counterbalanced continuing sales by oil producers diversifying out of sterling. Following the trend of other European currencies more closely, the spot pound firmed to $2.35 by early November.

Meanwhile, adverse economic developments led to some apprehension ahead of the November 12 budget message. The worsening inflation had triggered successive rounds of threshold wage increases, and recently negotiated wage settlements had cast doubt on the effectiveness of the government's "social contract" to achieve a voluntary pay restraint. Prospects of rising unemployment were increasingly underscored by news of further layoffs and business failures. The market was somewhat reassured by new budget proposals to alleviate corporate liquidity strains without having an excessive overall stimulative impact as many market participants had feared. Moreover, the extension of the Bank of England's supplementary deposits scheme to allow the banks to help provide sufficient corporate financing without encouraging a more rapid growth of the money supply was also viewed positively.

The market was caught by surprise, however, by an accompanying announcement from the Chancellor of the Exchequer that the United Kingdom's guarantee arrangements on official holdings of sterling would be allowed to expire in December. As these guarantees did not apply to the large accumulation of sterling holdings since September 1973, the market had taken in stride Australia's announced withdrawal from its arrangement in September 1974. But, since some dealers saw total abolition of guarantees as possibly stimulating accelerated diversification out of sterling, heavy selling pressure quickly materialized and the spot rate dropped below $2.30. After substantial Bank of England support, as well as renewed oil-related demand for November royalty payments, the market steadied and sterling moved narrowly against the dollar through early December. Nevertheless, with other currencies advancing against the dollar, sterling lost further ground against the currencies of Britain's major trading partners. During October and November, half of the government's $2.5 billion Euro-dollar loan and $400 million of the British Water Council's loan from Iran were taken into foreign exchange reserves, which increased on balance about $650 million for the two months.

Just before mid-December, it was reported that Saudi Arabia had informed the Aramco group that it wished all future oil payments to be made exclusively in dollars. The subsequent liquidation of sterling previously acquired by Aramco members and prospects of even more diversification of OPEC funds largely into Continental currencies triggered new selling pressure on the pound. The Bank of England resisted the rate decline with substantial support. Thereafter, Saudi Arabia reaffirmed publicly that it would continue to invest in sterling assets, and other Middle East sterling holders followed up with similar reassuring statements. The market then steadied and, when a severe squeeze developed in the Euro-sterling market, the pound benefited from some covering of short sterling positions. Over the remainder of the year, the spot rate traded narrowly around $2.34 and the trade-weighted value of sterling recovered from the record low set on December 12.

During January, sterling once again lagged behind the strong advance of the major continental European currencies against the dollar. New fears about corporate solvency in Britain and about possible diversification of sterling balances exerted a drag on sterling. Later in the month, the favorable impact of improved trade figures for December was more than offset by successive reductions in the Bank of England's minimum lending rate to 11 percent and corresponding declines in London money market rates. Consequently, the pound weakened further against major Continental currencies although rising somewhat against the dollar to $2.38 by the month end. The Bank of England provided further moderate support to check the erosion. Over the two months of December and January, official dollar sales, together with other foreign-currency payments, were partly offset by additional drawings on the United Kingdom government's $2.5 billion Euro-currency loan, but Britain's reserves nevertheless declined by about $1 billion.

Table IV

UNITED STATES TREASURY SECURITIES
FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding January 1, 1974	Issues (+) or redemptions (—)					Amount outstanding January 31, 1975
		1974				1975	
		I	II	III	IV	January	
Swiss National Bank	1,459.2	+127.3					1,599.3
Bank for International Settlements	127.3	—127.3					-0-
Total	1,586.4	{+127.3 —127.3	-0-	-0-	-0-	-0-	1,599.3*

Note: Swiss-franc-denominated security issued to the Bank for International Settlements was reissued to the Swiss National Bank at its maturity in January 1974.

* Increase in amount outstanding reflects valuation changes through April 1974.

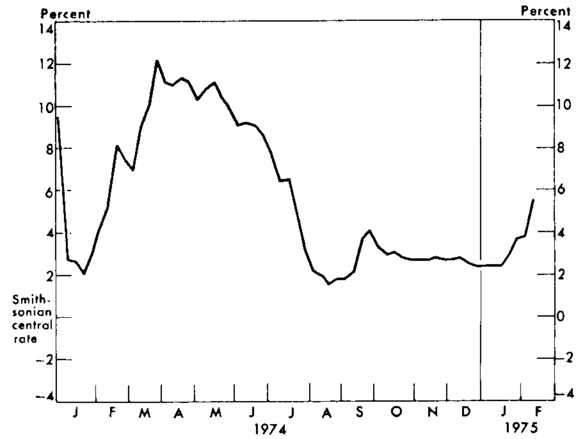
JAPANESE YEN

A $6 billion increase in Japan's oil import bill in the first half of 1974 and sharply higher commodity prices had driven Japan's current account into deep deficit early in the year. This was largely financed by heavy short-term borrowings by Japanese banks, both in the Euro-dollar market and in the United States. By midsummer, however, with the Euro-markets under unusual strains, some Japanese banks were reportedly approaching credit limits and facing increasing costs of funds there. The Japanese authorities requested the banks to refrain from excessive borrowing, and then the demand for spot dollars in Tokyo increased. By August 22, the yen had fallen over 10 percent from its late-March 1974 peak to $0.003294, its lowest point since it was floated in February 1973. The Bank of Japan from time to time intervened in the market to avoid wide fluctuations in the yen rate, providing support through moderate sales of dollars. The authorities also took a series of steps in August and early September to relax impediments to inflows of foreign funds to Japan. Controls were eased on net conversions of dollars into yen by foreign banks, on prepayments for Japanese exports, and on nonresident investments in certain Japanese securities. In addition, reserve requirements on nonresident "free yen" deposits were reduced to zero. These measures helped relieve the pressure, and the yen rate steadied above its lows.

Meanwhile, Japanese economic activity remained sluggish after a sharp decline early in the year. Upward pressure on wholesale prices abated, but consumer prices continued to rise rapidly. Therefore, the Japanese authorities maintained their highly restrictive monetary policy. With domestic sales sagging and inventory financing becoming increasingly burdensome, Japanese companies placed greater emphasis on exports. As shipments abroad surged, Japan's trade balance, after a $2.7 billion first-half deficit, swung decisively into surplus by late summer. Successive reports of this turnaround contributed to the improvement in market sentiment in September. After mid-September, wire service reports that a $1 billion loan had been arranged between an oil-producing nation and Japan sparked active bidding for yen. Later in the month, figures were released showing a current-account surplus for August—the first since the escalation of oil prices the winter before—and the yen was bid up further to a level 3 percent above its August lows.

By early October the yen had steadied around $0.003333, but market uncertainties persisted and the yen came under some renewed pressure in late October. Trading then came into better balance during November

Chart V
JAPAN
MOVEMENTS IN EXCHANGE RATE *



*See footnote on Chart II.

and early December, as the Japanese authorities further relaxed restrictions on capital inflows from abroad. The Ministry of Finance permitted Japanese corporations to use the proceeds of certain foreign bond issues for domestic purposes, and several companies quickly moved to arrange new issues abroad. The Bank of Japan also asked Japanese banks to reduce as much as possible the additional cost of their borrowings in the Euro-dollar market.

Continuing market concern over prospects for the yen resurfaced in late December and early January. Pressure on the yen gradually eased, however, as dealers reacted to news of Japan's strong export performance in December and as new Japanese corporate foreign borrowings were converted into yen. Moreover, the market responded favorably to the Bank of Japan's reaffirmation of its policy of restraint, until prices had stabilized, and to the generally anti-inflationary thrust of the government's draft budget. By late January, the yen had begun to advance in sympathy with the sharp rise of European currencies against the dollar, reaching $0.003363, some 3 percent above the August low.

FRENCH FRANC

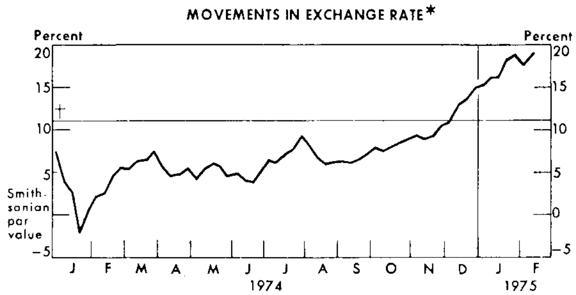
In contrast to many other industrial countries, France enjoyed real economic growth and relatively low unemployment during the year. On the other hand, the inflation rate remained relatively high, compared with price trends in Germany and neighboring countries.

Moreover, the trade account, which had been in moderate surplus throughout 1973, swung into deep deficit by May. In part, this deterioration was in response to relatively buoyant domestic demand. More importantly, it reflected a $6 billion increase for 1974 in France's oil import bill, as well as the adverse shift in French terms of trade following the downward float of the franc early in the year.

