BANK FOR INTERNATIONAL SETTLEMENTS

FORTY-SIXTH ANNUAL REPORT

1st APRIL 1975 – 31st MARCH 1976

BASLE

14th June 1976

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FORTY-SIXTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 14th June 1976

Gentlemen,

I have the honour to submit herewith the forty-sixth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1975 and ended on 31st March 1976.

After deduction of 5,588,025 gold francs transferred to the Provision for Exceptional Costs of Administration, the net profit for the year amounted to 178,876,749 gold francs, compared with 182,063,281 gold francs for the preceding year and 145,063,281 gold francs for the financial year 1973–74.

The Board of Directors recommends that, in application of Article 51 of the Bank's Statutes (as amended in July 1975), the present General Meeting should allocate the sum of 47,876,749 gold francs in payment of a dividend of 100 Swiss francs per share.

The Board further recommends that 52,400,000 gold francs be transferred to the General Reserve Fund, and the remainder of 78,600,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1975–76 will be payable to shareholders on 1st July 1976.

Chapter I introduces the Report with a survey of economic problems and policies in the context of the world's deepest post-war recession and the broad recovery that now seems well under way. Chapter II looks in more detail at the course of the business cycle, while Chapter III examines the progress made towards taming inflation and the rôle of monetary policy in this process. Chapter IV goes on to analyse the impact of these developments on domestic credit and capital markets. Turning to the international sphere, Chapter V describes the changing pattern of trade and payments; this is followed in Chapter VI by an account of developments in the international credit and capital markets, with particular reference to the Euro-markets. Chapter VII focuses on questions relating to exchange markets, floating rates, global reserves, gold and monetary reform. Chapter VIII deals with the Bank's activities during the financial year, the Balance Sheet and the financial results.

I. A SURVEY OF ECONOMIC DEVELOPMENTS: 1975–76.

Two general themes run through this Report. The first is that the deep recession in the industrial countries in 1974–75 and the broadly based recovery which is now following have solved some of the more immediate problems that appeared intractable only a year ago. The market economies have displayed greater resilience and flexibility than even their most faithful supporters had dared to hope. This should instil some humility in forecasters — and lend courage to policy-makers. For, if the second theme of this Report is correct, courage they are going to need. It is argued that neither the recession nor the current revival has solved the major underlying long-term problems; they have merely managed to repress or conceal them. The testing-time for policy will come as the upswing gathers momentum and new strains emerge. And some countries seem to stand a better chance of facing up to these than others.

From recession to recovery: a success story.

The profile of recession and recovery is described in Chapter II. The recession was longer and more painful than any since the Great Depression. But it is now clear that most of the industrial countries are experiencing a vigorous cyclical upturn which in many respects seems to be following quite closely the traditional pattern. After the combination of inflation and recession had dealt a sharp blow to confidence, business and consumer optimism rapidly revived, and the recovery seems to be developing much along text-book lines. This favourable turn of events owed a great deal to the action of governments, which had successfully applied the necessary measures to prevent the recession from degenerating into depression. As a result, pre-recession levels of real GNP have been regained by those larger countries which are leading the revival — i.e. the United States, Germany and France. Some of the industries where only nine months ago the outlook seemed quite bleak — for example, the motor industry — have picked up strong momentum. True, unemployment remains disturbingly high, but it has ceased rising, and indeed has recently been declining in a number of countries. True, the recovery has not yet embraced all sectors — investment goods industries are still lagging behind — but this is to be expected after such a deep recession. Nor is the degree of recovery the same in all industrial countries. Nevertheless, one would have to be rather pessimistic to believe that the simultaneous upturn now under way in all major industrial countries will come to a halt somewhere in the middle.

Meanwhile, the rate of inflation has slackened noticeably (Chapter III). By the spring of 1976 the twelve-month rate of increase in consumer prices had been brought down to about 2½ per cent. in Switzerland, 5–6 per cent. in the United States and Germany and around 8–11 per cent. in most other countries. In the United Kingdom, too, recent developments suggest that the monster of two-digit inflation is retreating. In Italy, however, the inflationary outlook has taken a disturbing turn since the beginning of the year. Though it has accelerated since mid-1975, the growth of the money supply in some major countries has been relatively slow during the recession and the early phase of recovery, suggesting that the proper lessons were drawn from the inflationary excesses of the previous cycle.

In view of the near-crisis conditions reached in many economic sectors, the development of domestic credit and capital markets (Chapter IV) has been remarkably smooth. Up to the spring interest rates were declining, or at least remained stable, and this as much as a year after the trough of the business cycle. However, rates rose sharply in some of the countries hit by the exchange disturbances in early 1976 and have since firmed more generally. The "normal" relationship between long and short-term rates has again become the rule, helping to re-establish a healthy market for long-term funds. Benefiting from this, enterprises have succeeded in improving their debt structure. The huge rise in the public sector's financing deficit does not yet seem to have "crowded out" anybody. In fact, since there was a sharp net fall in the business sector's demand for credit, it was easily financed by the sizable increase in household savings.

International trade and payments (Chapter V) have been much less disturbed than one had reason to fear. Admittedly, under the impact of the recession in the industrial countries, the volume of international trade has declined for the first time since the war. But, with the recovery, trade volume appears to have been picking up fairly strongly since the autumn of 1975. More important still, balance-of-payments disequilibria have been tending to diminish, and their financing has proved manageable. The current surplus of the OPEC area declined in 1975 to about half of what it was in 1974; the large deficit of the industrial countries as a whole practically vanished (although it reappeared from the autumn onwards) and the deficit of the non-oil less-developed countries (LDCs) was financed more easily than expected — thanks, to a large extent, to the vigorous expansion of international bank lending.

The development of international bank lending (Chapter VI) has been remarkable on at least two counts. First, commercial banks have granted credits on a large scale to LDCs and other deficit countries, both through the Euro-currency market and out of domestic funds. Coming on top of earlier lending, predominantly to industrial countries, this amounts to an increasing involvement of the commercial banking community in balance-of-payments financing. Secondly, despite the worries expressed about the proliferation of this kind of risk-taking, the commercial banks have on the whole fared much better in 1975–76 than in 1974. Their profits and net assets have increased, although concern has persisted about the structure of their balance sheets.

Those who are optimistic by nature can even point to one or two satisfactory developments on the international monetary scene last year (Chapter VII). During the summer the US dollar made up part of the ground lost between early 1974 and the spring of 1975, and since then has remained relatively stable, both in terms of the effective exchange rate and vis-à-vis the "snake" currencies. Moreover, agreements were reached in Washington, Rambouillet and Jamaica on a number of points regarding the international monetary system. While these agreements can hardly be called a "reform", they have at least the merit of adjusting the Articles of the IMF to current realities.

Trouble ahead?

Such a sanguine view of current economic trends, however, neglects many of the underlying problems which are analysed in various chapters of this Report.

Well before the last recession the growth trend of real output in the major industrial countries was slowing down, with that of fixed capital formation dropping even more markedly. Despite the recovery in output, unemployment rates seem to be coming down only slowly from their socially unacceptable levels. Enterprises have not yet shown any obvious enthusiasm for increasing investment, and all economic projections foresee the persistence of high levels of unemployment. The rate of inflation, while lower than a year ago, is much higher in all countries (except Switzerland) than in the similar phase of earlier business cycles. Considering the depth of the recession, commodity prices (especially food) tended, on the whole, to remain high and they have again been on an uptrend for some time now. While wages are rising more slowly, they still outpace the expected rate of productivity growth. The substantial increase in public-sector deficits in 1974–75 was mostly due to the recession; but in some countries it was superimposed on an adverse trend which had started some years ago. The recession made it possible to finance these deficits without any excessive expansion in the money supply. But will monetary authorities be able to maintain moderation once loan demands from the enterprise sector start rising?

In the international economy, the current accounts of the major industrial countries began deteriorating in conjunction with the current business revival. This underlines the precarious nature of the balance achieved in the first half of 1975. At the same time, many of the non-oil-producing LDCs are unlikely to benefit from a rise in their export earnings sufficient to offset the price increases for their imports of fuel, food and industrial products. The financing of payments disequilibria has so far progressed remarkably well, thanks largely to official loan assistance and grants but also in substantial measure to commercial-bank credit. But to what extent can the commercial banks be expected to go on fulfilling this function? And, indeed, should their growing involvement in country financing be welcomed? As for exchange rates, the relative stability of the dollar should be set against the major disturbances experienced in Europe during the early months of 1976, with the lira falling sharply, the pound sterling declining and the French franc withdrawing from the "snake" arrangements. The steadily widening range of exchange rates in Europe points to deep-seated imbalances between countries and at the same time raises serious doubts about the ability of appreciations and depreciations to correct them. As for the relative stability of the dollar/DM rate since last summer, a much longer period is needed to test it to the full. More generally, while the Washington and Jamaica agreements have put a formal end to the world of Bretton Woods, they have not produced a new set of really binding rules governing balance-of-payments adjustment and financing. The continuing confusion is well illustrated by the fact that central-bank intervention in 1975–76 reached proportions reminiscent of the old days of pegged rates. And what has it achieved?

To a large extent, of course, there is no contradiction between the optimistic interpretation of recent developments and the deeper concern over underlying, unresolved problems. On the one hand, the optimism derives from, and is justified by, the fact that the industrial countries have displayed a remarkable ability to extricate themselves from their painful recession and to achieve a measure of success in fighting inflation. On the other hand, the problems are those which by their nature can be expected to resurface unresolved as the upswing advances. It may also be argued that a year ago most policy-makers would have been happy to be confronted with problems arising out of a recovery — which then appeared very remote indeed.

The contrasts to be found in present economic trends are, however, not merely a matter of time perspective. The following chapters try to show that the most significant feature of the past year has been a growing divergence in the behaviour of the major industrial countries — both in their policies and in the actual course of their economic development. Therefore any general description is bound to take account of these divergent tendencies.

Diverging patterns of behaviour.

The whole of the western industrial world has been exposed since the late 1960s to a series of common challenges. The latest and most sudden was the steep rise in the prices of oil and commodities in 1973–74, which resulted in a sharp deterioration in the terms of trade of the developed areas. While these did improve slightly in 1975 as compared with the low recorded during the second quarter of 1974, they were at the end of 1975 still some 10–12 per cent. less favourable than they had been in mid-1973.

It would be a mistake, however, to focus our attention exclusively on this external "shock", because strong disruptive forces had already been at work for some time. Inflation was the most obvious among them. But the most important, and that which probably lies at the root of many difficulties (including inflation), was a gradual yet fundamental alteration in the patterns of income distribution and growth. For reasons which are hard to detect, several interconnected changes began taking place in the late 1960s and the early 1970s: a decline in the real rate of return on capital; a rise in the share of wages and salaries in the national income at the expense of profits; a declining trend in fixed capital outlay by the enterprise sector; a growing share of government in GNP; a slow-down in the growth of productive capacity and, therefore, in real growth itself.

In that period, nevertheless, rising aspirations with regard to real income and a legitimate desire to protect employment prompted governments to embark upon expansionary monetary and fiscal policies at the appearance of the slightest slack in demand. During the moderate recession of 1971–72, for instance, highly stimulatory measures to create money and increase expenditure were taken simultaneously by many countries, seemingly oblivious to the fact that the growth of capacity had already slowed down. The outcome was world-wide inflation, disorderly markets for short and long-term funds and, in the end, a deep recession with high unemployment. The upsurge of oil and commodity prices, by accelerating cost-push inflation and at the same time dampening demand, added new impetus to both price increases and the recession. But it was not the prime mover.

Meanwhile, the international monetary system inherited from Bretton Woods collapsed: the US dollar, overvalued vis-à-vis other currencies and gold, had become incapable of performing the functions of the unchallenged international reserve currency. The difficult adjustments of the 1970s had to be met in a world in which floating, combined with easy access to international credit markets, left individual countries very much free to "choose" their own policies. These policy adaptations, moreover, had to be made in the face of the triple challenge of a changing pattern of growth, sharply higher oil and commodity prices and the absence of agreed rules governing the international adjustment process.

The "choices" have varied considerably from country to country, according to their tradition, social structure and political organisation. At one end of the spectrum lie Germany, Switzerland, the United States and perhaps Japan. Admittedly, it would be foolhardy to maintain that these countries have actually solved their major problems; but it is also clear that they are much farther than other countries along the road towards doing so. The story began when all four put an early emphasis on the fight against inflation — even at the risk of leading themselves, and the world, into recession and high unemployment. Over the ensuing two years wage settlements led to a decline in real wage rates in the United States and to only moderate gains in Germany, Switzerland and Japan. Inflation rates have been brought down substantially, mainly as a direct result of domestic policies but — in the cases of Germany and Switzerland — also under the impact of currency appreciation. Real interest rates have become positive, and the credit and capital markets have returned to normal. Last but not least, caution continues to prevail: all four countries seem determined to achieve a sizable reduction in the public-sector deficit. It is perhaps no coincidence either that three of these countries — Germany, Switzerland and the United States (a fourth being Canada) — have adopted explicit (and publicly announced) targets for monetary aggregates. Nor is it a coincidence that Germany, Japan and the United States were well placed to lead the world out of recession.

Indeed, they can well afford to do so. Not only are their external positions relatively strong, but they are embarking upon business recovery in conditions which justify some hope that the upswing will not turn into the "boom-and-bust" variety. Wage settlements have remained moderate so far, the increase in business profits and cash flows has become either a fact or at least a recognised objective, and company and bank balance sheets have improved. In short, there is some hope (though not yet a certainty) that a non-inflationary rise in fixed capital investment will develop, leading to the absorption of unemployment.

At the other end of the spectrum are those countries whose inflation rates are still well above 10 per cent., whose current accounts are still (or again) running large deficits, and whose currencies have been depreciating. Of these, Italy and the United Kingdom are the main examples. It is significant that in both Italy and the United Kingdom the public-sector deficit has shown a rising trend for some years, and therefore cannot be ascribed exclusively to the recession. When one looks at the last few years, it appears that in both countries downward floating has become part of a vicious circle rather than of a process of adjustment. Their example shows clearly that while floating (even downwards) may be unavoidable in present circumstances, it does *not* grant countries freedom to neglect real, internal adjustment if they want to eradicate inflation and re-establish external balance. And the very recent experience of the United Kingdom demonstrates how difficult it is to break out of this vicious circle even when both the government and public opinion have come to realise the need to do so and are ready to take, or accept, drastic policy measures.

While it is in these two large countries that the problem of inflation has been most deep-rooted, a number of the other industrial countries seem to find themselves somewhere between the two extremes. Though they have generally made progress towards reducing their inflation rates, both wages and prices are still rising at uncomfortably high rates. In the spring of 1976 the twelve-month rate of price increase in most other countries, including the Benelux, Canada, France and Sweden, fell within a range of 8–11 per cent., while wage gains were running at between 13 and 16 per cent.

It appears, therefore, that industrial countries have responded in very different ways to the changes in their growth patterns and income distribution, and to the deterioration in their terms of trade. It is, moreover, difficult to assess with any degree of certainty which of them have in fact succeeded in making the necessary real adjustment; and this doubt applies even to those countries which, on the basis of the most recent experience, appear to have performed much better than the others. The reason for this uncertainty lies in the recession which re-established external balance on current account and has slowed down inflation. But, as the recovery moves ahead, the real problems of adjustment — clearly perceived by most in 1974 but swept under the rug by the recession — will reappear.

The diverging patterns of behaviour among the major industrial countries, which are so vividly reflected in exchange rate developments, should be a major source of concern to public opinion as well as to policy-makers. And not only in those countries which are caught up in a vicious circle of inflation and exchange depreciation. The concern must be international, for it is hard to see how some countries could prosper when others face the prospect of a major disruption in their economic life.

II. RECESSION AND RECOVERY IN THE WESTERN INDUSTRIAL WORLD.

The western industrial countries are by now well along the path of recovery from the worst recession experienced since the 1930s.

Following the vigorous boom in 1972 and 1973, the steep drop in activity from late 1973 into 1975 had clearly been greater than any previous post-war decline, as measured by industrial production, real GNP and employment. Moreover, the downslide had been generally twice as long as earlier post-war recessions. Its unusual amplitude resulted from a combination of several factors which were already discussed in last year's Annual Report: the synchronisation of the boom, which had produced world-wide bottlenecks and shortages of energy and raw materials; the strong and persistent inflationary forces, which had caused real and financial distortions, fast inventory disinvestment and a sharp decline in fixed capital formation; the deflationary impact of soaring commodity prices and quadrupled oil costs; and the cumulative effects of restrictive monetary and fiscal policies aimed at bringing down two-digit rates of inflation to acceptable levels. Once the process of decline had been set in motion, strongly rising unemployment and the inflationary erosion of financial assets brought about an unexpected rise in personal savings ratios, and this accelerated the decline well in excess of practically all official and private forecasts.

No wonder that by early 1975 the mood in all western industrial countries had turned to dark pessimism. Plunging profit rates, alongside rising excess capacity, had undermined business confidence. The high level of unemployment, heavily concentrated among the young and in particular sectors, had created understandable concern. Moreover, the persistence of high rates of inflation — which was hard to reconcile, within the framework of traditional economic thinking, with the declining utilisation of resources — made it difficult for governments to relax their anti-inflationary stance, and practically impossible to embark upon active policies of stimulation as long as there were no clear signs of inflationary pressures diminishing. All this led to gloomy predictions. Some observers expected the recession to continue and deepen; others even talked of a world-wide depression and the crisis of capitalism.

We know now that the upturn started just about when the pessimism was at its greatest. As measured in terms of industrial production, it began in the spring of 1975 in Japan and the United States, and in the summer in Germany; from there it has spread gradually to most of western Europe.

This chapter recounts the story of the recession and the upturn. It attempts to identify the factors which lie behind the current recovery and tries to assess their strength. The conclusions are relatively optimistic as regards the immediate future; but it also appears that only few countries — and even these only to a limited extent — have managed to bring under control those forces which might lead to a revival of inflation, inadequate capital formation, international disturbances, and hence a premature braking of the current business upswing.

Fluctuations in industrial production, 1974–76.

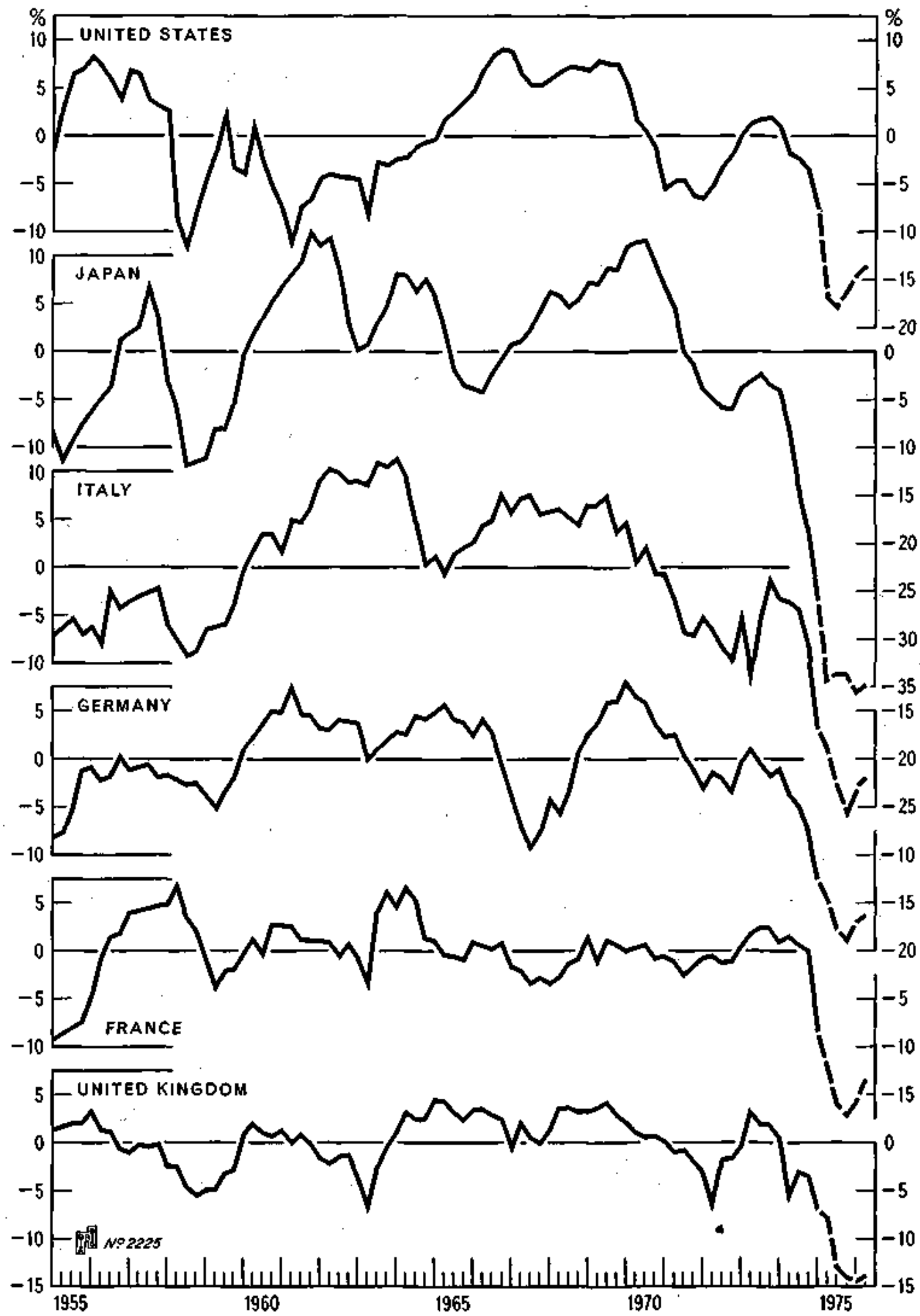
The synchronised economic expansion came to an end near the close of 1973, when production peaked in several major industrial countries. The steep drop in activity in 1974 and early 1975, the bottoming-out of the recession around mid-year and the subsequent recovery in activity are recorded clearly in the movements of industrial production indexes. Since quarterly movements of GNP are not available for the wide range of countries of interest here, the industrial production indexes have been taken as a good means of drawing comparisons between countries, although they are much less comprehensive measures of real economic activity. The movements of these indexes outline the peaks and troughs of national cycles. They reveal a pattern of leads and lags among the large and small industrial countries as well as the depth and duration of production swings.

The 1974–75 recession was the most severe experienced during the post-war period. The characteristics of the recent cycle can be compared with earlier fluctuations both in particular countries and across countries in the following graphs, which depict deviations of industrial production from log-linear trends. Any point on the cycle indicates the deviation of the actual industrial production index from the trend level, expressed as a percentage of the trend value. During the period 1955–74 for which the growth trends were calculated, Japan and Italy achieved the highest long-run average growth: 12.3 per cent. and 7.1 per cent. respectively, represented by the horizontal lines in the graph. Average growth in the United States and the United Kingdom lay at the lower end of the range: 4.6 per cent. and 3.6 per cent. respectively. In general, output in France and the United Kingdom has oscillated much less than in the United States and Japan.

One interesting conclusion that may be drawn from the graph is that the 1974–75 recession hit major countries when the level of industrial output was already below the long-run trend of the past twenty years. Indeed, it appears that the trend may itself have undergone a fundamental change in the late 1960s. From 1971 onwards, in any case, the index of output in most of these countries was below the long-term trend level except (in some instances only) in the boom year 1973. This raises the obvious question whether the severity of the recession should not be regarded as the manifestation of a major break in the growth trend of the western industrial world rather than as just one of the usual business cycles sharpened by an accidental coincidence of "special" factors, such as the synchronisation of both the boom and the recession and the sharp rise in oil prices.

The time sequence of the 1974–75 recession, the trough and the subsequent recovery is shown in the following table. Industrial production peaked first in the United Kingdom in October 1973, and then in Japan, Germany and the United States in November. Following this lead, output in the other industrial countries soon crested and then began to fall back, with lags of some four to twelve months. At first the leading countries experienced only modest declines in output. All

Cycles in industrial production.*



* Percentage deviations of industrial production indexes from their log-linear trend values. The average compounded growth rates represented by the zero lines are as follows: United States, 4.6 per cent.; Japan, 12.3 per cent.; Italy, 7.1 per cent.; Germany, 5.4 per cent.; France, 5.7 per cent.; United Kingdom, 3.6 per cent. The trends are based on quarterly data for the period 1955-74.

indications pointed to a relatively mild recession, both in the United States and in Europe. But after the deflationary forces had cumulated late in 1974, production in most countries plunged. The fall was very sharp in virtually all the advanced countries in the fourth quarter of 1974 and the first quarter of 1975. In the United States, for example, industrial production fell by 12.3 per cent. from the third quarter of 1974 to April 1975, after having dropped by only one per cent. in the previous ten months. By late 1974 the serious deterioration in consumer confidence and the weakening of personal income had led to a sharp cut in household spending, particularly on consumer durables. Business financial positions had worsened markedly, compelling a rapid liquidation of inventories and a cut-back in fixed investment, both of which accentuated the decline in output already under way.

In the spring of 1975, when the economic climate in the industrial world was at its gloomiest, the seeds of recovery began to take root. By that time the major countries, which had been in a downturn for about a year and a half, had already relaxed monetary restraint and initiated some fiscal stimulus, albeit cautiously.

Recession and recovery in industrial production.

Countries	Recession						Recovery	
	Cyclical peak 1973–74[1]	Cyclical trough 1975[1]	Number of months	Percentage change in production: Peak to trough	Percentage change in production: 3rd quarter 1974 to trough	Trough to latest month	Latest month	Number of months
Countries leading the downturn								
United Kingdom	Oct. 73	Aug.	22	− 10.6	− 8.5	1.8	March 76	7
Germany	Nov. 73	July	20	− 11.5	− 8.7	7.0	March 76	8
Japan	Nov. 73	Feb.	15	− 20.4	− 13.9	16.7	March 76	13
United States	Nov. 73	April	17	− 13.5	− 12.3	11.4	April 76	12
Countries following by 4–6 months								
Switzerland	March 74[2]	March[2]	12	− 18.5	− 16.0	14.0	Dec. 75[3]	9
Canada	March 74	Sept.	18	− 8.0	− 5.9	4.5	March 76	6
Italy	April 74	Aug.	16	− 15.6	− 13.6	9.4	March 76	7
Countries following by more than 6 months								
Austria	June 74	Oct.	16	− 9.9	− 8.7	3.2	Feb. 76	4
Belgium	June 74	July	13	− 13.8	− 12.5	9.6	Feb. 76	7
Finland	June 74	July	13	− 10.3	− 10.0	1.5	Dec. 75	5
Netherlands	June 74	July	13	− 10.0	− 9.7	6.0	March 76	8
Spain	June 74	March	9	− 11.7	− 9.3	2.7	Dec. 75	9
Sweden	June 74	July	13	− 5.6	− 4.2	6.9	Feb. 76	7
France	July 74	May	10	− 13.1	− 5.6	9.0	March 76	10
Norway	Nov. 74	Sept.	10	− 4.9	− 2.8	6.3	March 76	6

[1] Peaks and troughs based on three-month centred averages of seasonally adjusted industrial production indexes from national sources. [2] First quarter. [3] Fourth quarter 1975.

After the sharp decline, industrial production first levelled out in Japan (February) and the United States (April) as well as in some of the smaller countries.

Whereas the individual downturns had been spread over a period of some twelve months, the troughs in national output were narrowly clustered in the summer of 1975, particularly those of the major European economies. Signs of revival began to appear in the form of quickening consumer demand, the completion of stock liquidation and some actual resumption of stock-building later in the year and, in some countries, a pick-up in export orders and housing construction. The pattern of recovery seemed to point to a mutually stimulating rise in expenditure by major countries — namely the United States, Japan and Germany — which was spread via international trade to their trading partners.

The recovery — measured by the percentage rise in industrial output from the trough to the latest monthly figure available — has gone far enough to make good a substantial part of the decline in production suffered during the recession. The upswing has reversed about three-quarters of the previous decline in Belgium, France, Germany, Japan, Switzerland and the United States, while Italy and the Netherlands have recovered by roughly one-half. Among the major countries, activity is lagging only in the United Kingdom and Canada, but these countries had not been hit by as deep a recession as the others.

The picture is less rosy, however, if one looks back at the graphs. Industrial production in all major countries is still very far off the level corresponding to the growth path of the last twenty years. Only a production increase going well beyond the 1973–74 peaks could ensure the continuation of that trend. The sheer graphical impression is that this is unlikely to happen.

Continued growth outside the OECD area.

While there has been a fairly close synchronisation in the business cycle of western industrial countries, this is fortunately not true for the world as a whole. Even though the recession had gradually spread throughout the industrial world by early 1975, the eastern European economies and many of the emerging industrial countries continued to grow, albeit at slower rates. Many of them sought to continue their national investment programmes, and therefore went on importing capital goods, materials and other manufactures from the industrial world. Indeed, the OPEC countries were straining to grow rapidly and to absorb an overwhelming inflow of imported manufactures. To this extent, the level of real activity in some of the industrial countries was actually aided from abroad. This is shown in some detail in Chapter V.

The industrial growth of eastern European countries remained generally high in 1975, with increases in industrial production ranging from 7.5 per cent. in the Soviet Union to 12.4 per cent. in Rumania. Everywhere, the prime engine of growth was fixed industrial investment. One of the principal policy objectives was to generate productivity gains in order to overcome the higher prices of raw materials and oil, as well as the shortages of skilled labour emerging, for example, in the German Democratic Republic and Poland. In contrast to the industrial sectors, agriculture has on average fallen below target levels and constitutes the chief brake on overall economic growth.

As for the non-oil LDCs, their growth had been stimulated until well into 1974 by the high level of commodity prices — and therefore rising export earnings — which for the group as a whole had offset initially the increase in oil costs. At a later stage, of course, they began to feel the impact of the recession in the major industrial countries. Their export volumes declined and the terms of trade deteriorated with the collapse of commodity prices and the steady rise in prices of manufactures, the latter reflecting continuing inflation in the industrial countries, and in some cases exchange appreciation as well. Nevertheless, many of the LDCs still managed to maintain manufactured imports by using trade credits, borrowing in the international capital and money markets, and drawing down foreign exchange reserves to finance their mounting trade deficits.

The rôle of consumer demand, government policies and inventory adjustment in the upturn and recovery.

It is not easy to assess the relative contributions of demand components to the upturn and the current recovery, which took most observers so much by surprise. Quarterly figures on GNP are available only in a few countries, and data on investment in stocks are in most cases unreliable. One has therefore to rely mainly on yearly GNP figures; and this is particularly inconvenient for 1975, since data for that year still strongly reflect the recessionary forces dominant at least until the summer. Stock adjustments and the external balance contributed very substantially to the revival of economic activity, just as these demand components had sharply steepened the decline in activity in the fourth quarter of 1974 and the first quarter of 1975 (see table). In some countries, for example the United States, the United Kingdom and Germany, housing construction recovered somewhat, partly in response to generally easier monetary policy, but this activity contributed only in small part to the rise of GNP in late 1975. On the negative side, business fixed investment generally persisted as the major drag on aggregate demand into 1976.

Revival of consumer spending. Consumer behaviour, however, was the key to the economic upswing that occurred in most countries during 1975, much as it had played a significant rôle in the recession the year before. Over 1975, private consumption made a sizable positive contribution to the change in GNP in France, Germany, the Netherlands, Japan and the United States, just to cite the major instances. For example, in the United States private consumption contributed a positive 0.6 percentage point to the overall change in GNP, which nevertheless declined by 2.0 per cent. on balance. Similarly, the positive effect of consumer spending was not enough to overcome the negative impact of other sectors in Austria, France and the Netherlands, where the decline of total investment was the major depressant throughout the year, or in Germany, where both the external sector and investment had a negative effect on GNP. At the same time, in Japan consumption was the most important factor in the rise in real GNP and has to a large extent offset the drag exerted by weak fixed investment and stock liquidations. Only in Italy and Switzerland did consumer spending decline significantly in 1975. In both countries a substantial fall in fixed investment also depressed real GNP. A positive contribution

Contribution of changes in demand components to changes in real gross national product.

Countries	Years	Real GNP	Net external balance	Investment: stocks	Investment: non-residential	Investment: dwellings	Consumption: private	Consumption: public
		percentage change	contribution to percentage change in GNP*					
Austria	1973	5.8	− 1.3	3.5	0.9		2.4	0.4
	1974	4.1	0.6	0.6	0.3		2.1	0.4
	1975	− 2.0	0.8	− 2.8	− 1.7		1.4	0.3
Belgium.	1973	6.2	− 1.5	1.0	0.4	1.2	4.5	0.7
	1974	4.0	0.2	0.5	0.8	0.6	1.7	0.4
	1975	− 1.4	0.4	− 2.5	− 0.5	− 0.1	0.5	0.8
Canada	1973	6.9	− 0.7	0.5	1.8	0.4	4.4	0.7
	1974	2.8	− 3.2	1.0	1.4	− 0.1	2.5	1.5
	1975	0.2	− 0.8	− 2.5	0.9	− 0.5	2.2	1.0
Denmark	1973	2.8	− 5.7	3.2	2.0		3.0	0.3
	1974	1.9	4.6	1.2	− 2.1		− 2.1	0.4
	1975	− 1.0	.	.	.		.	.
Finland	1973	6.5	− 1.3	1.8	1.0	0.3	3.8	0.9
	1974	4.4	− 2.0	2.7	0.5	0.4	2.2	0.6
	1975	0.0	− 3.8	0.5	1.4	− 0.7	2.0	0.6
France	1973	5.9	− 0.4	0.8	1.1	0.4	3.5	0.5
	1974	3.8	0.6	− 0.5	0.5	0.3	2.5	0.4
	1975	− 2.5	1.6	− 4.2	− 1.0	− 0.2	1.3	0.0
Germany	1973	5.1	2.1	0.7	0.2	0.0	1.6	0.6
	1974	0.4	3.0	− 1.2	− 1.2	− 0.9	0.1	0.6
	1975	− 3.4	− 3.6	− 0.4	− 0.5	− 0.6	1.2	0.5
Italy	1973	6.8	− 1.3	2.3	1.5	0.2	3.9	0.3
	1974	3.4	1.5	− 0.7	0.6	0.2	1.6	0.3
	1975	− 3.7	2.7	− 2.7	− 2.0	− 0.6	− 1.2	0.1
Japan.	1973	9.9	− 1.4	1.7	3.7	1.0	4.2	0.6
	1974	− 1.2	1.2	0.2	− 2.8	− 0.8	0.7	0.3
	1975	2.0	1.8	− 2.5	− 0.9	− 0.1	3.2	0.6
Netherlands . . .	1973	4.7	1.3	0.3	1.2	0.1	1.7	0.1
	1974	3.3	2.1	0.8	− 0.3	− 0.8	1.5	0.0
	1975	− 1.8	− 0.5	− 2.7	− 0.6	− 0.4	1.8	0.7
Norway	1973	3.9	− 2.4	0.1	3.7	0.2	1.7	0.7
	1974	5.3	− 2.5	3.0	2.3	− 0.0	2.1	0.5
	1975	2.7	− 2.9	− 1.2	3.2	0.4	2.6	0.7
Spain	1973	8.1	− 1.0	0.6	3.2	0.3	4.4	0.5
	1974	5.0	− 1.1	0.7	1.1		3.7	0.5
	1975	0.7	0.2	− 0.1	− 1.1		1.4	0.3
Sweden.	1973	3.5	2.1	− 0.4	0.4	− 0.1	1.0	0.5
	1974	4.2	− 1.6	2.6	0.7	− 0.4	2.3	0.7
	1975	0.5	− 1.9	0.7	− 0.4	− 0.5	1.6	1.0
Switzerland . . .	1973	3.2	0.4	1.0	− 0.2	0.2	1.4	0.3
	1974	2.0	1.0	2.6	− 0.5	− 1.2	− 0.3	0.3
	1975	− 7.0	3.8	− 4.0	− 4.9	− 0.9	− 1.4	0.4
United Kingdom	1973	6.5	0.4	2.0	0.7	− 0.2	2.9	0.7
	1974	− 0.3	1.0	− 0.8	− 0.2	− 0.2	− 0.7	0.5
	1975	− 1.7	0.2	− 2.2	− 0.2	0.2	− 0.2	0.6
United States . .	1973	5.3	0.9	0.6	1.3	− 0.2	2.8	− 0.1
	1974	− 1.8	0.8	− 0.7	− 0.3	− 1.2	− 0.5	0.1
	1975	− 2.0	0.6	− 1.5	− 1.6	− 0.7	0.6	0.6

* The percentage contributions of the expenditure components add up to the percentage change in GNP, except for differences due to rounding.

from the external sector, i.e. the improvement in their current-account balances in real terms, largely mirrored a decline in stocks.

The positive influence of consumption can be attributed both to the stabilising effects of government transfer payments and to the decline in savings ratios. The former reflected the impact of automatic stabilisers (such as unemployment benefits), as well as discretionary action to support personal disposable income through transfer payments of various kinds. Indeed, real income of households before the impact of government taxes and transfers actually declined in 1975 in the United States, Germany and Italy. However, according to estimates by the OECD, increases in real personal disposable income after taxes and transfers ranged from 0.9 per cent. in Italy and 1.4 per cent. in the United States to 3.0 per cent. in France and 4.4 per cent. in Germany. Only in the United Kingdom was there virtually no change.

Even with the rise in real disposable income in virtually all countries, consumer spending could not have risen as it did, had there not been a decline in savings ratios in the second half of 1975 from the very high levels reached in 1974 and early 1975.

Ratios of personal saving to disposable income.

Countries	1969	1970	1971	1972	1973	1974* 1st half	1974* 2nd half	1975* 1st half	1975* 2nd half
	in percentages								
Canada	5.4	5.3	7.4	8.9	8.7	8.7	8.6	10.0	8.3
France	14.8	17.0	16.9	16.7	17.8	17.2		17.5	
Germany	13.4	13.9	13.8	14.9	14.2	14.4	15.8	17.0	15.0
Japan.	19.2	20.0	20.7	22.1	22.0	22.9	23.7	23.8	22.9
United Kingdom.	8.2	9.1	8.8	10.0	10.9	12.0	15.1	13.4	14.3
United States . .	5.6	7.4	7.7	6.2	8.1	7.7	7.4	8.6	7.9

* Seasonally adjusted data from national sources.

Consumer confidence had been depressed to post-war lows by the shock of the fourfold increase in oil prices, persistent double-digit price inflation which drastically eroded both purchasing power and the real value of financial assets, and finally the prolonged threat of unemployment which eventually peaked out at the highest levels since the 1930s. Amid these uncertainties, families had postponed purchases of durable goods and housing, items which ordinarily require large down-payments or heavy financing burdens. Indeed, housing purchases had been depressed for an unusually long period as a result of the rapid rise in house prices, as well as of the shortage and cost of mortgage money in most countries until mid-1975. As a result, the ratio of savings to personal disposable income rose to very high levels. The peaks were reached generally in the first half of 1975.

Thereafter, savings ratios eased back to lower levels. For example, the ratio in Germany dropped from 17.0 per cent. to 15.0 per cent. in the second half of 1975, in the United States from 8.6 to 7.9 per cent., and in Canada from 10.0 to 8.3 per cent. Meanwhile, in the United Kingdom, where the inflation rate had remained the highest among industrial countries, the savings ratio remained high at around 14 per cent.

Until further research into the matter, judgement has to be suspended on the reasons for the fall in savings ratios in most of the major countries. Was this the result of a decline in the rate of inflation? Or of the rise in the value of financial assets? Or of returning confidence? At any rate, savings ratios are still high by historical standards and a further drop could stimulate consumer demand quite strongly. There is some evidence — for instance, in the soaring car registration figures in many countries since early 1976 — that this might indeed be happening.

Government stimulus to aggregate demand. In the course of 1975 fiscal and monetary policy became broadly expansionary in most industrial countries. All the major governments introduced significant stimulatory packages including tax concessions for consumers and business, substantial improvements in transfer payments, particularly for the retired and unemployed, as well as expanded public-works programmes. Moreover, the automatic stabilisers operated through the tax system, although often with considerable time lags. In addition, government consumption of goods and services in 1975 made moderate positive contributions to changes in GNP in a number of countries.

As a result of increased cash outlays and the fall-off in tax receipts at least during the first half of the year, the public sector incurred huge financial deficits, a substantial part of which was the automatic result of the deep recession in the private sector. It is difficult to distinguish the effects of automatic stabilisers and discretionary measures on the government deficit, but national sources do provide some estimates of their relative impact. In the United States the Federal deficit rose by $62 milliard between 1974 and 1975, and it is estimated that almost half of this was caused by the cyclical increase in expenditures and the decline in tax receipts. The French believe that roughly one-quarter of the deficit of around Fr. fr. 43 milliard in 1975 can be attributed to the effects of the automatic stabilisers. The public-sector cash deficit in Germany rose to DM 70 milliard in 1975 — almost three times the previous year's figure — and about one-third of the deficit was thought to be due to the impact of the automatic stabilisers. However, such a break-down is not available for Italy and the United Kingdom, where the size of public-sector deficits was extremely large even at the previous cyclical peak. The comparative size of budget deficits and their financing are discussed in Chapter IV.

The rise of government transfer payments during the recession was attributable largely to automatic stabilisation effects. As unemployment rose to the highest levels since the Great Depression, the growth of transfers, already on an uptrend during the past ten years, accelerated sharply. In the United States, for example, unemployment doubled to 8.3 million in the eighteen months up to the cyclical trough in the second quarter of 1975. During the same period transfer payments under all government programmes climbed by almost 45 per cent. to some $175 milliard at an annual rate in the second quarter of 1975. This represented about 16 per cent. of personal disposable income and 49 per cent. of Federal expenditure for that year. In Germany transfer payments rose by 25 per cent. in 1975, to an amount equivalent to roughly half of net wages and salaries, in contrast to 39 per cent. the year before. A substantial increase in transfer payments was also evident in France, Japan and Canada, and in many other countries.

Apart from the important rôle played by automatic stabilisers and transfers, most governments initiated major discretionary fiscal packages. The United States, in addition to increasing transfer payments sharply, implemented the Tax Reduction Act of 1975, passed in March. This legislation provided for cuts in personal tax withholding rates and corporate taxes for the remainder of 1975 (amounting to about $12 milliard) and for lump-sum cash rebates amounting to nearly $10 milliard and supplementary cash payments to social security beneficiaries. The fiscal impact of this package was unusually strong in comparison with similar programmes to stimulate other post-war recoveries. The personal and business tax concessions were extended to cover the first six months of 1976.

Other major industrial countries further eased their fiscal policies in the course of 1975. The German Federal Government, after offering a 7½ per cent. investment bonus to stimulate capital spending in late 1974, added measures in August aimed mostly at bolstering construction, housing and public works. The French authorities announced in September a major programme to reinforce the expansionary stance of fiscal policy already evident in the first half of 1975. The measures provided for substantial stimulus continuing into 1976, including an investment tax credit, large-scale public-works investments, and increases in transfer payments. The Italian authorities, after starting to relax policies early in 1975, announced in August a set of reflationary budget measures providing aid to housing and hospital construction, public works and agriculture. As the Japanese recovery faltered in the second half of 1975, the government introduced further stimulatory measures, including increased public-works spending and financial aid to business, to be implemented during the fiscal year ending March 1976.

Unlike the shifting policy emphasis on the European continent in 1975, the United Kingdom's main efforts had to be focused increasingly on inflation, even as unemployment rose steadily to reach 1.2 million in February 1976. A voluntary incomes policy formed the keystone of the government's stabilisation programme. Only modest outlays were made to stimulate industrial investment projects and construction. At the same time, however, public consumption rose considerably and absorbed a growing proportion of available resources.

Accompanying the gradual shift towards fiscal stimulus, there was a general relaxation of monetary policy (see Chapter IV). Although short-term interest rates had already moved downwards from their peaks in Germany, the United Kingdom and the United States, the decisive turn in monetary policy did not come until late 1974 and early 1975, when central banks undertook a quick succession of discount rate cuts. Reflecting weak private credit demand as well as progressively easier policies with respect to bank liquidity, short-term rates continued generally on a downward course. The principal exceptions were the United States and the United Kingdom, where money-market rates rose for a time during the summer and early autumn partly in response to restrictive policy actions. Interest rates continued to decline in the early months of 1976, except in countries where exchange-market difficulties prompted official moves towards restraint. Recently, in the course of May, signs of a more general firming of short-term rates have been evident in both national and international markets.

Economic policy in other countries also became more expansionary in 1975, as the worst of the recession spread to them with a lag, particularly when the volume of international trade dropped off sharply. The Netherlands and Denmark provided some stimulus via tax cuts and public works, while Switzerland moved cautiously to aid the hard-pressed construction industry and Austria followed a mildly expansionary path. Elsewhere, in Ireland, Australia and New Zealand, budgets became more stimulatory. Finland sought to pursue a relatively restrictive policy in response to a difficult balance-of-payments problem, and Spain moderated its expansionary stance to restrain domestic price increases. In several countries fiscal measures have been linked in varying degrees to incomes policies, as, for example, in the Netherlands, Norway, Denmark and Sweden, as well as in New Zealand. In general, the smaller countries have also eased monetary policy in line with the major countries, though in Finland, Greece, New Zealand and South Africa the external considerations imposed a certain constraint.

Inventory adjustments and international trade. While consumer spending, sustained or even stimulated by fiscal and monetary policies, was the base on which the recovery was built, inventory adjustments and the corresponding revival of international trade gave added impetus to the upswing.

Very large and abrupt stock adjustments occurred during both the 1974–75 recession and the subsequent recovery. These movements reinforced the swings in production and international trade, in most industrial countries to a degree unprecedented in the post-war period. Moreover, the sharp stock liquidations in the first half of 1975 paved the way for production increases and the rebuilding of inventories in the upswing later in the year and in early 1976. When, in late 1974, consumer demand had dropped off in the major countries, inventory-to-sales ratios had risen to historically high levels, particularly in the United States. At the same time, the acute deterioration in business liquidity — a combined result of declining profits and restrictive monetary policy — made it both difficult and costly to finance excess stocks. Business men therefore unloaded inventories of both finished consumer goods and partially finished inputs. In order to reduce the ratio of inventories of inputs relative to falling production and sales, firms had to cut back their purchases by more than the drop in production. The simultaneous destocking in most countries of both finished and intermediate goods and primary processed materials had an almost immediate and drastic impact on imports into the industrial countries. This result is clearly mirrored in the sharp improvement in the trade balance of most industrial countries.

During the second half of 1975 the inventory liquidation had largely run its course in the United States and Japan and was tapering off in Europe. As a result, the rise in consumer demand had a multiplier effect on production, and by the end of the year stock-building was evident in some sectors in several countries. In the recovery, as in the downswing, the inventory adjustment once again had an impact on imports, this time by raising their level. That this development was under way in the latter part of 1975 is confirmed by the gradual deterioration of the trade balances of the major industrial countries.

Prospects for the recovery and the rôle of business investment.

While most signs point to a broadly based recovery that by now is spreading throughout the industrial world, and while the pattern of revival seems to be following the familiar paths displayed in earlier post-war recoveries, the longer-term prospects for a sustained advance of the economy depend to a large extent on fixed capital formation in the enterprise sector.

A revival of investment would generate demand for capital goods, intermediate products and construction — sectors in which there are for the time being excess capacities. However, investment purely as a demand stimulus does not appear crucial, for it may be argued that the current recovery is proceeding fast enough to dispel major worries about a prospective inadequacy of aggregate demand. But investment also performs another function: it creates additional productive capacity and it *may* create new jobs. It need not do so, however: in many instances, it can lead to a reduction of employment.

