August 1982-January 1983 Semiannual Report
(This report was released to the Congress and to the press on March 3, 1983.)

Treasury and Federal Reserve Foreign Exchange Operations

The dollar rose against all major foreign currencies from August through mid-November 1982, exceeding the peaks of the previous year and reaching the highest levels on a trade-weighted basis of the floating rate period. The dollar then reversed course through the middle of January, ending the six-month period lower on balance against the Japanese yen and the Swiss franc but higher against most other major foreign currencies.

The dollar was strongly bid in the exchange markets early in the period under review even as U.S. interest rates dropped sharply and as interest differentials favoring dollar-denominated assets narrowed appreciably. In part, bidding for dollars reflected a deepening apprehension about the international banking system. As evidence emerged of the liquidity pressures facing first Mexico and then other developing countries, doubts spread in the markets about the willingness or the ability of one or several of these borrowers to meet their external obligations. In response, individual institutions sought to augment their liquidity positions, especially in dollars, against potential funding or cash-flow problems and in advance of important statement dates, particularly around end-September. In this environment, market participants became wary about the credit exposures of potential counterparties in the interbank market. Their heightened perception of risk was reflected to an extent in the widening yield spread between U.S. Government obligations and private credit instruments.

In part, the dollar's buoyancy also reflected market perceptions that the outlook for the U.S. economy was favorable relative to those for other countries. Inflation in the United States was rapidly receding in product and labor markets, and the previously adverse inflation differentials which the United States had experienced *vis-à-vis* Germany and Japan were quickly eroding. Widely anticipated shifts in balance-of-payments positions against the United States following the dollar's two-year rise were slow to materialize. Moreover, the outlook for economic growth remained more positive for the United States than elsewhere.

Meanwhile, the prospects of recovery in the near term and of looming fiscal deficits over the medium term were seen as limiting the scope of future interest rate declines in the United States. To be sure, Federal Reserve authorities had indicated during the summer that they would tolerate monetary expansion at somewhat higher than the targeted annual rate in view of economic uncertainty and strong liquidity demands. Short-term interest rates had declined from their mid-year peaks in response to the sluggishness of the economy and of credit demands by some 6½ percentage points through late August and then, after some backing-up in September-October, by a further ½ percentage point by late October. In the meantime, the Federal Reserve lowered its discount rate in five

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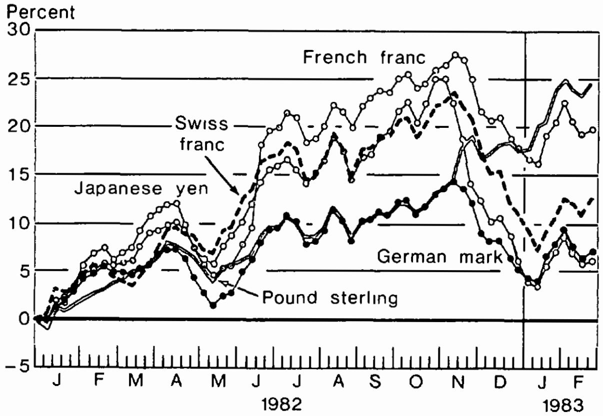
Chart 1

The Dollar Against Selected Foreign Currencies

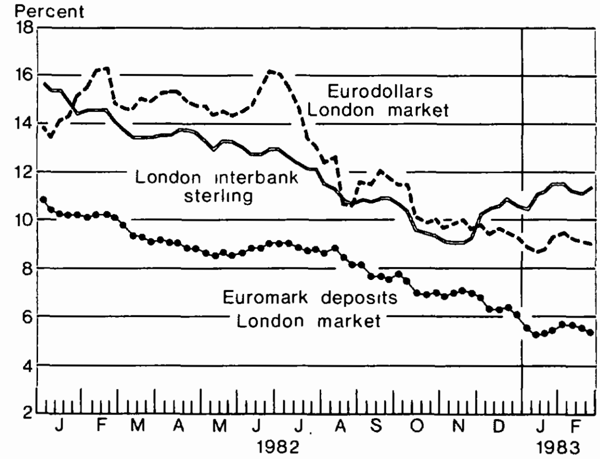


Percentage change of weekly average bid rates for dollars from the average rate for the week of December 28, 1981-January 1, 1982 Figures calculated from New York noon quotations

Chart 2

Selected Interest Rates

Three-month maturities *



* Weekly averages of daily rates

Table 1

Federal Reserve Reciprocal Currency Arrangements

In millions of dollars

Institution	Amount of facility January 1, 1982	Bank of Mexico special facility effective August 30, 1982	Amount of facility January 31, 1983
Austrian National Bank	250		250
National Bank of Belgium	1,000		1,000
Bank of Canada	2,000		2,000
National Bank of Denmark	250		250
Bank of England	3,000		3,000
Bank of France	2,000		2,000
German Federal Bank	6,000		6,000
Bank of Italy	3,000		3,000
Bank of Japan	5,000		5,000
Bank of Mexico			
Regular facility	700		700
Special facility	-0-	325	325
Netherlands Bank	500		500
Bank of Norway	250		250
Bank of Sweden	300		300
Swiss National Bank	4,000		4,000
Bank for International Settlements			
Swiss francs-dollars	600		600
Other authorized European currencies-dollars	1,250		1,250
Total	30,100	325	30,425

steps from 12 percent to 9½ percent in three months. But no fundamental change in Federal Reserve operating procedures had been indicated. Compared with other countries, the decline in U.S. nominal interest rates still lagged behind the reduction of inflation so that real interest rates remained high, both absolutely and relative to other countries. Furthermore, because of the weakness of economies abroad, foreign monetary authorities were expected to take full advantage of any decline in U.S. interest rates that appeared to be sustainable to ease credit conditions in their own economies. These expectations were confirmed when official and market interest rates in major European countries declined in late August and again in October.

For all these reasons, the dollar was bid higher in the exchange markets in frequently active trading through mid-November. The uptrend was uneven. In view of the heightened perception of risk that prevailed at the time and uncertainty over the timing and profile of the anticipated recovery in the United States, the markets were susceptible to abrupt shifts in sentiment or movements in exchange rates. Under these circumstances, the U.S. authorities intervened on one day in early August and on three days early in October, when the dollar was bid up sharply to higher levels in unsettled markets The Federal Reserve and the U.S. Treasury purchased $57.0 million equivalent of Japanese yen and $45.0 million equivalent of German marks. Of the total Japanese yen acquired, $38.5 million was for the Federal Reserve and $18.5 million for the U.S. Treasury. The German mark purchases were evenly split between the Federal Reserve and the Treasury. At the dollar's peak, it had risen 11 and 7½ percent from late-August levels against the yen and the mark, respectively, to levels not seen in five years or more. Against some of the other Continental currencies, the dollar had moved up to record levels.

By mid-November, the international economic climate had changed significantly. Expectations of a U.S. economic recovery had been disappointed, and recent statistics were suggesting that recession, while deepening further abroad, had not yet ended in the United States. The unemployment rate in the United States had shot up quickly to 10½ percent just before Congressional elections, and a number of political campaigns had focused on economic issues, leaving market operators sensitive to the possibility that more policy initiatives might be undertaken to stimulate the economy. By this time, also, the U.S. trade position had posted several large monthly deficits. The anticipated deterioration in net exports not only appeared to have materialized but, coming at a time of weak domestic demand, suggested that the potential drop into deficit and the resulting drag on the U.S. economy might be far deeper than previously envisaged. Press and official commentary associated the dollar's past appreciation with the weakness of U.S. trade and employment.

In addition, market participants came to the judgment that the prospects and priorities for the international financial system had changed. The immediate risks of a major international loan default receded, as first Mexico and then other countries negotiated adjustment programs with the International Monetary Fund (IMF) and established procedures for arranging near-term financing needs. However, the success of these countries' stabilization programs and of their efforts ultimately to meet their heavy external obligations was seen as requiring a more buoyant international economy and substantially reduced financing costs.

Accordingly, market participants continued to anticipate further easing of U.S. short-term interest rates for a time. But, during the winter, they began to question the scope for further substantial interest rate drops in light of recent behavior of the monetary aggregates. In the event, the Federal Reserve reduced its discount rate in two more steps to 8½ percent by mid-December. But, at least in the market for medium- and longer term securities, the downtrend in interest rates was beginning to meet resistance.

Under these circumstances, market participants were willing to diversify their portfolios by liquidating some of their dollar-denominated assets. Investors chose to realize the capital gains they had earned on their investments in the United States and to participate in the rallies in capital markets abroad that were being triggered by expectations of further interest rate cuts there. In addition, market professionals were willing to take positions on expectations that a long-awaited reversal of the dollar's sustained advance had finally arrived.

Consequently, the dollar declined from mid-November through mid-January by 19 percent against the Japanese yen and by 14½ and 10½ percent, respectively, against the Swiss franc and German mark. Of all the major currencies, the dollar rose only against the pound sterling which, like the dollar, had begun a decline in mid-November and then depreciated more rapidly in response to the prospect of declining oil prices to touch a record low in terms of the dollar by the second week of January.

After mid-January, the decline in the dollar stalled or was partially reversed. Whereas industrial economies abroad remained weak, the first clear signs appeared that the U S. recession was bottoming out. Moreover, the prospect of large, projected U.S. fiscal deficits, together with the recent, more rapid monetary growth, raised uncertainty whether the Federal Reserve might tighten credit market conditions again. Both Treasury and Federal Reserve officials stressed the longer term need to reduce the deficits and to maintain the anti-inflationary resolve of monetary policy. Thus, expectations faded of further interest rate declines and, in fact, market yields edged up somewhat during January. With interest rates abroad generally holding steady or declining slightly, differentials favorable to dollar assets once again widened. By the close of January, the dollar was trading slightly higher against most European currencies than at the beginning of the six-month period under review. It remained lower, however, against the Japanese yen and the Swiss franc than it had been on July 30. In trade-weighted terms, the dollar rose slightly over the six months. The U.S. authorities did not intervene after early October.

Table 2

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

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

Bank drawing on Federal Reserve System	Outstanding January 1, 1982	1982 I	1982 II	1982 III	1982 IV	1983 January	Outstanding January 31, 1983
Bank of Mexico	-0-	-0-	+800.0 —600.0	+1,400 0 — 900 0	—217.4	—109 6	373 0
* Bank for International Settlements (against German marks)	-0-	-0-	-0-	-0-	+124.0 —124.0	-0-	-0-
Total	-0-	-0-	+800.0 —600.0	+1,400 0 — 900.0	+124.0 —341.4	—109 6	373 0

Data are on value-date basis.

* BIS drawings and repayments of dollars against European currencies other than Swiss francs to meet temporary cash requirements.

