BANK FOR INTERNATIONAL SETTLEMENTS

FORTY-SEVENTH ANNUAL REPORT

1st APRIL 1976 – 31st MARCH 1977

BASLE

13th June 1977

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FORTY-SEVENTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 13th June 1977

Ladies and Gentlemen,

I have the honour to submit herewith the forty-seventh Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1976 and ended on 31st March 1977.

After transfer of 2,856,416 gold francs to the Provision for Exceptional Costs of Administration and 5,000,000 gold francs to the Provision for Building Purposes, the net profit for the year amounted to 167,920,050 gold francs, compared with 178,876,749 gold francs for the preceding year and 182,063,281 gold francs for the financial year 1974–75.

The Board of Directors recommends that, in application of Article 51 of the Bank's Statutes, the present General Meeting should apply the sum of 47,920,050 gold francs in payment of a dividend of 100 Swiss francs per share.

The Board further recommends that 48,000,000 gold francs be transferred to the General Reserve Fund, and the remainder of 72,000,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1976–77 will be payable to shareholders on 1st July 1977.

Chapter I introduces the Report with a brief survey of the main economic events of 1976 and early 1977 and presents an analysis of current policy issues in the western industrialised world. On the domestic side Chapter II looks in more detail at the course of economic recovery over the past year, while Chapter III examines the twin problems of inflation and unemployment. Chapter IV analyses developments in the industrial countries' domestic credit and capital markets, as well as the evolution of their monetary policies. On the international side Chapter V, besides describing last year's trade and payments relationships, takes a look at world payments imbalances since the oil price increases and their implications for the adjustment process. In Chapter VI an account is given of international credit and capital markets in 1976, together with an assessment of the risks for the banking system arising out of the rapid growth of its international lending. Chapter VII examines the course of exchange rates, the question of managed floating, gold and international liquidity. Chapter VIII deals with the Bank's activities during the financial year, the Balance Sheet and the financial results.

I. ECONOMIC DEVELOPMENTS AND POLICY ISSUES.

The economic scene over the past year presented a picture of kaleidoscopic change. Both domestically and in the international economy encouraging developments emerged side by side with others that give cause for concern. This mixed picture makes it more than usually difficult to assess the significance of rapidly shifting business indicators, balance-of-payments statistics, reserve positions and exchange rates.

As a result, almost every major development has lent itself to contrasting interpretations, pessimistic or optimistic. The speed of the recovery has slowed down; but is this not the surest way of achieving sustainable, non-inflationary growth in the long run? Moreover, has last summer's pause in activity not given way since the winter to renewed expansion in some leading countries? The rate of inflation has remained on the average disturbingly high; but some countries have been more successful in fighting inflation than they themselves had expected, while others have taken determined measures in that direction. Imbalances in international payments have persisted; but some significant adjustment has nevertheless taken place. The earlier part of 1976 witnessed major exchange rate changes; in contrast, the winter of 1976–77 proved remarkably calm. The involvement of the private banking system in the financing of external deficits has given rise to justifiable worries; but how else could the oil deficits have been financed so expeditiously and on such a scale? Finally, in view of the absence of any hard and fast rules governing adjustment, our present international monetary arrangements may well deserve to be described as a non-system; yet not only has international trade *not* broken down, but it even registered a healthy expansion in 1976.

This Report will, of course, give a detailed description of events in 1976 and early 1977, especially in the field of monetary and financial developments. It will also attempt to give as objective an account as possible of the contrasting views on their interpretation and on the policy conclusions that can be drawn. But it will not refrain from taking sides in the debate; on the contrary, it will try to evaluate the many changes that have occurred in the western industrial countries since last year, for better or worse.

This evaluation is presented in broad outline in this introductory chapter, while the summary of the general policy recommendations has been left to the Conclusion.

Positive developments on the international scene.

Despite appearances, most of the better news concerns the international scene: to some extent the working of the adjustment process, but much more so the financing of the continuing imbalances on current account.

Admittedly, the total of world payments imbalances, as measured by the sum of individual current-account surpluses and deficits, remained as substantial in 1976 as in the previous year, and therefore only a little lower than during the record year of 1974. This was due both to the persistence (and the slight worsening) of the global oil disequilibrium, and to imbalances between the non-oil industrial countries and the LDCs. But there have been some favourable shifts in the positions of major individual economies. Paradoxical as it may seem, the most important of these concerns the United States, which is at present running a current-account deficit and thus carrying part of the global oil deficit — to which, of course, the dramatic expansion in US imports of oil substantially contributed. At the same time, Germany's current-account surplus, though still large in absolute figures, has become relatively small in relation to its gross national product, and might well decline further in 1977. The United Kingdom has taken drastic measures to reduce its external deficit, and these, together with the coming on stream of the North Sea oil fields, are expected to yield results some time during the current year. The French trade figures have begun to improve significantly. Among the larger LDCs, India and Argentina registered surpluses in 1976, while Asia as a whole (even excluding Japan) did better than in 1975. Yugoslavia turned its current-account deficit into surplus, and many Comecon countries have reduced their deficits.

There remain, of course, ample grounds for concern. Firstly regarding the possible size of this year's US current-account deficit. While in the present circumstances such a deficit contributes to world recovery and facilitates the adjustment process elsewhere, it is in no one's interest that it should reach excessive proportions or become lasting. It would be a grave mistake to believe, merely because the dollar floats, that the state and the structure of the US balance of payments simply do not matter. A deep US current-account deficit, even if it were offset by capital imports, could not be a permanent arrangement; and much less so since in fact it is not. Secondly, it has become evident that, with oil prices at their current level and in the absence of drastic energy economies, the oil imbalance will not disappear. Thirdly, the large movements in exchange rates which have occurred since the beginning of floating have so far produced comparatively limited balance-of-payments adjustment. Finally, the deficits being run by the Mediterranean countries have reached record levels, and seem in many cases to be remarkably intractable. All this has to be acknowledged; but at the same time the examples quoted above suggest that a reversal of individual external imbalances is quite possible, provided countries are ready to embark upon appropriate and complementary adjustment policies.

Even more encouragingly, adequate funds have been forthcoming from both private and official sources to finance most of the deficits within the OECD area as well as among the non-oil LDCs. Experience has confirmed — not unexpectedly — that the overall supply of funds could adjust itself to the demand emanating from deficit countries. In a global sense, there has been no shortage of international liquidity. Again, this is not to deny that the accumulation of debt may leave some countries with an excessive burden of debt servicing. Nor should the potential problems raised by the substantial involvement of the private banking system in balance-of-payments financing be overlooked. There is the problem of the risks that have to be assumed by individual banks; there is also the question whether the adjustment process is best served by this kind of financing. The imposing of conditions is an essential part of the adjustment process, and it is uncertain, to say the least, whether individual private banks are in a position to play the game of conditional lending as efficiently, gradually and smoothly as international organisations are supposed to do.