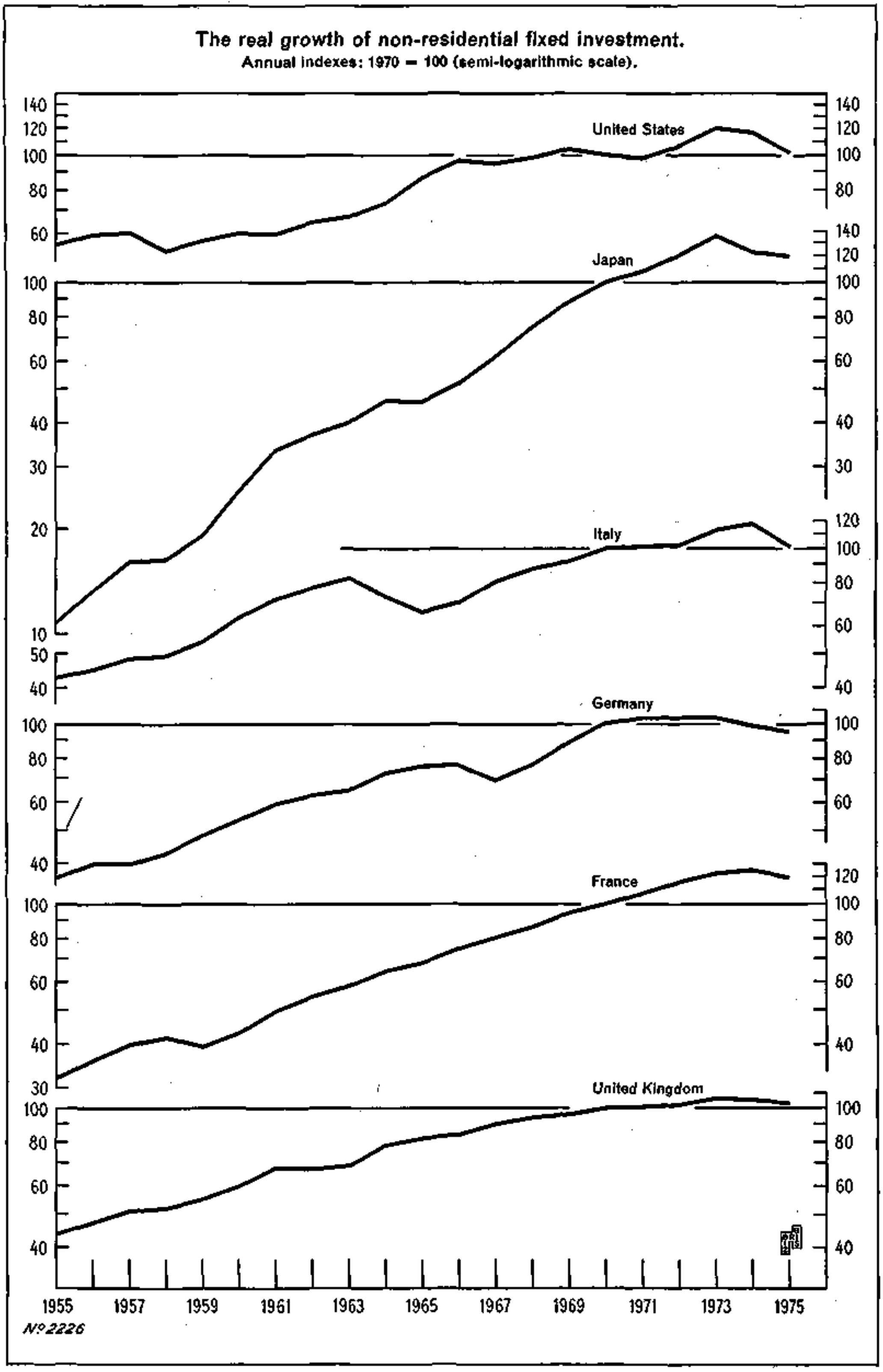
The accelerated rise in labour costs in most industrial countries — especially in western Europe — over the last few years has given businesses a tremendous incentive to steer investment towards the labour-saving type, at the expense of capacity (and job) creating investment of the capital-widening type. The severity of the recession has, of course, accelerated this trend, which probably started a few years ago. The danger of this investment pattern, if it persists despite the business recovery, is that the expanding economies may run into capacity bottlenecks at a time when there is still substantial unemployment. The likelihood of this happening is clearly suggested by current unemployment figures which have so far remained exceptionally high.

Average rates of unemployment.[1]

Country	1966–70	1971–75	1974 1st half	1974 2nd half	1975 1st half	1975 2nd half	1976 latest month
	as percentage of total labour force						
France	1.7	2.6	2.0	2.5	3.6	4.1	4.4[2]
Germany	1.0	2.1	2.4	3.0	4.8	4.7	4.8[5]
Italy	3.5	3.3	2.8	2.9	3.3	3.4	3.5[4]
Japan	1.2	1.4	1.2	1.5	1.8	1.9	2.0[3]
United Kingdom	2.1	3.2	2.5	2.7	3.4	4.6	5.3[5]
United States	3.9	6.1	5.1	6.2	8.4	8.5	7.5[5]

[1] Based on national definitions not strictly comparable from country to country. Adjusted for seasonal variations.
[2] March. [3] February. [4] Fourth quarter of 1975. [5] April.

To avoid such imbalance, most of the western countries need a substantial increase in investment of *both* the types mentioned above. Needless to say, a fully-fledged investment boom, coming on top of a vigorously rising trend of private and public consumption, could be as dangerous as no revival of capital spending, for it would set the stage for a new wave of inflation. Therefore, what the western industrial world needs, if it wants to approach again the high and more balanced growth rates of the early 1960s, is to keep the expansion of total expenditure relatively slow while increasing the share of capital formation at the expense of consumption.


The real growth of non-residential fixed investment.
Annual indexes: 1970 = 100 (semi-logarithmic scale).
United States
Japan
Italy
Germany
France
United Kingdom
1955
1957
1959
1961
1963
1965
1967
1969
1971
1973
1975
N° 2226

Prospects of this second objective being achieved are far from encouraging. The unusual combination of rampant inflation and steep recession in 1974–75 dealt a severe blow to business profitability and cash flow in most countries. But in longer-term perspective this cyclical deterioration in profitability only accentuated the decline in the real rates of return on capital investment that most countries had experienced since the 1960s. It was against this background that the collapse of investment spending occurred in 1974–75. The remarkable improvement in corporate cash flow in the United States in the second half of 1975 should be viewed in the same context. The cyclical rebound of profits by itself has corrected only what happened during the recession and has so far done little to reverse the long-run decline in corporate profitability.

The evidence on declining profit rates presents a disturbing picture with hardly optimistic implications for investment of the capital-widening type. According to national sources, the return on capital in Germany declined to 14.4 per cent. in 1974, compared with 22.7 per cent. in 1970. In the United Kingdom the downward movement has been even sharper. After adjustment for stock appreciation and replacement valuation, the after-tax rate of real return on capital declined from 7–9 per cent. in the early 1960s to about 3.5 per cent. in the early 1970s and to nearly zero in 1974, if no account is taken of tax relief on inventory appreciation. In the United States, too, it has been estimated that the after-tax return on capital (valued at replacement cost) declined by nearly one-half between the mid-1960s and 1973.

Moreover, as a result of the cyclical deterioration in profitability, corporate cash flow (capital consumption allowances and retained earnings) has shown a further appreciable decline. This is significant because investment bears a fairly close relationship to cash flow. In Japan, for instance, the bad performance of investment during the past two years can undoubtedly be partly attributed to the sharp decline in self-financing capacity. In this context, it is of interest that the self-financing ratio fell from around 83 per cent. in 1972 to only 50 per cent. in 1974 and an estimated 59 per cent. in 1975. The same applies to France, where the self-financing ratio for fixed investment declined to 58 per cent. in 1975 from 64 per cent. the year before.

The impact of these developments on non-residential fixed investment is striking. Except in France, the rising trend of such investment was interrupted well before the recession: as early as 1966 in the United States and 1970–71 in Germany, Italy, Japan and the United Kingdom.

As a counterpart to the deterioration in business profitability, there has been a gradual longer-term rise, then during the recession a marked further increase, in the share of labour in the national income. At a time when the decline in the terms of trade of the industrial countries (see Chapter V) would have warranted a stabilisation, or perhaps even a fall, in real wages, the opposite happened: wages continued to rise faster than the cost of living, the only notable exception being the United States. The burden of adjustment thus fell almost entirely on profits. Over the years governments themselves have in some countries contributed to the squeeze on profits by raising the taxes on company earnings.

It is still too early to see whether the current recovery is proceeding along lines that will result in a redistribution of income in favour of profits of sufficient vigour to bring about an appropriate growth in capacity-widening and employment-creating investment. There are some signs that the United States is moving in this direction: the decline in real wages during the recession is now being followed by a substantial improvement in corporate profits. But will this continue? There are also signs that what the United States may achieve through the working of market forces, Germany will perhaps accomplish through a fair degree of social consensus: the moderate wage settlements during the early months of 1976 are likely to create a proper environment for rising business profits. But will this last? In a large part of the industrial world the outlook is far from bright. The unconstrained operation of market forces is rejected because it would tend to create hardship and inequality. At the same time, it is difficult to find other politically acceptable ways of ensuring capital formation sufficient to absorb unemployment and to lift growth rates back to the levels reached in the 1960s. Yet this is what most people still expect.

III. INFLATION AND MONETARY POLICY.

Although the time lags were unusually long, the recession *did* slow down inflation in the industrial countries, and the first stage of the business revival has helped to consolidate earlier success in the fight against inflation. But the degree of success has so far been uneven from country to country. Moreover, the world runs the risk of a renewed acceleration of price increases should the synchronised recovery get out of control. It is therefore essential that monetary policy, by keeping a tight rein on monetary aggregates, should contribute to maintaining the moderate pace of recovery.

While this may turn out to be a difficult task, given the large size of public-sector deficits, there is at least one comforting fact that emerges from last year's statistics: in many countries the growth of the money supply remained more moderate during the recession and early upswing than in the comparable phase of the preceding cycle.

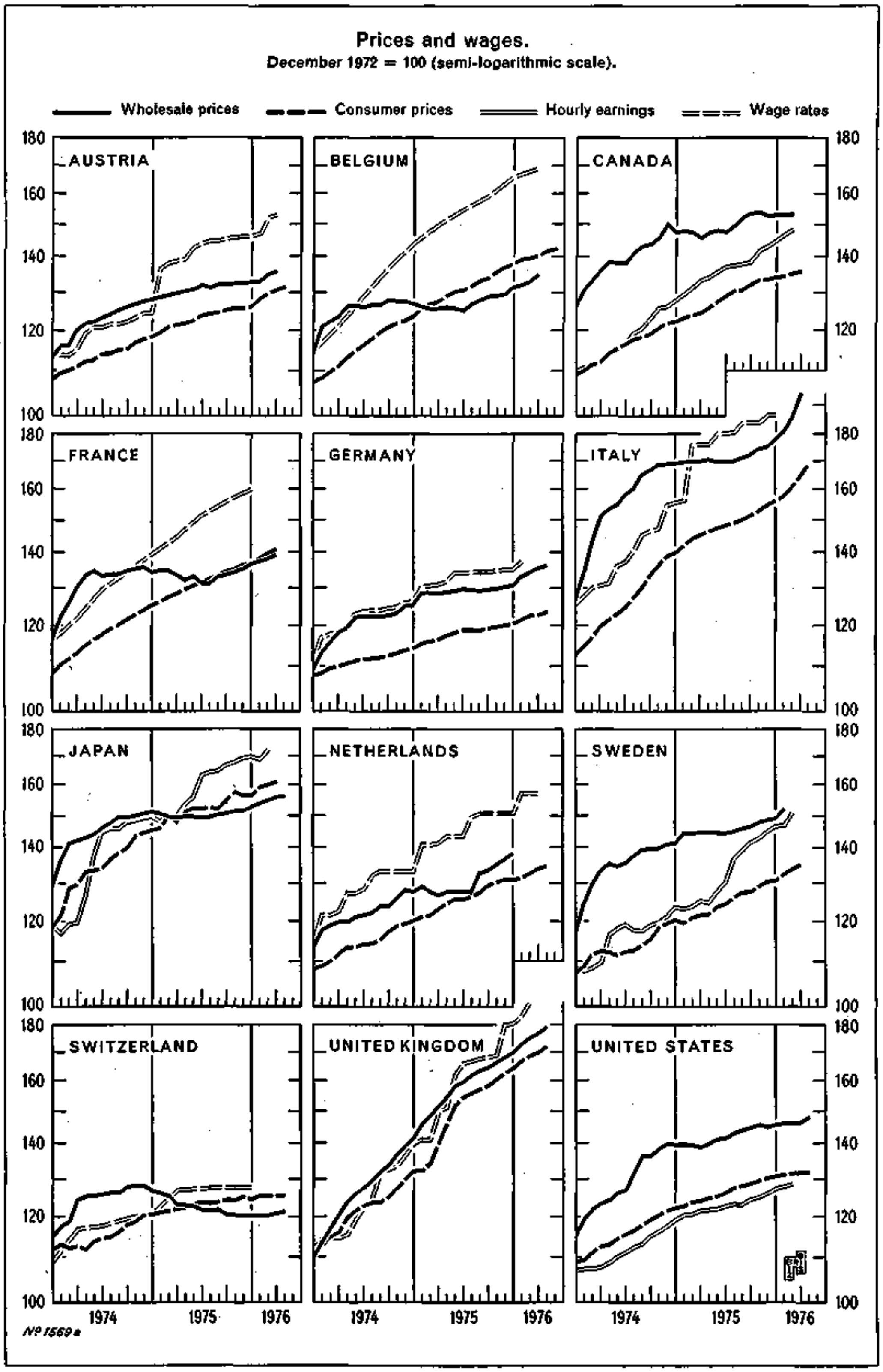
The recent course of price inflation.

Consumer price inflation has been gradually moderating for about a year and a half now, though at a more satisfactory pace in some countries than in others.

Inflation rates, it may be recalled, had accelerated sharply in 1974 despite the onset of recession in late 1973. Largely under the impetus of earlier steep rises in oil and commodity prices, consumer prices generally reached their peak rates of increase in late 1974. By December twelve-month rates of inflation were running in most countries at between 10 and 25 per cent. Only in two cases — Germany and Switzerland — did inflation rates actually decline in 1974.

Meanwhile, wholesale prices began to advance more slowly around the summer or early autumn of that year. By the turn of the year they were definitely on a more stable path, and in most countries they remained relatively flat over the first half of 1975. Indeed, in some countries, such as the Benelux, France and Switzerland, wholesale prices edged downwards over this period. Of the major countries, only the United Kingdom continued to experience sharp increases.

Following these developments with the usual time lag, the rising trend of consumer prices reached an inflection point around the turn of 1974. During 1975 the rate of increase in most countries was significantly lower than in the preceding year. Thus, by December a sizable group of countries — Austria, Denmark, Germany, Japan, Switzerland and the United States — had succeeded in bringing down consumer price inflation to twelve-month rates ranging between 3½ and 7½ per cent. Inflation rates in a number of other countries, including the Benelux, Canada, France, Italy and Sweden, were bunched around 9–11 per cent. In the United Kingdom, on the other hand, consumer prices still increased over the year by almost 25 per cent.



Prices and wages.
December 1972 = 100 (semi-logarithmic scale).
Wholesale prices
Consumer prices
Hourly earnings
Wage rates
AUSTRIA
BELGIUM
CANADA
FRANCE
GERMANY
ITALY
JAPAN
NETHERLANDS
SWEDEN
SWITZERLAND
UNITED KINGDOM
UNITED STATES
180
160
140
120
100
1974
1975
1976
Nº 1569 e

Consumer prices.

Countries	1971 December	1972 December	1973 December	1974 December	1975 June	1975 December	1976 latest month
	Twelve-month rates of change to						
	In percentages						
Austria	4.9	7.6	7.8	9.7	8.3	6.8	7.7[1]
Belgium	5.6	6.4	7.3	15.7	12.5	11.0	9.7[1]
Canada	5.0	5.1	9.1	12.3	10.3	9.5	8.9[1]
Denmark	5.7	7.1	12.6	15.5	10.6	4.3	8.9[1]
Finland	8.6	7.1	14.1	16.9	18.1	18.1	16.7[2]
France	6.0	6.9	8.5	15.2	11.7	9.6	9.6[2]
Germany	5.8	6.5	7.8	5.9	6.4	5.4	5.2[1]
Italy	4.7	7.4	12.5	24.5	19.0	11.2	13.9[2]
Japan	4.6	5.3	19.1	21.9	13.4	7.6	9.3[1]
Netherlands	8.4	7.9	8.2	10.9	10.3	9.1	9.8[1]
Spain	9.7	7.3	14.2	17.9	17.1	14.1	16.2[1]
Sweden	7.1	6.2	7.5	11.6	10.6	8.9	11.1[2]
Switzerland	6.6	6.9	11.9	7.6	8.0	3.4	2.2[1]
United Kingdom	9.0	7.7	10.6	19.2	26.1	24.9	18.9[1]
United States	3.4	3.4	8.8	12.2	9.3	7.0	6.1[1]

[1] April. [2] March.

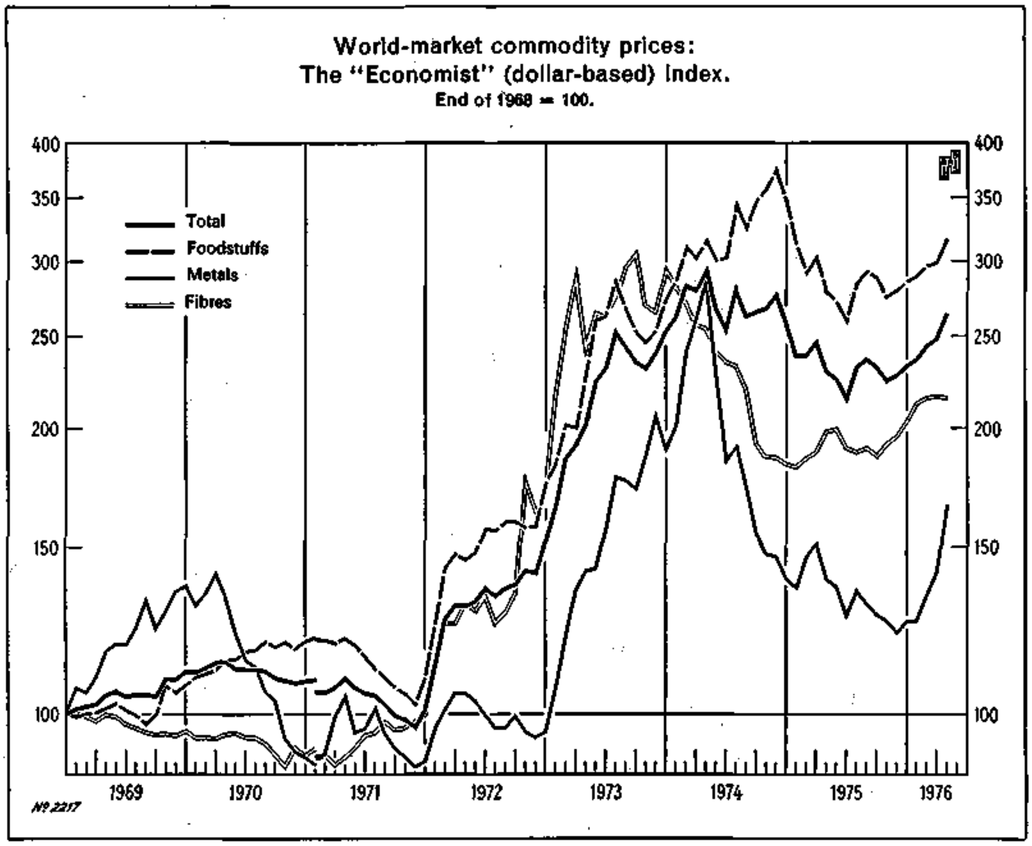
Developments in the early months of 1976 have been rather mixed. The twelve-month inflation rate has come down further in such countries as Belgium, Canada, Switzerland and the United States, and the picture would look better still on the basis of the last six months' data alone. In the case of the United Kingdom, for example, the increase in prices from October to April, expressed at an annual rate, fell to 15.4 per cent., which was a marked improvement compared with the results for 1975. On the other hand, consumer price inflation seems recently to have been gaining renewed momentum in several countries. These increases may to some extent reflect the initial impact of the renewed rise in wholesale prices under way in many countries since the summer of 1975.

Nonetheless, the broad pattern of price movements since early 1975 points to two obvious conclusions. First, the western industrial countries have experienced a general slow-down in the rate of price inflation. Secondly, the degree of success achieved has varied widely from country to country. How can these developments be explained?

Factors underlying the general slow-down of inflation.

The most pervasive single factor contributing to the deceleration of inflation was the world-wide recession itself. Its influence was felt both indirectly, through the decline in world-market commodity prices, and directly through the weakening of demand in labour and product markets. However, owing to the sheer momentum of inflation, and more particularly to the time needed for previous rises in oil and commodity prices to work their way through the system, the prices of final goods were slow to respond to the slackening of demand.

International commodity prices. The leading factor in the easing of inflationary pressures last year was the decline in commodity prices on world markets. According to the "Economist" (dollar-based) index, they began to fall on average from the spring of 1974 onwards, with the decline continuing irregularly until about the middle of 1975. Within the total, the prices of fibres turned downwards first, followed by a sharp break in metals prices in April, while the foodstuffs component continued to rise strongly before giving way late in 1974. These declines found their way very quickly, though with varying lags, into wholesale prices in individual countries (see graph, page 25). By the middle of 1975 the "Economist" index stood at about 2.2 times its level at the end of 1971, against a multiple of nearly 3 at the high recorded in April 1974.



The price of crude oil, not included in the commodity price indicator, weakened somewhat until the late summer of 1975 owing to the slackness of demand and the efforts of some producing countries to win a larger share of the market. In September the OPEC countries announced a new increase of 10 per cent. in their basic selling prices, to remain effective until mid-1976. Since that time actual market prices appear to have firmed against the background of world economic recovery.

Since last summer the general commodity price index has been rising again, pulled ahead initially by foodstuffs but later also by fibres and metals. By the spring of 1976 the index had returned to over 2.6 times its December 1971 level, thus regaining about one-half of its decline during the recession. The impetus behind these changes came mainly from the renewed economic upswing, but prices of foodstuffs were pushed higher by special factors, such as a further poor grain harvest in the Soviet Union and a reduction in coffee supplies caused by severe frost damage in Brazil.

Nominal wages, unit wage costs and profit margins. Just as the fall in world commodity prices led to a slow-down in domestic price inflation, the improved trend of consumer prices exerted a moderating influence on the growth of nominal wages. In addition, the weakening of domestic demand, through its direct impact on labour and product markets, led to some reduction of wage pressures but at the same time also caused a significant erosion of profit margins.

Wages in industry.[1]

Countries	Twelve-month rates of change to						
	1971 December	1972 December	1973 December	1974 December	1975 June	1975 December	1976 latest month
	in percentages						
Austria	12.5	7.2	12.0	15.3	15.6	10.4	.
Belgium	12.6	15.0	16.3	24.1	19.6	18.0	12.3[2]
Canada	8.6	8.2	9.5	16.6	17.7	13.2	13.3[2]
Denmark	13.9	11.3	24.7	22.4	20.2	14.7	.
Finland	19.2	11.4	19.2	24.6	23.5	18.9	.
France	*10.7*	*12.2*	*15.9*	*20.3*	*17.2*	*14.8*	.
Germany	5.6	9.3	7.5	15.0	9.8	8.0	4.2[3]
Italy	*10.8*	*12.1*	*25.4*	*24.1*	*31.1*	*20.3*	.
Japan	13.8	16.9	19.1	25.6	12.9	13.8	14.6[4]
Netherlands	15.0[5]	10.7[5]	14.2[5]	16.6[5]	13.4[6]	13.9[5]	13.5[3]
Spain	12.1	19.8	24.7	31.4	24.5	26.2[5]	.
Sweden	10.6	11.3	8.8	13.7	9.1	18.7	22.7[4]
Switzerland	*8.9*	*8.5*	*9.2*	*10.7*	*8.3*	*5.8*	.
United Kingdom	9.0	14.0	14.7	26.7	24.3	20.7	19.3[4]
United States	6.0	6.5	6.6	11.7	10.2	7.1	6.6[4]

[1] Monthly, weekly or hourly earnings, except for figures in italics, which are wage rates. [2] March. [3] January. [4] February. [5] October. [6] July.

The behaviour of nominal wages differed widely from country to country. In some the growth rate declined substantially. This was notably the case in Germany, Switzerland and the United States, where wage earnings or rates rose during 1975 by only 6–8 per cent., and also in Japan, where the growth of earnings was only about half as large as in 1974. Another group of countries, including Belgium, Canada, Denmark, France and the Netherlands, succeeded in bringing wage inflation down quite appreciably, but the rates of increase, ranging from 13 to 18 per cent., remained high. In yet others — Finland, Italy, Spain and the United Kingdom — increases in nominal wages ranged from nearly 20 to around 25 per cent.

Contrasts in wage developments were greater still when measured in terms of wage costs per unit of output. In the United States and Germany unit costs in manufacturing industry remained practically stable over 1975, while in Japan they rose by 6 per cent., though this compares with an increase of nearly 35 per cent. in 1974. In all three cases, but especially in the United States, the results already reflected gains in man-hour output as recovery got under way. In most other countries, however, the rise in unit wage costs last year was as much as 15–25 per cent., and in some cases even higher. These increases partly reflect the low rate of capacity utilisation as well as labour hoarding.

In many cases, however, the disturbing fact remained that the rate of increase in wages bore no reasonable relationship to actual or potential gains in productivity. In many countries, particularly those of western Europe, wages had become closely linked to consumer prices through indexation arrangements, a principal effect of which was to make it more difficult to achieve a quick slowing-down of inflation. These arrangements are more formalised in some countries (for example, the Benelux and Italy) than in others, and they have made it practically impossible to make fundamental adjustments in real incomes, as would have been appropriate following the terms-of-trade losses imposed through higher oil and commodity prices.

Against this background, therefore, a number of countries have undertaken new initiatives in the field of incomes policy. In each case the objective has been to interrupt the upward spiral of wages and prices.

In the United Kingdom a major factor in the slowing-down of price inflation was the acceptance by the trade unions of a programme of voluntary restraint on wage increases. Under this policy wage rises for the year beginning in August 1975 were to be limited to £6 per week, with no increases being allowed on incomes in excess of £8,500 per annum. This ceiling was equivalent on average to a 12 per cent. rise at an annual rate. The arrangement followed a twelve-month period in which wage rates had risen by close on 35 per cent. In his April 1976 budget the Chancellor of the Exchequer offered a package of tax concessions, conditional upon labour's acceptance of a new guide-line for the growth of wages during the year beginning August 1976. As subsequently agreed upon, the new pay formula provided for a maximum increase of 5 per cent. in weekly wage rates, but with an upper limit of £4 and a minimum of £2.50. The agreement was expected to restrain the average increase in earnings over the year to around 6 per cent., and on this basis the tax concessions were to be granted in full.

In Canada a highly charged labour-market situation led the government in October 1975 to introduce a major anti-inflationary programme which included price and income guide-lines mandatory for most groups. The aim is to scale down the rate of price increase from 10 per cent. at the beginning of the programme to about 4 per cent. after three years.

In several countries progress in curbing inflation has seemed to hinge on the alteration, or temporary suspension, of indexation arrangements. In the Netherlands, where price inflation in 1975 was almost as fast as in 1974, the government introduced a freeze on all labour agreements for six months from last December, though this did not cover the semi-annual indexation adjustment which was made early in 1976. In Belgium, where the indexation system now in force covers both public and private sectors and involves frequent adjustments, a decision has been taken to cut for a time the link with prices for wages above a certain amount. In Italy the sliding scale arrangement was actually made more sensitive to price increases as the result of a new labour-management agreement reached at the beginning of 1975. Since that time, with the lira having plunged sharply and with inflationary forces again mounting, voices have been raised for some modification of the indexation system.

Policy priorities and the interaction between inflation and exchange rates.

In the industrial countries the course of inflation followed widely different paths. While some of the reasons for these differences have been alluded to above, the most fundamental lay in the policy priorities adopted by the individual countries and the way in which these policy preferences tended, via their direct influence on the exchange rate, to feed back on the inflation rate itself.

Just over two years ago all the industrial countries had, in varying degrees, faced much the same problem, namely that of adjusting themselves to the impact of the sharp rise in oil and commodity prices. The differences in their reactions expressed themselves mainly in the choice they made between combating inflation as opposed to sustaining economic activity and accepting greater current-account deficits.

Three large countries — Germany, Japan and the United States — provided the lead by embarking on policies clearly designed to contain inflation. Another country which took an unrelenting stand against inflation was Switzerland.

At the other end of the spectrum were several countries which sought to maintain employment at fairly high levels. These included Canada, Norway, Sweden and the United Kingdom, all of which could for the time being count on ready access to finance from abroad.

Other countries generally fell somewhere in between. In some cases, such as Belgium, France and Denmark, the "snake" arrangement involved a certain monetary discipline. In various countries, such as Denmark, France, Italy and Spain, the severity of the oil deficits made it difficult to aim directly at balance on current account, and therefore domestic restraint had to be combined with external borrowings.

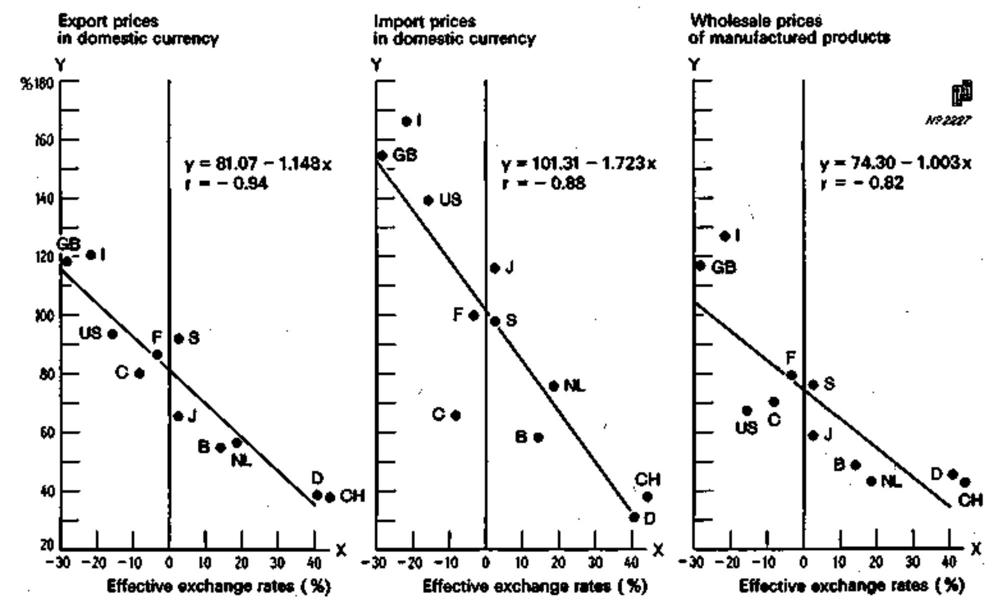
The principal conclusion emerging from these diverse experiences seems fairly clear. On the one hand, those countries which acted against inflation with speed and persistent determination succeeded remarkably well in bringing it under better control. They were able to do so, moreover, essentially by means of market forces. On the other hand, those which gave greater weight to output and employment found themselves faced, even two years later, with seemingly intractable problems of wage/price inflation and with most of the ill-effects of recession as well. In several cases, therefore, recourse to incomes policies, often as an adjunct to monetary and fiscal action, soon appeared to be the only satisfactory way to break quickly out of the inflationary spiral.

A second major reason for the diversity of inflationary results lies in the modus operandi of floating exchange rates.

For several years now the price and wage performances of individual countries have been closely bound up with the relative movement of exchange rates. According to one view, the greater monetary autonomy which countries enjoy under a floating régime implies that exchange rate movements will passively reflect the inflation rates which countries "choose" to maintain relative to inflation in other countries. While there is considerable truth in this view, experience has shown that the inter-relationships between inflation and floating rates are much more complex. The causal relations run in both directions and often tend to be self-reinforcing. This stems from the fact that movements in exchange rates may often be the result of changes in such factors as confidence, expectations and the monetary/fiscal policy mix. Hence they can, through their influence on import and export prices, exert an independent effect on the rate of domestic price and wage inflation. The influence is particularly strong in open economies with large trading sectors and in economies where wages respond promptly to changes in the consumer price level.

To put the matter another way, forceful action to combat inflation may be expected to have not only direct effects on domestic prices and wages but also an indirect effect via the exchange rate. The policy actions themselves, together with the expectations they engender, tend to strengthen the rate by more than is warranted on immediate purchasing-power-parity grounds. In this way, by lowering import costs and holding down export profits, exchange appreciation reinforces the direct effects of anti-inflationary policies and helps to make them self-fulfilling. Whenever, on the other hand, domestic inflation leads to exchange depreciation, this will tend

The interrelation between changes in effective exchange rates and selected prices.*



* Cumulative percentage changes over the period 1968–75. B = Belgium, C = Canada, F = France, D = Germany, I = Italy, J = Japan, NL = Netherlands, S = Sweden, CH = Switzerland, GB = United Kingdom and US = United States.

to feed inflation — and such a "vicious circle" can then be broken only through drastic policy action.

That there is close interdependence between exchange rates and domestic inflation is, perhaps, clear enough in a priori terms. This matter is discussed in more detail in Chapter VII, but the graphs above present a summary view of the mutual relationship between percentage changes in effective exchange rates and in prices (for the period 1968–75) for a number of countries. They show, for instance, that in those countries which experienced large depreciations — Italy and the United Kingdom — the percentage increase in local-currency import prices was about 5 times, and that in wholesale prices and local-currency export prices about 2½–3 times, as much as in Germany and Switzerland which recorded large appreciations.

The problem ahead.

As most economies are still operating much below their full potential, there is hope for some continued easing of wage and price pressures over the remainder of the year. This tendency could be strengthened, as recovery gathers momentum, by the effect of an upsurge in productivity in reducing unit labour costs of output. Of course, since profitability has been severely squeezed, it will be natural — and even desirable — for business firms to seek to restore profit margins to satisfactory levels. At this stage, therefore, the trend of prices will depend, even more than usual, on the extent to which unit production costs can be held down.

As far as nominal wages are concerned, recent developments in some countries are broadly encouraging. In Germany the new round of wage settlements has involved increases of around 5½–6 per cent. In the United States, where the schedule of new contract negotiations is heavy, settlements have so far been running at about 9–10 per cent., while productivity has recently been rising well. In Canada the government's new incomes policy has apparently helped to moderate wage increases, though the exceptions permitted under the guide-lines are proving troublesome. In the spring round of wage bargaining in Japan further progress has been made towards consolidating the remarkable slow-down in wage gains between 1974 and 1975. And, most encouragingly, the trade unions in the United Kingdom have accepted a tightening of the general guide-line for wage and salary increases in the year beginning in August, although by its nature the new pay formula may lead to further distortions in the structure of wages.

In a number of countries, however, progress on the wages front has been less perceptible. In Italy, for example, where new three-year contracts are under negotiation, the trade unions have not only adamantly opposed any alteration of cost-of-living indexation arrangements but have also demanded substantial increases in real wages.

In more general terms, however, the most serious immediate threat of renewed inflation comes from developments in world commodity markets. Since last summer, with recovery getting under way and spreading out geographically, international commodity prices have been rising again. These increases have already had a distinct impact on wholesale prices, and they may soon be coming to the surface increasingly in consumer prices as well. It would then be only a matter of time until wages are affected.

What are the chances that developments will in fact move along these lines? This will very largely depend on the strength of the upswing in individual countries and the extent to which it is synchronised among them. As Chapter I has shown, the upswing has already proved to be stronger and more general than was earlier expected. The danger of a recurrence of the 1972–73 simultaneous boom, with sharply rising world-market prices, cannot be ruled out.

In short, there is a strong *general* case at the present time for national policies keeping aggregate demand on a taut rein. Only by ensuring that economies grow at a moderate pace, after due allowance for their mutually-reinforcing interaction, can a resurgence of inflation be avoided and scope left for a sustained period of high investment.

The rôle of monetary policy.

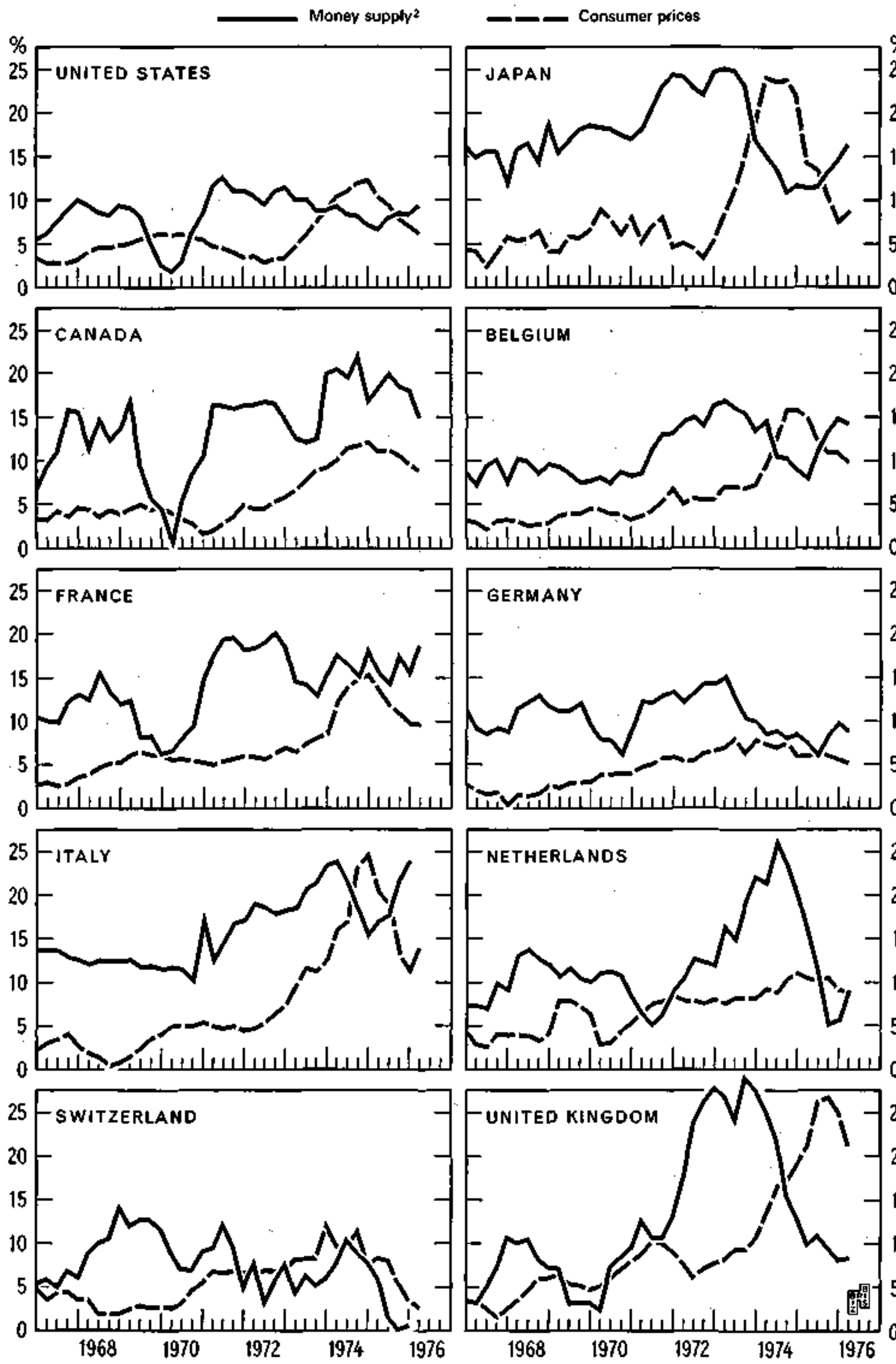
In view of the problems ahead, national authorities have been at pains to consider how to avoid the pitfalls of the years 1972–73 and to make continued headway against inflation as economic recovery proceeds. In this context it is fairly widely accepted that adherence to a steadier rate of monetary growth than in the past could help towards this end.

The "rediscovery" of money is not a recent phenomenon. Nonetheless, the past decade has provided further strong prima facie evidence of the close long-term relationship between monetary expansion and price inflation, on a world-wide as well as on a national level. As the following graphs show, the acceleration of price inflation in 1972–74 was preceded by a substantial speeding-up of monetary expansion. Moreover, this faster pace of money growth had already been initiated in the recession period of 1970–71. In the light of this experience, increasing attention has been focused on the "monetary aggregates" — principally the monetary base, the money supply (variously defined) and bank credit — and their relationships to final demand.

It is encouraging to observe that the rates of growth of the money supply during the recession and early recovery have not bounded upwards as they did in the previous cycle. There are, of course, several ways of measuring the changes in the degree of liquidity and comparing them in the two periods. Since the recession was much deeper and prices were rising much faster in the second period, it seems useful to carry out a double comparison: on the one hand, between the cumulative real changes in money balances in the two periods and, on the other, between the latter and changes in real GNP. This can give us some idea of the comparative *growth* of real liquidity over the two cyclical phases, although it does not, of course, measure the adequacy (or excess) of liquidity at any point of time.

As the table shows, the growth of the money supply in real terms was much more moderate in all major countries between mid-1973 and end-1975 than in the roughly

The money supply and consumer prices.[1]



[1] Twelve-month rates of change based on quarterly data. [2] M_2; for Germany and the United Kingdom, M_3.

A comparison of "real" monetary growth: Two cycles of recession and recovery.

Countries	Cumulative change from June 1969 to Dec. 1971: real money supply[1]	real GNP	June 1973 to Dec. 1975: real money supply[1]	real GNP
	In percentages			
France	19.5	14.9	11.2	− 0.4
Germany	15.0	10.3	7.9	− 0.3
Italy	28.5	4.4[2]	13.2	− 7.2[2]
Japan	39.4	22.7	− 3.5	1.8
United Kingdom	5.4	4.9	− 11.5	− 1.3
United States	10.2	3.8	− 1.6	− 1.0

[1] Adjusted for corresponding changes in consumer prices. M_1 for Germany, United Kingdom and United States; M_2 for other countries. [2] Industrial production.

corresponding phase of the previous cycle. Among the countries, however, there were some fairly pronounced differences. In Japan, the United Kingdom and the United States real money growth was actually negative and less than the change in real GNP, while in France, Germany and Italy it was positive and well ahead of the movement of real GNP. On the whole, the better performance in the present cyclical phase would seem to be ascribable to the fact that closer attention was paid to the monetary aggregates, but it may also reflect the sharpness of the decline in the private sector's demand for bank credit, which made it a great deal easier to achieve moderation in the growth of the money supply.

Practices regarding monetary norms. While there is substantial agreement on the long-term inflationary implications of excessive monetary expansion, monetary authorities differ considerably in their approach to monetary management and even in their apparent degree of control over the behaviour of money.

Up to now only a limited number of central banks have adopted the practice of setting norms — whether as targets or indicators — for the growth of monetary aggregates. Among these there are significant differences in the types of norms chosen, the purposes they are supposed to serve and the flexibility with which they are applied. One common feature in a few countries is the belief that public knowledge of the norms (especially when they are restrictive) will dampen inflationary expectations.

In the United States the Federal Reserve Board has been using monetary targets since 1970, but it began to make these public only in the spring of 1975. Attention is paid to several aggregates, and the target for each aggregate is expressed as a range of permissible growth over the year ahead. Since the targets are subject to change on a quarterly basis, and since the acceptable range of growth is fairly wide, the authorities have a good deal of operational flexibility.

In Switzerland the authorities had set a target of 6 per cent. for the growth of central-bank money in 1975. This proved to be quite ample, because GNP declined slightly in nominal terms and fell by 7 per cent. in real terms. The same target has been retained for 1976, but it will be reviewed if recovery turns out to be stronger than expected.

The Deutsche Bundesbank also employs a monetary growth target, the purposes of which seem to be more broadly conceived than in the United States and Switzerland. The target is expressed as an annual rate of growth of central-bank money (currency in circulation plus banks' compulsory reserves adjusted for changes in reserve ratios) and has been found to vary most closely with M_3, which corresponds to M_2 plus savings deposits at statutory notice. As the norm of 8 per cent. growth during 1975 was exceeded, owing to developments late in the year, the norm for 1976, though again fixed at 8 per cent., will be applied on the basis of year-to-year averages, thus implying a slackening in the rate of increase. In publishing the target, the Bundesbank expressed the hope that management and the trade unions would "... endeavour to use this monetary margin as far as possible for expanding production and employment and not for raising prices and costs".

In Canada, too, the central bank has been giving more attention to the monetary aggregates, focusing primarily on M_1. No targets were revealed until last October, when the Bank of Canada announced that the trend in monetary growth should be kept within a range of 10–15 per cent. a year. In February 1976, when it was seen that M_1 was running above the maximum rate, monetary policy was tightened. Moreover, it was indicated that the rate of increase would have to be gradually reduced to be consistent with the decline in inflation implied by the government's economic programme.

The Bank of Italy has long made operational use of the "monetary base", although more recently it has also had to lay stress on a system of limits for overall credit growth. Last November a limit was set for total domestic credit during 1976 and, within it, one for credit for Treasury requirements and another for direct Bank of Italy credit to the Treasury.

In other countries the central banks appear to place primary emphasis on interest rates, although in some cases credit availability has at times been limited with the help of credit ceilings or guide-lines, or by acting directly on the liquidity of commercial banks. In these countries the money supply tends to be looked upon more as an indicator — mainly of the efficacy of overall economic policy — than as an explicit operational target. The reason for this approach lies partly in the looseness of the observed relationship between money and spending. But to a large extent, particularly in such countries as Belgium, France and the Netherlands, it reflects the openness of the economy and the account taken of external considerations. Furthermore, it may to some extent be a reflection of the frequency and preponderance of disequilibrating domestic forces not easily amenable to central-bank influence alone. In the United Kingdom, for example, the monetary authorities formulate a view about the desired path of monetary growth, but the actual outcome is seen to depend heavily on wage/price behaviour, the public-sector borrowing requirement and the market for public-sector debt.

Problems of monetary control. The ability — or the willingness — of central banks to rely exclusively on controlling monetary aggregates seems to be limited by two sets of factors.

The first is a series of technical problems, which appear with varying intensity in most countries. One of these consists in disruptive short-term shifts in the preference for liquidity which are apt to produce large swings in interest rates if the growth rate of the money supply is held rigidly constant. Since few central banks are ready to accept such short-term swings, an appropriate adjustment of the money supply is often regarded as inevitable. A second point is that it takes some time before central banks are able to ascertain whether the broader monetary aggregates are really on target, and even more time to see whether the corrective action is producing the expected result or not. Last but not least, substantial long-term shifts seem to occur between different kinds of monetary holdings, to a large extent under the influence of a steady flow of innovations in the financial system. As a result of all these problems, central banks tend to look at several variables at the same time.

The more fundamental problem, however, concerns the actual degree of control that a central bank is able, given the particular socio-political context in which it operates, to exercise over the quantity of money. To see this problem in perspective, it is useful to look at the recent behaviour not simply of the money supply but also of its credit counterparts.