To counter the worsening inflation and the weakening trade position, the French government imposed progressively more stringent economic policies. In June, the government adopted a new anti-inflation program containing credit, tax, price control, and energy-saving measures. In September, it followed up by renewing ceilings on credit growth (except on credits to finance export production) and announcing a stringent $11 billion limit on oil imports for 1975. Meanwhile, around midyear, the Bank of France had hiked its discount rate to a record 13 percent, stiffened penalties for banks exceeding official credit ceilings, and maintained a severely tight money market. As monetary policies in other countries were gradually relaxed, substantial interest rate differentials in favor of the French franc emerged. In response, short franc positions—built up before the floating of the franc and the French presidential elections in May—began to be covered and French enterprises stepped up their borrowings abroad.

The franc remained relatively firm during the late summer and early fall. Although it eased from its early-August levels as the dollar strengthened around midmonth, its decline was less pronounced than for most currencies. Favorable interest rate incentives, together with news of more bank failures and large exchange losses elsewhere in Europe, prompted further repatriations of funds and a building-up of franc balances by nonresidents. By the end of August, the franc had resumed an uptrend which gained momentum after mid-September, when discussions of multilateral proposals and direct deals for financing European oil deficits helped to dispel some of the market's concern over France's large oil deficit. The franc at times outpaced the German mark and other European currencies in the general upswing of currencies against the dollar, rising 4 percent to $0.2145 by November 7. To moderate the rise of the franc, the Bank of France made increasingly heavy purchases of dollars, thereby contributing to the $600 million increase in French reserves during the three months to end-October.

Chart VI
FRANCE
MOVEMENTS IN EXCHANGE RATE*

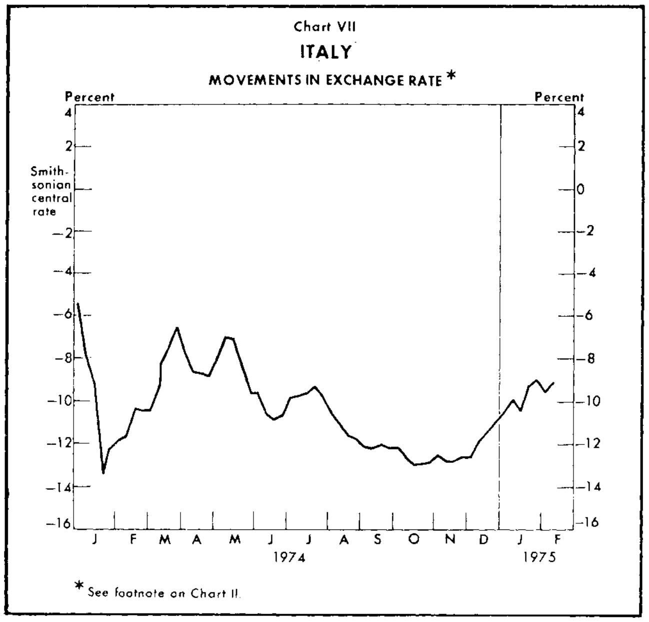


* See footnote on Chart II.
† Central rate established on February 12, 1973.

Meanwhile, the economic climate in France was deteriorating. The high rate of inflation generated growing labor unrest, and by early November a number of strikes erupted that threatened to disrupt production. At the same time, the government's austerity measures were beginning to bite, causing an abrupt slowing of output and a jump in unemployment. Against this uncertain background, the rise in the franc faltered. Indeed, while holding steady against the dollar through much of November, the franc dropped to its lowest levels against the German mark and other Continental currencies in five months. Following reports of large-scale layoffs and short hours, the labor strikes ended and pressure against the French franc eased. Late in the month, market tone improved further after President Giscard d'Estaing relieved growing concern over unemployment by promising renewed economic expansion for 1975 and providing special assistance to industries most vulnerable to the slowdown.

By early December the franc was again in demand. French interest rates remained near their peak levels with the three-month Euro-franc rate some 8 percentage points above the corresponding Euro-dollar rate. Moreover, France's trade deficit was narrowing far more rapidly than had been forecast, as imports slackened in the face of weakening domestic demand and lower energy requirements. In addition, news of a $1 billion loan agreement with Iran and other successful Middle East negotiations promised to bolster France's external position in the coming year. The franc climbed sharply, therefore, again outpacing other currencies as the dollar declined in December. The Bank of France resumed intervention, buying dollars regularly to keep the franc's rise in line with other currencies.

After the first week in January, the French government began gradually to relax its restrictive monetary policy. The Bank of France cut its discount rate 1 percentage point to 12 percent on January 9. In addition, minimum reserve requirements were reduced on January 21, and the regulation of bank credit was made more flexible. Nevertheless, French interest rates remained well above those in most other markets and the French franc continued to advance. Boosted further by news of a trade surplus in December—the first monthly surplus since 1973—the franc moved up to $0.2349 just before the end of January to trade nearly 14 percent above its mid-August lows.



ITALIAN LIRA

Midsummer 1974 marked a significant turning point in Italian economic and balance-of-payments trends. During the first half of 1974, inflation was continuing at a rate two to three times faster than in most other major industrial countries, as sharply higher costs for imported oil and other commodities, production bottlenecks in some industries, and an expanding government budget deficit helped perpetuate the inflationary spiral. The current-account deficit had more than doubled under the weight of a $6 billion increase in oil imports for 1974, exerting persistent pressure on the lira in the exchanges. The authorities had intervened heavily to prevent a substantial depreciation of the lira from worsening domestic inflation. The bulk of this intervention had been financed by new foreign borrowings, including EC short-term assistance, and by midyear Italy's medium-term indebtedness to the Euro-dollar market stood at $8 billion. Meanwhile, to eliminate the nonoil deficit, contain inflation, and rein in public spending, the authorities progressively stiffened monetary and fiscal policies and imposed an import-deposit scheme.

By midyear these measures were beginning to take hold. A sudden weakening of domestic demand was narrowing the nonoil component of the trade deficit, and declines in world commodity prices promised an unexpected further improvement. The severe tightening of domestic liquidity was stimulating a substantial influx of short-term funds, as Italian commercial banks borrowed heavily in the Euro-dollar market to finance domestic lending. Conversions of these borrowings had a steadying effect on the Italian lira in the exchanges, and the Bank of Italy had been able to add to its reserves.

By late July, the Italian authorities had become concerned that the rapid growth of bank borrowing abroad would frustrate the extremely restrictive monetary policy and might aggravate existing strains in the international capital markets. Therefore, the authorities instructed banks to limit their net foreign indebtedness to July 19 levels, and the net inflow of funds began to taper off in early August. Then, after Italy's severe liquidity crunch eased somewhat with the exemption of all agricultural products from the import-deposit scheme, the repayment of foreign borrowings picked up and continued throughout the next several weeks. By the end of September, Italian banks had reduced their net foreign indebtedness by almost $1 billion. As these repayments coincided with the normal seasonal slackening of tourist receipts, the lira periodically came under some selling pressure during August and early September. The Bank of Italy provided occasional moderate support for the lira rate to prevent it from weakening too rapidly against other European currencies.

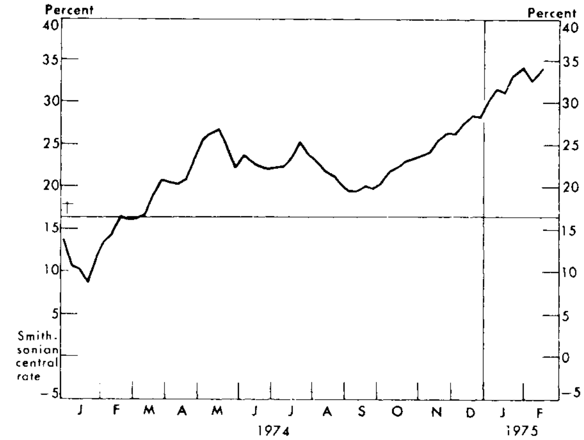
In the meantime, Italy obtained new official credits to cover its current-account deficit. In early August, the Italian authorities drew a total of $622 million equivalent from the International Monetary Fund (IMF) against its gold tranche and the first tranche of its $1.2 billion standby. Later in the month, the Bank of Italy obtained $2 billion by way of a reciprocal gold-dollar deposit with the Bundesbank. (In that transaction, the gold was valued at 80 percent of average recent market prices or about $120 per ounce.) Then, in mid-September, Italy borrowed $315 million from the IMF oil-financing facility and renewed its European Monetary Cooperation Fund credit of $1,885 million. The government also announced a second takedown of $540 million equivalent from Italy's IMF standby credit. The new borrowings, which were taken into official reserves over the two months through the end of September, helped improve market sentiment, and the lira held about 3 percent below its late-July levels until early October.

Meanwhile, the Italian economy had markedly slowed down, with industrial output falling sharply. Domestic price inflation continued to worsen, however. As Cabinet disagreement over continuation of the government's austerity program surfaced, leading to Prime Minister Rumor's resignation on October 3, outflows of funds put renewed pressure on the lira. The exchange rate slipped about 1 percent against the dollar and 4 percent against other EC currencies, while the Bank of Italy provided heavy support in the first half of the month to moderate the lira's decline. Although selling pressures temporarily subsided toward the end of October, the lira remained relatively weak and did not participate in the general upsurge of European currencies in November. By the end of that month, the lira had depreciated by a further 1 percent against the other EC currencies while holding steady against the dollar. Over the two months, intervention sales of dollars were mainly responsible for a $1.2 billion decline in official reserves.

