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Contents

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Treasury and Federal Reserve Foreign Exchange Operations February-July 1976

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During the six-month period under review, as the authorities of industrial countries sought to deal with the cumulative effects of deep-rooted economic and financial instabilities, the exchange markets experienced several episodes of severe strain, in some cases resulting in sharply altered rate relationships among major currencies. The strains were particularly acute within Europe. Between January and the end of July, against the dollar the Italian lira depreciated by a net 20 percent, the pound by 14 percent, and the French franc—having left the European Community (EC) "snake" arrangement—by 8 percent. Maintenance of the EC snake itself entailed large-scale intervention on several occasions. Although both the German mark and the Swiss franc were often in heavy demand, on balance they appreciated by only 2 percent and 4 percent, respectively. Elsewhere the Japanese yen and the Canadian dollar each rose a net 3½ percent against the dollar.

The dollar, through its role as vehicle currency in the market and intervention currency for central banks, was only occasionally caught up in the turmoil. Thus, when the markets were particularly unsettled in February and March, the Federal Reserve sold a total of $270.4 million of German marks and Dutch guilders, mainly financed by swap drawings. This debt, however, was quickly cleared away by mid-May. Thereafter, the Federal Reserve had no occasion to intervene in the market through the end of July, while taking advantage of opportunities to build up modest balances.

The dollar's greater resiliency, in contrast to other periods of exchange market unsettlement in recent years, largely reflected the lifting of many of the market's previous concerns over the United States economic performance. Our recovery had by early 1976 gained considerable momentum, erasing earlier fears that the upturn would falter. At the same time, the rate of inflation in the United States, already one of the lowest among major industrial countries, continued to moderate. As a sign of our underlying competitiveness in world markets, United States exports continued to rise in line with, if not faster than, the recovery of economies abroad. Although the even greater rise in imports swung the United States trade balance back into sizable deficit, the sources of this surge—the rapid rebuilding of inventories early in the year and the ballooning of fuel imports in the summer—were generally taken as further evidence of the strength of our expansion. In addition, United States interest rates were fairly steady. Since they remained well above rates in Germany and Switzerland, they helped avoid the kind of sudden shifts of funds which had occurred in other recent periods of exchange market stress. More broadly, with many other political and financial uncertainties less pressing, traders were more inclined to focus on the problems afflicting other countries.

The pressures on individual European currencies largely reflected market concern over the profound disparities in economic performance and policies among those countries. By early 1976, only a few countries were showing clear signs of sustained recovery and many European governments were still being pressed at home for further stimulus to reduce the uncomfortably high levels of unemployment. At the same time, although some progress had been made everywhere against the

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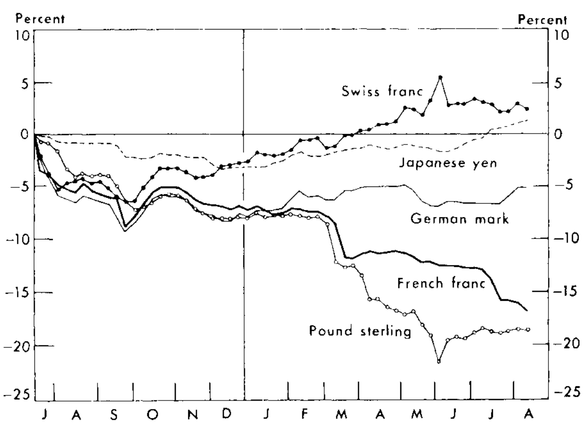
inflationary excesses of the earlier 1970's, large differentials in inflation rates remained, with Switzerland and Germany at the low end of the spectrum and Italy and the United Kingdom at the high end. To the market, the persistence of differential trends in production and prices threatened to distort competitive relationships and thus eventually to lead to further exchange rate adjustments. Market participants, uncertain of the timing and extent of potential adjustments, feared that a significant movement in any European currency rate might set off a chain reaction in other rates as well. Consequently, each time pressures developed in one currency or another—whether that currency was floating alone or linked to others in the EC snake—the whole array of European currency relationships became open to question. On these occasions, traders hastened to take speculative positions or to hedge exposures and, in this rush to buy or sell individual currencies, the markets frequently became one-sided.

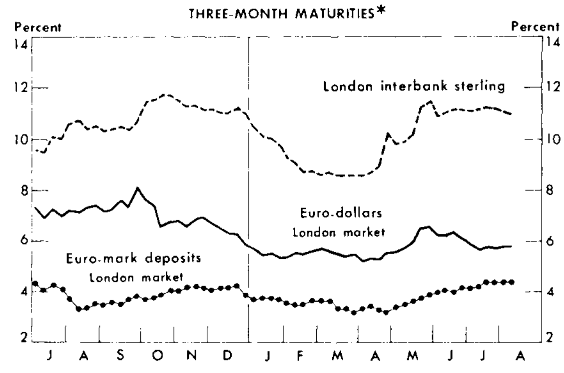
These episodes presented harsh policy choices to the authorities. For those whose currencies came into heavy demand, to allow the exchange rate to appreciate risked stifling exports at a time of domestic concern over unemployment, while to hold the rate through intervention risked rekindling inflation through excessive domestic monetary expansion. For others whose currencies came under heavy selling pressure, to support the rate through measures such as monetary restraints risked delaying or aborting economic recovery, while to permit the exchange rate to fall sharply risked exacerbating inflationary pressures through the higher cost of imports. For many, these difficulties were compounded by political uncertainties and by concerns over labor relations. Consequently, as recounted in the body of this report, the national authorities responded with a variety of short-term measures to deal with the immediate exchange market pressures while seeking to establish a framework for greater stability over the long run.

Chart I
SELECTED EXCHANGE RATES*



*Percentage deviations of weekly averages of New York noon offered rates from the average rate for the week of July 7-11, 1975.

Chart II
SELECTED INTEREST RATES
THREE-MONTH MATURITIES*



*Weekly averages of daily rates.

During the period under review, the United States authorities provided assistance, in the form of short-term credits, to the Bank of Italy, the Bank of Mexico, and the Bank of England. With Italy, the Federal Reserve swap arrangement had already been reactivated in January by a drawing of $250 million, and the Bank of Italy drew a further $250 million in March. When market reflows into lire developed in the early summer, these drawings were completely repaid in July.

With Mexico, in early April the Bank of Mexico drew the full $360 million available under its swap line with the Federal Reserve. That drawing remained outstanding at the end of July.

With the United Kingdom, in early June the United States authorities agreed to provide up to $2 billion to the Bank of England as part of a $5.3 billion total international standby credit facility. As in several credits extended by the United States authorities in the past, both the Federal Reserve and the United States Treasury participated, each standing ready to provide $1 billion. The availability from the Federal Reserve was under the existing $3 billion swap arrangement. The Treasury's credit line, also in the form of a short-term swap facility, was for the account of its Exchange Stabilization Fund. By end-July, in proportion to the Bank of England's borrowings from other countries participating in the facility, the drawings on the Federal Reserve and the Treasury each amounted to $200 million.

To summarize other Federal Reserve operations, the System sales of German marks in February and March amounted to $250.8 million, of which $133.9 million was drawn under the swap arrangement with the German Bundesbank and the remainder from balances. Purchases of marks amounted to $265.6 million, which was used to repay the swap drawings by mid-May and to replenish balances. Sales of Netherlands guilders in February amounted to $19.6 million, drawn under the swap line with the Netherlands Bank. Purchases of guilders amounted to $23.0 million, also to repay the swap drawing and to add to balances.

With respect to obligations outstanding since August 1971, the Federal Reserve purchased $177.3 million of Belgian francs and used most of these francs to liquidate a further $170.5 million of the franc-denominated debt to the National Bank of Belgium and to reduce the total to $82.4 million equivalent. The Federal Reserve in February transferred its $600 million of Swiss-franc swap debt from the Bank for International Settlements (BIS) to the Swiss National Bank. During the period, the System purchased $33.2 million equivalent of Swiss francs from correspondents and liquidated $20 million of its debt with the Swiss central bank. This reduced commitments to $1,147.2 million, which remained outstanding as of end-July. The United States Treasury's $1,599.3 million of medium-term Swiss franc-denominated obligations to the Swiss National Bank was unchanged during the February-July 1976 period.

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

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

GERMAN MARK

By early 1976, the German economic recovery had begun to catch up with the earlier turnaround in the United States, with the initial impulse having been provided by domestic consumption and exports. At the same time, the rapid increase in German foreign orders suggested to many market participants that export growth would keep pace with a predicted rise in imports, thereby enabling Germany to hold on this year to most of its $3.8 billion 1975 current-account surplus, unlike other countries for which deficits were expected. As for wages and prices, Germany continued to record one of the lowest inflation rates in the industrialized world. At 5 percent per annum, the increase in consumer prices was just about half that of neighboring EC countries, while pay awards in recently negotiated union contracts in Germany remained moderate. When announcing its monetary growth target for 1976, the Bundesbank had stressed that the authorities would continue to attach a high priority to keeping a tight rein on inflation. If as a result German interest rates turned higher later in the year, the market saw the potential for reversal of the heavy volume of funds placed abroad by German banks in 1975.

The improving economic trends in Germany seemed more favorable than indications of price, output, and external payments performances suggested for other EC countries. Thus, by late January, following a sharp decline in the Italian lira and a rapid buildup of speculative selling pressures against the French and Belgian francs, dealers began to question whether the mark, still relatively weak within the EC snake, should not strengthen against other European currencies. Speculative funds were increasingly shifted into marks. Consequently, the mark rate moved up steadily against those European currencies and then against the dollar as well. By January 30 the mark had been bid up to $0.3868, 1½ percent above its late-1975 low, in occasionally unsettled trading.

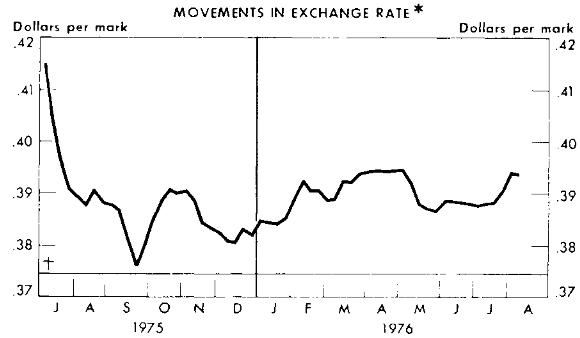
By early February the movement of funds into the mark gathered momentum, as rumors of a realignment of currencies within the EC snake, possibly including a revaluation of the mark, surfaced in the market. By Monday, February 9, the continued weakness of the French franc and Italian lira, news of a devaluation of the Spanish peseta, and press reports that an EC currency realignment would be discussed at the upcoming meeting between German Chancellor Schmidt and French President Giscard d'Estaing provoked talk of an imminent mark revaluation. Despite firm official denials of any intention to revalue, the already broad-based bidding for marks quickly intensified. The mark was driven up 2¼ percent higher from end-January levels to $0.3955 against the dollar and, for the first time since November 1974, to the top of the EC snake. As the advance of the mark extended the band to its full limit of 2¼ percent against the French franc, market participants rushed to take advantage of the emerging two-way speculative opportunity, thereby aggravating pressure on the franc. In response, the French and German central banks stepped up their intervention to defend the limits of the snake, in dollars and in each other's currency as well. Occasionally, the unsettled trading conditions in Europe washed over into the New York market. Thus, the Federal Reserve intervened on four days during February 2-11 to sell a total of $137.4 million equivalent of marks, financed by $80.9 million of drawings under the swap arrangement with the Bundesbank and by use of existing balances.

By February 13, the mark had begun to ease back against the dollar and to move away from the upper limit of the EC snake in the wake of this concerted central bank intervention and in response to statements emerging from the Franco-German summit reaffirming existing EC parities. Through the month end, the mark continued to settle back except for two occasions, February 19 and February 27, when the market was again briefly unsettled in New York. On these two days, the Federal Reserve sold $15.8 million equivalent of marks from balances. Otherwise, as trading conditions continued generaly to improve, the System was able to purchase $65.2 million of marks in the market and from correspondents through early March, using part of these acquisitions to repay $26.4 million equivalent of the recently incurred swap indebtedness with the Bundesbank.

On March 4, the mark was trading quietly around $0.3880 when a sudden, sharp decline in sterling prompted renewed concern over the viability of existing European currency relationships. After the European close the next day, as some of the funds moving from sterling into dollars were in turn switched into marks, the mark was pushed up by over ½ percent against the dollar and again to its upper limit against the French franc in the EC band. This polarization of the snake made trading conditions hectic once more. To help settle the market in New York, the Federal Reserve sold $40.1 million of marks, of which $29.6 million was from balances and $10.5 million was financed by a further drawing on the swap line. The mark and French franc remained under almost continuous pressure at the opposite limits of the joint float during the following week, and both the Bundesbank and the Bank of France continued to intervene heavily in each other's currency. Against the dollar the mark held fairly steady until Friday, March 12, when, amid unsettled pre-weekend trading prior to an EC finance ministers' meeting, the mark again came into heavy demand in New York. The Federal Reserve then sold another $12.7 million of marks, financed by a swap drawing.