In most countries the growth of money and quasi-money (mainly time and savings deposits) was appreciably lower in 1974 than its average during the recession and upswing of 1969–73. But in a number of them it accelerated again last year, often to rates more or less comparable with the earlier period. However, since prices were still rising at a relatively high rate in 1975, money creation was generally smaller in real terms than in 1969–73. Even in nominal terms monetary expansion in some countries — Japan, the Netherlands, Switzerland, the United Kingdom and the United States — was quite low by earlier standards. And, compared with 1974, Canada achieved a marked deceleration in its monetary growth.

Bank credit to the private sector slowed down in a number of countries in 1975. The deceleration was especially marked in the United Kingdom, Germany (where it had started already in 1974) and the Netherlands, but it was also quite perceptible in Belgium, France and Japan. In the United States such credit actually declined in absolute terms. The most important factor underlying these changes appears to have been the sharp fall in business investment, particularly in stock-building, but in some cases they also reflected a shift to long-term borrowing outside the banking system. In contrast, in some countries, mainly those where the strongest efforts were made to cushion the recession and where wage increases were pronounced, bank lending to the private sector was still on average quite considerable.

What is striking is the extent to which money creation in many countries came to depend on the monetary financing of public-sector deficits. Had such deficits not emerged — or increased — and had they not been financed through the banking system, the rate of growth of the money supply could in some cases have fallen well below acceptable levels. In other words, it is very doubtful whether an easing of monetary policy, e.g. by open-market operations, could have been carried out on a scale sufficient to counteract the heavy decline in loan demand from the private sector.

The banking system: Monetary survey.

Countries	Years	Contribution to growth of money and quasi-money of changes in: net foreign assets	domestic credit to: public sector	domestic credit to: private sector	Change in money and quasi-money[1]	Change in: real GNP	Change in: GNP deflator	Change in: nominal GNP
		in percentages						
Austria	1969–73	1.2	2.4	10.9	14.3	6.5	6.3	13.2
	1974	0.2	1.9	9.9	12.2	4.1	10.5	15.0
	1975	5.5	5.9	9.2	19.4	− 2.0	8.9	6.7
Belgium	1969–73	2.2	4.1	6.5	12.4	5.3	5.7	11.3
	1974	− 2.0	5.5	4.3	9.0	4.0	12.7	17.2
	1975	2.6	4.8	7.7	14.8	− 1.5	13.2	11.5
Canada	1969–73	0.6	1.5	12.0	13.3	5.2	5.0	10.5
	1974	2.5	− 0.8	16.9	19.4	2.8	13.8	17.0
	1975	− 1.1[2]	2.2[2]	12.9[2]	13.3[2]	0.2	9.6	9.8
Denmark	1969–73	1.6	− 2.8	11.5	10.1	3.9	7.8	12.0
	1974	− 0.7	0.2	9.7	8.4	1.9	11.2	13.3
	1975	− 1.5	4.4	16.8	25.1	− 1.0	11.5	10.5
Finland	1969–73	1.9	− 3.3	16.1	15.3	5.9	7.7	14.1
	1974	− 4.4	− 0.8	25.9	17.2	4.4	19.2	24.4
	1975	− 6.2[2]	4.0[2]	27.2[2]	23.4[2]	0.0	16.5	16.5
France	1969–73	1.5	− 0.5	15.5	16.8	5.6	6.2	12.1
	1974	− 2.0	3.1	15.8	18.1	3.8	11.6	15.8
	1975	2.8	4.2	12.8	16.0	− 2.5	12.3	9.5
Germany	1969–73	2.2	0.8	10.2	13.3	4.4	6.7	11.4
	1974	0.3	2.2	5.0	9.5	0.4	7.0	7.4
	1975	2.3	6.1	4.0	13.6	− 3.4	8.2	4.5
Italy	1969–73	− 0.2	7.2	11.9	20.6	4.0	7.3	11.6
	1974	− 2.9	8.9	14.2	16.3	3.4	16.3	20.3
	1975	− 1.1	13.4	10.3	23.7	− 3.7	17.2	12.9
Japan	1969–73	0.8	0.0	18.9	20.6	9.2	6.9	16.7
	1974	− 1.9	2.3	12.4	11.5	− 1.2	20.7	19.3
	1975	− 0.7	5.0	11.6	14.5	2.0	7.3	9.4
Netherlands.	1969–73	3.7	0.3	10.6	14.1	4.9	7.7	13.0
	1974	1.8	0.4	13.0	14.6	3.3	8.8	12.4
	1975	4.3	3.4	8.1	12.1	− 1.8	10.9	8.9
Norway	1969–73	1.5	3.9	7.6	13.5	3.7	8.7	12.7
	1974	1.2	1.0	8.5	11.2	5.3	9.5	15.3
	1975	3.6	3.2	10.6	15.5	2.7	11.9	14.9
Spain	1969–73	3.5	1.5	16.9	21.0	6.8	7.8	15.1
	1974	− 0.9	2.1	18.6	19.3	5.0	13.9	19.6
	1975	− 0.7	3.1	17.2	18.4	0.7	16.4	17.2
Sweden.	1969–73	1.9	1.7	6.9	9.0	2.9	6.4	9.5
	1974	− 1.1	3.4	8.9	8.1	4.2	8.7	13.3
	1975	2.2	3.0	9.4	10.1	0.5	13.6	14.4
Switzerland	1969–73	1.9	0.9	7.2	9.1	4.1	8.0	12.4
	1974	0.0	− 0.7	6.0	4.2	2.0	6.6	8.7
	1975	0.7[3]	0.9[3]	5.6[3]	6.0[3]	− 7.0	6.3	− 1.1
United Kingdom. . .	1969–73	1.1	1.4	9.7	18.8	3.2	7.9	11.4
	1974	− 4.9	5.8	8.9	12.8	− 0.3	13.1	12.8
	1975	− 3.2	8.9	0.1	7.7	− 1.7	26.4	24.3
United States	1969–73	0.5	4.0	7.8	12.1	3.4	5.1	8.7
	1974	− 0.9	2.1	7.4	9.4	− 1.8	9.7	7.7
	1975	0.9	4.8	− 1.1	6.0	− 2.0	8.7	6.5

[1] December to December. Equal to the sum of the first three columns, except for differences attributable to changes in unclassified assets and liabilities. [2] September to September. [3] November to November.

Source: IMF, *International Financial Statistics,* and national sources.

Despite the transition to floating exchange rates, variations in the banking system's net foreign assets have continued to figure as an important counterpart to changes in money and quasi-money. While the reason for this may often lie in the central bank's intervention policy, it may also be associated with the conduct of monetary policy itself. For example, in Germany, where the Bundesbank reduced its own net foreign assets in 1975, the combination of monetary ease and weak credit demand led the banks to increase substantially their net holdings of foreign claims. In various other "snake" countries, too, the change in net foreign assets was a sizable counterpart of monetary expansion. In most cases the central bank's official exchange reserves rose appreciably, while in France and the Netherlands, as well as in Austria, the commercial banks' net foreign position also rose by a large amount.

In certain other countries, on the other hand, a decline in the banking system's net foreign assets was a negative element in the growth of money and quasi-money. This was the case, for instance, in Finland, Italy, Japan and the United Kingdom.

To keep the growth of the money supply at a moderate rate during the current cyclical revival, monetary authorities will face a difficult task, which will be more or less the reverse of that of 1975. Sooner or later, loan demand from the private sector will pick up as a result of renewed stock-building and possibly even of increased fixed-capital expenditure. Will it be possible at the same time to reduce the financing of the public sector through the banking system? This will largely depend on a simultaneous cut in the public-sector budget deficit. Over this, however, central banks have no command.

Another stumbling block to monetary control may prove to be an excessive autonomous rise in money wages. In many countries wages are already increasing well in excess of productivity gains, and this tendency may become more pronounced and widespread as the upswing progresses. To the extent that central banks feel impelled to accommodate, or "finance", these wage increases, monetary growth will be so much the higher. However, in so far as countries succeed in negotiating workable forms of incomes policies, monetary expansion will tend to be that much lower. Indeed, success in containing the wage/price spiral, with all its political overtones, is a basic prerequisite to the attainment of a moderate and steadier rate of monetary growth.

The upshot of this brief monetary survey is that there are no technical tricks in monetary management by which it would be possible to control the deposit liabilities of the banking system without paying due attention to the influences impinging on its asset formation, and therefore to all other policy constraints to which central banks are subject. It is possible that until a few years ago attention was excessively concentrated on how expenditure was financed by the banking system, and that this optique may have led to a neglecting of the potential inflationary effects of a rise in the money supply. A healthy reaction against this one-sidedness has more recently taken place in both monetary thought and monetary policy. It would be regrettable if this reaction, by disregarding the forces which underlie changes in bank lending, were to push the pendulum to the other extreme.

IV. DOMESTIC CREDIT AND CAPITAL MARKETS.

Developments in the major domestic credit and capital markets were dominated by the recession, the expansionary fiscal and monetary policies pursued and the significant slow-down in the pace of inflation. The business revival has so far had only a limited impact on the markets, but the currency upheavals in early 1976 did affect interest rates in some European centres and signs of a more general rise in rates have recently become apparent.

The combined influence of these factors was, quite naturally, a general easing of the tensions experienced in 1973–74 and a return to more normal market conditions. Interest rates declined markedly everywhere, though in March–May 1976 they turned up in Belgium and France and rose quite sharply in Italy and the United Kingdom. The differential between long and short-term rates has returned to normal in most countries, and real interest rates have also become positive, at least in those countries which achieved a measure of success in their fight against inflation. As a result, the business sector has greatly improved its debt structure by replacing short-term liabilities by bond or equity financing.

These favourable developments took place despite the dramatic rise in the financing requirements of the public sector, which has so far led neither to a "crowding-out" of other expenditures nor to an unwarranted growth in the money supply. The explanation, of course, lies in the depth of the recession, which was accompanied by a compensating change in the financial flows generated by the private sector.

The picture is much less encouraging, however, if one looks in some detail at individual countries. The favourable assessment applies with little or no reservation only to Switzerland, Germany and the United States — the same countries that have been singled out in previous chapters for their better-than-average performance. But where underlying inflationary forces still seem to be strong — notable examples being Italy and the United Kingdom — there is a high risk that the normalisation of financial markets will be only short-lived. It is no mere coincidence that the public-sector deficit reached the highest proportion of GNP in these two countries, where, moreover, the recession-induced increase in 1974–75 came on top of a rising trend in progress for several years.

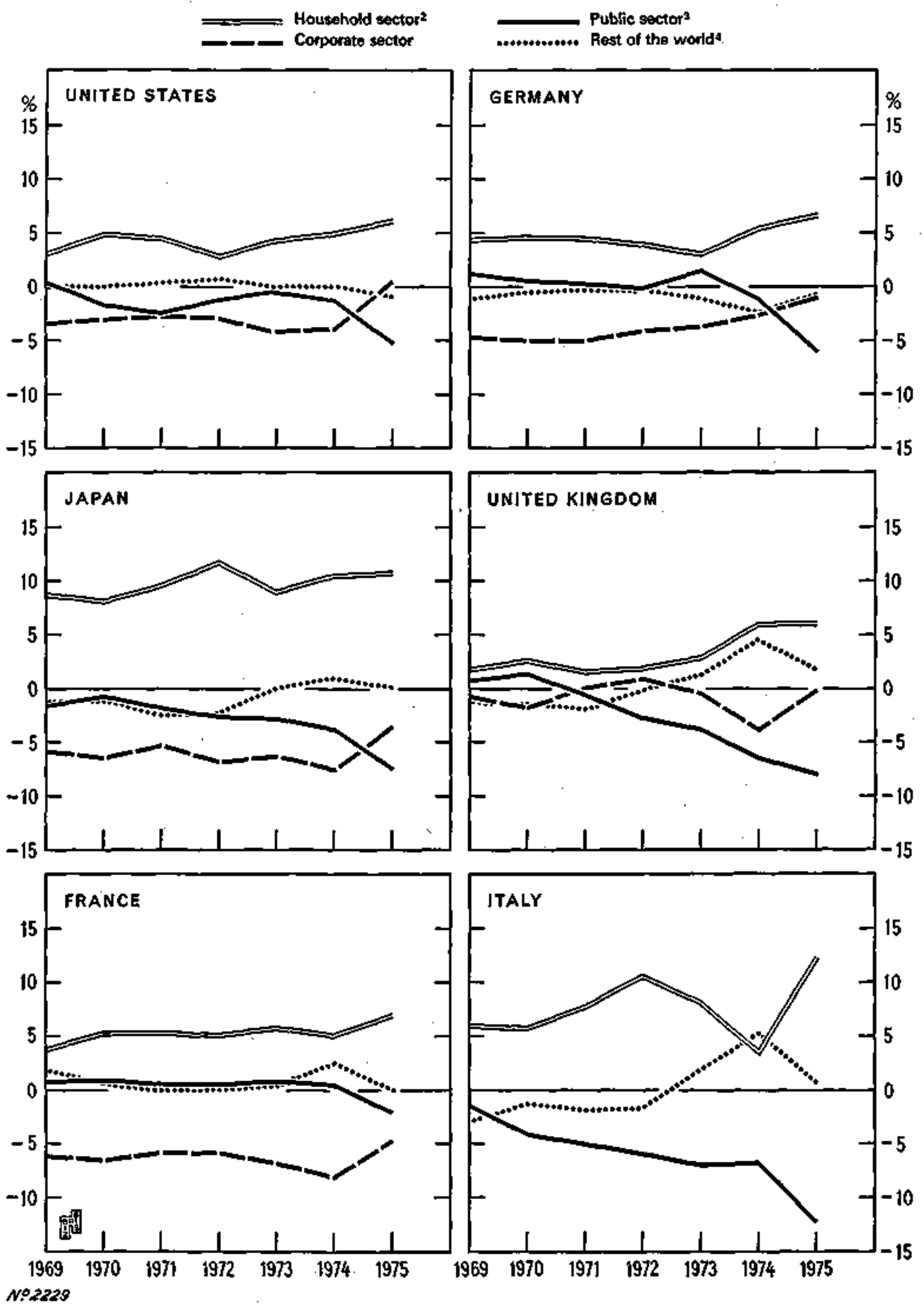
The changing pattern of sectoral financial flows.

In the major industrial countries some remarkably large shifts occurred last year in the sources and uses of credit and capital-market funds.

On the demand side, extensive cut-backs in corporate fixed investment and inventories — which exceeded the decline in cash flows — led to a sharp reduction in borrowing. On the other hand, with the concurrent emergence of unusually

Financial surpluses and deficits by sector.[1]

As a percentage of gross national product.



[1] Sectoral classifications, which vary from country to country, are based on national sources, except that in the case of Germany housing has been treated as belonging to the household rather than to the enterprise sector. [2] *For Italy, total private sector.* [3] *For Italy, central government only.* [4] *A surplus of the rest of the world* represents net lending to (or the current-account deficit of) the domestic economy.

large counter-cyclical budget deficits, public-sector borrowing requirements mounted steeply.

On the supply side, the household sector recorded an exceptionally large increase in net financial claims, partly because of higher rates of personal saving and partly because of a contraction in outlays on new dwellings. In most countries except Germany the growth in the net supply of funds from the household sector outstripped the rise in the combined net demand from the enterprise and public sectors. The difference was reflected in an improvement in the external current-account position, representing either a reduction in borrowing from, or an increase in lending to, the rest of the world.

One of the most striking developments last year was the unusually steep decline in the net financing requirement of business, the change being equivalent to some 3–4 per cent. of GNP in the United States, Japan, the United Kingdom and France. It was significantly less than this (about 1½ per cent.) only in Germany, where enterprise investment, and with it borrowing, had already been tapering off since 1971.

The household sector's financial surpluses were very high in all countries. But, on an annual basis and in relation to GNP, those in the United States and Japan do not seem very far out of line with previous cyclical experience and their long-term upward trend. The rises in 1974 and 1975 seem much more unusual in some European countries.

In the public sector, financial deficits last year were without recent parallel. They ranged from some 2 per cent. of GNP in France to between 5 and 8 per cent. in the United States, Germany, Japan and the United Kingdom. In Italy the deficit of the central government alone came to 12 per cent. of GNP.

Public-sector financial positions have shown considerable cyclical variation in the past, and the recession was obviously the major factor in the deterioration in 1974 and 1975. But equally striking are the differentiated movements over a longer period. Whereas in Germany and the United States these movements appear to be largely cyclical, those in Italy, the United Kingdom and, to a lesser extent, Japan seem to have contained a strong trend element in the direction of rising deficits. In France, at least until last year, the government succeeded in keeping the budget in near-balance and fixed investment and the economy on a stable growth path (see Chapter II).

Financing of the business sector.

The cut-back in corporate investment and borrowing in 1975 has to be set against the background of heavy borrowing in earlier years, which had brought about a serious deterioration in liquidity and capital positions. In the United States, for example, total liabilities of manufacturing companies rose from 50 per cent. of shareholders' equity in the early 1960s to nearly 100 per cent. in 1974, while the ratio of liquid assets to short-term liabilities (all non-financial corporations) fell from around 40 to 24 per cent. In Germany the capital and reserves of a sample of companies reporting to the Bundesbank fell from 30 to 24 per cent. of the balance-sheet total between 1965 and 1974, while short-term debts rose from 41 to 45 per cent. In the United Kingdom the market value of the fixed-interest debt of industrial and commercial companies rose from £9 milliard in 1964 to £23 milliard in December 1974, with almost the whole of the rise taking the form of indebtedness to the banking system. At the same time the adjusted real rate of return on capital investment declined very sharply. In the Netherlands, over the same period, the rise in the recorded debt of the private sector, also mainly in the form of bank borrowing, was so rapid that in relation to national income it increased from 64 per cent. to nearly 94 per cent.

After many years of sustained economic expansion in which standards of prudence had weakened, the recession revealed to management the dangers arising out of this situation. In addition, the incentive to borrow which had been created by accelerating inflation and falling real interest burdens came to a sudden end with sharp rises in long-term interest rates and the growing prospect of a slow-down in inflation. In the early stages of the adjustment corporate liquid assets were also cut back (the United States, the United Kingdom) or not increased (Germany). As a result, all the financial resources freed by the cut-back in investment were used to retire debt.

At the same time, there was also some consolidation of the debt structure of enterprises, which had become markedly biased towards short-term liabilities. This was made possible by the strong recovery of securities markets last year. In the United States bond issues by non-financial corporations came to a record $27 milliard, compared with an already high $20 milliard in 1974. Stock issues rose by $6 milliard to reach $12 milliard, helping in particular to relieve the acute balance-sheet problems of utility companies and banks, though by early 1976 many other borrowers had joined the queue. In France bond issues by the enterprise sector doubled last year, while in Japan industrial bond issues rose by over 50 per cent., with share issues nearly tripling. In Germany and the United Kingdom, where the corporate sector benefited little from bond finance, share issues did particularly well, rising by 50 per cent. in the former case and recovering to £1.3 milliard in the latter after two years during which the market had been almost dry. In France and Germany enterprises also appear to have funded short-term indebtedness by expanding their long-term borrowing from banks, frequently at lower interest costs.

Reflecting lower borrowing requirements and increased capital issues, corporate borrowing from banks fell at an annual rate of $16 milliard in the United States during the first three quarters of 1975 and slowed down markedly in other countries. In Germany, for example, the level of bank credits to enterprises in September was only negligibly higher than a year earlier. At the same time companies issued less short-term market paper and their balance sheets were also improved, at least temporarily, by slower growth in commercial claims and debts, including international trade credit, which had expanded substantially in the previous year.

By the winter signs of an upturn in bank lending to the business sector had become evident in Germany, France and some other countries as well. But with cash flows improved and investment still very weak, business demand for short-term credit has generally remained subdued.

Banks, too, took action to strengthen their balance sheets last year. In this context, business failures, which reached only moderate proportions, were a less serious problem than had been feared, though the construction industry was badly hit in some countries. But loan portfolios had become more risky, so that the banks applied more stringent standards in new lending and bid less aggressively for time deposits. In quite a few countries, by exercising caution in adjusting lending rates downwards, they were able to increase profit margins and to build up reserve funds. In several European countries, as well as in the United States, the capital positions of banks were also improved by bond or share issues.

Borrowing and lending by households.

One element of the high financial surplus of households in 1975 was the low level of borrowing for the year as a whole. However, the yearly figures mask the cyclical movement. A cut-back started in 1974 and continued during the early part of last year. As this followed a very strong expansion of consumer and mortgage debt during the previous inflationary boom, some consolidation of financial positions appears to have occurred in the personal sector too. But by late last year a renewed expansion of household borrowing was already under way in most of the larger countries.

Mortgage credit expansion quickened in the United Kingdom, Canada and the United States. In this last country home mortgages rose to an annual rate of $45 milliard in the fourth quarter of 1975, compared with one of $28 milliard a year earlier, becoming one of the most buoyant elements of private credit demand. Running ahead of the rise in the value of construction, much of the increase served, at least initially, to finance transactions involving existing houses, thereby increasing the liquidity of the economy generally. In some other countries, including Germany, the upturn in mortgage lending was less pronounced and the level remained rather depressed.

Consumer credit fell in the United States in the first half of 1975 but went up at a $12 milliard annual rate in the second half. An acceleration in personal bank credits late last year after a period of weakness was also a feature of a number of countries, including France, the United Kingdom and Germany. In some cases this reflected an easing of selective restraint measures.

However, the most important element of households' financial surpluses was a large increase in financial assets. What form did it take? Deposit formation accounted for the bulk of the rise last year — for about two-thirds in the United States and nearly three-quarters in Germany and Japan. In the United States this was a significantly higher proportion than in 1974, when currency and deposits were only 54 per cent. of total asset accumulation. The deposit share also rose in Germany but fell somewhat in the other two countries. In most countries, however, there were marked changes in the composition of deposit formation. In the United Kingdom, the United States and Japan the share of currency and demand deposits declined, while that of time and savings deposits increased or remained high. There was also a shift within this latter category: a very large build-up of savings deposits took place with banks and specialised savings institutions in practically all major industrial countries. This is not recorded as monetary expansion in quite a number of countries, but the fact remains that savings deposits are potentially liquid. Should households decide to accelerate spending, they could easily finance their consumption expenditure by drawing on these assets.

Distribution of personal-sector asset accumulation.

Countries	Years	Demand deposits and currency	Time and savings deposits[1]	Total deposits and currency	Securities and money-market paper[2]	Insurance and pension claims	Other
		as a percentage of total asset accumulation					
United States	1973	9.7	50.0	59.7	16.0	23.4	0.9
	1974	6.7	47.1	53.8	17.5	30.8	− 2.1
	1975	5.3	59.9	65.2	10.1	27.2	− 2.5
Germany	1973	2.5	61.8	64.3	18.4	17.2	0.1
	1974	9.2	59.9	69.1	13.8	17.1	—
	1975	9.1	64.8	73.9	10.8	15.3	—
Japan	1973	21.4	57.6	79.0	7.9	11.4	1.7
	1974	14.0	64.4	78.4	8.6	13.8	− 0.8
	1975	9.6	64.4	74.0	12.0	12.8	1.2
United Kingdom	1973	45.4[3]	31.0	76.4	− 12.4	37.2	− 1.2
	1974	38.9[3]	24.2	63.1	1.5	36.4	− 1.0
	1975	3.8[3]	50.1	53.9	− 10.1	50.9	5.3

[1] Includes funds placed with savings institutions providing housing loans and, in the case of Japan and the United Kingdom, trust claims and national savings respectively. [2] Includes unit trust claims. [3] Includes all bank deposits.

Household purchases of securities rose considerably in Japan and also reached comparatively high levels in Germany in the first half of the year and in the United States towards the year's end. But in both these countries periods of net selling by households held down the figure for the year as a whole, while in the United Kingdom the personal sector substantially reduced its security portfolio on balance during the year. Incomplete data suggest that as a proportion of household asset accumulation purchases of securities increased only in Japan, where the rise was mainly in bank debentures, and fell significantly in the United States. Only in Japan and Belgium did household purchases constitute a large proportion of total security sales. Elsewhere, the main support for the bond market came not from households directly but rather from financial institutions, which obtained the funds for their purchases mainly from household deposits.

The rise in insurance and pension fund claims of households seems not to have kept pace with other household financial investments last year in Germany, Japan and the United States. In the last two countries, however, such assets had expanded sharply in 1974. In the United Kingdom the flow of funds into contractual claims increased appreciably last year, presumably in delayed reaction to the inroads of inflation into their real value.

The financing of public-sector borrowing requirements.

Having already risen significantly in 1974, public-sector borrowing requirements went up sharply last year. The following table gives a rough indication of the sources of central-government financing except in the case of Germany, where the breakdown relates to all public authorities. Financing requirements are measured on a cash basis net of debt redemption but including borrowing for lending purposes.

Government financing.[1]

Items	Years	Belgium	France	Germany	Italy	Japan	Netherlands	United Kingdom	United States
		in milliards of national currency units							
Public-sector financing requirement[2] . . .	1973	69.0	− 7.4	8.9[3]	9,265	.	2.4	4.2	18.4
	1974	81.0	− 6.3	27.2[3]	9,735	.	5.1	6.4	29.4
	1975	145.0	31.5	65.5[3]	16,800	.	9.9	10.4	101.5
Central-government financing requirement. . . .	1973	71.0	− 7.2	2.7	7,495	860	− 0.5	2.4	13.0
	1974	76.3	− 4.3	10.1	8,660	2,660	1.1	3.5	18.6
	1975	128.0	43.0	34.0	14,150	5,325	6.4	8.4	91.9
met by:									
Central bank	1973	− 0.5	− 3.3	− 1.8[3]	5,015[4]	1,230	− 1.8		9.7
	1974	5.2	4.1	− 1.8[3]	6,500[4]	3,000	− 1.8		5.6
	1975	− 0.6	18.9	6.3[3]	5,425[4]	2,145	0.1	1.2	9.3
								0.1	
Banks	1973	41.2	− 6.0	5.6[3]	870	− 245	− 0.8	2.1	− 6.8
	1974	22.3	− 0.4	21.6[3]	1,565	− 345	0.3		1.9
	1975	31.4	12.2	44.7[3]	4,775	2,000	1.8		26.1
Other domestic sources.	1973	33.8		4.5[3]	1,505		2.1	1.7	9.8
	1974	50.3		6.6[3]	595		2.6	1.9	8.9
	1975	97.8	2.1	11.2[3]	3,950	− 125	4.6	5.8	49.2
			− 8.0			5			
Foreign sources. . .	1973	− 3.5	11.9	0.6[3]	105	1,180	—	− 0.5	0.3
	1974	− 1.5		0.8[3]	—		—	1.5	2.2
	1975	− 0.6		3.3[3]	—		—	0.5	7.3

[1] Based partly on BIS estimates. [2] Central government, local authorities and social security, on a cash basis. [3] All public authorities; figures for banks include residual changes in cash balances. [4] Only short-term debt which is relevant to the monetary base.

Monetary financing played a significant rôle in all countries and a very large one in most. Borrowing from the banking system covered about a quarter of the requirement in the United Kingdom, Belgium and the Netherlands and about 40 per cent. in the United States; it accounted for approximately three-quarters in France, Germany, Italy and Japan. Moreover, in three countries — France, Italy and Japan — the central bank itself provided between one-third and one-half of the total financing.

Security issues covered the bulk of Treasury requirements in the United Kingdom, the United States, Japan, the Netherlands and, in the first half of the year, Germany. But most were sold to banks and other deposit institutions and very little to non-financial sectors. Even in the United States $47 milliard of Treasury issues were placed with banks and other private financial institutions, with private domestic non-financial investors (mainly corporations and local authorities) taking up only $18 milliard. Moreover, a very large proportion of the securities issued were at short or medium term. Bond issues accounted for only about 7½ per cent. of total public-authority borrowing in Germany and only about 5 per cent. of Treasury issues in the United States. In Germany and the United Kingdom the authorities deliberately catered for investor preferences for short maturities so as to minimise pressures on long-term interest rates. It should also be recalled that in France, Italy and Belgium government borrowing outside the banking system proper includes recourse to funds collected by specialised savings-deposit institutions.

The concern, at times widespread, that heavy government borrowing would result in pressures on interest rates or in a monetary explosion seems in the event to have been excessive or at least premature. Large Treasury issues and apprehensions as to future requirements at most slowed or temporarily checked a generally downward course of long-term interest rates. And, though a build-up of fairly liquid assets was not avoided, private demand for credit was so weak that in most countries large-scale government borrowing from the banking system proved compatible with moderate rates of expansion of money proper.

Comparative interest rate developments.

Under the influence of persistently weak private demand for bank credit and policies designed to ease bank liquidity, short-term interest rates continued on a broadly downward course last year, reaching their lowest levels for two years. The extent of the decline and the timing, however, differed substantially from country to country. (See graph, next page.)

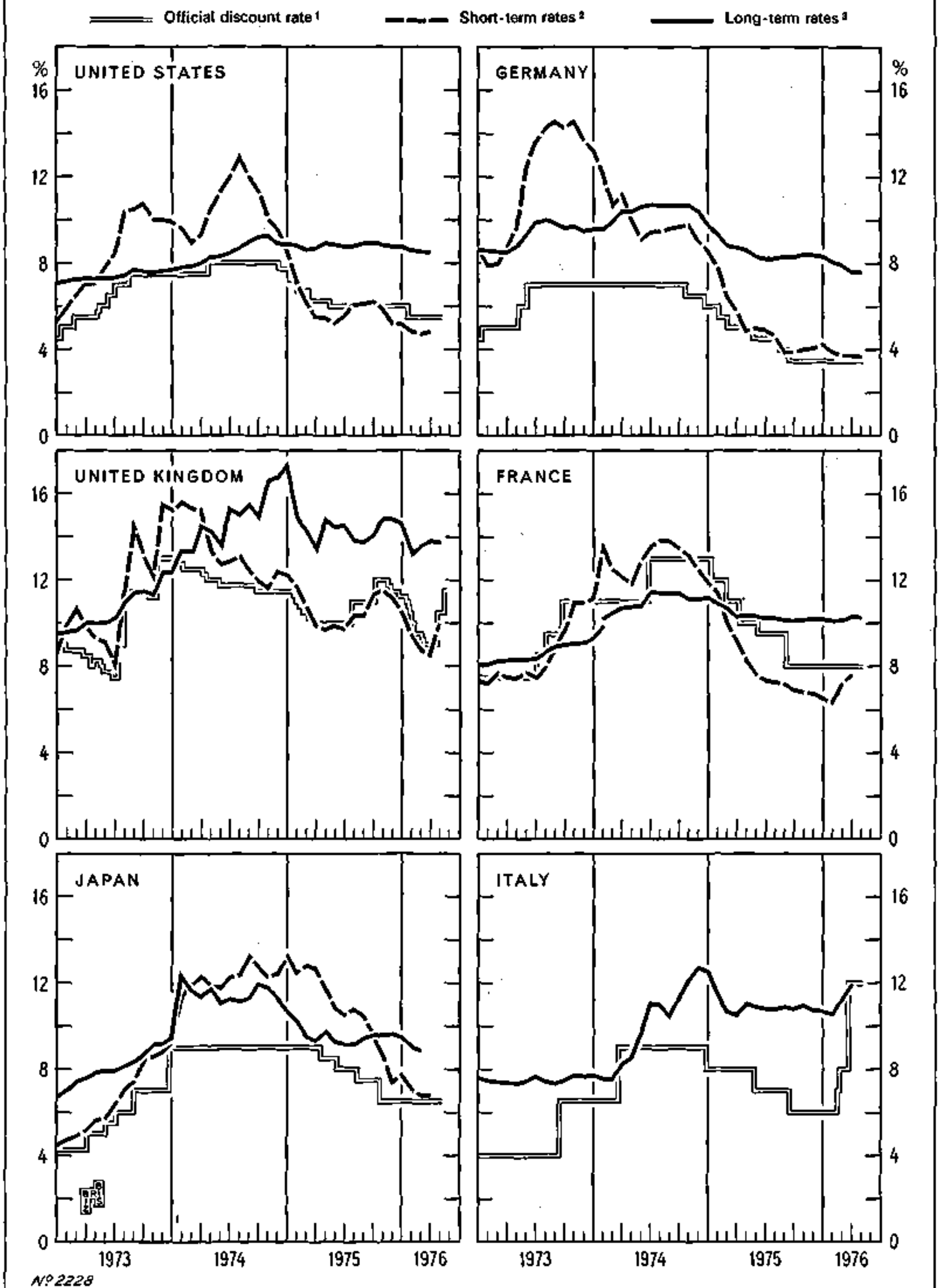
In early 1975 short-term interest rates were everywhere still in sharp retreat from their earlier peaks, with the pace much faster in Europe than in the United States.

Developments diverged again during the summer. In the United States official efforts were made to dampen an acceleration of monetary expansion associated with large government cash disbursements, and Treasury borrowings at short term were heavy. Consequently money-market rates turned up in June, the Federal funds rate rising by 1¼ percentage points between May and early October. With sterling under periodic pressure, the UK authorities encouraged wider differentials between domestic and dollar rates between April and October. But in France, Germany, Switzerland and Japan, under increasing monetary policy stimulus, short-term rates merely levelled out for a time from the spring before falling again.

After October, when the Federal Reserve eased its management of bank reserves in response to unexpectedly slow monetary growth late in the summer, short-term interest rates turned downwards in the United States and fell in relation to those elsewhere.

Following a general easing in early 1976, money rates have recently moved upwards in the United States but are still around their early 1975 levels — an unusual cyclical recovery experience. Sterling rates continued to fall until April but have since risen significantly. Divergent movements elsewhere were dominated for a time by policy reactions to the currency upheavals, with rises in Belgium, France and Italy

Short and long-term interest rates.



¹ For the United Kingdom, minimum lending rate. ² For the United States, Federal funds; for Germany and the United Kingdom, three-month interbank rates; for France, day-to-day money; for Japan, call money. ³ For the United States, Aaa corporate bonds; for Germany, public-authority bonds; for the United Kingdom, twenty-year gilt-edged; for France, public and semi-public-sector bonds; for Japan, Telephone and Telegraph bonds; for Italy, industrial credit institution bonds.

and slight falls in Germany and Switzerland. In Japan, well behind the other countries in the short-rate cycle, money-market rates continued to decline.

Long-term interest rates had by early 1975 fallen back to levels considerably below their earlier peaks, particularly in the United Kingdom and Italy where, at least in nominal terms, rates had previously been highest. In Germany substantial Bundesbank support for the market was necessary to prevent a rise in the autumn but, as in the United States, clear evidence of a slow-down in inflation encouraged further modest declines by early 1976. In recent weeks long-term yields in some countries have edged up somewhat.

Since the decline in money-market rates was much steeper than that in rates for long-term funds, the normal maturity structure was re-established in all countries. Key short-term rates fell below long-term yields in the United Kingdom as early as the spring of 1974 and then, around the turn of the year, in the United States and France, and in the spring of 1975 in Germany and Italy. In Japan, where monetary restraint was continued later than elsewhere, the change occurred only in the autumn.

This tilting of the yield curve, which provided particularly receptive conditions for security issues, was brought about (as might normally be expected) by the decline in business activity. The recession prompted monetary authorities to relax restrictions at a time when demand for bank credit was falling anyhow; and at the same time it induced businesses to consolidate their debt structure in the way described earlier in this chapter, which has tended to slow down the decline in long-term rates.

The relationship between long-term rates and rates of inflation continued to vary markedly from one country to another. Where the price performance has recently been best — in Germany, Switzerland and the United States — yields stayed high enough to offer investors a fairly normal rate of real return. In other countries, while in nominal terms remaining higher than in the three above-mentioned markets, yields still do not offset rates of inflation measured over twelve months. However, current rates of inflation in some of these countries are more moderate or are expected to come down. Viewed in this perspective, long-term interest rates may imply better real returns than is apparent at first sight.

Developments in the major markets.

In the *United States* Federal Reserve policies, aiming at more stable long-term monetary growth, led last year to some appreciable short-term swings in bank reserve positions and money-market rates of interest. On balance the measures taken were expansionary: a substantial volume of reserves was made available to the commercial banks through open-market operations and reserve requirements were lowered on several occasions — in February in respect of sight deposits, in May in respect of Euro-currency borrowings and in October and January 1976 in respect of long-dated time deposits. Discount rates, which had been brought down from 7¾ to 6 per cent. in several stages in early 1975, were lowered further to 5½ per cent. in January 1976. However, a reversion to a tighter policy stance between June and October, mainly in response to faster monetary expansion in the spring, was clearly reflected in the Federal funds rate.

United States: Uses and sources of credit-market funds.[1]

Items	1970	1971	1972	1973	1974	1975 1st half	1975 2nd half	1976 1st quarter
	adjusted annual rates, in milliards of dollars							
Demand for funds								
US Government securities	12.8	25.5	17.3	9.7	12.0	84.1	86.3	91.0
Corporate and foreign bonds	20.7	19.7	13.2	10.2	21.9	41.3	25.8	28.6
State and local-government securities	11.2	17.6	14.4	13.7	17.4	17.1	13.8	8.4
Mortgages	25.7	46.9	67.3	73.2	55.9	49.3	60.9	61.0
Consumer credit	6.0	11.2	19.2	22.9	9.6	− 1.5	12.0	17.1
Domestic bank loans	6.7	7.8	18.9	35.8	27.3	−20.2	− 2.5	−14.6
Foreign bank loans	− 0.3	1.6	2.9	2.8	4.7	1.4	6.6	4.2
Other	9.7	5.6	5.7	11.8	27.4	4.8	9.9	21.2
Total[2]	92.5	135.9	158.9	180.1	176.2	176.3	212.8	216.9
Met directly by								
Federal Government	2.8	3.2	2.6	3.0	7.4	12.7	13.9	15.1
Federal Reserve	5.0	8.9	0.3	9.2	6.2	7.0	10.1	7.6
Commercial banks	35.1	50.6	70.5	86.6	64.6	16.3	38.2	19.2
Savings institutions	16.9	41.4	49.3	35.1	26.9	58.8	53.2	83.5
Other financial institutions	23.0	18.6	33.5	37.1	40.0	39.9	39.4	38.2
Private non-financial sector	− 0.6	−13.2	− 5.7	8.4	19.5	30.8	59.4	38.0
Foreign sector	10.3	26.4	8.4	0.7	11.6	10.8	− 1.4	15.3
Total[2]	92.5	135.9	158.9	180.1	176.2	176.3	212.8	216.9
Corresponding changes in financial assets								
Money (M_1)	10.5	12.7	16.7	12.6	10.8	19.8	7.3	4.8
Time and savings deposits	56.1	81.0	85.2	76.3	71.9	91.1	86.2	108.3
Credit-market claims	25.9	42.2	57.0	91.2	93.5	65.4	119.3	103.8
Total[2]	92.5	135.9	158.9	180.1	176.2	176.3	212.8	216.9

[1] Does not include equity issues by non-financial business, which amounted to	5.7	11.5	10.5	7.3	3.9	10.4	9.4	7.2
Total net flows, including equities	98.2	147.4	169.4	187.4	180.1	186.7	222.2	224.1
Total, as percentage of GNP	*10.0*	*13.9*	*14.5*	*14.3*	*12.8*	*12.9*	*14.3*	*13.9*

[2] Excludes funds raised by US Government-sponsored credit agencies for re-lending purposes.

The commercial banks' contribution to credit-market activity fell markedly last year. Total bank credit expanded by only $27 milliard, less than half the growth recorded in the previous year and the smallest since 1969, when there was rigorous monetary restraint. Moreover, the whole of the increase was accounted for by acquisitions of government securities. Banks' commercial and industrial loans fell sharply throughout most of the year, while mortgage and consumer lending increased much less than in the year before. Less aggressive in competing for funds, banks permitted their large CD issues to run down by about $10 milliard, while gradually lengthening the maturities of those outstanding. The increase in their liabilities chiefly took the form of savings deposits. The thrift institutions, which also saw large inflows of funds — at about three times the 1974 rate — and which until late in the year were faced with only weak demand for mortgage credit, increased their holdings of government securities by some $15 milliard.

Funds raised on the bond market by domestic firms — mainly industrial corporations and utilities — amounted to $27 milliard in 1975, or 40 per cent. more than in 1974, while foreign bond issues reached $6 milliard, three times the 1974 figure. Canadian local-government borrowers, in particular, were attracted to New York by a large interest differential but, increasingly, other foreign borrowers also gained access to the market. Buying support came as usual mainly from insurance and pension institutions but households, banks and mutual savings banks also increased their takings last year. Vigorous issuing activity in the bond and share markets, together with a strong recovery in mortgage lending, was evident in early 1976. State and local-government issues fell back from earlier high levels as the difficulties of New York and some other cities weakened confidence. As a result, local authorities were obliged to cut back their deficits for 1976.

Recession brought an increase in domestic business failures, highlighted by the bankruptcy of a large retail chain, while the financial problems of real-estate investment trusts continued and the finances of New York City required Federal assistance. Confidence seemed fragile at times, risk premiums in interest rates increased — particularly in the municipal bond market — and some banks experienced large loan losses. Abroad, the problems of the tanker industry and of some developing countries called into question the recoverability of US banks' large foreign loans. But the overall soundness of the banking system was well maintained. Although not all of the problems have been fully resolved, economic recovery and the loan-loss reserves which most banks were able to put aside during the year have substantially improved the financial climate.

In *Germany* the pursuit of stable monetary growth in the recessionary conditions prevailing through most of last year implied liberal money-market policies. The official discount rate was lowered in five stages between February and September from 6 to 3½ per cent. and banks' free liquid reserves were permitted to rise from DM 5 milliard in January to almost DM 16 milliard in November. The banks' reserve requirements were lowered in July and August, quota restrictions on Bundesbank lombard credit were removed, rediscount quotas for banks were raised and on occasion banks were offered short-term "open-market" loans at discount rates outside their rediscount quotas. Moreover, when in the summer both domestic and external conditions fostered expectations of a rise in bond yields, a pause in public-authority and non-resident issues was introduced. Between late July and late October the Bundesbank purchased a total of DM 7.5 milliard of bonds, eventually accepting an expansion of central-bank money in excess of its target for the year.

In the autumn and winter it became clear that public-sector borrowing had been more than sufficient to cover financing requirements, which proved to be smaller than expected, thanks to the business recovery. This resulted in a renewed build-up of deposits by the public sector at the Bundesbank. To avert strains in the money market, part of the Federal Government's balance was temporarily transferred to credit institutions. But by early 1976 monetary expansion was well established on a faster course. To counteract part of the expansionary effect on bank liquidity of official intervention in the exchange market, reserve requirements were increased in May and June.

Germany: Borrowing and lending of non-financial sectors.

Items	1970	1971	1972	1973	1974 1st half	1974 2nd half	1975 1st half	1975 2nd half
	in milliards of Deutsche Mark							
Borrowing sector								
Public sector	8.6	13.3	15.0	16.0	4.1	19.8	24.1	40.8
Enterprises	59.2	69.1	68.7	60.2	22.1	36.2	12.2	28.6
Housing	20.0	23.6	34.7	41.7	11.6	13.7	9.5	13.5
Households	3.4	5.8	8.3	3.9	− 0.4	0.0	0.8	3.6
Foreign	35.6	21.7	21.2	37.6	27.0	14.7	17.5	21.2
Total	126.8	133.5	147.9	159.4	64.4	84.4	64.1	107.7
Instruments								
Bank loans	58.0	71.7	91.6	77.8	23.5	50.2	26.7	76.4
Fixed-interest securities	2.2	3.7	3.8	1.5	1.9	9.1	13.6	7.9
Shares	6.0	7.0	5.9	5.0	2.6	3.2	3.5	4.6
Other domestic	17.8	20.2	26.3	32.6	24.6	21.8	8.8	14.2
Other foreign	19.5	15.1	4.5	17.1	9.1	4.7	10.3	7.9
Bundesbank foreign position	23.3	15.8	15.8	25.4	2.7	− 4.6	1.2	− 3.3
Total	126.8	133.5	147.9	159.4	64.4	84.4	64.1	107.7
Channels								
Banking system	87.8	95.6	115.5	106.9	30.4	61.9	43.4	98.8
Other	39.0	37.9	32.4	52.5	34.0	22.5	20.7	8.9
Total	126.8	133.5	147.9	159.4	64.4	84.4	64.1	107.7
Corresponding assets								
Demand and time deposits	43.1	42.2	46.9	55.7	8.9	18.5	−11.9	38.3
Savings deposits	20.5	28.1	32.8	14.9	13.1	17.8	38.3	29.4
Security market	19.1	16.2	24.7	27.4	4.5	8.4	11.9	1.1
Other domestic	39.4	42.2	37.6	57.0	21.8	31.5	23.5	34.1
Other foreign	4.7	4.8	5.9	4.4	16.1	8.2	2.3	4.8
Total	126.8	133.5	147.9	159.4	64.4	84.4	64.1	107.7
Total, as percentage of GNP	*18.5*	*17.5*	*17.7*	*17.2*	*13.2*	*16.7*	*12.6*	*20.3*

Total bank lending expanded at an annual rate of 7 per cent. in the first half of 1975 but accelerated to a 13 per cent. rate in the second half. Strong competition among lenders had stimulated declines in interest rates on a broad front and private demand for bank credit seems to have increased, possibly already under the impact of the business revival but also owing to the fact that the changing interest rate differentials induced enterprises to shift back towards domestic loans and away from borrowing abroad, most of which had been from foreign subsidiaries of German banks. The public authorities also had large-scale recourse to cheaper bank loans, covering two-thirds of their borrowing requirement for the year in this way. Still enjoying large inflows of savings deposits, the banks made substantial purchases of securities from November onwards.

Under the combined influence of a perceptible slow-down in inflation, a decline in the deficit of the public sector and falling US interest rates, the bond market showed increasing resilience from October. By early 1976, with issuers taking more account of investor preference for short maturities, capital-market activity was back to the high levels seen a year earlier.

In *Japan* there was little evidence of an easing of monetary restraint until the spring of last year, considerably later than in most of the other major countries. Bond yields fell at the beginning of 1975 under the influence of foreign purchasing and a slow-down in inflation. More indicative of developments in credit conditions, the Bank of Japan's discount rate was kept at the 9 per cent. "oil crisis" level until April 1975. Thereafter it was lowered in four stages to reach 6½ per cent. in October. With the call-money rate falling steeply during the year and into early 1976, the rates on medium-term bank debentures — the major capital-market instrument — fell by 2½ percentage points. However, in the spring of 1976 these rates — like those on bank deposits and lending, which fell by only 1 percentage point in the twelve months ending January — were still quite high by pre-1973 standards.

Private demand for credit weakened but was bolstered to some extent by continuing pressures on cash flows in some industries. Total bank loans and discounts increased by 12 per cent. last year, compared with 11 per cent. in 1974 and 17 per cent. in 1973. Influenced by official suasion designed to ensure that the financial institutions would take up the bulk of government bond issues sold to the private sector, the banks alone increased their holdings of government securities from Yen 1.25 to 3.25 milliard in the 1975 calendar year.

Total issues of bonds and bank debentures came to over Yen 14 milliard last year, compared with Yen 12 milliard in 1974. For the first time since December 1973 the market was opened for two small foreign issues.

In the *United Kingdom*, in an attempt to cope with recurrent pressures on sterling, priority in monetary policy was given to maintaining a differential between domestic and dollar interest rates. While generally encouraging high Treasury bill yields, the authorities applied penal lending rates in assisting the money market, notably in May, July, September 1975 and April 1976. Otherwise, official accommodation, including the temporary release of special deposits in January–February 1976, was designed merely to smooth over Treasury operations and the waves of gilt sales. However, it was essentially by taking advantage of strong demand for government securities that policy was able to be restrictive last year.