Table 3

Drawings and Repayments by the Bank of Mexico under Special Swap Arrangements

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

Drawings on	Outstanding January 1, 1982	1982 I	1982 II	1982 III	1982 IV	1983 January	Outstanding January 31, 1983
United States Treasury special temporary facility for $1,000 million	*	*	*	+ 825 0 — 825 0	*	*	*
Drawings on special combined credit facility:							
Federal Reserve special facility for $325 million	*	*	*	+ 89 8 — 43.8	+211 2	+ 42 0	299 3
United States Treasury special facility for $600 million	*	*	*	+ 166.8 — 81.3	+392.2	+ 78 0	555.8
Total	*	*	*	+1,081.6 — 950.0	+603 5	+120.0	855 0

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

* Not applicable.

Table 4

Drawings and Repayments by the Central Bank of Brazil under Special Swap Arrangements with the United States Treasury

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

Drawings on United States Treasury special facilities for	Outstanding January 1, 1982	1982 I	1982 II	1982 III	1982 IV	1983 January	Outstanding January 31, 1983
$500 million	*	*	*	*	+ 500 0 − 500 0	*	*
$280 million	*	*	*	*	+ 280.0	-0-	280 0†
$450 million	*	*	*	*	+ 450 0	-0-	450.0
$250 million	*	*	*	*	+ 250 0 − 104 2	−145 8	*
Total	*	*	*	*	+1,480 0 − 604.2	−145 8	730 0

Data are on a value-date basis

* Not applicable.

† This swap drawing repaid at maturity on February 1, 1983

As discussed in the body of this report, the Federal Reserve and the U.S. Treasury provided credits to Mexico through a combination of long-standing facilities and new arrangements. On the first day of the period under review, the Bank of Mexico repaid a one-day $700 million drawing on its swap line under the Federal Reserve's reciprocal currency arrangement, used to finance a short-run liquidity need. Then, with the Mexican authorities proceeding with discussions with the IMF of a new stabilization program, the Bank of Mexico requested and was granted on August 4 a $700 million drawing on that same swap line. As of January 31, $373 million was still outstanding under that facility. Also, over the August 14-15 weekend, the Mexican authorities arranged a temporary new $1 billion swap facility with the Exchange Stabilization Fund (ESF) of the U.S. Treasury to meet immediate cash needs pending the conclusion of an agreement for a $1 billion advance payment for oil from the U.S. Department of Energy for the U.S. strategic reserves. The Mexican authorities drew $825 million against the ESF facility and then, on August 24, repaid the entire drawing. The Treasury and the Federal Reserve participated on August 30 in a $1.85 billion multilateral financing program for the Bank of Mexico in cooperation with several other monetary authorities, under the aegis of the Bank for International Settlements (BIS), through swap arrangements of $600 million and $325 million, respectively. The Bank of Mexico had outstanding drawings of $299 million on the Federal Reserve and $556 million on the U.S. Treasury under the facility as of January 31.

During the period, the U.S. monetary authorities provided or participated in the provision of short-term bridging credits to Brazil and Argentina also.

With respect to Brazil, the U.S. Treasury provided in October and November $1.23 billion of short-term financing following adoption of economic policies at the October meeting of Brazil's National Monetary Council. The financing was provided under three swap facilities in anticipation of Brazil's drawings under the compensatory financing facility of the IMF as well as on its reserve position with the IMF. The first $500 million facility was drawn on October 28 and November 3 and repaid on December 28. Other facilities totaling $730 million were made available in November and remained outstanding at the end of the period.* Meanwhile, on December 23 the BIS, acting with the support of the U.S. Treasury and monetary authorities in other industrial countries, provided the Central Bank of Brazil with a $1.2 billion credit facility, which was subsequently increased to $1.45 billion. In anticipation of this arrangement, the Treasury through the ESF provided on December 13 an advance of $250 million through a swap arrangement, which has since been repaid. As part of the liquidity-support arrange-

* Of this amount, a swap drawing of $280 million was repaid at maturity on February 1, 1983

ments for the BIS provided by the participating monetary authorities, the ESF has agreed to be substituted for the BIS for $500 million of the total credit facility in the unlikely event of delayed repayment by the Central Bank of Brazil.

With respect to Argentina, on January 24 the BIS announced, with the support of a group of its member central banks and the U.S. monetary authorities, a $500 million bridging loan to the central bank of Argentina to be repaid by the end of May as other funds become available to that country. In this case, the Federal Reserve has agreed to be substituted for the BIS at its request for up to $300 million of the total credit facility in the unlikely event that the credit remains outstanding for a longer period of time than is now contemplated.

In other operations, the U.S. Treasury redeemed at maturity on September 1 and December 14 German mark-denominated securities equivalent to $671.2 million and $664.1 million, respectively, and on January 26 the Treasury redeemed at maturity the last of its Swiss franc-denominated securities equivalent to $458.5 million. After these redemptions, the Treasury had outstanding $1,275.2 million equivalent of notes (public series), which had been issued in the German market with the cooperation of the German authorities

Table 5

United States Treasury Securities, Foreign Currency Denominated

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

Issues	Amount of commitments January 1, 1982	1982 I	1982 II	1982 III	1982 IV	1983 January	Amount of commitments January 31, 1983
Public series:							
Germany	3,622.3	-0-	−451.0	−1,231.9	−664 1	-0-	1,275 2
Switzerland	458.5	-0-	-0-	-0-	-0-	−458 5	-0-
Total	4,080.8	-0-	−451.0	−1,231.9	−664.1	−458 5	1,275.2

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

Table 6

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

In millions of dollars

Period	Federal Reserve	United States Treasury: Exchange Stabilization Fund	United States Treasury: General account
First quarter 1982	-0-	+ 15.9	− 4.2
Second quarter 1982	-0-	+ 1.5	+ 78.5
Third quarter 1982	-0-	− 2.3	+ 89.4
Fourth quarter 1982	-0-	+ 4.3	+ 16 0
January 1983	-0-	+ 0.5	+ 38.3
Valuation profits and losses on outstanding assets and liabilities as of January 31, 1983	−573.7	−965 2	+360.6

Data are on a value-date basis

in connection with the dollar-support program of November 1978. All these notes are scheduled to mature by July 26, 1983.

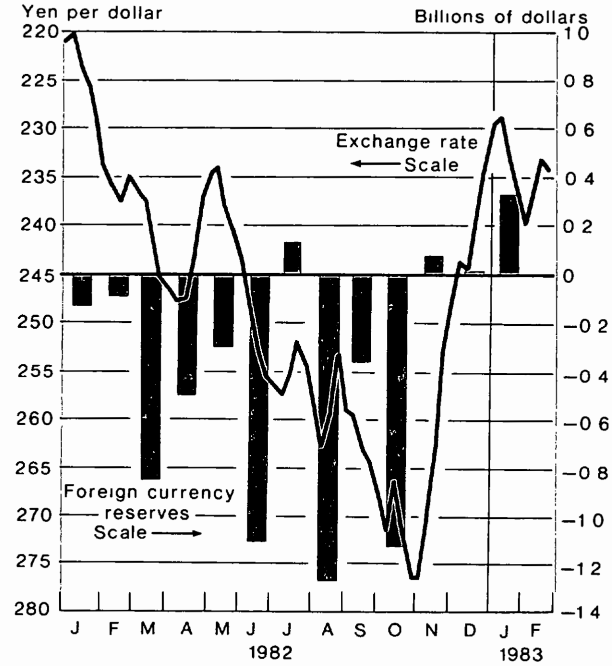
In the six-month period from August through January, the Federal Reserve had no profits or losses on its foreign currency transactions. The ESF recorded a gain of $4.2 million in connection with sales of foreign currency to the Treasury general account which the Treasury used to finance interest and principal payments on foreign currency-denominated securities. The Treasury general account gained $84.9 million on the redemption of German mark- and Swiss franc-denominated securities. Valuation gains or losses, as presented in Table 6, represent the increase or decrease in the dollar value of outstanding currency balances if valued at end-of-period exchange rates as compared with those at which the assets and liabilities were acquired. As of January 31, 1983, valuation losses on outstanding balances were $573.7 million for the Federal Reserve and $965.2 million for the ESF. The Treasury general account had valuation gains of $360.6 million related to outstanding issues of securities denominated in foreign currencies.

The Federal Reserve and the Treasury invest foreign currency balances they acquire as a result of their foreign exchange operations through a variety of investments that yield market-related rates of return and provide a high degree of quality and liquidity. Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve had invested some of its own foreign currency resources and those held under warehousing agreements with the Treasury in securities issued by foreign governments. As of January 31, the Federal Reserve's holdings of such securities was $1,367 million. The Treasury had invested $2,536 million in such securities as of end-January.

Chart 3

Japan

Movements in exchange rate and official foreign currency reserves



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

Japanese yen

Japan's economic performance, though still impressive by international comparison, had by midsummer fallen short of earlier expectations in many important respects. Externally, exports had declined under the influence of the worldwide recession, increasing barriers to Japanese goods, and import cutbacks by several financially strapped developing countries previously among Japan's fast-growing export markets. Although imports had also dropped and the current account remained in surplus, the trend of continuous trade balance improvement, which had reemerged after the second oil-price rise late in the 1970s, was now broken. Moreover, the current account surplus was overshadowed by large outflows of capital that reflected in part lower interest rates in Japan than in other centers. Internally, efforts to generate a domestic economic recovery faltered, as a modest upturn in consumer expenditures earlier in the year petered out and investment stagnated. With slower than expected growth leading to a renewed shortfall in tax revenues and an overrun in the government's borrowing requirement, Japan's bond market came under pressure while the stock market was depressed by the deteriorating economic outlook. These developments also contributed to the outflows of capital from Japan.

Thus, the Japanese yen had become a victim of repeated disappointment about the prospects for the economy and large net capital outflows. Commercial leads and lags built up strongly against the currency. By end-July it had fallen 20 percent against the dollar from the highs of November 1981 to ¥ 255.60, while easing 8 percent against the German mark. The authorities had intervened at times to cushion the yen's decline, and Japan's foreign currency reserves had dropped $3.2 billion during the eight months to $21.8 billion.

Meanwhile, monetary policy was being relied on to provide stimulus to Japan's economy while fiscal policy was constrained by concern over the budget deficit and the commitment to eliminate the borrowing gap by 1984. But the yen's continued weakness greatly reduced the maneuverability of the monetary authorities to respond during the summer months to evidence of a further weakening of demand and a rise in unemployment. The yen's steep fall had boosted the international competitive position of Japanese industry and, in the current recessionary environment, this development was attracting strong criticism from abroad and aggravating trade frictions. Thus, the authorities were reluctant to risk any further easing of interest rates for fear of stimulating even greater outflows of capital, even though a rapid deceleration in inflation had left Japan's interest rates in real terms high by historical standards. Instead, the Bank of Japan kept short-term rates around 7 percent. Against this background the yen remained on offer, fluctuating closely in response to changes in liquidity conditions in the United States. When interest rates abroad fell sharply during mid-August, the yen firmed temporarily only to give way to renewed selling pressures when the downtrend in foreign interest rates later seemed to lose momentum.