Following consultations over the March 13-14 weekend among the EC finance ministers, the French government decided to withdraw the franc from the EC snake, while the Dutch and Belgian authorities announced the suspension of the Benelux currency arrangement. In subsequent disclosures in the press, it was reported that Germany had been prepared to revalue the mark as part of a broad realignment of snake parities which, in the end, could not be worked out. These disclosures made dealers all the more convinced that the mark would be either unilaterally revalued within the EC snake or allowed to float independently. Therefore, when the market reopened on the

Chart III
GERMANY
MOVEMENTS IN EXCHANGE RATE*



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

† Central rate established on June 29, 1973.

morning of March 15, the mark began to rise against the dollar, pulling the remaining EC currencies up in its wake. In an attempt to maintain orderly markets, the Bundesbank bought substantial amounts of dollars as well as Belgian francs, Danish kroner, and Norwegian kroner through March 19. This intervention contributed to the $3.7 billion increase in Germany's foreign exchange reserves in February and March. The pressures on the mark also spilled over into the New York market. Consequently, over March 16-17 the Federal Reserve sold $34.9 million equivalent of marks. Of this, $29.8 million was drawn under the swap line, raising outstanding drawings since February to a peak of $107.5 million, and the remainder was from balances.

The tensions within the snake began to dissipate following the March 20-21 weekend, as the German government again expressed its commitment to maintaining the existing mark parity within the snake. Against the dollar the mark snapped higher before the quarter end, as German commercial banks bid for marks to meet reserve requirements and traders positioned for the end of an accounting period. After the Bundesbank purchased a small amount of dollars at the Frankfurt fixing on March 30 and the Federal Reserve sold $9.9 million equivalent of marks from balances later that day, the market quieted. The spot rate then leveled off to trade around $0.3945 throughout April, some 2 percent above end-January levels. Meanwhile, as funds began to flow back out of Germany, the Federal Reserve acquired sufficient marks to repay $27.5 million of its swap debt with the Bundesbank, reducing the total outstanding to $80 million.

During the spring, economic statistics were reinforcing the market's view that the German and American recoveries were becoming more nearly synchronized and that the moderating trend of inflation in both countries was continuing. Thus, day-to-day movements in the mark rate depended largely on relative money market conditions. As the German government drew down during April and May balances that had been built up at the Bundesbank, the money market became liquid and remained comfortable even after the Bundesbank announced a two-stage increase in required reserves effective May 1 and June 1. By comparison, United States money market rates turned up somewhat in late April. As a result of these divergent tendencies, the mark slipped back gradually against the dollar during May, declining 2½ percent to $0.3849 by the beginning of June. Taking advantage of the dollar's buoyancy, the Federal Reserve acquired marks in the market and from correspondents sufficient to repay the remaining $80 million swap debt with the Bundesbank and to restore modest working balances.

Meanwhile, some dealers also moved to unwind long-

Table II

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 1, 1976	Drawings (+) or repayments (—) 1976: I	II	July	System swap commitments, July 31, 1976
National Bank of Belgium	297.6	— 86.5	— 83.7	—45.0	82.4
German Federal Bank	-0-	{+133.9 {— 26.4	—107.5		-0-
Netherlands Bank	-0-	{+ 19.6 {— 19.6			-0-
Swiss National Bank	567.2	{+600.0* {— 20.0			1,147.2
Bank for International Settlements (Swiss francs)	600.0	—600.0*			-0-
Total	1,464.8	{+753.5 {—752.6	—191.2	—45.0	1,229.6

Note: Discrepancies in totals are due to rounding.

* Consolidation of Swiss-franc swap debt.

standing positions in marks against other European currencies. Thus, as short-term funds flowed back out of Germany, other central banks participating in the EC snake bought marks to repay much of their commitments with the Bundesbank. Nevertheless, the mark edged lower in the snake and also dropped as much as 8 percent to a record low against the Swiss franc by early June. To stem the erosion of the mark rate against the Swiss franc as well as to facilitate the further financing of the German government's budget deficit, the German government arranged with the Swiss authorities to place a mark-denominated borrowing of DM 750 million with the three major Swiss commercial banks. As dealers positioned for potential mark purchases against sales of Swiss francs ahead of the June 15 payment date for this loan, the mark rate was temporarily bid up to as high as \$0.3908. It soon settled back to trade between \$0.3875 and \$0.3890 in well-balanced trading until late in the period.

By summer, economic indicators showed that both the German and United States economic expansions had slowed somewhat in the second quarter. At first, these reports were largely offsetting in their impact on market psychology. But toward the end of July, this news was accompanied by gradual declines in United States short-term interest rates that contrasted with gently rising money market rates in Germany. Moreover, the market was increasingly aware of German public sector borrowing abroad. Then, sizable buy orders for marks prompted a sharp rise in the spot rate just before the month end. This unexpected advance after a long period of steadiness soon attracted professional demand for marks and a recurrence of pressure on the EC snake. In sometimes hectic trading, the rate jumped 1¾ percent in two days to \$0.3952 by July 30, some 2 percent above end-January levels.

STERLING

In contrast to most other EC currencies, sterling remained fairly steady in early 1976. By that time the exchange market's previous extreme pessimism over prospects for the pound had lifted somewhat. The wage restraint program adopted in midsummer 1975 had already showed positive results in slowing Britain's severe wage-price spiral. The nearly 13½ percent depreciation of sterling over the whole year 1975 had left British exports fairly competitive. Although the British economy was still in deep recession, the economies of most major trading partners were well into recovery and an export-led upturn for the United Kingdom was a distinct possibility. In the meantime, large interest rate differentials favoring the pound stimulated sizable placements in both short- and long-term sterling instruments, thereby offsetting the continuing current-account deficit.

Consequently, even as other European currencies were buffeted by heavy divergent pressures in January and February, sterling traded narrowly just above \$2.0250 against the dollar through early March. Over the same period, its effective depreciation since the December 1971 Smithsonian agreement, having held steady around 30 percent through early February, rose to around 30.5 percent before falling again to around 30.1 percent in early March. The Bank of England, intervening to avoid sharp movements in the rate either up or down, was able to accumulate a modest amount of dollars from market operations in January-February which, together with public sector borrowings and a \$1.2 billion drawing on the International Monetary Fund (IMF) oil facility, contributed to a \$1.6 billion increase in Britain's reserves over the two months. As this generally more favorable exchange market atmosphere emerged at the turn of the year, the United Kingdom authorities allowed interest rates to ease in an attempt to stimulate domestic investment spending and thereby to reduce unemployment. The Bank of England's minimum lending rate had been gradually reduced from its peak of 12 percent in November 1975 to 9¼ percent by late February, with scope for even further reduction on the basis of market interest rates in early March.

Sterling's stability nevertheless clearly rested on fragile underpinnings. Although heartened by the results of the wage restraint program, many traders remained skeptical that the first year's phase would meet its full objectives and that the next phase, still to be negotiated, would be sufficient to achieve lasting improvement. Moreover, the very depth and prolongation of the recession in Britain raised concerns in the market that the government would eventually shift to a more stimulative fiscal policy, possibly in the budget to be announced in April. Furthermore, in the context of massive speculation over relationships among other European currencies, the fact that Britain continued to have one of the highest inflation rates among industrial nations—running by then at 15 percent per annum—led most market participants to expect that sooner or later the pound would undergo a further downward adjustment.

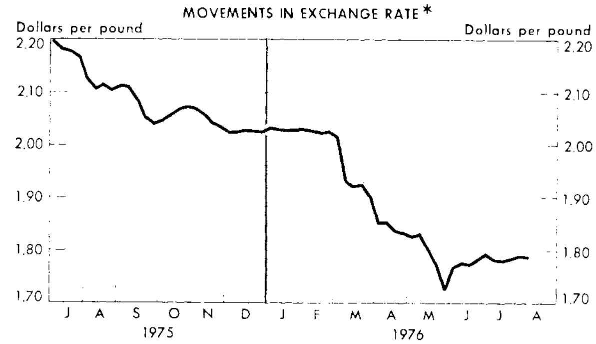
Against this background, the market atmosphere changed abruptly in a swiftly moving sequence of events beginning on March 4. On that day the United Kingdom authorities, confronted with a substantial but short-lived bunching of commercial orders in the marketplace, intervened to supply sterling and absorb dollars to avoid a potentially unsustainable appreciation of sterling above prevailing levels. Once these demands were met, however, sterling came on offer so suddenly that many market participants concluded that the authorities had acted to depress the rate. Heavy selling pressure emerged the next day in Europe, and sterling plunged with little market resistance through the $2.00 level. On that day also, the minimum lending rate was reduced by a further ¼ percentage point to 9 percent. That weekend, sterling's breach of the $2.00 bench mark was featured in press and television news commentary around the world. Widespread selling of pounds resumed on Monday, March 8, and sterling fell nearly ten cents to below $1.93 before edging back late in the day to trade around $1.9425. Meanwhile, the Bank of England had intervened heavily to moderate the decline.

This precipitous drop of over 4 percent in three trading days left the market badly shaken. With the pound now vulnerable to further downward pressure, it was soon caught up fully in the interplay of speculative forces besetting other EC currencies. Commercial leads and lags shifted abruptly against sterling as did the flow of nonresident investment funds. Various uncertainties were injected into the market by Prime Minister Wilson's unexpected resignation and the ensuing struggle within the Labour Party from which Mr. Callaghan emerged as successor, the wide range of public pronouncements on Britain's policy choices by economic analysts and spokesmen for different interest groups, and the continuing unrest on the labor front. These concerns heightened the market's anticipation of the budget address, scheduled for April 6. Although sterling leveled off just above $1.90 toward end-March, a new wave of precautionary selling drove the rate down by a further 3 percent to $1.85 in early April.

Chart IV

UNITED KINGDOM

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III

In framing the budget message, the United Kingdom government addressed many of the issues which troubled the market. Among other measures, Chancellor Healey announced a proposal to provide tax relief to the nation as a whole on the condition that, in the second phase of the pay policy, the trade unions accept even more severe restraints on wage increases than before. As the government and the trade union leadership pressed ahead with their negotiations, the sterling market reacted nervously to each twist and turn in the highly publicized bargaining process. Meanwhile, the pound's already sharp slide, increasingly less favorable interest rate differentials for sterling, and reserve needs for some sterling holders prompted many to continue to disinvest their sterling assets or switch into other currencies. This process added to the drag on the spot rate for sterling and to the drain on British reserves, as the Bank of England intervened to sell substantial amounts of dollars to cushion the pound's decline. As a result, United Kingdom reserves dropped a full $2.2 billion during March-April, even after the receipt of $600 million of public sector borrowings.

In a sharp reversal of policy, the Bank of England began to tighten money market rates, hiking its minimum lending rate 1½ percentage points to 10½ percent on April 26 and following up with another 1 percent increase on May 24. Moreover, on May 5, the government announced successful completion of the wage policy negotiations with the Trades Union Congress. In exchange for the tax cut, the government had secured agreement from the union movement's leadership to limit phase-two wage increases, beginning on August 1, to 4.5 percent per annum under a formula which came close to the terms set forth in the budget address. Also, to bolster cash reserves, in early May the United Kingdom authorities announced that they would take down a further $806 million from the IMF, under a previously arranged first-credit-tranche standby.

Nevertheless, during May the market became so thoroughly demoralized that favorable developments were virtually ignored, or greeted with skepticism, while traders reacted quickly to anything which might conceivably affect sterling adversely. News reports that particular trade unions might possibly reject the negotiated limitations on wage increases and further bits of unfavorable economic news—the unexpected increase in the April trade deficit, the sharp rise in April retail prices, the decline in United Kingdom industrial production in March—sparked renewed selling of sterling. As the rate continued to plunge, dealers expressed open concern over the willingness or the ability of the authorities to halt the slide. Consequently, even as the Bank of England

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, 1976	Drawings (+) or repayments (—) 1976			Drawings on Federal Reserve System outstanding July 31, 1976
		I	II	July	
Bank of England	-0-		+200.0		200.0
Bank of Italy	-0-	+500.0		—500.0	-0-
Bank of Mexico	-0-		+360.0		360.0
Bank for International Settlements (against German marks)	-0-		+ 14.0 — 14.0	+ 37.0 — 37.0	-0-
Total	-0-	+500.0	+574.0 — 14.0	+ 37.0 —537.0	560.0

provided further support—official reserves declined by $250 million in May net of the IMF drawing—the pound dropped through $1.80 to $1.75 by end-May and plummeted to as low as $1.7020 in the first week of June. This represented a drop from early March of 15¾ percent against the dollar and 11.8 percentage points to 41.9 percent on an effective trade-weighted basis since the December 1975 Smithsonian agreement.

Meanwhile, Chancellor of the Exchequer Healey and other government spokesmen expressed the firm view that the various measures taken so far would achieve the greater price stability and improved productivity necessary to strengthen sterling over the long run. Indeed, the wage restraint program negotiated with the Trades Union Congress was by that time gaining acceptance in votes among individual unions. To deal with the immediate concerns of the exchange market, however, the United Kingdom authorities began in early June to discuss short-term credit availability with foreign central banks and governments.