Thus a striking feature of the year was the sale of £5.2 milliard of government stock — reminiscent of, but far outdoing, the similar cyclical experience of 1971. Issues at five years or less accounted for about one-third of the total but, with inflation abating, investor preferences shifted towards long-dated stocks. Domestic sales outside the banking system amounted to £4.4 milliard — most of it taken up by institutional investors, including building societies which, in the prevailing constellation of interest rates, witnessed a spectacular inflow of new funds. In addition, domestic non-bank investors, again mainly financial institutions, acquired an unprecedented £550 million of Treasury bills, which offered an unusual interest advantage over bank deposits and sterling CDs after mid-year.

With their private-sector lending unchanged, the banks were called upon mainly to finance the public-sector borrowing requirement. In the process their liquid-asset ratios expanded strongly until very late in the year.

Companies raised very little loan capital other than in the form of convertible issues. But equity issues rose sharply and remained buoyant until early 1976, by which time mortgage lending by building societies was staging a strong recovery. Short-term sterling interest rates declined markedly between October 1975 and late April 1976 when, with the aim of checking the pound's downward slide, the Bank of England's minimum lending rate was raised from 9 to 10½ per cent. In late May this rate was raised further, to 11½ per cent.

In *France* the authorities sought in the first phase of the recession to moderate the decline in interest rates. Besides protecting the franc, an adequate level of yields relative to the rate of inflation was considered necessary to channel savings into longer-term instruments. However, account had increasingly to be taken of unemployment. Under cautious money-market policies the one-month rate came down from 11 per cent. in January 1975 to around 7 per cent. in the summer — with its advantage over Euro-dollar rates gradually narrowing. It fell to around 6½ per cent. in January 1976, after which some renewed rise was encouraged for external reasons. The Bank of France's discount rate was brought down from 13 to 8 per cent. between January and September. Reserve requirements were lowered substantially and bank credit ceilings were not cut back when actual credit expansion increasingly fell short of them. In fact, measures were taken to encourage many specific types of lending. Regulated interest rates on deposits were kept relatively high but, with other deposit and money-market rates falling, banks lowered their base lending rates from 12.4 to 8.6 per cent. during the year.

Total bank credit to enterprises and individuals expanded by 14 per cent., compared with 17 per cent. in 1974. There was a particularly marked slow-down in short-term credits — especially those closely related to business activity, such as discount and export credit. However, short-term personal loans, on which the restrictions were eased in September, expanded by 35 per cent. and non-mobilisable medium and long-term equipment credits went up by 27 per cent. Total liquid placements in the economy expanded by 22 per cent., compared with 13½ per cent. in 1974. Savings deposits rose by 29 per cent.

Bond issues reached a record Fr.fr. 43.4 milliard, approximately double the depressed volume of 1974. The government made no issues on its own behalf but guaranteed a Fr.fr. 5 milliard issue in the spring for financing subsidised investment credits to industry. All other issuing sectors benefited from a rise in bond purchases. Share issues, however, fell slightly below the 1973 and 1974 levels.

The norms for bank credit-granting for the second half of 1976, announced in April, are designed to help keep monetary expansion in line with the growth of nominal GNP.

In *Italy*, with the extreme weakness of the economy helping to keep domestic credit expansion within the limits agreed with international creditors and with the current account improving substantially, monetary policy was relaxed considerably from the spring of 1975 onwards. Following the removal in March of the import deposit requirement, quantitative restrictions on bank credit expansion were abolished in April and the banks' compulsory bond investment coefficient was eased for the second half of 1975. The Bank of Italy's discount rate was lowered from 8 to 6 per cent. in two stages in May and September. Between early 1975 and January 1976 the prime lending rates of commercial banks were reduced from some 19 per cent. to around 12 per cent.

Total domestic credit expansion in 1975 amounted to some Lit. 31,000 milliard, an increase of 19 per cent. compared with one of 16 per cent. in 1974. Of this, the Treasury took Lit. 13,700 milliard, while bank lending to the private sector expanded by about 14 per cent. compared with 20 per cent. in 1974. With offerings by the government and the special credit institutions increasing sharply, total bond issues reached Lit. 12,125 milliard, compared with Lit. 3,500 milliard in 1974. Net placements outside the banking system amounted to nearly Lit. 3,000 milliard (following large net reductions in holdings in 1974) and the banks took up Lit. 6,250 milliard, far in excess of their investment obligations. The surging Treasury deficit and the official refinancing of short-term export credits contributed to an 18.5 per cent. growth of the monetary base in 1975.

In early 1976, with the lira sinking sharply in exchange markets, the export refinancing facilities were curtailed and the reserve requirements of banks increased, while the Bank of Italy raised its discount rate in three stages from 6 to 12 per cent. by March. The import deposit requirement, introduced in May, was also expected to exert a prompt and substantial check on domestic liquidity creation.

V. INTERNATIONAL TRADE AND PAYMENTS.

In 1975 and the early part of 1976 the course of world trade and payments was primarily determined by the fluctuations of economic activity in the industrialised countries. On the trade side, the deepest industrial recession of the post-war era produced a significant reduction in the volume of world imports and exports. The volume of imports into the developed countries was down by as much as 8 per cent. in 1975. Larger still, in relative terms, was the decline of nearly 17 per cent. in the volume of imports into the non-oil developing countries, due partly to the reduction in their export revenues brought about by the recession, and partly to higher oil prices. In other areas, however, certain factors combined to limit the overall downturn of world trade and the world economy. Imports into the OPEC countries rose even faster than in 1974. In addition, the centrally-planned economies increased their import volumes in 1975, both in trade with the rest of the world and, to a lesser extent, with each other. These supporting factors began to falter towards the end of the year. In the case of the OPEC countries, this was to some extent a matter of sheer physical inability to continue absorbing such a high level of imports, though declining revenues also led some of these countries to cut back. There were signs, too, that financial considerations may have begun to limit the flow of imports to certain of the centrally-planned economies. By that time, however, the recession in the industrialised countries had largely bottomed out and their import demand was beginning to recover. Thus, in the event, both the scope and duration of the decline in world trade confounded the worst fears of the pessimists and by the end of 1975 the trend was clearly upwards again.

Last year's shrinkage of world trade had the effect of substantially diminishing two of the three main elements in the unprecedented world payments disequilibrium that had emerged in 1974. Both the OPEC area's current surplus and the OECD area's deficit were greatly reduced. On the other hand, the non-oil developing countries' combined deficit grew further. Despite a number of difficult situations, therefore, balance-of-payments financing problems were on a lesser scale than they had been in 1974, in the immediate aftermath of the increase in oil prices. With the recovery of world trade, however, earlier imbalances are beginning to re-emerge. The whole of the collective improvement in the industrialised world's external balance was cyclical; changes in individual countries' positions, moreover, were unevenly spread, with a number of them still showing deficits, or at best a balanced position, on current external account at the bottom of the cycle. By early 1976 the OECD area's current payments deficit may have been running at an annual rate of nearly $20 milliard.

The events of 1975 and early 1976 show how rapidly the world balance of payments can change, first one way, then another. The present situation is that basic adjustments remain to be made, both between the oil-exporting countries and the rest of the world and also among the industrial countries. In the meantime there are likely to be some significant financing problems. While these should not be on the scale of 1974, their handling may in certain cases be complicated by the volume of existing external indebtedness.

World trade.

In 1975, under the influence of the recession in the industrialised countries, world trade, the real growth of which had already slowed down from 12 to 5 per cent. between 1973 and 1974, showed an actual decline of 6 per cent. — the first contraction of any significance in the post-war era. The trade recession was accompanied by a substantial slowing in the growth of the average unit value of internationally traded goods; the rate of increase fell from over 40 per cent. to somewhat less than 10 per cent. Consequently the growth of world trade in dollar terms, at $35 milliard, was just one-eighth of the 1974 figure. The whole of last year's trade recession was concentrated in the first half of the year; as economic activity began to pick up in a number of major industrial countries, the volume of world trade showed a rise of 6 per cent. at an annual rate between the two halves of the year and it appears that for 1976 the rate of growth may be in the region of 10 per cent.

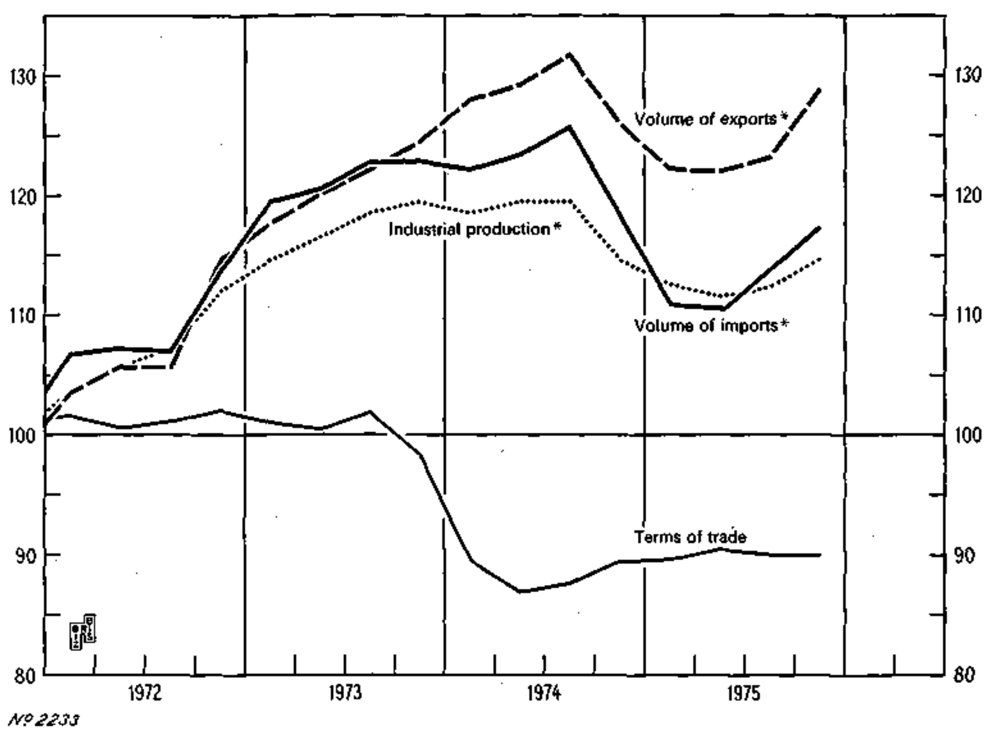
World trade.[1]

Areas	Exports (f.o.b.)				Imports (c.i.f.)			
	1974	1975			1974	1975		
		Year	1st half	2nd half		Year	1st half	2nd half
	in milliards of US dollars							
Developed areas								
Western Europe:								
EEC	275	294	151	143	293	297	151	146
Other countries	64	68	35	33	92	96	51	45
Total	339	362	186	176	385	393	202	191
(Volume index 1973 = 100)	*(105)*	*(100)*	*(99)*	*(101)*	*(99)*	*(94)*	*(93)*	*(94)*
United States	99	108	54	54	108	103	51	52
Canada	34	34	17	17	35	36	18	18
Japan	56	56	27	29	62	58	29	29
Other countries[2]	20	21	11	10	28	27	14	13
Total developed areas	548	581	295	286	618	617	314	303
(Volume index 1973 = 100)	*(107)*	*(102)*	*(101)*	*(103)*	*(101)*	*(93)*	*(92)*	*(94)*
Developing areas								
OPEC[3]	137	119	56	63	32	50	23	27
(Volume index 1973 = 100)	*(105)*	*(85)*	*(82)*	*(88)*	*(139)*	*(200)*	*(188)*	*(212)*
Other areas	95	93	46	47	122	126	63	63
(Volume index 1973 = 100)	*(103)*	*(96)*	*(92)*	*(100)*	*(105)*	*(88)*	*(89)*	*(87)*
Total developing areas	232	212	102	110	154	176	86	90
(Volume index 1973 = 100)	*(104)*	*(91)*	*(87)*	*(94)*	*(115)*	*(117)*	*(115)*	*(119)*
Eastern Europe[4] and USSR	65	78	37	41	71	93	45	48
Grand total	845	871	434	437	843	886	445	441
(Volume index 1973 = 100)[5]	*(106)*	*(100)*	*(98)*	*(102)*	*(103)*	*(97)*	*(96)*	*(98)*

[1] Excludes centrally-planned Asian economies. [2] Australia, Israel, New Zealand, South Africa. [3] Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela. [4] Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania. [5] Excludes eastern Europe and USSR.

The characteristics of the recession in the developed countries that produced the downturn in world trade have been described in Chapter II; the following graph illustrates the course of these countries' industrial production and their imports during the cycle. In particular, between the second quarters of 1974 and 1975 their combined output declined by 6½ per cent. and their imports by 10½ per cent. In the final quarter of last year, when Europe began to follow the economic recovery that had already got under way in the United States and Japan, total imports into the industrialised countries turned fairly sharply upwards.

Developed areas: Industrial production, volume and terms of trade, 1972-75.
Quarterly indexes: 2nd half 1971 = 100.



* Seasonally adjusted.

Taking the year 1975, the developed countries experienced a decline of 8 per cent. in import volume. As with the recession, the pattern was not uniform, but in general those countries suffering the largest declines in industrial production in 1975 were also the ones where imports fell the most. Thus Switzerland's severe domestic recession resulted in a volume decline in imports of 17 per cent., while among the larger countries, Japan and the United States experienced reductions of 12½ and 11½ per cent. respectively. The fall of 11 per cent. in Italy's imports reflected the effects of recession and the import deposit scheme in the early part of the year, only partly offset by a sharp upturn towards the end. In other countries, domestic conditions were less depressed, and the imports of Canada, the Netherlands and Sweden all fell by 5 per cent. or less, while those of Germany and Norway actually rose, by 3 and 1 per cent. respectively. The economic recovery among the developed countries in the second half of the year brought with it a rise in the volume of their imports. This amounted to 4 per cent. at an annual rate; with the United States remaining the major expansionary element, this growth appears to have strengthened further in the early part of 1976 to an annual rate of perhaps as much as 10 per cent.

Non-oil developing countries' imports, after a year in which they had held up well in the face of the oil price increases and subsequent weakening of demand for their exports, fell in volume by a substantial 17 per cent. in 1975. The decline was heavily concentrated in the first half of the year, though it continued later at a slower pace.

Partly offsetting the recessionary influence of the developed countries on world trade, imports into both the oil-producing countries and, to a lesser extent, the centrally-planned economies continued to rise in 1975. As far as the OPEC countries are concerned, their imports rose by some 45 per cent. in volume terms, which was even more than the year before. As the following table shows, all the major industrial countries shared in this increase, with the United States, Japan and Germany being the main suppliers and Sweden and the United Kingdom showing the biggest relative gains. The rate of growth of these markets began to fall off quite sharply, however, in the second half of the year. This was the result partly of congestion in ports and internal distribution systems and partly of the curtailment of planned expenditure by certain countries in the face of declining oil revenues.

Industrial countries: Exports* to the OPEC countries and centrally-planned economies.

Countries	OPEC			Centrally-planned economies		
	Percentage changes on year earlier		Value (f.o.b.) in milliards of dollars	Percentage changes on year earlier		Value (f.o.b.) in milliards of dollars
	1974	1975	1975	1974	1975	1975
BLEU	49	66	1.2	70	4	0.9
Canada	101	34	0.7	6	42	1.1
France	64	63	4.9	34	64	2.9
Germany	80	68	6.8	48	16	7.1
Italy	86	65	3.7	65	32	2.4
Japan	99	55	8.4	101	19	4.7
Netherlands	46	60	1.4	59	17	0.9
Sweden	75	83	0.7	49	43	1.2
Switzerland	48	57	0.8	43	25	0.8
United Kingdom	45	78	4.5	23	24	1.5
United States	86	60	10.8	−17	48	2.9
Total	76	63	43.9	42	28	26.4

* Based on customs data.

As for the centrally-planned economies, part of last year's trade expansion was within their own area. In addition, however, their imports from market economies rose rapidly for the second year in succession, as the above table shows. Purchases of high technology goods were accelerated to meet targets in the final year of 1971–75 plans, and the poor harvests made large grain purchases necessary.

On the export side, all the main groups of countries experienced volume declines last year. By far the largest were in the OPEC countries, whose total exports were nearly 20 per cent. lower than in 1974. This was concentrated in sales to the industrialised countries and reflected the combined effects of recession and conservation measures. Non-oil developing countries on the other hand, despite their heavy dependence on markets in industrial countries, experienced a more moderate 7 per cent. decline in export volume. Their sales had already shown signs of falling off in 1974; and they responded at an early stage to the upturn in the industrial world, led as it was by a turn-round in stock-building. The export volume of developed countries fell by some 5 per cent. in 1975. As with imports, there were quite wide variations between countries.

Apart from those of the non-oil developing countries, the relative movements of export and import volumes of each group of countries were reinforced by changes in their respective terms of trade in 1975. The combined terms of trade of the developed countries began to improve between the second and third quarters of 1974, and by mid-1975 the favourable movement amounted to about 4 per cent. For the remainder of the year there was little change. Not all of them shared in the general improvement, however; in Canada and Japan the terms of trade deteriorated, while in the Benelux countries they were virtually unchanged. The non-oil developing countries' terms of trade moved adversely for the second successive year, so that even the sharp reduction in the volume of their imports was insufficient to prevent a further worsening of their trade balance.

Balances of payments.

These trade developments were the principal factor in last year's shifts on current external account, illustrated for the main groups of countries in the next table. The developed countries' combined current deficit declined from $34.3 to 8.7 milliard and the combined OPEC surplus from $65 to 35 milliard. On the other hand, the combined deficit of non-oil developing countries may be estimated to have gone up from $15 to 25 milliard. Eastern Europe and the USSR, for which consistent current-account data are not available, showed an increase in their combined foreign trade deficit from $2 to 10 milliard.

The more favourable position of the *industrial countries'* current payments situation in 1975 was concentrated in five major countries — the United States, Italy, France, the United Kingdom and Japan — which showed a combined improvement of $34 milliard. Partly offsetting this, the current accounts of Germany, Canada and Sweden showed an opposite movement totalling $10 milliard. In the smaller OECD countries, there were a number of relatively large individual changes on current account, but the combined position was little different from 1974. In addition to its unevenness, last year's better position on current account still left the OECD countries with a combined deficit of $5½ milliard, even though unemployment was running at record post-war levels. And among the five countries with the biggest improvements only the United States recorded a substantial surplus, while the United Kingdom's deficit was still uncomfortably high. For the most part, therefore, countries had no margins of safety in this area when the recovery got under way and from late 1975 onwards a number of trade balances began to deteriorate again.

International current-account transactions.[1]

Countries and areas	Trade balance (f.o.b.)			Services and transfers			Current balance		
	1973	1974	1975	1973	1974	1975	1973	1974	1975
	in milliards of US dollars								
Developed areas									
BLEU[2]	+ 1.2	+ 0.9	+ 0.7	− 0.1	0	+ 0.4	+ 1.1	+ 0.9	+ 1.1
Canada	+ 2.7	+ 1.5	− 0.8	− 2.7	− 3.2	− 4.2	0	− 1.7	− 5.0
France	+ 0.8	− 3.8	+ 1.5	− 1.5	− 2.1	− 1.4	− 0.7	− 5.9	+ 0.1
Germany	+15.3	+21.9	+17.1	−10.9	−12.2	−13.3	+ 4.4	+ 9.7	+ 3.8
Italy	− 4.0	− 8.5	− 1.1	+ 1.5	+ 0.7	+ 0.6	− 2.5	− 7.8	− 0.5
Japan	+ 3.7	+ 1.4	+ 5.1	− 3.8	− 6.1	− 5.8	− 0.1	− 4.7	− 0.7
Netherlands	+ 0.8	+ 0.4	+ 0.6	+ 1.5	+ 1.6	+ 0.9	+ 2.3	+ 2.0	+ 1.5
Sweden	+ 2.3	+ 0.7	+ 0.8	− 1.1	− 1.6	− 2.3	+ 1.2	− 0.9	− 1.5
Switzerland	− 1.8	− 2.1	+ 0.1	+ 2.1	+ 2.3	+ 2.9	+ 0.3	+ 0.2	+ 3.0
United Kingdom	− 5.7	−12.3	− 7.2	+ 3.7	+ 3.8	+ 3.3	− 2.0	− 8.5	− 3.9
United States	+ 1.0	− 5.3	+ 9.0	− 0.7	+ 5.1[3]	+ 2.9	+ 0.3	− 0.2[3]	+11.9
Group of Ten and Switzerland	+16.3	− 5.2	+25.8	−12.0	−11.7	−16.0	+ 4.3	−16.9	+ 9.8
Other countries	− 9.0	−24.5	−24.4	+ 8.6	+ 7.1	+ 5.9	− 0.4	−17.4	−18.5
Total developed areas	+ 7.3	−29.7	+ 1.4	− 3.4	− 4.6	−10.1	+ 3.9	−34.3	− 8.7
of which: *OECD*	*+ 7.5*	*−26.7*	*+ 5.1*	*− 4.2*	*− 5.1*	*−10.6*	*+ 3.3*	*−31.8*	*− 5.5*
Developing areas[4]									
OPEC	+27	+107	+74	−23	−42	−39	+ 4	+65	+35
Other areas	− 2	− 14	−19	0	− 1	− 6	− 2	−15	−25
Total developing areas	+25	+ 93	+55	−23	−43	−45	+ 2	+50	+10
Eastern Europe and USSR	− 1	− 2	−10	.	.	.	.	.	.

[1] On a transactions basis. [2] On a partly cash basis; exports and imports partly c.i.f. [3] Excluding special US Government grants amounting to $3.1 milliard. [4] Partly estimated.

In many cases changes in current balances were accompanied by opposite shifts on capital account. Among countries with reduced deficits, net capital inflows to the United Kingdom, Denmark and Ireland were sharply down, while in Italy there was a net outflow. Where deficits were larger — as in Canada, Finland, Norway and Sweden — inflows of capital increased, especially at longer term. At the other end of the spectrum, net capital outflows from Germany declined with the current-account surplus, though to a lesser extent. In a number of instances, however, the two parts of the external balance did not move in offsetting directions. Net inflows into France and Switzerland remained close to 1974 levels and the same was broadly true of outflows from Japan and the United States.

In absolute terms, easily the biggest improvement was in the current balance of the *United States*, from a slight deficit to a surplus of $11.9 milliard. The trade account improved even more, by $14.3 milliard, to a $9 milliard surplus. Total exports, despite a small volume decline, were up by $8.9 milliard. Nearly half of this value increase was in sales to OPEC countries, while by categories the biggest gains were in exports of capital goods and automotive equipment. For the second year running agricultural exports reached the high level of $22 milliard. Imports declined between the two years by $5.4 milliard.

The trade account improved by $8.5 milliard to a $4.8 milliard surplus between the second half of 1974 and the first half of 1975. Nearly all of this came from the side of imports, the volume of which fell by 16 per cent. As the economy began to recover imports rose by $1.9 milliard in the second half of the year, including a 12 per cent. volume increase in the third quarter. But with exports also gaining both in value and volume — especially agricultural sales to the Soviet Union — the trade surplus for the second half of the year was $4.3 milliard. With the United States still leading world economic recovery, the trade balance swung sharply back to a $1.6 milliard deficit in the first quarter of 1976. Import volume increased by a further 9 per cent., while the volume of exports fell by 4 per cent. This was enough to swing the current account back into moderate deficit.

The surplus on invisibles and transfers declined from $5.1 to 2.9 milliard in 1975. Net investment income fell from $10.1 to 6 milliard, largely owing to sharply lower earnings on overseas petroleum investments.

Long-term capital outflows, at $10.5 milliard, were the same in total as the year before, though quite different in composition. Foreign bond issues on the US market rose by $4.8 to 7.2 milliard and longer-term bank lending doubled to $2.3 milliard. On the other hand, renewed foreign interest in US equities — the Dow Jones index rose during the year by nearly one-third — produced a $3.9 milliard increase in total purchases of US securities other than Treasury issues, including equity investments of $1.4 milliard by OPEC countries. In addition, net direct investment dropped from a net outflow of $5.2 to one of 3.8 milliard. Non-bank short-term capital inflows, at $3.4 milliard, were slightly less than in 1974, but similar in structure — including unidentified receipts of rather more than $4.5 milliard. Thus, the shift in the overall balance of payments reflected rather closely developments in the current account.

Even more dramatic in relative terms was the improvement, amounting to 5 per cent. of GNP, in *Italy's* current balance of payments last year, with the deficit falling to $0.5 milliard. The trade deficit was down from $8.5 to 1.1 milliard, import volume declining by 11 per cent. while exports actually grew by 2 per cent. Like other industrial countries, Italy expanded its sales strongly to OPEC countries and to the centrally-planned economies; unlike most of them, however, it also maintained sales to the Common Market at high levels. The invisible surplus of $0.6 milliard was about the same as in 1974, lower workers' remittances and the increasing burden of interest payments on external debt being covered by higher tourist receipts and reduced government transfers abroad.

The various restrictive measures taken in mid-1974 had already begun to reduce the deficit in the latter part of that year. As the economy moved into recession the trend was reinforced and during each of the first three quarters of 1975 the current account, seasonally adjusted, was in approximate balance. In the third quarter, when domestic output and demand turned upwards, imports, the

Developed countries: Balances of payments.[1]

Countries	Years	Current balance	Capital balance	Overall balance[2]	Adjust-ments[3]	Adjusted overall balance (=total external monetary movements)[4]
		in millions of US dollars				
Austria	1974	− 460	+ 520	+ 60	+ 70	+ 130
	1975	− 340	+ 1,370	+ 1,030	− 90	+ 940
Belgium-Luxembourg[5]	1974	+ 910	− 250	+ 660	− 200	+ 460
	1975	+ 1,050	+ 440	+ 1,490	+ 70	+ 1,560
Canada	1974	− 1,670	+ 2,440	+ 770	+ 100	+ 870
	1975	− 5,010	+ 3,490	− 1,520	+ 160	− 1,360
Denmark	1974	− 920	+ 810	− 110	+ 120	+ 10
	1975	− 510	+ 150	− 360	− 30	− 390
Finland	1974	− 1,210	+ 810	− 400	+ 20	− 380
	1975	− 2,140	+ 1,710	− 430	− 10	− 440
France	1974	− 5,940	+ 5,900	− 40	− 440	− 480
	1975	+ 50	+ 5,480	+ 5,530	− 440	+ 5,090
Germany	1974	+ 9,670	− 6,500	+ 3,170	+ 90	+ 3,260
	1975	+ 3,820	− 3,580	+ 240	− 780	− 540
Greece	1974	− 1,240	+ 1,100	− 140	.	− 140
	1975	− 1,010	+ 820	− 190	.	− 190
Ireland	1974	− 710	+ 790	+ 80	+ 90	+ 170
	1975	− 120	+ 450	+ 330	− 90	+ 240
Italy	1974	− 7,820	+ 2,480	− 5,340	+ 180	− 5,160
	1975	− 520	− 1,270	− 1,790	− 140	− 1,930
Japan	1974	− 4,690	− 2,140	− 6,830	+ 100	− 6,730
	1975	− 680	− 1,940	− 2,620	− 140	− 2,760
Netherlands	1974	+ 2,030	− 1,320	+ 710	+ 290	+ 1,000
	1975	+ 1,500	− 1,230	+ 270	+ 590	+ 860
Norway	1974	− 1,240	+ 1,440	+ 200	+ 170	+ 370
	1975	− 2,590	+ 2,970	+ 380	− 300	+ 80
Portugal[6]	1974	− 820	+ 190	− 630	− 20	− 650
	1975	− 840	− 220	− 1,060	− 50	− 1,110
Spain	1974	− 3,270	+ 1,570	− 1,700	− 150	− 1,850
	1975	− 3,480	+ 2,030	− 1,450	− 90	− 1,540
Sweden	1974	− 930	+ 520	− 410	− 10	− 420
	1975	− 1,510	+ 2,520	+ 1,010	− 40	+ 970
Switzerland	1974	+ 170	+ 2,440	+ 2,610	.	+ 2,610
	1975	+ 3,020	+ 2,170	+ 5,190	.	+ 5,190
Turkey	1974	− 720	+ 60	− 660	.	− 660
	1975	− 1,800	+ 160	− 1,640	.	− 1,640
United Kingdom	1974	− 8,530	+ 5,120	− 3,410	+ 120	− 3,290
	1975	− 3,860	+ 1,060	− 2,800	+ 110	− 2,690
United States	1974	− 210	− 6,690	− 6,900	+ 330	− 6,570
	1975	+11,920	− 7,140	+ 4,780	− 140	+ 4,640
Yugoslavia	1974	− 1,230	+ 780	− 450	.	− 450
	1975	− 950	+ 780	− 170	.	− 170

Note: Wherever possible capital balances and overall balances of payments are shown exclusive of changes in commercial banks' short-term foreign positions which, together with changes in net official monetary positions, are treated as financing items.

[1] On a transactions basis. [2] Equal to the sum of actual transactions; excludes, wherever possible, valuation gains or losses in monetary items resulting from exchange rate movements. [3] Differences due to valuation adjustments and discrepancies in coverage. [4] Equal to the sum of the last two columns in the table on page 69. [5] Partly on a cash basis. [6] Metropolitan Portugal vis-à-vis the rest of the world.

volume of which had dropped by 18 per cent. in the first half of the year, began to rise; in the final three months, when they increased by 15 per cent., the current account moved to a $0.4 milliard deficit. Imports continued to grow rapidly in the first quarter of 1976, and the current-account deficit, before seasonal adjustment, widened to $1.3 milliard, a deterioration of over $0.9 milliard on the same period a year earlier.

Capital movements, which had shown a net inflow of $2.5 milliard in 1974, were on balance negative last year to the extent of $1.3 milliard. To a considerable extent this reflected the fact that public-sector institutions, which in 1974 had borrowed $2.1 milliard in the Euro-currency market, made repayments to it of $0.9 milliard in 1975. In addition, other capital movements, one of the influences on which was the termination of the import deposit scheme, showed an outflow of $0.4 milliard, compared with an inflow of the same size in 1974.

The current external account of *France* also returned to balance in 1975. The bulk of the improvement took place in the trade account, especially in the first half of the year when weak domestic demand brought about a sharp fall in the volume of imports. Taking the year as a whole, the decline amounted to 8½ per cent., with major falls in raw materials, energy products and manufactured goods. The decline in export volume, at 4 per cent., was much less pronounced. Sales of finished goods, with the help of increased export credits, were slightly above 1974 levels. The terms of trade also contributed to the improvement; export prices rose by 6 per cent., nearly twice as fast as import prices. The relative stability of the latter was assisted not only by lower raw-material prices but also by the strengthening of the franc. Furthermore, the deficit on invisible transactions contracted by $0.7 milliard to $1.4 milliard. This, too, was in part cyclical, the decline in imports and freight rates having reduced the deficit on transport account by $0.4 milliard.

The transformation of the current account eliminated the financing problems of the previous year and the shape of the capital account was accordingly rather different from what it had been in 1974. Long-term capital movements, which in 1974 had produced a $2.2 milliard net inflow, showed a $0.3 milliard net outflow. Nearly half of the swing resulted from an increase of over $1 milliard in long-term bank lending abroad, predominantly export credits. The reversal of the long-term capital account was largely offset by a $2 milliard increase in short-term inflows, including unidentified transactions, to the very large figure of $5.8 milliard. Total net capital inflows were therefore almost as high as the year before and the overall surplus of $5.5 milliard was the largest recorded by any developed country last year.

Between the third and fourth quarters of 1975 rising imports had pushed the trade balance, on a seasonally adjusted customs basis, from a $0.5 milliard surplus to a $0.6 milliard deficit. It was this development that helped trigger off pressure on the franc in January 1976. In fact the trade deficit for the first quarter was a little lower, at about $0.5 milliard.

Japan, too, moved close to balance on current account last year, the deficit contracting from $4.7 to 0.7 milliard. A particular feature was that this occurred despite a further deterioration in the terms of trade; import prices rose by 8½ per cent. while export prices showed virtually no change. Unlike all other industrial countries apart from Italy, Japan achieved a small volume increase, of 2½ per cent., in exports last year. Highly competitive pricing produced a rise in sales of manufactured goods. In the first half of the year, when demand in other developed countries was weak, exports to OPEC countries expanded rapidly, whilst in the second half a similar development occurred in sales to industrial countries, particularly the United States. On top of this, import volume was 12½ per cent. down on 1974. In the first quarter of 1976, with exports still rising strongly, the current account, on a seasonally adjusted basis, moved to a surplus of $1.2 milliard, compared with a deficit of $0.7 milliard in the previous quarter.

As in the United States and France, the capital-account balance in 1975 was about the same as in 1974, but different in structure. Net long-term outflows fell sharply, from $3.9 to 0.3 milliard. Interest rate differentials led to foreign purchases of Japanese securities worth $1.5 milliard and to Japanese bond issues abroad amounting to $1.2 milliard. At the same time, less trade credit was extended and outward direct investment reduced. Also in marked reversal of the pattern of recent years, there was an outflow of $1.2 milliard of identified non-bank short-term capital. The overall balance therefore remained in deficit for the third consecutive year but, at $2.6 milliard, the deficit was less than half the 1974 figure.

The reduction in the *United Kingdom's* current-account deficit, from $8.5 to 3.9 milliard, was wholly attributable to trade, the deficit on which in fact declined by $5.1 milliard. Of that amount, two-thirds may be attributed to the terms of trade and the rest to volume changes. In volume terms, imports were down by 7 per cent., with both raw materials (apart from food) and finished manufactures sharing in the fall. The reduction in exports was smaller, at about 4 per cent.; it reflected not only the tendency of UK exports to be maintained during trade recessions but also the strength of OPEC markets and, at any rate in the first part of the year, the price competitiveness established earlier. On invisible account the surplus contracted slightly, from $3.8 to 3.3 milliard; higher direct investment earnings and private services receipts were more than offset by the increased cost of servicing the public sector's foreign indebtedness.

On capital account, net inflows declined by almost as much as the current deficit. Borrowing abroad by public authorities (excluding the UK Government, whose borrowing is treated as a financing item) was down from $3 to 0.9 milliard; and the balance of private direct and portfolio investment shifted from a $2.5 milliard inflow to a $1.1 milliard outflow. On the other hand, the balancing item showed unidentified net receipts of $2.2 milliard, up from $0.8 milliard in 1974.

The first quarter of 1976 saw a further shrinkage of the trade deficit, to $0.9 milliard, bringing the current account fairly close to balance. Export volume was 10 per cent. above the third-quarter low point, while imports fell by 3 per cent. over the same period.

Switzerland experienced a record $3 milliard surplus on current account. A swing of $2.2 milliard eliminated the traditional trade deficit and even produced a small surplus. The domestic recession, the largest of any developed country in 1975, generated a substantial 17 per cent. fall in the volume of imports. Exports fell by considerably less (8 per cent.), with sales of investment goods fairly well maintained. Reflecting mainly the further appreciation of the franc, the terms of trade improved by a substantial 6½ per cent. to reinforce the volume movement. In addition, the surplus on invisibles rose substantially to $2.9 milliard. Higher net investment income coupled with a decline in workers' outward remittances more than offset a slight fall in net receipts from tourism.

Faced with a current surplus of this magnitude, and with the need to counter continuing upward pressure on the franc, policies were adopted to discourage the import, and encourage the export, of capital. Interest rates were reduced, rationing of foreign issues on the capital market suspended and measures taken to facilitate the granting of export credits. In gross terms, foreign issues of long-term Swiss franc bonds amounted to $0.9 milliard, almost three times as great as the year before. In addition, foreign issues of medium-term Swiss franc notes jumped from $0.9 to 2.8 milliard. Despite the authorities' best efforts, however, capital inflows exceeded outflows by $2.2 milliard, bringing the overall balance-of-payments surplus to $5.2 milliard.

Germany's current payments surplus fell from $9.7 to 3.8 milliard. Like nearly all industrial countries, it experienced a decline in export volume last year — though at 10½ per cent. it was at the top end of the range. Sales of basic materials and semi-manufactures such as steel and chemicals were down by 20 per cent., but those of capital goods held up relatively well. Unlike other industrial countries, however, the fall in exports was accompanied by a 3 per cent. increase in import volume. This was concentrated in the second half of the year, in response to the domestic economic recovery, and no doubt also reflected the increased competitiveness of imported goods. In this connection, imports from Italy and the United Kingdom rose year on year by 15 and 11 per cent. respectively. As for exports, the volume decline was entirely in the first half of the year, when it amounted to 10 per cent.; in the second six months exports rose by 2 per cent., including gains in the consumer and investment goods sectors. The trade surplus fell between the two halves of the year, from $9.4 to 7.7 milliard, but to judge from customs data there was a small improvement in the first quarter of 1976. Compared with developments on trade account, the $1.1 milliard increase in the invisibles deficit to $13.3 milliard in 1975 was fairly modest.

Net long-term capital exports, at $6.8 milliard, far exceeded the current-account surplus. The bulk of them went via the banking system and were largely export-related. In addition, for only the third time in ten years direct investment showed a net outflow, amounting to $0.7 milliard. This diminished foreign interest in the Federal Republic was a reflection not only of the recession, but also of higher relative production costs there as a result of the appreciation of the Deutsche Mark. In contrast to the long-term outflows largely via the financial sector, non-financial companies were heavy net importers of short-term capital, amounting to $2.6 milliard. This compared with a $3.6 milliard outflow in 1974, when substantial trade credit was granted. In the first nine months of 1975 companies took advantage of easier credit terms abroad, but as German interest rates declined this flow began to be reversed in the fourth quarter. Taking the year as a whole, the overall balance-of-payments surplus was only $0.2 milliard.

In *Canada* and *Sweden,* where the recession was comparatively mild, the current balance of payments deteriorated in 1975, Canada's deficit increasing from $1.7 to 5 milliard and that of Sweden from $0.9 to 1.5 milliard. In both countries the volume of exports fell more than that of imports, and in addition the invisibles deficit was sharply up. Net capital inflows to Canada, despite a record $4.2 milliard of public and private net new bond issues on foreign markets, were only $1 milliard up on 1974, so that the overall balance of payments showed a $1.5 milliard deficit. Net inflows to Sweden of $2.5 milliard produced an overall surplus of $1 milliard.

In both *Belgium-Luxembourg* and the *Netherlands* the current payments surplus showed relatively modest changes last year as compared with 1974. In Belgium-Luxembourg it expanded a little, from just under to just over $1 milliard, while in the Netherlands lower income from foreign petroleum investments brought it down from $2 to 1.5 milliard. A $0.7 milliard shift on capital account gave Belgium-Luxembourg a $1.5 milliard overall surplus. Net capital outflows from the Netherlands, at $1.2 milliard, were little changed from the previous year, so that the overall surplus fell back to $0.3 milliard.

Financing of surpluses and deficits.

Developed countries. From what has been said earlier in the chapter it is clear that while the combined balances of payments of the developed world moved closer to equilibrium in 1975, the picture is less homogeneous when countries' positions are looked at individually. Indeed there were a number of major industrialised countries where external monetary movements were considerably larger than they had been in 1974. This is true of the external monetary surpluses of Belgium-Luxembourg, France, Sweden and Switzerland as well as of Canada's deficit. In addition, the external monetary deficits of Italy, Japan and the United Kingdom, though smaller than in 1974, were still substantial — in the Italian and British cases because of the absence of the large-scale external borrowing by public-sector corporations which had been a prominent feature of 1974. It should be added that in most developed countries the total of external monetary movements in 1975 was not the same as the overall balance of payments, owing to valuation changes and statistical discrepancies. These adjustments, as well as the overall external balances corresponding to the total changes in external monetary positions, are shown in the fourth and fifth columns of the balance-of-payments table.

More recently, in the first quarter of 1976, exchange-market disturbances produced substantial changes in the external monetary positions of a number of European countries.

Among individual developed countries *France* showed the biggest overall payments surplus in 1975, amounting to $5.5 milliard. This was not, however, fully reflected in the external monetary position calculated in dollars, exchange rate movements during the year having produced a $0.4 milliard downward valuation of official monetary assets and the banks' net short-term foreign position. Including these adjustments, therefore, the overall monetary surplus came to $5.1 milliard, net official assets going up by $3.9 milliard and the banks' net short-term liabilities, on the basis shown in the following table, having been reduced by $1.2 milliard.

The rise in net official monetary assets, almost entirely in foreign exchange reserves, went on throughout the year. Official market intervention was at its heaviest in the second quarter, just prior to the franc's re-entry into the "snake", when the exchange reserves rose by $1.1 milliard, and also in the final quarter when the franc was again very firm. The $1.8 milliard rise in that quarter, however, also included the proceeds of a $0.4 milliard foreign currency deposit made in October by Iran. In the banking sector, the reduction in net external liabilities during the first three quarters was bigger than for the year as a whole. This reflected in part the fact that the strength of the French franc led residents to repay to the banks short-term foreign currency credits taken up in 1974 and to reduce their net forward purchases of exchange from the banks. In the final quarter, however, the banks' net foreign liabilities went up again, including a rise in non-resident franc balances.

The first-quarter 1976 exchange crisis produced a $3 milliard deterioration in the net official monetary position, more than half of which occurred in March. A significant part of this deterioration had a counterpart in an outflow of funds through the banks. The exchange reserves declined by $1.6 milliard over the quarter and in addition substantial indebtedness was incurred as a result of official operations in partner currencies to support the franc before its withdrawal from the European joint float in mid-March. In April, when this indebtedness was repaid, the exchange reserves declined by $1.3 milliard.

In *Switzerland* the authorities were faced in 1975 with strong upward pressures on the franc. As a result the National Bank began, for the first time since floating was introduced, to buy dollars in the market. For the year as a whole intervention totalled just over $4 milliard, but most of this was offset by sales of dollars for capital exports amounting in all to $3.5 milliard. The reserves rose in the course of the year by $1.5 milliard. Most of the $5.2 milliard overall payments surplus therefore had a counterpart in the foreign position of the banks. Excluding end-year window-dressing operations, their net external assets rose by $3.9 milliard to a total of $11.2 milliard.

During the first four months of 1976 the authorities purchased a further $3 milliard in the exchange market. This was, however, more than offset by official sales of dollars for capital exports totalling $2 milliard, as well as by the return to the banks of $1.8 milliard taken in by the National Bank under short-term swaps. At the end of April 1976, therefore, Switzerland's reserves were nearly $1 milliard lower than they had been four months earlier.

In 1975 the *United States'* net external monetary position registered a $4.6 milliard surplus. The net short-term position of the banking sector with non-residents improved by $7.6 milliard, but this was partly offset by a $3 milliard rise in net

Developed countries: External monetary positions.[1]

Countries	End of year	Gold[2]	Net foreign exchange	Claims on, or liabilities to, IMF	Total official assets (net)	Commercial banks (net)	Total foreign assets (net)	Changes: Official assets (net)	Changes: Commercial banks (net)
		In millions of US dollars							
Austria	1974	895	2,260	265	3,420	−1,145	2,275	+ 540	− 405
	1975	855	3,245	310	4,410	−1,200	3,210	+ 990	− 55
Belgium-Luxembourg	1974	1,780	2,275	1,340	5,395	−1,885	3,510	+ 405	+ 50
	1975	1,780	2,725	1,415	5,920	− 850	5,070	+ 525	+ 1,035
Canada	1974	940	3,620	1,105	5,665	495	6,160	− 15	+ 885
	1975	900	3,055	1,200	5,155	− 355	4,800	− 510	− 850
Denmark	1974	80	615	200	895	415	1,310	− 385	+ 385
	1975	75	605	165	845	80	925	− 50	− 335
Finland	1974	35	185	160	380	− 190	190	− 175	− 205
	1975	35	350	− 5	380	− 630	− 250	—	− 440
France	1974	4,260	2,700	770	7,730	.	.	− 455	− 25
	1975	4,260	6,330	1,015	11,605	.	.	+ 3,875	+ 1,220
Germany	1974	4,965	24,615	3,345	32,925	835	33,760	− 445	+ 3,700
	1975	4,965	23,385	3,550	31,900	1,320	33,220	− 1,025	+ 485
Greece	1974	155	750	− 15	890	30	920	− 155	+ 15
	1975	150	760	− 200	710	25	735	− 180	− 5
Ireland	1974	20	1,150	100	1,270	− 410	860	+ 240	− 70
	1975	20	1,420	95	1,535	− 440	1,095	+ 265	− 30
Italy	1974	3,480	− 460	−1,460	1,560	−1,300	260	− 4,820	− 345
	1975	3,480	−1,645	−2,780	− 945	− 725	−1,670	− 2,505	+ 575
Japan	1974	905	11,185	1,270	13,360	-11,595	1,765	+ 1,380	− 8,110
	1975	865	10,355	1,325	12,545	-13,530	− 985	− 815	− 1,935
Netherlands	1974	2,295	3,430	1,135	6,860	− 145	6,715	+ 1,015	− 20
	1975	2,295	3,335	1,480	7,110	460	7,570	+ 250	+ 605
Norway	1974	40	1,760	190	1,990	− 100	1,890	+ 445	− 75
	1975	40	1,820	235	2,095	− 130	1,965	+ 105	− 30
Portugal	1974	1,190	1,005	35	2,230	265	2,495	− 595	− 55
	1975	1,135	15	10	1,160	230	1,390	− 1,070	− 35
Spain	1974	600	5,115	310	6,025	−1,985	4,040	− 775	− 1,080
	1975	600	5,160	− 440	5,320	−2,820	2,500	− 705	− 835
Sweden	1974	245	1,210	240	1,695	1,095	2,790	− 775	+ 355
	1975	235	2,560	235	3,030	735	3,765	+ 1,335	− 360
Switzerland	1974	3,515	5,410	—	8,925	5,800	14,725	+ 445	+ 2,160
	1975	3,515	6,850	95	10,460	9,450	19,910	+ 1,535	+ 3,650
Turkey	1974	150	110	90	350	.	.	− 655	.
	1975	150	−1,230	− 210	−1,290	.	.	− 1,640	.
United Kingdom	1974	890	3,325[3]	1,075	5,290	.	.	− 1,185	− 2,110[4]
	1975	890	835[3]	1,205	2,930	.	.	− 2,360	− 330[4]
United States	1974	11,650	-76,800[5]	4,225	-60,925	−2,665[6]	-63,590	− 8,335	+ 1,760
	1975	11,600	-80,060[5]	4,545	-63,915	4,970[6]	-58,945	− 2,990	+ 7,635
Yugoslavia	1974	60	920	− 120	860	.	.	− 450	.
	1975	60	775	− 145	690	.	.	− 170	.

[1] For most of the countries shown in the table the figures given do not correspond exactly to published figures. [2] In about half the countries shown gold is valued at the old official price of $ 42.22 per ounce and in the remainder at SDR 42.22, being converted to dollars at prevailing dollar/SDR rates. [3] Includes, as a liability, the May 1974 Euro-currency loan, of which $1.5 milliard was paid over in 1974 and $1.0 milliard in 1975. [4] Includes changes in the banks' foreign currency positions vis-à-vis non-residents, in their sterling claims on non-residents and in all sterling liabilities to non-residents, official and private. [5] Equals convertible currency assets minus bank-reported liabilities to foreign official institutions. [6] Banks' short-term claims on foreigners minus their short-term liabilities to non-official foreigners.

official liabilities. In the banking sector, where the very large \$18.3 milliard rise in short-term lending to non-residents during 1974 was followed by a further one of \$10.8 milliard in 1975, net flows of funds were highly responsive to interest rate movements. In the first half of the year lower US rates induced an outflow of \$7.7 milliard, including a \$6.6 milliard rise in short-term lending. In the third quarter, when US interest rates rose relative to those in other countries, there were net banking inflows of \$3.9 milliard, but this was reversed as US rates eased once more in the final quarter.