Market sentiment improved considerably in December, as the new government under Premier Moro moved swiftly to implement its economic program. Monetary policy was kept restrictive, although the Bank of Italy made a modest cut in its historically high discount rate. In addition, measures to discourage crude oil imports were adopted and plans for expanded capital investments in energy, agriculture, and public works were proposed. In the exchanges, a significant reflow of funds, which had been moved out of the lira at the height of the Cabinet crisis, was reinforced by continuing tight money market conditions. Furthermore, the slowdown of economic activity was dampening import demand. Thus, the lira rate firmed almost 2½ percent during December.

After the year-end, however, the lira again came on offer. The Bank of Italy relaxed its restrictive stance somewhat further and, as liquidity strains in Italy eased during January, short-term reflows slowed. In addition, although Italy's nonoil trade was improving, a seasonal weakening in the trade balance and a bunching of oil payments depressed the rate. As on other occasions, moreover, pressure on the dollar occasionally spilled over onto the lira, and it lost substantial ground against the EC currencies. The Bank of Italy again provided support, and by the month end the immediate pressures had lifted. On January 31, the lira rate stood at $0.001564, about 1 percent higher than at the outset of the reporting period.

Chart VIII
NETHERLANDS
MOVEMENTS IN EXCHANGE RATE*



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

NETHERLANDS GUILDER

The Netherlands strong current-account surplus in 1974, together with expectations of further improvement in the balance of payments in 1975, kept the Dutch guilder strong against both the dollar and other European currencies during the reporting period. Prospects for increased natural gas exports blunted the impact of higher prices on oil imports, while port and shipping services were improving the net invisibles balance. Reports of a continuing large current-account surplus had spawned revaluation rumors in late July. Speculative demand for guilders had been countered by coordinated Netherlands Bank-Federal Reserve intervention, and the rumors were spiked by an official denial of any revaluation intentions. The guilder then turned lower, dragged down by the declining German mark, and substantial intervention against marks was required to maintain the limits of the EC band.

The only Federal Reserve intervention in guilders late in the summer came on August 9 when $5.3 million equivalent was sold along with other currencies, as markets were briefly unsettled during the period of transition of presidential authority in the United States and after release of disappointing United States wholesale price figures. The sale of guilders was financed by a drawing on the swap line with the Netherlands Bank and, as the guilder quickly resumed its decline, sufficient guilders were acquired to liquidate the swap commitment. By early September, the guilder had fallen 3¾ percent to $0.3663.

Money market conditions in Amsterdam then tightened, as seasonally heavy tax payments pushed up Dutch interest rates at a time when a cut in reserve requirements in

Germany was adding to liquidity in Frankfurt. In addition, the Dutch government announced, as part of its 1975 budget proposal, a steep increase in the price of natural gas, estimated to add $500 million to the Netherlands' 1975 exports. Consequently, the guilder was again bid up and, as the EC snake came under increased pressure, the Netherlands Bank stepped up its purchases of marks. The Dutch central bank also began to provide substantial amounts of guilders through one- to three-month dollar swaps with the commercial banks, lessening domestic liquidity strains. In the two months August-September, Dutch official reserves increased by about $1 billion.

In October, the guilder participated in the upward movement of continental European currencies against the dollar, with little reaction to a percentage point reduction in the Netherlands Bank's discount rate to 7 percent late in the month. In view of the relative positions of EC snake currencies in November, when the European currencies began to advance more sharply, the Federal Reserve supplemented its intervention against marks by offering guilders as well. The Federal Reserve sold $6.5 million equivalent of guilders on November 7 and a total of $22 million equivalent during the coordinated central bank intervention of November 18 and 19. The Netherlands Bank followed up in the Amsterdam market by purchasing moderate amounts of dollars. The System's sales were financed by drawings on the swap line and were repaid through market purchases when the guilder temporarily declined. Dutch reserves increased another $550 million during October and November, largely as a result of continued dollar swap transactions with the Dutch banks.

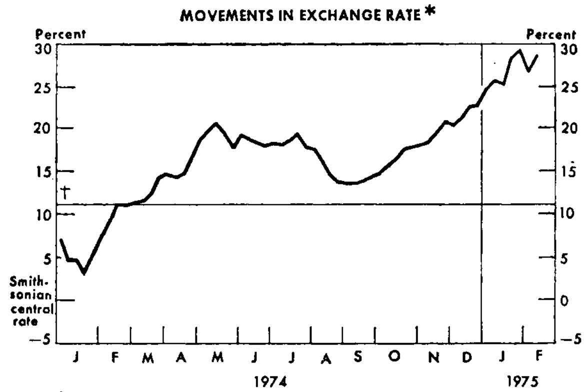
By early December, the guilder strengthened again to a level 6½ percent above its September low. Meanwhile, the Dutch government, increasingly concerned about rising unemployment and sluggish domestic economic activity, particularly in the construction industry, had announced new measures to stimulate the economy. Taxes on wages and salaries would be cut as of April 1, 1975, investment incentives were broadened, and private sector payments for social services were reduced. Together with the planned deficit in the September budget, these actions would provide substantial fiscal stimulus while monetary policy would remain moderately restrictive to counter inflationary pressures. Thus, Dutch interest rates held above those in some other financial centers and provided an incentive for funds to move into guilders as the dollar generally remained on offer in the exchanges in December. The Dutch authorities again provided liquidity through dollar swaps with commercial banks and also bought modest amounts of dollars outright in the spot market. For its part, the Federal Reserve also intervened in guilders in New York on December 17 and 27, selling a total of $9.6 million equivalent of guilders along with other currencies to cushion the decline in dollar rates. These sales were financed by additional swap drawings, of which all but $3.2 million was repaid through subsequent market purchases. The guilder nevertheless was pulled sharply higher in January by the speculative rise of the mark and Swiss franc. It reached a peak of $0.4175 on January 27—14 percent above its September low—before dropping back somewhat on subsequent days along with other currencies.

BELGIAN FRANC

The slowdown in Belgium's economy that set in around mid-1974 was more gradual than in most other industrial economies. The pace of domestic inflation, on the other hand, remained high relative to that for Belgium's principal trade partners. Consequently, the authorities maintained a restrictive monetary policy, with the result that Belgian interest rates rose to levels above those prevailing in most other Continental financial centers and remained relatively firm throughout the second half of the year. The pull of high yields in Belgium prompted both a reflux of previous outflows and inflows of new short- and long-term capital. These inflows, together with a current account that was still in surplus despite higher imported oil costs, provided a continuing buoyancy for the Belgian franc in the exchanges.

Accordingly, the Belgian franc declined more gradually

Chart IX
BELGIUM
MOVEMENTS IN EXCHANGE RATE *



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

against the dollar in August than most other European currencies, while holding just below the top of the EC band. The Federal Reserve sold $2.5 million equivalent of Belgian francs, along with its sales of other currencies, to forestall a sudden slippage in dollar rates on August 9. Of this, $1.7 million was financed by a drawing on the swap line with the National Bank of Belgium and the remainder was drawn from System balances. The swap commitment was promptly repaid as the Belgian franc was pulled down by the German mark. In early September, the commercial rate bottomed out at $0.025275, almost 4 percent below early-August levels.

After mid-September, however, the franc began to rise again. Liquidity in Belgium was tightened further by tax payments and by higher reserve requirements on call deposits. Moreover, there was a shift of funds into francs out of German marks in response to a tightening of foreign exchange restrictions both in Germany and Luxembourg. In November, the rise of the Belgian franc accelerated as pressure on the dollar generally intensified. To dampen the franc's advance and avert a buildup of pressure within the EC snake, the National Bank of Belgium frequently made modest purchases of dollars in Brussels. In New York the Federal Reserve offered Belgian francs, along with other European currencies, to smooth the decline in dollar rates on November 7, 18, and 19 and December 17. Total sales of Belgian francs amounted to $13.7 million equivalent, of which $13.2 million was drawn on the swap line and subsequently was repaid through market purchases. The remainder was drawn from balances.

By the year-end the slowing pace of Belgian economic activity had induced an easing of credit demands, and Belgian interest rates turned down. Late in January, in view of domestic and international interest rate trends, the National Bank relaxed its credit policy by reducing the discount rate by ½ percentage point to 8¾ percent, raising ceilings on credit growth, and releasing reserves against bank time deposits. Nevertheless, the decline in Belgian interest rates lagged behind those elsewhere. The Belgian franc thus held at or near the top of the EC band, requiring the central bank to purchase moderate amounts of other participating currencies. As the European currencies generally strengthened against the dollar, therefore, the commercial franc advanced to $0.028600 on January 31, and the National Bank purchased further small amounts of dollars to resist the rise. At this level, the commercial Belgian franc stood almost 13 percent above its September low. As of January 31, System swap commitments with the National Bank of Belgium totaled $261.8 million equivalent of Belgian francs, all incurred prior to August 15, 1971.