From those discussions, largely conducted over the weekend of June 5-6, emerged a $5.3 billion package of standby credits to the United Kingdom from the Group of Ten countries plus Switzerland and the BIS. As part of the package, the Federal Reserve stood ready to make available up to $1 billion under the swap arrangement with the Bank of England and the United States Treasury up to $1 billion through the Exchange Stabilization Fund. In announcing the United States participation, the United States Treasury and the Federal Reserve said: "These arrangements have been made in the light of the recent fall in the value of the pound sterling under exchange market pressures which have led to disorderly market conditions, and in the common interest in the stability and efficient functioning of the international monetary system."

Announcement of the standby credit was carried by the news services shortly after 10:30 a.m. New York time, at which point the Bank of England and the Federal Reserve Bank of New York, as its agent, simultaneously entered their respective markets, bidding openly for sterling at the current rate of exchange. The combined force of the news and the central bank presence in the market had an electrifying effect. Within a matter of minutes and with only a nominal purchase of sterling by the authorities before they withdrew to the sidelines, the spot rate shot upward in a rise which carried it to $1.80 by the time the London market reopened the following morning. However, the market quickly sought to test the determination of the British authorities to support the rate at prevailing levels. As sterling dropped back to around $1.77, the Bank of England countered with substantial dollar sales, both in London and through this Bank in New York, while reinforcing a liquidity squeeze by operating in the market for short-dated swaps. These operations helped stabilize the pound somewhat, and over subsequent days fairly good two-way business was again moving through the market.

Nevertheless, dealers continued to look for new domestic policy initiatives to cut public expenditures and to restrict monetary growth, as well as evidence of an underlying improvement in British economic performance. Consequently, sterling remained vulnerable to an occasional burst of selling pressure and on individual days official support for the pound was quite heavy. By end-June, the spot rate was around $1.77 and intervention had diminished considerably. To offset outflows from reserves resulting from recent intervention operations, the Bank of England drew in late June on the standby facility. In this connection, it took down $200 million on the swap line with the Federal Reserve and $200 million from the Exchange Stabilization Fund.

During July, the sterling market gradually became less fragile and rate movements progressively narrowed. Evidence of a more firmly based economic recovery began to appear. Moreover, the British government announced details of a reduction in public sector expenditure for the 1977-78 fiscal year to free more resources for exports and industrial investment. Although the market initially reacted with some disappointment that these measures were not stronger, trading conditions soon improved. By end-July the pound had settled around $1.78, some 4½ percent above the early-June low. Meanwhile, the effective trade-weighted depreciation had improved to 38.8 percent.

SWISS FRANC

Coming into 1976, the market's attitude toward the Swiss franc was even more bullish than before. Switzerland's inflation rate had declined to below 3½ percent per annum, a striking improvement from the 10 percent rate that had prevailed just twelve months before and well below rates elsewhere. The current-account balance was in exceptionally strong surplus and, with domestic demand still stagnant and showing few signs of an early recovery, was expected to remain favorable well into the new year. Although Swiss interest rates had been kept low and the outflow of capital was swollen with greatly increased nonresident borrowings in Swiss francs, the market was concerned over the potential demand for francs that could arise whenever borrowers covered themselves. Indeed, a number of market participants with recent and long-standing debts in Swiss francs moved to cover their franc exposures in early January. The franc, therefore, came into strong demand, rising through the month end by some 5½ percent from its September 1975 low to $0.3844 against the dollar while reaching par against the German mark.

In the meantime, the Swiss authorities, concerned about the eventual adverse effects of a strengthening exchange rate on Swiss exports, took steps to limit the franc's rise. The official discount and Lombard rates were reduced further to 2½ percent and 3½ percent, respectively, in early January. In addition, the National Bank stepped up its official purchases of dollars in Zurich and, to a modest extent, in New York through this Bank as agent. To avoid jeopardizing the authorities' monetary target for the year, these operations were offset in part by the ongoing program requiring foreign borrowers of Swiss francs to convert the proceeds of their borrowings at the central bank and in part by increased government borrowings.

Although by early February the particular demands for Swiss francs had largely been met, the franc soon was caught up in the tensions afflicting other currencies in mid-February and early March. Marked up against the dollar in sympathy with the rise of the German mark, the rate increased to $0.3970 on March 17, even as the National Bank continued to intervene. After pressures within the EC snake began to subside late in March, the Swiss franc remained in demand in response to the usual quarter-end needs for francs. The National Bank provided liquidity assistance, mostly through swaps over the month end but also through further outright spot dollar purchases, with the result that the spot rate held steady against the dollar and around par with the German mark.

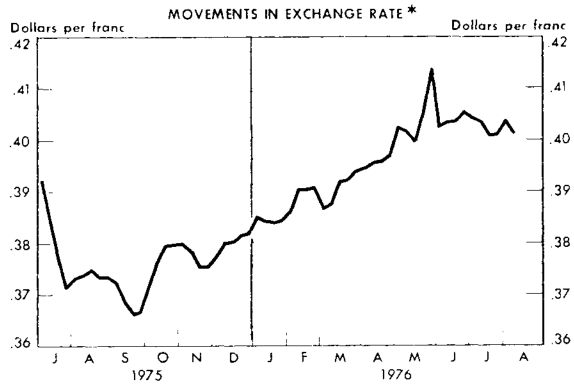
Early in April, however, the Swiss franc once again emerged as a focus of market attention, rising strongly not only against the dollar but also against the German mark. Recent economic indicators confirmed the further moderation of price increases in Switzerland as well as the continued strength of the current-account surplus. Switzerland once again provided a haven for those funds seeking an escape from the continued uncertainties elsewhere, and the franc was bid up strongly as funds were shifted out of Italian lire and sterling. Renewed hedging of long-term Swiss-franc commitments by United States and other corporations, periodic inflows from the Organization of Petroleum Exporting Countries (OPEC), eastern Europe, and third world countries, and outright speculative positioning further reinforced demand for Swiss francs.

In view of these continuing sources of strength, the market became fearful that the authorities would again seek to contain the franc's rise by imposing yet more controls against the inflow of foreign funds. The announcement early in April of new regulations restricting the importation of foreign bank notes seemed to confirm the

Chart V

SWITZERLAND

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

market's concern, and the franc again became strongly bid. The Swiss National Bank continued to purchase dollars in the market to contain the franc's rise. At the same time, however, National Bank President Leutwiler conceded that neither the balance-of-payments nor cost-price relationships warranted a restoration of earlier rates for the franc. Thus, the franc was subjected to successive waves of demand that swept the spot rate up by June 2 to a peak of \$0.4197, 9 percent above late-January levels and its highest point since early 1975. In the meantime, the franc gained some 8 percent to a record high against the German mark.

The protracted rise of the Swiss franc threatened to aggravate the pressures on Swiss exporters at a time when the domestic economy still had not joined in the economic recovery developing elsewhere. In response, the Swiss authorities prepared to stiffen their resistance to the franc's advance. They agreed that a DM 750 million loan for the German government be placed with the three major Swiss commercial banks and that the marks be purchased in the market. On June 8 the Swiss National Bank announced an extensive package of exchange controls and other measures to curb the "excessive speculation that led to the Swiss franc's clear overvaluation". In addition, the authorities pledged to "intervene massively, if necessary, to correct disorderly exchange rate movements", blocking the Swiss franc countervalue of their dollar purchases if needed to avoid undermining Swiss monetary targets. Moreover, the Swiss central bank again cut both its discount and Lombard rates to 2 percent and 3 percent, respectively, the lowest levels since 1963.

Following these actions, the Swiss authorities immediately stepped up the scale of their intervention in both dollars and German marks. As the market assessed the impact of this heavier intervention and the German government borrowing on the franc-mark relationship, dealers moved to cut back some of their large Swiss franc positions. The franc therefore fell back 5½ percent against the dollar to \$0.3960 on June 9, while dropping a similar amount against the German mark. As the Swiss franc weakened, some of the banks and multinational corporations with exposures in francs took advantage of these rates to begin again to cover themselves. Moreover, sales of Swiss francs to finance participations in the German government loan soon tapered off. As a result, demand for francs reemerged and remained periodically heavy over subsequent days, with the National Bank providing resistance to a further sharp rise in the rate.

By the end of June, the Swiss National Bank had purchased a total of \$4.4 billion since the beginning of the year. During the first quarter, the bulk of the spot intervention had been offset, largely under the capital export conversion program, and the National Bank had provided temporary liquidity partly by conducting short-term swaps with the Swiss banks. During the second quarter, however, a smaller portion of the reserves injected through the Swiss National Bank's intervention was absorbed and the Swiss money market became increasingly liquid. To help keep monetary expansion in line with the National Bank's target, reserve requirements on foreign deposits were raised, effective July 26, and government borrowings were stepped up. But even so, Swiss interest rates remained extremely low in sharp contrast to the somewhat firmer tendencies that developed from time to time in other centers.

Consequently, the Swiss franc leveled off to trade more narrowly around \$0.4038 during most of July. Just before the month end, however, it was pulled up somewhat by the German mark's advance. As a result, by July 30, the franc was on balance somewhat more than 4 percent above end-January levels but still 3¾ percent below its peak of early June. Against the German mark, it had gained 2½ percent on balance over the period, though the gap between the two currencies had narrowed some 5½ percent from its widest point two months before.

During the period, the Federal Reserve transferred its \$600 million of Swiss franc swap debt from the BIS to the Swiss National Bank. The System purchased \$33.2 million equivalent of Swiss francs from correspondents and liquidated \$20 million of its debt with the Swiss central bank. Swiss franc commitments outstanding at end-July totaled \$1,147.2 million.

FRENCH FRANC

During much of 1975, the French franc was bolstered by a strong improvement in France's external position. A severe recession at home and reduced energy requirements helped to swing France's trade account into surplus. Relatively high interest rates in France had stimulated sizable inflows of foreign funds, while French companies had been encouraged to borrow abroad. Thus, the French franc remained relatively firm within the EC snake after its reentry at the former parity in July 1975. The Bank of France intervened frequently to keep the franc off the top of the EC band, with the official purchases reflected in the increase in French reserves recorded for the second half of 1975.

By the turn of the year, however, the balance of market forces began to turn against the French franc. The fiscal stimulus provided early last fall, when the recovery in France—as in other European countries—was still lagging behind that in the United States, had by then generated a quick rebound in the domestic economy. This drew imports in from abroad sufficient to turn France's trade position back into deficit by late 1975. It also raised market concern over whether the inflation rate, which had eased just below 10 percent, would continue to decline toward levels more nearly in line with those in Germany and the United States. In the meantime, domestic interest rates eased back somewhat, thereby narrowing the interest differentials favoring France. As credit conditions improved, French companies repaid some of their previous foreign borrowings while new borrowings abroad declined.

With the outlook for France's balance of payments more uncertain, the French franc was left exposed to the successive waves of selling which developed in early 1976. Following the January 21 suspension of official support for the Italian lira and its subsequent sharp drop, the market increasingly came to question the competitive relationships within Europe and the viability of existing EC parities. As a result, the French franc had already come on offer late in January when dealers unloaded long French franc positions and leads and lags shifted against the franc. As the franc weakened, it dropped below the midpoint of the EC snake. The Bank of France intervened to cushion its decline by selling dollars heavily in Paris and limited amounts in New York with the Federal Reserve Bank of New York acting as its agent.

Nevertheless, speculative pressures within the EC monetary agreement continued to mount as repeated rumors of a possible realignment of snake currencies—involving some combination of a franc devaluation and a German mark revaluation—swept through the markets. Consequently, the franc and the mark were pushed toward the opposite extremes of the joint float by the second week of February. The February 9 devaluation of the Spanish peseta and the approach of a scheduled Franco-German summit meeting on February 12-13, reportedly to discuss among other things an EC currency realignment, further intensified the two-way speculation within the snake. In response, the Bank of France stepped up the scale of its operations, selling large amounts of dollars as well as a substantial sum of German marks between February 9 and February 12. At the same time, in Frankfurt, the Bundesbank followed up on its dollar purchases with some French franc acquisitions to help keep the franc above the floor of the snake.

Table IV

UNITED STATES TREASURY SECURITIES
FOREIGN CURRENCY SERIES

In millions of dollars equivalent

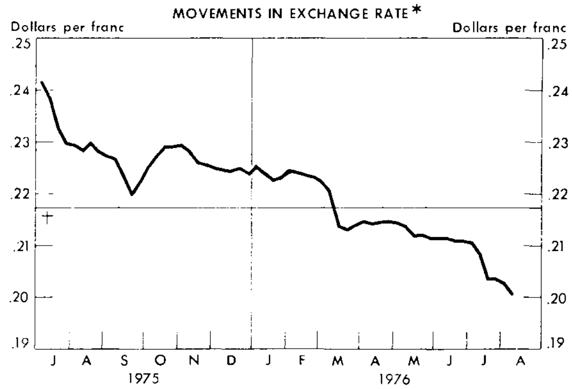
Issued to	Amount outstanding January 1, 1976	Issues (+) or redemptions (—) 1976 I	II	July	Amount outstanding July 31, 1976
Swiss National Bank	1,599.3				1,599.3
Total	1,599.3	–0–	–0–	–0–	1,599.3

In the wake of this officially acknowledged intervention, the markets began to settle down by February 13. Moreover, reports from that weekend's summit meeting reaffirming prevailing EC parities, together with a tightening of French interest rates, prompted some covering of short franc positions. As a result, the franc regained a portion of the ground it had lost against the mark and later eased back less than other Continental currencies as the dollar generally firmed. By the month end, it had declined against the dollar some ½ percent from early-February levels to $0.2234. Against other European currencies, however, it had firmed to a level ¾ percent above the floor of the EC snake, and the Bank of France began to recoup some of its reserve losses.