In the official sector the US reserve position at the IMF went up by \$0.4 milliard, but the major changes were on the liabilities side, where foreign official dollar holdings rose by \$3.5 milliard. This was only one-third of the 1974 figure, additions to OPEC dollar reserves held in the United States falling from \$10.5 to 4.2 milliard. Other official dollar holdings were reduced on balance by \$0.7 milliard. While OPEC countries' official balances rose fairly steadily over the year, the movement of other official holdings was more volatile, reflecting the intervention policies of foreign monetary authorities. Thus in the first quarter when the dollar was weak they rose by \$2.3 milliard, whilst in the third quarter they fell by \$4.5 milliard as the dollar strengthened. In the first quarter of 1976 US net official monetary liabilities declined by \$0.8 milliard. Reserves rose by \$0.7 milliard, including the lira counterpart of \$0.5 milliard drawn by Italy on the Federal Reserve swap line. Official liabilities showed a small net decrease for the whole quarter, a rise of \$1.2 milliard in January and February being followed by a \$1.3 milliard decline in March.

The net external monetary position of *Belgium-Luxembourg* improved by \$1.6 milliard in 1975, three times the previous year's figure. Reflecting the liquid state of the economy, short-term funds flowed out through the banks, whose net external indebtedness declined by \$1 milliard. Net official assets rose by \$0.5 milliard. In the first quarter of 1976, when the Belgian franc came under pressure, net official assets declined by \$1.3 milliard. Liabilities arising out of support given by Belgium's partners in the joint float, particularly the Netherlands, rose by \$0.8 milliard, while dollar reserves were drawn down by \$0.5 milliard. To a considerable extent this was the counterpart of a \$0.6 milliard outflow through the banks, as residents increased forward purchases of exchange and non-residents drew down their franc balances. From late March onwards the situation began to improve and in April net official monetary assets went up by \$0.3 milliard.

The only other developed countries with large surpluses were *Sweden* and *Austria*. In both countries the surpluses were added to reserves, while in Sweden there was in addition a net \$0.4 milliard short-term inflow through the banks.

Although the balance of payments of *Germany* showed a \$0.2 milliard overall surplus, downward valuation adjustments totalling \$0.8 milliard to the official reserves and the banks' net short-term external positions meant that the overall external monetary position, expressed in dollars, deteriorated over the year by nearly \$0.6 milliard. Net official monetary assets declined by \$1 milliard, partly offset by a \$0.5 milliard increase in the banks' net short-term foreign assets.

During the course of the year there were considerable fluctuations in the reserves, related to the varying fortunes of the Deutsche Mark in the exchange market. In the first quarter net official assets rose by $2.2 milliard, mainly as a result of substantial Bundesbank purchases of dollars as well as swap drawings of Deutsche Mark by the Federal Reserve System. During the subsequent weakening of the Mark fairly heavy official support was given, net official assets being reduced by $3 milliard during the second and third quarters.

Short-term banking flows generally responded to domestic credit and money-market conditions. Over the first nine months of the year the commercial banks increased their net foreign assets by $1.7 milliard — the bulk of it ($1.4 milliard) occurring in the second quarter. In the fourth quarter there was a substantial short-term inflow to the banks, amounting to $1.2 milliard. A number of factors were at work, including seasonal window-dressing operations, but the main causes were the lowering, from the beginning of August, of the minimum reserve ratios for external liabilities and the lifting of the ban on interest payments on non-residents' deposits in early September.

In the first quarter of 1976 net official assets rose by $3.7 milliard, of which claims arising out of support operations for other "snake" currencies accounted for $2.8 milliard. More than half of the official monetary surplus had a counterpart in inflows of funds through the banks, totalling $2.3 milliard. These included a $1 milliard increase in non-resident DM balances and a $0.9 milliard reduction of non-residents' short-term DM indebtedness to the banks, both of them no doubt partly speculative in character. In April official claims arising out of the earlier support operations within the "snake" were reduced by $1.9 milliard, but net official assets fell by only $0.5 milliard.

In the *Netherlands* the overall external surplus for 1975, measured as the total of external monetary movements, was $0.9 milliard — three times as much as the figure of $0.3 milliard recorded in the balance-of-payments data. It has not been possible to reconcile these two figures. Net official monetary assets rose by $0.3 milliard during the year and, in addition, the banks' net short-term position improved by $0.6 milliard. In the first half of the year the net outflow through the banks totalled $1.5 milliard, only a small part of which was reflected in a $0.2 milliard reduction in net official assets; during the second half the picture was completely reversed, a net inflow of $0.9 milliard through the banks being accompanied by a significantly smaller $0.4 milliard rise in net official assets. In the first quarter of 1976 the official external monetary position improved by a further $0.2 milliard and that of the banks by a similar amount.

The net external monetary position of the *United Kingdom* deteriorated in 1975 by a further $2.7 milliard, slightly less than in 1974. Net official assets declined by $2.4 milliard and there was a small net inflow through the banks. In the official sector currency reserves declined by $1.5 milliard during the year. The total of official intervention in support of sterling was, however, much greater. Thus, in the first quarter the government drew the remaining $1 milliard of its $2.5 milliard 1974 Euro-currency loan, while in addition the reserves benefited to the extent of $0.9 milliard from other public-sector foreign currency borrowing.

In the banking sector net inflows fell between 1974 and 1975 from $2.1 to only 0.3 milliard. In particular, sterling holdings of oil-exporting countries, which had grown by $5.3 milliard in 1974, showed a small decline. The earlier increase had continued into the first quarter of 1975, when it amounted to $0.8 milliard; but during the rest of the year OPEC sterling balances were reduced by the equivalent of $1.1 milliard. Although other official holders also reduced their balances in 1975, by $1 milliard, this was more than offset by increased private holdings, so that total non-resident sterling balances were little changed in the year.

In January and February 1976 sterling remained largely unaffected by the currency turbulence and $1.6 milliard was added to the reserves, three-quarters of which came from a drawing on the IMF oil facility and the remainder from further public-sector borrowing. In March and April the heavy pressure on sterling brought about a $2.2 milliard reserve loss after further public-sector external borrowing abroad of $0.6 milliard. In May a further $0.8 milliard was drawn on the IMF.

Japan's $2.8 milliard balance-of-payments deficit in 1975 was largely financed through the banking system, whose net liabilities increased by a further $1.9 milliard. In addition, however, unlike 1974, net official assets declined by $0.8 milliard. The year was divided into two distinct phases. Over the first six months there were strong inflows of funds and the reserves rose by about $1 milliard; half of this, however, had a counterpart in official liabilities as a result of Treasury bill sales to non-residents. These transactions were unwound in the third quarter when, with domestic interest rates falling, inward security investment virtually ceased. By August substantial official intervention was necessary to support the yen, and in the third quarter as a whole foreign currency reserves fell by $1.2 milliard. Subsequent intervention was on a much smaller scale, with official foreign currency holdings falling by a further $0.2 milliard in the final quarter. In the first quarter of 1976, when the balance of payments was practically in equilibrium, net banking inflows of $0.9 milliard were broadly reflected in the growth of net official monetary assets.

Italy's net external monetary position continued to deteriorate in 1975, although the overall deficit, at $1.9 milliard, was rather less than half the 1974 figure. As there were net short-term outflows of $0.6 milliard through the banks, net official assets fell by $2.5 milliard.

In the first six months the overall deficit amounted to less than $0.5 milliard, financed largely through the banks. Although net official assets were almost unchanged, there were shifts in their composition. In March $0.5 milliard of the $2 milliard loan granted by the Deutsche Bundesbank in 1974 was reimbursed, while $0.4 milliard was drawn from the IMF. In the third quarter, when the overall deficit was still very moderate, a $1.2 milliard short-term banking outflow led to net official assets being drawn down by $1.4 milliard. During the quarter Italy drew $0.9 milliard on the Fund's oil facility. In the fourth quarter the dramatic worsening of the overall balance was largely responsible for a further $1.1 milliard deterioration in the net official position. The whole of this decline was in foreign exchange holdings, which by the end of the year were down to $1.2 milliard.

The 1976 currency crisis brought a $1.7 milliard decline in net official assets during the first four months of the year. Exchange reserves actually rose by $0.2 milliard, but $1 milliard was borrowed from the Euro-market via the EEC, $0.5 milliard drawn on the Federal Reserve swap line and another $0.5 milliard obtained by redrawing that part of the Bundesbank's 1974 loan that had been repaid a year earlier. In May the central banks of the EEC agreed to grant Italy a credit of $0.5 milliard, while the BIS decided to open a credit line for $0.6 milliard.

Canada's $1.4 milliard overall deficit for 1975 had a counterpart in deteriorations of $0.9 milliard and $0.5 milliard respectively in the net positions of the banks and the authorities. Banking inflows were concentrated in the first and third quarters of the year, and the decline in reserves in the second quarter. Capital inflows had already shifted the overall balance of payments into moderate surplus before the end of the year. In January and February 1976 they became so large that substantial official intervention was necessary and net official assets rose by $0.5 milliard. In the following two months the Canadian dollar eased slightly and there was a small deterioration in the net official position.

Oil-exporting countries. In 1975 the funds available for investment by the oil exporters as a group were reduced from $56.9 to 32.1 milliard. Moreover, their placement differed in a number of respects from what it had been in 1974. One aspect of this was that the proportion of the total surplus invested in relatively liquid forms, including bank deposits and government securities, fell from 70 to 40 per cent. At the same time investments of all kinds in the United States and the United Kingdom fell from 57 to 34 per cent. of the total. A considerable proportion of the funds invested at longer term went to developing countries in the form of loans, both bilaterally and through international agencies.

Oil-exporting countries: Estimated deployment of investible surpluses.

Items	1974	1975
	in milliards of US dollars	
Bank deposits and money-market placements:		
Dollar deposits in the United States	4.0	—
Sterling deposits in the United Kingdom	1.7	0.2
Deposits and loans in foreign currency markets	24.0	9.3
Other[1]	10.1	3.7
Total	39.8	13.2
Long-term investments:		
Special bilateral arrangements	11.9	12.1
Loans to international agencies	3.5	4.0
Other[2]	1.7	2.8
Total	17.1	18.9
Total new investments	56.9	32.1

[1] Including marketable government securities. [2] Including equity and property investments in the United States and the United Kingdom.

Non-oil developing countries. In the table on international current-account transactions the aggregate current-account deficit of the non-oil developing countries is shown as having risen between 1974 and 1975 from $15 to 25 milliard. For the sake of uniformity with the other data given in that table, those figures include the developing countries' substantial receipts from official unilateral transfers. In considering the extent of these countries' external financing problems, however, these transfers, which in effect are financing items, have to be excluded from the current account. If that is done, the combined deficit of these countries may be estimated as having gone up from $23 milliard in 1974 to $36 milliard in 1975. Financing may be divided into three broad categories: long-term official loans and grants (including unilateral transfers); private financing, mainly from bank sources but also including direct investment and trade credits; and the use of reserves plus borrowing by monetary authorities. Very broadly, it may be estimated that developing countries received $14 milliard from the first source in 1975 and $17 milliard from the second, of which about $14 milliard was provided through banking channels. In addition, they made net drawings from the International Monetary Fund amounting to $1.8 milliard, most of which was drawn on the oil facility, while their reserves fell by almost $2 milliard.

VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

1975 was a year of growth, continuing structural changes and consolidation in the international credit and capital markets.

Growth was strong in all markets, and exceptionally vigorous in their longer end. The Euro-currency market narrowly defined — as measured by the external assets and liabilities of the eight reporting European countries — continued to expand at a well-sustained rate throughout last year. After an increase of "only" $27 milliard in 1974, the gross external assets of banks in these countries went up by $43 to 258 milliard, or by 20 per cent. The acceleration would appear even more pronounced if exchange rate changes were eliminated from the valuation of the assets. However, a large part of the increase was due to a renewed expansion of interbank positions. The growth of the "net" market, defined according to the traditional BIS method, thus slowed down from $45 milliard in 1974 to about $28 milliard, with the total amount of credit outstanding reaching $205 milliard at the end of 1975.

Outside the reporting European area, too, international bank lending grew at a fast pace. If foreign currency banking in Canada and Japan, as well as activity in the Caribbean area and other offshore centres, is added to that in the European area, total foreign currency credit outstanding (net of double-counting) may be roughly estimated to have expanded by nearly $40 milliard to $250 milliard in 1975. Foreign lending by banks in the United States, which had registered an increase of $19.5 milliard in 1974, expanded by a further $13 milliard in 1975, with the total amount of foreign claims reaching $59 milliard at the end of the year. However, a large part of the increase in US bank lending was channelled through the Caribbean area and through banks in the reporting European countries and is therefore already included in the above-mentioned figure for the net growth of international bank credit.

The most rapid expansion occurred in the bond market. The total of international and foreign issues amounted to $22 milliard in 1975, almost double the 1974 figure.

The data on the growth of international bank credit point clearly to a gradual change in the geography of the market, with centres outside Europe assuming greater importance. The revival of lending by banks located in the United States started in 1974, following the abolition of the balance-of-payments restriction programme; it continued in 1975, under the influence of sluggish domestic demand for bank credit. The emergence of the Caribbean centres began a few years ago. At first they merely acted as relay stations for funds collected elsewhere. It now appears that deposits received from non-banks are to a substantial extent booked directly in these centres. Moreover, expansion continued in Asia, especially in Singapore and Hong Kong, with deposits coming both from the "traditional" Euro-currency market and from other sources. On pages 86 and 87 an attempt is made — despite incomplete statistical coverage — to present an overall picture of these new dimensions in international bank lending.

Change was not confined to the shifting geographical pattern of international banking. It was also discernible in the nature of credit operations, and particularly the increasing involvement of banks in balance-of-payments financing. Euro-borrowings had, of course, been initiated by national authorities to cover external deficits ever since the early days of the Euro-currency markets, but the major turn was taken in 1973–74, when a number of European countries had deliberate recourse to the market to finance their large current-account deficits. This trend continued in 1975, when international banks played an important rôle in covering the external financing requirements of LDCs, eastern European countries and even some "high absorber" oil producers.

1975 was also a year of consolidation. As "normalisation" proceeded in domestic markets, the maturity structure of interest rates returned to its traditional shape, giving a powerful stimulus to the expansion of bond issues. The profit margins on revolving medium-term loans became sufficiently large to enable banks to build up reserves. Last but not least, in the absence of any widely publicised large exchange losses during the year, interest differentials on deposits paid by banks of different size and category showed a sharp reduction compared with 1974. This accounted in large measure for the renewed expansion of interbank business.

Main factors at work in international markets.

The dominant influence on international banking in 1975 was the severe recession in the major industrial countries during the greater part of the year. However, while in the domestic context the decline in economic activity severely retarded the growth of credit, the impact on the Euro-currency market was much more differentiated, with contractionary influences being largely offset by a number of expansionary stimuli.

As explained in Chapter IV, the recession led in the industrial countries to reduced financing needs, easy availability of domestic bank credit and a revival of the longer-term capital markets. The result was a sharp drop in the demand for Euro-currency funds from industrial borrowers in the developed countries and a slow-down in the flow of non-bank funds to the market. On the other hand, faced with very weak domestic credit demand, the banks stepped up their supplies of funds for international lending. Banks in the reporting European area may be estimated to have provided nearly $10 milliard of net new funds to the Euro-currency market, and a similar trend may be observed in the case of banks in the United States. The gross external liabilities of the latter, which had risen by $22 milliard in 1974, declined by $2 milliard in 1975; together with a continued increase in their foreign lending, this meant that the net external position of banks in the United States shifted from $14 milliard of liabilities to $1 milliard of assets.

A second channel through which the recession influenced the development of international bank lending was its impact on balance-of-payments patterns. The improvement in the current account of the main industrial countries had its counterpart in the declining surpluses of the oil exporters and the substantial increase in the deficits of the non-oil LDCs and the eastern European countries. At the same time, many of the smaller industrial countries and other developed countries continued to have large balance-of-payments shortfalls. Hence, the increased lending potential of the international banking community veered quite naturally towards the financing of these deficits. On the sources side of the market, the most striking effect of balance-of-payments developments was the fairly marked slow-down in Euro-currency deposits by oil-exporting countries. This was due not only to the drop in oil surpluses, but also to a desire — stimulated by the "normal" interest differential — to place a growing proportion of surplus oil funds in the Euro-bond market. In addition, the supply of new funds from other countries outside the Group of Ten — particularly the developing countries, many of which had in times of surplus invested a substantial part of their official reserve accruals in the Euro-market — remained sluggish.

Apart from the more or less quantifiable effects on the demand and supply structure of the Euro-currency market, the cyclical slow-down also affected the development of the market in a number of other ways. For one thing, the easing of monetary conditions after a period of extreme credit tightness eliminated one of the principal sources of tension in the market and helped it finally to overcome the shock of the mid-1974 crisis of confidence. Another helpful development in this context was the recovery of the capital markets, which made it easier not only for the banks' customers but also for the banks themselves to improve financial structures; the greater availability of equity capital and weak domestic credit demand eased capital-ratio constraints and induced the banks to increase the activity of their affiliates in the Euro-market. A third factor contributing to the return of confidence was that, probably owing to its fairly limited exposure vis-à-vis the real-estate sector and its concentration on the largest firms, the Euro-market seemed to be less plagued with bad-debt problems than banks in several national markets. In particular, the financial difficulties of New York may have helped to correct some of the impressions left by the mid-summer 1974 crisis concerning relative credit risks and the standing of individual groups of banks. Moreover, after the lessons learnt in the preceding years, 1975 brought no further news of spectacular foreign exchange losses by banks, and the Euro-market received increased attention from supervisory authorities. The multi-tiered interest rate structure which had emerged to the disadvantage of certain groups of banks in the summer of 1974 flattened out in the course of 1975, and interbank business picked up again. The premium which banks in the Euro-market had to pay on dollar deposits in comparison with banks in the United States, while still quite high at the beginning of the year, slowly fell back to its usual level of just under ½ per cent. on three-month deposits.

Despite this return to more normal conditions, the market does not seem to have forgotten the events of mid-1974. Banks have continued on the whole to be more selective in their lending policies and the average maturity of syndicated Euro-currency loans has remained considerably shorter than it was before the summer of 1974. The margins charged over the London interbank rate on loans to prime borrowers stood at around 1⅜ per cent. throughout 1975, i.e. nearly

External assets and liabilities of banks in individual reporting countries, the United States, the Caribbean area and Singapore in domestic and foreign currencies.

			1973	1974	1975			
			Dec.	Dec.	March	June	Sept.	Dec.
			in millions of US dollars					
Belgium-Luxembourg	Assets	Domestic currency	1,160	1,650	1,730	1,860	1,620	1,720
		Foreign currencies	24,450	32,210	35,410	36,890	36,740	39,070
	Liabilities	Domestic currency	1,800	2,500	2,590	2,700	2,420	2,650
		Foreign currencies	23,840	31,280	34,440	35,930	35,820	37,860
France	Assets	Domestic currency	1,850	1,080	1,200	1,410	1,390	1,180
		Foreign currencies	27,630	31,820	31,670	34,530	36,110	39,020
	Liabilities	Domestic currency	4,510	3,680	3,920	4,250	4,140	4,370
		Foreign currencies	27,360	32,510	32,060	33,730	34,610	38,110
Germany	Assets	Domestic currency	8,130	14,210	15,660	17,960	18,010	21,010
		Foreign currencies	6,700	8,360	8,680	9,500	9,160	10,640
	Liabilities	Domestic currency	9,080	11,250	11,810	11,070	10,560	13,620
		Foreign currencies	6,650	7,680	7,820	8,200	7,780	9,310
Italy	Assets	Domestic currency	790	600	600	600	580	440
		Foreign currencies	23,810	12,510	9,120	9,130	10,390	14,980
	Liabilities	Domestic currency	1,820	1,330	1,320	1,460	1,510	1,620
		Foreign currencies	23,870	13,610	10,400	10,440	10,410	15,040
Netherlands	Assets	Domestic currency	910	2,670[1]	2,990	2,970	3,560	3,460
		Foreign currencies	9,410	13,350[1]	14,120	15,630	16,010	17,350
	Liabilities	Domestic currency	1,180	2,070[1]	2,280	2,370	2,230	2,150
		Foreign currencies	9,620	12,600[1]	13,290	14,250	14,860	16,370
Sweden	Assets	Domestic currency	220	430	490	510	540	570
		Foreign currencies	1,710	2,060	2,300	2,420	2,590	2,570
	Liabilities	Domestic currency	460	510	480	530	550	580
		Foreign currencies	900	1,040	1,260	1,340	1,650	1,750
Switzerland	Assets	Domestic currency	7,320	9,160	9,650	9,970	9,360	9,070[2]
		Foreign currencies	9,630	12,300	14,000	16,490	15,680	16,260
	Liabilities	Domestic currency	6,560	8,510	7,970	8,060	6,920	4,630[2]
		Foreign currencies	9,200	10,560	10,970	11,660	10,450	12,020
United Kingdom	Assets	Domestic currency	1,440	1,850[3]	1,730	2,010	1,890	1,700
		Foreign currencies	84,280	102,560[3]	106,830	107,780	112,190	118,240
	Liabilities	Domestic currency	6,150	9,530[3]	10,010	9,490	9,170	9,240
		Foreign currencies	90,660	111,490[3]	116,330	118,960	123,060	128,210
Total	Assets	Domestic currency	21,820	31,650	34,050	37,290	36,950	39,150
		Foreign currencies	187,620	215,170	222,130	232,370	238,870	258,130
	Liabilities	Domestic currency	31,560	39,380	40,380	39,930	37,500	38,860
		Foreign currencies	192,100	220,770	226,560	234,510	238,640	258,670
Canada	Assets	Domestic currency	400	410	380	370	380	460
		Foreign currencies	11,940	13,540	13,100	13,240	14,030	13,390
	Liabilities	Domestic currency	1,090	1,610	1,680	1,780	1,880	2,010
		Foreign currencies	11,530	11,730	11,660	11,850	12,990	12,070
Japan	Assets	Domestic currency	810	1,370	1,390	1,330	1,420	1,530
		Foreign currencies	16,300	19,240	19,440	17,670	19,190	19,830
	Liabilities	Domestic currency	690	870	1,160	1,580	1,730	1,480
		Foreign currencies	12,930	24,080	25,220	24,070	25,050	25,210
United States	Assets	Domestic currency	25,990	44,940	48,660	52,400	52,880	57,960
		Foreign currencies	730	1,280	1,220	1,300	1,220	1,400
	Liabilities	Domestic currency[4]	38,050	59,620	53,770	55,130	56,760	57,820
		Foreign currencies	600	770	680	580	550	600
Caribbean area[5]	Assets	Foreign currencies[6]	24,940	33,230	35,580	41,510	43,830	47,800
	Liabilities	Foreign currencies[6]	24,960	33,230	35,710	41,570	43,610	47,550
Singapore	Assets	Foreign currencies[7]	6,020	10,130	10,700	10,770	11,250	12,330
	Liabilities	Foreign currencies[7]	5,870	9,680	10,100	10,260	10,860	12,010

[1] Includes long-term positions not reported previously. On the old basis the figures for December 1974 were: assets, 1,040 million and 12,040 million respectively; liabilities, 1,360 and 11,890 million. [2] Break in series due to change in coverage. [3] The coverage of these figures is slightly different from that used previously. On the old basis the figures for December 1974 were: assets, 1,870 and 103,100 million respectively; liabilities, 7,730 and 112,360 million. [4] Excluding US Treasury bills and certificates held in custody on behalf of non-residents. [5] Assets and liabilities of branches of US banks in the Bahamas, Cayman Islands and Panama. [6] Including negligible amounts in domestic currencies. [7] Including positions vis-à-vis non-bank residents of Singapore.

External assets and liabilities of banks in individual reporting countries and in the Caribbean area in dollars and other foreign currencies.

			1973 Dec.	1974 Dec.	1975 March	1975 June	1975 Sept.	1975 Dec.
			in millions of US dollars					
Belgium-Luxembourg	Assets	US dollars	11,000	15,210	16,020	17,310	17,550	18,670
		Other foreign currencies	13,450	17,000	19,390	19,580	19,190	20,400
	Liabilities	US dollars	10,500	13,350	13,600	15,550	16,470	17,960
		Other foreign currencies	13,340	17,930	20,840	20,380	19,350	19,900
France	Assets	US dollars	20,320	24,210	23,050	25,440	26,800	29,690
		Other foreign currencies	7,310	7,610	8,620	9,090	9,310	9,330
	Liabilities	US dollars	18,220	22,650	21,600	22,930	23,780	27,000
		Other foreign currencies	9,140	9,860	10,460	10,800	10,830	11,110
Germany	Assets	US dollars	5,050	6,140	6,120	6,800	6,570	7,700
		Other foreign currencies	1,650	2,220	2,560	2,700	2,590	2,940
	Liabilities	US dollars	5,550	6,160	5,840	6,290	5,950	7,400
		Other foreign currencies	1,100	1,520	1,980	1,910	1,830	1,910
Italy	Assets	US dollars	16,570	9,770	7,290	6,990	8,360	12,100
		Other foreign currencies	7,240	2,740	1,830	2,140	2,030	2,880
	Liabilities	US dollars	16,280	10,440	7,660	7,830	7,810	11,830
		Other foreign currencies	7,590	3,170	2,540	2,610	2,600	3,210
Netherlands	Assets	US dollars	5,710	7,960[1]	8,300	9,870	9,990	10,400
		Other foreign currencies	3,700	5,390[1]	5,820	5,760	6,020	6,950
	Liabilities	US dollars	4,690	6,290[1]	6,630	7,800	8,870	10,670
		Other foreign currencies	4,930	6,310[1]	6,650	6,450	5,990	5,700
Sweden	Assets	US dollars	1,090	1,320	1,500	1,580	1,800	1,790
		Other foreign currencies	620	740	800	840	790	780
	Liabilities	US dollars	500	560	860	700	970	1,020
		Other foreign currencies	400	480	600	640	680	730
Switzerland	Assets	US dollars	6,910	8,930	10,300	12,580	12,120	12,890
		Other foreign currencies	2,720	3,370	3,700	3,910	3,560	3,370
	Liabilities	US dollars	6,470	8,140	7,870	8,700	7,840	9,420
		Other foreign currencies	2,730	2,420	3,100	2,960	2,610	2,600
United Kingdom	Assets	US dollars	65,460	82,690[2]	85,190	86,660	91,430	96,940
		Other foreign currencies	18,820	19,870[2]	21,640	21,120	20,760	21,300
	Liabilities	US dollars	69,170	88,840[2]	91,300	94,190	99,300	104,170
		Other foreign currencies	21,490	22,650[2]	25,030	24,770	23,760	24,040
Total	Assets	US dollars	132,110	156,230	157,770	167,230	174,620	190,180
		Other foreign currencies	55,510	58,940	64,360	65,140	64,250	67,950
	Liabilities	US dollars	131,380	156,430	155,360	163,990	170,990	189,470
		Other foreign currencies	60,720	64,340	71,200	70,520	67,650	69,200
Canada	Assets	US dollars	11,170	12,700	12,290	12,470	13,340	12,640
		Other foreign currencies	770	840	810	770	690	750
	Liabilities	US dollars	10,840	11,090	11,050	11,300	12,530	11,560
		Other foreign currencies	690	640	610	550	460	510
Japan	Assets	US dollars	14,770	17,150	17,180	15,580	17,360	16,960
		Other foreign currencies	1,530	2,090	2,280	2,090	1,830	1,870
	Liabilities	US dollars	12,350	22,960	24,160	23,160	24,140	24,340
		Other foreign currencies	580	1,120	1,060	910	910	870
Caribbean area[3]	Assets	US dollars	23,130	30,240	31,900	38,150	40,480	44,490
		Other foreign currencies[4]	1,810	2,990	3,680	3,360	3,350	3,310
	Liabilities	US dollars	23,500	30,350	32,150	38,470	40,460	44,540
		Other foreign currencies[4]	1,460	2,880	3,560	3,100	3,150	3,010

[1] Includes long-term positions not reported previously. On the old basis the figures for December 1974 were: assets, 7,180 and 4,860 million in US dollars and other foreign currencies respectively; liabilities, 5,900 and 5,990 million. [2] The coverage of these figures is slightly different from that used previously. On the old basis the figures for December 1974 were: assets, 82,690 and 20,410 million in US dollars and other foreign currencies respectively; liabilities, 88,980 and 23,380 million. [3] Assets and liabilities of branches of US banks in the Bahamas, Cayman Islands and Panama. [4] Including negligible amounts in domestic currencies.

three times as large as in early 1974, and should have given considerable room for the accumulation of reserves against losses.

Although the Euro-market has shown itself able not only to survive the worst recession since the 1930s but even to expand and prosper during such a period, new fears about its health and soundness have arisen. These fears stem primarily from the market's exposure vis-à-vis developing countries, whose external payments position has deteriorated sharply as the combined result of higher oil prices and the recession in the industrial world. International bank lending in 1974 and 1975 helped to limit the fall in the import capacity of these countries, thus preventing the recession in the industrial nations from becoming even worse than it already was. While this lending was therefore to be welcomed from an anti-cyclical point of view, it entailed a very sharp increase in the short and medium-term indebtedness of the borrowers. Indeed, the ratio of foreign debt to current-account receipts seems to have reached a disturbingly high level in some of the developing countries and one or two of them have been obliged to defer amortisation and even the payment of interest.

Euro-currency markets: the significant figures.

In the course of 1975 the total external assets and liabilities of the reporting European banks rose by about $50 and 37 milliard respectively to reach almost $300 milliard each at the end of the year. Of the expansion in assets, $7.5 milliard was in domestic currencies, while liabilities in domestic currencies showed a decline of $0.5 milliard. However, the latter figures were strongly influenced by valuation effects resulting from the appreciation of the dollar and by a change in the statistical coverage of domestic currency positions reported by banks in Switzerland. In the absence of these statistical influences, the growth in external assets and liabilities in domestic currency would have amounted to about $10.5 and 5 milliard respectively. The German banks, which acted as large-scale exporters of money throughout the year owing to the lull in domestic credit demand, accounted for a substantial proportion of these increases and the resultant $5.5 milliard change in the net position. Reflecting the various official regulations against capital inflows, the Swiss banks' external liabilities in domestic currency showed a decline of about $1.5 milliard (after allowance for valuation effects and the change in statistical coverage), while external domestic currency assets registered a moderate increase.

Of the growth in the reporting banks' external assets in foreign currency, $34 milliard was in dollars and $9 milliard in other denominations. The two corresponding figures on the liabilities side were $33 and 5 milliard respectively.

Reflecting developments in the exchange markets, the growth in dollar positions was concentrated in the last three quarters of the year, while during the first quarter most of the expansion was in other currencies. After rising by 2.2 percentage points in 1974, the share of the dollar in total gross positions went up by 1.8 percentage points in 1975 to 73.5 per cent., its highest level since 1972.

However, as in the case of domestic currency positions, the recorded increase in the non-dollar component of the market was affected by valuation changes.

External positions of reporting European banks in dollars and other foreign currencies.

End of month	Dollars: Total	Dollars: of which vis-à-vis non-banks	Other foreign currencies: Total	of which: vis-à-vis non-banks	of which: Deutsche Mark	of which: Swiss francs	of which: Pounds sterling	of which: Dutch guilders	of which: French francs
	in millions of US dollars								
				Assets					
1968 Dec. . . .	30,430	5,150	7,270	1,240	3,920	1,820	610	290	240
1969 Dec. . . .	47,630	6,090	10,540	2,230	5,990	2,980	580	370	150
1970 Dec. . . .	60,370	11,850	17,880[1]	4,680	10,110	5,080	610	560	400
1971 Dec. . . .	71,500	14,360	28,630	6,750	16,220	8,180	1,620	700	490
1972 Dec. . . .	98,000	18,340	33,840	8,000	20,390	7,780	2,180	720	700
1973 Dec. I . .	133,760	23,880	54,840	11,990	31,400	14,590	3,150	1,320	1,750
Dec. II[2] . .	132,110	24,730	55,510	13,980	31,410	15,000	3,080	1,240	1,760
1974 March . .	146,100	28,710	58,530	14,090	32,950	15,800	3,090	1,220	1,700
June . . .	154,170	31,300	59,670	14,790	33,730	16,110	3,130	1,320	1,290
Sept. . . .	148,970	31,300	52,750	15,250	30,390	13,250	2,490	1,480	1,360
Dec. I . .	155,450	34,350	58,950	18,030	34,620	14,330	2,040	1,870	1,480
Dec. II[3] . .	156,230	34,920	58,940	18,080	34,950	14,420	2,050	1,880	1,480
1975 March . .	157,770	37,360	64,360	20,070	40,100	13,900	1,940	2,060	2,130
June . . .	167,230	37,260	65,140	20,610	39,020	14,140	2,810	2,460	2,300
Sept. . . .	174,620	38,430	64,250	19,970	39,320	14,050	2,560	2,170	2,270
Dec. . . .	190,180	40,870	67,950	20,450	41,620	15,430	1,980	2,100	2,570
Memorandum item									
Positions vis-à-vis residents[4]									
1971 Dec. . . .		*5,850*		*1,770*					
1972 Dec. . . .		*5,120*		*3,530*					
1973 Dec. I . .		*8,830*		*5,150*					
Dec. II[2] . .		*8,820*		*5,110*					
1974 Dec. I . .		*16,430*		*6,330*					
Dec. II[3] . .		*17,110*		*6,560*					
1975 Dec. . . .		*17,410*		*6,570*					
				Liabilities					
1968 Dec. . . .	26,870	6,240	6,840	1,530	3,010	2,290	800	250	230
1969 Dec. . . .	46,200	10,460	10,520	1,340	4,640	4,030	810	350	210
1970 Dec. . . .	58,700	11,240	16,590[1]	2,450	8,080	5,720	940	550	420
1971 Dec. . . .	70,750	9,980	26,970	2,740	14,630	7,760	2,110	860	440
1972 Dec. . . .	96,730	11,810	35,200	3,620	19,540	8,810	2,210	1,360	1,080
1973 Dec. I . .	130,470	16,370	60,960	5,610	32,140	17,060	4,790	2,260	2,160
Dec. II[2] . .	131,380	17,470	60,720	5,630	32,020	17,160	4,560	2,260	2,130
1974 March . .	143,980	18,660	65,190	6,310	33,310	20,390	4,470	2,090	2,180
June . . .	151,680	19,680	67,840	7,310	35,450	19,850	5,100	2,290	2,080
Sept. . . .	146,930	19,930	60,180	7,410	30,740	17,090	4,300	2,370	2,440
Dec. I . .	156,180	22,440	64,750	8,100	34,220	18,250	3,560	2,760	2,270
Dec. II[3] . .	156,430	22,210	64,340	8,080	34,380	18,290	3,590	2,760	2,270
1975 March . .	155,360	21,000	71,200	8,260	40,330	16,180	3,920	3,440	3,090
June . . .	163,990	21,620	70,520	7,880	40,080	15,480	3,690	3,820	3,600
Sept. . . .	170,990	22,150	67,650	7,220	38,710	14,760	3,280	3,740	3,330
Dec. . . .	189,470	24,280	69,200	6,690	39,940	15,290	3,140	3,550	3,350
Memorandum item									
Positions vis-à-vis residents[4]									
1971 Dec. . . .		*2,450*		*1,150*					
1972 Dec. . . .		*3,260*		*1,720*					
1973 Dec. I . .		*5,020*		*2,560*					
Dec. II[2] . .		*5,020*		*2,550*					
1974 Dec. I . .		*8,560*		*3,780*					
Dec. II[3] . .		*8,960*		*3,930*					
1975 Dec. . . .		*9,410*		*3,210*					

[1] $570 million of the 1970 increase in assets and $360 million of that in liabilities is due to the inclusion of positions in certain currencies not reported previously. [2] As from December 1973 (December II) the figures no longer include the Euro-currency positions of the BIS (previously reported under the figures for the Swiss banks) but do incorporate certain long-term positions not reported previously. [3] Includes certain long-term positions not reported previously by some of the banks as well as some minor changes in the coverage of the statistics. [4] Does not include the positions of German banks prior to December I 1974.

Excluding these valuation effects, non-dollar foreign currency assets may be estimated to have expanded by about $13 milliard and liabilities by $9 milliard, of which Euro-positions in Deutsche Mark alone seem to have accounted for nearly $10 and 9 milliard respectively. Assets in Swiss francs rose by about $1.5 milliard (still excluding valuation effects), while liabilities declined by about $2.5 milliard. The resultant $4 milliard change in the net position was probably influenced by exchange rate considerations. Reflecting the strong performance of the French franc in the exchange market until the end of 1975, positions in that currency showed a sharp increase in relative terms, with assets going up by over 70 per cent. In terms of the extent to which it was used for Euro-market operations, the French franc overtook the guilder and sterling in 1975 and at the end of the year ranked fourth after the Swiss franc. In absolute figures, however, the amounts remained quite small, while the Deutsche Mark consolidated its position as the second currency in the market after the dollar.

A notable development in 1975 was the acceleration in the growth of interbank positions and the equally pronounced slow-down in the market's direct positions with the non-bank sector. Interbank assets, for example, rose by $34.6 milliard, compared with an increase of $13.2 milliard in 1974; on the other hand, claims (external plus domestic) on non-banks went up by only $8.6 milliard, after a record increase of $22.5 milliard in 1974. On the liabilities side of the market, deposits by non-banks (both residents and non-residents, but excluding trustee funds), which had risen by $12.8 milliard in 1974, edged up by only $0.4 milliard: the sharp drop in short-term interest rates was undoubtedly the main factor involved.

With regard to the contribution of individual market centres to the overall growth in Euro-currency positions, the largest expansion in absolute terms was recorded, as usual, by banks in the United Kingdom, which accounted for 40 per cent. of the overall increase in external foreign currency assets and liabilities. In terms of percentage changes, however, growth rates were higher in most of the continental European centres and the United Kingdom's share in outstanding positions declined by 1.5 percentage points to about 47.5 per cent. The main reason for the slightly less important rôle of the United Kingdom was the greater concentration of the new international business of US banks in their branches in the Caribbean area. Whereas the assets of US bank branches in the Bahamas, Cayman Islands and Panama rose by 44 per cent. in 1975, the corresponding figure for US branches in London was only 14 per cent. After advancing by $2.9 milliard in 1974, the external net liability position of banks in the United Kingdom went up by $1.0 milliard in 1975 to $10.0 milliard, this increase being more than accounted for by foreign currency lending to UK non-bank residents.

On the European continent the gross external positions of Italian banks, which had contracted by nearly 60 per cent. in the twelve-month period to March 1975, began to expand again in the second half of the year. This come-back reflected the gradual narrowing of the premium which the Italian banks had to pay over LIBOR; the improvement in Italy's current-account position in 1975 and the smoothness with which the banks had been able to scale down rapidly their involvement in the Euro-market were undoubtedly key factors in the market's favourable reappraisal of their standing. Moreover, in 1975 the Italian banks eliminated their net indebtedness to the market, which had amounted to \$1.1 milliard at the beginning of the year.

The net external position in foreign currencies of the French banks also showed a strong movement in the first nine months of the year, swinging from \$0.7 milliard of liabilities to \$1.5 milliard of assets, though there was some decline during the fourth quarter. This turn-round was officially encouraged and reflected the strength of the French franc on the exchanges. The largest net money exporters in 1975 were the German banks, whose total net external assets increased by \$5.1 to 8.7 milliard, and the Swiss banks, which recorded an expansion of \$4.5 milliard (after elimination of the effects of the change in statistical coverage); however, a large proportion of these increases in net foreign placements was in domestic currency, reflecting the rôle of the Deutsche Mark and the Swiss franc in the Euro-market.

Euro-currency markets: sources and uses.

The table presented below provides estimates of how, net of double-counting, the amount of Euro-credit outstanding through the banks of eight reporting European countries was distributed on both the sources and uses sides of the market.

Estimated sources and uses of Euro-currency funds.

End of month	Reporting European area		Other G-10 countries	Other developed countries	Eastern Europe	Offshore banking centres[3]	Oil-exporting countries[4]	Developing countries	Unallocated	Total
	Total[1]	*of which* Non-bank[2]								
	in milliards of US dollars									
Uses										
1973 Dec. .	49.0	29.5	26.2	14.7	7.4	18.7	14.3		1.7	132.0
1974 Dec. I .	61.9	41.0	36.4	20.2	9.8	26.7	3.5	15.7	2.8	177.0
Dec. II	61.5	41.3	36.4	20.4	9.8	26.7	3.5	15.7	3.0	177.0
1975 March	64.3	44.3	35.5	21.7	11.9	29.4	3.8	15.8	3.6	186.0
June .	63.6	45.0	36.3	24.3	12.6	30.5	4.3	16.8	3.6	192.0
Sept. .	62.1	43.2	37.9	23.9	13.5	33.0	4.8	17.5	3.3	196.0
Dec. .	63.0	43.6	36.7	25.8	15.6	35.6	5.3	19.5	3.5	205.0
Sources										
1973 Dec. .	50.8	27.5	19.3	17.7	3.7	12.5	24.6		3.4	132.0
1974 Dec. I .	68.5	36.9	20.5	18.4	5.1	17.8	29.1	15.5	2.1	177.0
Dec. II	67.8	36.2	20.6	18.5	5.0	17.8	29.1	15.5	2.7	177.0
1975 March	73.0	37.8	21.3	17.8	4.5	18.2	31.8	16.1	3.3	186.0
June .	75.7	36.5	21.4	18.3	3.7	21.3	32.5	16.1	3.0	192.0
Sept. .	77.3	38.0	23.2	19.4	4.5	20.5	32.3	15.5	3.3	196.0
Dec. .	79.5	38.5	23.7	19.9	5.1	21.8	34.6	16.2	4.2	205.0

[1] Includes: (a) under "Uses", the banks' conversions from foreign currency into domestic currency and foreign currency funds supplied by the reporting banks to the commercial banks of the country of issue of the currency in question (such as DM funds deposited with German banks); (b) under "Sources", deposits by official monetary institutions of the reporting area, the banks' conversions from domestic into foreign currency and foreign currency funds obtained by the reporting banks from the banks in the country of issue of the currency in question (such as funds received in Deutsche Mark from German banks). [2] On the sources side including trustee funds to the extent that they are transmitted by the Swiss banks to the other banks within the reporting area and to the extent that they are not reported as liabilities vis-à-vis non-banks outside the reporting area by the Swiss banks themselves. [3] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, Virgin Islands, West Indies. [4] Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates, Venezuela.

To begin with the uses side, a major development in 1975 was undoubtedly the sharp drop in the offtake by residents of the Group of Ten countries. While in 1974, a year of large oil-induced current-account deficits and tight domestic credit conditions, the reporting European countries absorbed about $13 milliard of new funds from the market, in 1975 they seem to have borrowed only about $1.5 milliard. The explanation lies, of course, in improved current-account positions and domestic credit ease. Non-European Group of Ten countries reduced their new takings from about $10 milliard in 1974 to less than half a milliard. Japanese banks borrowed only $2.5 milliard in 1975, much less than in the year before ($7.1 milliard), and US bank and non-bank residents, after increasing their recourse to the market by $4.7 milliard in 1974, actually repaid $1.8 milliard in 1975.

Partly in consequence of persistently weak current-account positions, developed countries outside the Group of Ten continued to tap the market on a large scale in 1975, their total offtake amounting to $5.4 milliard. A further $5.8 milliard was borrowed by eastern European countries, whose gross indebtedness to the market went up by as much as 60 per cent. as a result. At $3.8 milliard, the figure for new funds drawn direct from the market by developing countries seems relatively modest; but a very substantial part of the $8.9 milliard of new funds placed by the reporting European banks in the Caribbean area and in other offshore banking centres has undoubtedly been on-lent to developing countries. Finally, oil-exporting countries themselves took up $1.8 milliard of new Euro-funds, though part of this seems to have reflected Bahrain's emerging rôle as an offshore banking centre.

On the sources side of the market, direct deposits by oil-exporting countries went up by $5.5 milliard last year, compared with an increase of over $20 milliard in 1974. Some of the countries within this group, notably Saudi Arabia and Venezuela, continued to build up their Euro-currency deposits at a fairly rapid pace; some other countries, such as Kuwait, seem to have invested their newly accruing surpluses in longer-term forms outside the Euro-currency market; and several of the high absorbers in the group, notably Iran, Libya and Algeria, began to draw on their previously accumulated Euro-currency balances for import payments.

The supply of new funds to the market from Group of Ten countries appears to have slowed down from about $19 milliard in 1974 to about $15 milliard in 1975, but if valuation effects are excluded the difference between the two figures is probably quite small. A significant feature, however, was the drop from roughly $9 to 2 milliard in new funds supplied to the market from non-bank sources within the reporting European area. Apart from the greater attraction of the long-term capital markets, this development also seems to reflect the circumstance that after the rapid build-up in 1974 there was no further major increase in Euro-dollar deposits by oil companies last year. On the other hand, the input of new funds by banks in the reporting area may be estimated to have increased from $8 milliard in 1974 to about $9 milliard, the extent of the acceleration being strongly understated by valuation effects. The $3 milliard received by the market from other Group of Ten countries was more than accounted for by banks in the United States, where domestic credit demand was particularly weak. In addition, part of the $4 milliard increase in the market's liabilities to offshore banking centres seems to have reflected the pass-through of US funds via the Caribbean area to the reporting European banks.

New deposits by other developed countries rose by about $1.5 milliard, partly as a result of the redepositing in the market of accruals to official reserves associated with Euro-currency borrowing. On the other hand, the supply of new funds to the market from eastern European countries and non-oil developing countries was quite small, owing to the weak balance-of-payments positions of these countries.

Total international bank lending.

Whereas the emphasis in the preceding sections was placed on foreign currency credits intermediated by the banks in the eight reporting European countries, the table on pages 86 and 87 provides a broader picture of international banking. It does so by means of a detailed country break-down of the external assets and liabilities in both domestic and foreign currencies of a much larger group of banks, comprising banks located not only in the eight European countries, but also in the United States, Japan and Canada, as well as branches of US banks operating in the offshore banking centres of the Caribbean area and the Far East. Unfortunately, these figures are available only in respect of one date, i.e. end-1975. Hence, there is no way of establishing the flow figures for 1975, except on the basis of some very rough estimates. Even from the point of view of stocks outstanding, the figures do not give a full picture of total international bank positions, since they exclude, for example, the assets and liabilities of non-US banks operating in the offshore banking centres of the Caribbean and the Far East. Moreover, the geographical break-down available for the reporting banks in Canada, Japan, Switzerland and the United States is less than complete. Finally, the figures for the reporting banks' claims on the individual countries should be interpreted with care. The country's external debt is likely to be larger, since it will probably include debts to non-banks or banks not included in the table. Moreover, nothing is said about the identity of the borrowers, which may be the local affiliates of the lending banks themselves. But despite these shortcomings, the table should afford some insight into the rôle of individual countries or groups of countries as takers of international bank credit or as suppliers of funds.

The most interesting aspect of the table is perhaps the information it provides concerning international bank lending to non-oil-producing LDCs. After making some assumptions about the distribution of the residuals and the item "Unallocated", it would appear that total gross claims outstanding vis-à-vis the developing countries amounted to about $63 milliard at the end of 1975. The increase during the year may be estimated at around $17 milliard, of which barely $4 milliard came, as already indicated, in the form of Euro-funds directly from banks in the reporting European area and slightly more than $5 milliard from banks in the United States. Latin American countries (excluding the oil exporters) accounted for about two-thirds of the amount outstanding and probably the same proportion of the increase during 1975. Two of these countries, Brazil and Mexico, had particularly heavy recourse to foreign bank credit, accounting for 45 per cent. of the reporting banks'

External positions in domestic and foreign currency of banks in Group of Ten countries and Switzerland and of the foreign branches of US banks in the Caribbean area and the Far East.[1]

In millions of US dollars,
end-December 1975.