CANADIAN DOLLAR

The gradual decline of the Canadian dollar that had begun in June 1974 continued with only brief interruptions during the six-month period under review. The downtrend primarily stemmed from a progressive erosion of Canada's trade surplus during 1974 and an increasingly pessimistic market assessment of prospects for 1975. Export growth fell off sharply as a result of the severe slackening of United States demand and the break in world commodity prices that tended to weaken Canada's terms of trade. By contrast, the deceleration of economic activity in Canada was more moderate than elsewhere, with a still buoyant investment demand sustaining imports of capital goods. Consequently, many published Canadian forecasts showed the Can.$706 million export surplus for the first half of 1974 swinging into deficit by early 1975. Whereas trade deficits in earlier years had been financed by large capital inflows, prospects for long-term inflows were now uncertain and short-term capital flows were largely responding to the shifting interest rate incentives between Canada and the United States.

In early August, when the near-record levels of dollar interest rates yielded strong disincentives against Canada, selling of Canadian dollars intensified as United States corporations repatriated funds to their home offices. Labor unrest in Canada further depressed the market. The spot rate fell almost 1 percent to a low of $1.0109 by August 28. The Bank of Canada intervened to avoid too rapid a decline and, during August, Canada's reserves fell $160 million. In September and October, as the retreat of United States short-term rates was underscored by declines in United States prime rates, the Canadian dollar recovered somewhat. Positioning by Canadian banks in anticipation of several conversions of foreign borrowings and of their October 31 fiscal year-end also temporarily spurred demand for the Canadian currency. But, by late October, the spot rate was again easing.

Meanwhile, the sharp production cutbacks in United States output were exerting an increasingly heavy drag on the Canadian economy. As demand for credit weakened, Canadian banks lowered their prime rates. In addition, the Bank of Canada cautiously eased the restrictive stance maintained during the first half of the year by reducing its discount rate to 8¾ percent, the first cut from the peak 9¼ percent level established in July. Shortly thereafter, chartered banks' secondary reserve requirements were lowered 1 percent to 7 percent. Then, on November 18, the government announced a somewhat more stimulative budget for the fiscal year beginning April 1975, featuring cuts in the personal income tax. These actions were largely

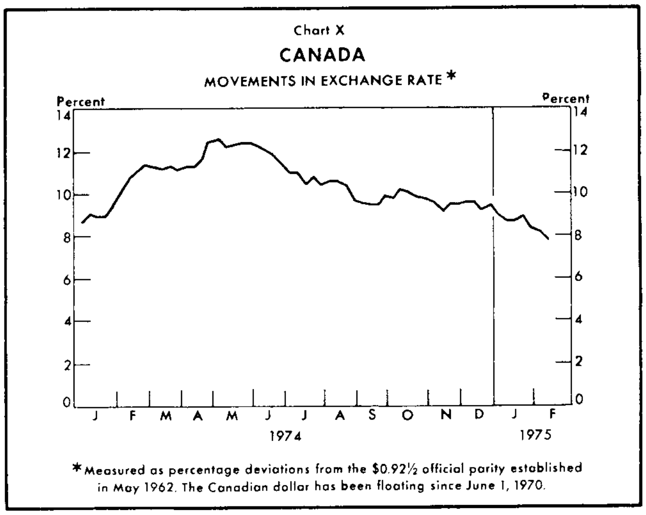


Chart X
CANADA
MOVEMENTS IN EXCHANGE RATE *

*Measured as percentage deviations from the \$0.92½ official parity established in May 1962. The Canadian dollar has been floating since June 1, 1970.

in line with market expectations, and the Canadian dollar fluctuated narrowly between \$1.01 and \$1.0150 through mid-December.

Late in the month, however, market sentiment toward the Canadian dollar worsened again. News of a Can. \$149 million trade deficit for November confirmed expectations of a continuing deterioration in Canada's underlying payments position, and the market was expecting another cut in the central bank discount rate. As Canadian banks added to their United States dollar positions and commercial leads and lags worsened, the Canadian dollar fell to a twelve-month low of \$1.0004 on January 9. Several days later, the Bank of Canada, having reduced secondary reserve requirements by another percentage point in early January, lowered its discount rate by another ½ percentage point to keep it in line with the general decline of Canadian money market rates. Since exchange dealers had actually counted on a larger cut and there were substantial conversions of Canadian provincial foreign borrowings that boosted the spot rate, the Canadian dollar briefly rebounded to nearly \$1.01. Once the conversions were completed, the rate turned lower again. After the final trade figures for 1974 were released, revealing a steep erosion of Canada's trade surplus to Can.\$419 million for the year—little more than a fifth of the 1973 level—the Canadian dollar eased to \$1.0008 on January 31. This represented a 2 percent decline against the dollar since August levels and a substantial depreciation against virtually all other major currencies.

EURO-DOLLAR

The Euro-currency markets continued to suffer from the erosion of confidence that afflicted international banking following the failure of banks in several countries last year. Persistent nervousness in the market was reflected in new cuts last fall in credit lines to many market participants. In particular, smaller and even medium-sized banks and those of certain countries under balance-of-payments pressure remained subject to rather close and, in some cases, increasingly tight credit ceilings by their traditional suppliers. The multitiered rate structure that had emerged last spring and summer, therefore, persisted. The strains in the market gradually subsided, however, with the result that the differentials between the rates charged to different classes of banks narrowed and almost disappeared early in 1975.

The improved market tone owed much to an announcement by the Bank for International Settlements on September 10 that the central bank governors meeting at Basle, following a discussion of the problems of a lender of last resort in the Euro-markets, had concluded that means are available for the provision of temporary liquidity and will be used if and when necessary. The market was further reassured when consortium banks responded to the Bank of England's request for firm commitments from shareholders to support the banks' operations if they ran into problems at any time. Another boost to market confidence was given by an official statement that "the Federal Reserve is prepared, as a lender of last resort, to advance sufficient funds suitably collaterialized to assure the continued operation of any solvent and soundly managed member bank which may be experiencing temporary liquidity difficulties associated with the abrupt withdrawal of petrodollars—or any other deposits".

After a fairly steep decline in outstanding deposits last summer, the Euro-currency market resumed its expansion in the final quarter of last year, albeit at a much reduced rate. Its continued growth benefited greatly from renewed placements of sizable OPEC deposits, which brought the total for the year to an estimated \$23 billion or 40 percent of OPEC countries' surpluses. Thus, the market remained the major receptacle for those funds that the oil-producing countries were unable to spend for goods and services and did not employ for grants-in-aid and loans to oil-importing countries. During the summer and fall, the market also benefited from sizable advances by United States banks to their branches, notably those located in the Bahamas, which then passed on these funds to a variety of bank and nonbank borrowers.

As OPEC and other major supplier countries added further to their Euro-currency holdings, overall liquidity in the market improved but the market continued to suffer from a maldistribution of liquidity. The very large banks in the market had ample funds at their disposal, often more than they desired in view of their capital and surplus positions. While the very large banks grew in strength and importance, the role of some of the medium-sized and smaller banks became stationary or diminished. A few banks unable to command the relatively attractive rates offered to their bigger competitors actually scaled down their operations.

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

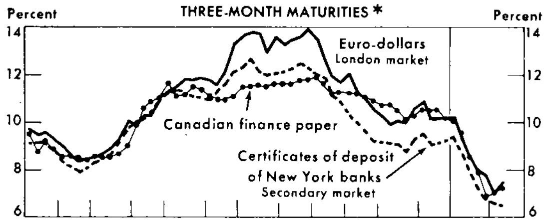
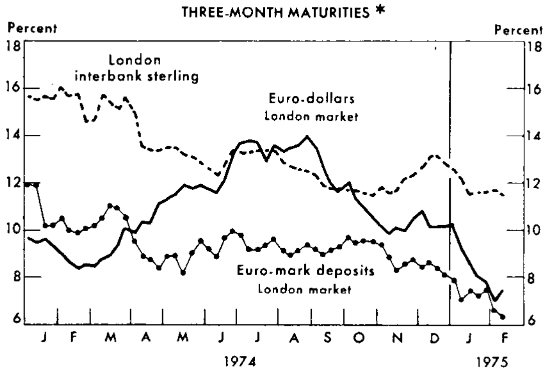


Chart XII
SELECTED INTEREST RATES
THREE-MONTH MATURITIES *



* Weekly averages of daily rates.

It was the medium-term Euro-loan market that was most seriously affected by the strains in international banking. Last summer and fall, the rate of increase in the volume of medium-term loans slowed down considerably, as many syndicate participants no longer were able to secure funds at competitive interest rates. Consequently, the syndication of balance-of-payments and project loans carrying very distant repayment schedules diminished significantly. Reduced competition permitted lenders to widen the spreads of rates on loans over the rates they paid for funding these loans and to tighten other terms and conditions, including the shortening of average maturities for medium-term loans funded with short-term funds on a floating-rate basis. In more recent weeks, however, as money market conditions in many parts of the world became easier, spreads between loan and deposit rates were again narrowing somewhat.