Chart VI

FRANCE

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

†Central rate established on February 12, 1973.

Nevertheless, most market participants remained convinced that an early realignment of EC parities was inevitable. Thus, when sterling's sharp decline in early March and the continuing plunge of the Italian lira again brought into question competitive relationships within Europe, a new and more virulent round of speculation against the franc was quickly ignited. In the wake of these precipitous declines in exchange rates for two of France's major trading partners, the French franc came under massive pressure, as commercial and professional market participants offered huge amounts of francs in the exchanges at the same time that the German mark was strongly bid. Leads and lags shifted even more heavily against the franc, and the large-scale speculative positions established during January and February were lengthened even further. The Bank of France met these pressures with further forceful intervention that resulted in a considerable loss of French reserves for the several days that preceded the March 13-14 meeting of EC finance ministers.

Over the weekend, when no realignment within the EC snake was achieved at the summit meeting, the French government decided to withdraw the franc from the EC snake and allow it to float independently. When trading resumed on Monday, March 15, the franc at first plummeted over 5 percent in a nervous and uncertain market. But, as the cost of overnight borrowings in the Euro-franc market abroad soared to as much as 800 percent per annum, dealers responded by covering their extremely expensive short franc positions. The spot rate soon recovered to around $0.2150 against the dollar, or about 2½ percent below its old support limit against the German mark within the EC snake.

Over subsequent weeks, dealers remained cautious toward the French franc and there were no significant reversals of the speculative outflows of January-March. The franc market was roughly in balance, however, as a modest unwinding of adverse leads and lags and conversions of new French corporate borrowings abroad tended to offset continuing commercial demand for foreign currencies by French residents. The spot rate drifted down gradually to $0.2108 by early June, as the dollar gained generally in response to a renewed rise in United States short-term interest rates. Against other EC currencies, the French franc held fairly steady. The Bank of France was therefore able to take advantage of occasional bidding for francs to purchase currencies in the market. Even so, the decline in France's reserves for the first five months of the year came to about $3 billion.

During the summer, the market became even more hesitant toward the franc. Although the pace of inflation had moderated, many market participants feared that a continued expansion of domestic demand would reverse this trend and widen the gap between inflation rates in France and those abroad. Then, the market's attention shifted to the impact on France of the severe European drought. More serious in France than in most other countries, the drought was expected by many forecasters to push up food prices, cut into agricultural exports, and increase oil imports to compensate for the loss of hydroelectric power.

Under these circumstances, the selling of French francs again built up early in July. The Bank of France initially resisted with heavy dollar sales. But the pressures continued, fueled by open debate in the press over the government's resolve to stem a further decline in the rate and to contain continuing wage and price pressures. The authorities then moved to resist a further decline in the franc rate by raising domestic interest rates, including a 1½ percentage point increase to 9½ percent in the Bank of France's discount rate, effective July 22. The market at first interpreted this move as indicating a considerably more flexible intervention policy, and the rate briefly eased further. By the end of July the spot rate had fallen to about 10 percent below its former lower intervention point against the German mark. Trading at $0.2035, the franc was some 9 percent below early-February levels against the dollar.

ITALIAN LIRA

Pressure against the Italian lira had been building up during the fall of 1975 in response to deepening economic and political uncertainties in Italy. Industrial activity showed only tentative signs of recovery, as sectoral bottlenecks blunted the impact of the fiscal and monetary stimulus provided earlier in the year. At the same time, the strengthening of the dollar against the lira prompted large repayments of foreign borrowings by Italian banks and a drop in domestic interest rates facilitated the financing of a sharp rise in raw materials imports as firms began to restock depleted inventories. Thus, the outflow of capital accelerated and the trade balance deteriorated sufficiently to erode much of the improvement evident earlier in 1975. Meanwhile, the fall in real income in Italy and renewed upturn of the inflation rate had generated increasing political and social unrest, with important labor negotiations approaching a critical stage. After a prolonged cabinet crisis, Italy's minority coalition government resigned in January 1976 and, as efforts went forward to strike a new political compromise on which a viable cabinet could be formed, the lira came heavily on offer in the exchanges.

At first, the Bank of Italy countered these pressures with forceful intervention to keep the lira rate roughly in line with other European currencies. From January 2 to January 20, it sold more than $500 million, raising the entire reserve loss since mid-1975 to $2.4 billion. As a result, the Bank of Italy was left with only $594 million in convertible currency reserves and, to add to its cash balances, it drew $250 million under the swap line with the Federal Reserve. But, in the absence of a new government and with the adequacy of Italy's reserves a matter of open discussion in the press and the market, prospects of a further flight of capital from the country became overwhelming. Thus, on January 21 the Italian authorities announced that the Bank of Italy would suspend official dealings in the exchange market to conserve reserves.

This decision left the lira effectively floating freely and, with selling continuing into February, the spot rate dropped fairly sharply from time to time in a thin market. There were occasional pauses in the decline, as traders responded to events which gave rise to hopes of an end to Italy's governmental crisis or a resumption of official dealing. Nevertheless, the market was so thoroughly demoralized that two hikes in the Bank of Italy's discount rate from 6 percent to 8 percent during February and increased bank reserve requirements evoked little market response. Moreover, the eventual announcement that a new minority government would be formed under Premier Aldo Moro gave but a momentary boost to market psychology. Instead, in increasingly one-sided trading, the lira fell to $0.001245 (Lit 803) by February 24, 15¼ percent below levels prevailing before the cabinet resignation.

Meanwhile, the Italian authorities grew more concerned about the deterioration of market conditions and the drop in the rate that threatened to set off a new bout of inflation at home. Consequently, the Bank of Italy moved ahead with plans to resume official intervention to restore more orderly trading once again. Even as the new government was being formed, the Italian authorities initiated discussions for a new IMF standby and concluded arrangements with other EC governments to borrow $1 billion in the international markets through the EC oil facility. As these negotiations to secure medium-term credit went forward, the Federal Reserve agreed to make available to the Bank of Italy, in addition to the $250 million already drawn, a further $500 million under the swap arrangement to backstop the Bank of Italy's cash resources.

Late in February, when the new government presented its economic program to parliament, the authorities also announced that they would reopen official exchange market dealings on March 1, with some $2 billion of credit available including the funds extended for this purpose by the Federal Reserve. The market responded favorably and, while potential purchasers of foreign currencies held off satisfying their needs until March 1, the lira was marked up over 4½ percent to $0.001302 (Lit 768) temporarily at the end of February.

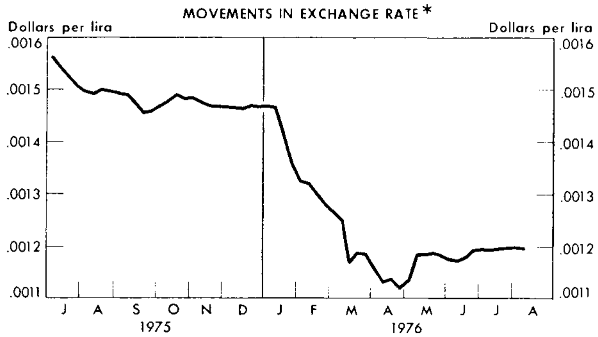
In early March, when the backlog of commercial orders for dollars particularly by Italian oil companies reached the market, the lira immediately came under selling pressure. Then, just as the market was settling down, the lira was caught up in the resurgence of generalized speculation over European currency relationships. Hit by renewed selling, the spot rate was driven down by 9 percent to $0.001188 (Lit 842) by March 16, even as the Bank of Italy provided large-scale support. The Italian authorities responded to these pressures by tightening regulations on capital outflows and by restricting the capacity of commercial banks to cover their customers' forward lira sales through requiring a 10 percent reduction in commercial bank "spot against forward" transactions by the month end. More importantly, they imposed severe fiscal and monetary deflationary measures, raising the Bank of Italy's discount rate an unprecedented 4 percentage points to 12 percent and proposing emergency tax and gasoline price increases estimated to absorb some $1.8 billion equivalent. The announcement of these measures, at a time when there were still only tentative indications of a recovery in the domestic economy, impressed the market and touched off a sharp rebound in the spot rate. In the forward market, however, the discount on three-month lire more than doubled to over 17 percent per annum on March 31, as liquidity in Italy tightened and the new exchange control restrictions began to take effect. Meanwhile, the Bank of Italy took down another $250 million on its swap line with the Federal Reserve, raising the total of actual drawings to $500 million. The EC oil-facility borrowing was also completed, bringing a further $1 billion into Italian reserves.

The tentative improvement in market conditions following the March measures was dealt a stunning blow in early April, when a serious disagreement over noneconomic issues erupted in parliament. As it became clear that new elections were inevitable, market fears of a strong showing by the Communist Party led to renewed capital outflows which pushed the spot rate down by May 5 to a record low of $0.001090 (Lit 917), fully 26 percent below early-January levels. Also in early May the forward discount soared to 42 percent per annum.

Chart VII

ITALY

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

After the close of trading that day, the Italian caretaker government began to announce a set of tough foreign exchange restrictions designed to curb import growth, to encourage reversals of adverse leads and lags, and to stabilize the lira spot rate until a new government could be elected. As of May 6, all foreign currency purchasers, except grain importers, were required to deposit 50 percent of the countervalue of their acquisitions in noninterest-bearing accounts for three months. This measure, aimed at discouraging speculative outflows via the over-invoicing of imports, was also expected to mop up about $4 billion equivalent of liquidity over three months. On May 7, Italian exporters were told to convert foreign currency earnings within seven days of receipt to shorten the lag between export transactions and foreign currency conversions. On May 10, exporters granting foreign currency trade credits of up to 120 days were required to convert 30 percent of the value of those credits into lire within seven days of the transactions. Moreover, technical changes in existing exchange restrictions were announced to raise both the cost and risk of maintaining short lira positions.

The imposition of these sweeping exchange restraints provoked an immediate scramble for lira balances. The spot rate shot up to as high as $0.001235 (Lit 810) in early European trading on May 10, before settling around $0.001193 (Lit 838) later in May, 9½ percent above the low early in the month. Thereafter, as the exchange control measures continued to contribute to a squeeze on domestic liquidity, the lira traded more quietly around this level until the June 20-21 general elections.

The election outcome, with a narrow but clear-cut plurality for the Christian Democratic party, swept aside a major source of market uncertainty, and a reflux of speculative funds developed as soon as the first results were known on June 21. Thereafter, news of a reduced balance-of-payments deficit for May and a slowing in the rate of inflation lifted some of the gloom surrounding the Italian economic outlook. With Italy's tourist earnings becoming seasonally strong and the various exchange controls continuing to induce a reversal of adverse leads and lags, the lira came into demand. In view of the earlier heavy reserve losses, the Bank of Italy took advantage of the lira's buoyancy at prevailing rates to absorb large amounts of dollars in the market. Consequently, while the substantial inflows of funds continued, the lira rate held steady through end-July. The Bank of Italy was thus able to post reserve gains of $1.7 billion for June and July, even after repaying in late July the full $500 million of swap drawings on the Federal Reserve.

NETHERLANDS GUILDER

Coming into 1976, the Netherlands guilder was bolstered by expectations of a continuation of that country's strong payments position. A sharp rise in natural gas exports, together with a recession-induced fallback in imports, had already widened the current-account surplus to $1.6 billion in 1975. With economic recovery well under way in several of the Netherlands' major foreign markets, the outlook for Dutch exports promised to be even brighter for 1976. Sizable capital outflows were expected to continue, reflecting the relatively low interest rates in Amsterdam compared with other financial centers, but not in sufficient volume to offset fully the current-account surplus. Moreover, although unemployment was still rising and the inflation rate was still about 10 percent, the domestic economy was beginning to show signs of an upturn. Consequently, exchange market sentiment was extremely favorable, and the guilder traded firmly at the top of the EC snake as well as at the upper limit against the Belgian franc in the 1½ percent Benelux band.

When tensions developed in many European currency markets in late January, a press report that the Benelux band might be abandoned—although immediately denied by the Netherlands and Belgian governments—triggered large-scale speculative demand for guilders and offerings of Belgian francs. To counter these pressures, the Netherlands Bank intervened in coordination with the National Bank of Belgium and bought substantial amounts of Belgian francs as well as dollars. The Dutch central bank announced a ½ percentage point cut in its discount rate to 4 percent and 1 percentage point reductions in other official lending rates. In Belgium, the authorities also took several measures to support the franc, including the boosting of short-term interest rates. This forceful response, coupled with an easing of liquidity conditions in Amsterdam and a corresponding tightening of liquidity in Brussels, reassured the market, and by early February the immediate strains had subsided somewhat.