But this Report takes the view that the external problems lying ahead can be more easily solved than those which countries are facing domestically. By themselves, the problems of adjustment and financing appear manageable both in the sense that they are now better understood and because there is an emerging consensus on how to solve them in practice. On the domestic front, on the other hand, there is a lack of understanding as well as of consensus on policy choices. Hence our relative optimism regarding balance-of-payments adjustment and financing is of little comfort if countries are unable to come to grips with the deeply worrisome twin internal problems of inflation and unemployment. The main policy task for 1977 — and perhaps for some years to come — is how to devise appropriate strategies for dealing with both these ills. If *domestic* policies are successful in this respect, the management of the international economy will not pose insuperable problems.

The central issues: Unemployment and inflation.

In this particular field the Report will strike a much less sanguine note and its policy recommendations will be much less clear-cut.

Apprehensions voiced last year about the possibility of a synchronised runaway boom have proved, happily enough, unfounded; but they have been replaced by other, more complex, concerns. During the summer and the early autumn of 1976 the recovery came to an unexpected halt even in those three large countries — the United States, Japan and Germany — which had led the world out of the recession. Since then expansionary forces seem to have regained momentum, especially in the United States and to some extent in the Federal Republic, and business confidence has again improved in some other European economies. Moreover, the continued "normalisation" of financial markets and balance-sheet structures as well as the skilful monetary policy being applied by most countries have provided a healthy basis for moderate long-term growth.

It has become painfully clear, however, that the current and expected rate of expansion will not reduce unemployment very soon to levels that were once deemed acceptable. Moreover, except more recently in the United States, there are few signs of any strong revival in business investment. Yet it is widely recognised that unless such a revival occurs, the strength of the recovery itself as well as the solution of many longer-term problems remain uncertain. At the same time, the underlying rate of inflation in the western industrial countries has since last summer been displaying a dangerous downward stickiness except in those countries where exchange rate appreciation has contributed to the success of domestic stabilisation efforts — but unfortunately such exceptions cannot become the rule everywhere.

The disconcerting coexistence of relatively slow growth, sluggish capital expenditure and high unemployment with persistent inflation constitutes the major challenge to policy-makers in the western industrial world. And it will not be easy for them to face up to this challenge. Not only may the social burden of applying the appropriate policy mix prove politically unacceptable, but in addition there seems to be no general agreement, either internationally or within individual countries, on just what the optimum combination of policies should be. This disagreement to some extent reflects differences in policy priorities both between individual countries and within each of them. But it also reflects more deep-seated differences in the assessment of what is happening and why — in other words, in economic analysis proper. Finally, the greatest source of confusion arises from the fact that countries now diverge widely in terms of the particular nature of their problems. In spite of floating, international trade still transmits expansionary or deflationary impulses, and the behaviour of real output therefore remains similar from country to country. But the substantial changes in exchange rates have accommodated wide differences in inflation rates; moreover, sizable differences among countries have appeared in the allocation of real resources and the working of the labour market. This suggests that it should be up to each country to find its own optimum policy mix.

Finding the right answers to these questions is, of course, of paramount importance to each country individually, but it is of equal importance for the international community as a whole. However good our understanding of the process of balance-of-payments adjustment and however skilful our organisation of appropriate channels of external financing, no institutional framework will resist the disruptive forces set in motion when countries respond in strikingly different ways to the twin challenge of inflation and unemployment. Floating exchange rates may accommodate small discrepancies between the policy approaches of individual countries; or they may even absorb large ones over a certain period — as they have so far. But it would be illusory to believe that they provide a basis for more lasting independence of economic policies. In the longer run the western industrial world will remain as interdependent under a régime of floating as under one of fixed parities. Persistent large differences in inflation rates coinciding with unacceptable levels of unemployment are apt under *all* exchange rate régimes to lead to protectionism and a breakdown of free trade — not to mention of free capital movements. There are disturbing signs of this already happening — although still only on a limited scale.

Hence the need for the international co-ordination of policy attitudes towards fighting inflation and unemployment. Of course, the country-to-country differences alluded to above necessitate widely differentiated policy approaches. Thus, while all countries face the dilemma of inflation and unemployment, agreement among countries should be sought in regard to responsibilities and objectives rather than in regard to policy mixes or instruments — provided that the latter are internationally consistent.

Outline of the Report.

In analysing the state of the cyclical recovery, Chapter II provides the background to the rest of the Report. It raises two broad, interdependent issues: why has the current expansion slowed down — even in countries that have remained free of external constraints? What can or should be done about it? It does not provide any simple answer to the first question, but suggests that the weakness of capital expenditure, which is the focal point of the analysis, should be attributed to the combined influence of inadequate profitability, high costs of equity financing, excess capacities and numerous uncertainties surrounding business activity — with all these factors together contributing to a lack of confidence in strong, steady, balanced long-term growth. It follows that while there might be good reasons for some countries to stimulate both aggregate demand and, directly, capital expenditure, this should not be undertaken in a way that would generate counter-productive expectations. "Fine-tuning" of demand management should be abandoned, but the authorities should demonstrate their determination (and ability) to ensure moderate medium to long-term growth.

While appropriate demand management will help to ensure a steady, moderate expansion, the industrial countries will have to live for some time with higher-than-normal unemployment. And, despite this, there is little assurance that they can count on any spontaneous further decline in the rate of inflation (Chapter III). For notwithstanding excess capacities and idle labour, anti-inflationary policies have been yielding diminishing returns in many countries since the summer of 1976. The average underlying rate of inflation in the OECD area has remained obstinately stable over the last twelve months, its decline in the countries with appreciating currencies having been offset by acceleration elsewhere. Out of these circumstances has arisen the vicious and virtuous circle approach, which the chapter discusses by contrasting the German and Swiss experiences with those of the United Kingdom and Italy. The "stabilisation" of inflation at current levels is clearly not feasible since no inflation rate has ever remained lastingly stable at such levels. It is also unacceptable internationally, since it implies large absolute differences between countries and therefore carries with it the danger of renewed unrest in the exchange markets.

The common features of domestic financial and money markets (Chapter IV) have been the continuous (although uneven) improvement of financial structures and a complete lack of evidence of "crowding-out" of private expenditure by the large public-sector deficits. But the markets have behaved very differently according to whether they are located in countries with declining inflation rates and no external constraints or, on the contrary, in more inflationary countries which have had to fight simultaneously against internal imbalance and external deficit. In the first group of countries, the concurrence of receding inflationary expectations, the temporary pause in the business revival and the moderate, steady growth of the monetary aggregates has produced a further "normalisation" of the markets, and implied on the whole a stabilisation or a downward trend in interest rates. In the second, more numerous group of countries, monetary policy has had to be deliberately restrictive. This led at various times during 1976 to sharp increases in interest rates — followed, however, by substantial declines wherever the reversal in the external position of the country made it possible to relax the restrictive stance of policy.