Interest rates in the market, after rising to virtually unprecedented levels, dropped in September and October in response to sharp across-the-board declines in United States money market rates. The downtrend in Euro-dollar rates stalled toward the end of November, as the decline in United States domestic rates slowed and as year-end positioning prompted some bidding for dollar funds. Early this year, rates resumed their precipitous fall in response to actual and expected declines in United States prime rates and other interest rates. By end-January, three-month rates had dropped below 8 percent, almost one half of the peak levels reached last summer.

The Business Situation

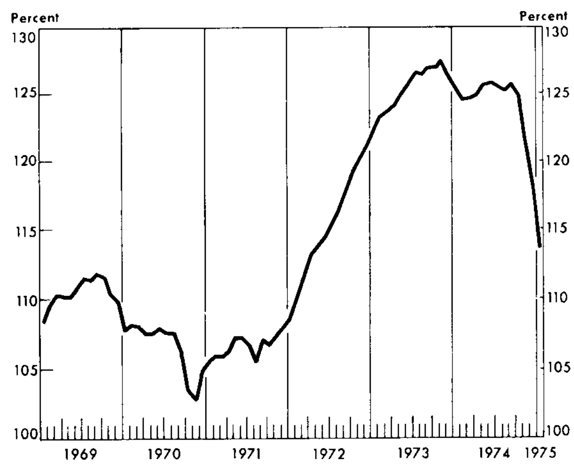
By nearly every measure, the economic contraction has deepened further in the new year. Industrial production fell 3.6 percent in January, and new orders for manufactured durable goods declined precipitously. Moreover, net new capital appropriations by the nation's 1,000 largest manufacturers were reported to have decreased in the fourth quarter of 1974 after several years of heady gains. There was a slim increase in personal income in January, but it was largely attributable to higher transfer payments, as income from salaries and wages declined $0.9 billion. Labor market conditions have continued to reflect the increasingly pervasive slack, with industrial work forces substantially reduced. Nevertheless, the economy's performance is not completely devoid of hopeful signs. Residential construction recovered a bit in January, as housing starts registered a slight gain, and retail sales posted a second consecutive monthly increase.

The reduced pace of economic activity in recent months has succeeded in dampening inflation, and the price outlook is more encouraging than it has been in some time.* Wholesale prices declined in February for the third time in as many months, led by sharp reductions in the prices of farm products and related items. While industrial wholesale prices increased, the rate of advance was considerably below the inordinately rapid rate observed throughout most of 1974. Furthermore, sluggish demand and weak materials prices have begun to exert a restraining impact on finished goods prices. At the retail level, the vigorous promotional efforts which sparked retail sales were accompanied by some price reductions, including the much-publicized price rebates on automobiles and some consumer appliances. Partly as a result, the consumer price index in January recorded its smallest monthly rise in nine months.

INDUSTRIAL PRODUCTION

On a seasonally adjusted basis, industrial production declined 3.6 percent in January (see Chart I). Combined with the revised 3.1 percent drop recorded in December, this constitutes the sharpest two-month slide in industrial output since the 1930's. The January decrease, the fourth in as many months, left the Federal Reserve industrial production index at 113.7 (1967=100). This is 9.5 percent below its level at the end of September 1974 and 10.8 percent beneath its cyclical peak of November 1973.

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100

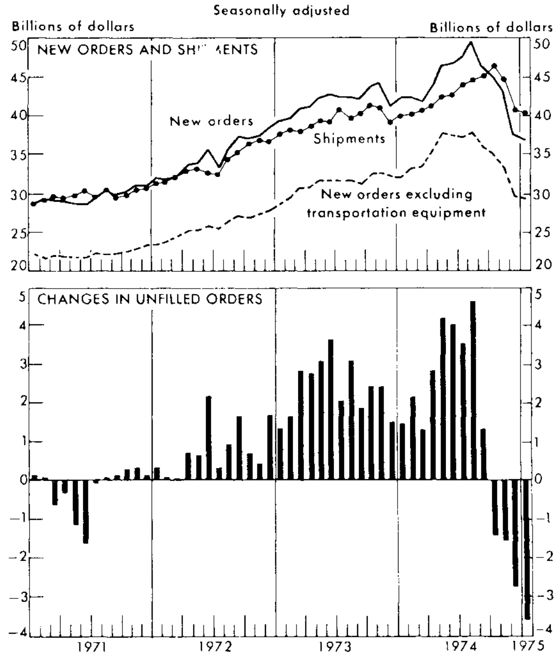


Source: Board of Governors of the Federal Reserve System.

*Revised estimates indicate that the gross national product (GNP) increased $13.9 billion on a seasonally adjusted annual-rate basis in the fourth quarter of 1974. However, while the estimate of real GNP remained unchanged from the preliminary figure, a decline of 9.1 percent, the annual rate of change of the implicit price deflator for GNP was raised from 13.7 percent to 14.4 percent.

The January cutback in industrial output was widespread, with sharp reductions in business equipment, consumer goods, and industrial materials. The output of business equipment fell 4.6 percent in January, after having declined 3 percent in December. The production of consumer durable goods was reduced by 6.1 percent, in part because of the 9.5 percent cutback in automobile output. Automobile assemblies in January proceeded at an annual rate of 4.8 million units, down from 8.3 million units in October when the auto manufacturers first announced their intentions to reduce the scale of operations. In February, automobile production declined even further to an annual rate of 4.4 million units. Facing a large overhang of inventories and weakening prices, producers of industrial materials reduced their rate of output in January by 4.1 percent. This followed the 4.6 percent contraction in December and brought the decline in industrial materials production to 13.8 percent since September. In mild contrast to the other manufacturing sectors, output in the mining and utilities industries increased slightly in January. The gain was attributable, however, to the large increase in coal production during the period following the settlement of the miners' strike in December.

Chart II
ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS
Seasonally adjusted



Source: United States Department of Commerce, Bureau of the Census.

CAPITAL APPROPRIATIONS, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturing firms declined by 24 percent in the fourth quarter of 1974, according to a survey by The Conference Board, Inc. Total appropriations in the fourth quarter were $12.5 billion, compared with $16.4 billion in the third quarter. The petroleum industry accounted for the largest changes in appropriations in both the third and fourth quarters of 1974. In the third quarter, firms in the petroleum industry increased appropriations by 18 percent, compared with only a 4.6 percent increase in the other industries. In the fourth quarter, however, firms in the petroleum industry reduced their appropriations by 57 percent, while nonpetroleum industries cut back only 7.4 percent.

New orders for durable manufactured goods declined $1.1 billion in January, continuing the downtrend that began last August (see Chart II). Most of the January drop is attributable to a $1 billion fall in the orders for primary metals. However, there were also sizable declines in orders for transportation equipment and machinery. Looking at marketing categories, bookings for household durables inched up in January, but the important capital goods group registered a $650 million decrease. The backlog of unfilled orders for durable goods also fell in January, by $3.6 billion. The latest decline, the fourth in a row, was the largest percentage contraction in durable goods orders backlogs since 1960.

Durable goods industries accounted for the entire increase in total manufacturing inventories during January. Inventories in the durable goods sector increased by $1.2 billion, while they declined by $0.1 billion in the nondurable goods industries. The breakdown of the January inventory advance by stage of fabrication implies that much of the gain was unintentional. Of the total $1.1 billion increase, more than half—$620 million—was composed of finished goods, while materials and supplies on hand rose $260 million and work in progress increased by $200 million.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose $2.6 billion in January, down from the $7 billion monthly rise averaged during 1974. The January gain occurred despite a $0.9 billion decline in wage and salary income; increases in dividends and interest and in transfer payments offset the fall in wages and salaries. Reflecting the sharp cutbacks in employment and production, private industry payrolls decreased at a \$1.8 billion annual rate in January. The reduction was concentrated in manufacturing, where payrolls have now fallen 6.4 percent since October and are only 0.6 percent above their level of January 1974. The weakness in manufacturing has been balanced somewhat by modest gains in wages and salaries in service industries and in government. In addition, transfer payments—social security, unemployment, and welfare and veterans' benefits—increased at a \$2.7 billion rate in January, following a very large \$6.3 billion increase in December. With the continued decline in farm prices, the income of farmers recorded its fourth consecutive monthly decrease in January. Over the year ended in January, farm income fell nearly 36 percent.