During September-October, sentiment toward the yen remained cautious as the markets' earlier presumption that the dollar would soon ease came to be challenged. In the United States, the scope for further interest rate cuts in the near term had come into question. More importantly, the flare-up of debt problems in Mexico and other developing countries triggered a strong demand for dollar-denominated assets, even though market participants were initially concerned about the credit exposures of individual U.S. banks. The Japanese yen became caught up in these concerns. Meanwhile, at home, attention again focused on the government's efforts to wrestle with its fiscal deficit, especially after Prime Minister Suzuki announced that the government's finances were in a "state of emergency" and the goal of balancing the budget by 1984, to which his government had emphasized its strong commitment, would have to be abandoned. Steps were taken to cut some expenditures to make room for selective stimulus via new public works spending and housing loan subsidies. But these measures were viewed as not sufficient either to contain the growing deficit or to revive private demand. In October, the Prime Minister's surprise announcement that he would not seek reelection led to a difficult four-way succession struggle.

In this atmosphere the yen fell irregularly, dropping 9 percent from end-July levels to a 5½-year low of ¥ 278.60 on November 4 against the generally strong dollar. It had weakened also against other currencies, falling 4 percent against the mark by early November. The Bank of Japan at times sold dollars both in Tokyo and in New York to support the currency in the exchange markets. These sales were greater than the $2.8 billion decline in Japan's foreign exchange reserves over the three months to $19.1 billion by end-October. The U.S. authorities joined in concerted intervention operations with the Japanese authorities to counter disorderly markets on August 4 and October 4-6, as the dollar rose sharply. A total of $57.0 million of yen was purchased, of which $38.5 million was on behalf of the Federal Reserve System and $18.5 million was for the account of the U.S. Treasury.

During November the Japanese yen finally began to recover, buoyed at first by a major shift in international investment flows. By this time, the four-month rally in U.S. capital markets showed signs of peaking, encouraging many investors from Japan and elsewhere to take profits on dollar investments and to shift into other markets. Since the Japanese monetary authorities had so far refrained from following interest rate cuts abroad, market participants assessed that there might be considerable latitude now for rates in Japan to ease, generating expectations of potential capital gains. At the same time, the outlook for economic growth globally had deteriorated considerably, and the prospect that Japan's economy would still expand, however slowly, made investment in the stock market in Tokyo relatively more attractive than in other financial centers. Foreign investors, therefore, became large net purchasers of Japanese securities, contributing to a strong rally in the Tokyo stock and bond markets. Long-term bond yields were brought down nearly 1 percentage point in the rally, even though the Bank of Japan's discount rate was unchanged and short-term interest rates held steady. Net overseas investment by Japanese residents declined, and long-term capital outflows slowed. Although these tendencies had begun to appear in earlier months, the turnaround in investment had a particularly strong impact in November, when the long-term capital account registered its first surplus in eighteen months. This news was viewed in the market as evidence that the yen was finally embarked on a sustainable recovery.

Before long, the bidding for yen broadened. Reports circulated that some large Japanese exporting firms, which had postponed dollar sales in earlier months when the yen was weak, had begun actively to sell dollars forward. The election of a new prime minister by an unexpectedly wide margin in late November and Prime Minister Nakasone's first statements affirming continuation of most of the previous government's policies helped dispel earlier political uncertainties Japan was seen as relatively free of the immobilizing policy disagreements that were taking place in so many other countries and as continuing to follow a clear and consistent path of macroeconomic restraint The yen thus came into demand and rose nearly 19 percent against the dollar between early November and early January to ¥ 226 55 by January 10. Against the German mark the currency rose some 10 percent over the same period

By early January, market participants began reassessing the outlook for further interest rate declines abroad in light of indications that the U S economy might be recovering more quickly than had been thought and the prospect that the U S fiscal deficit might again exert upward pressure on long-term U S. interest rates. Meanwhile, expectations had become firmly entrenched that the Japanese authorities would soon lower official short-term interest rates Also, Japanese institutional investors had already begun to invest once more abroad After locking in some capital gains on their domestic securities, many took advantage of "partly paid" bonds in the Eurobond market to make an initial instalment on a new issue and, if the yen were to strengthen, benefit from this before completing their subscriptions Once the balance in the market began to tip against the yen, many traders in the interbank market and on Chicago's International Monetary Market (IMM) who apparently were holding large long yen positions moved to cover their positions. The ensuing selling brought the yen down quickly to ¥ 242 10 on January 24. In these circumstances, the Japanese authorities did not proceed with the discount rate cut which the market had come to expect would occur after Prime Minister Nakasone's visit to the United States. As a result, the Japanese yen moved up to close the period at ¥ 240 90, well below its early-January highs but up almost 6 percent on balance over the six-month interval The Bank of Japan made only modest intervention sales of dollars in the last three months of the period. Therefore, the country's foreign exchange reserves closed at $19 5 billion, little changed from the end-of-October level but still down $2.3 billion from their end-July level.

German mark

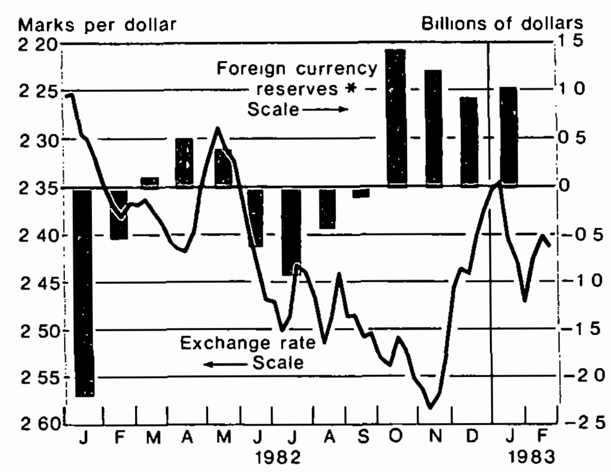
By August 1982 the German mark had strengthened against most foreign currencies, while continuing to decline against the U.S. dollar. The mark's performance *vis-à-vis* other European currencies reflected primarily a moderation of inflation and the greater progress made by Germany than by most of its neighbors in gaining balance-of-payments equilibrium. Capital outflows continued to weigh against the dollar-mark exchange rate, however, attracted by higher U.S interest rates and concern that Germany was more vulnerable to the political and financial strains then developing Internally, proposals for dealing with persistently large fiscal deficits had led to protracted debates within Germany's coalition government. Also, financial strains in the private sector had left market participants wary about individual German financial institutions. Moreover, the openness of Germany's economy exposed it to possible disruptions of oil flows arising from conflict in the Middle East, the spread of recession among industrialized countries, and repercussions of economic sanctions adopted by the United States against the Soviet Union

Consequently, the mark, which had already fallen from its November 1981 high by 11 percent against the dollar to DM 2 4430 by end-July, dropped further to a low of DM 2 5315 by early trading in the Far East on August 11 During August the German authorities continued to sell dollars in modest amounts to facilitate the fixings in Frankfurt Early in the month the U S. authorities operated once, purchasing $5 million

Chart 4

Germany

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

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

The continued decline of the mark through midsummer was one of the complications facing the authorities as they tried cautiously to steer the economy out of protracted stagnation. For almost a year, the Bundesbank had taken advantage of improvements in Germany's external position and price performance, together with the rise in the mark in effective terms, to lower its official discount and Lombard rates. At the same time, fiscal policy was geared to a reduction of the public-sector deficit.

Another complication was an unexpected deterioration in the economic climate in Germany. As foreign demand weakened sharply after midyear, Germany's economic stagnation gave way to recession. The sag in new foreign orders reflected the weakness of the global economy, dwindling Organization of Petroleum Exporting Countries (OPEC) surpluses, and severe financing constraints facing many nonoil-developing countries. Already liquidity difficulties had emerged for a number of firms including AEG-Telefunken, generating talk of the need for governmental action to support the economy and employment. But, at the same time, an accord on the 1983 federal budget reached just weeks before was beginning to be questioned on the grounds that it rested on overly optimistic assumptions for the economy. Thus, prospects grew of enlarged official borrowing needs, and Germany's bond market again had come under pressure.

Against this background, market participants expected that the authorities would take advantage of any opportunity that might arise to lower interest rates and thereby deflect pressure for further fiscal stimulus. When U.S. interest rates resumed their downtrend after mid-August, interest differentials adverse to the mark sharply narrowed. As a result, the interest differential for three-month Eurodeposits shrank to 2½ percentage points from more than 7½ percentage points two months before. Under these circumstances, the mark recovered strongly to DM 2.41. The Bundesbank then moved on August 27, in concert with the Swiss and Dutch central banks, to cut the discount and Lombard rates to 7 percent from 7½ percent and to 8 percent from 9 percent, respectively. The action was described by Bundesbank President Poehl as an important step to provide support to the domestic economy.

Except for the short-lived recovery late in August, the mark continued to decline through early November. Although the mark's continuing weakness during the fall reflected in part the overall strength of the dollar, the situation at home also contributed. The market's expectation that the German authorities would take advantage of any opportunity to cut interest rates in Germany was confirmed by the Bundesbank's action of late August. The renewed drop in economic activity was a source of discouragement in Germany and was reflected in a rise in unemployment close to the psychologically important two million level for September. In October, the government recognized that the weak performance of the economy would necessitate revision of the government's budget forecasts, and debate intensified over the choice to accept a larger than expected deficit or to cut welfare expenditures drastically. The Bundesbank continued to ease monetary conditions after interest rates abroad moved lower and adverse interest differentials began to narrow. Effective October 1, it reduced banks' minimum reserve requirements, thereby releasing about DM 5.5 billion of liquidity on a permanent basis. Effective October 22, the Bundesbank cut its discount and Lombard rates, both by 1 percentage point to 6 percent and 7 percent, respectively.

Thus the mark remained under fairly steady downward pressure against the dollar. It fell to DM 2.6050 in European trading on November 11, shortly after news of the death of Soviet President Brezhnev, down nearly 8 percent from its highs touched in late August. Operating on two occasions early in October when the mark fell abruptly in unsettled market conditions through the low levels of early August, the U.S. authorities purchased a total of $40 million equivalent of marks, shared equally between the Federal Reserve and the U.S. Treasury.

In mid-November, when the demand for dollar-denominated liquidity subsided and sterling came on offer, the German mark appeared to market participants as an attractive alternative currency for investment. Germany's current account was again improving, with most forecasters expecting balance for 1982. The November current account registered one of the largest surpluses on record. In addition, German banks were no longer alone in having international exposures which, even if an immediate problem had been diverted, might impinge on earnings later on. Reflecting the more favorable outlook for the mark and declining adverse interest differentials, German portfolio managers moved quickly to shift funds out of dollars and sterling into mark-denominated investments. Meanwhile, German exporters, who had previously postponed hedging their dollar receipts, moved to sell dollars forward.