Liabilities/assets vis-à-vis		Liabilities	Assets
Group of Ten			
Belgium-Luxembourg	HCJU	17,742	22,886
France	HCJU	25,982	23,000
Germany	HCJU	18,072	21,350
Italy	HCJU	12,540	16,549
Netherlands	HCJU	15,142	11,392
Sweden	HCJU	2,477	4,065
Switzerland	CJU	52,323	10,047
United Kingdom	HCJU	64,120	55,282
Canada	HJU	9,898	7,104
Japan	HCU	9,108	31,929
United States	HCJ	41,957	30,629
Total		269,361	234,233
Non-Group of Ten western Europe			
Andorra		41	–
Austria	CU	4,758	3,793
Cyprus		260	166
Denmark	CU	1,275	2,741
Finland	CU	909	3,068
Gibraltar		53	22
Greece	CJU	2,829	2,897
Iceland		33	175
Ireland	C	1,392	1,421
Liechtenstein		210	240
Malta		481	4
Monaco		10	1
Norway	CU	2,552	4,347
Portugal	CU	753	597
Spain	CU	6,967	5,154
Turkey	CJU	773	1,013
Vatican		105	–
Yugoslavia	CJU	1,051	1,760
Residual	HCJU	6,669	4,377
Total		31,121	31,776
Other developed countries			
Australia	CU	986	2,641
New Zealand	C	166	783
South Africa	CU	805	4,762
Residual	HCJ	163	792
Total		2,120	8,978
Eastern Europe			
Albania		41	86
Bulgaria		282	1,600
Czechoslovakia		250	288
Germany (GDR)		1,324	3,317

Liabilities/assets vis-à-vis		Liabilities	Assets
Eastern Europe (contd.)			
Hungary		748	2,194
Poland		508	3,870
Rumania		374	880
Soviet Union	CU	2,854	7,597
Residual	HCJU	688	2,499
Total		7,069	22,331
Caribbean Area			
Bahamas	JU	11,058	25,460
Barbados		169	13
Bermuda	J	2,590	818
Cayman Islands		3,306	4,284
Cuba	JU	152	840
Dominican Republic		15	104
Haiti		3	9
Jamaica		117	370
Neth. Antilles	U	1,286	1,379
Panama	JU	4,701	7,035
Panama Canal Zone		–	9
Trinidad & Tobago		413	68
Virgin Islands (UK)		81	130
Virgin Islands (US)		–	100
West Indies (F)		24	1
West Indies (UK)		181	198
Residual	HCJ	1,913	3,537
Total		26,009	44,455
Latin America			
Argentina	JU	2,060	3,186
Belize		6	1
Bolivia		104	149
Brazil	JU	4,061	14,847
Chile	JU	515	786
Colombia	JU	618	1,576
Costa Rica		43	184
Ecuador	J	163	262
El Salvador		46	96
Guatemala		51	114
Guyana		71	20
Honduras		124	86
Mexico	JU	3,385	13,465
Nicaragua		127	223
Paraguay		98	38
Peru	JU	382	2,302
Surinam		122	13
Uruguay	U	353	161
Venezuela	JU	7,252	2,964
Residual	HCJU	6,021	7,038
Total		25,601	47,511

Liabilities/assets vis-à-vis		Liabilities	Assets
Middle East			
Oil-exporting countries:	J[2]		
a) Low absorbers: Kuwait, Qatar, Saudi Arabia and United Arab Emirates		24,570	1,163
b) High absorbers: Bahrain, Iran, Iraq, Libya and Oman		8,606	3,176
Other countries:			
Egypt	JU	1,521	914
Israel	JU	2,496	2,111
Jordan		414	56
Lebanon		2,515	390
Syria		775	35
Yemen		235	5
Yemen P.D. Rep.		84	—
Residual[3]	HCJU	6,523	1,294
Total		47,739	9,144
Other Africa			
Afars and Issas territ. (F)		28	3
Algeria	J	1,285	1,383
Angola		48	21
Benin P.D. Rep.		24	2
Botswana/Lesotho		—	32
Burundi		14	4
Cameroon		56	49
Central African Rep.		11	9
Chad		10	6
Congo		31	73
Ethiopia		229	—
Gabon		69	144
Ghana		90	10
Guinea		6	16
Ivory Coast		232	260
Kenya	J	405	123
Liberia	J	797	3,663
Malagasy		60	5
Malawi		54	41
Mali		16	2
Mauritania		56	6
Mauritius		51	1
Morocco	U	537	74
Mozambique P.D. Rep.		90	6
Namibia		—	7
Niger		30	12
Nigeria	J	381	270
Rhodesia		41	20
Rwanda		27	3
Senegal		72	109

Liabilities/assets vis-à-vis		Liabilities	Assets
Other Africa (contd.)			
Sierra Leone		46	7
Somalia		74	3
Sudan		141	254
Tanzania		152	4
Togo		56	15
Tunisia		286	25
Uganda		46	16
Upper Volta		12	2
Zaire	U	356	783
Zambia	J	143	341
Residual	CU	956	1,276
Total		7,020	9,080
Other Asia			
Afghanistan		24	1
Bangladesh		61	13
Brunei		624	30
Burma		36	7
Cambodia		97	—
China	U	1,002	863
Hong Kong	JU	4,837	5,910
India	JU	784	416
Indonesia	JU	473	2,478
Korea N.		9	155
Korea S.	JU	1,182	3,309
Laos		13	—
Malaysia	J	694	690
New Hebrides		12	73
Papua New Guinea		20	—
Pakistan	J	302	126
Philippines	JU	1,702	2,010
Sikkim/Bhutan		43	14
Singapore	HJ	4,725	5,789
Sri Lanka		24	10
Taiwan	JU	1,525	2,061
Thailand	JU	1,388	1,227
Vietnam N.		95	13
Vietnam S.		69	36
Residual	CU	1,232	1,509
Total		20,993	26,740
International institutions	U[4]	4,219	517
Unallocated	HCJU	5,885	6,902
Grand total		447,137	441,667
Memorandum item: Oil-exporting countries	HJU	50,612	13,641

Note: For liabilities and assets of banks in Canada, Japan, Switzerland and the United States a full country breakdown is not available. Positions of banks in these countries have been allocated as indicated in the table by the following: H = Switzerland, C = Canada, J = Japan and U = United States. The liabilities of banks in the United States exclude US Treasury bills and certificates held in custody by the banks on behalf of non-residents.

[1] Foreign branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [2] Includes positions of Japanese banks vis-à-vis Kuwait, Saudi Arabia, United Arab Emirates, Iran, Iraq and Libya only. [3] Includes, partly on an estimated basis, the positions of US banks vis-à-vis Middle Eastern countries other than Egypt, Israel and Libya (which is included under the residual for "Other Africa"). [4] Excludes, except in the case of the Dutch and UK banks and the foreign branches of US banks in the Caribbean area and the Far East, regional institutions which are included under the residual items for the respective areas. The positions vis-à-vis the BIS are included under Switzerland, except for the US banks which report them under the residual for "Non-Group of Ten western Europe".

gross claims on developing countries. Other important borrowers in Latin America were Argentina, Peru and Colombia. Outside Latin America the main credit-takers were South Korea, Israel, Taiwan and the Philippines. On the other hand, relatively little seems to have been lent by the reporting banks to India, Pakistan and most of the African countries.

The table also shows that developing countries are not only borrowers but also important suppliers of funds; after an increase of roughly $3 milliard in 1975 their deposits with the reporting banks totalled about $40 milliard at the end of the year, though well over half of this amount seems to have represented official reserve holdings with banks in the Euro-market and the United States. Netting out assets and liabilities, the debtor position of developing countries was therefore much more modest. In fact, even the non-oil-exporting Middle Eastern countries, which — with the obvious exception of Israel — may have benefited indirectly from the oil price increases, were all net suppliers of funds. Similarly, the net indebtedness of some of the principal gross borrowers included in the item "Other Asia" was quite small, a number of countries, such as India and Thailand, having actually registered net claims on the reporting banks. On the other hand, even after deduction of assets held with banks abroad, the indebtedness of Latin American countries remains very substantial.

The very size of the reporting banks' assets and liabilities vis-à-vis Group of Ten countries — they amount to well over half of total gross external positions — reflects the importance of interbank positions within this area, and the extent of the resultant double-counting. More interesting than the gross positions are the reporting banks' net positions, i.e. assets less liabilities, vis-à-vis individual countries within the group. The most striking figure is undoubtedly the $42.3 milliard obtained in respect of the reporting banks' liabilities vis-à-vis Switzerland, an indication of the leading rôle played by Swiss banks on the supply side of international banking. Needless to say, this figure does *not* imply that all these funds have come "from within" Switzerland but that, Swiss residents apart, their ultimate source may be traced to non-banks and non-reporting banks outside Switzerland.

The second largest net figure within the Group of Ten was the reporting banks' $22.8 milliard of net claims on Japan. This was mainly due to the Japanese banks' extensive borrowing in the Euro-market and the United States, largely for the purpose of financing Japan's international trade. Another surprising figure, in view of the substantial net external assets of German banks, is the $3.3 milliard of net claims recorded by the reporting banks vis-à-vis Germany. The heavy net indebtedness of the German non-bank sector to the Euro-market seems to have been largely responsible.

On the whole, the reporting banks' assets and liabilities vis-à-vis European countries outside the Group of Ten roughly balanced each other out. However, the structure of their assets and liabilities varied quite considerably and there were also large differences in positions vis-à-vis individual countries. On the uses side, the bulk of these positions seems to reflect direct lending to the non-bank sectors of the countries concerned, whereas on the liabilities side most of the positions have arisen vis-à-vis banks, including official monetary institutions. In fact, several of the countries within this group use the Euro-market not only for balance-of-payments motivated borrowing or public-sector financing, but also as an outlet for the investment of their international reserves and liquidity. Of course, a substantial part of the reserves of these countries is also held in the form of deposits with banks in the United States. The largest net borrowers were Finland, Norway and Denmark, whereas Spain and Austria, despite heavy gross borrowings, were net suppliers of funds.

"Other developed countries" and "Eastern Europe" were all net receivers of international bank funds. About $8–9 milliard of eastern Europe's gross indebtedness of $22.3 milliard seems to have been incurred during 1975 alone, and in some of these countries the ratio between debts and exports to non-communist countries has reached quite a high level.

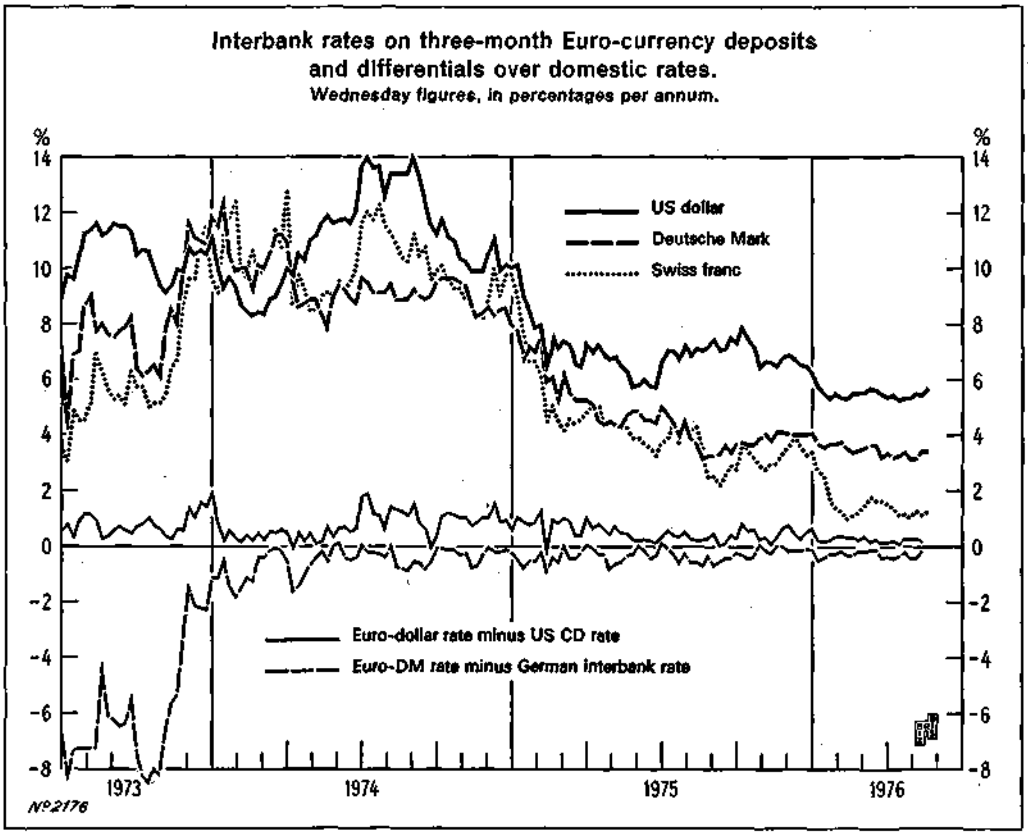
Claims of the reporting banks vis-à-vis the offshore banking centres in the Caribbean area and vis-à-vis Singapore, Hong Kong, the Lebanon and Liberia added up to about $60 milliard, whereas liabilities amounted to nearly $40 milliard. The resultant $20 milliard net position reflects mainly the rôle of these centres as net collectors of funds from banks in the United States, Canada and the European Group of Ten countries, and as a net source of credit to the developing world and certain other countries. The three exceptions to this rule are Bermuda, Liberia and the Lebanon: the $2.6 milliard of funds received by the reporting banks from Bermuda stemmed mainly from non-bank firms domiciled there; and the $3.7 milliard of claims registered vis-à-vis Liberia principally reflected loans to shipping companies domiciled in that country. The Lebanon's rôle was mainly that of a channel for funds from Middle Eastern oil-producing countries to the banks in the Group of Ten countries.

Deposits of oil-exporting countries with the reporting banks amounted to over $50 milliard, following an estimated increase of about $8–9 milliard during 1975, while their gross borrowings totalled barely $14 milliard. The only major net borrower within this group was Indonesia, with net debts of about $2 milliard.

Interest rates.

Reflecting the easing of domestic monetary conditions and the restoration of confidence, Euro-deposit rates receded in 1975 from the very high levels which they had attained in the two preceding years.

At the beginning of 1975 the downward movement in Euro-dollar rates, which had started in late summer 1974 concurrently with the relaxation of US monetary restraint, gained further momentum as the markets began to realise that the recession was deeper than anticipated. The three-month interbank rate, which had stabilised at around 10 per cent. in the closing months of 1974, took another steep plunge and in early February was quoted at below 7 per cent. Despite some upward reaction subsequently, the downward movement continued and in early June the three-month rate stood at around 5¾ per cent., its lowest level since 1972 and some 8 percentage points below its historical July 1974 peak. By that time also the last of the clouds hanging over the market after the mid-1974 storm had been dispersed: the premium



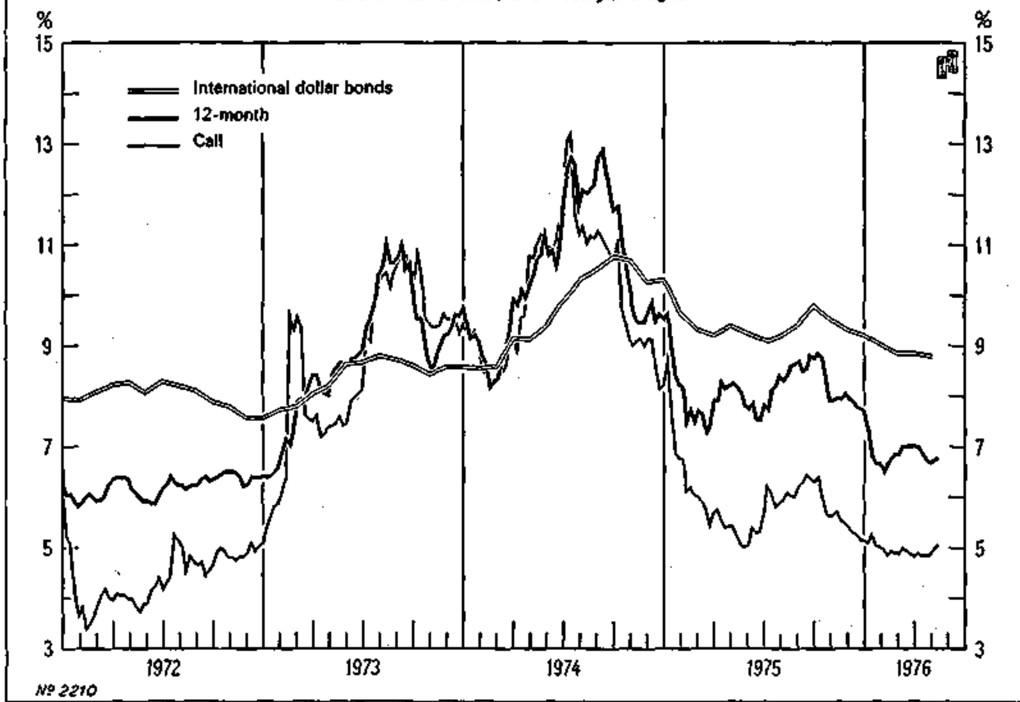
which the Euro-banks had to offer over CD yields in the United States, which was still fluctuating around 1 per cent. early in the year, had dropped to below ½ per cent. and the multi-tiered interest rate structure had nearly disappeared.

In the early summer, however, Euro-dollar rates firmed in line with domestic developments in the United States. The three-month rate reached a peak of 8¼ per cent. at the beginning of October before falling back to around 6½ per cent. in November. The rates resumed their downward movement in early December and, after reaching a low of 5¼ per cent. in late January, fluctuated around a level of 5⅝ per cent. in the following three months. In May, however, with the firming of interest rates in the United States, quotations began to go up again and stood at 6½ per cent. at the end of the month.

Owing to the greater calm in the exchange markets, Euro-Deutsche Mark and Euro-Swiss franc rates, while sharing the downward movement of Euro-dollar quotations, displayed greater stability than in preceding years. Reflecting the particularly large Swiss domestic liquidity surpluses and the continued strength of the franc on the exchanges, the decline in quotations was most pronounced in the case of Euro-Swiss franc rates, which were down to 1½ per cent. in early 1976, as compared with 11 per cent. two years earlier. Euro-Deutsche Mark deposit rates followed very closely the movement of German domestic interbank rates. The climate of stability and relaxation was not always shared by the Euro-French franc market, on which even twelve-month rates occasionally ran into double-digit figures during the early months of 1976 under the impact of the speculative attacks on the franc.

The return to a more normal relationship between long and short-term interest rates in the domestic markets was also reflected in the yield curves for Euro-currency deposits. Whereas during parts of 1973 and 1974 Euro-dollar call rates had exceeded twelve-month yields, in April 1975 twelve-month rates stood 2⅛ percentage points higher than one-month rates, and one year later this differential still amounted to about 1¾ percentage points.

Euro-dollar deposit rates and Euro-dollar bond yields.
End-of-month rates and weekly averages.



The international bond markets.

Just as the Euro-bond market had earlier been more severely affected by high rates of inflation and soaring interest rates than most domestic capital markets, its come-back in 1975 was much more spectacular. The total issue volume rose from \$4.5 milliard in 1974 to \$10.4 milliard, or \$3.5 milliard above its previous 1972 peak. The extent of the improvement in market sentiment was reflected most dramatically in the recovery of public issues, which expanded from \$1.6 milliard in 1974 to \$6.9 milliard; private placements rose by less than 20 per cent.

Conventional foreign issues in national markets, which in the two preceding years had fared better than Euro-bonds, advanced from \$7.8 milliard in 1974 to \$11.8 milliard. These figures, however, somewhat understate the actual expansion, since

International bond issues.[1]

Borrowing countries or areas	Years	Euro-bond issues: Total	of which: US dollars	of which: Deutsche Mark	of which: Private place-ments	Foreign issues: Total	of which: in United States	of which: in Switzer-land	of which: Private place-ments
		in millions of US dollars							
Western Europe	1973	2,080	1,120	550	500	960	50	730	490
	1974	1,460	460	380	810	1,490	370	660	1,200
	1975	4,680	1,360	1,850	1,490	2,980	890	1,820	1,360
Canada	1973	200	30	170	—	1,010	930	80	270
	1974	440	380	—	350	1,960	1,930	30	800
	1975	1,220	680	—	320	3,360	3,090	280	810
United States .	1973	820	710	50	130	500	—	400	110
	1974	110	100	—	10	80	—	80	30
	1975	310	220	—	80	140	—	40	120
Other developed countries[2] . .	1973	170	30	140	10	40	—	30	30
	1974	330	220	120	10	150	30	120	130
	1975	2,220	1,340	700	610	1,000	370	600	650
Rest of the world[3] .	1973	440	350	70	240	750	510	30	200
	1974	140	120	—	10	740	650	20	460
	1975	510	230	120	180	480	460	20	240
International institutions . .	1973	890	650	20	540	2,050	—	270	1,240
	1974	2,040	1,800	150	1,770	3,370	610	80	2,640
	1975	1,410	1,050	300	810	3,860	1,930	610	1,340
Total issues placed	1973	4,600	2,890	1,000	1,420	5,310	1,490	1,540	2,340
	1974	4,520	3,080	650	2,960	7,790	3,590	990	5,260
	1975	10,350	4,880	2,970	3,490	11,820	6,740	3,370	4,520

[1] Based on IBRD and OECD sources. [2] Australia, Japan, New Zealand and South Africa. [3] Including eastern European countries.

the 1974 figure had been boosted by \$2.1 milliard of private placements by the IBRD in oil-exporting countries, while there were hardly any such placements in 1975. Here again the strength of the market is more accurately reflected in the figure for public placements, which soared from \$2.5 milliard in 1974 to \$7.3 milliard. Over 85 per cent. of total foreign issues were accommodated by the markets of two countries: the United States, where the issue volume went up by nearly 90 per cent. to \$6.7 milliard, and Switzerland, where, with foreign borrowing fairly welcome for balance-of-payments reasons, there was an increase of 240 per cent. to \$3.4 milliard. In Germany, where the capital markets at times had difficulty in absorbing the large anti-cyclical public-sector deficit and where foreign issues were therefore banned for part of the year, foreign placements amounted to only \$0.6 milliard.

The most important single influence behind the brisk revival of the international capital markets was the sharp cyclical decline of short-term interest rates from their previous historical peaks. At the same time investors were slow to shed their pessimism with regard to the longer-run course of inflation and long-term rates moved downwards only sluggishly. The result of these two developments was a dramatic turn-round in yield differentials; whereas during parts of 1974 three-month

Euro-dollar deposits had earned over 3 percentage points more than Euro-dollar bonds, throughout most of 1975 Euro-dollar deposit rates were quoted 3 percentage points below Euro-bond yields. This marked shift in incentives helped the markets in two ways: firstly, it attracted the kind of funds from non-bank investors which in the preceding year had gone into the Euro-currency market; secondly, and this applies in particular to the Euro-bond market, it instilled new life into the ailing secondary markets where traders could again finance their stocks of bonds at interest rates lower than the dividends accruing on them.

On the other hand, fears of renewed inflationary pressures were reflected in an increase in the number of issues with adjustable rates and a marked preference for short-term paper. Whereas in previous years most bonds had tended to be in the ten to fifteen-year range, investor preference in 1975 was for bonds with maturities of between five and seven years, with longer-term paper being placed only at a higher cost and issues of over ten years being the exception. Furthermore, this reluctance on the part of investors to lend long was accompanied by a more rigorous evaluation of borrowers' credit-worthiness, as witnessed by the substantial premiums payable by non-prime borrowers and the predominance of top-quality borrowers from industrial countries.

The total amount of funds raised by private and public borrowers in developed countries through Euro-bond issues or traditional foreign issues went up from $6.0 milliard in 1974 to $15.9 milliard, while takings by other countries and international institutions remained unchanged at $6.3 milliard.

Issues by western European countries rose by 160 per cent. to $7.7 milliard. Of this amount, $4.7 milliard was raised in the Euro-bond market and $1.8 milliard in the Swiss market. Placements in the US market amounted to only $0.9 milliard, SEC requirements and the unfamiliarity of US investors with foreign borrowers continuing to act as obstacles. The largest borrowing countries within this group were France ($1.9 milliard), Sweden ($1 milliard), Norway ($0.9 milliard), Austria ($0.9 milliard) and the United Kingdom ($0.7 milliard).

International issues by public and private Canadian entities reached $4.6 milliard, far in excess of levels previously recorded. This massive recourse to the international capital markets, motivated by the sharp 1975 increase in Canada's current-account deficit and extensive project financing needs in the Canadian provinces, was encouraged by the relatively high Canadian interest rate level and facilitated by a partial lifting of the Canadian withholding tax on interest paid to non-residents. As usual the bulk was raised in the US markets but, for the first time, Canadian issues in the Euro-bond market, at $1.2 milliard, also assumed large proportions.

US borrowers, whose takings had dropped off sharply in 1974 as a result of the dismantling of the US balance-of-payments restraint programme, continued to account for only a fairly minor share of international bond issues. On the other hand, issues by other developed countries soared from $0.5 milliard in 1974 to $3.2 milliard, with Japan alone accounting for $1.6 milliard.

Of the $1.0 milliard raised by the rest of the world, $0.8 milliard, or slightly less than in 1974, went to borrowers in the developing countries. However, the

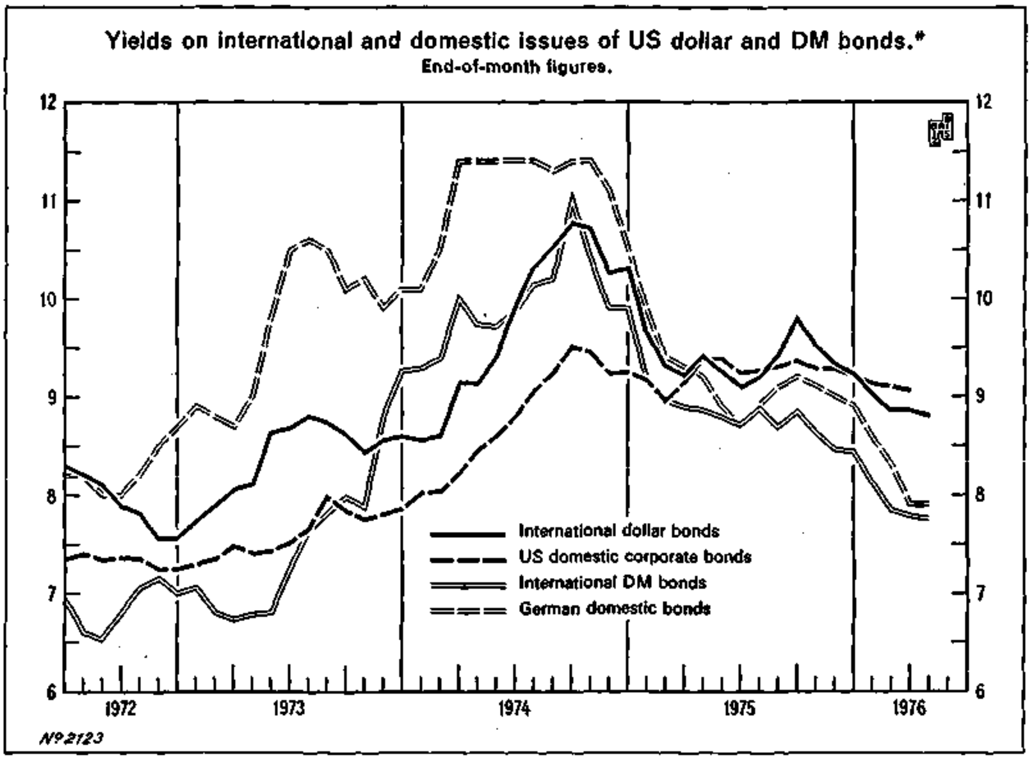
\$0.9 milliard taken up by developing countries in 1974 had included an amount of \$0.6 milliard obtained by Israel, whereas in 1975 this country raised only \$0.2 milliard. At \$5.3 milliard, issues by international institutions were about the same as in 1974, with the share accounted for by institutions engaged primarily in lending to developing countries amounting to \$3.6 milliard.

In the Euro-bond market, exchange rate considerations played an important rôle in the relative performance of the different currency components. The US dollar maintained its leading position, accounting for 47 per cent. of the total issue volume, though this was considerably less than in 1974. In the first half of the year, in fact, Deutsche Mark placements were running at a higher level, making up 42 per cent. of aggregate issues. In July, however, participation by German financial institutions in DM issues was suspended for domestic reasons. The resultant halt in DM issues tended to slow down total issuing activity, but this was partly compensated by a recovery in the US dollar segment of the market following the improved performance of that currency in the exchange market, as well as a growth in the Canadian dollar segment in response to higher yields and exchange rate anticipations. Issuing activity in Deutsche Mark picked up late in the year after the temporary ban had been lifted, but the share of DM-denominated issues in total offerings remained considerably lower than in the first half of 1975. Other sectors of the market, such as the guilder and units of account, absorbed a sizable volume of funds, particularly in the first half of the year; interest in these composite-currency-denominated bonds waned somewhat, however, when the dollar began to regain strength. Finally, mention should be made of the re-emergence of the French franc as an issuing currency as a result of its firmness in the exchange markets during most of 1975.

In early 1976 evidence of a further slow-down of inflation, related expectations of a continued rise in bond prices and a renewed widening of the differential between long and short-term rates gave an additional boost to the international bond markets. In the four-month period up to April the combined issue volume in the Euro-bond and foreign bond markets exceeded \$11 milliard and, if converted to an annual rate, was 50 per cent. higher than in 1975. Even more so than in 1975, the bulk of new issues was accounted for by OECD countries and international institutions, with Canadian borrowers alone taking up \$3.8 milliard. Another \$1 milliard was raised by the European Economic Community, for on-lending to Italy and Ireland.

In the Euro-bond market the share of dollar-denominated issues, at 61 per cent., was considerably larger than in 1975, with the demand for these bonds benefiting from the pronounced exchange-market weakness of several major European currencies. Issues in Deutsche Mark and Canadian dollars accounted for 21 and 12 per cent. of the volume.

After rising from 7¾ per cent. in early 1973 to a peak of 10¾ per cent. in the summer of 1974, Euro-dollar bond yields eased to about 9 per cent. in June 1975 — still quite a high level considering the severity of the recession. During the next few months they edged up in line with the temporary increase in short-term dollar interest rates but resumed their downward movement in October, and in April 1976 stood slightly above 8¾ per cent. The decline in Euro-dollar bond yields contrasted



* US domestic bond yields are calculated to final maturity, the others to average maturity.

with the near-stability of comparable US domestic rates and, as a belated reaction to the lifting of the US balance-of-payments restraint programme, Euro-dollar bond yields for the first time fell slightly below US domestic bond yields. With investors fairly optimistic about the outlook for price stability in Germany, Euro-DM bond yields showed a stronger decline than Euro-dollar bond yields; and their downward movement would have been even more pronounced had it not been for the progressive easing during 1974 and 1975 of the German measures to discourage capital inflows. As a result of this change in the regulations, the discount of Euro-DM bond yields in relation to German domestic bond yields, which in mid-1973 had exceeded 3 percentage points, contracted to about 3/8 percentage point in 1975.

VII. THE INTERNATIONAL MONETARY SCENE.

This chapter reviews the major international monetary developments of the past year and a half. The first section traces the evolution of the exchange rates of the principal currencies, with particular reference to the recovery of the dollar and the January–March 1976 disturbances in European exchange markets. In addition floating rates are examined in a longer perspective than that of the past year and a half, an attempt being made to consider for seven major countries both the extent to which floating may have contributed to better balance-of-payments equilibrium and whether the trend of exchange rates has been consistent with that of basic economic forces. The second section describes the less rapid growth of global reserves in 1975, the outcome principally of the reduced current payments surplus of the OPEC countries, and considers the question of the adequacy of the present level of international liquidity. Thirdly, there is an account of gold production and gold-market developments last year, the highlights of which were the decline in investment demand for the metal and in its market price. Lastly, the decisions taken by the Interim Committee of the Board of Governors of the International Monetary Fund at Washington and Jamaica are summarised and their significance for the workings of the monetary system analysed.

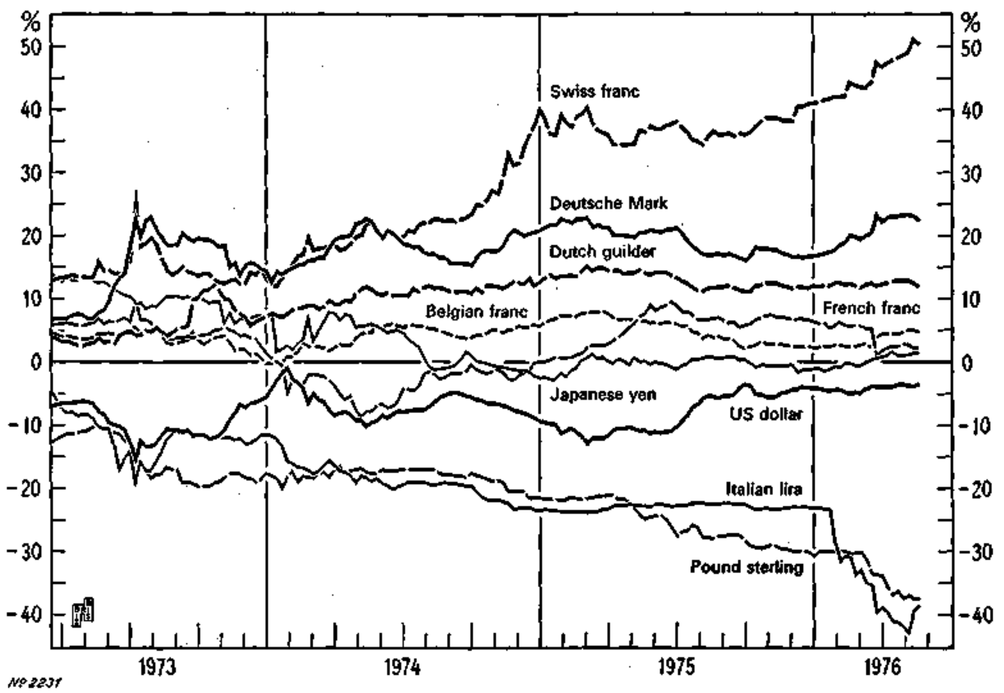
Exchange rate developments.

Exchange rate developments for the principal currencies during 1975 and early 1976 present a mixed picture. On the positive side there has been the recovery of the US dollar last summer and its subsequent stability, both in effective terms and vis-à-vis the "snake" currencies. This was most welcome not only for its own sake but from the point of view of exchange rate stability in general. On the negative side, the exchange rate disturbances that began in mid-January 1976 have accentuated the centrifugal tendencies of major currencies that have been evident since the fixed rate system broke down. The lira and sterling have both declined very sharply this year, while the French franc, which had returned to the European joint float in mid-1975, left it again in March. Parallel with this, the stronger European currencies, and in particular the Swiss franc, have appreciated further.

Fluctuations in effective exchange rates, 1975–76. At the end of 1974 the US dollar, on a trade-weighted basis, was about 9½ per cent. below its Smithsonian level, having declined by about 4½ per cent. since the end of August 1974. Despite signs that the current balance of payments had begun to improve, the downward movement continued until the end of February 1975, when the depreciation reached 13 per cent. — not far from the July 1973 low point. The US, German and Swiss authorities then came to an informal agreement designed to counteract the downward movement of the dollar by co-ordinated market intervention. Almost at once the dollar began to rise and the movement gathered momentum towards mid-year as the market finally took note of the stronger US current balance of payments and, simultaneously, US monetary policy was temporarily tightened. By late September the cumulative post-Smithsonian depreciation of the dollar had come down to only 3½ per cent. Since then, apart from a short-lived 2 per cent. weakening in October as a result of the financial difficulties of New York City, the effective rate for the dollar has been rather stable and at the end of April 1976 was very close to the end-September 1975 level.

The recovery of the dollar meant some opposite movement of the "snake" currencies. By the end of 1975 the trade-weighted appreciation of the Deutsche Mark had fallen to 16.7 per cent., 6 percentage points below the end-February 1975 peak. Even the Swiss franc, which declined less than the "snake" currencies against the dollar during the summer of 1975, was at the end of the year only 1 percentage point above its end-February level. Of the two independently floating major European currencies, sterling's depreciation had increased during 1975 by nearly 12 per cent., to around 30 per cent., while that of the lira had remained virtually unchanged at just over 23 per cent. despite the continued rapid rise of Italian wages and prices. Most of the downward movement of sterling, to a figure of almost 28 per cent., took place between early April and early July, when inflation had reached an annual rate of 30 per cent., and before the introduction of a new incomes policy. The latter brought a temporary recovery, but a further decline to the 30 per cent. depreciation level followed by end-November.

Effective post-Smithsonian changes in exchange rates.[1]
Friday figures, in percentages.



[1] Source: Bank of England.

The 1976 exchange-market disturbances began with the lira. In the final quarter of 1975 the balance of payments had returned to substantial deficit and when the government resigned on 9th January 1976 the lira came under strong pressure. At that point the exchange reserves were little over $1 milliard and two weeks later, when they were close to exhaustion, official intervention in the exchange market was suspended until early March. During that period the depreciation increased to about 35 per cent. Despite substantial further intervention in March and the first part of April, the lira continued to decline, reaching a record depreciation of about 43 per cent. just before the introduction of a compulsory 50 per cent. deposit on virtually all foreign exchange payments on 6th May. Since then there has been some recovery, the depreciation narrowing to 38 per cent. and the rate against the dollar improving from Lit. 915 to Lit. 845.

The withdrawal of official support for the lira, combined with some forecasts of a heavy trade deficit for 1976, touched off strong pressure on the French franc. Earlier, in July 1975, the franc had returned to the "snake" at the same central rates with other participants as had prevailed in January 1974, when it had withdrawn. In the meantime, however, its trade-weighted post-Smithsonian appreciation had risen from about zero to nearly 8 per cent. This had been brought about by a combination of the dramatic strengthening of the foreign trade balance, large capital inflows, part of which could be added to reserves, and a relatively restrictive domestic monetary policy. France's inflation rate, however, remained rather high, especially in comparison with Germany's. Moreover, later in 1975 policy was relaxed and the trade balance deteriorated. Substantial official support in late January and early February, together with a firm declaration by the French and German authorities that no adjustment of the franc/DM parity was needed, calmed the situation by mid-February. When sterling began to depreciate again in early March the franc came under renewed pressure and on 15th March, after cumulative reserve losses of $3 milliard, the decision to leave the "snake" was taken. Except for a few days, however, this did not lead to any very significant fall in the exchange rate of the franc. At the end of May the effective rate was only 2¾ percentage points below the mid-March level.

The third element in the crisis was the further dramatic decline of sterling, beginning in the first week of March. Between then and the end of April the trade-weighted depreciation widened from 30 to about 37 per cent., despite official intervention totalling nearly $3 milliard. Although it became clear in early May that the incomes policy introduced in August 1975 would be strengthened and continued for a second year, pressure on sterling persisted and by the end of the month the depreciation had almost reached 40 per cent.

On the other side of the medal, the Swiss franc and, to a lesser extent, the Deutsche Mark and other "snake" currencies have appreciated since January. In the case of the Swiss franc the trade-weighted appreciation increased from 41 per cent. in early January to 49 per cent. at the end of April and by another 3½ per cent. in the course of May. This brought the total appreciation of the franc since end-1974 to 10 per cent., despite substantial official intervention to moderate the rise.

The Deutsche Mark's appreciation since mid-January 1976 has been much less, from 17 to 22 per cent., bringing the Mark 6 per cent. below par with the Swiss franc. Inside the "snake" the French franc crisis affected the Belgian franc, but a combination of official intervention and monetary and exchange control restrictions brought the situation under control by late March, since when it has significantly improved. Over the whole period from end-1974 to end-April 1976, movements in the effective exchange rate of the Belgian franc have been relatively limited. The cumulative post-Smithsonian appreciation declined, in line with the recovery of the dollar, from 7.9 to 2.3 per cent. between March and September 1975, and at end-May 1976 it stood at 4 per cent.

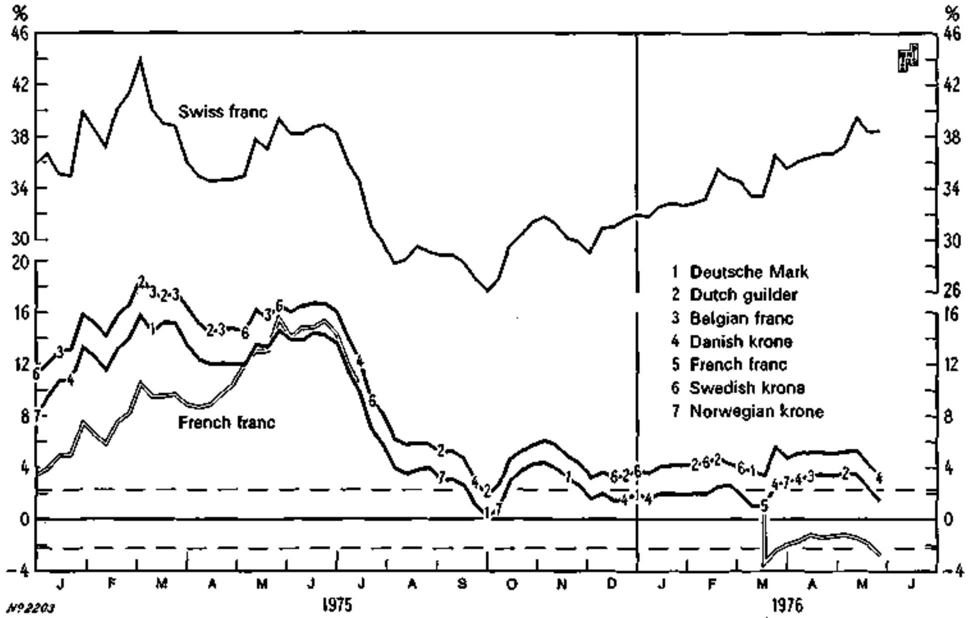
Given the dollar's recovery, movements in the effective exchange rates of other major currencies, too, were mostly fairly limited during the period under review. The appreciation of the guilder varied between 11 and 15 per cent. and that of the Swedish krona between 1.6 and 7.8 per cent. The yen strengthened from an effective depreciation of 2½ per cent. at end-1974 to an effective appreciation of 1½ per cent. in late May 1976. Since early 1975 the total range of its fluctuation has been little more than 1 per cent. The Canadian dollar, however, reflecting its close connection with the US dollar, rose from a trade-weighted depreciation of just over 5 per cent. in May 1975 to an appreciation of 4¾ per cent. one year later. Unlike the improvement of the US dollar, this movement was due to capital inflows, the current payments deficit actually increasing. Its timing, too, was different, more than half of the rise occurring in 1976.

The joint float of European currencies. The following graph, showing the evolution of the joint float of European currencies since the end of 1974, clearly illustrates the recovery and subsequent greater stability of the US dollar already referred to. When the dollar was at its weakest, in early March 1975, the "snake" currencies were ranged in a band from 16½ to 18¾ per cent. above their nominal central rates against the dollar. The dollar's subsequent rise was in two phases. During the first, which lasted from early March to end-April, the "snake" band declined by about 4 per cent., about half of this movement then being reversed during the following month. In the second and decisive phase, covering the three and a half months from mid-June, the dollar appreciated by about 14½ per cent. against the "snake", the major part of the movement taking place in July. By the end of September the "snake" band stretched from ½ to just under 2 per cent. above participants' nominal central rates against the dollar. At that point it had returned to the position from which the whole cycle had started just a year earlier. There followed the decline of the dollar in October, already mentioned, which was partially reversed in November; since then the "snake" has for six months moved within narrow limits against the dollar, with the participating currencies in a band a few per cent. above their nominal central dollar rates.

Inside the "snake" the principal developments in 1975 were the weakening of the Deutsche Mark and the re-entry of the French franc. After having been at the top of the band early in the year, capital outflows pushed the Mark to the bottom during the course of March, just as the recovery of the dollar was getting under

Joint float of European currencies and independent float of the Swiss franc against the US dollar.

Friday spot quotations as percentage above (+) or below (—) nominal central or middle rates as from 19th March 1973.*



* For Germany, the Netherlands and Norway calculations are based on central rates fixed on 29th June, 15th September and 16th November 1973 respectively.

way. Until the 1976 currency crisis began, it remained weak and, for considerable periods, was at the bottom of the "snake". It may be added that during 1975, although the "snake" was from time to time fully stretched, the volume of intervention in participants' currencies to support the Deutsche Mark, or other currencies, was quite limited. To a large extent the "snake" was controlled by intervention in the dollar exchange market. In addition, substantial support was given to the Deutsche Mark in the spring and summer of 1975 by the Federal Reserve Bank of New York, which repurchased $0.8 milliard of Deutsche Mark drawn on the swap line during the September 1974–March 1975 weakness of the dollar.

The French franc returned to the "snake" on 11th July, after an eighteen-month absence. Within three weeks it had joined the Belgian, Dutch, Danish and Swedish currencies at the top of the band and it remained strong for the rest of the year.