International payments have continued to be dominated by huge and sometimes persistent imbalances (Chapter V). As a direct result of the cyclical recovery, the oil disequilibrium has again increased, the surplus being heavily concentrated in a very small number of low-absorbing OPEC countries. This suggests that there is little hope for its early disappearance. As pointed out above, there have been some changes for the better in the external balances of the oil-consuming countries: not only within the OECD area, but also among the non-oil LDCs. However, the total imbalance in world payments — i.e. the sum of individual deficits and surpluses on current account — did not decline in comparison with 1975. Moreover, the heavy concentration of deficits in some LDCs as well as in a dozen or so OECD countries should certainly be regarded with concern. Nonetheless, the financing of these imbalances has not so far run into major difficulties, thanks to the flow of private capital, bank lending and official funds. The chapter ends with a discussion of the successes and failures of the adjustment process and the rôle that could be played by exchange rate movements in facilitating better adjustment. The conclusion is that, while there is scope for improving the mechanism of adjustment, the world will have to live with substantial imbalances. Is the flow of international financing likely to be adequate?

Judging by recent experience, the answer is undoubtedly "yes". International bank lending (Chapter VI) has continued to provide ample funds for the deficit countries, both through the narrowly defined Euro-currency market and by means of foreign lending in domestic currencies. The year 1976 saw a confirmation of most of the trends that had emerged a couple of years earlier: the increasing rôle of US banks' lending either directly from the United States or through other financial centres; the development of offshore centres; and the dominant share of balance-of-payments financing in international bank lending. "Confirmation" is perhaps an understatement: 1976 witnessed a strong acceleration of these tendencies, especially during the last quarter. They have, of course, raised problems of their own, especially in connection with the risks borne by the banks. The chapter pleads in favour of better information and a strengthening of co-operation between private lenders and international institutions.

Chapter VII describes exchange rate developments, the course of official interventions and the gold market, and discusses the two topical, interdependent issues facing international monetary policy today: the management of exchange rates and the adequacy or insufficiency of international liquidity.

On the first of these issues, governments should certainly remain free to "manage" exchange rates, but under the international surveillance of the IMF. Exchange rates should be allowed to reflect pronounced and persistent underlying differences in domestic inflation rates; but it would be just as mistaken to allow exchange rate movements to contribute to an accentuation of inflation differentials as to prevent them from responding to the latter. Moreover, some external imbalances will be cured only if there is a change in *real* exchange rates — and no such change will occur unless there are major shifts in domestic policies. An assessment of each individual country's exchange rate policy should therefore take into account, on a case-by-case basis, a complex body of evidence and set of policy objectives. Surveillance of exchange rate policies should not, because it could not, rely on any simple, predetermined guidelines.

On the second issue, the Report stresses the difficulties of defining unambiguously the concept of international liquidity. For a number of years now the supply of deficit financing seems to have been determined by the demand for it, and the chances are that there will not be — because there cannot be — a *global* shortage of balance-of-payments financing in the future. Defined in this broad and global sense, international liquidity is probably sufficient. But there can still be specific shortages, for it is by no means certain that international loans will always flow in the right directions, or that adequate conditionality will be attached to them. This points to the desirability of co-operation between official institutions and private lenders; in this sense, international liquidity needs to be strengthened, mainly by increasing the resources available to the IMF for granting conditional credit.

II. THE COURSE OF ECONOMIC RECOVERY.

Over the past year the recovery in economic activity proved to be disappointingly weak. Although the upswing was initially buoyant and promising, it came to a fairly abrupt halt in the early summer of 1976. Signs of renewed expansion did not emerge until late in the year and early 1977 — and even then only in a few countries. Investment activity remains sluggish, and unemployment is expected generally to remain high even if the recent revival of business confidence is soon more broadly confirmed.

Several constraints inhibit active demand stimulation by governments. The rate of inflation is still high in almost all countries, and even where it has continued to decline there is acute concern that new stimulatory measures would revive inflationary expectations. Public-sector budget deficits have remained unusually large everywhere, giving rise to fears that further stimulus would take them to intolerably high levels in both the short and the long run. Some countries, moreover, are manifesting a loss of faith in the efficacy of demand management through discretionary fiscal policy. Finally, a large number of countries simply cannot afford to undertake domestic expansion since they are already running unsustainably large external deficits.

Recession and upswing: Some international comparisons.

As recorded in last year's Report, economic activity in the early months of 1976 seemed to be in a phase of strong recovery. On the basis of substantial production increases in most countries during the first quarter, it appeared that the ground lost in the recession would be speedily regained and that the momentum of activity would carry output on to higher levels. While it was recognised that re-stocking was playing a major rôle and that many deep-rooted problems of a structural nature remained to be solved, there was also growing concern that such a synchronised buoyant upswing might fairly quickly lead to a re-emergence of the inflationary strains experienced in the years 1972–73.

By late spring, however, the economic upswing had already begun to lose its momentum and in the summer it came to a virtual standstill, even in the key "strong" countries — the United States, Germany and Japan — where the seeds of recovery had been thought to be most firmly implanted. Until nearly the end of the year economic activity wavered along this plateau, giving rise to uncertainty as to whether the western industrial world was simply experiencing a lengthy pause or was running up against some more fundamental impediments to sustained expansion.

More recent developments have to some extent helped to dispel the gloom. This applies particularly to the United States where, despite a short interruption caused by extremely bad weather conditions in early 1977, production has been rising quickly again since late 1976. In Germany output has once more been expanding since late last summer, although at a more moderate pace than earlier in the upswing. In Japan, on the other hand, domestic demand has tended to remain weak, particularly in relation to growth potential, and the authorities have sought in recent months to give a measured dose of new stimulus. In all three countries, it may be added, the authorities have repeatedly given reassurances that steps will be taken, if necessary, to keep their economies on a moderate upward course.

The statistical profile of recession and recovery, measured in terms of changes in industrial production, is shown for the major western industrial countries in the accompanying table. By the middle of 1976 production had more or less returned to its mid-1974 level (which approximately marked the preceding peak in most countries), the principal exceptions being Belgium, Sweden, Switzerland and the United Kingdom.

Movements in industrial production.[1]