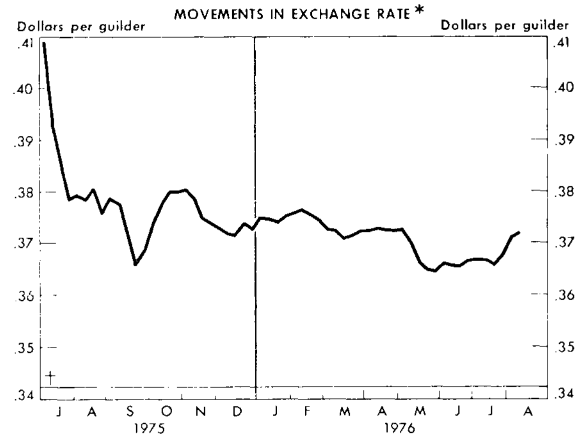
By that time, however, the markets were alive with rumors of a possible general realignment of EC currencies. In view of the strong ties between the Netherlands and German economies and the fact that each enjoyed a substantial current-account surplus, market participants tended to tag the guilder as a prime candidate for revaluation along with the German mark. Consequently, as the mark came into heavy demand, the guilder also strengthened, joining the mark at the upper limit of the EC snake and stretching the Benelux band once again. The dollar market became unsettled, too, and the guilder rose by ¾ percent to a peak of $0.3781. In this atmosphere, when a flurry of demand for guilders developed on February 11 in the New York market, the Federal Reserve supplemented its offers of German marks with offers of guilders, selling $19.6 million equivalent financed by a drawing on the swap line with the Netherlands Bank. Subsequently, as the immediate exchange market turbulence abated and the guilder eased back somewhat, the Federal Reserve purchased sufficient guilders to liquidate the swap debt by early March.

Following sterling's drop below the $2.00 level, expectations of a broader EC exchange rate realignment reappeared, generating renewed demand for guilders. By the second week of March, the guilder was hard against its upper margin for the Belgian franc. Even though there was sizable intervention to defend the Benelux limits, bringing total support since early February to over $350 million equivalent, the guilder was pushed to the top of the EC band along with the mark.

The results of the March 13-14 EC finance ministers' meeting in Brussels had a jarring effect on market expectations for the guilder. The Benelux joint float arrangement was abruptly suspended, relieving an immediate source of speculative demand. At the same time, the press reported that, in the showdown which developed at Brussels, Dutch officials had rejected proposals to revalue the guilder. By that time, also, technical factors were weighing on the market, as the guilder liquidity created by central bank intervention, together with usual seasonal factors, had so eased money market conditions in the Netherlands that short-term interest rates there were well below those in Germany and Belgium. Consequently, the guilder came on offer, easing slightly against the dollar but falling sharply against the mark and other currencies within the EC snake. The Netherlands Bank began to sell moderate amounts of dollars to cushion the decline, but by April 6 the guilder had slipped to the bottom position of the joint float.

During the spring, several developments prompted increasingly bearish sentiment toward the guilder. Economic indicators during the first months of 1976 showed that Dutch exports had leveled off and that the incipient economic recovery at home had stalled. The inflation rate remained stubbornly high, well above those in Germany, Switzerland, and the United States. Moreover, serious union opposition had emerged to a proposed extension of the government's social contract for limiting wage increases. In addition, higher government borrowing requirements associated with continued growth of public sector spending were a source of concern to the market. At the same time, widespread press reports of disputes within the government coalition over a number of social and eco-

Chart VIII
NETHERLANDS
MOVEMENTS IN EXCHANGE RATE*



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

nomic issues added further to the uncertainties.

Through early May the spot guilder therefore stayed in the lower range of the EC band. Against the dollar it held steady at around \$0.3725, as the National Bank of Belgium completed guilder purchases to repay commitments incurred prior to suspension of the Benelux band. Thereafter, the guilder was left more exposed to selling pressure that intensified after mid-May. The rate began to soften and reached a low of \$0.3628 on June 1, some 4 percent below the February high, before the immediate selling pressure subsided. To keep the guilder away from its lower intervention limit against the mark in the EC band, the Netherlands Bank intervened in substantial volume, with the result that reserves declined by nearly \$1.2 billion between mid-March and mid-June. Moreover, the Netherlands Bank, following market developments, raised its discount rate in two ½ percentage point steps to 5 percent by June 18. During that time, the Federal Reserve took the opportunity to purchase a modest amount of guilders (\$3.6 million equivalent) for working balances.

By mid-June the Dutch money market had gradually tightened, partly as a result of the heavy exchange market intervention by the authorities. Moreover, recent economic indicators were more favorable, with tentative signs of improvement in industrial production and better price figures. At the time of end-June positioning in the Netherlands, therefore, a scramble for guilder balances developed, pushing up market interest rates sharply and prompting some covering of short guilder positions in the exchange market. The guilder thus turned firmer against the dollar and came off the floor of the EC snake.

Thereafter, the guilder market was in better balance until late in July, when the snake came under renewed strains as the movement into German marks became more generalized. At that time, the Netherlands Bank again intervened in support of the guilder within the EC band and announced a further ½ percentage point increase in its discount rate to 5½ percent, effective August 2. By end-July the guilder rate had recovered to \$0.3708, some 2¼ percent above its June low.

BELGIAN FRANC

Late in 1975, Belgium's balance of payments had shifted into deficit as a result of a slowdown in exports and an increased outflow of long-term capital. Domestically, the economy was slow to join in the recoveries already getting under way in other countries. In addition, Belgium's inflation rate, while declining to below 10 percent, was still high enough to generate market concern that it could thwart a sustained recovery. There was further uneasiness that the government had not reached agreement with the trade unions for modifying Belgium's wage indexation system, a mechanism many observers felt was helping to weaken the competitiveness of Belgian exports.

Against this background, the commercial Belgian franc, trading around \$0.025520 *vis-à-vis* the dollar in early January 1976, had fallen to near the bottom of the EC snake and had also settled at the lower limit of the separate 1½ percent Benelux band with the Dutch guilder. There was no particular pressure against the franc, however, until late in January when, amidst generalized speculation over European currency relationships, newspaper reports suggesting that the Benelux currency arrangement might be disbanded set off heavy selling of Belgian francs. The selling reflected adverse shifts in commercial leads and lags and was therefore concentrated in the market for commercial francs. The financial franc, which floats freely, moved in parallel to the commercial rate but was not under unusual strain. Although the press reports were officially denied, the pressure continued and intervention mounted by both the Belgian and Netherlands central banks, largely in Benelux currencies. As a result, liquidity tightened in Brussels and simultaneously eased in Amsterdam, raising the cost of holding positions short of francs and long of guilders and thereby relieving the strain on the franc by mid-February.

Bolstered by the continuing tautness in Belgium's local money market, the franc was not immediately caught up in the market turmoil surrounding other European currency markets early in March. But by March 11, as traders came once again to expect an adjustment of EC parity relationships, speculative selling of Belgian francs re-emerged. The spot rate was driven back to its lower limit against the guilder, where it again required heavy support.

The announcements following the EC finance ministers' meeting over the March 13-14 weekend only intensified the selling of Belgian francs. News that the French franc had been withdrawn from the EC snake and the Belgian and Netherlands governments had suspended the Benelux currency arrangement generated expectations that the Belgian franc would be either devalued or cut loose from the joint float. Dealers therefore drove the franc almost immediately to the bottom of the snake, which was then being pulled up against the dollar by the rise of the German mark.

The Belgian government, however, quickly signaled its determination to keep the Belgian franc in the snake at its existing parity to prevent a falling exchange rate from aggravating domestic inflation. As the Belgian franc came heavily on offer against the mark at the lower limit of the snake, the National Bank of Belgium intervened heavily between March 15 and March 19, selling large amounts of marks while the Bundesbank purchased a large volume of Belgian francs in Frankfurt. Moreover, to convince the market of its resolve to support the franc, the Belgian authorities took further steps to raise the cost of holding speculative positions against the franc. The National Bank announced a 1 percentage point hike in its discount rate to 7 percent, effective March 18, and restricted access to its short-term lending facilities. In addition, it required commercial banks to deposit a fixed percentage of their funds in government securities. These measures were followed up with public affirmations on the part of a number of Belgian officials of their determination to guarantee the existing Belgian franc parity.

By March 22, the combined impact of these various liquidity-tightening measures had taken hold. Overnight rates in the Euro-Belgian franc market were bid as high as 200 percent per annum, and the cost of rolling over short franc positions became more than most speculators were willing to bear. Thus, in a sharp two-day turnaround, the franc jumped over 2 percent against the dollar and traversed the entire width of the EC snake before easing back to trade around $0.025600, fairly comfortably within the joint float.

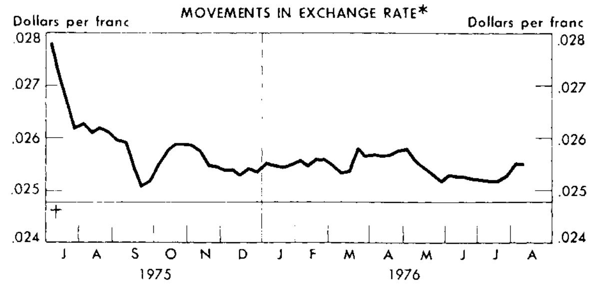
By early April, industrial production in Belgium was rising more strongly than anticipated at the beginning of the year, but the pace of domestic price increases remained worrisomely high. The Belgian cabinet agreed on budget cuts on April 5 to reduce domestic inflation further and to provide support for the exchange rate. In addition, the authorities followed up their mid-March measures by strengthening the controls on resident foreign exchange transactions. The cumulative effect of these various actions was to trigger a gradual reversal of previously adverse leads and lags. As these reflows persisted throughout April and May, the Belgian authorities were able gradually to ease their mid-March monetary restrictions, reducing some interest rates to pre-crisis levels and, in early June, lifting the special regulations requiring commercial banks to maintain specific levels of investments in government securities. In addition, the National Bank completed its repayment of Dutch guilder commitments incurred prior to suspension of the Benelux band and purchased sufficient German marks to liquidate its commitments in that currency as well. Even so, the commercial franc continued to hold in the middle of the EC snake, while falling off with the other European currencies against the dollar.

Thereafter, dealing in francs was generally quiet and well balanced through early July. Only on two successive Fridays in late May-early June was trading temporarily unsettled by a spillover of pressure directed at the Dutch guilder. In each case, the National Bank of Belgium quickly countered with small sales of dollars. In mid-July, however, as the market began once again to reassess existing European currency relationships, pressures on the Belgian franc were renewed and the franc fell to its lower limit against the German mark. The National Bank re-

Chart IX

BELGIUM

MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

†Central rate established on February 12, 1973.

sumed its intervention and also announced a discount rate increase of 1 percentage point to 8 percent, effective July 26. Subsequently, the Belgian franc was dragged up by the rise of the German mark to trade by the month end at \$0.025527, close to its early-February level against the dollar.

During the six months under review, the Federal Reserve continued to make small frequent purchases of Belgian francs against swap commitments incurred prior to August 1971. These acquisitions, totaling \$177.3 million equivalent, were used to repay a total of \$170.5 million equivalent of such commitments, reducing the outstanding swap debt to \$82.4 million, and to add to balances.

JAPANESE YEN

Early in 1976 the balance of market sentiment had swung back in favor of the Japanese yen, as an unexpectedly rapid improvement in the balance of payments outweighed lingering concern over the sluggishness of Japan's economic recovery. The current account had returned to surplus, as export shipments of automobiles and a few other items expanded sharply in response to the inventory buildup in the United States and elsewhere while Japan's import growth remained stagnant. Moreover, Japan enjoyed sizable inflows of capital as short-term interest rates, though down from their mid-1975 highs, were still well above comparable interest rates in the United States. The resulting interest rate differentials favoring Japan stimulated large foreign purchases of Japanese government securities, not only on an uncovered basis but also on a covered basis, since the forward yen was frequently at a premium. Moreover, taking advantage of favorable market conditions, Japanese corporations were active in borrowing in the European and New York bond markets as well as through foreign-currency-denominated loans from Japanese branches of foreign banks. Conversions of these foreign borrowings gave an additional lift to the yen in the exchanges.

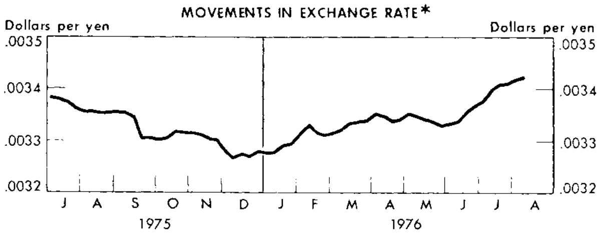
Coming into February 1976, therefore, the yen had advanced 1 percent from its December 1975 lows and it rose another 1 percent to \$0.003333 (¥300) by mid-month. In March the yen was again well bid, largely in response to uncertainties in the European currency markets. Meanwhile, a number of reports suggested that several overseas monetary authorities had increased their yen holdings. With these reports, market uncertainty over the durability of existing exchange relationships in general stimulated demand for yen by both residents and nonresidents to cover future needs. By early April a scramble for yen developed, as Japanese banks and trading companies rushed to cut back their dollar positions, Japanese corporations converted their foreign borrowings, and nonresidents responded to an increased premium on the forward yen by moving more funds into Japanese securities. The spot rate jumped in hectic trading to a peak on April 8 of \$0.003365 (¥297.2), some 3 percent above its mid-December low. Throughout this period the Bank of Japan met the sporadically heavy demand for yen with occasionally large purchases of dollars in Tokyo to moderate the rise and to maintain orderly markets. These purchases, especially in February and April, accounted for the bulk of Japan's \$2.1 billion increase in reserves in the first four months of this year, reversing the \$1.8 billion loss in the second half of 1975.