In this environment, the German mark strengthened considerably against most currencies. Against the dollar it rose steadily, surpassing by early December its high point of August and moving to a seven-month peak of DM 2.3295 by January 10. At this level, it was up nearly 10½ percent from its mid-November lows. Within the European Monetary System (EMS), the mark had previously moved from the bottom of the new intervention points established after the last realignment. Now, as the dollar weakened and funds were shifted into German marks, the mark emerged near the top of the EMS band. As the mark strengthened, it was used increasingly as an intervention currency by other EMS countries.

After January 10, however, the mark lost some of its gains. At this time, the dollar generally rose as signs of a bottoming-out of the U.S. recession and the pressures of large Treasury financing needs seemed to limit prospects for further declines in U.S. interest rates. Moreover, the outlook for the mark was clouded by political uncertainties and capital again flowed out of Germany. In addition, German stock and bond prices dropped, reports circulated in the market that German residents were moving to hedge or repay their Swiss-franc liabilities, and foreign entities postponed planned investments in Germany. At the end of January the mark was trading at DM 2.4735, down about 6 percent from its early-January highs and down about 1 percent from end-July levels.

The earlier strengthening of the mark afforded an opportunity for the Bundesbank again to reduce its discount and Lombard rates a full percentage point to 5 and 6 percent, respectively, on December 3, while providing liquidity to bring short-term interest rates in line with the new Lombard rate. In addition, it announced that it would maintain the 4 to 7 percent target range for the growth of central bank money, continuing to aim at the upper half of the range as long as economic activity remained weak and the inflation performance and external situation permitted. In the wake of these actions, domestic money market rates eased significantly so that, despite some further softening in U.S. rates, the mark's adverse interest differential widened slightly. During January, however, no further cuts in official interest rates were made, though the Bundesbank raised rediscount quotas by DM 4 billion effective February 1

From August through January, Germany's foreign currency reserves were subject to diverse tendencies. For the most part, the Bundesbank intervened only modestly as a seller of dollars in support of the mark throughout the period, with most of the operations undertaken to settle imbalances at the fixings in Frankfurt. The German authorities also acted as sellers of German marks in modest amounts against EMS currencies and, on occasion, against dollars to alleviate strains within the joint float. Germany's reserves stood at $40.6 billion at end-January, up about $4.1 billion on balance from the $36.5 billion end-July level.

During the period, the U.S. Treasury redeemed at maturity $1,335.3 million equivalent of its German mark-denominated securities. These redemptions, which occurred on September 1 and December 14, left the Treasury with $1,275.2 million equivalent of mark-denominated notes (public series) outstanding.

Swiss franc

For much of the first eight months of 1982, the Swiss franc had declined from its strong levels of late 1981 under the weight of heavy capital outflows. With Switzerland's earlier policies of restraint having moderated inflation and the Swiss economy weakening, the Swiss National Bank aimed at providing sufficient liquidity to prevent any further drag on economic activity by keeping central bank money on a 3 percent targeted average growth path during the year. In the event, central bank money growth had fallen short of the target during the early months, so that fairly substantial injections of liquidity were required during the spring. Interest rates fell and rate differentials adverse to franc placements became extremely wide. In response, foreign official and corporate borrowers placed heavy demands on Switzerland's capital market. These, together with other capital outflows, more than offset the demand for Swiss francs arising from Switzerland's current account surplus. Consequently, by end-July, the franc had fallen 19 percent against the dollar and 8 percent against the German mark from its peak in the closing months of 1981. Meanwhile, Switzerland's foreign exchange reserves had risen to $11.8 billion, largely reflecting the use of foreign exchange swaps to provide liquidity to the banking system.

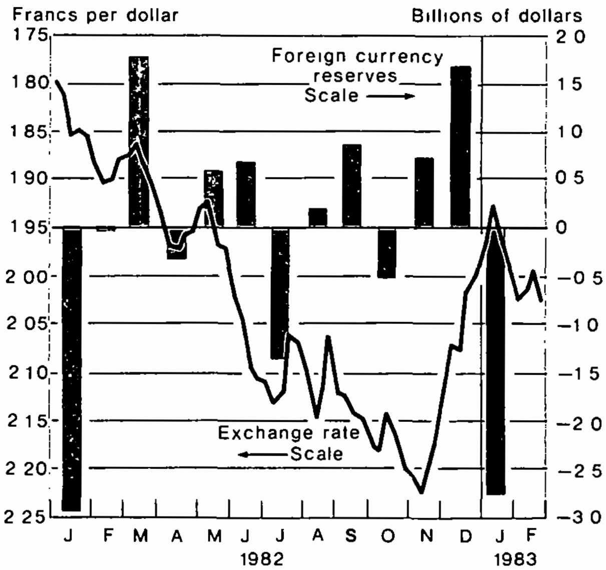
By early August, signs of weakness in Switzerland's economy were spreading. Exports, which had held up well earlier in the year and cushioned the impact of the recession, were falling victim to the sluggishness of demand abroad, especially in Germany, and the lagged effects of the franc's appreciation the year before. Nevertheless, market participants began to sense that the monetary authorities might have less leeway than before to continue forcefully to ease monetary conditions. Inflation, which had slowed to about 5 percent, remained stubbornly high by comparison with both historical experience and other industrial countries. The persistence of inflation in the face of a declining economy partly reflected the impact of recent declines in the franc on domestic prices of imported products. Moreover, the growth of central bank money had begun to rise toward the authorities' target.

As a result, the franc, while fluctuating widely against the dollar in response to day-to-day shifts in current and prospective money market conditions and

Chart 5

Switzerland

Movements in exchange rate and official foreign currency reserves



See exchange rate footnote on Chart 3

international liquidity strains, traded narrowly against the German mark during August. Although against the dollar the franc had declined a further 4 percent to a low of SF 2.1650, it bounced back quickly later in the month Under these circumstances, the National Bank joined with other European central banks in a concerted move to take advantage of the continued decline in interest rates in the United States to cut rates in their respective countries, effective August 27. But, in view of the already low level of interest rates in Switzerland, the National Bank cut its discount and Lombard rates only ½ percentage point to 5 percent and 6½ percent, respectively.

After late August, when all currencies were declining against the dollar, the Swiss franc again began to fall more rapidly than the German mark Although short-term interest rates in Switzerland declined less rapidly than elsewhere, by late October at 3 to 3½ percent they remained the lowest in all the industrialized countries As a result, nonresidents continued to borrow heavily in the Swiss capital markets and to convert the proceeds to other currencies. To be sure, the attraction of Switzerland as a safe haven increased during the fall, as concern deepened about the potential ramifications of the growing list of international debt problems, and Swiss financial institutions were believed to be less threatened by liquidity strains than many others. But much of the flows into Swiss banks were into dollar-denominated deposits On balance, therefore, the persistent interest-sensitive capital outflows continued to weigh against the franc

As the Swiss franc resumed its decline with little apparent resistance from the Swiss authorities, market participants came to the view that the National Bank had put priority on achieving its monetary target for the year and was willing, at least while the Swiss economy was weak, to accept a continued gradual decline of the franc, especially against the mark. On October 22, however, the Swiss National Bank unexpectedly did not join other European monetary authorities in a reduction of official lending rates. Subsequently, senior officials from the Swiss National Bank, while indicating concern that the recession not be exacerbated, underscored the divergent forces operating on monetary policy and pointed to the need to avoid a weakening of the franc and an aggravation of inflation Before long, most Swiss money market rates steadied or firmed slightly, and by early November the Swiss franc's slide against the mark began to slow. Against the dollar, however, the Swiss franc continued to decline through November 8, when it hit a five-year low of SF 2 2410 By this time the franc was 7½ percent down from end-July levels *vis-à-vis* the dollar and at SF 0 86, down 1 percent against the mark.

Following the shift in sentiment against the dollar around mid-November, the franc rebounded more strongly than other European currencies. As investors sought to shift funds out of dollars and to a lesser degree also out of German marks, Switzerland's traditional role as a safe haven and its relative political stability made the Swiss franc an attractive alternative. Unlike most countries, Switzerland had a sizable current account surplus, buoyed by investment income and tourist receipts The Swiss government's fiscal discipline compared favorably with the experience of most other countries Renewed tensions in the EMS prompted some switching of funds out of participating currencies and into the franc Also, market participants came less to expect further easing of monetary policy The Swiss National Bank had kept the same 3 percent growth target for central bank money for 1983 as in 1982 Although it again lowered official lending rates on December 3 in coordination with similar measures by other European central banks, the ½ percentage point declines of the bank rate to 4½ percent and of the Lombard rate to 6 percent were again less than those abroad. The authorities were anxious to keep official lending rates above market rates in order to control better the level of liquidity over month ends and, with the approach of the important end-December reporting date, banks were positioning to ensure adequate levels of cash resources in Swiss francs.

As a result, during December and early January the Swiss currency came into strong demand in the exchanges. As the franc's rise continued and as the dollar depreciated against all currencies, market participants began to worry that much of the earlier borrowings in the Swiss capital markets remained unhedged. Therefore, they came increasingly to expect that, if the dollar were to continue to decline, earlier borrowers of Swiss francs would bid for francs to cover their liabilities Thus, the upward potential for the franc was seen as greater than for most other currencies, prompting market professionals and participants on Chicago's IMM to take substantial long franc positions. The franc came strongly in demand in the exchanges, rising to SF 1.9150 on January 10 against the dollar, up 14½ percent from its November lows. Against the mark, which was undermined by political uncertainties and expectations that the Bundesbank would again lower official rates, the franc rose to SF 0.8144 on January 21, up almost 5½ percent since early November.

After mid-January, the Swiss franc pared back some of its gains first against the dollar and then against the German mark as well. Money market conditions in Switzerland remained comfortable, and interest rates continued to ease, dropping below 3 percent for three-month Euro-Swiss franc deposits. Though the interest differentials adverse to the franc were not so wide as they had been in mid-1982, the low level of rates continued to provide an inducement to borrowers to raise funds in Swiss francs. As a result, the franc eased back to trade by the end of January at SF 2.0250 against the dollar and SF 0.8187 against the mark. At these levels the franc was down nearly 6 percent against the dollar from its earlier January highs and ½ percent lower against the mark.

Nevertheless, on balance for the six-month period under review, the franc rose 2½ percent against the dollar and 4 percent against the mark to stand near its record high on a trade-weighted basis. Between end-July and end-January, Switzerland's foreign exchange reserves rose $368 million to $12.2 billion in response to foreign currency swap operations, interest earnings on outstanding reserves, and net market purchases of dollars in intervention operations. Intervention by the authorities was infrequent and limited for the most part to replenishing reserves which had been run down by earlier sales to customers.

On January 26 the United States Treasury redeemed at maturity franc-denominated securities equivalent to $458.5 million, thereby completing the redemption of franc-denominated securities totaling the equivalent of $1,203.0 million issued in connection with the dollar-support program of November 1978.