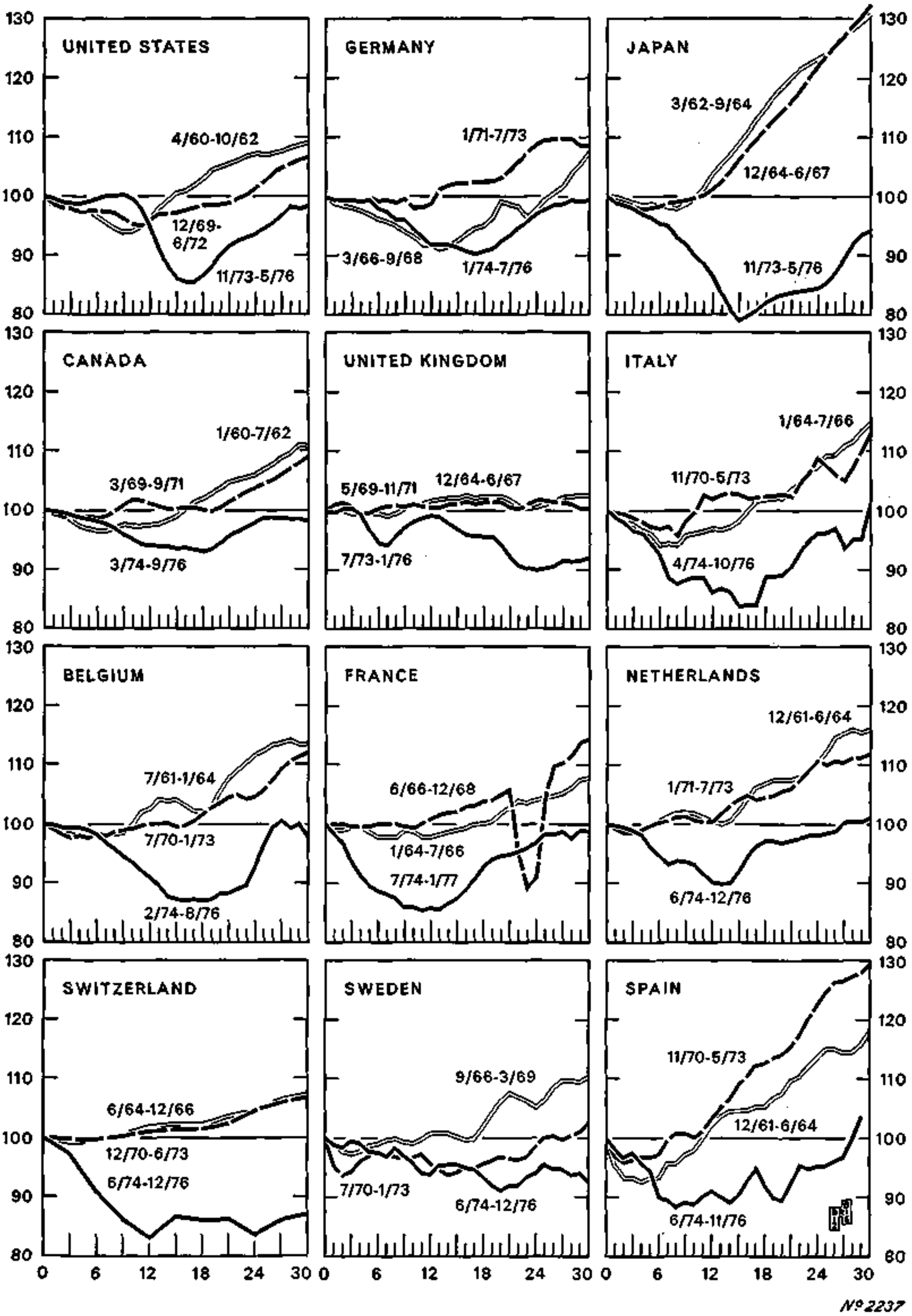
Countries	Change over twelve months to June 1975	Change over twelve months to June 1976	Change June 1976 to February 1977 at annual rate	Overall change June 1974 to February 1977
	in percentages			
United States	− 11.8	11.8	3.7	1.1
Germany	− 7.6	10.3	2.9	3.9
Japan	− 11.2	13.2	3.1	2.7
France	− 10.4	10.7	3.6	1.6
Italy	− 12.4	11.6	12.6	6.0
United Kingdom	− 8.8	1.8	6.9	− 2.9
Belgium	− 11.4	8.3	3.1	− 2.1
Canada	− 5.8	5.0	3.6	1.3
Netherlands	− 8.7	7.8	—	− 1.6
Sweden	− 6.5	1.6	− 3.4	− 7.2
Switzerland	− 16.6	2.2	7.8[2]	− 11.4[2]

[1] Seasonally adjusted data. [2] To December 1976.

After the middle of 1976 the development of industrial production varied from country to country but the picture was broadly one of faltering recovery. By February 1977 output in a number of countries was still below mid-1974 levels. Moreover, given that potential output had continued to expand as a result of additional investment and in some cases a growing labour force, unemployment remained high or increased even further (see Chapter III).

The striking features of the present production cycle, namely its unusual depth and the weakness of recovery, can be seen in the accompanying graph. The course of the monthly industrial production index for each country is traced from the preceding cyclical peak and compared with previous cycles in that country. It is true, of course, that the current recovery as measured from the cyclical trough has not differed greatly from previous cyclical upswings. The essential point,

Cyclical comparisons of industrial production.
Months from preceding peak (= 100).*



* Centred 3-month moving averages.

however, is that the troughs from which countries started were much deeper than those of past post-war recessions. Thus, it was possible for economic activity to follow a "normal" recovery path for a considerable period and still remain well short of full resource utilisation.

Consequently, the current recovery has left much more slack than did previous upturns at comparable stages of the cycle. In the United States, for example, the two earlier recoveries shown in the graph succeeded in restoring a near-normal rate of capacity utilisation in manufacturing industry. At the end of 1976, however, capacity utilisation stood at just over 80 per cent., according to estimates of the Federal Reserve Board. While this was well above the 1975 low of 70 per cent., it was still far below the 1973 peak of 88 per cent. This partly reflected the fact that, over the three intervening years, manufacturing capacity in the United States increased by almost 10 per cent., and a more or less similar development may be assumed to have taken place elsewhere. Survey data for other countries generally showed that utilisation rates had climbed less than half-way back from the trough to their previous cyclical peak.

Outside the western industrial countries, economic activity tended to expand but at a rather laboured pace. Industrial growth in the eastern European countries was somewhat less vigorous in 1976 than it had been the year before. As a group, these countries too are faced with the difficulty of adjusting to the higher price of energy, and they have also implemented measures to improve their trade position and curb the growth of their external indebtedness. These measures, of course, have had a dampening effect on their imports from the western countries. Elsewhere, the economic situation of the non-oil developing countries showed some modest improvement in 1976, as the economic recovery in the western industrial countries led to a revival in the demand for primary commodities. Although the external payments deficit of some of these countries is still quite large, in most it has been reduced to a level that can be sustained without a further retardation of domestic development efforts.

Patterns of recovery: A varied picture.

Fluctuations in inventory investment have played an unusually important rôle throughout the current business cycle, accentuating both the downswing and the early phase of the upswing. As the economic outlook deteriorated sharply in 1974, business firms sought to avert the danger of being left with a huge overhang of inventories. Once the stock cycle had turned, in most cases during the spring of 1975, the replenishment of inventories went ahead quite rapidly. In the United States the swing in inventory investment between the second quarter of 1975 and the first quarter of 1976 accounted for nearly half of the 5.9 per cent. growth in real gross national product. In other industrial countries swings were generally less pronounced than in the United States but they were still very sharp by historical standards. As a rule, of course, inventory fluctuations tend to be closely related to the rate of change in final demand. Hence, when final demand slowed down last year and inventories were found to be piling up faster than planned, business firms reacted by curtailing production.

The question, then, is why real final demand slowed down so abruptly at mid-year. In this connection, it would be helpful to examine how the components of demand have behaved during the current recovery in relation to past cyclical experience. The table below shows the total percentage change in these components, measured from the preceding cyclical peak, for the current and two previous cycles. It refers only to the six countries for which quarterly national income data are available, but these countries account for about 80 per cent. of total OECD output. Dates of the cyclical peaks in the individual countries were chosen on the basis of industrial production movements. The real gross national product data, which include spending on public and private services as well as on residential construction, are of course broader in coverage than industrial production data. However, they confirm that the current recovery in real output has been considerably weaker in most countries than at comparable stages of past cycles. But beyond this broad generalisation the differences in the behaviour of the components of real final demand in individual countries seem to be as striking as the similarities.