Although Japan's export performance in the first quarter had far outstripped even the most optimistic forecasts, by mid-April many market participants had begun to question whether this improvement could be sustained. The current sharp upsurge in exports was concentrated in only a few of Japan's export industries. A slowdown in consumer spending, together with increased talk of import restrictions in many of Japan's foreign markets, threatened to forestall any spilling-over of demand to other export sectors and to blunt sales of those exports currently in strongest demand. Moreover, figures for the first quarter pointed to a renewed strong advance in output in Japan and a decline in inventories of imported materials, suggesting that Japan's imports would soon expand as well.

This more skeptical outlook helped bring the market for the Japanese yen into better balance after mid-April. Shortly thereafter, interest rates in the United States began to firm while rates in Japan eased. As the previously favorable interest rate differentials narrowed and eroded incentives for foreigners to maintain their short-term investments in Japan, some of the earlier inflows were reversed. During subsequent weeks, the Bank of Japan intervened nominally, and then only to counter a brief flurry of demand for yen in early May. Otherwise, the rate eased back on its own, slipping 1 percent to around \$0.003330 (¥300.3) by June 4. Later that month the Japanese authorities took the opportunity to announce an easing of some foreign exchange controls—covering travel allowances and outward payments—that had previously been tightened in response to the oil crisis, but this announcement generated no immediate reaction in the market.

In late June, press reports out of the Puerto Rico economic summit suggested that officials of other countries had raised questions concerning Japanese foreign exchange policy. Subsequently, following release of further

Chart X
JAPAN
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

strong trade figures for May, the Japanese press carried reports from a government source indicating a readiness to accept a further appreciation of the yen. In this atmosphere, the yen was bid upward once again, reaching as high as $0.003420 (¥292.4) toward mid-July, before renewed intervention by the Bank of Japan and a prompt denial of the press reports quieted the market. Thereafter, in more subdued trading, the yen settled back somewhat to $0.003412 (¥293.1) by the month end. At this level the yen was, on balance, about 3½ percent higher than early-February levels.

CANADIAN DOLLAR

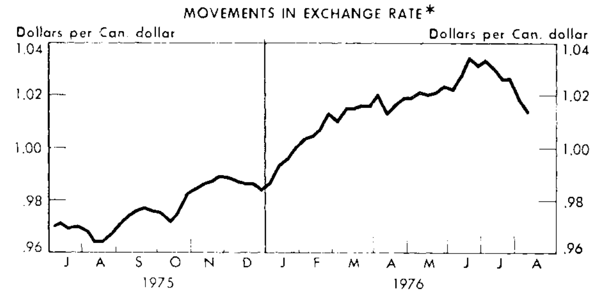
In 1974-75, with Canada's economic slowdown decidedly shallower than the recessions in other major industrial countries, domestic demand remained relatively buoyant, serious inflationary pressures persisted, and the current-account balance moved into deeper deficit. During the second half of 1975, this deficit was more than offset by an increasingly heavy volume of long-term foreign borrowings, which totaled $3.2 billion. As economic activity in Canada gained more momentum from the pickup of activity in the United States, the Canadian authorities moved to check cost-push pressures by introducing a three-year anti-inflation program, which included wage and price controls, and announced targets to contain the growth in monetary aggregates. But the demand for credit remained strong, and Canadian interest rates did not follow the declines in other industrial countries late in the year. In response to the lower cost and greater availability of funds abroad, provincial authorities, public utilities, and private enterprises increasingly tapped foreign markets early in 1976, raising inflows to $3 billion for the first quarter alone.

Thus, while the market remained hesitant about the longer term implications of the more rapid wage inflation in Canada than in the United States, dealers expected that inflows of long-term capital would cover by far the current-account deficit and provide a strong underpinning for the exchange rate in 1976. Consequently, the Canadian dollar continued the steady advance that had begun in August 1975. Buoyed by conversions of several large new borrowings as well as occasionally heavy commercial demand for grain purchases, it was bid up to $1.01½ by the end of February. The Bank of Canada, which continued to intervene to moderate day-to-day exchange rate movements, was on balance a buyer of dollars, and official reserves increased during the first two months by $551 million.

From early March through late May, by contrast, the market for Canadian dollars was more nearly balanced. Day-to-day movements in the spot rate were at times quite large, as the market adjusted to the flow of continuing conversions, announcements of yet more new issues, or rumors of OPEC shifts into Canadian dollar-denominated assets. In addition, dealers were sensitive to signs of possible changes in interest rate differentials between Canada and the United States that might alter incentives to borrow abroad. In early March, in reaction to a slight firming in United States money market rates, the Canadian dollar eased before snapping back just a couple of days later after the Bank of Canada raised its discount rate from 9 percent to 9½ percent. But, on balance, by late May the Canadian dollar had gained only fractionally to the $1.02 level, as part of the demand arising from continued conversions of foreign borrowings was increasingly taken out of dealers' own positions.

In early June, however, market sentiment became decidedly more bullish toward the Canadian dollar. The

Chart XI
CANADA
MOVEMENTS IN EXCHANGE RATE*



*See footnote on Chart III.

domestic recovery seemed to be well under way and the rate of price advance had abated to 6 percent under the anti-inflation program. The Montreal Olympics was expected to generate substantial tourist earnings. The leveling-off of United States short-term interest rates was seen as a positive factor for the Canadian dollar. And then a renewed burst of reported foreign issues by Canadian interests caught many dealers by surprise. Consequently, market participants began to bid progressively more heavily for Canadian dollars, in part to cover the new large-scale conversions expected during the summer. By June 24 the spot Canadian dollar rate had been propelled to a two-year high of $1.0388, with the Bank of Canada on balance buying substantial amounts of dollars to moderate the rise.

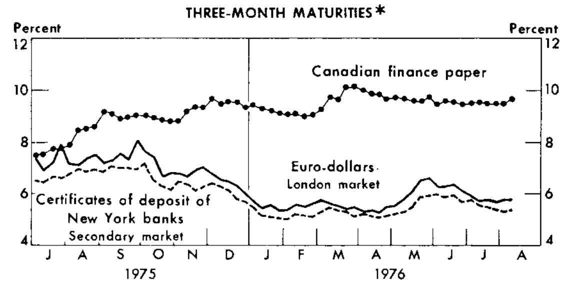
By this time, the rise of the Canadian dollar had attracted the attention of many more market participants abroad. Professional position taking increased, exchange rate movements for the Canadian dollar became more volatile, and each swing in the rate triggered a larger flurry of activity. In the face of these unsettled market conditions, the Bank of Canada operated increasingly forcibly on both sides of the market to maintain orderly trading conditions until market activity slackened by early July.

Subsequently, many market participants came to feel that the Canadian dollar had risen to unrealistically high levels. In addition, most of the conversions for the large borrowings placed in July had already been covered, and

Chart XII

INTEREST RATES IN THE UNITED STATES, CANADA, AND THE EURO-DOLLAR MARKET

THREE-MONTH MATURITIES*



*Weekly averages of daily rates.

the calendar of upcoming issues indicated a reduced volume of scheduled placements. Moreover, the eventual turnaround in tourist receipts, following the end of the Olympics, weighed on the market. Consequently, the Canadian dollar drifted back in a tendency that began to accelerate late in July as dealers started to cut back their own positions. By the month end, the spot rate had declined to $1.02½, still some 3½ percent above early-1976 levels. Although the Bank of Canada was a net seller of dollars in July, its net market operations contributed to a $467 million increase in Canadian official reserves since the beginning of the year.

The Business Situation

The growth of economic activity remained modest during the first months of the summer. In July, industrial production registered only a small gain while both housing starts and retail sales declined. Employment gains were small in August, and the rate of joblessness increased for the third successive month. At the same time, however, evidence suggesting that the pause in activity would be temporary continued to mount. Personal income posted a large advance in July, which should help to stimulate consumer spending, and the Department of Commerce index of leading indicators advanced for the seventeenth consecutive month. Residential building permits rose and prospects for increased outlays for business fixed investment improved, as new orders for nondefense capital goods jumped sharply.

Although month-to-month price changes are volatile and difficult to interpret at times, the overall performance of most key indicators suggests that inflationary pressures are gradually diminishing. Wage settlements remain high but are generally decelerating and, when advances in productivity are considered, cost pressures appear to have moderated. In the consumer sector, favorable movements in food prices have helped hold overall price increases to about a 4½ percent annual rate over the first seven months of this year. On the wholesale front, overall price gains have been moderating. While price increases for industrial commodities accelerated over the three-month period ended in August, steel producers appear to have dropped plans for further price hikes this fall. Prospects of improved foreign production and record-size domestic crops have been reflected in reduced spot food prices, and wholesale food prices have continued downward.

PRODUCTION, ORDERS, INVENTORIES, AND LEADING INDICATORS

Industrial production inched ahead a scant 0.2 percent in July, the smallest increase recorded since October 1975. Over the period from March 1975 through July 1976 covering the first sixteen months of the economic recovery, industrial output climbed a healthy 12.6 percent at an annual rate. In more recent months, however, the growth of production has slowed noticeably, largely reflecting the ebbing in consumer demand and, to a lesser extent, the rubber and coal strikes. The slowdown appears to be broadly based among sectors. Output of consumer goods, after rising at a 14.9 percent annual rate from March 1975 to May 1976, remained unchanged over the three-month period ended in July. This production adjustment coincided with the midsummer lull in consumer buying and with efforts by businessmen to keep inventories lean. Production of business equipment has increased only modestly in recent months, and the output of intermediate products and materials has followed a basically similar pattern. In July, strike activity retarded coal mining and the production of motor vehicles and parts was significantly reduced. The outlook for auto production, however, is good. In the second half of the year, domestic auto manufacturers have programmed production at 4.2 million units, close to the record 1973 rate.

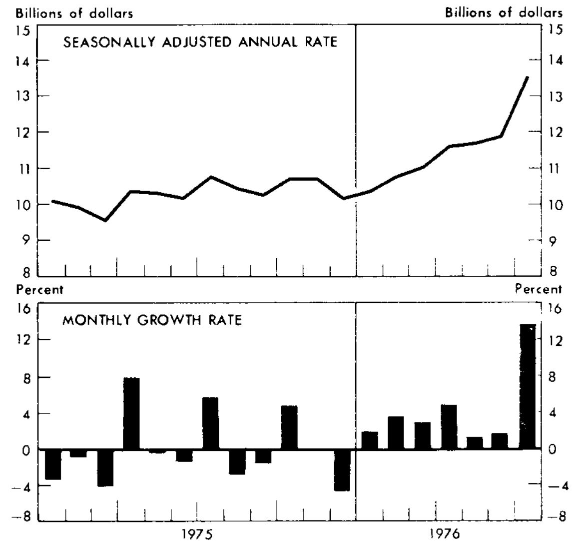
New orders received by durable goods manufacturers fell in July, but the decline can be attributed to an exceptionally large drop in defense-related capital goods orders. Other sectors generally showed strength. The sharp drop in defense orders appears to be related to the delayed beginning of the 1977 fiscal year for the Federal Government. In previous years, the Department of Defense placed a large number of orders at the end of the fiscal year, which were registered in the July data. As a consequence, seasonally adjusted orders for July typically lie well below unadjusted figures because seasonal adjustment procedures are designed to eliminate the impact of regular periodic movements. This July is unique, however, because of the change in the Federal Government's fiscal year. As part of the fiscal changeover, a transition quarter has been instituted, effectively delaying the end of fiscal 1976 until October. This has reduced the reliability of the seasonal adjustment factors, especially in July, and increased the likelihood of a sharp spurt in seasonally adjusted new orders for defense equipment occurring in the fall.

The book value of manufacturing and trade inventories increased sharply in June, rising by $3.5 billion. To at least some extent, it appears that the inventory buildup was unintentional and reflected the impact of recent slackening in the growth of consumer demand. Inventory building continued in the manufacturing sector during July, with nondurables accounting for most of the accumulation. Nondurables shipments advanced in line with inventories, however, and the inventory-shipments ratio was little changed in that sector. The pattern differed in durables manufacturing, where a marked drop in shipments combined with a modest $223 million increase in inventories to cause a jump in the inventory-sales ratio. Overall, the book value of manufacturing inventories increased nearly $870 million in July and shipments advanced only slightly, resulting in a third consecutive monthly increase in stocks relative to sales.