Sterling

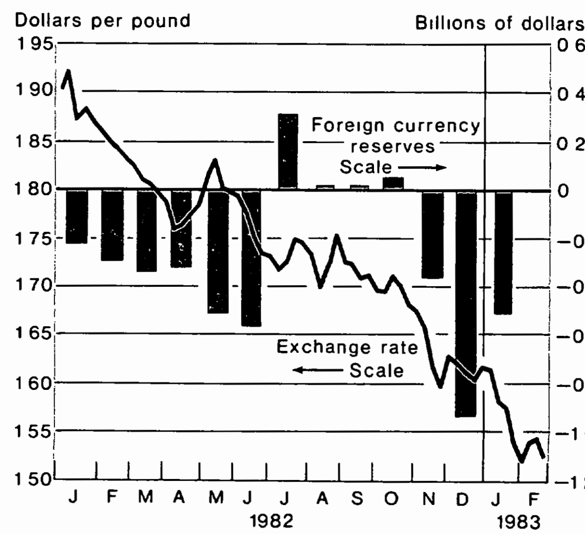
Coming into the period, sterling was trading steadily against other European currencies and declining against the dollar. At end-July the pound was holding around 91.5, according to the Bank of England's trade-weighted effective index, but had eased to $1.7475 against the dollar.

Sentiment toward the pound reflected in part market confidence in the Thatcher government's resolve to maintain the stringent financial policies that were already seen to be producing results. The growth of the monetary aggregates had slowed to the government's 8 to 12 percent target range. Inflation had decelerated to below double-digit rates. And the borrowing requirement of the public sector was declining and apparently falling short of the £9½ billion rate projected for the current fiscal year. To be sure, disappointment had deepened about the prospects that Britain would sus-

Chart 6

United Kingdom

Movements in exchange rate and official foreign currency reserves



See footnotes on Charts 3 and 4

tain a recovery from its protracted recession, as evidence accumulated that output had posted little gain from its low point of 1981. But progress on inflation, the fiscal situation, and monetary control, together with the decline of interest rates abroad and sterling's stability as measured by the trade-weighted index, were seen in the market as conditions which would permit a further cautious easing of interest rates and help stimulate the economy.

Additional factors also helped sustain sterling relative to most other currencies during the late summer and early fall. There were worries over potential disruption to the flow of oil from the Middle East as the result of fighting in Lebanon and between Iran and Iraq. More important, intensifying financial strains and growing concerns over international credit exposures made traders and investors more conscious about the creditworthiness of counterparties and the safety of their assets. In these circumstances, both Britain's oil self-sufficiency and the favorable reputation of London's financial system made sterling a relatively secure asset. With the market expecting British interest rates to ease —but to ease more gradually than in many other countries—investment funds were attracted to London to take advantage of the perceived potential for capital gains. By late October a major rally had become established in the market for United Kingdom government securities and successive records were being set in British indexes of stock prices, attracting further capital inflows.

These factors did not prevent sterling from easing further against the dollar which was buoyed even more than the pound by concern over liquidity strains. By end-October, sterling had moved irregularly lower by 4½ percent to $1.6725. But, against other currencies, the pound held steady or even strengthened so that, in trade-weighted terms, it rose to 92.5 by end-October. The Bank of England's intervention operations were only partly reflected in the three-month $93 million increase in foreign exchange reserves from July's level of $10.88 billion.

As the autumn progressed, however, concern intensified about the outlook for the economy. Neither consumption nor investment had gained during the early part of the year as had been expected and, with the shakeout of labor continuing, the unemployment rate took a sudden jump to 14 percent in September. As market participants perceived a possible shifting from the policy requirements of fighting inflation to those of rekindling economic growth, currencies thought to be overvalued came under suspicion. Meanwhile, a boom in retail sales led to fears that rising imports might contribute to a deterioration in the British foreign trade balance. Although actual trade figures published toward the end of the year did not show any such deterioration, attention was drawn to a government forecast that Britain's current account surplus, which mainly reflected oil exports, would disappear by 1983. Consequently, considerable commentary focused on Britain's competitive position, all the more so after the Scandinavian devaluations in early October.

The government argued that the problems of unemployment and competitiveness were closely linked: improvement of Britain's trade position required both continued progress on inflation and more rapid deceleration of pay increases. But critics of government policy argued that, despite the recent moderation of labor costs, deceleration of inflation, and depreciation of the pound, British industry over a period of several years had suffered a considerable net loss of competitive position, ground that would be difficult to make up in the future since inflation and productivity were also improving in competitor countries. Early in November, the Confederation of British Industry proposed a major program to create jobs and stimulate the economy, including a sharp cut in interest rates. Some industrialists continued to advocate overt government measures to devalue sterling by 5 to 10 percent These proposals, coming from a group thought to support the Thatcher program, brought the government's political support into question.

In mid-November, the Chancellor presented a mid-year budget review in which limited fiscal measures were announced to make up for some of the shortfalls in government expenditures and the public-sector borrowing requirement. In this way the government attempted to counteract the tendency for fiscal policy to be more restrictive than intended, aiming new actions at the need to increase the competitiveness of the corporate sector. The accompanying economic projection, however, pointed to a continuing deterioration in Britain's current account, largely because any modest recovery or buildup of inventories was expected to give strong stimulus to manufacturing imports. In the Parliamentary discussion, government officials deflected proposals for explicit action to devalue sterling. But reports that appeared in the press over the November 13-14 weekend left market participants with the clear impression that the British government would prefer a lower, more competitive exchange rate for the pound.

After that weekend, sentiment toward sterling turned decidedly bearish. Foreign investors and British residents, including large institutional investors, began to shift funds out of longer term sterling-denominated securities and into assets denominated in other currencies, taking profits from the recent sharp price appreciation in the London capital market. The pound also came under broad-based selling pressure from market professionals, corporations, and traders on the IMM. Against the dollar the pound fell to $1.5950 by November 17, while in trade-weighted terms it dropped to 87.8.

Several days after the sharp break in the sterling rate, United Kingdom money market interest rates rose, British banks raised their base lending rates by 1 percentage point or more, and the Bank of England then increased its own dealing rates to reflect the rise. Thereafter, sterling recovered somewhat to trade against the dollar around $1.6332 by end-November. But it had broken stride against other currencies which now were rising against the dollar.

The market for sterling remained unsettled during December. By then, the Labor Party had issued its own policy recommendations, calling for a sharp acceleration in public spending, substantially lower interest rates, and a 30 percent devaluation of the pound over two years. In addition, there was increasing talk that oil prices might decline substantially, raising the possibility of sharply reduced oil-export receipts and government revenues. Investment funds continued to be shifted out of sterling assets, despite a further widening of interest rate differentials favoring the pound. In effective terms, sterling declined.

Against the dollar, however, sterling traded without clear direction until early January, when the pound turned lower once again. Although the Bank of England's intervention during December had been detected in the market, publication in early January of December's official reserves, showing a decline slightly in excess of $1 billion, was a surprise. Political elements also played a role in shaping sentiment, first when strains developed between the United Kingdom and several Middle East oil-producing nations over the Palestine Liberation Organization issue and then as some observers predicted that the Thatcher government would decide to call elections well before the mandated time in 1984. Also, growing expectations of a deterioration in British oil-export revenues as a consequence of OPEC's apparent failure to agree to production quotas added to the bearish sentiment toward sterling. Thus, the spot rate resumed its decline against all currencies, dropping in effective terms as low as 80.6 on January 11.

By mid-January, however, pressures on sterling began to abate. In part, interest rate differentials favorable to the pound had widened further following an additional rise in British banks' base lending rates. Also, the impact of declines in oil revenues appeared to have been largely discounted. Moreover, evidence of increasing support for the government and reaffirmation of its policy approach in a white paper on fiscal year 1983-84 expenditures helped reassure the markets. Thus, on an effective basis, sterling steadied to close the six-month interval at 80.9, a net decline of 11½ percent. However, sterling continued to decline against the dollar which appreciated generally after January 10. The pound set a series of historic lows toward the end of the month before closing near the last of them at $1.5210. With sterling trading more steadily on a trade-weighted basis, the Bank of England scaled back its intervention in January. Nevertheless, Britain's reserves declined by $1.8 billion during the three months of November to January to close at $9.2 billion.

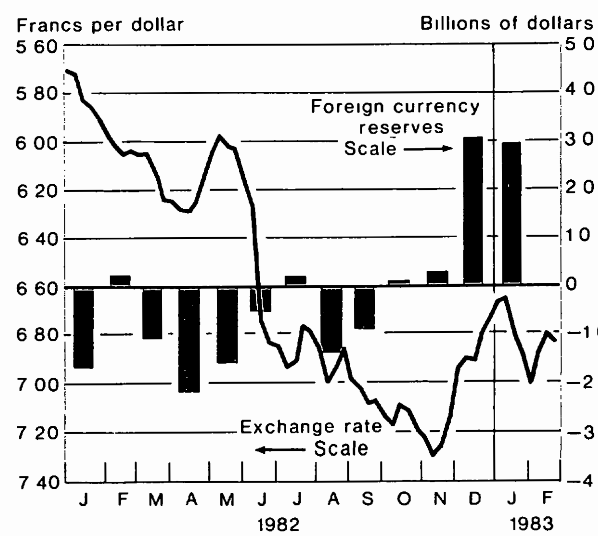
French franc

The French franc was trading firmly near the top of the EMS as the period opened, although at FF 6.8025 it was declining to successive lows against the dollar. The franc had moved to the upper portion of the joint float after its mid-June devaluation, supported by stringent foreign exchange controls and wide favorable interest differentials over most other European currencies. But reflows which in the past had often fol-

Chart 7

France

Movements in exchange rate and official foreign currency reserves



See footnotes on Charts 3 and 4

lowed such devaluations proved in this instance to be relatively modest, thus limiting the authorities' scope to rebuild reserves or to lower domestic interest rates in an effort to stimulate economic recovery. This cautious response reflected market participants' concern that the franc's new EMS parity rates might not be sustainable in light of France's inflation and its rapidly rising budget and current account deficits.

Inflation in France remained over 10 percent at midyear in contrast to other industrial countries, especially Germany. Although at the time of the June EMS realignment, the French government froze wages and prices for four months, and price and wage increases dropped significantly during the summer, many anticipated pressure for "catch up" increases when the scheme expired at the end of October. Governmental efforts pressing both employers and unions to accept voluntary price restrictions to replace the freeze met opposition.

Meanwhile, French economic policy had continued to stress economic stimulus relative to inflation reduction through the spring, clouding prospects that inflation differentials could be reduced soon. Even if proposals made in June were adopted in the September budget to cut expenditures and increase revenues, the government faced a large and growing fiscal deficit expected in fiscal 1983 to climb over 3 percent of gross domestic product (GDP). Thus, market participants worried that inflationary fiscal pressure would intensify just as the wage and price freeze was being phased out.