A cyclical comparison of cumulative changes in the components of real gross national product.

Countries	Periods compared[1]	Real gross national product	Consumption		Investment[2]		Exports	Imports
			private	public	non-residential	residential		
		cumulative percentage changes from previous peak						
Germany.	II/66 — I/69	10.8	9.7	5.2	11.8	— 6.1	30.7	25.3
	III/71 — II/74	9.0	6.2	13.0	— 6.5	— 3.8	42.7	23.5
	I/74 — IV/76	2.9	8.3	8.8	7.4	—11.2	3.9	20.0
United Kingdom . .	IV/64 — I/68	8.7	9.5	12.6	17.0	24.7	19.7	17.1
	II/69 — III/72	8.0	12.6	9.4	8.8	5.9	8.6	19.3
	III/73 — IV/76	1.8	— 1.2	10.4	—13.9	0.9	13.0	0.6
Japan	I/62 — I/65	31.0	30.9	24.6	31.7	71.0	62.4	39.2
	IV/64 — IV/67	33.0	26.6	17.0	40.4	50.4	37.2	52.9
	IV/73 — IV/76	8.1	9.2	15.2	—12.9	— 0.5	50.0	7.3
United States . . .	I/60 — II/63	11.2	10.9	15.3	9.0	13.4	22.0	13.0
	IV/69 — I/73	14.1	16.0	— 0.0	12.5	60.6	31.2	26.1
	IV/73 — I/77	4.4	10.0	4.7	— 7.9	— 3.9	7.8	10.3
Canada	I/60 — IV/62	11.7	8.5	20.1	5.1	— 9.3	9.7	— 1.6
	I/69 — IV/71	13.0	13.6	19.1	14.9	15.4	15.4	13.9
	I/74 — IV/76	4.5	14.6	7.7	0.5	— 0.7	— 0.9	8.2
France.	I/64 — I/66	10.4	8.3	12.1	15.8	29.0	15.7	9.6
	II/66 — II/68	2.7	5.8	8.7	12.2	— 2.5	— 6.9	5.3
	III/74 — III/76	3.5	8.3	1.6	4.1		6.6	12.7

[1] For each country the most recent cycle, covering the period from the peak to the latest quarterly figures, is compared with the performance over the same number of quarters in previous cycles. [2] Excluding changes in stocks.

Perhaps the biggest difference has been in the development of external trade relationships in individual countries. Whereas Germany, against the background of an appreciating Deutsche Mark, was quite successful in stimulating private domestic demand (except housing) and in shifting it towards imports, private domestic demand in Japan remained relatively weak and a very large increase in real net exports of goods and services was recorded. In the United Kingdom private (but not public) consumption, as well as plant and equipment investment, dropped off markedly in this cycle; however, the concurrent improvement in real net exports has to be set against a deterioration in the terms of trade. In contrast, private consumption in Canada and France was relatively strong and appears to have contributed to weakness in the external accounts.

With regard to the similarities, there was a certain consistency in the behaviour of individual demand components. Fixed investment in plant and equipment remained unusually depressed almost everywhere (except Germany), but particularly in countries where consumption was especially weak. In the housing sector, too, the construction of new dwelling units has been running well below pre-recession peak levels.

Cyclical and structural change: Where do we stand?

The protracted economic pause after mid-1976 was a perplexing development that took policy-makers by surprise. More recently, despite signs that the advance has been resumed in some countries, doubts persist as to how vigorous this revival will be and how long it can be sustained on a stable path. The present cycle has certainly proved to be very different from previous ones in terms of depth, duration and underlying causes. In most countries 1977 marks the fourth year since the previous cyclical peak, and in many countries it appears that several more years will have to pass before unemployment can be reduced to acceptable levels. This cycle is clearly not the same, either quantitatively or qualitatively, as that of the 1930s. But seen as an extended "growth" depression, in the sense that the growth of output remains for many years well below its previous trend, it also differs appreciably from most recessions since the war. Is the weakness of the current recovery due to an abnormal cyclical response of public policy? Or are more fundamental structural factors at work? As far as diagnosis and prescription are concerned, a number of widely differing approaches have been adopted. The analyses proposed are not always mutually exclusive, and their relevance may vary considerably from country to country.

According to one view, our present economic malaise is largely ascribable to the fact that the policy-making authorities, particularly in the "strong" countries, have been excessively cautious in stimulating aggregate demand. They failed earlier, it is said, to appreciate that the major inflationary impulses of recent years, such as the sharp rise in oil and food prices, were mostly of an extraordinary and transient nature. Nor did they adequately allow for the strong depressive impact of these exogenous price increases on expenditure. Hence, in seeking to combat inflation by severely restraining domestic demand, the authorities unwittingly contributed to a recession whose cumulative costs, measured in terms of unemployment and lost output, far outweigh the costs of the feared inflation itself. Over the past year proponents of this view have contended that a moderate additional demand stimulus, given the extensive under-utilisation of capacity and manpower prevailing, would not imply unacceptable inflationary risks. Moreover, such action is seen as a prerequisite for growth in world trade at a pace which could help weaker countries to earn their way instead of accumulating ever-heavier debt burdens.

A second and contrasting view holds that economic "fine-tuning" by means of discretionary fiscal policy has come to have little more than a transient impact on real output and employment. Furthermore, faster growth in the monetary aggregates, though it may provide an effective short-run stimulus, tends over the long run merely to accelerate the rate of price inflation. At the same time, the high level of unemployment is regarded as an inevitable consequence and cost of past inflation, and hence the elimination of inflation is considered to be a precondition for renewed, sustainable growth. In other words, given the high sensitivity of modern goods and labour markets to wage and price expectations, there is no longer any reliable short-term trade-off between unemployment and inflation. Any further discretionary stimulus to economic activity would, by enhancing inflationary expectations, soon lead to offsetting reactions in the private sector. Business firms, expecting subsequently to be caught between rising costs and a return to a policy of restraint, would postpone planned investment. Consumers, expecting the value of accumulated savings to be further eroded, would spend less. Investors, expecting interest rates to rise, would shift their funds away from the capital and equity markets and into more liquid assets. Thus, according to this view, the surest way to get back on a stable growth path is simply to persevere with a policy of moderate, steady expansion of the monetary aggregates.