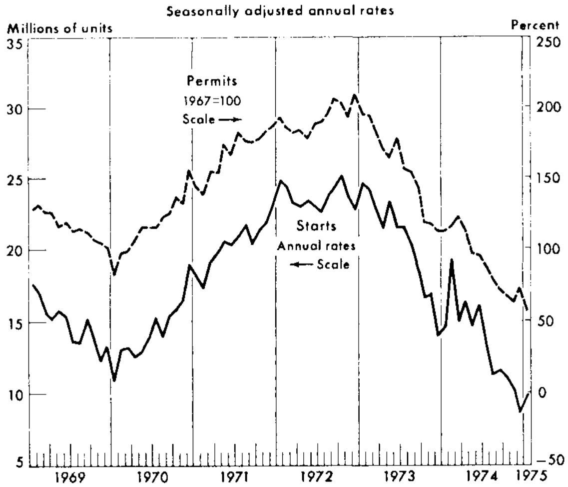
Spurred by unusually widespread clearance sales, retail sales increased 0.9 percent in January to a monthly total of \$45.1 billion. This was the second successive increase in retail sales, following sizable declines in the three previous months. The dollar value of January's sales was 4.9 percent above that of a year earlier. However, since retail prices rose approximately 12 percent over this period, there has been a substantial reduction in the real volume of goods sold. Consumer spending on durable goods, which has been quite depressed in recent months by high interest rates and consumer pessimism, was 0.9 percent higher in January than in December. Most of the increase reflected the 2 percent increase in automobile sales that was motivated by the cash rebate programs initiated in the middle of the month. Sales of new domestic automobiles climbed to an annual rate of 6.6 million units in January and to 7.2 million units in February. Sales of nondurable goods were 1 percent higher in January than a month earlier and were 7.8 percent above their level of January 1974.

The residential construction industry showed tentative signs of recovery during January. Housing starts increased 13 percent to an annual rate of 987,000 units, up from December's 875,000 units (see Chart III). The prospects for further recovery remain clouded, however. The issuance of new building permits, which is sometimes an indicator of building activity in the following month or two, declined in January to the lowest point on record for the series, which dates to 1959. On the other hand, thrift institutions have realized substantial net deposit inflows during recent months. These inflows, combined with declines in short-term interest rates, should increase the supply of mortgage funds and eventually lead to lower financing costs. Another positive factor is the recent decline in the vacancy rate in multiple dwellings, which fell 0.2 percentage point during the fourth quarter of 1974 to 6 percent. The rental vacancy rate normally moves quite slowly, and a decline of this size indicates a firmer tone in the rental market which could stimulate new construction in the coming months.

Chart III

PRIVATE RESIDENTAL CONSTRUCTION

Seasonally adjusted annual rates



Source: United States Department of Commerce, Bureau of the Census.

PRICE DEVELOPMENTS

In recent months, prices at the wholesale and retail levels provided further evidence that the rate of inflation is abating. Wholesale prices in February declined at a 9.2 percent annual rate, the third consecutive monthly decrease. While consumer prices in January increased at a 7.7 percent annual rate, this was the slowest advance since last April.

Contributing to the February decline in wholesale prices was the sharp 41.1 percent annual-rate drop in prices of farm products and processed foods and feeds. This weakness in farm product prices, following substantial declines in December and January, has led agricultural experts to speculate that supply conditions in these markets may have permanently improved and that food prices in the near future may be weaker than they were previously expected to be. The prices of industrial commodities at the wholesale level increased at a 6.5 percent annual rate in February. These prices over the past three months have risen at a 4.3 percent annual rate, which stands in sharp contrast to their performance during the preceding twelve months when they rose 27.4 percent. The wholesale prices of basic raw materials fell at a 1.1 percent rate in February which, following their 19.4 percent rate of decline in January, suggests that final goods prices may soften in the months ahead as the recent decreases in materials prices work their way forward to advanced stages of production.

January marked the second consecutive month that the rate of inflation at the consumer level has slowed. Retail food prices increased at a 9.9 percent rate, slightly more rapid than December's advance. However, the acceleration is attributable to hikes in the prices of restaurant meals; grocery prices actually rose somewhat more slowly than they had in December. The prices of nonfood consumer items advanced at a 6.7 percent rate, as increases in the prices of shoes, gasoline, and household durables more than offset the decline in new car prices. In contrast, over the year ended November 1974, the prices of nonfood consumer items had risen 12.3 percent. The prices of services increased at a 9.6 percent rate in January, with household utility costs registering a substantial increase.

LABOR MARKET DEVELOPMENTS

Labor market conditions deteriorated somewhat further in February, although the unemployment rate remained unchanged at 8.2 percent of the civilian labor force. Nonagricultural employment declined by over 450,000 persons, but this was more than matched by a fall in the labor force. The February decline in employment was the fifth in as many months, bringing the total decrease over the period since September 1974 to more than 2.2 million workers. Reflecting the reductions in industrial production, most of the drop in employment has occurred among adult males in manufacturing, while employment in the nonmanufacturing sector has fallen relatively little since September. The sharp decline in the labor force in February reversed the growth of recent months. Indeed, over the five months ended in February, the labor force decreased by nearly 340,000 workers. Taking a somewhat longer perspective, over the year ended in February the labor force climbed by 955,000, or 1.1 percent.

January's labor turnover rates also reveal the degree to which industry's demand for labor has eroded in recent months. The layoff rate jumped sharply to 3.5 percent, up from 2.6 percent in December. This increase brought the layoff rate in January to nearly three times what it was in September, when industrial production began to decline in earnest. Meanwhile, the scarcity of job openings caused the number of workers voluntarily leaving their jobs to decline to 1.4 percent. In September the quit rate was 2.1 percent, and in January 1974 it was 2.6 percent.

The Money and Bond Markets in February

Short-term interest rates fell further in February, continuing the downtrend that began in the summer months of 1974. The declines in most cases were modest, particularly in comparison with the sharp drops registered in January. The Federal funds rate, however, fell substantially further in February. For the month as a whole, the effective rate averaged 6.24 percent, its lowest level since January 1973. In addition, early in February the Board of Governors of the Federal Reserve System approved a reduction in Federal Reserve Bank discount rates from 7¼ percent to 6¾ percent, the third reduction in three months. And, effective March 10, the discount rate was lowered from 6¾ percent to 6¼ percent at ten Reserve Banks, including New York.

Private demands for short-term credit were sluggish again in February. Business loans at major New York City banks, for example, fell sharply for the second consecutive month, despite several reductions in the banks' prime lending rates. At the same time, however, the Treasury borrowed heavily. Nevertheless, rates on United States Government securities moved irregularly lower on balance over the first three weeks of the period. Late in the month, the Treasury announced plans to raise $7 billion in new cash between mid-March and mid-April through sales of coupon-bearing issues. Rates rose significantly in response to this disclosure, finishing the month about unchanged from end-of-January levels. Yields in the corporate and tax-exempt bond markets initially declined but retraced their steps toward the close of the month, as indications that the Treasury would be borrowing substantial sums tempered the interest rate outlook. Moreover, participants in the tax-exempt bond market grew increasingly concerned about the financial difficulties confronting the New York State Urban Development Corporation (UDC).

Preliminary data indicate that the narrowly defined money stock (M_1) expanded at a moderate pace in February. M_1 had actually declined in January and registered only sluggish growth over the last six months of 1974. The recent sharp drop in short-term market interest rates has encouraged sizable flows into commercial bank consumer-type time and savings deposits in the last several months. These deposits advanced rapidly again in February and, as a result, the more broadly defined money stock (M_2) continued to expand at a faster pace than M_1.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Money market rates continued to fall in February, but in most cases the declines were considerably smaller than those experienced in the previous month (see Chart I). The rate on 90- to 119-day dealer-placed commercial paper, for example, closed the period at 6¼ percent, a drop of ⅜ percentage point over the month as compared with the 2¾ percentage point decline registered in January. Similarly, after falling sharply in January, rates on other maturities of commercial paper, on bankers' acceptances, and on certificates of deposit (CDs) in the secondary market edged downward in February. In contrast, the Federal funds rate moved substantially lower, although the decline did not match January's steep drop. For the month as a whole, the effective rate on Federal funds averaged 6.24 percent, 89 basis points below the level of the preceding month.