Moreover, the French current account deficit had increased sharply and, for the year as a whole, the deficit more than doubled to $12 billion. The deterioration reflected a steep decline in export volumes, an acceleration of imports buoyed by domestic demand pressure, and a shrinking of the invisibles surplus mainly because of rising interest charges on foreign debt.

In this context, beginning in mid-August and extending over the fall and winter months, the franc came under intermittent bouts of pressure. Speculative selling was particularly intense before weekends, when most EMS realignments had occurred in the past. There was concern, not only that the franc might be devalued within the EMS, but that it might be withdrawn altogether from the currency arrangement or that the French authorities might institute a two-tier exchange rate system. By late August the franc dropped to the middle of the EMS band, and by early September it had moved down toward its central rate against the German mark. The Bank of France intervened frequently in the exchanges to support the currency, selling both dollars and German marks. During August-September France's foreign currency reserves declined $2.3 billion to $11 billion, and the authorities announced a ten-year $4 billion syndicated Eurocurrency line of credit to bolster reserves. The franc remained on offer subsequently, but any further decline of the franc against the mark was limited. Against the dollar, however, the franc declined to a low of FF 7.3250 in November, down 7½ percent from its end-July level.

After the dollar turned lower in November, the franc experienced difficulty keeping pace with the strengthening mark. The Bank of France stepped up its intervention, especially in dollars, and the franc emerged along with the mark in the upper portion of the EMS band. At one point in December, however, the franc-mark cross rate fell to a low of FF 2.8385 which was still, however, only ⅛ percent below its bilateral parity.

Meanwhile, France's domestic economy, which had shown modest growth during the first half of 1982, stagnated thereafter, disappointing the authorities' hopes of a consumer-led recovery. Real private consumption spending decelerated, most categories of investment expenditures declined, industrial production fell further, and unemployment remained high at around 2 million. The French authorities introduced several new measures over the fall to spur investment and employment and had been quick to lower domestic interest rates when it appeared that exchange market conditions permitted. They had also announced measures to promote exports and slow imports. But at the same time the authorities acted to contain inflationary pressures. They introduced modified price controls following the expiration of the freeze on November 1, and announced in December a substantial reduction of the 1983 M-2 growth target and a tightening of ceilings for growth of bank lending. In remarks before the National Credit Council, Finance Minister Delors stated that monetary policy for 1983 would be geared to defending the EMS parity of the franc and to continuing the battle against inflation, while also permitting a continued decline in interest rates.

In the exchange markets, selling pressures against the French franc faded somewhat in mid-January, as market participants concluded that any EMS realignment would not occur before French and German elections in the spring. As the period drew to a close, the usual month-end demand for francs emerged, enabling the Bank of France to scale back its intervention support and make modest net purchases of dollars. By end-January the franc was trading in the upper portion of the joint float, as it had been when the period opened. Against the dollar the franc was trading at FF 7.0100, 3 percent lower on balance for the period under review but some 4 percent higher than its early-November lows. Meanwhile, France's foreign exchange reserves increased from the end-September lows to post a net $4.3 billion gain over the six-month period to $17.6 billion.

Throughout the period, French enterprises continued to borrow in foreign markets and to convert the loan proceeds into francs in the exchange market. During February, Finance Minister Delors affirmed that France's public external debt increased during 1982 by $8.8 billion, not including the $4 billion syndicated loan announced in September.

Italian lira

The Italian lira was trading firmly above the narrow EMS band at the end of July, but against the dollar it had fallen to a new low of Lit 1,367.00. The lira sustained its position in the EMS on the basis of seasonal tourist inflows, exchange control measures introduced earlier in the year to discourage unfavorable shifts in leads and lags, and the attraction of high interest rates. Since interest rates elsewhere were trending down, differentials favorable to the lira widened and Italian residents stepped up their borrowings abroad. The Bank of Italy had taken advantage of the lira's relative strength to rebuild foreign currency reserves to a level of $13.9 billion by end-July.

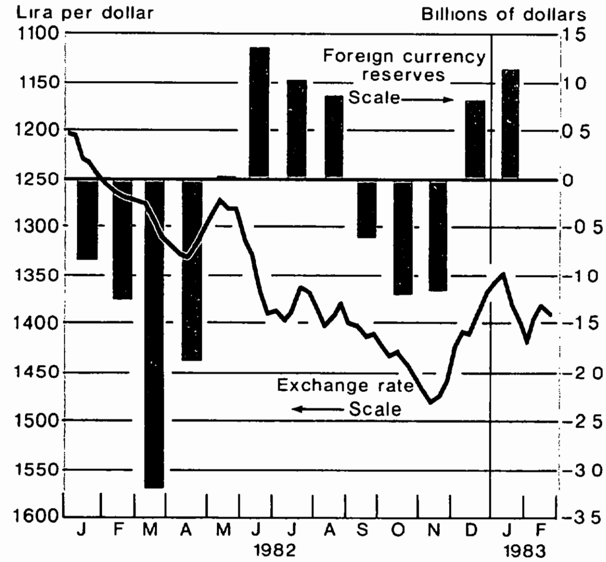
The Bank of Italy's policy of monetary restraint was aimed at reducing Italy's persistent high inflation rate, countering the effects of seemingly uncontrollable fiscal deficits and preventing a sharp drop of the lira which would exacerbate inflation. During the period under review, the Italian economy, like others among the industrialized countries, fell more deeply into recession, thereby complicating efforts to contain the fiscal deficits. But Italy was one of the few industrialized countries not to experience a sharp reduction of inflation. Indeed, the hope for any improvement diminished as proposed programs to rein in fiscal deficits failed to meet parliamentary approval, leading to successive governmental crises and, as negotiations remained deadlocked on reforms to Italy's wage indexation system, the *scala mobile.*

Consequently, the burden of fighting inflation continued to fall to the Bank of Italy, which operated to limit the expansion of credit and to keep liquidity under control. During August and early September, the high interest rates together with tourist inflows remained sufficient to keep the lira firm within the EMS while it continued to decline against the dollar. The lira's relative position within the EMS permitted the authorities to rebuild reserves and to ease short-term domestic interest rates to help take pressure off the weak economy. On August 24 the monetary authorities

Chart 8

Italy

Movements in exchange rate and official foreign currency reserves



See footnotes on Charts 3 and 4

lowered the discount rate and the base rate for advances by the central bank by 1 percentage point to 18 percent, the first change in nearly 1½ years, and the Italian Banking Association followed by cutting prime rates by 1 percentage point to 20.75 percent. But these cuts were generally more than matched by reductions of official and market rates elsewhere on the Continent so that the lira's wide interest rate differential was largely maintained.

After mid-September, the lira eased back within the EMS while continuing to fall against the dollar through mid-November. With the lira easing and prospects of a resolution of Italy's fiscal and labor problems becoming increasingly remote, the lira became caught up in the pressures within the EMS. As rumors spread of an imminent realignment, the lira was identified as a candidate for downward adjustment, prompting Italian exporters to repay foreign currency debt and to shift into lira financing. Thus, the lira eased back to within the narrow EMS band beginning in mid-October, while also declining to a new record low of Lit 1,489.60 against the dollar in mid-November. The Bank of Italy tightened domestic credit conditions, pushing up short-term interest rates even as comparable rates abroad were declining. The authorities required exporters to borrow 70 percent of their financing needs in foreign currencies. In addition, the Bank of Italy began to intervene heavily and, in the three months of September-November, Italy's foreign exchange reserves dropped $3 billion from $14.8 billion to $11.8 billion.

The firming Italian interest rates, together with the change in sentiment toward the dollar, helped bring the market into better balance after mid-November. By end-December the lira had once again moved above the narrow EMS band, a position it generally maintained through the end of January.

Meanwhile, the pressure of the government's huge financing needs not only added to the strains in Italy's financial markets but also generated an acceleration of total credit expansion, thereby undercutting the Bank of Italy's policy of monetary restraint. Accordingly, on December 23 the authorities announced proposed measures to improve control over money creation in future years by shifting from administrative mechanisms toward monetary base control. The new system was designed in part to force the Treasury to compete for funds with the private sector. In the meantime the government proposed measures designed to hold the 1983 borrowing requirement to Lit 70 trillion, some 16 percent of GDP and, since it had exceeded its legal monthly borrowing limit at the central bank, it asked Parliament to approve a special one-year advance.

In January, agreement was finally reached between Italian employers and labor unions over ways to reform the *scala mobile*. It was agreed to cut automatic inflation-linked wage increases by 15 percent and to undertake further negotiations about the exclusion from indexation of those elements of inflation emanating from future increases in value added taxes, as well as from exchange rate depreciation if inflation exceeds the target rate for the year. The pact raised hopes for reducing inflation and appeared to diminish the threat of industrial strife by clearing the way for negotiations over new three-year wage contracts.

Partly in response to these developments, the Bank of Italy was able first to scale back its intervention support and subsequently to make some net dollar purchases to rebuild reserves, except for a brief time in mid-December. By end-January the lira was trading at Lit 1,418.00, up nearly 5 percent from its November lows. Nonetheless, over the six-month period under review, the lira declined 3½ percent against the dollar and 2½ percent against the mark. Meanwhile, Italy's foreign exchange reserves increased by $2 billion during the last two months of the period to $13.8 billion by end-January.

European Monetary System

Early in August, the currencies participating in the intervention arrangement of the EMS were holding to the pattern that first emerged from the realignment of June 12-13. In this adjustment, the central parities of the German mark and Dutch guilder were revalued by 4¼ percent, those of the French franc and Italian lira were devalued by 5¾ percent and 2¾ percent, respectively, and the bilateral central rates of the remaining currencies were otherwise left unchanged. Since this realignment, the Italian lira had traded above the top of the 2¼ percent limit applied to other EMS currencies, utilizing its freedom to trade in a wider band. The French franc and Irish pound were near the top of the 2¼ percent band, followed closely by the Danish krone. The Belgian franc remained near the middle, while the German mark and Dutch guilder traded at the bottom of the joint float.

This latest parity adjustment was the third in eight months. Yet considerable skepticism remained that, despite major policy adjustments in many participating countries, there was sufficient willingness to harmonize economic policies and to narrow the divergent economic performances to permit even the new currency structure to last. Most participating countries had adopted some degree of restraint during preceding years to stabilize their economies from the ravages of inflation following the oil-price increases of the late 1970s. But substantial inflation differentials remained, and market participants worried that extraordinarily high rates of unemployment in some countries would force the authorities there to compromise these efforts. Moreover, most countries were attempting to bring public-sector deficits under better control but with varying degrees of success, and some found themselves in divisive internal debates over priorities for economic policy. During the period under review, these divergencies reemerged to exert strain on the currency relationships within the EMS. But, as long as another realignment was thought not to be imminent, modest amounts of funds flowed back into those currencies which offered the highest interest rates.