A third view regards our current problems primarily as a consequence of long-term trends in both income distribution and sectoral financial positions. For a number of years now, it is argued, the income share accruing to business firms has undergone a steady erosion. This skewing in factor shares has materially reduced firms' ability and willingness to undertake new productive investment. Over much of this time, furthermore, inflation mitigated that erosion by reducing the real burden of outstanding financial liabilities and facilitating recourse to additional borrowed funds at very low real interest rates. Then, from about 1974 onwards, companies experienced acute cash-flow problems and awoke to the need for an extended period of balance-sheet restructuring. Their efforts took the form of a reduction in costs and work forces, the cancellation or postponement of investment projects and the rebuilding of liquidity positions, partly through the repayment or lengthening of debt. The process of financial restructuring is now fairly well advanced in some countries, but the desire to avoid a renewed deterioration may still be acting as an impediment to investment. Moreover, while the squeeze on profit shares has eased up appreciably in various countries, profitability is historically low and appears still to be discouraging new investment. In addition, consumers have held back on spending and have been saving at an unusually high rate. While this partly reflects the inroads on real financial wealth caused by persisting inflation, uncertainties relating to income and employment prospects have also contributed to households' cautious mood.

Finally, there is a genus of opinion that views present-day problems in still longer-term perspective. Some observers, for example, believe that we have reached a turning-point in the so-called Kondratieff cycle, involving long cyclical swings that extend over periods of twenty-five to fifty years. A current interpretation holds that the western industrial world's remarkable economic advance over recent decades has been based on the availability of cheap and plentiful sources of food, raw materials and energy. This situation is considered to have changed in a fundamental way, so that further progress depends on the implementation of far-reaching structural adjustments based mainly on an upgrading and redirection of national investment efforts. Along different lines, mention is sometimes made of certain other long-term developments which seem to be acting as a constraint on renewed growth, such as the emergence of extensive excess capacity in housing construction, shipbuilding, iron and steel, and textiles.

This catalogue of diagnoses is a long one but it reflects the many imponderables standing in the way of a balanced assessment of the present position and prospects. In the following pages an attempt will be made to throw a little light on some of these issues. The view that emerges will be an eclectic one.

The utilisation of resources: Adjustment versus accommodation.

Since the early 1970s individual industrial countries have been subjected to a series of unusual external shocks: the breakdown of the system of fixed exchange rates, an unprecedented bout of world inflation and a steep rise in the prices of oil and other commodities. In reaction to the inflationary strains and external deficits that emerged in 1973–74, national authorities adopted widely differing policy stances, ranging from "adjustment", mainly by combating inflation, to "accommodation", by sustaining domestic demand and employment. As a consequence, countries have more recently found themselves on very dissimilar terrain, as far as the contours of their particular problems are concerned. While it is true that the diffusion of recession left practically all of them with high unemployment and weak aggregate demand, this does not imply that there has to be a common solution. The fact is that each country seems to have its own characteristic problems relating to the broad allocation of resources — between domestic absorption and exports, between the public sector and the private sector and between consumption and investment.

Personal consumption and saving. In this recovery, as in previous ones, the prime mover was an acceleration in consumption spending and a closely related rebuilding of stocks. Where available, quarterly and half-yearly data for the principal industrial countries indicate that consumption speeded up appreciably during the initial recovery phase, though with considerable differences in timing. The additional spending was concentrated mainly on durable goods, especially motor cars. In the United States, for example, real outlays on durable goods increased over the year to the first quarter of 1976 by 17 per cent. but then slowed down to an annual growth rate of under 4 per cent. over the remainder of the year. While data on durable consumer goods expenditure are not generally available for other countries, new car registrations in Germany and Japan suggest that similar developments occurred in these two countries as well. Already in the first half of 1976, however, the growth of consumption began to falter in one country after another, and in the second half it was much below normal in practically all of them. This abrupt change of pace weakened business confidence and induced a renewed decline in stocks.

Changes in real gross national product and its components.

Countries	Years	Real gross national product	Final demand*	Exports	Imports	Domestic demand: Total	Consumption: private	Consumption: public	Investment: non-residential	Investment: residential
		annual rates of change, in percentages								
Belgium . .	1962-73	5.1	4.9	10.6	10.3	4.7	4.6	5.6	4.5	4.5
	1974	4.2	3.6	10.7	11.6	3.9	2.5	4.4	6.8	10.2
	1975	− 1.8	1.2	− 9.9	−10.9	0.9	0.9	7.0	− 3.5	− 6.1
	1976	2.3	− 0.2	7.0	8.5	0.4	2.3	3.5	− 6.2	13.9
Canada . .	1962-73	5.6	5.6	9.4	9.0	5.6	5.4	5.5	6.1	6.8
	1974	3.2	2.4	− 2.3	8.9	5.2	4.9	6.6	7.0	− 2.0
	1975	0.6	3.0	− 7.3	− 2.5	4.0	4.8	3.7	5.0	− 7.7
	1976	4.6	3.7	9.5	8.1	4.5	6.3	3.0	− 3.5	18.8
France . . .	1962-73	6.1	6.1	11.1	12.0	6.2	5.5	5.6	7.9	7.8
	1974	2.9	3.3	9.8	4.8	2.3	2.6	2.8	− 0.3	4.9
	1975	− 1.4	1.7	− 3.7	− 7.2	1.3	3.2	2.7	− 4.6	− 3.9
	1976	4.9	.	9.5	15.8	.	4.2	4.2	.	.
Germany . .	1962-73	4.6	4.6	10.1	9.9	4.4	4.6	3.8	5.5	3.5
	1974	0.4	1.6	12.5	4.7	− 1.4	0.2	4.5	− 8.2	− 8.7
	1975	− 2.5	− 2.6	− 9.1	0.8	1.1	2.5	3.6	0.4	− 9.0
	1976	5.5	3.6	10.4	10.8	3.6	3.3	2.8	6.5	2.5
Italy	1962-73	4.8	4.7	9.2	9.4	4.7	5.4	3.9	3.4	2.2
	1974	3.9	4.2	9.3	2.1	2.7	2.5	2.9	3.9	2.6
	1975	− 3.6	− 0.5	3.4	−10.5	− 3.3	− 1.4	2.7	−14.8	−11.6
	1976	5.6	3.0	11.8	12.3	2.8	3.2	1.9	3.6	− 1.2
Japan . . .	1962-73	10.2	10.1	14.4	14.2	10.2	8.8	6.2	12.6	15.1
	1974	− 1.3	− 1.6	19.2	11.7	− 2.5	1.4	4.3	−10.4	−11.7
	1975	2.4	4.6	4.3	− 8.5	0.7	6.0	6.8	− 5.9	7.9
	1976	6.1	6.1	15.6	7.6	3.0	4.3	4.3	3.6	9.8
Netherlands	1962-73	5.7	5.6	10.8	10.8	5.1	5.6	2.9	5.5	9.3
	1974	2.4	2.4	3.0	0.0	0.5	2.3	1.4	− 1.3	−13.7
	1975	− 2.2	0.4	− 3.7	− 2.7	1.3	3.0	2.6	− 3.1	− 7.1
	1976	4.2	2.7	9.2	9.7	2.6	4.0	4.0	− 4.0	2.2
Norway. . .	1962-73	4.2	4.2	8.0	8.0	4.3	4.0	5.7	4.5	7.3
	1974	5.0	2.1	0.5	4.3	3.9	4.0	3.3	5.9	− 0.3
	1975	3.6	5.5	3.1	6.6	7.0	5.4	5.0	10.8	7.3
	1976	5.3	5.4	7.3	10.8	7.1	6.1	4.5	13.7	− 1.0
Spain . . .	1962-73	6.9	6.8	12.6	12.0	6.8	6.2	5.9	9.3	
	1974	4.9	6.2	− 1.6	4.7	5.3	5.6	5.7	4.4	
	1975	0.8	.	− 2.7	− 2.0	0.9	2.1	3.6	−3.5	
	1976	1.7	.	7.4	5.1	1.6	2.3	3.9	−1.4	
Sweden . .	1962-73	3.8	3.8	9.1	7.5	3.4	2.9	4.4	4.1	2.7
	1974	4.0	1.5	8.1	14.9	3.2	4.3	2.9	3.8	3.2
	1975	0.6	− 0.1	− 9.0	− 2.1	2.1	2.9	5.5	− 1.5	2.1
	1976	1.0	4.9	6.8	5.5	4.5	3.2	2.9	0.3	4.5
Switzerland.	1962-73	4.2	4.3	7.2	7.5	4.2	4.2	3.6	4.1	5.3
	1974	1.7	− 0.4	1.9	− 0.6	− 1.4	− 0.5	1.6	0.0	−17.4
	1975	− 8.0	− 2.6	− 7.0	−15.4	− 5.6	− 2.9	1.4	− 8.3	−39.3
	1976	− 0.1	− 2.0	8.9	10.4	− 2.0	− 1.7	6.0	− 6.9	− 4.8
United Kingdom .	1962-73	3.1	2.9	6.1	6.3	3.0	2.9	2.3	4.6	3.5
	1974	− 0.5	0.6	7.3	1.3	− 1.2	− 1.2	1.9	− 1.4	− 2.5
	1975	− 2.4	0.3	− 4.1	− 6.7	− 0.5	− 1.0	4.6	− 3.0	6.6
	1976	1.4	−	6.7	4.9	− 0.7	0.2	2.7	− 5.3	− 0.3
United States . .	1962-73	4.0	4.0	7.5	8.1	4.0	4.3	2.5	4.7	4.2
	1974	− 1.7	− 1.1	10.6	1.0	− 1.8	− 1.1	1.7	− 1.5	−27.8
	1975	− 1.9	− 0.1	− 7.0	−17.0	− 0.7	1.5	2.9	−12.0	−16.3
	1976	5.9	4.3	5.9	16.2	4.9	5.5	2.9	0.6	20.0