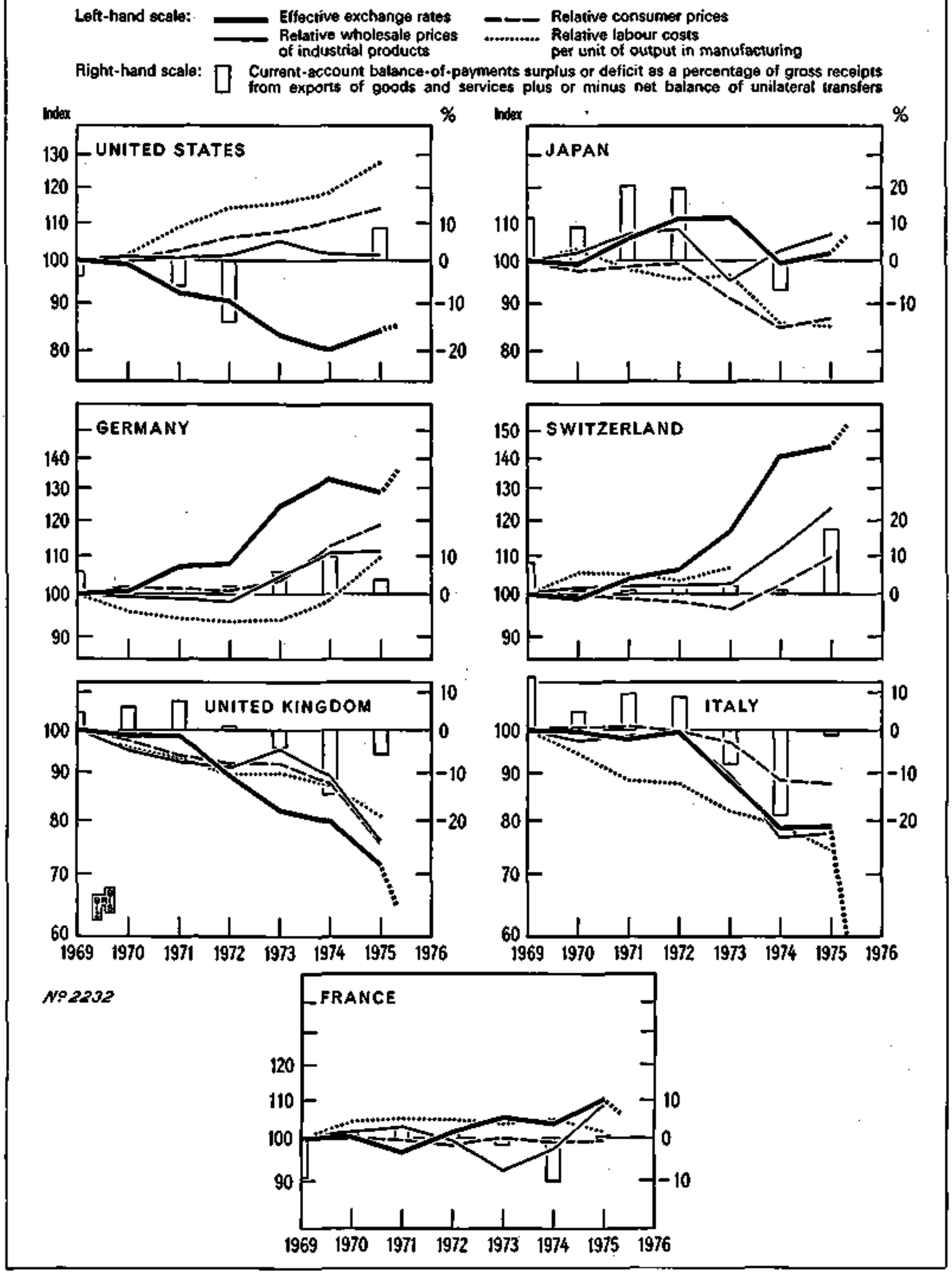
So far as the "snake" is concerned, the January–March currency crisis divides into three phases. The first one, during which the Deutsche Mark returned to the top of the "snake" but the French franc, although under pressure, did not become the weakest currency (that position being occupied by the Danish krone), lasted from 21st January until 13th February. At that point the market was temporarily reassured by the Franco-German statement that there would be no change in the relationship between the franc and the Deutsche Mark. The second phase began on 5th March, when the French franc weakened again, in the wake of sudden pressure on sterling. The Deutsche Mark was again at the top of the "snake" and the French franc most of the time at the bottom until its withdrawal from the joint float on 15th March. At the same time pressure on the Belgian franc inside the Benelux "worm" led to this arrangement being suspended, the margins of fluctuation between the Belgian franc and the Dutch guilder becoming the same as those between all other participants in the joint float. In the third phase, which followed immediately, the brunt of the market pressure switched to the Belgian franc and the Danish krone. Firm measures to support both currencies, however, soon brought the crisis to an end on 22nd March and by the end of the month the width of the "snake" had contracted to less than 2 per cent. During April and May it remained less than fully stretched, with the Deutsche Mark still consistently at the top of the band and the Dutch guilder, from late April onwards, the weakest currency of the group.

Floating in a longer-term perspective. The major disturbances in the European markets during the early months of 1976 and, more generally, the steadily widening spectrum of exchange rates ever since floating started, raise at least two questions. Has floating contributed to a better balance-of-payments adjustment, i.e. to lessening the large disequilibria which characterised the balance-of-payments pattern of industrial countries in the early 1970s? And has the trend of exchange rates been, broadly speaking, consistent with the divergent rates of inflation?

The graphs on page 102 attempt to throw some light on these questions by showing the evolution of the current accounts as well as the trade-weighted exchange rates of seven major industrial countries over a longer period, since the end of 1969, comparing them with the movements of three indicators of these countries' relative inflation rates — their consumer prices, their industrial wholesale prices and their unit labour costs in manufacturing. There are, of course, questions which these graphs cannot pretend to answer. It cannot be emphasised too strongly, at the outset, that comparisons of this kind provide no basis for forecasting future developments of exchange rates. Indeed, exchange rates are determined by the *total* supply of, and demand for, any individual currency: and these are the outcome not only of trade transactions, but also of invisible transactions and capital flows (which may play a predominant rôle, and not only in periods of speculation). Moreover, even if one focuses exclusively on trade, the three indexes shown in the graphs provide only a rough-and-ready impression of changes in relative competitive positions. The choice both of the base period and of indexes is difficult; the statistical data are imperfect and not easily comparable as between countries; there are various ways of weighting the indexes; and some of them — for instance that of relative unit labour costs illustrated in the graphs — may be subject to cyclical influences which are not only strong, but vary greatly between countries. In addition, competitive positions are affected by a number of factors other than prices or costs, such as the ability to deliver, the capacity to adjust to changes in demand, the availability and cost of export finance, and so forth. For all these reasons the results shown in the graphs need to be interpreted with great caution.

A look at the current balance-of-payments positions and their evolution, even after allowing for the effects of the oil price increases, suggests a very mixed answer to

Selected industrial countries: Changes in effective exchange rates, relative prices and costs,* and current-account balances of payments, 1970–76.



* Indexes: 1969 = 100, end-year figures for prices and annual averages for labour costs.

Note: The price indexes for the individual Group of Ten countries show the relationships between the development in the trade-weighted prices of other countries and the prices of the country concerned. If the index moves, e.g. above 100, this means that in relation to end-1969 weighted prices in the other Group of Ten countries have gone up by more than in the country in question. The same applies to the indexes of unit labour costs.

the question whether or not floating exchange rates have contributed to a better working of the adjustment process. For reasons which were explained in Chapter V, the single year 1975 cannot be taken as reflecting countries' underlying positions on current external account, since during strong cyclical fluctuations income effects are likely to outweigh price effects. Taking instead the average of the last two or three years, the graphs for the United States and Japan would suggest at any rate some connection between the evolution of the current balance of payments and that of exchange rates. Thus, in the United States current payments deficits up to 1972 gave way in 1973–74 to a position of approximate balance and then in 1975 to a sizable surplus, while in Japan the very large surpluses of the early 1970s disappeared. In some other countries, however, nothing of the kind happened: despite major declines in their exchange rates, both the United Kingdom and Italy have remained deficit countries, while Germany and Switzerland, despite the substantial appreciation of their currencies, have remained surplus countries.

To the second question, whether the trend of exchange rates has been consistent with relative rates of inflation, the graphs again suggest a mixed answer. In some of the highly "open" European countries, where wages respond quickly to price changes, exchange rates and indexes of competitive position have been moving broadly in the same direction. This happened in the United Kingdom and in Italy and also in Germany and Switzerland. There is, however, no simple one-way chain of causation linking these movements of exchange rates, costs and prices. Clearly, autonomous domestic cost and price pressures have, as said elsewhere in the Report, been stronger in Italy and the United Kingdom than in Germany and Switzerland, while the opposite has been the case so far as the authorities' reaction to them was concerned. Equally, however, an appreciating currency tends to lessen the extent of such pressures and to lighten the task of maintaining reasonable price stability, while a depreciating currency does the opposite. Hence, something in the nature of virtuous and vicious circles may have been at work — but this of course in no way lessens the part that policies may have played in countries' having become caught up in vicious circles, or in their being unable to break out of them. Moreover, the graphical impression is that in some cases appreciations or depreciations may have "overshot the mark" in relation to relative costs and prices. This impression is supported by what is known about the magnitude of speculative pressures on some currencies.

In contrast to these four cases are those of the United States and Japan, where the movements of effective exchange rates are less obviously related to those of the cost and price indicators. So far as the United States is concerned, three remarks may be ventured. Firstly, a significant improvement in its competitive position was certainly needed at the end of the 1960s and, equally certainly, has occurred since then. Secondly, the illustrated evolution of relative unit labour costs in manufacturing very considerably overstates the improvement that has taken place, since a good part of it has been cyclical and results from the fact that in the United States employment reacts more readily to declines in output than in other countries. Thirdly, capital movements during most of the period since March 1973 may well have tended to limit more than normally the influence on the dollar's exchange rate of the improved competitive position and current external account — partly because of the loss of confidence in the dollar that was associated with the breakdown of the Bretton Woods system and partly because of the 1974 liberalisation of capital outflows. On the other hand the deterioration of the US current account since the end of 1975 has been accompanied by a slight appreciation of the dollar's effective exchange rate, as a result of favourable offsetting capital flows.

In the case of Japan the contrasts, where they do appear, are less sharp. Moreover, given the very favourable position of the yen in the overall exchange rate structure at the end of the 1960s, some part of that advantage had to be given up if a better alignment of currencies was to be obtained. Not only is it the movement of unit labour costs that, as in the US case, presents the greatest contrast with the evolution of the exchange rate, but this index greatly exaggerates any relative adverse movement in Japanese costs that may have occurred, especially since 1973. Contrary to what happens in the United States, Japanese unit costs increase in a recession because unemployment is not part of the economy's adjustment process.

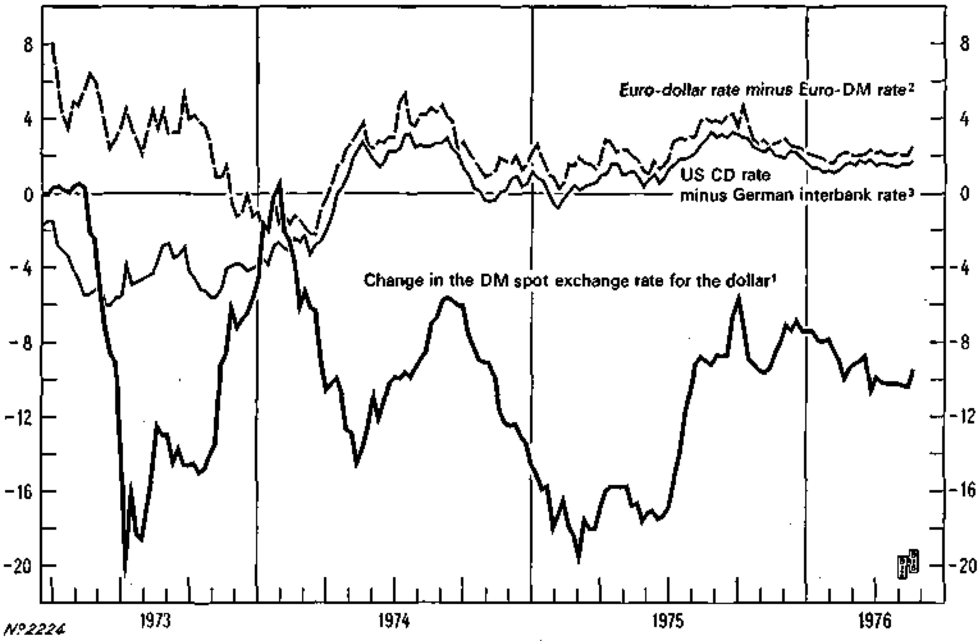
In the situation as it was in March 1973, as well as during the three years since then, it is hard to see what practical alternative there has been to floating exchange rates. And looking at the longer-run trends of major industrial countries' exchange rates, they have, fairly clearly, been in the right directions. Moreover, some earlier payments imbalances have in the process been corrected; others, however, still remain troublesome, or have even assumed larger proportions. Floating, while it may be inevitable, therefore needs to be managed not only in the narrow sense of exchange-market intervention but, more importantly, through domestic financial and economic policies. Beyond that, however, much remains to be clarified about both the theory and practice of managed floating.

Floating and interest rates. In the three years or so since the US dollar began to float there have, in addition to the longer-term changes in effective exchange rates discussed above, been a number of wide shorter-term swings of the pendulum between the dollar and leading European currencies. And just as the movements in effective exchange rates may usefully be compared with indicators, however rough, of countries' relative cost and price performances, so the question may be asked what connection these ups and downs of the dollar — illustrated in the following graph vis-à-vis the Deutsche Mark — may have had with changes in relative monetary conditions, particularly interest rates.

Over the whole period since March 1973 there have been three phases during which the dollar declined against the Deutsche Mark (and other "snake" currencies). Each of these was followed by a phase of nearly equal recovery. Only in the cycle that ran from January to September 1974 did the dollar undergo a significant net depreciation, amounting to about 7 per cent., vis-à-vis the Deutsche Mark. In the other two, from March 1973 to January 1974 and from September 1974 to September 1975, the wheel came virtually full circle.

If the evolution of the dollar/DM spot rate is compared with that of the interest rate differential between three-month bank certificates of deposit in New

The US dollar and the Deutsche Mark:
Exchange rate developments and interest rate differentials, 1973–76.



¹ Percentage changes compared with the rate prevailing on 19th March 1973 (+ = above, — = below), Friday figures. ² Differential between 3-month Euro-rates on the basis of Friday figures (+ = in favour of $). ³ Differential between US 3-month CD rate and German 3-month interbank deposit rate on the basis of Wednesday figures (+ = in favour of $).

York and three-month interbank deposits in Frankfurt, it can be seen that the onset of the dollar's weakness in both the first and third of the cycles coincided with a movement of the interest rate differential against the United States. On the former of these occasions, Germany took advantage of its release in March 1973 from the intervention obligations of the Bretton Woods system to tighten drastically its monetary policy; in the latter case, interest rates were declining in both countries, but more so in the United States than in Germany. Furthermore, in the first cycle the decline of the dollar and the tightening of German policy covered roughly the same period. On the other hand, in the third cycle the dollar continued to fall until March 1975, months after the interest rate differential had become rather small. Moreover, in the second of the three cycles, the weakness of the dollar during the first part of 1974 contrasted with a sharp movement of the interest differential in its favour. As regards the upward movement of the dollar in the three cycles, only in the third — from March to September 1975 — can it be said that the differential was clearly moving in favour of the dollar.

Thus, over the whole period from March 1973 to September 1975, covering the three cycles, the relationship between the exchange rate and interest rates was very sporadic. Other factors often predominated in the exchange markets. Sometimes these were very tangible in nature, as when all controls on US banks' foreign lending were removed in January 1974, just at the moment when most of the world's balance-of-payments financing needs were sent sky-high by the oil price increases. At other times, for instance in late 1974 and early 1975, once a decline of the dollar had got under way, it fed on itself — a sure sign that basic confidence was lacking.

The presence of other factors, particularly confidence factors, also meant that, even when the exchange rate was moving in harmony with interest rate differentials, there was no relation whatever between the relative size of the movements. This was most obviously the case in the very first months of the floating dollar, when the downward swing of the pendulum against the Deutsche Mark was 20 per cent. in less than three months. But it was also true of all the other periods, up to late 1975, when exchange rates and interest rates were moving in the same direction.

Only since late 1975 has the dollar stabilised sufficiently for the changes in its exchange rate to be related to interest rate differentials, not only in direction but also, to some extent, in magnitude. The conclusion must therefore be the text-book one, that only when all other things are equal will interest rate movements really determine those of exchange rates. And in the present world that cannot be relied upon to happen very often.

Global reserves.

After five years of rapid expansion, the growth of global reserves slowed down markedly in 1975. Valued in current dollars, the estimated increase in countries' total official holdings of gold, foreign exchange, special drawing rights and IMF reserve positions was $9 milliard, little more than a fifth of the $40.4 milliard 1974 figure. Over a quarter of the difference between these figures, however, resulted from fluctuations in the market value of the dollar. In 1974 its depreciation in terms of other reserve assets had added about $3 milliard to reserve growth measured in dollars, while its recovery in 1975 produced an opposite effect of over $5 milliard. By types of reserve asset, virtually the whole of last year's $2 milliard decline in the dollar value of gold reserves, as well as the major part of the $0.6 milliard drop in countries' SDR holdings, was the result of valuation changes. Moreover, in constant dollars the increase in total Fund reserve positions would have been $4.6 milliard and in total foreign exchange reserves nearly $10 milliard. Less than $2 milliard of this underlying growth of exchange reserves seems to have been placed in the traditional reserve centres; a $3.1 milliard rise in dollar reserves held in the United States was partly offset by a $1.3 milliard decline in sterling reserves held in the United Kingdom. The remainder, or nearly $8 milliard, would appear to have been invested in the international market or in national markets outside the United States and the United Kingdom.

As in 1974, the reason for the continued growth of global reserves was that the oil-importing countries managed to finance a very large part of their combined current-account deficit through borrowing, with the result that only a fraction of the oil-exporting countries' reserve gains were offset by reserve losses elsewhere. The fact that global reserves grew more slowly reflected a combination of the decline in the aggregate OPEC surplus and the decrease, from 63 to 37 per cent., Changes in global reserves, 1973–75.[1]

Areas and periods	Gold	Foreign exchange	IMF reserve positions	SDRs	Total
	in millions of US dollars				
Group of Ten + Switzerland					
1973	+ 3,485	+ 4,985	+ 105	+ 740	+ 9,315
1974	+ 520	+ 1,860	+ 1,740	+ 395	+ 4,515
1975	− 1,605	+ 920	+ 1,615	− 230	+ 700
Amounts outstanding at end-1975	*33,815*	*64,980*	*8,380*	*7,765*	*114,940*
Other developed countries					
1973	+ 475	+ 3,125	+ 170	+ 155	+ 3,925
1974	+ 55	− 2,165	− 105	− 185	− 2,400
1975	− 215	− 1,230	− 350	− 90	− 1,885
Amounts outstanding at end-1975	*4,160*	*19,845*	*660*	*855*	*25,520*
Developing countries other than oil-exporting countries					
1973	+ 175	+ 7,565	+ 250	+ 255	+ 8,245
1974	− 50	+ 2,725	− 190	− 30	+ 2,455
1975	− 95	− 1,440	− 105	− 215	− 1,855
Amounts outstanding at end-1975	*2,140*	*25,875*	*610*	*1,255*	*29,880*
Total oil-importing countries					
1973	+ 4,135	+ 15,675	+ 525	+ 1,150	+ 21,485
1974	+ 525	+ 2,420	+ 1,445	+ 180	+ 4,570
1975	− 1,915	− 1,750	+ 1,160	− 535	− 3,040
Amounts outstanding at end-1975	*40,115*	*110,700*	*9,650*	*9,875*	*170,340*
Oil-exporting countries[2]					
1973	+ 165	+ 4,185	+ 100	+ 45	+ 4,495
1974	+ 55	+ 33,840	+ 1,940	+ 40	+ 35,875
1975	− 50	+ 9,325	+ 2,790	− 50	+ 12,015
Amounts outstanding at end-1975	*1,450*	*59,060*	*5,130*	*385*	*66,025*
All countries					
1973	+ 4,300	+ 19,860	+ 625	+ 1,195	+ 25,980
1974	+ 580	+ 36,260	+ 3,385	+ 220	+ 40,445
1975	− 1,965	+ 7,575	+ 3,950	− 585	+ 8,975
Amounts outstanding at end-1975	*41,565*	*169,760*	*14,780*	*10,260*	*236,365*

[1] Including valuation changes. [2] Including, for Kuwait, an estimate of the government's foreign exchange holdings.

in the proportion of it invested in assets that are included in reserves. Thus, the total OPEC reserve gain slowed down from nearly $36 to 12 milliard. The 1975 figure included a $2.8 milliard rise in IMF reserve positions, nearly all of it representing contributions to the Fund's oil facility. The larger part of the $9.3 milliard growth in OPEC foreign exchange holdings was placed in the Euro-market; liquid investments in the United States went up by about $4.2 milliard, while sterling reserves appear to have declined by $0.3 milliard.

To a far greater extent than in 1974, the oil exporters' combined reserve gains were concentrated on a few countries. Saudi Arabia alone, with an increase of $9 milliard, accounted for over three-quarters of the total. Other major increases were recorded by Kuwait (estimated at $2.3 milliard) and Venezuela ($2.3 milliard). On the other hand, Iran's reserve gains declined from $7.1 to only 0.3 milliard. At the same time, a number of oil-exporting countries experienced a decline in reserves, notably Libya, whose holdings dropped from $3.6 to 2.2 milliard, and Indonesia, with a decline from $1.5 to 0.6 milliard.

The reserves of the Group of Ten countries and Switzerland went up by $0.7 milliard. Without valuation changes the increase would have amounted to about $3 milliard, not very much less than the corresponding figure for 1974. About $2 milliard of the 1975 increase (adjusted) was in IMF reserve positions, reflecting the Fund's substantial use of these countries' currencies, principally the Deutsche Mark, the US dollar, the Dutch guilder and the French franc. The only Group of Ten country which had significant recourse to the Fund's resources in 1975 was Italy, whose debtor position went up by $1.2 milliard. Other developed countries' reserves, which had fallen by $2.4 milliard in 1974, showed a further $1.9 milliard decline last year.

Non-oil developing countries' reserves, which had registered a $2.5 milliard increase even in 1974, declined by $1.9 milliard last year. The largest falls were recorded by Brazil ($1.3 milliard) and Argentina ($0.9 milliard), while a number of other countries, notably in Asia, showed reserve gains.

Although last year's reserve growth was relatively modest, at least by the standard of other recent years, it brought the cumulative increase in global reserves, as conventionally measured, since the end of the 1960s to over $150 milliard. From this the conclusions are sometimes drawn that reserve growth in the 1970s has been excessive and that at their present level total reserves contain a substantial inflationary potential that is overhanging the monetary system. The first of these conclusions certainly contains some truth, in that at the beginning of the decade substantial reserve increases came about through the US payments deficit. However, the notion that global reserves — or, more broadly, international liquidity — are now dangerously high needs closer examination. And the answer is far from being straightforward.

Official reserve statistics provide useful information on external financing operations and the external monetary positions of individual countries or groups of countries. By themselves, however, they cannot pretend to give a full picture of total international liquidity, any judgement on the adequacy or inadequacy of which needs to take a number of other considerations into account.

In looking at reserve developments during the first half of the 1970s one important aspect is that gold reserves, the volume of which has not changed significantly, have become even more difficult to use than they were in the 1960s, when the US Treasury and the IMF were still the buyers of last resort — even though, at $35 per ounce, there were not then many sellers. Moreover, the recent decisions on gold taken by the Interim Committee of the Board of Governors of the International Monetary Fund, together with the arrangements entered into among the Group of Ten countries concerning future gold transactions, make it very hard to say that there is any longer a basis even for estimating the cash value of this element of reserves.

As regards those reserve assets which have grown since the end of the 1960s, i.e. essentially official holdings of foreign currencies, it has to be remembered that the gross assets necessarily have a counterpart in external liabilities somewhere in the system as a whole. This may not make so much difference, within a rather wide range, if the counterpart liabilities are incurred by the system's principal reserve currency country; but the situation is rather different when, as has been the case since end-1973, the counterpart to huge reserve gains by a relatively small group of countries has been a rapid increase in the foreign indebtedness of much of the rest of the world apart from the United States.

Another reason for caution in the interpretation of the statistics concerns the country distribution of reserves. Despite the very rapid growth of the global total since 1969, there are relatively few countries whose present international liquidity position can be said to be really comfortable. These are, essentially, some (though by no means all) of the OPEC countries and a few industrial countries — notably Germany and Switzerland.

In addition to reserves and credit facilities, another element of international liquidity is the net foreign position of the private banking sector. Here, too, one country's assets are necessarily another's liabilities; and international bank lending in the past two or three years has to a large extent been balance-of-payments orientated. Moreover, only two countries, Germany and Switzerland, have really large net foreign asset positions in the banking sector.

In sum, it would appear that the rapid growth of global reserves since 1970 has to a large extent resulted from the heavy use — and in some cases, the using-up — of international credit facilities. The statistical growth of international liquidity, as measured by global reserves, has therefore been accompanied by a deterioration of many countries' net external liquidity positions. In fact the argument, based on the global reserve statistics, that there is now a potentially inflationary overhang of liquidity in the system, the effects of which will be increasingly felt as the world economic recovery proceeds, comes rather close to saying that Germany, Switzerland, Saudi Arabia and Kuwait are about to spend the bulk of their rather large foreign assets on increased net imports of goods and services.

It would, however, be unwarranted to draw the opposite conclusion, namely that international liquidity is becoming scarce. The last couple of years have witnessed a remarkable expansion of bank lending and (to a lesser extent) of official assistance to a number of countries whose *net* external position has strongly deteriorated or has even become negative — not to mention those for which no full information is available in this respect. And it is practically impossible to venture a forecast on the willingness and ability of the banking system to continue with such policies. But, given the dynamics of international banking and of capital markets, one is tempted to believe that countries with a good historical record of repaying debts will be able to count on raising new loans. Whether this is desirable or not is a different matter; but the conclusion is that quite a few countries may prove able to continue financing their deficits in this way, despite their poor net external asset position.

On balance, then, a certain degree of agnosticism appears justified. The present total of official reserves does not, given its distribution, seem to pose an inflationary threat; on the other hand the potential for further reserve growth through credit operations may be considerable.

Gold production and the gold market.

In 1975 world gold production (excluding that of the USSR, other eastern European countries, mainland China and North Korea) contracted by a further 65 tons to stand at 930 tons. This brought the cumulative decline since the 1970 peak to 27 per cent.

World gold production.

Countries	1929	1940	1946	1953	1970	1972	1973	1974	1975
	in metric tons								
South Africa . . .	323.9	436.9	371.0	371.4	1,000.4	909.6	855.2	758.5	708.1
Canada	60.0	165.9	88.5	126.1	74.9	64.7	60.8	52.8	50.4
United States . . .	64.0	151.4	49.0	60.9	54.2	45.1	36.2	35.0	32.1
Rhodesia	17.4	25.7	16.9	15.6	15.6	15.6	15.6	20.0	20.0
Ghana	6.4	27.6	18.2	22.7	22.0	22.5	22.5	20.0	18.2
Philippines	5.1	34.9	—	14.9	18.7	18.9	17.8	16.6	15.8
Australia	13.3	51.1	25.6	33.4	19.3	23.5	17.2	16.2	15.0
Colombia	4.3	19.7	13.6	13.6	6.3	5.8	5.6	8.3	10.5
Japan.	9.3	12.6	1.3	7.1	7.9	7.6	6.7	6.2	6.0
Mexico	20.4	27.4	13.1	15.0	6.2	4.5	4.1	4.2	4.2
Zaire	4.9	17.4	10.3	11.5	5.6	4.4	4.2	4.0	3.0
Total listed .	529.0	970.6	607.5	692.2	1,231.1	1,122.2	1,045.9	941.8	883.3
Other countries . .	41.5	194.4	59.0	62.0	36.4	45.0	48.2	51.6	44.5
Estimated world total*	570.5	1,165.0	666.5	754.2	1,267.5	1,167.2	1,094.1	993.4	927.8

* Excluding the USSR, eastern Europe, mainland China and North Korea.

South Africa accounted for three-quarters of last year's drop in western gold production, its output decreasing from 758 to 708 tons. The quantity of ore milled was 0.7 per cent. less than in 1974 and, in addition, its average gold content was 6.1 per cent. lower. This brought the total decline in the average grade of ore milled since 1971, the year before the market price of gold began to rise steeply, to 30 per cent.; over the same four years the mines' average working costs per ton of ore milled more than doubled — largely as the result of a fourfold increase in wages. During 1972–74 the rise in the average price received by the mines for their ore had afforded scope for mining lower-grade ore and granting substantial pay increases while at the same time increasing average profits per ounce of gold mined more than sixfold. Last year, however, the continuing reduction in the grade of ore mined plus a further 27 per cent. rise in average working costs in the face of a weakening gold market — in dollar terms the average price received by the mines fell by about 2 per cent. — brought an 11 per cent. decline in the industry's average profits despite the 18 per cent. devaluation of the rand in September.

Apart from the fall in western production, market supplies of new gold were about the same as in 1974. Sales by communist countries amounted to an estimated 150 tons and, in addition, total western gold reserves declined by 50 tons, including market sales of 39 tons by the United States Treasury and 16 tons out of South Africa's reserves. The total amount of gold available for meeting non-monetary demand may therefore be put at 1,130 tons, or about 4 per cent. less than in 1974.

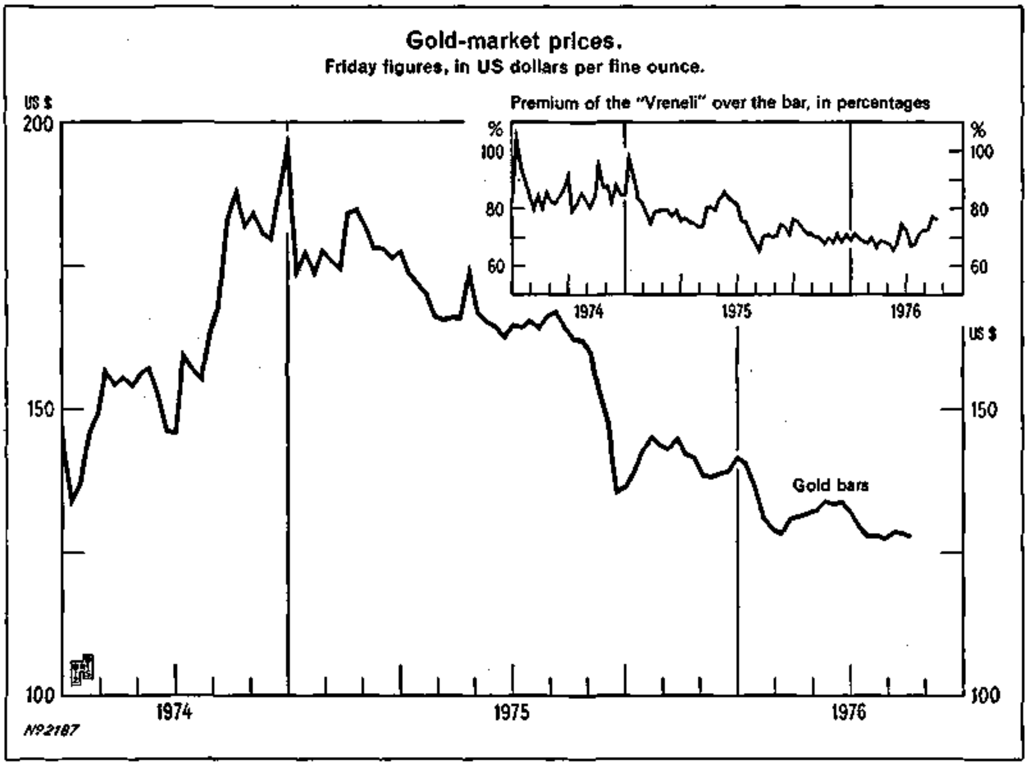
Last year's decline in new gold supplies, however, was more than offset by the significant reduction that occurred in non-monetary investment demand for the metal. As a result, the market price fell by 25 per cent. during the year, from $186.50 to $140.25 per ounce. In part this was a reaction to the very strong increase in demand that had driven the price up nearly fivefold between end-1971 and end-1974 to a peak of almost $200 per ounce. In addition, the easing of inflationary pressures and the recovery of some equity markets lessened the attractions of gold as an investment. Most importantly, however, the decline in non-monetary demand for gold was the result of the agreement about the future of gold's monetary rôle that was reached at the August 1975 meeting of the Interim Committee of the Board of Governors of the International Monetary Fund. This included decisions to abolish the official price, not to increase the combined gold stock of the IMF and the Group of Ten countries, to restitute one-sixth of the Fund's gold to members and to sell another sixth for the benefit of developing countries. Taken as a whole, the August 1975 agreement appeared to the market as effectively closing the door on any attempt to re-establish gold as an important element in the monetary system and therefore on any chance of a new and higher official price being fixed at some time in the future. While this had a sharp effect on investment demand for the metal, the decline in the market price did lead during the course of the year to some revival of industrial demand, the level of which had been depressed by the 1972–74 increase in the price.

Estimated sources and uses of gold.

Items	1971	1972	1973	1974	1975
	in metric tons				
Production	1,230	1,165	1,095	995	930
Estimated sales by communist countries	90	200	330	150	150
Total	1,320	1,365	1,425	1,145	1,080
Change in western official gold stocks	− 100	90	− 40	− 30	− 50
Sales on the free market*	1,420	1,275	1,465	1,175	1,130

* Residual figures.

Looking at the course of events in the gold market, the "fixing" price had reached an all-time peak of $197.50 on 30th December 1974, immediately before the legalisation of private gold ownership in the United States and the first gold auction held by the US Treasury. In the event US demand for gold proved very modest; and at the Treasury auction on 6th January only 23 out of the 62 tons offered were actually sold, at prices ranging from $153 to $185 per ounce. The market price then dropped to around $175 per ounce. Unfounded rumours of central-bank support for the market pushed quotations up to $185 per ounce at one point in February, but demand soon fell off again and by mid-April the price was down to $165 per ounce. Apart from a brief rise to over $170 per ounce in late May, the price then remained in the $160–170 range until 29th August when, for the first time since October 1974, it went below $160 per ounce. During this period the US Treasury held a second auction, on 30th June, at which 16 tons of gold were sold at $165 per ounce.



Then came the Interim Committee's Washington agreement on 31st August, to the effect of which was soon added that of possible gold sales by the USSR to finance grain imports, though the latter in fact did not materialise on any significant scale. Within less than a month the market price of gold dropped by over $30 per ounce, to a low point of $128.75 on 23rd September. With South Africa withholding a part of current output from the market, quotations recovered to over $140 per ounce by the end of the month and during the remainder of the year they fluctuated only a few dollars on either side of that figure.

Following the Jamaica meeting of the Interim Committee in the second week of the new year, which confirmed the plan for IMF gold sales, the market price took a further fall to $124 per ounce on 22nd January. This was followed by a modest rally and in mid-March quotations were around $134 per ounce. The gold market was not affected by the currency unrest in Europe and, with the prospect of Fund gold sales still hanging over it, quotations declined to around $128 per ounce in April.

On 6th May 1976 the IMF announced its policies and procedures for the sale by public auction over a four-year period of one-sixth of the Fund's gold (about 778 tons) for the benefit of developing countries. During the first two years, sixteen auctions will be held — approximately one every six weeks — at each of which 24,260 kgs of gold will be offered. Until the proposed second amendment of the Fund's Articles of Agreement becomes effective, no bid may be submitted by the governmental or monetary authorities of a member of the Fund or by an agent on behalf of these authorities at a price inconsistent with the Articles of Agreement of the Fund, but the Bank for International Settlements may submit bids. The Fund reserves the right to reject any or all bids. For the first auction, on 2nd June, the common pricing method is to be used; that is, gold will be awarded at the same price to all accepted bidders at or above the lowest accepted price.

The announcement caused little visible reaction on the bullion market and gold was traded at $128.15 at the London morning "fixing" on 7th May — about one dollar above the previous day's level. By the end of the month, however, the price had eased to about $125.

The international monetary system.

At its January 1976 meeting in Jamaica the Interim Committee of the Board of Governors of the International Monetary Fund completed agreement on a wide range of matters. These included the sixth general review of members' quotas, together with a temporary enlargement of their existing drawing rights; measures to provide assistance to developing countries; a number of matters concerning the organisation and operation of the IMF; and, most fundamentally, some of the basic rules of the monetary system. Many of the decisions entail changes in the Fund's Articles and a comprehensive amendment has now gone to member countries for the consent of their legislatures.

As regards quotas, it had already been agreed in early 1975 that their total should be raised by 32½ per cent. to SDR 39 milliard, including a doubling from 5 to 10 per cent. of the share of major oil-exporting countries and the maintenance of the collective share of all other developing countries at around 22 per cent. This meant a reduction in the combined share of developed countries from 72 to 68 per cent. The two principal reductions are those from 22.9 to 21.5 per cent. in the US share and from 9.6 to 7.5 per cent. in the UK share in total quotas. Provision is also being made that all members' currencies should be usable in Fund drawings. Until the new quotas come into force, the size of each credit tranche in countries' existing quotas is to be increased by 45 per cent.

So far as measures to assist developing countries are concerned, three elements may be distinguished. Firstly, in August 1975 a subsidy account was established to assist countries most seriously affected by the current situation in meeting the interest costs of drawings on the Fund's oil facility. Secondly, the use of the Fund's facility for compensatory finance of export fluctuations has been liberalised. Drawings under the facility may now go to 75 per cent. of a member's quota in all, instead of 50 per cent., and net drawings in any twelve-month period to 50 per cent., instead of 25. Thirdly, one-sixth of the Fund's gold stock, or 25 million ounces, is to be sold at market-related prices and the proceeds in excess of the official price used for the benefit of developing countries. A proportion of the excess proceeds equivalent to the share of developing countries in total Fund quotas will be transferred to them directly, while the remainder will be used to provide balance-of-payments assistance on concessionary terms to developing countries with low per capita incomes. This concessionary finance is to be channelled through a Trust Fund administered by the IMF.

As regards the proposed changes in the rules of the monetary system, to put the recent decisions into full perspective they have to be seen in the context of the broad process of efforts towards international monetary reform that has been going on since late 1963. At that time official discussions were initiated by the Finance Ministers of the Group of Ten, who instructed their Deputies "to undertake a thorough examination of the outlook for the functioning of the international monetary system and its probable future needs for liquidity". From this examination, however, two subjects were excluded: the official price of gold and floating exchange rates; in other words, it was taken for granted that the monetary system would continue to be based on fixed exchange rates and that the monetary gold price would continue to be $35 per ounce. Much of the frustration of the following twelve years can be attributed to the fundamental contradiction between attempting a reform and excluding a priori even a discussion on the price of gold or the exchange rate régime.

In 1963 there were two views about the main problem confronting the system. One, explicitly referred to in the Group of Ten Ministers' mandate to their Deputies, was that the problem was one of potentially inadequate reserve growth; in other words that, given the growing shortage of monetary gold and the exclusion of any increase in its price, dollar reserves could no longer increase at their former pace and that ways had therefore to be found of providing for adequate overall growth of reserves other than through these two types of assets. The other, based on the persistent US payments deficit, was that the system was suffering mainly from the failure of what came to be known as the adjustment process, and in particular from the failure of the United States to adjust its external balance. The two problems were, of course, related, since the United States could not fundamentally correct its balance of payments without changing the dollar price of gold.

During the latter part of the 1960s the first of these views gradually gained the upper hand, culminating in the establishment of the SDR in 1969 and the subsequent allocation of $9½ milliard of SDRs to Fund members during 1970–72. Intended as a supplementary reserve asset, but in fact rather hybrid in character, the SDR was introduced just when total reserves began to expand on a scale never before seen. In the first two years of its existence exchange reserves, mainly under the influence of a huge increase in the US payments deficit, rose by $49 milliard — an amount equal to over 60 per cent. of total reserves of all kinds outstanding at the end of 1969 and eight times the SDR allocations for 1971–72. The explosion of dollar reserves led to the suspension of convertibility by the US authorities in August 1971;

and a few weeks later the second phase of monetary reform discussions was set on foot, when the Fund's Board of Governors requested the Executive Directors to report on "measures that are necessary or desirable for the improvement or reform of the international monetary system". In July 1972 the task of formulating and negotiating reform proposals was given to the newly-created Committee of Twenty.

The Committee had hardly begun its work when in March 1973 all other major currencies began to float against the dollar. Putting a brave face on the situation, the Committee at once announced that "in the reformed system the exchange rate régime should remain based on stable but adjustable par values", adding that "floating rates could however provide a useful technique in particular situations". In other words, the object of reform remained a new par value system.

Apart from the novel idea that the reformed system should help promote the flow of real resources to developing countries, the main proposals before the Committee showed a considerable change of emphasis from the earlier discussions and were largely concerned, in one way or another, with the improvement of the adjustment process. Hardly, however, had the Committee submitted a draft outline of reform to ministers — an outline which posed as many questions as it answered — than the price of oil escalated, leaving no practical alternative to an indefinite continuation of floating. The Committee shelved the attempt to agree on a reformed system. Instead, it submitted its ideas on how the system might evolve in the form of a revised version of its reform outline and proposed that in the meantime the Fund and its members should, so far as possible, pursue the objectives and principles contained in the outline. It also proposed the creation of an Interim Committee of the Board of Governors of the International Monetary Fund, with advisory functions in managing and adapting the monetary system, in considering proposals by the Executive Directors to amend the Articles of Agreement and in dealing with sudden disturbances that might threaten the system. Thus, in September 1974 the Interim Committee was given the task of seeing what it could make of the Committee of Twenty's unfinished business.

The Interim Committee's work in this area covered three main points, all of them deriving from the Committee of Twenty's outline of reform: the exchange rate system; a reduction in the monetary rôle of gold; and arrangements designed to promote the objective of making the SDR the principal reserve asset of the system. But if the Interim Committee returned to points that had been discussed at length earlier, its conclusions were in important respects very different.

In particular, on the fundamental question of the future exchange rate system, the Interim Committee's discussions were marked by the disappearance of the earlier consensus that a reformed system meant a more flexible par value system. It is true that at the outset of its work, in January 1975, the Committee asked the Executive Directors to prepare an amendment to Article IV of the Fund Agreement that would incorporate the Committee of Twenty's consensus on stable but adjustable par values with floating in particular situations. However, this hitherto consecrated formula was soon challenged by the view that a country's exchange rate policy is more important than its exchange rate régime; in other words, that floating rates may be no less valid than par values as a way for countries to meet their exchange rate obligations as members of the Fund.

The US Government, in particular, argued strongly for this view. The French Government, on the other hand, took the view that the Committee of Twenty's prescription for a reformed exchange rate system had been too loose and that floating exchange rates should be admitted only in exceptional circumstances. Most other leading countries were somewhere in between these two positions. Well aware that it was impossible to return to fixed rates in the foreseeable future, they were reluctant to abandon them as the longer-term aim, or norm, of the system.

In the end, the question was resolved at a meeting of the Heads of Government of the United States, the United Kingdom, France, Germany, Italy and Japan at Rambouillet in November 1975, when the two principal protagonists, the United States and France, agreed on a draft of a new text of Article IV which, with some relatively minor changes, was subsequently accepted by the rest of the Fund's membership. The new Article IV will allow countries to declare to the Fund any exchange rate arrangements of their choice — whether fixed or floating — with the exception of a par value fixed in terms of gold or another currency. In addition, it specifies that the Fund, by an 85 per cent. majority decision, may "make provision for general exchange arrangements" or may determine that conditions "permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values". In no circumstances, however, may the Fund limit a country's right to have the exchange arrangements of its choice.

In place of the old obligation to maintain par values, changeable only in case of fundamental disequilibrium, the new text lays down what are called "obligations regarding exchange arrangements". Under these, countries will undertake to collaborate with the Fund and with each other "to assure orderly exchange arrangements and to promote a stable system of exchange rates". The ways in which they are expected to do this are for the most part very general: for instance, by the pursuit of economic growth with reasonable price stability, and by the avoidance of exchange rate manipulation.

Parallel with the nature of countries' obligations, the responsibilities of the Fund in this area are also rather general: to "oversee" the monetary system in order to ensure its effective operation, as well as the compliance of member countries with their obligations; to exercise "firm surveillance" over exchange rate policies; and to "adopt specific principles for the guidance of all members with respect to these policies".

The revised exchange rate arrangements of the IMF will be the contrary of the old ones in their basic conception: in the Bretton Woods system the exchange rate was a fixed point, intended to assure domestic stability through the discipline of the balance of payments; under the new dispensation, stability is conceived of as proceeding outwards from the domestic economy to the balance of payments with no exogenous help from the rate of exchange. Another way of putting the new philosophy is to say that the authorities will not resist fundamental market forces. As to what they will resist, the participants at the Rambouillet meeting agreed that their monetary authorities would act "to counter disorderly market conditions, or erratic fluctuations in exchange rates". The daily telephonic exchanges of the "snake" members about market conditions and interventions were extended to include the United States, as well as Canada, Japan and Switzerland, and provision was made for periodical consultations between both Finance Ministers and their Deputies. Beyond that, judgement as to whether the market is disorderly or rate movements erratic, together with any decision on intervention or other corrective action, is left up to each country. Such judgements are often uncertain and in any case the United States has made it clear that the agreement does not signify any basic change in its policy of limited intervention. This is another way of saying that in the US view fundamental market forces comprise a much wider range of factors — notably capital movements — than in the eyes of many European countries for which the word "fundamental" refers primarily to the current balance of payments.

The agreement reached by the Committee on gold certainly means that it will be phased out of the formal monetary system, i.e. out of the International Monetary Fund. The official price will be abolished and gold will no longer be the common denominator for expressing currency values; all existing obligations to use gold in transactions with the Fund (e.g. for the payment of "gold tranche" subscriptions) will be eliminated; except by an 85 per cent. majority, the Fund will no longer be authorised to accept gold in exchange for currencies, e.g. in repayment of members' drawings; one-third of its gold stock, or 50 million ounces, will be disposed of — half of it, as mentioned above, at market-related prices for the benefit of developing countries and the other half at $35 per ounce to all members pro rata to quotas; and in its dealings in gold the Fund will be required to avoid management of the price, or the establishment of a fixed price in the gold market. Moreover, provisions are also being made that will enable the Fund, by an 85 per cent. majority, to dispose of part or even all of the rest of its gold.

The abolition of the official price means that in theory Fund members will then be free to deal in gold with whomever they like and at any price. Furthermore, their gold reserves will be increased as a result of the disposal of part of the Fund's gold stock. The Group of Ten countries, however — which between them own 73 per cent. of world gold reserves — have entered into arrangements which effectively limit that freedom at least for an initial period of two years; firstly, that they will take no action to peg the price of gold; and, secondly, that their combined gold stock, plus that of the IMF, will not be increased beyond its end-August 1975 level. These arrangements, to which other Fund members may adhere, mean that the use of gold outside the IMF will be limited.

The third element of "reform" concerns measures to promote the use of SDRs and to put them at the centre of the system. Firstly, they are to become the system's formal unit of account, in terms of which par values (if any) will be expressed. Beyond that, certain changes are to be made in the operating rules of the SDR facility. The "balance-of-payments need" test for their use by Fund members will be eliminated; and their possible uses in Fund operations and transactions will be extended, e.g. to the payment of "gold tranche" subscriptions. But the limits beyond which countries need not accept them remain, as do the rules for the partial reconstitution of balances after use — though the latter may now be changed by a 70 per cent. majority decision. More importantly, the SDR is at present a minor element in reserves; no future allocations are currently foreseen; and in the meantime additions to reserves continue, as in the past, to take the form mainly of foreign exchange holdings.

Both in theory and in practice the differences between the Bretton Woods system and the new arrangement are more complex than is sometimes allowed. This is particularly true of the exchange rate régime, under which countries will be able to choose between a fixed and a floating exchange rate; in other words, floating is only one option. And so far as actual practice is concerned, present arrangements are very far from consisting only of individually floating rates. In fact, since March 1973 the great majority of Fund members have continued to attach their currencies in one way or another. Thus, at present fifty-three currencies are attached to the US dollar, thirteen to the French franc and five to the pound sterling. In addition, there are the six European currencies participating in the joint float against the dollar, maintaining 2¼ per cent. margins on either side of fixed cross rates for each other's currencies. And twelve members of the Fund maintain the rates for their currencies in terms of the SDR. The present system is, in fact, principally one of floating blocs with, in addition, some major currencies floating on their own.

The outcome of the Interim Committee's work has in some quarters been described as comparable with the Bretton Woods agreement, and as ushering in a new political and monetary era. Another view was given by the Managing Director of the IMF, who described the proposed amendment as "a complete updating of the Articles of Agreement in the present situation". In other words, the Fund has adapted itself to the world, instead of the other way round. Or, to put it even more bluntly, one should expect little change in the workings of the international monetary system as a result of Washington, Rambouillet and Jamaica.

VIII. ACTIVITIES OF THE BANK.

1. Development of co-operation between central banks and international organisations.

Last year the Bank again played an active rôle in facilitating co-operation among central banks. In addition to the regular meetings of the Governors of the central banks of the Group of Ten countries and Switzerland and to those of the Board of Directors, it organised periodic meetings of central-bank officials to examine matters such as the development of the gold and foreign exchange markets and the Euro-currency market and to study and exchange information on other economic, monetary, technical and legal questions of interest to central banks.