After mid-August, the currencies of France and Denmark began to weaken within the EMS. Both countries had experienced above-average real growth earlier in the year, boosted in part by the continuing impact of earlier fiscal stimulus and reflected in widening trade deficits, together with persistently high inflation. The French government had pledged fiscal restraint and imposed a price freeze following the mid-June realignment, but market participants still doubted that policy priority had in fact shifted from supporting employment to reestablishing internal and external balance to the economy. The Danish government was locked in parliamentary debate over budget proposals for 1983, including expenditure cuts and tax increases to curtail the government's borrowing requirement. When the government resigned early in September, speculation developed that a new government might devalue the krone. Under these circumstances, both currencies fell to around the midpoint of the 2¼ percent band toward the end of August amid frequent bouts of rumors that another realignment was imminent. The pressure against the French franc subsided following the government's presentation of a budget early in September which confirmed its determination to contain government spending. The pressures against the Danish krone were renewed during the first half of October by news of devaluations of other Scandinavian currencies before being put to rest by a substantial tightening of Danish monetary and fiscal policies.

The renewed pressures against these two currencies spread to the Belgian franc. The Belgian government had taken forceful action earlier in the year to redress the imbalances in Belgium's economy by devaluation, suspension of wage indexation, a price freeze, and fiscal restraint. Already some progress had become apparent as domestic restraint began to cut into imports, reducing the trade deficit. But Belgium's huge public-sector deficit had yet to decline in the face of a weak economy, and questions remained whether the stabilization policies would be sufficient to offset earlier losses in competitiveness. Thus the Belgian franc became identified in the rumors of realignment as a candidate for devaluation and headed for the bottom of the EMS band, where it traded during the entire second half of the period under review.

Meanwhile, the German mark and Dutch guilder began to move up from the bottom of the band, partly in response to bidding in anticipation of a further realignment. In addition, both countries had comparatively good price and trade performance. Of the two currencies, the guilder was the stronger just as the Netherlands was the only participating country whose current account was in surplus.

By mid-September, all the currencies in the narrow band were clustered closely around the middle of the band. This arrangement contributed to a relatively calm mood in the European markets through October. At this point, the French franc had eased to about parity *vis-à-vis* the German mark, a relationship that the French authorities chose to retain for the rest of the six-month period.

Beginning late November, however, pressures within the EMS became more frequent and intense. The German mark was strengthening as the dollar depreciated generally in the exchanges and the mark moved quickly to the top of the EMS. The guilder had already been trading firmly at the upper limit. Isolated at the bottom was the Belgian franc which at times required intervention support.

Other currencies also became subject to selling pressures at this time. The Irish pound joined the Belgian franc at the bottom of the band temporarily, after the British pound began to drop in the exchanges from mid-November. The French franc came on offer and was given official support to keep pace with the German mark while it rose within the joint float, as concern developed in the market over the adequacy of France's official reserves. Also, the Italian lira weakened, falling toward the middle of the band.

In this environment, expectations revived of an EMS realignment to include revaluation of the German mark and Dutch guilder against the currencies then requiring frequent intervention support either at their mandatory limits or intramarginally. Thus, from late November through December, there was a pattern of intense market speculation ahead of most weekends.

These pressures eased in early January after a meeting of European Community finance ministers passed without a realignment. Thereafter, most market participants concluded that a change of official parities would be postponed at least until after elections were held early in March in both Germany and France. Moreover, after mid-January the mark eased considerably against the dollar and other EMS currencies because of political uncertainties ahead of these elections. Even so, the band continued to be frequently stretched to its limit between the Dutch guilder at the top and the Belgian franc at the bottom.

Against the dollar, the EMS currencies as a group showed little net change over the six-month period under review. All EMS central banks, however, took advantage of the opportunity provided by a worldwide decline in interest rates to reduce their own lending rates during the period. The easing in official and market interest rates came later and was less extensive in the other countries than it was in Germany and the Netherlands.

EMS-related intervention was undertaken fairly constantly during the period and was heaviest during late August-early October and again in late November-mid-January. Although substantial intervention support was conducted in EMS currencies, especially the German mark and the Dutch guilder, sizable amounts were also done in U.S. dollars. Official dollar sales were particularly large, as it turned out, briefly in late August and during the winter months—times when the dollar was declining in the exchange markets.

Canadian dollar

As the period began, the Canadian dollar was recovering from a protracted and deep decline. The Canadian currency touched a historic low of U.S.$0.7683 (Can.$1.3016) late in June, but by the end of July had moved up nearly 4 percent to U.S.$0.7987 (Can.$1.2520). The Canadian dollar continued rising to about U.S.$0.8130 (Can.$1.23) in September, after which it traded for the most part within a 2 percent range around that level for the remainder of the period.

The recovery and subsequent steadier performance of the Canadian dollar reflected the subsiding of concerns that had clouded the currency's prospects for several years. Among these was a long-standing and harsh debate over the appropriate priorities for economic policy. Faced with deepening recession and climbing unemployment, on the one hand, and a persistent double-digit inflation rate fueled by high wage settlements on the other, the government chose to retain a strong anti-inflationary posture for both fiscal and monetary policy. The choice was convincingly evident in a summer budget message which had called for limits on salary increases of government employees and price increases in federally regulated sectors of the economy, as well as other measures designed to brake inflation during the next two years. Moreover, the government's initiative to restrict public-sector wage increases was quickly adopted by some provincial governments and helped set a pattern for private settlements. Monetary policy was also geared to forestalling inflation, including inflationary pressure from a further sharp decline in the Canadian dollar. Thus, interest differentials favorable to the Canadian currency had widened considerably, prompting Canadian provincial governments and some private concerns to borrow more abroad and to convert the proceeds in the exchange market.

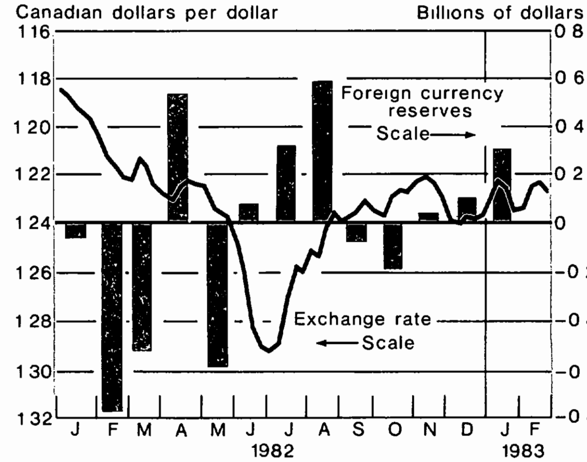
In addition, foreign concerns over Canada's controversial National Energy Policy had also faded. The policy was adopted in the fall of 1980 to stimulate Canadian ownership and development of the nation's natural resources. The pace of implementation had been significantly retarded in 1981, reducing what had been heavy capital outflows. By mid-1982 the government had gone further, with the Foreign Investment Review Agency cutting red tape and long delays in processing applications in an effort to rekindle direct private investment inflows. These developments eased market worries that Canada faced an extended reversal of the capital inflows which traditionally finance development and offset current account deficits.

Moreover, Canada's strong trade performance bolstered the Canadian dollar. Exports overall held steady

Chart 9

Canada

Movements in exchange rate and official foreign currency reserves

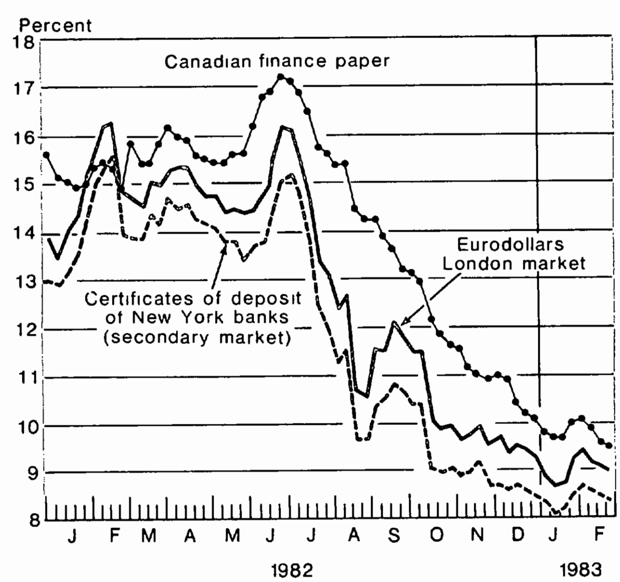


See exchange rate footnote on Chart 3

Chart 10

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

Three-month maturities*



*Weekly averages of daily rates

as shipments of automobile, grain, and energy products remained robust enough to offset declines in demand for other products susceptible to declining competitiveness and shrinking foreign markets. Meanwhile, imports had plummeted, reflecting weak domestic demand. Canada's current account was heading toward surplus for 1982, the first since 1973 Just on the basis of the first eight months of the year, Canada's trade surplus had cumulated to double the $5.5 billion total for all of 1981.

Against this background the Canadian dollar continued to move up gradually from early-August levels through the fall. However, it faltered at times when the decline in U.S. interest rates stalled or temporarily was reversed. The Canadian authorities were attempting to maintain a relatively smooth trend for interest rates, so that any temporary increases in U.S. rates resulted in a narrowing of the rate differentials favorable to the Canadian dollar, reawakening concerns that the recession at home would limit the scope of the authorities to follow should U.S. rates continue to rise. But, at the same time, the currency gained support as evidence accumulated that the weakness of the economy was finally showing through in a reduction of inflation and an easing of wage pressures. In late October the government issued an economic statement stressing its anti-inflation posture and including only minor changes to the budget for 1982, easing worries that significant new fiscal stimulus would be announced. The Canadian dollar then climbed to its highest point of the period at U.S.$0.8213 (Can.$1.2176) on November 10, a 6½-month high and a rise of some 2½ percent from end-July

With the Canadian dollar firm in the exchanges, the Bank of Canada made substantial net purchases of U.S. dollars during August-October. Canadian foreign exchange reserves rose $364 million to $2.4 billion, even though the authorities had by end-October repaid all the $2.4 billion drawings made by the end of June under standby facilities with commercial banks. Also, the government's revolving credit agreement with international banks had been enlarged by $1 billion to $4 billion during September.

After mid-November, the Canadian dollar eased. As a substantial deceleration of inflation in both consumer prices and wage settlements became more fully established and Canada's external position continued to improve, market participants became wary that the principal justifications for high Canadian interest rates would erode. At the same time, real GNP was reported to have declined at an annual rate of 4 percent in the third quarter—the fifth consecutive quarterly decline—while the unemployment rate had climbed to a post-depression high of 12.7 percent in October. Consequently, through early December, the Canadian dollar came off its highs, falling more than 2 percent to U.S.$0 8029 (Can.$1.2455), even as the U.S dollar was declining against most other major currencies.