* Equals change in real gross national product minus net investment in inventories.

According to annual data, available for a greater number of countries, the change in consumption spending last year varied considerably from country to country. Comparatively large increases, higher than the 1962–73 averages, were recorded by the United States, Canada, Sweden and Norway. In most other countries, including Germany and Japan, the rise fell within a range of 3–4½ per cent. and was significantly below the long-term rate of growth. In the United Kingdom and Switzerland total consumption spending actually declined, while in Spain its growth was again unusually low. This varied pattern appears to have been largely the outcome of differences in the growth of real disposable income.

But, apart from these differences, why did consumption spending run so quickly out of steam? One reason was the incidence of fiscal drag as nominal pre-tax incomes continued to be pushed up by wage/price inflation. In 1976, according to OECD estimates, changes in the impact of net taxes on households (direct taxes and social security contributions less transfer payments) significantly reduced the growth of real disposable income in the United States, Canada, France, Germany and Italy. Another reason was the leakage from the domestic income stream of expenditure associated with higher payments for oil imports.

Still another factor was the behaviour of personal saving. In many countries, it is true, consumption continued to benefit from a decline in personal saving ratios from their unusually high levels. But the decline was limited, or even for a time reversed, and saving propensities generally remained exceptionally strong. On the one hand, inflation continued to reduce the real value of financial assets in many countries, and financial investors tried to make good this erosion of wealth by higher rates of current saving. On the other hand, large-scale unemployment and uncertainties about prospective income and job security encouraged a high rate of saving based on precautionary motivations.

Ratios of personal saving to disposable income.[1]

Countries	1965–69	1970–74	1975 1st half	1975 2nd half	1976 1st half	1976 2nd half
	in percentages					
Canada	5.9	7.9	10.9	9.6	11.0	8.1
France	15.4	17.1	17.7		16.3	
Germany	12.2	14.3	16.8	14.8	14.5	14.6
Japan	18.8	21.6	23.8	22.9	22.7	22.2[2]
United Kingdom	8.3	10.7	15.0	14.7	14.9	13.6
United States	6.5	7.8	8.1	7.5	7.0	6.0

[1] Seasonally adjusted data from national sources. [2] Third quarter.

The most important reason of all, perhaps, was that the growth of personal disposable income was not sustained mid-way during the upswing by the usual pick-up in dwelling construction and new investment in plant and equipment. What were the obstacles to recovery in these sectors?

Dwelling construction. In past cycles housebuilding has generally been a stabiliser of prime importance. Typically, as credit-market conditions ease during a recession, mortgage funds become relatively cheap and plentiful, and new construction plays a leading rôle in moving the economy upwards again. Subsequently, with plant and equipment investment responding to rises in consumption and construction activity, credit markets begin to tighten again, which in turn leads to a tapering-off in dwelling construction.

Over practically the whole of the post-war period, moreover, housebuilding in most countries recorded a strong underlying uptrend. In a number of cases this trend owed much to official policies designed to encourage dwelling construction: public housing, subsidies, fiscal privileges, savings schemes and the like.

But in the current cycle dwelling construction has not taken hold in the usual way. In 1975 the trough of the recession in dwelling construction more or less coincided in most countries with that in overall industrial activity. In a number of countries, such as the United States, Japan, Germany, the Netherlands, Sweden and Switzerland, the trough was quite deep, marking the end of a downslide of two or three years' duration. The decline was also sharp and protracted in France and Italy, but occurred with a sizable time-lag. Beginning in 1975, a fairly buoyant recovery got under way in the United States and Canada, and last year signs of renewed advance were also evident in Belgium, the Netherlands and Sweden. But elsewhere dwelling construction has remained relatively depressed.

How can the prolonged weakness in the housebuilding sector be explained? It seems unlikely that financing constraints are the main impediment. In most countries the financial institutions that lend mortgage money have experienced large inflows of new funds in recent years, and loanable funds are now generally in ready supply. However, mortgage interest rates remain fairly high by historical standards and may therefore be a deterrent to borrowing. This could easily be the case if, as seems probable, borrowers' expectations about the likely rise in house prices are now much less exuberant than in the past. Indeed, the weakest segment of the housing market has been that concerned with multiple-unit construction for sale or rent. This has been the case, for example, in France, the Netherlands, Switzerland and the United States. In such undertakings, of course, profit margins and expectations of long-term capital gains play a major rôle. In short, the recession in dwelling construction has been partly a reaction to the slowing-down of inflation after a long period of accelerating price rises.