The Bank continued to participate as an observer in the work of the Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System. Following the Committee's meeting on 31st August 1975 in Washington, the Bank agreed to act as registrar in connection with the arrangements entered into between the Group of Ten countries concerning their future gold transactions.

The Bank further continued to provide the Secretariat for the Committee of Governors of the central banks of the member states of the European Economic Community and for the Board of Governors of the European Monetary Co-operation Fund, as well as for their sub-committees and groups of experts. The latter include in particular the Committee of Governors' Alternates, which systematically prepares studies for discussion at the meetings of the Governors; a group specialising in matters relating to foreign exchange markets, intervention policies on these markets and Community credits (Community exchange system, Community borrowing, etc.); a group commissioned to carry out periodic examinations of the monetary situation in member countries and of the problems raised by the co-ordination of national monetary policies; a group concerned with the harmonisation of monetary policy instruments applied by member countries (this group is responsible to both the Monetary Committee of the EEC and the Committee of Governors); a group entrusted with drawing up regulations for the future staff of the European Monetary Co-operation Fund (a task which has recently been completed); and an ad hoc committee established in the summer of 1975 to study the problems raised by the draft US legislation on the operation of foreign banks in the United States.

These committees and groups held a large number of regular and ad hoc meetings in 1975–76, mostly in Basle and generally in preparation for discussions among the Governors. On the basis of their work the Governors were able to take various decisions and to prepare reports and opinions for the Ministers of Finance of the EEC countries or for monetary authorities of countries outside the Community regarding in particular the Community exchange system (its operation and adaptation, the possible association of other countries and the strengthening and geographic extension of central-bank concertation on intervention policies), the execution of financial operations connected with Community borrowing, co-ordination in the field of banking supervision and the consequences that the draft legislation proposed in the United States might have for European banks established in that country.

The Bank also continued to provide the Secretariat for the Committee on Banking Regulations and Supervisory Practices established by the Governors of the Group of Ten countries in December 1974. Furthermore, the Bank continued to perform the functions entrusted to it in August 1964 by the Ministers of the Group of Ten of collecting and distributing to all the participants in the Group and to Working Party No. 3 of the Organisation for Economic Co-operation and Development statistical data concerning the financing of external surpluses and deficits of the Group of Ten countries. It also continued to assemble, survey and distribute statistical data on the Euro-currency market and to be associated with other work of the Group of Ten and of the OECD.

Finally, the Bank has continued to act as Secretariat for the computer experts of the central banks of the Group of Ten countries who have been meeting both at the BIS and at various central banks to exchange ideas and experiences regarding the use and development of computer hardware and software, and has assisted them further in these and connected matters. The experts have been following closely changes in the field of mechanisms for international payments and the work on related standards which is being carried out within the framework of the International Standards Organisation. They have paid particular attention to the security and reliability aspects of electronic systems for financial messages and payments. Their discussions have been broadened to include a more detailed examination of the likely overall policy implications of possible developments in the payments sphere, as well as of specific questions relating to payment orders, message authentication procedures, etc. During the year steps have been taken to establish an experimental computerised data bank containing macro monetary and economic information of value to the participating central banks. This experiment will permit the exchange of up-to-date information between the central banks and the BIS and, inter alia, will make it possible to gauge the usefulness of such a service for the BIS and the central banks.

2. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1976, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

* * *

* In this chapter the term "francs" (abbreviated to F) signifies *gold* francs, except where otherwise indicated. The gold franc is the equivalent of 0.290 322 58... grammes fine gold—Article 4 of the Statutes. Assets and liabilities in US dollars are converted on the basis of US $1 = 0.736 662 grammes fine gold; all other items in currencies at central or market rates against the US dollar.

The balance-sheet total at 31st March 1976 stood at the record figure of F 43,425,770,553
against, on 31st March 1975, F 41,940,402,173

It thus registered an increase of F 1,485,368,380
or 3.5 per cent., which is considerably less than that recorded in the previous financial year (10,325 million and 32.7 per cent.).

BIS: Development of the balance-sheet total over the past ten financial years.

Financial years ended 31st March	Total of Balance Sheet	Movement over the year	
	in millions of francs		in percentages
1967	8,232	+ 350	+ 4
1968	12,041	+ 3,809	+ 46
1969	14,643	+ 2,602	+ 22
1970	20,699	+ 6,056	+ 41
1971	23,856	+ 3,157	+ 15
1972	29,362	+ 5,506	+ 23
1973	25,250	− 4,112	− 14
1974	31,615	+ 6,365	+ 25
1975	41,940	+ 10,325	+ 33
1976	43,426	+ 1,486	+ 4

The following items are not included in the Balance Sheet:

(i) bills and other securities held in custody for the account of central banks and other depositors;

(ii) assets held by virtue of the functions performed by the Bank (as Depositary, Trustee or Paying Agent) in connection with international loans;

(iii) assets and liabilities arising from the Bank's functions as Agent for the European Monetary Co-operation Fund in connection with Community borrowing operations;

(iv) gold under earmark held by the BIS; this item amounted to 1,160 million francs on 31st March 1976, against 1,091 million on 31st March 1975.

LIABILITIES (COMPOSITION OF RESOURCES).

BIS: Development of the composition of resources over the past ten financial years.

Financial years ended 31st March	Paid-up capital and reserves	Borrowed funds	Sundry liabilities	Balance-sheet total
	in millions of francs			
1967	151	7,764	317	8,232
1968	170	11,548	323	12,041
1969	200	14,133	310	14,643
1970	463	20,060	176	20,699
1971	539	23,086	231	23,856
1972*	754	28,401	207	29,362
1973*	849	24,179	222	25,250
1974*	967	30,378	270	31,615
1975*	1,122	40,435	383	41,940
1976*	1,253	41,617	556	43,426

* After allocation of the net profit for the year.

A. Capital, reserves, provisions and miscellaneous liabilities.

(a) Paid-up capital F 300,703,125

The Bank's authorised capital remained unchanged; so also did the issued capital, which is made up of 481,125 shares paid up to the extent of 25 per cent.

(b) Reserves

(1) *Legal Reserve Fund* F 30,070,313

This amount showed no change; it has in fact remained unchanged since 1971, when it reached 10 per cent. of the currently paid-up capital, which is the maximum laid down in Article 51(1) of the Statutes.

(2) *General Reserve Fund*

after allocation of the net profit for 1975–76 F 423,847,193

This compares with 371.4 million francs on 31st March 1975, the difference of 52.4 million francs representing the amount it is proposed to transfer to the Fund from the net profit; the proposed increase in this Reserve Fund is in conformity with the provisions of Article 51(3) of the Statutes.

(3) *Special Dividend Reserve Fund* F 75,175,781

This Reserve Fund remained unchanged.

(4) *Free Reserve Fund*

after allocation of the net profit for 1975–76 F 423,118,200

This compares with 344.5 million francs on 31st March 1975, the amount it is proposed to transfer to the Fund from the net profit being 78.6 million francs.

The Bank's overall reserves after allocation of the net profit for 1975–76 thus stand at F 952,211,487

This compares with 821.2 million francs at the beginning of the financial year, giving an increase of 131 million; it may be recalled that the increase in the overall reserves amounted to 118 million in the financial year 1973–74 and 155 million in the financial year 1974–75.

(c) The item "Miscellaneous" rose to F 445,658,395

This compares with 265.7 million francs on 31st March 1975; the increase of 180 million is mainly due to book-keeping adjustments made necessary by the fact that various gold swaps were concluded at market-related prices, i.e. on a different basis from the conversion system described in the footnote to page 120.

(d) Provision for Building Purposes F 62,965,885

This compares with 90.6 million francs; the decrease of 27.6 million francs is the result of incurred expenditure of 26.1 million francs and an exchange difference of 1.5 million francs.

(e) Profit and Loss Account, *before* allocation F 178,876,749

This figure represents the net profit for the financial year 1975–76; it shows a decrease of 3.2 million francs compared with the net profit for the preceding financial year of 182.1 million, which was a record figure. Details of the proposed allocation of the profit for 1975–76, subject for the first time to the new provisions of Article 51 of the Statutes as approved by the Extraordinary General Meeting held on 8th July 1975, are given in Section 6 below; these proposals, to which a number of references have already been made in connection with the development of the reserves, provide in particular for a sum of 47,876,749 francs — against 27.1 million in the preceding financial year — to be set aside in respect of the dividend of 100 Swiss francs per share to be paid on 1st July 1976.

B. Borrowed funds.

The following tables show the *origin, nature* and *term* of the Bank's borrowed resources.

BIS: Borrowed funds, by origin.

Origin	Financial years ended 31st March 1975	1976	Movement
	in millions of francs		
Deposits of central banks	38,861	39,976	+ 1,115
Deposits of other depositors	909	1,641	+ 732
Notes	665	—	− 665
Total	40,435	41,617	+ 1,182

The increase recorded in "Deposits of central banks" was moderate, particularly in relative terms (2.9 per cent.). The increase was accounted for chiefly by deposits in US dollars; in contrast, liabilities in Swiss francs and, in smaller measure, Deutsche Mark decreased.

The movements affecting the two other items virtually offset one another:

(i) "Deposits of other depositors" almost doubled, mainly as a result of the receipt of funds in US dollars from the market; and

(ii) the item "Notes" was liquidated, following the non-renewal, in January and February, of the outstanding balance of notes in Swiss francs that had been issued by the Bank and subscribed by commercial banks; this item, which was opened in June 1963, had appeared in the balance sheet practically without interruption since then.

Among the above-mentioned categories of borrowed funds, the preponderant share in the total of the first — "Deposits of central banks" — remained unchanged compared with its level at the beginning of the financial year (96 per cent.).

BIS: Borrowed funds, by nature and term.

Term	Deposits in gold: Financial years ended 31st March 1975	1976	Movement	Deposits in currencies: Financial years ended 31st March 1975	1976	Movement	Notes: Financial years ended 31st March 1975	1976	Movement
	in millions of francs								
Sight	3,079	2,568	− 511	365	682	+ 317	–	–	–
Not exceeding 3 months	481	642	+ 161	29,197	30,233	+ 1,036	665	–	− 665
Over 3 months	9	310	+ 301	6,639	7,182	+ 543	–	–	–
Total	3,569	3,520	− 49	36,201	38,097	+ 1,896	665	–	− 665

In relation to the total of borrowed resources, the proportion of deposits in gold again declined, though this time only very slightly.

(a) Deposits in gold F 3,519,616,019

This figure compares with that of 3,569 million francs at 31st March 1975, representing a decrease of 49 million; the reduction of 511 million in sight deposits, due to withdrawals by central banks, was only partially offset by transfers to time accounts.

(b) Deposits in currencies F 38,096,738,893

This figure compares with that of 36,201 million francs at 31st March 1975, representing an increase of 1,896 million (5.2 per cent.). Only one-sixth of this increase was accounted for by sight deposits — the total of which nevertheless almost doubled; the remainder involved funds at not exceeding three months and, in smaller measure, funds at over three months.

ASSETS (EMPLOYMENT OF RESOURCES).

BIS: Distribution, by nature, of sight assets and other investments.

Nature	Financial years ended 31st March 1975		1976		Movement	
	in millions of francs					
Sight assets						
Gold	4,122		3,993		− 129	
Currencies	87	4,209	72	4,065	− 15	− 144
Treasury bills						
Currencies		515		289		− 226
Time deposits and advances						
Gold	104		49		− 55	
Currencies	31,782	31,886	34,530	34,579	+ 2,748	+ 2,693
Securities at term						
Currencies		5,143		4,463		− 680
Total						
Gold	4,226		4,042		− 184	
Currencies	37,527	41,753	39,354	43,396	+ 1,827	+ 1,643

The table on the preceding page gives a break-down of the main items of the assets according to their *nature*.

The distribution of these assets calls for the following comments:

(a) Gold F 3,992,834,022

This item, consisting entirely of gold in bars, amounted to 4,122 million francs on 31st March 1975. The small reduction of 129 million during the last financial year was due to the net use of gold in swaps concluded against currencies and the repayment of deposits received in gold to which reference has already been made; however, the effect of these two categories of operation was attenuated by the maturing of investments made in gold. On the other hand, it should be noted that, as indicated in note 3 to the Balance Sheet, the portion of gold holdings pledged stood at 700 million francs, compared with 334 million at the beginning of the financial year, representing an increase of 366 million.

(b) Cash on hand and on sight account with banks F 71,791,282

This figure compares with 87 million francs at 31st March 1975, representing a decrease of 15 million.

(c) Treasury bills F 289,001,315

This compares with a figure of 515 million francs at 31st March 1975, representing a decline of 226 million.

(d) Time deposits and advances F 34,578,489,352

This figure compares with one of 31,886 million francs at 31st March 1975. The increase of 2,693 million, or 8.4 per cent., during the financial year was far larger than the rise in total assets, the other items shown in the above table having all recorded declines.

The gold component of this item fell from 104 million to 49 million, the Bank having run off investments of gold in the form of time deposits, as already mentioned above.

Time deposits and advances in currencies rose from 31,782 million to 34,530 million, thus recording quite a sizable increase of 2,748 million. The rise, which involved chiefly US dollars, represents facilities extended to a fairly large number of central banks and additional investments made on various markets. As on the liabilities side, investments in Swiss francs in particular and in Deutsche Mark showed a decline.

(e) Securities at term F 4,463,458,413

This figure compares with one of 5,143 million at 31st March 1975. The reduction of 680 million, or 13.2 per cent., broadly corresponds to the difference between maturing bank certificates of deposit and purchases of other types of paper.

The table on the next page shows the distribution of time deposits and advances and securities at term, by *maturity*.

BIS: Time deposits and advances and securities at term, by maturity.

Term	Financial years ended 31st March 1975	1976	Movement
	in millions of francs		
Not exceeding 3 months	27,546	29,493	+ 1,947
Over 3 months	9,483	9,549	+ 66
Total	37,029	39,042	+ 2,013

As this table shows, almost all of the increase represented investments for periods not exceeding three months.

(f) Miscellaneous F 30,196,168

This figure compares with 187 million francs at 31st March 1975. The sharp decrease of 157 million was a result of the book-keeping adjustments mentioned above in connection with the item "Miscellaneous" on the liabilities side.

Forward gold operations.

These operations, which appear under note 2 to the Balance Sheet, resulted in a positive net balance (gold receivable) of F 174,708,398 compared with one of 40 million at the end of March 1975. This increase of 135 million, appreciable in relative terms, was attributable to the net effect of swap operations of gold (repurchased forward) against currencies, already mentioned above in connection with assets in gold (item a).

3. The Bank as Trustee for international government loans.

In conformity with the agreements in force, the Bank continued to perform the functions of Trustee for the new bonds which were issued by the Government of the Federal Republic of Germany, in accordance with the London Agreement on German External Debts of 27th February 1953, in respect of the German External Loan 1924 (Dawes Loan) and of the German Government International Loan 1930 (Young Loan).

As regards the Dawes Loan, all outstanding conversion bonds matured in October 1969 and all outstanding funding bonds matured in October 1972. In accordance with Article 16 of the General Bond of the Dawes Loan dated 10th October 1924, the Trustee has repaid to the German Government all amounts which remained unclaimed as at 30th September 1975 by holders of outstanding conversion bonds and relevant coupons.

The financial year 1975–76 for the Young Loan ended on 1st June 1976. The interest in respect of the financial year amounted to the equivalent of about 25.1 million francs and was duly paid to the Bank and distributed by the latter among the Paying Agents. Redemption of conversion bonds in respect of the financial year 1975–76 was effected partly by purchases of bonds on the market and partly by a drawing. All the outstanding funding bonds were redeemed on 1st December 1972, whereas the final maturity date for the conversion bonds is fixed at 1st June 1980.

The question whether the exchange guarantee attached to the Young Loan under the terms of the London Agreement was applicable in the case of the revaluations of the Deutsche Mark in 1961 and in 1969 was submitted in May 1971 to the court of arbitration provided for in the Agreement; the arbitral proceedings are in progress. As regards the more recent question whether the exchange guarantee is applicable when currencies of issue of the Young Loan undergo material changes in exchange value — whether as a result of the adoption of floating exchange rates or of central rates — without a formal change in their respective par values being involved, the Trustee has drawn this matter to the attention of the governments of the countries in which issues of the Loan were made and has requested them to take the matter up and do everything to ensure that an appropriate solution is reached.

German Government International Loan 1930 (Young Loan).
Conversion bonds.

Issue	Currency	Redemption value*			
		Bonds issued	Bonds purchased or drawn for redemption in respect of the financial years 1958-59 to 1974-75	1975-76	Balance after redemption
American . . .	$	67,086,000	17,901,000	1,618,000	47,567,000
Belgian	B.fr.	202,870,000	51,974,000	4,762,000	146,134,000
British	£	20,666,300	5,286,300	485,200	14,894,800
Dutch.	Fl.	52,580,000	13,250,000	1,204,000	38,126,000
French	Fr.fr.	501,900,000	129,669,000	11,916,000	360,315,000
German	DM	14,509,000	3,603,000	307,000	10,599,000
Swedish . . .	S.kr.	92,780,000	24,056,000	2,210,000	66,514,000
Swiss	Sw.fr.	58,393,000	14,727,000	1,309,000	42,357,000

* Redemption value on 1st May 1976 established in accordance with the provisions of the London Agreement on German External Debts of 27th February 1953 but without taking into account the revaluations of the Deutsche Mark in 1961 and 1969, the floating of exchange rates and the introduction — and in certain cases the subsequent alteration — of central rates for various currencies of issue.

The Bank is also Trustee for the assented bonds of the Austrian Government International Loan 1930, the service of which was carried out in conformity with the relevant agreements.

The following table shows the position with regard to this Loan:

Austrian Government International Loan 1930.

Issue	Currency	Nominal value			
		Bonds assented	Bonds purchased or drawn for redemption in respect of the financial years 1959 to 1974	1975	Balance after redemption
American . . .	$	1,667,000	1,293,000	103,000	271,000
Anglo-Dutch .	£	856,600	640,700	51,400	164,500
Swiss	Sw.fr.	7,102,000	4,723,000	429,000	1,950,000

4. The Bank as Depositary under the terms of the Act of Pledge concluded with the European Coal and Steel Community.

The following table shows the amounts outstanding on the secured loans issued by the European Coal and Steel Community between 1954 and 1961 for which the Bank performs the functions of Depositary in accordance with the provisions of the Act of Pledge concluded between itself and the Community on 28th November 1954.

During the financial year 1975–76 the amounts received by the Bank for the service of the secured loans came to the equivalent of about 8 million francs in respect of interest and about 32 million francs in respect of redemption. By the end of the financial year the total amount outstanding had been reduced to the equivalent of approximately 146 million francs.

Secured loans of the European Coal and Steel Community.

Series of Secured Notes	Dates of issue	Countries of issue	Lenders	Original amounts of loans		Amounts unredeemed on 1st April 1976	Rates of interest %	Year of final maturity or redemption
1st	1954	United States	US Government	$	100,000,000	25,000,000	3⅞	1979
2nd	1955	Belgium	Caisse Générale d'Epargne et de Retraite, Brussels	B.fr.	200,000,000	75,600,000	3½	1982
3rd	1955	Germany	Westdeutsche Landesbank Girozentrale, Düsseldorf[1]	DM	50,000,000	12,392,600	3¾	1981
4th	1955	Luxembourg	Caisse d'Epargne de l'Etat, Luxembourg	B.fr.	20,000,000	7,560,000	3½	1982
				L.fr.	5,000,000	—	3½	1961
5th	1956	Saar	Landesbank Saar Girozentrale, Saarbrücken	DM	2,977,450[2]	404,933	4¼	1977
6th	1956	Switzerland	Public issue	Sw.fr.	50,000,000	—	4¼	1974
7th	1957	United States	Public issue	$	25,000,000	—	5½	1975
8th	1957	United States	Public issue	$	7,000,000	—	5	1962
9th	1957	United States	Bank loans	$	3,000,000	—	5	1962
10th	1957	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	46,005,703	5⅝	1982
11th	1958	United States	Public issue	$	35,000,000	7,400,000	5	1978
12th	1958	United States	Public issue	$	15,000,000	—	4½	1963
13th	1960	United States	Public issue	$	25,000,000	8,500,000	5⅜	1980
14th	1960	United States	Public issue	$	3,300,000	—	4¾	1963
				$	3,300,000	—	4⅞	1964
				$	3,400,000	—	5	1965
15th	1961	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	60,818,219	5¼	1986
16th	1961	Netherlands	Public issue	Fl.	50,000,000	19,850,000	4½	1981

[1] The original lenders, Rheinische Girozentrale und Provinzialbank and Landesbank für Westfalen Girozentrale, were merged as from 1st January 1969 under the name Westdeutsche Landesbank Girozentrale. [2] This loan, which was contracted in French francs, was converted into Deutsche Mark in 1959. The original amount was 350,000,000 old French francs.

5. The Bank as Agent for the European Monetary Co-operation Fund.

The Bank continued to perform the functions of Agent for the European Monetary Co-operation Fund which it has been executing since 1st June 1973. This Community institution, which was set up on 6th April 1973 by the member states of the European Economic Community, is still only in the initial stage of its operation, but its activities have recently become more diversified as a result of the conclusion in March and April 1976 of the first Community borrowing operations, the administration of which has been entrusted to the Fund.

As the Fund's technical Agent, the Bank thus now performs two sets of functions: on the one hand, book-keeping operations concerning the working of the exchange system introduced in the Community in April 1972 and, on the other, the new functions relating to the execution of financial operations connected with Community borrowing.

In the first case, the Bank's rôle consists principally in keeping the Fund's accounts and recording therein:

- the debts and claims vis-à-vis the Fund of the EEC central banks participating in the "snake" arrangement which arise from interventions carried out by those banks in member countries' currencies in order to maintain a fixed margin of fluctuation between their exchange rates of not more than 2.25 per cent.;

- the periodic settlement of these debts and claims, which generally takes place at the end of the month following the intervention;

- operations carried out in connection with the short-term monetary support arrangements (operations of this kind disappeared from the Fund's books in December 1974, when the monetary support received by the Bank of Italy during the preceding nine months was consolidated into medium-term financial assistance).

During the financial year 1975–76, the number of accounting operations varied considerably in line with the situation on the foreign exchange markets of the EEC countries participating in the "snake" and with the greater or lesser recourse by these countries to interventions in dollars, which are not entered in the Fund's books.

In its new function as Agent of the Fund for the administration of borrowing and lending operations concluded by the Community in accordance with the Regulations and Decisions adopted by the Council of the European Communities in February 1975 and March 1976, the Bank is responsible principally for the following tasks:

- carrying out payments connected with these borrowing and lending operations;

- opening the necessary accounts in the Fund's books and recording such financial operations;

- keeping a check on the due dates laid down in the borrowing and lending contracts for the payment of interest and repayment of the principal;

– informing the Commission of the European Communities of the operations carried out for the account of the EEC.

The payments mentioned above are effected through the accounts which the Fund has opened in its name at the Bank; the accounts in question are, however, merely transit accounts, as the sums received by the Fund under borrowing arrangements entered into by the Community are transferred on the same value date to the account specified by the central bank of the country receiving the corresponding loan.

The first Community borrowing operations involved an amount equivalent to about US $1.3 milliard; ten-thirteenths of this sum was made available to Italy and three-thirteenths to Ireland.

6. Net profits and their distribution.

The accounts for the forty-sixth financial year ended 31st March 1976 show a net operating surplus of 184,464,774 francs, as compared with 187,622,476 francs for the preceding financial year and 168,212,066 francs for the financial year 1973–74. The principal reasons for the decrease recorded in the year under review are a reduction in the average margin between the interest rates obtained by the Bank on funds held in currencies and those paid by it on the deposits of its customers, and an increase in the level of the Bank's costs of administration.

The Board of Directors has decided to transfer to the Provision for Exceptional Costs of Administration an amount of 5,588,025 francs; no allocation is being made this year to the Provision for Building Purposes. As a result of the afore-mentioned transfer the net profit amounts to 178,876,749 francs, against 182,063,281 francs for the previous financial year and 145,063,281 francs for the financial year 1973–74. The allocation of this amount is governed by Article 51 of the Statutes.

On the basis of this provision, the Board of Directors recommends that the net profit of 178,876,749 francs be applied by the General Meeting in the following manner:

(i) an amount of 47,876,749 francs in payment of the dividend of 100 Swiss francs per share;

(ii) an amount of 52,400,000 francs to be transferred to the General Reserve Fund; and finally

(iii) an amount of 78,600,000 francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose which is in conformity with the Statutes.

The Board of Directors' recommendation of a dividend of 100 Swiss francs per share, which compares with the amount of 75.05 Swiss francs per share paid for the previous financial year, reflects the greater latitude as regards the Board's dividend recommendations which results from the amendment of Articles 51 and

52 of the Bank's Statutes adopted at the Extraordinary General Meeting held in July 1975.

If the above-mentioned proposals are accepted, the dividend will be paid on 1st July 1976 to the shareholders whose names are entered in the Bank's share register on 20th June 1976.

The Balance Sheet, the Profit and Loss Account and a table showing the movement during the financial year on the Provision for Building Purposes will be found at the end of this Report. The Bank's accounts have been audited by Messrs. Price Waterhouse & Co., Zurich, who have confirmed that the Balance Sheet and the Profit and Loss Account, including the notes thereon, give a true and fair view of the state of the Bank's affairs at 31st March 1976 and of its profit for the year ended on that date. Messrs. Price Waterhouse & Co.'s report is appended at the foot of the Balance Sheet.

7. Changes in the Board of Directors and in the Management.

Baron Ansiaux, whose mandate as a member of the Board was due to expire on 7th August 1975, was re-appointed under Article 27(2) of the Statutes by M. Cecil de Strycker, Governor of the National Bank of Belgium, in July 1975.

In August 1975 Dr. Paolo Baffi succeeded Dr. Guido Carli as Governor of the Bank of Italy and became an ex-officio member of the Board in place of Dr. Carli. At the meeting of the Board held on 14th October 1975 the Chairman expressed the sincere and deep gratitude of all members of the Board for Dr. Carli's remarkable services to the Bank during a period of office of more than fifteen years.

At the same meeting the Chairman informed the Board that Dr. Baffi had appointed Dr. Antonino Occhiuto under Articles 27(2) and 28 of the Statutes to fill the vacancy on the Board caused by his appointment as Governor of the Bank of Italy for the unexpired period of his term of office ending on 7th November 1975 and for a further period of three years. The Chairman also reported that Dr. Baffi had appointed as his Alternates Dr. Rinaldo Ossola, who had acted as Alternate to Dr. Carli, and Dr. Mario Ercolani in place of Prof. Francesco Masera. The Chairman expressed to Prof. Masera the Bank's appreciation for his valuable services during a period of nearly seven years.

At the meeting of the Board held on 9th December 1975 the Chairman announced that Dr. Karl Klasen, President of the Deutsche Bundesbank, had appointed Dr. Johann Schöllhorn as a member of the Board in place of Dr. Leonhard Gleske. This appointment was made under Articles 27(2) and 28 of the Statutes for a period of three years ending on 31st December 1978. The Chairman thanked Dr. Gleske for the very valuable services he had rendered to the Bank during his term of office of more than five years.

The mandate of Dr. Jelle Zijlstra, who had been elected to the Board under Article 27(3) of the Statutes, was due to expire on 31st March 1976. He was re-elected at the meeting of the Board held on 9th March 1976.

At the same meeting the Chairman informed the Board that Dr. Klasen had appointed Dr. Leonhard Gleske to act as his Alternate in place of Herr Johannes Tüngeler as from 1st April 1976. He expressed the Bank's gratitude to Herr Tüngeler for his valuable services during a period of nearly seven years.

Dr. Milton Gilbert, who had been the Bank's Economic Adviser and the Head of its Monetary and Economic Department since 1960, relinquished his appointment at the end of December 1975. At the Board's meeting on 9th December 1975 the Chairman thanked Dr. Gilbert on behalf of all members of the Board for the great skill and professional competence which he had always shown in carrying out his important functions for the Bank. At its meeting in October 1975 the Board appointed Prof. Alexandre Lamfalussy Economic Adviser and Head of the Monetary and Economic Department as from 1st January 1976.

The Chairman announced at the Board meeting held on 9th March 1976 that the Bank had decided to promote Dr. Warren D. McClam and Mr. Michael G. Dealtry to the rank of Deputy Manager as from 1st April 1976.

* * *

The Bank learned with deep regret of the death of Dr. Johan Willem Beyen on 29th April 1976. Dr. Beyen had been Alternate of the President from May 1935 until May 1937 and President of the Bank from May 1937 until the end of December 1939.

CONCLUSION.

Recovery in the western industrial world is now well advanced. There are no signs that a premature slow-down lies ahead; indeed, some of the leading countries appear to be on the threshold of a new boom. The major long-term problems, however, have not been solved. With few exceptions, inflation continues at historically high rates, unemployment is expected to remain painfully high, and there are serious doubts about the chances of raising capital expenditure to a level adequate to ensure a satisfactory pace of long-term growth. Yet a relatively fast development of productive capacities is needed for several reasons: social expectations within the industrial countries are unlikely to be fulfilled without it; new capacities are needed to absorb unemployment; and, last but not least, industrial countries face a transfer problem, i.e. the need to provide the real resources required to adjust to the deterioration in their terms of trade over recent years and, at the same time, to help raise the standard of living of non-oil LDCs.

Policy should therefore be aiming at a double objective — endeavouring, on the one hand, to keep a firm command over aggregate expenditure, so as to prevent the expansion from getting out of control, and, on the other, to raise the share of investment in total spending at the expense of consumption.

What broad lines of policy would seem appropriate to this end?

Monetary policy should play a major rôle in achieving the first of these targets. There is evidence in many countries that the growth of the money supply in real terms has so far been slower than during the corresponding phase of the preceding cycle. This is reassuring, but only up to a point. First, moderation has not been achieved in all countries. Secondly, the monetary excesses of the previous cycle appear to have occurred not so much in the recession itself as during the early upswing, the strength of which was at the time greatly underestimated. There is now a danger of repeating the same mistake. Authorities may be unduly influenced by a temporary slackening in the pace of revival, the slow absorption of unemployment or continuing weakness in certain industrial sectors. In the circumstances some countries might well be tempted to allow a high rate of money creation. Such a temptation should, however, be resisted on the highly plausible assumption that the synchronisation of the recovery in all major industrial countries will ensure its continuity.

In this context it might well be helpful if more countries were to commit themselves publicly to a target for the growth of one or several of their monetary aggregates. Such an announcement could be useful on two counts. First, it might impose a constraint on government policy — especially on the monetary financing of the public sector. Secondly, it might also have a dampening effect on inflationary expectations by conveying to the public, as well as to labour and management, that the authorities were committing themselves fully to the objective of mastering inflation.

To be convincing in this respect, such targets should not provide for a growth in the money supply paralleling that of nominal GNP. This could mean implicit acceptance of current rates of price inflation. On the contrary, the monetary targets, which could be gradually reduced as time goes on, should imply a decline in the rate of inflation.

Without the active assistance of *fiscal policy,* however, it is most unlikely that a moderate monetary policy would be either feasible or effective.

Its feasibility could easily be impaired if, as the upswing progresses, large public-sector deficits were to persist in conjunction with the expected decline in household saving ratios and a possible increase in the external financing requirements of the enterprise sector. Even a partial reversion of household financial surpluses and corporate deficits to their pre-recession levels could entail unduly heavy credit demand from the public and private sectors combined.

In these circumstances central banks would find themselves faced with two unpleasant alternatives. On the one hand, they could accommodate both kinds of credit demand — perhaps being pushed in this direction by political pressures at a time of persisting slack in output and employment. But the result would be an increase in money supply quite incompatible with containing inflation over the long term. On the other hand, the monetary authorities might pursue a policy aimed at a steady, moderate rise in money supply, thereby running the risk that private spending might be "crowded out" by public expenditure. This could occur either directly, where ceilings on credit to the private sector are introduced, or indirectly through higher interest rates, given that government expenditure is notoriously less responsive to interest rates than private spending. In this event monetary discipline would prevail, but at the cost of discouraging fixed capital formation. The principal hope, therefore, of avoiding excessive money creation or higher interest rates lies in reducing the size of the government's borrowing requirement as the upswing proceeds.

The effectiveness of monetary policy, even assuming satisfactory operational control of the money stock, depends upon the relationship between money and the flow of expenditure. Velocity sometimes changes in unpredictable ways, but experience suggests that it is likely to rise as an upswing progresses. In the course of a vigorous recovery, therefore, monetary authorities might find it appropriate to lower their target rates of monetary growth. But how could they achieve such an objective if, while accommodating the revival of private-sector credit demand, they must go on helping to finance an unduly large government deficit?

The upshot of these considerations is that a major reduction in the public sector's borrowing requirements is a prerequisite of a successful monetary policy as the recovery moves ahead. Nor is this all. For, even if the public sector's deficit were to fall back in a satisfactory way, the means employed to obtain such a reduction cannot be a matter of indifference. In many industrial countries the level of taxation on current earned income seems to have approached, or exceeded, the limits of economic efficiency — which is another way of saying that the sheer size of the public sector has become a problem. For this reason the emphasis in budget restraint should fall on cuts in public expenditure rather than on increases in taxation.

However, even if budgetary policy works hand in hand with monetary policy, it cannot be expected that this will do much more than keep aggregate expenditure in line with the growth of productive capacity. In a number of countries an *incomes policy,* formulated partly with a view to restoring corporate earnings to satisfactory levels, could play a useful rôle for several — interdependent — reasons.

Such a policy could lead to a shift in the composition of domestic expenditure from consumption towards capital formation and, within the latter, from labour-saving investments towards those creating employment. It could also help to bring the increase in money incomes more into line with the growth of productivity. Finally, it might enable certain countries — particularly those more open economies in which wages, salaries and other incomes respond very quickly to import-induced increases in the domestic price level — to break out of the vicious circle of inflation and exchange depreciation.

Only in the United States did the market mechanism and the depth of the recession produce a slow-down in the rise of money wages sufficient to bring about a decline in real earnings. That this did not happen in other countries reflected not only their greater concern about unemployment but also the widespread incidence of de facto or contractual wage-indexation arrangements. What the market did not achieve during the recession, it is unlikely to produce during the recovery. Hence the need in some countries for explicit incomes policy measures. These should be adapted to local circumstances: they could range from the voluntary acceptance of general guide-lines, based on a broad social consensus, to mandatory ceilings on the growth of incomes.

Incomes policies, admittedly, have had a chequered history. They are extremely difficult to negotiate, particularly where the emphasis of restraint would seem to fall primarily on wage-earners. Where the need for such policies is now indicated, it will require considerable social cohesion and political will to put together a workable formula. Most probably, however, this would have to limit effectively the rise of personal incomes of all kinds and not only of wages. The success of the British policy since last August, and the probability that it will continue for another year, seems to confirm that real break-throughs can at times be accomplished in the incomes sphere.

In short, we may expect in the future that monetary, fiscal and incomes policies will all be called upon, in varying degrees at different times and in different countries, to play their appropriate part.

Firm domestic policies appear even more desirable if the current cyclical upswing, the likely resurgence of inflationary pressures and the need for increasing capital formation are set against the *international background.*

The present international monetary system is characterised by a striking absence of strict rules for either balance-of-payments adjustment or the creation of international liquidity.

Floating appears to be the rule rather than the exception, but there has not been — and is unlikely to be — an absolutely free floating of individual currencies. Many individual countries will continue to intervene in the exchange markets either because they belong to one of the currency groups — of which the European "snake" is the most prominent example — or for policy reasons of their own. Moreover, countries may switch from one exchange régime to another whenever the need arises. In practice, the result has been, and may well continue to be, a bewildering combination of exchange rate fluctuations and large reserve movements.

Paradox and uncertainty also abound in the field of international liquidity: gold reserves, declaredly on their way out of the system, remain as large in volume as ever; SDR reserves, declaredly on their way to the centre of the system, are only a modest element in the picture; in contrast, national currencies, chiefly the dollar, continue to provide the bulk of gross reserve growth, with international borrowing having risen to very high levels. The outcome — though considerable doubt surrounds both the concept and the measurement of international liquidity — is that the financing of deficits has proved, and may prove in the near future, easier than many observers had forecast, except for the poorer non-oil-producing LDCs. However, this would reflect principally the availability of funds through private international channels, supplemented by ad hoc assistance arranged between national authorities on a bilateral or multilateral basis, rather than through the creation of "net" international assets. At any rate, prospects for global liquidity control, founded on internationally-concerted decisions through the IMF, are — to say the least — remote.

It would, of course, be unfair to condemn our present arrangements simply because they lack coherence and logic. Floating, however imperfect, combined with large-scale international bank lending, has helped to save the world from a deep depression. Nor would it be justified to attribute an inherent inflationary bias to today's monetary framework, which could be contrasted with the "discipline" of pegged exchange rates: indeed, countries with strong stabilisation policies can isolate themselves through exchange appreciation more effectively than in the past from inflationary impulses emanating from other countries. But the absence of strict rules of conduct, coupled with large-scale international bank lending and official assistance, *does* create an environment conducive to highly divergent patterns of country behaviour. In fact, these have already emerged. Obviously, such divergences tend to lead us further away from, rather than towards, an acceptable ordering of world affairs. To avert such disruptive influences, domestic policy-makers must clearly face up to their prime responsibility of creating conditions for non-inflationary, balanced growth.

The fight against the polarisation of the industrial world into groups of countries following divergent paths will, however, be successful only if there is a measure of co-ordination between national policies and if a certain degree of exchange stability becomes a recognised objective.

The burden of the argument set out in this Report is that the synchronisation and the strength of the current recovery might quite soon justify a moderating — if not restrictive — stance in monetary policy, adequately assisted by budgetary and incomes policies. This raises the difficult question of the *international co-ordination of stabilisation policies.* If past experience is any guide, the likelihood is that the leadership in moderation will be assumed by the United States and Germany, both because they are well advanced along their cyclical upswing and on account of their deep-seated aversion to inflation. This, of course, would do little towards re-establishing international balance, and might indeed accelerate the diverging trends in exchange rates. On the other hand, it must also be recognised that there is little hope of keeping world inflation under control unless both the United States and Germany maintain their own expansion at a moderate pace. The practical conclusion is that policy restraint should first be exercised by countries whose inflation rates are still high and whose currencies are under strain — and that those countries could then be followed (rather than preceded) in such policy measures by the United States and Germany.

What rôle can *managed floating* play in helping to stabilise exchange rates? If the "management" of floating is defined in the narrow sense — i.e. as central-bank intervention in the foreign exchange markets — its success over the past few years appears to have been very limited. Intervention has generally helped to maintain orderly markets where sharp, brief aberrations have occurred or where exchange rate movements have taken place slowly under fairly calm conditions. But, where strong forces of change are at work, there is little evidence that "leaning against the wind" can do more than temporarily dampen the movement. The sharp increase in foreign exchange holdings by Switzerland did little to prevent the franc from appreciating; nor is it obvious that Italy and the United Kingdom significantly moderated the slide of their currencies by bearing major losses of reserves. In the recent currency flare-ups only Belgium appears successfully to have resisted market forces; but it was able to do so precisely because reserve losses were accompanied by a drastic cut in domestic bank liquidity, i.e. by appropriate *domestic* policies.

The lack of impact of managed floating narrowly defined is hardly astonishing. The high degree of interdependence between industrial countries in terms of both trade and capital flows makes it practically impossible to resist exchange movements which a majority of market operators consider to be warranted on economic or financial grounds. No amount of international liquidity creation could provide central banks with adequate ammunition for countering massive market movements based on strong expectations. The "management" of floating should therefore aim at influencing these expectations through a set of credible domestic policy measures.

In this much broader sense, the "management" of floating is highly desirable — especially among countries closely linked through trade and the flow of services and capital. This clearly applies to most European countries, and especially (but not exclusively) to those which are members of the EEC. Sharp changes in exchange rates between these countries may impair the growth of trade and (in the case of depreciation) render the stabilisation of the domestic price level exceedingly difficult, without providing large benefits in terms of balance-of-payments adjustment. But experience has now taught us that relative stability of exchange rates cannot be achieved merely by market intervention, even on a massive scale. Such intervention needs to be accompanied by short-term money-market measures designed to achieve rapid, perhaps large, changes in bank liquidity and, at the same time, by stabilisation measures of a more fundamental kind which will make intervention credible. So long as the monetary targets of the European countries remain widely divergent, so long as public-sector deficits vary considerably from one country to another, so long as wage settlements occur at vastly different rates, nobody will believe that intra-European exchange rates will settle down to a calmer life. And, to repeat, no amount of intervention will change this state of affairs.

While the steadiness of intra-European exchange rates is of prime importance for the development of European integration, the stability of the US dollar — especially as measured against the "snake" currencies and the yen — also deserves attention. In view of the major rôle which the dollar continues to play as an international reserve currency, and of the growing importance of the Deutsche Mark in this respect, there can be little order in the international monetary system unless the dollar remains fairly stable in relation to the "snake". A relative stability has been achieved since last autumn; it is in nobody's interest to revert to the sharp cycles which occurred between early 1973 and mid-1975. Assuming that the United States and Germany achieve similar success in combating inflation and that no other specific disturbances arise, comparative interest rate developments might well play the dominant rôle in influencing the behaviour of this key exchange rate. Would it be unrealistic to hope for a measure of co-ordination in the interest rate policies of these two countries?

By deliberate choice (for some countries) or by force of circumstances (for others), the world is going to be living with floating currencies for quite some time to come. But this should not imply that the stability of exchange rates does not matter.

René Larre

General Manager

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1976

ASSETS

BALANCE SHEET

(Before and after

		Gold francs
Gold		3,992,834,022
Cash on hand and on sight account with banks		71,791,282
Treasury bills		289,001,315
Time deposits and advances		
Gold		
Not exceeding 3 months	48,627,729	
Currencies		
Not exceeding 3 months	25,517,559,044	
Over 3 months	9,012,302,579	
		34,578,489,352
Securities at term		
Not exceeding 3 months	3,927,089,237	
Over 3 months	536,369,176	
		4,463,458,413
Miscellaneous		30,196,168
Land, buildings and equipment		1
		43,425,770,553

Note 1: The gold franc is the equivalent of 0.290 322 58... grammes fine gold — Article 4 of the Statutes. Assets and liabilities in US dollars are converted on the basis of US $1 = 0.736 662 grammes fine gold; all other items in currencies at central or market rates against the US dollar.

Note 2: At 31st March 1976, gold receivable against currencies on forward contracts amounted to 174,708,398 gold francs.

Note 3: The equivalent of 699,992,915 gold francs' worth of gold was pledged at 31st March 1976 in connection with deposits received.

AT 31st MARCH 1976

allocation of the year's Net Profit)

LIABILITIES

		Before allocation	After allocation
		Gold francs	Gold francs
Capital			
Authorised: 600,000 shares, each of 2,500 gold francs ...	1,500,000,000		
Issued: 481,125 shares	1,202,812,500		
of which 25% paid up		300,703,125	*300,703,125*
Reserves			
Legal Reserve Fund	30,070,313		*30,070,313*
General Reserve Fund	371,447,193		*423,847,193*
Special Dividend Reserve Fund	75,175,781		*75,175,781*
Free Reserve Fund	344,518,200		*423,118,200*
		821,211,487	*952,211,487*
Deposits (gold)			
Central banks			
Sight	2,534,328,922		
Not exceeding 3 months...	642,307,346		
Over 3 months	309,856,200		
Other depositors			
Sight	33,123,551		
		3,519,616,019	*3,519,616,019*
Deposits (currencies)			
Central banks			
Sight	633,488,347		
Not exceeding 3 months...	29,078,628,522		
Over 3 months	6,776,566,462		
Other depositors			
Sight	48,069,087		
Not exceeding 3 months...	1,154,808,322		
Over 3 months	405,178,153		
		38,096,738,893	*38,096,738,893*
Miscellaneous		445,658,395	*445,658,395*
Provision for Building Purposes		62,965,885	*62,965,885*
Profit and Loss Account		178,876,749	—
Dividend payable on 1st July 1976		—	*47,876,749*
		43,425,770,553	*43,425,770,553*

REPORT OF THE AUDITORS TO THE BOARD OF DIRECTORS AND TO THE GENERAL MEETING OF THE BANK FOR INTERNATIONAL SETTLEMENTS, BASLE

In our opinion the Balance Sheet and the Profit and Loss Account, including the notes thereon, give a true and fair view of the state of the Bank's affairs at 31st March 1976 and of its profit for the year ended on that date. We have obtained all the information and explanations which we have required. The Bank has kept proper books, and the Balance Sheet and the Profit and Loss Account are in agreement with them and with the information and explanations given us.

Zurich, 27th April 1976

PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1976

		Gold francs
Net interest and other income ...		219,866,998
Less: Costs of administration:		
Board of Directors ...	463,940	
Management and Staff ...	27,359,013	
Office and other expenses ...	7,579,271	35,402,224
Net operating surplus ...		184,464,774
Less: Amount transferred to Provision for Exceptional Costs of Administration ...		5,588,025
Net Profit for the financial year ended 31st March 1976 ...		178,876,749

The Board of Directors recommends to the Annual General Meeting that the Net Profit should be allocated in accordance with Article 51 of the Statutes as follows:

	Gold francs
Dividend: 100 Swiss francs (equivalent to 99.51 gold francs) per share on 481,125 shares ...	47,876,749
	131,000,000
Transfer to General Reserve Fund ...	52,400,000
	78,600,000
Transfer to Free Reserve Fund ...	78,600,000
	—

Movement on the Provision for Building Purposes during the financial year ended 31st March 1976

		Gold francs
Balance at 1st April 1975 ...		90,548,730
Less: Amortisation of expenditure incurred ...	26,072,900	
Exchange difference ...	1,509,945	27,582,845
Balance at 31st March 1976 per Balance Sheet ...		62,965,885

BOARD OF DIRECTORS

Dr. J. Zijlstra, Amsterdam	Chairman of the Board of Directors, President of the Bank
Henri Deroy, Paris	Vice-Chairman

Baron Ansiaux, Brussels
Dr. Paolo Baffi, Rome
Bernard Clappier, Paris
Dr. Karl Klasen, Frankfurt a/M.
Dr. Fritz Leutwiler, Zurich
The Rt. Hon. Lord O'Brien of Lothbury, London
Dr. Antonino Occhiuto, Rome
The Rt. Hon. Gordon Richardson, London
Dr. Johann Schöllhorn, Kiel
Cecil de Strycker, Brussels
Krister Wickman, Stockholm

Alternates

Dr. Otmar Emminger, Frankfurt a/M., or
Dr. Leonhard Gleske, Frankfurt a/M.
Georges Janson, Brussels
Christopher W. McMahon, London, or
M. J. Balfour, London
Dr. Rinaldo Ossola, Rome, or
Dr. Mario Ercolani, Rome
Marcel Théron, Paris, or
Gabriel Lefort, Paris

MANAGEMENT

René Larre	General Manager
Dr. Antonio d'Aroma	Assistant General Manager
R. T. P. Hall	Head of the Banking Department
Dr. Günther Schleiminger	Secretary General, Head of Department
Prof. Alexandre Lamfalussy	Economic Adviser, Head of the Monetary and Economic Department
Dr. Antonio Rainoni	Manager
Maurice Toussaint	Manager
Prof. Dr. F. E. Klein	Legal Adviser

D. H. Stapleton	Deputy Secretary General
Robert Chaptinel	Deputy Manager
Dr. Warren D. McClam	Deputy Manager
M. G. Dealtry	Deputy Manager
R. G. Stevenson	Assistant Manager
Rémi Gros	Assistant Manager