Beginning early in December, however, the Canadian dollar steadied. Bank of Canada Governor Bouey forcefully ruled out a policy of pushing interest rates lower or depreciating the exchange rate and stressed the importance of consolidating hard-won gains on the inflation front. With the Canadian dollar remaining generally firm through December and January, domestic interest rates declined slightly more than those in the United States. The Canadian dollar closed the six-month period under review at U.S.$0.8086 (Can.$1.2367), down about 1½ percent from its November highs but nevertheless 1 percent above its end-July level. The Bank of Canada was a net purchaser of U.S. dollars over the three months ended in January so that Canadian foreign currency reserves rose $475 million. Over the entire six-month period under review, Canadian foreign currency reserves rose $839 million to close the period at $2.9 billion.

Mexican peso

At midsummer the Mexican authorities were implementing an economic program, announced in April, designed to redress the cumulative effects of several years of large fiscal deficits and aggressive industrialization efforts, slowing oil-export revenues, and heavy servicing costs on Mexico's large external debt. Although the peso had been allowed to depreciate to Mex.$49 by end-July from around Mex.$27 six months earlier, and other measures had been taken to reduce the fiscal and balance-of-payments deficits, concern remained that the policy measures in place were insufficient to meet announced intentions or the problems at hand. Commercial bank and Eurobond lending to Mexico had dried up, significant arrears had developed in private-sector debt payments, and considerable private capital had flowed out of Mexico apparently in expectation of further devaluation of the peso. In addition, Mexican foreign currency reserves had fallen to dangerously low levels over the preceding months. The Bank of Mexico had on three occasions drawn on its swap line with the Federal Reserve to meet month-end liquidity needs. The third of those drawings was for $700 million on July 30, which was repaid the following business day. In view of Mexico's worsening liquidity position and the government's undertaking to speed up implementation of its economic program after the presidential election had been completed, the Bank of Mexico requested, and was granted on August 4, a drawing of $700 million on its swap line with the Federal Reserve to replenish reserves while an adjustment program was worked out with the IMF. The drawing was for three-month maturity with possible renewal.

As part of its program, the government of Mexico announced a series of increases in prices of basic consumer goods, effective August 1, to reduce large subsidies that had bloated the government's deficit. The prospect of a further acceleration of Mexico's roughly 60 percent inflation rate generated a renewed surge of capital outflows.

With exchange market pressure at an intense level, the Mexican government announced on August 5 the introduction of a two-tier exchange system De-signed to avoid formal exchange controls while nevertheless channeling scarce foreign currency resources to priority uses, a preferential rate of Mex $49 was established, to apply to the Mexicans' payments of interest and principal on public-sector and "productive" private debt, as well as for "essential" imports. All other foreign exchange purchases were to be executed in a free market where the peso would float. On the inflow side, the proceeds of Mexican exports of petroleum products and new public borrowings abroad were to be converted in the "preferential" market, the free market to receive other sources of revenue. The free market peso rate immediately dropped to over Mex.$70 but the capital flight continued, forcing the peso rate rapidly downward. In response, on August 12 the authorities temporarily closed the foreign exchange market in Mexico and announced that henceforth any withdrawals from deposit accounts at Mexican banks denominated in U.S. dollars (so-called Mexican dollar accounts) would be permitted only in pesos.

Following high-level negotiations that weekend between the Mexican and the U.S. governments, the U.S. Government arranged guarantees from the Commodity Credit Corporation for $1 billion in private credit to finance exports of basic foodstuffs to Mexico during the subsequent year, as well as a $1 billion advance payment by the Department of Energy for oil to be added to the U.S. strategic reserves. To meet immediate cash needs, the U.S. Treasury arranged a temporary swap facility with the Mexican government for $1 billion until August 24, the date on which the Department of Energy advance oil payment would be executed. A drawing of $825 million was made and repaid under this facility. With the emergency funding from the U.S. authorities in place, the government of Mexico reopened the exchange market on August 19, this time on a three-tier basis. The priority rate of Mex.$69.50 was established to apply to withdrawals in pesos from Mexican dollar accounts. When the market reopened, the free market rate fluctuated between Mex.$100 and Mex.$130.

Meanwhile, negotiations with the monetary authorities of other countries proceeded, leading to the conclusion, on August 30, of a $1.85 billion multilateral financing arrangement, with $925 million through the BIS, $600 million from the U.S. Treasury, and $325 million from the Federal Reserve. The funds provided by the U.S. authorities were to be drawn on a *pari passu* basis with those of the BIS. Drawings were to be provided in line with progress toward an agreement between Mexico and the IMF on an adjustment program which would enable Mexico to qualify for drawings under the IMF's Extended Fund Facility.

The provision of official financing dealt with only part of the problem. By this time, considerable worry had developed in the international financial community that Mexico would be unable to service its roughly $80 billion in external indebtedness, and private-sector external finance remained difficult if not impossible to arrange. With a heavy burden of international debt obligations maturing in coming months, Mexico's Secretary of Finance met on August 20 with 115 financial institutions with significant exposure to Mexico to solicit the banks' cooperation in accepting a ninety-day grace period, commencing August 23, in which maturing loans would be renewed for ninety days at current market rates. In return, the Mexican government would bring all public-sector interest arrears current, pay in full at maturity all publicly issued bonds and notes, and develop an economic adjustment program acceptable to the IMF. An advisory group of commercial banks was established to conduct negotiations on debt restructuring and arrange for a new financing of $1 billion from the commercial banks. The response of the banking community to this initiative was positive.

On September 1, however, outgoing President Lopez Portillo surprised the international financial community when he announced in his final state of the nation address decisions to nationalize Mexico's private commercial banks, to impose formal exchange controls, and to adjust interest rates in Mexico. Interest rates on several categories of loans were reduced significantly, while rates on small bank deposits were increased. The new exchange controls had the effect of eliminating the free foreign exchange market, all transactions to be conducted at a new "preferential" rate of Mex.$50 or an "ordinary" rate of Mex.$70. Foreign exchange would be sold to Mexican residents at the ordinary rate as available.

Following these initiatives, interbank trading in pesos continued outside Mexico for a time, even though the free peso market in Mexico was closed. But, before long, virtually all foreign exchange receipts other than those derived from oil exports or official borrowings were left abroad, either to pay for imports or to be held in liquid form. Thus, there was little foreign exchange available through the official "ordinary" rate market established under the exchange controls. In addition, the overseas branches of Mexican banks encountered considerable difficulty maintaining interbank deposit lines, and the withdrawals at times placed pressure on Mexican foreign exchange reserves. In these circumstances, the peso gradually dropped to Mex.$125.

On November 12, the government agreed in principle with the IMF management on an economic adjustment program which would, if approved by the IMF executive directors, provide Mexico with about $3.9 billion of IMF financing over a three-year period. The program, considerably more stringent than the April one, called for a sharp reduction of Mexico's fiscal deficit as a share of gross national product, progressive reduction of Mexico's net external borrowing though 1985, exchange rate and interest rate policies to assure competitiveness of Mexican exports and to promote domestic savings, and a substantially reduced current account deficit. The program was expected to result in a sharply lower rate of real domestic economic growth at least through 1984. It was designed to reduce drastically Mexico's inflation rate then running at nearly 100 percent, so as to build a foundation from which Mexico could resume the stable and sustainable real economic expansion required to service its external obligations and to meet domestic demands for improved living standards. The letter of intent was signed by the outgoing Lopez Portillo administration but carried the full endorsement of Miguel de la Madrid, scheduled to take office as president of Mexico on December 1.

With the letter of intent signed only about two weeks prior to the expiration of the ninety-day grace period on maturing external debt obligations, the government of Mexico asked international banks to extend the grace period through March 23, 1983 under roughly the same terms as before. During much of the balance of the period under review, the government worked with the banks on the outlines of a program for dealing with Mexico's external indebtedness and financing needs through 1983, to include not only public-sector needs but also arrears of interest payments on private-sector debts. The main elements in the proposal involved restructuring about $20 billion in public-sector debts and the raising of $5 billion of new money from the banks to meet Mexican financial needs for 1983. Any new funds were to be drawn in phase with the availability of funds under the IMF agreement, *i.e.*, subject to the condition that Mexico remain in compliance with the economic adjustment program agreed with the IMF. It was also envisaged that banks would maintain the level of their interbank deposits with Mexican banks operating in overseas markets.

The new president, in his inaugural address, endorsed the undertakings Mexico had made with the IMF, while also indicating that the exchange controls would be modified. On December 13 and December 20, respectively, a presidential decree was signed and Bank of Mexico procedures were published to establish exchange controls intended to direct more foreign exchange into Mexico's official reserves and banking system. Toward this end, effective December 20 two separate markets were established, one controlled and the second free of controls. The controlled market was to include all commercial exports, the foreign currency costs of border trading firms, all operations with respect to public and private debt, costs of diplomatic and consular services, and contributions by Mexico to international organizations. The Bank of Mexico specified initial buying and selling rates for the controlled market at Mex.$95.00-95.10 with the rate to be depreciated steadily in line with the inflation differential between the United States and Mexico, calculated initially at an annual rate of about 50 percent. It was intended that over time the controlled and free market rates would converge. The free market was intended for all transactions not specifically eligible for the controlled market. It was initially set up with guidance from the central bank to facilitate an orderly opening, the guidance to be eliminated as soon as possible. When the market opened on December 20, the rate was set at Mex.$148.50-150.00. The free market eliminated the special border zone for foreign exchange established in early November. After some nervousness, markets settled down and the peso quotations on the interbank market in the United States moved in line with the free market rate in Mexico.

On December 23, 1982, the IMF announced that its executive board had approved the Extended Fund Facility for Mexico, and initial drawings under the facility were made immediately thereafter. The Bank of Mexico, using the proceeds of these borrowings, made partial repayment of its drawing on its regular swap line with the Federal Reserve in December and January so that, as of January 31, $373 million was outstanding.

For the remainder of the period under review, the peso traded relatively quietly and narrowly in the overseas interbank market, quoted generally in line with the free market rate in Mexico. Between December 20 and January 31, 1983, the free market rate in Mexico was adjusted toward the controlled market on three occasions to Mex.$147.90-149.40 at the close of the period, while reflows of capital—largely from individuals

—permitted the Mexican commercial banks to purchase a sizable amount of dollars in the free market through end-January. At the same time, the controlled rate was adjusted lower daily to Mex.$100.46, a depreciation of 5½ percent as compared with the December 20 level.

The steadiness of the rate in the U.S. overseas interbank market during this interval reflected general market perception that the de la Madrid administration had made an effective beginning on dealing with the problems at hand. This positive response helped Mexico husband its reserves and, by the close of the period, a small amount of the combined $1.85 billion U.S.-BIS credit facility remained to be drawn. Negotiations were not yet complete on the debt restructuring or on details of the $5 billion loan, but a total of about $4.7 billion in new money had been pledged by banks that were participants in those negotiations. These matters remained of critical priority, however, as signs of stress were accumulating in Mexico. Production bottlenecks were widespread, due to limited availability of imported goods. In addition, commercial banks abroad remained concerned about the need to deal with overdue principal payments on private-sector debt. Thus, more work remained to be done before all necessary elements of a successful adjustment program could be said to be in place.