The Commerce Department index of leading indicators continued to signal underlying strength in July as it advanced 0.5 percent, its seventeenth consecutive monthly gain. Six of the eleven components of the index available thus far showed improvement, including residential building permits and contracts and orders for new plant and equipment. Reflecting the weakness in consumer spending, manufacturers' new orders for consumer products and materials appeared among the five components of the index of leading indicators that moved adversely. Though recent gains have been moderate, the direction of movement in the indicators remains unmistakable and serves to underscore the continuing momentum of the recovery.

Chart I

NEW ORDERS FOR NONDEFENSE CAPITAL GOODS



Source: United States Department of Commerce.

CAPITAL SPENDING AND CORPORATE PROFITS

Prospects for a pickup in business spending on fixed capital appear, on balance, to be brightening. To be sure, in most industries, capacity constraints are not a concern at this point but, because of the long delay between planning and the eventual arrival of capital projects on stream, businessmen appear to be looking ahead to production requirements in 1977 and 1978. New orders for nondefense capital goods jumped by a record amount in July, marking the seventh consecutive monthly gain (see Chart I). Propelled by the large July increase, these orders have risen 32 percent since the end of 1975. Because of the lag between orders and shipments, this advance should strengthen spending on producers' durable equipment into 1977.

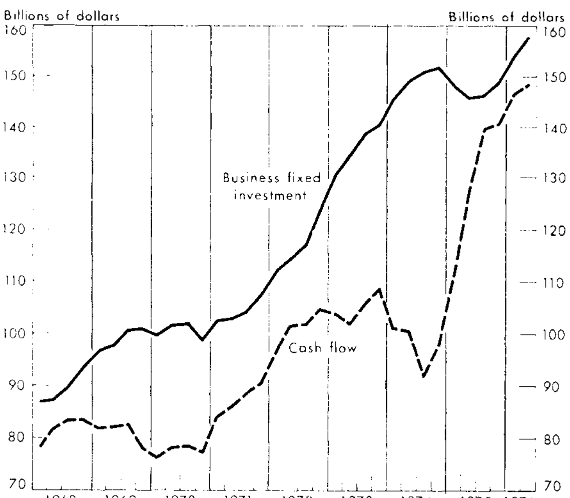
The most recent Commerce Department survey of planned plant and equipment spending indicates a 7.4 percent increase in such outlays over 1976 as a whole. While this represents little change in plans from the previous survey conducted in the spring, second-quarter spending fell short of expectations. Planned expenditures in the second half of the year have been marked up, especially in the fourth quarter. In a separate survey conducted by The Conference Board, the nation's 1,000 largest manufacturers increased new appropriations for plant and equipment 13.2 percent in the second quarter. Since appropriations are the first step in the investment process, the advance recorded by the latest Conference Board survey provides the basis for increased outlays over coming quarters. Moreover, the gain would have been substantially larger had it not been for a drop in appropriations by petroleum companies. Oil companies have been reluctant to expand capital outlays both because of concern over slim profits and because of price controls on domestic production.

Prospects for increased capital spending are also supported by the turnabout of retained earnings available to finance additional outlays that has occurred during the recovery. Revised data indicate that nonfinancial corporate cash flow—the sum of capital consumption allowances and aftertax profits—rebounded 61 percent since its cyclical low in the third quarter of 1974, while business fixed investment gained only 4.6 percent over the same period (see Chart II). The improved cash flow situation, caused mainly by a strong surge in profits, both increases the attractiveness of investment in new plant and equipment and reduces firms' dependence on outside sources of finance. The impact of this turnabout on investment spending was blunted in 1975 by the presence of extensive spare capacity. Moreover, firms tended to adopt the attractive alternative of debt retirement, thereby creating improved balance-sheet positions. But now, with debt burdens somewhat reduced and firms looking to capacity requirements in 1977 and beyond, the availability of ample internal funding will greatly facilitate needed expansion.

Underlying in part the expected growth in fixed investment outlays for the rest of 1976 are mandated expenditures for pollution abatement. These growing expenditures, amounting to more than 5 percent of total business fixed investment, have served to shore up investment spending during the recession and should contribute some momentum on into 1977. Of course, this additional expenditure normally does not increase productive capacity.

Chart II

CASH FLOW AND BUSINESS FIXED INVESTMENT



Note: Cash flow is measured after taxes and includes inventory valuation and capital consumption adjustments.

Source: United States Department of Commerce, Survey of Current Business.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a strong 1 percent increase in July, the largest rise since October 1975. A major part of the jump was due to higher social security payments which resulted from a midyear cost-of-living increase of 6.4 percent. At the same time, wage and salary disbursements to workers in the private economy rose sharply. This advance reflected gains in employment and higher average hourly earnings. On the near horizon, Federal Government employees' wages and salaries may receive a boost this fall from a proposed pay hike of nearly 5 percent.

The advance report of retail sales suggested an ebbing in consumer demand through July. Retail sales declined in that month and have been essentially flat since April. After adjustment for the impact of higher prices, it appears that consumers have actually retrenched in recent months. Nevertheless, the latest surveys suggest that consumer confidence continues to improve, and the recent rapid growth of personal income should provide some impetus to consumer spending in the period ahead.

The overall outlook for residential construction remains clouded. While ample mortgage money is available, borrowing costs have held at high levels. The multifamily sector in particular is still substantially depressed. True, the prospects for multifamily building appear to have improved, as rental vacancy rates remain much below 1975 levels and the absorption rate of newly completed apartments has risen, but profit margins continue to be squeezed by higher maintenance, repair, and construction costs. As a consequence, the incentive to build is generally not strong. In contrast to the lackluster multifamily sector, the recovery in single-family housing starts has pushed to more than 1.1 million units in recent months, considerably above levels that prevailed a year earlier. Single-family starts, however, have leveled off at this plateau. This leveling may be due, in part, to builder concern over relatively high stocks of unsold homes. Merchant builders' sales of new one-family homes have moved erratically in recent months. At the same time, inventories of unsold homes have been edging up so that, at current sales rates, inventory stocks represent about nine months of sales.

PRICES, WAGES, AND THE LABOR MARKET

The recent pattern of changes in consumer and wholesale prices has been roughly in line with the experience of the preceding two or three months. Consumer prices, for example, advanced at a 5.6 percent annual rate in

July, just a little below the 6 percent rise posted over the three-month interval ended in June. Prices for food climbed at only a 1.3 percent rate in July. On the other hand, the prices charged for consumer fuel and power jumped substantially. Leaving the volatile food and energy components aside, consumer prices rose in July at a 6 percent rate.

Wholesale prices, seasonally adjusted, rose at a 2.6 percent annual pace over the three months ended in August. This relatively moderate increase was heavily influenced by large outright declines in the prices of farm products and processed foods and feeds. Wholesale prices of industrial commodities, normally less volatile than farm-prices, climbed at a rate of 7.6 percent over the same period, spurred by increases in metals prices and in energy-related items. Though wholesale prices of crude materials excluding foods and feeds jumped substantially during June and July, in August this spurt cooled. Overall, the evidence suggests that future price increases may be close to recent experience. The National Association of Purchasing Management reports that most purchasing executives anticipate only moderate to slight increases in the prices they pay. Given the promising agricultural outlook, it is likely that food prices will behave favorably while energy prices may well move adversely.

Throughout the first half of 1976, the rise in private nonfarm business-sector unit labor costs has been well below the underlying trend rate of increase in consumer prices and has thus exerted a moderating influence on the overall rate of price increase. Unit labor costs rose at an annual rate of 3.3 percent in the second quarter, close to the 3.5 percent first-quarter pace. Though increases in unit labor costs have been quite moderate, compensation per hour worked advanced at a 9.1 percent annual rate in the second quarter, down a bit from 9.5 percent first-quarter gains. These substantial pay increases were offset by brisk productivity gains, as output per hour worked in the private nonfarm business sector advanced at a 5.8 percent rate in the first quarter and this pace fell off only slightly to 5.6 percent in the second three months of the year.

The labor market situation was little changed in August. Reflecting the slowdown in the growth of real output, total employment edged ahead at an annual pace of only 1 percent. Although labor force growth slowed after its oversize July spurt, a sufficient number of new workers entered the labor market to push the unemployment rate up from 7.8 to 7.9 percent. Increased unemployment was not evenly spread across labor market groups. Among persons less than twenty-five years of age, there was a substantial increase in the rate of unemployment, with teenage unemployment—a volatile component—recording its largest rise since January 1975. On the other hand, there was an encouraging August reduction in the rate of joblessness among those aged twenty-five and over. Still, even among these groups, there has been some slippage, on balance, over the previous few months. Moreover, the percentage of persons claiming extended unemployment of over fifteen weeks duration, which had fallen from 3.2 percent of the labor force last winter to 2.1 percent this spring, has risen for three months and now stands at 2.5 percent.

The Money and Bond Markets in August

Bond yields declined in August, extending the trend begun in early June, while rates on money market instruments generally edged down following larger declines in July. By the month end, interest rates on most bonds were near and in some cases slightly below previous lows for the year recorded in April. Contributing to the decline in bond yields were reduced concern over the rekindling of very rapid inflation and expectations of continued slackening in the pace of debt financing in the Government and corporate markets. Treasury borrowing needs for the near term were scaled down after the early-August refunding raised more new cash than planned. In addition, the corporate calendar was fairly light during the month and announcements of forthcoming offerings were very modest in comparison with the recent past. Most new issues having somewhat lower yields than in recent months were well received. Underwriting syndicates broke through 1976 lows with a few new corporate and municipal bond issues, some of which encountered initial investor resistance.

Preliminary estimates of the narrowly defined money stock (M_1) and the more broadly defined money stock (M_2) indicate continued expansion at moderate rates. With the absence of any strong turnaround in business loan demand, banks continued to allow the volume of large negotiable certificates of deposit (CDs) outstanding to run off over the month. Consequently, the bank credit proxy declined in August.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on some money market instruments edged downward in August, while rates on others remained essentially unchanged. At the July 20 meeting of the Federal Open Market Committee (FOMC), it was agreed that the Federal funds rate would be permitted to vary within a 4¾ to 5¾ percent range until the next meeting on August 17. In fact, the effective rate on Federal funds remained in a fairly narrow trading range in the intermeeting period (see Chart I). For August the Federal funds rate averaged 5.29 percent, 2 basis points below the average of the previous month. The rate on 90- to 119-day commercial paper held near the level recorded late in the previous month and closed the period at 5.38 percent. Rates on 90-day bankers' acceptances fell about 7 basis points over the month. Reflecting the shrinking supply of CDs outstanding, rates on 90-day certificates in the secondary market declined further during most of the month and stood at 5.33 percent by the end of August. Subsequent to a ¼ percentage point reduction effective at the beginning of the month, the quoted rate commercial banks charge prime business borrowers remained at 7 percent.

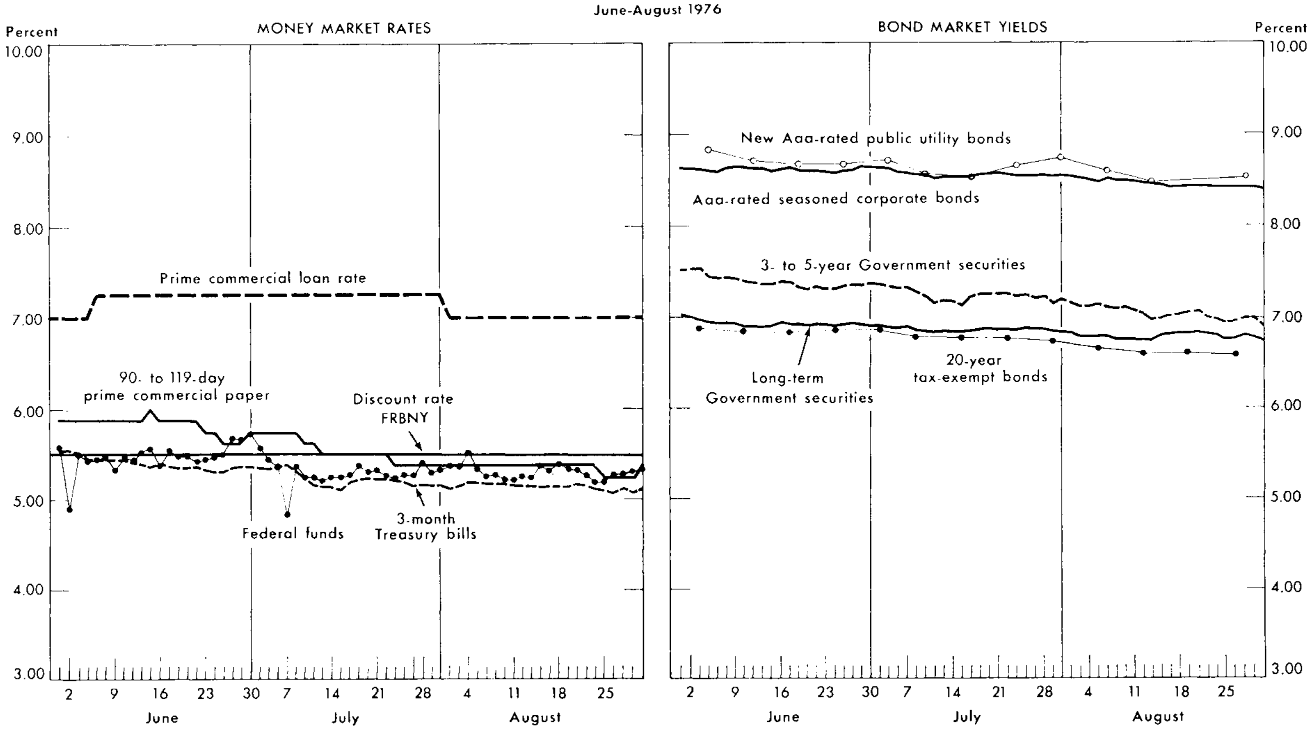
During August, Federal Reserve open market operations continued to be shaped, in part, by fluctuations in Treasury balances at the Federal Reserve Banks. The rise that usually begins around the middle of the month was enlarged substantially when the Treasury received the funds raised in its quarterly financing. Buyers were required to pay for the securities no later than August 16. As the amount of funds raised was larger than originally planned and not needed for expenditures until later, the Treasury kept these deposits at the Federal Reserve Banks. To offset the associated drain on commercial bank reserves, the Federal Reserve engaged in large acquisitions of Treasury securities in the final two weeks (see Table I).