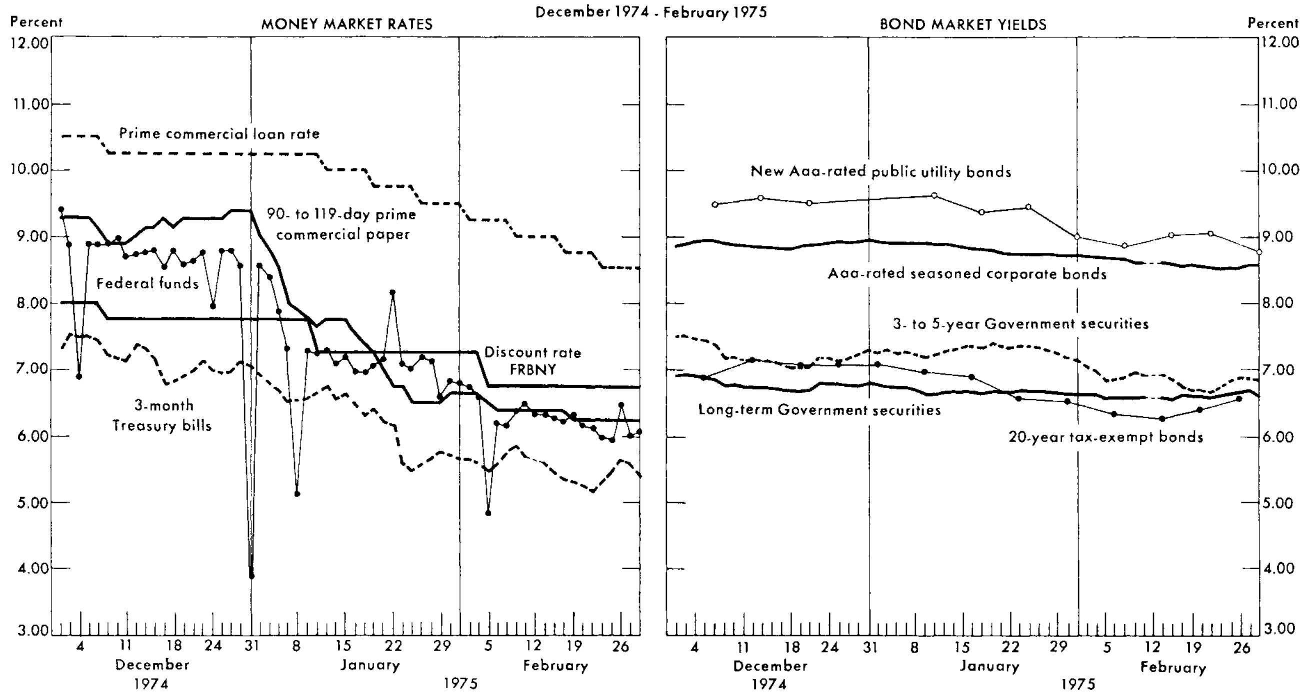
From a longer perspective, money market rates have fallen dramatically from the extraordinarily high levels reached in the summer of 1974. In general, rates on money market instruments have dropped by about 5 to 7 percentage points from their peaks. A decline in short-term rates is, of course, normal during an economic contraction when businesses and consumers curtail their borrowings in the short-term markets and the monetary authorities are pressing reserves on the banking system. In the current economic downturn, however, the declines thus far have been steeper than—and, except for the 1969-70 experience, have been nearly twice as steep as—in any previous contraction in the postwar period. In part, the sharper drop in short-term rates in the current episode reflects the relatively high level at which rates peaked in 1974, as well as the severity of the contraction in economic activity.

Duplicating the experience of previous postwar contractions, the declines in commercial banks' prime lending rates have lagged the fall in other short-term market rates. In February, most banks reduced their prime rates by ½

Chart I

SELECTED INTEREST RATES

December 1974 - February 1975



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five dealers that report their rates, or the midpoint of the range quoted if no consensus is available; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa-rated bond of at least twenty years' maturity; daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

to ¾ percentage point. By the close of the month, most were quoting a rate of 8½ percent, a substantial drop from the record high of 12 percent which prevailed over the July-September period. The decline in the commercial bank prime lending rate in February narrowed the spread between these and other money market rates, but the prime rate remained relatively high nevertheless. As a result, businesses continued to shift some of their borrowings from banks to the commercial paper market. Reflecting this shift, as well as the general weakness in short-term credit demands, commercial and industrial loans at weekly reporting banks fell by $956 million over the four weeks ended February 26. Meanwhile, the volume of nonfinancial commercial paper outstanding rose $557 million over the same period. With the weakness in business loan demand, banks withdrew from active bidding for CD funds, and the volume of CDs at New York City weekly reporting banks dropped over the four statement weeks of the month by $967 million. Member bank borrowings from the Federal Reserve rose by $38 million over the four weeks ended February 26, averaging $149 million for the period (see Table I).

In February, the Board of Governors announced revisions to the money stock and related measures to incorporate data obtained from nonmember banks in the October 1974 call reports and from reports from foreign agencies and branches. The revisions raised the levels of the money stock measures slightly beginning in May

1974 but did not change the overall pattern of growth. In particular, the new data for M_1—private demand deposits adjusted plus currency outside banks—still show a substantial deceleration in growth over the last six months of 1974 and a sharp decline in the level of M_1 in January of this year. In February, however, M_1 developed renewed strength, rising at a seasonally adjusted annual rate of 6.9 percent from the four weeks ended January 29 to the four weeks ended February 26. Notably, the demand deposit component of M_1 rose over this period at a moderate pace, after contracting sharply in January. The renewed growth of M_1 over the four statement weeks in February partly offset January's decline and left M_1 about unchanged from its level of thirteen weeks earlier (see Chart II).

Over the last several months, M_2—which adds to M_1 time deposits less large CDs—has been much more buoyant than M_1, as declines in market rates have encouraged flows into time and savings deposits. In February this pattern continued, with M_2 rising at a seasonally adjusted annual rate of 10.1 percent over the four statement weeks in February from its average level over the previous four weeks. However, the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—remained unchanged over this period, in part reflecting a decline in CDs as well as a drop in member bank liabilities to their foreign branches.

THE GOVERNMENT SECURITIES MARKET

Interest rates on Government securities moved irregularly in February. Strong demand dominated the market as the month began, and rates on all maturities declined. Subsequently, concern over the potential size of Treasury borrowing led to upward pressure on rates, especially around midmonth. The downtrend later reemerged but was again interrupted toward the end of the month.

February was marked by unseasonably large Treasury sales of Government securities. A total of \$3.4 billion in new cash was raised by the Treasury. On February 19, \$3 billion in new cash was raised through the auction of two notes, \$1.5 billion of two-year maturity and \$1.5 billion maturing in eighteen months. The minimum denomination in each case was \$5,000. Competitive tenders of \$5.8 billion were received, and the average yield for the two-year issue was set at 6.09 percent, while a yield of 5.94 percent was established on the eighteen-month notes.

Late in the month the Treasury announced its intention to raise \$7 billion in new cash from mid-March to mid-April through the sale of coupon-bearing issues, while fur-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1975

In millions of dollars; (+) denotes increase and (—) decrease in excess reserves

Factors	Changes in daily averages— week ended				Net changes
	Feb. 5	Feb. 12	Feb. 19	Feb. 26	
"Market" factors					
Member bank required reserves	+ 528	+ 673	+1,015	+ 501	+2,717
Operating transactions (subtotal)	+ 51	+1,065	—1,209	—1,160	—1,253
Federal Reserve float	+ 178	— 164	+ 31	+ 273	+ 318
Treasury operations*	+ 392	+1,146	— 463	—1,502	— 427
Gold and foreign account	— 71	+ 66	— 98	+ 61	— 42
Currency outside banks	— 52	— 597	— 879	+ 177	—1,351
Other Federal Reserve liabilities and capital	— 396	+ 613	+ 202	— 168	+ 251
Total "market" factors	+ 579	+1,738	— 194	— 659	+1,464
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 690	—1,898	+ 470	+1,144	— 974
Outright holdings:					
Treasury securities	— 433	—1,866	+ 246	+ 803	—1,250
Bankers' acceptances	+ 10	— 24	— 15	+ 12	— 17
Federal agency obligations	— 16	— 22	—	— 12	— 50
Repurchase agreements:					
Treasury securities	— 248	+ 32	+ 186	+ 386	+ 356
Bankers' acceptances	+ 28	— 62	+ 31	+ 11	+ 8
Federal agency obligations	— 31	+ 44	+ 22	— 56	— 21
Member bank borrowings	— 46	— 7	+ 139	— 48	+ 38
Seasonal borrowings†	+ 1	— 1	+ 2	— 1	+ 1
Other Federal Reserve assets‡	+ 349	— 159	— 284	— 463	— 557
Total	— 387	—2,064	+ 325	+ 633	—1,493
Excess reserves‡	+ 192	— 326	+ 131	— 26	— 29
	Daily average levels				**Monthly averages§**
Member bank:					
Total reserves, including vault cash‡	37,044	36,045	35,161	34,634	35,721
Required reserves	36,646	35,973	34,958	34,457	35,509
Excess reserves	398	72	203	177	213
Total borrowings	97	90	229	180	149
Seasonal borrowings†	11	10	12	11	11
Nonborrowed reserves	36,947	35,955	34,932	34,454	35,572
Net carry-over, excess or deficit (—)‖	24	155	26	— 88	29

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended February 26, 1975.
‖ Not reflected in data above.

ther amounts might be raised in bills. An additional $1.2 billion in coupon issues would be raised to repay maturing debt. Of the $7 billion in new cash, $1.75 billion would consist of notes due November 15, 1981, $1.5 billion of notes maturing May 31, 1976, $1 billion of two-year notes maturing March 31, 1977, $1.25 billion of bonds maturing May 15, 1990, and $1.5 billion of notes due November 30, 1976. The $1.2 billion refunding will consist of two-year notes maturing March 31, 1977. There was some indication that an additional amount of new cash ranging between $11 billion and $21 billion would be required before the end of June.

The market was quick to react to the announcement of the Treasury's financing plans. The rate on three-month bills, for example, which had fallen about 38 basis points on balance over the first three weeks of the month, rose 10 basis points during the week following the announcement. Rates set at the fourth weekly Treasury auction of February were slightly higher, as well, than those set at the previous week's auction (see Table II). Similarly, after the Treasury's announcement, rates on intermediate-term coupon issues advanced from 5 to 15 basis points, while yields on long-term bonds rose 4 to 7 basis points. These increases appeared short-lived, however, as Treasury bill rates and yields on intermediate Government securities declined in the last two days of the month. For the month as a whole, rates on most Treasury issues changed little.

Yields in the market for Federal agency securities displayed the same pattern in February as those on Treasury securities, although movements were not so sharp. Sales of short-term notes by the Department of Housing and Urban Development for local public authorities were well received. First, early in the month, a 3.49 percent average interest rate was set on $680.2 million of tax-exempt notes with an average maturity of 8.3 months. Then, at midmonth an average interest rate of 3.57 percent was established for a $418 million tax-exempt issue of urban-renewal notes with an average maturity of 7½ months. The average yield on commitments to buy Government-backed mortgages auctioned by the Federal National Mortgage Association fell below 9 percent for the first time since last April and continued to fall at the second such auction in February. The Federal Home Loan Banks successfully sold at the start of the month $300 million of 8¾-year bonds partially to replace $1.2 billion maturing on February 25. A 7⅜ percent coupon was placed on this issue. The Federal Home Loan Mortgage Corporation (FHLMC) introduced a new type of security with a $300 million issue of guaranteed-mortgage certificates due March 15, 2005. It was offered to yield 8.20 percent. An option for the investor to resell the issue to the FHLMC at the issue price in fifteen years was included. The farm credit agencies entered the market at midmonth with a $391.6 million Banks for Cooperatives (BC) offering due September 2, 1975 and a $897 million Federal Intermediate Credit Banks (FICB) issue due December 1, 1975. The respective yields of 6.05 percent and 6.15 percent were substantially below the 7.05 percent paid in January on a similar issue. At the end of February, the BC and the FICB offered an additional $75 million of short-term bonds, with coupons ranging from 7.40 percent to 9.45 percent.

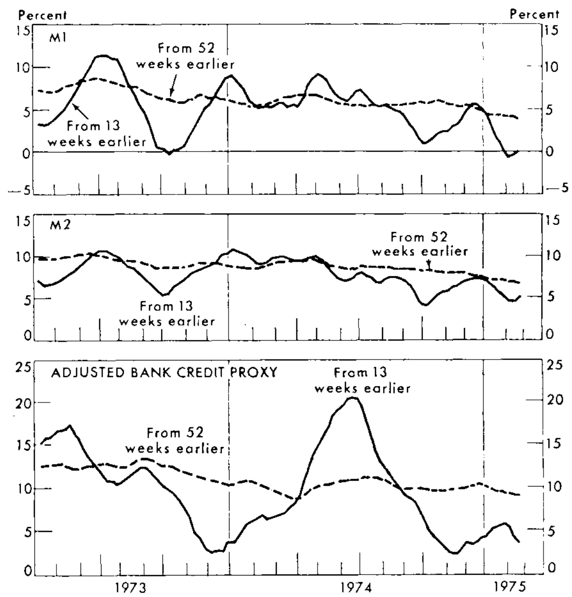
THE OTHER SECURITIES MARKETS

Yields in the corporate bond market continued to decline at the beginning of the month but began to stabilize soon afterward, partly as a result of dealers reducing

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier and 52 weeks earlier. The latest statement week plotted is February 26, 1975.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

inventories that had built up in January. The calendar was heavy in February, but new issues were generally well received. As the yields of recently offered Aaa-rated bonds initially fell, investor interest spread to seasoned corporate bonds and those of less than top quality. In light of the strong demand for corporate bonds evidenced at the beginning of the month, some borrowers advanced the dates of their issues. Near the close of the period, however, yields backed up sharply, retracing some of their earlier declines, in response to the Treasury's announcement of future borrowing and the growing supplies of corporate and tax-exempt issues.

During the first week of February, a utility successfully sold $35 million of Aa-rated first-mortgage bonds yielding 8.67 percent in thirty years. This represented the lowest return on a new long-term high-grade utility bond in almost a year, significantly below the record 10.6 percent yield registered in late 1974. In the same vein, a second utility sold $100 million of A-rated thirty-year bonds at a yield of 9.55 percent, 3.45 percentage points lower than the yield associated with an issue it offered last September. By midmonth, however, the sharp decline in yields on utility bonds reduced their attractiveness relative to industrial bonds. This development was partly responsible for the slow-paced sale of $125 million of thirty-year first-mortgage bonds of Commonwealth Edison Company at that time. A $300 million issue of thirty-year Aaa-rated debentures by Mobile Alaska Pipeline Company, on the other hand, sold out at 8.45 percent.

The last several days of the month witnessed sharp price reductions among recently offered and seasoned corporate bonds while newly issued corporate bonds were accorded mixed receptions, in light of the Treasury announcement of large offerings of Government securities by mid-April. The announcement that the Treasury planned to sell $1.25 billion of long-term bonds to raise new cash weighed particularly heavily on the market. The yield on the Commonwealth Edison bonds jumped 23 basis points after being released from syndicate restrictions. However, a thirty-year Aaa-rated bond issue of Dallas Power and Light Company sold well at a yield of 8.78 percent, significantly lower than those of earlier issues.

Retail demand for tax-exempt issues was also strong as the month began, and both short- and long-term issues benefited. A $103.5 million offering of various maturities by the New York State Housing Finance Agency, priced to yield 4.5 percent in 1975 to 7.6 percent in 2006, quickly sold out. Reflecting the recent decline in short-term interest rates, the one-year bond yielded 2 percentage points less than it had in a similar offering in October while the longest maturity bond yielded only a 0.35 percentage point less. A $290 million issue of one-year notes by New York City offered in the first week of the month yielded 7.25 percent, substantially below the 9 percent obtained in the city's two previous note issues. The market became more cautious toward the end of February in expectation of a large volume of future offerings in addition to the large backlog of unsold municipals. A $125 million bond offering by Massachusetts required some price reduction before it was sold, with yields ranging from 3.6 percent in 1976 to 6.3 percent in 2025, while $40 million of an Illinois issue was released from syndicate restrictions and declined sharply in price, bringing it more closely in line with the Massachusetts issue.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—February 1975			
	Feb. 3	Feb. 10	Feb. 14	Feb. 24
Three-month	5.669	5.800	5.408	5.455
Six-month	5.736	5.800	5.483	5.675
	Monthly auction dates—December 1974-February 1975			
	Dec. 11	Jan. 8	Feb. 5	
Fifty-two weeks	6.625	6.378	5.313	

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

The state and municipal markets were directly affected by the UDC's financial problems. The corporation was unable to raise the required money to redeem $104.5 million of maturing short-term notes. In reaction to this, yields rose considerably in the tax-exempt market during the last several days of the month, and there was heightened concern about the quality of issues. Yields on new issues of the states of Connecticut and Louisiana were set above prevailing market rates. The issues, Aaa- and Aa-rated, respectively, were well received at the higher yields, however.

The Bond Buyer index of twenty municipal bond yields fell 14 basis points over the first three weeks of the month but then rose 15 basis points in the final week to close at 6.55 percent. The Blue List of dealers' advertised inventories stood at $652 million at the month end, having risen by $91 million for the month as a whole.

Sixtieth Annual Report

The Federal Reserve Bank of New York has published its sixtieth *Annual Report,* reviewing major economic and financial developments in 1974 and the highlights of the Bank's operations.

The *Report* commented that "a combination of severe, and in some respects unprecedented, economic strains caused deep concern throughout much of the industrialized world in 1974". It noted that the "United States shared many of the economic woes which beset the rest of the world". The *Report* further stated that, "while the symptoms of economic contraction began to become pronounced and general in the domestic economy only relatively late in 1974, inflation was an acute problem throughout the period. . . . far worse than it had been in the preceding year". Although "it is difficult to provide a wholly adequate explanation for the price inflation", the *Report* listed several factors that contributed to it, including the Federal budget deficit over the past several years, fuel and food supply shortages, and depreciation of the dollar. With regard to monetary policy, the *Report* said that open market operations were used as the primary instrument in 1974 "to moderate the rate of monetary expansion". At the same time, "the monetary authorities were fully aware that an abrupt slowing in monetary growth was not desirable".

In his letter presenting the *Report* to the member banks, Alfred Hayes, President of the Bank, observed that "economic policy makers face a very difficult environment in 1975. A strengthening of international financial cooperation is clearly required." He pointed out that, in the United States, "we must attempt to arrest the marked rise in unemployment and to lay the groundwork for a resumption of sustained economic growth". In addition, Mr. Hayes stated that "we must be careful to avoid overly stimulative policies which could add . . . to the costs of achieving . . . price stability. Striking the proper balance in pursuing these objectives is no easy task."

The *Annual Report* may be requested from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. A copy is being mailed to *Monthly Review* subscribers.