Recovery in the demand for business loans has yet to materialize. Commercial and industrial loans at all weekly reporting banks, including loan sales to affiliates, fell by $884 million over the four statement weeks ended August 25. While business loans at weekly reporting banks have dropped about $8.7 billion from their level of fifty-two weeks earlier, most other major categories of loans have increased over the same period. For example, consumer instalment loans at weekly reporting banks have risen 7.9 percent, or $2.7 billion over this period, and real estate loans have gone up 4.3 percent, or $2.6 billion.

Chart I

SELECTED INTEREST RATES

June-August 1976



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.

Preliminary data indicate that in August M_1 grew at about the same moderate rate as in the previous month, while expansion in M_2 slowed a bit from that of July. Over the four weeks ended August 25, M_1—private demand deposits adjusted plus currency outside commercial banks—averaged 7.3 percent at a seasonally adjusted annual rate above its average level in the four statement weeks ended eight weeks earlier. At the July meeting, the FOMC established a tolerance range of 4 to 8 percent for growth of M_1 over the two months ended with August. Tolerance ranges are short-run operating guides for the intermeeting period. They are set at each FOMC meeting and applied to the two-month period ending the following month. During the four statement weeks ended August 25, M_2—M_1 plus commercial bank time and savings deposits other than large negotiable CDs—averaged 11.1 percent at an annual rate above its average during the four statement weeks ended eight weeks earlier. The FOMC M_2 tolerance range for the two months ended August was 7½ percent to 11½ percent. Taking a longer perspective, over the 52-week period ended with the four-week averages through August 25, M_1 expanded 4.5 percent while M_2 rose 9.6 percent (see Chart II).

Following a modest increase in the previous month, the adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—declined in August. The drop

Table I
FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1976
In millions of dollars; (+) denotes increase and (—) decrease in excess reserves

Factors	Changes in daily averages— week ended				Net changes
	August 4	August 11	August 18	August 25	
"Market" factors					
Member bank required reserves	— 62	+ 660	— 461	+ 358	+ 495
Operating transactions (subtotal)	—1,467	+2,301	—1,105	—4,474	—4,745
Federal Reserve float	— 5	+ 50	+ 260	— 377	— 72
Treasury operations*	—1,402	+2,271	— 637	—4,065	—3,833
Gold and foreign account	— 38	+ 64	— 128	+ 112	+ 10
Currency outside banks	— 75	— 436	— 509	+ 33	— 987
Other Federal Reserve liabilities and capital	+ 52	+ 351	— 92	— 175	+ 136
Total "market" factors	—1,529	+2,961	—1,566	—4,116	—4,250
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+2,061	—3,628	+2,665	+4,211	+5,309
Outright holdings:					
Treasury securities	— 407	— 559	+ 886	+1,286	+1,206
Bankers' acceptances	— 10	— 15	— 16	— 17	— 58
Federal agency obligations	—	—	—	— 4	— 4
Repurchase agreements:					
Treasury securities	+2,107	—2,634	+1,576	+2,596	+3,645
Bankers' acceptances	+ 327	— 345	+ 173	+ 252	+ 407
Federal agency obligations	+ 44	— 75	+ 46	+ 98	+ 113
Member bank borrowings	— 3	— 34	— 37	— 18	— 92
Seasonal borrowings†	— 5	+ 4	+ 4	—	+ 3
Other Federal Reserve assets‡	— 87	+ 219	— 652	— 201	— 721
Total	+1,971	—3,442	+1,975	+3,992	+4,496
Excess reserves‡§	+ 442	— 481	+ 409	— 124	+ 246

	Daily average levels				Monthly averages‖
Member bank:					
Total reserves, including vault cash‡§	34,706	33,565	34,435	33,953	34,165
Required reserves	34,262	33,602	34,063	33,705	33,908
Excess reserves§	444	— 37	372	248	257
Total borrowings	156	122	85	67	108
Seasonal borrowings†	22	26	30	30	27
Nonborrowed reserves	34,550	33,443	34,350	33,886	34,057
Net carry-over, excess or deficit (—)¶	— 4	191	— 23	152	79

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.
§ Adjusted to include waivers or penalties for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.
‖ Average for four weeks ended August 25, 1976.
¶ Not included in data above.

in the proxy reflected a sharp fall in the volume of CDs outstanding. Since their peak in January 1975, CDs have declined in most months and, by the end of August, were almost $28 billion below their peak level of around $93 billion.

THE GOVERNMENT SECURITIES MARKET

Yields on Federal Government securities extended previous declines during the course of August. The Treasury raised over $6 billion of new cash early in the month, when it replaced $4.5 billion of maturing issues with $2 billion of three-year notes auctioned August 3 at an average yield of 6.91 percent, about $8 billion of 8 percent ten-year notes sold August 4, and $1 billion of 25-year bonds auctioned August 6 at an average yield of 8.01 percent. Available on a subscription basis in minimum denominations of $1,000, the ten-year notes were substantially oversubscribed and the orders accepted by the Treasury exceeded its original plan to issue between $4 billion and $6 billion of the notes. As a result, projections of future Treasury borrowings were lowered accordingly. Financing needs of the Federal Government remained substantial, however, and an additional $3 billion was raised through note auctions during the month. On August 19, $2.5 billion of two-year notes was sold at an average return of 6.67 percent, 28 basis points below that of a similar offering the month before. These replaced $1.4 billion of maturing securities. An auction of four-year notes on August 31 raised $2 billion. The average yield was 6.93 percent, down 78 basis points from a similar sale in early June.

With these operations accomplished smoothly and with the inflation outlook improving, rates on outstanding intermediate- and long-term issues continued the declines begun in early June. By the end of the month, they were only somewhat above the lows for the year recorded in April. Treasury bill rates generally edged down during the month. At the last regular weekly auction in August, average issuing rates on the new three- and six-month bills were 5.09 percent and 5.35 percent, respectively (see Table II). These levels represented declines of 10 and 15 basis points from rates established at the final auction in July. The yield on the 52-week bill auctioned on August 18 was about 25 basis points below that attained four weeks earlier. Rates on most bills ended the month from 5 to 25 basis points below levels at the end of July.

Prices also continued to rise in the Federal agency market. Early in the month, the Federal Home Loan Banks refinanced maturing securities through issuing $700 million of four-year bonds with a yield of 7.30 percent and

$500 million of eight-year bonds with a yield of 7.85 percent. At the same time, $200 million of 8⅜ percent Federal Home Loan Mortgage Corporation-guaranteed certificates with a thirty-year maturity was priced to yield 8.52 percent. These issues were well received. On August 18, $28 million of new cash was raised through sales of $436.1 million of 5.65 percent six-month Banks for Cooperatives bonds and $770 million of 5.85 percent nine-month Federal Intermediate Credit Bank bonds. The rates on these two issues were down 15 and 25 basis points, respectively, from similar issues sold a month earlier and were the lowest since April. Also, at midmonth the Department of Housing and Urban Development placed $287.3 million of tax-exempt notes to finance urban renewal projects at an average interest rate of 2.958 percent, down almost 28 basis points from a similar sale in the previous month. On August 25, the Federal National Mortgage Association issued $800 million of 54-month debentures at 7.35 percent and $400 million of ten-year debentures at 7.90 percent, raising $200 million of additional cash.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

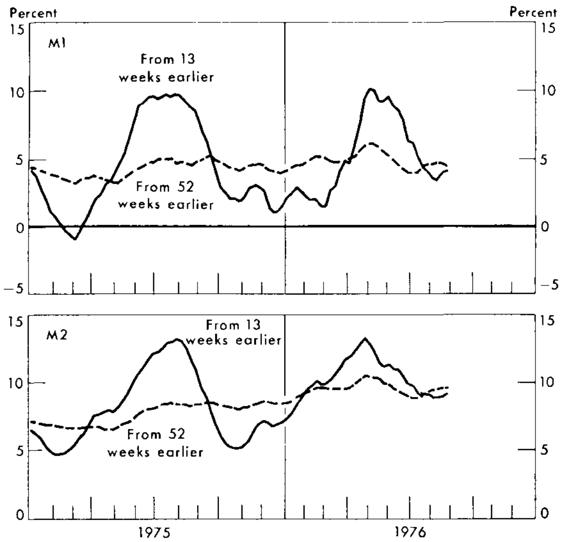
Maturity	Weekly auction dates—August 1976				
	August 2	August 9	August 16	August 23	August 30
Three-month	5.151	5.181	5.143	5.138	5.091
Six-month	5.473	5.422	5.390	5.380	5.351
	Monthly auction dates—June-August 1976				
	June 23	July 21	August 18		
Fifty-two weeks	6.081	5.887	5.633		

* 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.

Chart II

GROWTH OF SELECTED MONEY STOCK MEASURES

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 August 25, 1976.

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

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

Source: Board of Governors of the Federal Reserve System.

OTHER SECURITIES MARKETS

Yields in the corporate bond market reacted to stable money market rates, a light calendar of new financing, and reports of slower economic expansion by extending the decline begun in June. By the month end, returns on outstanding issues were near lows for the year recorded in April. Municipal bonds also benefited from the improved tone of the debt markets generally.

New issue activity in the corporate sector was highlighted during the month by a key offering of Aaa-rated telephone debentures. The $175 million underwriting was offered to investors at a yield of 8.25 percent for forty years. This return was 43 basis points lower than a comparably rated telephone issue offered two months earlier and was the lowest on such an issue in two and one-half years. The terms were widely regarded as a test of the market's ability to pass through the April trough in interest rates. Initially, investors evidenced little interest in these terms and sales proceeded slowly, although the issue was reported sold by the end of the month. Providing further evidence of market improvement over the month, $70 million of an electric utility's A-rated thirty-year first mortgage bonds was successfully distributed at an 8.95 percent return, the lowest on a utility issue with this rating since April. The decline in yields on corporate debt also was exemplified in the $100 million sale of Baa-rated seven-year notes by the finance subsidiary of an industrial corporation. The return on these notes was 9.55 percent, while the same borrower had provided a 10 percent yield on five-year notes only two months earlier.

In the tax-exempt sector, a good reception was accorded Pennsylvania's $130 million offering of A-1/AA-rated (Moody's/Standard & Poor's) bonds priced to yield between 3 percent in 1977 and 6.7 percent in 1995-96. A similar issue by Pennsylvania sold in March at yields ranging from 3.25 percent in 1976 to 7.05 percent in 1995. However, investors considered yields from 4.1 percent in 1981 to 5.4 percent in 1994 on a $150 million Oregon issue unattractive. In some maturities, these Aaa/AA-rated bonds were down 20 basis points from a similar offering by Oregon in April, when municipal yields reached their previous lows for the year. The State of California's Aaa-rated bonds also sold slowly at prices scaled to yield 3 percent in 1977 to 5.5 percent in 1996, somewhat below the rates on an earlier California financing in March. Late in the month, however, underwriters easily distributed $111 million of Tennessee bonds rated Aaa/AA and yielding from 3 percent in 1977 to 5.7 percent in 1996. Reflecting the rate declines over the month as a whole, The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds stood at 6.52 percent on September 2, down 21 basis points from the end of July and the lowest level for 1976. The Blue List of dealers' advertised inventories rose by $67.7 million to close the month at $824 million on September 1.

A novel development in the capital markets during August was a $367.2 million bond offering by the National Power Corporation, the government-owned public utility of the Philippines. A relatively large issue for a foreign governmental borrower in the United States, it consisted of $160 million of serial bonds yielding from 8.05 percent in 1987 to 8.2 percent in 1989 and $207.2 million of 8¼ percent sinking-fund bonds due in 1991. The bonds, which were unrated, were the first public offering in the United States to be guaranteed by the United States Government through the Export-Import Bank, which usually makes direct private loans. The bonds were sold at rates somewhat above United States Government agency securities of similar maturities.