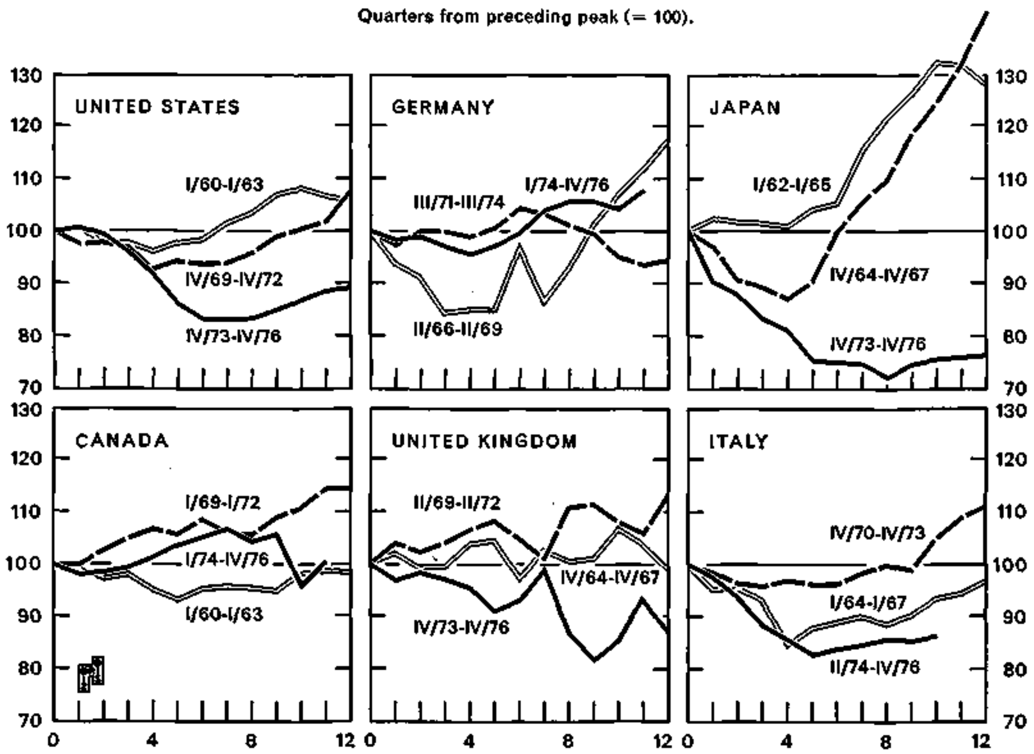
Some still longer-term factors may also have been at work. Historically, there is some pre-war evidence of long housing cycles of some twenty years' duration and it is possible that post-war tendencies of this kind have more recently begun to express themselves. In many countries housebuilding capacity was geared at an early stage to the rapid production of new dwellings, and a high growth rate has been maintained on average over many years. But for some time housing demand, particularly in Germany, Switzerland, the Netherlands and Scandinavia, has shown signs of saturation. This tendency has been reinforced in some cases by demographic trends, particularly marked in certain areas, towards a slowing-down of both population growth and current household formation. In some countries, such as

Germany and Switzerland, the authorities have seen a need to initiate a gradual reduction in the size of productive capacity in this sector. All in all, the outlook for housing is relatively buoyant only in a limited number of countries, while elsewhere modest growth or even further decline may be expected.

Business fixed investment spending.

At the beginning of 1976 many observers had counted on a revival of business spending on fixed investment goods to impart added thrust to the recovery later in the year. This had been the normal pattern of past recoveries. However, at the end of 1976 *real expenditure on business fixed investment in most countries* other than Germany not only remained well below the pre-recession peak but also lagged far behind the pace of past cyclical experience. Indeed, in Japan, the United States and Italy real plant and equipment spending had barely increased at all above the cyclical low reached in 1975. In Germany business fixed investment was spurred in part by the investment premium instituted in late 1974, but its recovery has been modest in relation to the level of investment already attained by 1970. The continuing weakness of business fixed investment spending played a key rôle in the mid-year pause in the recovery. Without the sustaining impetus of higher plant and equipment expenditure, the interacting expansion of employment, disposable income and consumption spending simply petered out.

Real non-residential fixed investment.
Quarters from preceding peak (= 100).



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The incentive for business firms to undertake investment in new plant and equipment is determined jointly by the rate of return they expect to earn on the investment and the cost of capital — i.e. the rate of return that companies are required to earn by their owners, given the yields that can be obtained on alternative investments. While these elements are difficult to measure, partly because they relate to expectations, it is still possible to form a tentative assessment of how they have behaved during the current recovery.

The cost of capital is the cost to companies of financing new investment projects. In the accompanying table the interest yields on corporate bonds in selected years are shown for the United States, the United Kingdom and Germany. While these long-term interest rates have lately receded from the all-time peaks reached in 1974, they are still quite high by historical standards. Of course, during periods of rapid inflation it is extremely difficult to gauge whether nominal rates are effectively high or low since they incorporate a premium to cover expected inflation. In this connection, a more reliable measure — one that is less susceptible to inflation though not altogether immune — is the dividend/price ratio on equity shares. The dividend yield, while not precisely equal to the cost of capital, is nevertheless likely to mirror large medium-term movements in this cost.

Yields on long-term corporate bonds and equity shares.

Countries	Yields on long-term corporate bonds					Dividend/price ratio for corporate equities				
	1964	1968	1972	1974	1976	1964	1968	1972	1974	1976
	annual averages									
Germany	6.2	6.7	8.1	11.1	8.2	3.0	3.1	3.1	4.2	3.5
United Kingdom	6.5	8.3	9.8	16.7	15.2	4.7	3.7	3.3	8.2	6.0
United States	4.8	6.9	8.2	9.5	9.8	3.0	3.1	2.8	4.5	3.8

The dividend yields for the United States, the United Kingdom and Germany are shown on the right-hand side of the table. In all three countries the yield had risen to quite high levels in 1974 because of a large risk premium due to the uncertainties of deep recession and rapid inflation. By 1976, however, the yield in Germany had fallen to a level not far above that of 1972, a year marked by large capital outlays. In the United Kingdom, on the other hand, the dividend yield in 1976 remained well above those of comparable earlier periods, and the same was true of the United States, though to a much smaller extent. The historically high level of dividend yields reflects to some extent the relatively low level of stock prices. For instance, from 1963–65 to 1976 industrial equity prices, adjusted for inflation, declined in Germany, the United Kingdom and the United States by 45, 50 and 20 per cent. respectively. This probably reflects a combination of uncertainties concerning profits and the continuation of high inflationary expectations. In any event, it would appear that the cost of capital has remained comparatively high and has been one factor discouraging companies from undertaking new investment.

With regard to the other aspect of the incentive to invest, company profits staged a much better come-back during the upswing in some countries than in others. Up to the end of 1976 after-tax profits on a book-value basis more than doubled in relation to their cyclical low in the United States and Japan, while a smaller but still appreciable increase was recorded in gross trading profits in the United Kingdom. Nonetheless, company profits in Japan and the United Kingdom were still below pre-recession levels. In Germany company profits increased substantially in the first half of 1976 — helped along by the recognition given by the trade unions to the need for some improvement in company capital structures — but this gain was partly eroded in the second half of the year. In certain countries, on the other hand, persistent upward pressure from the costs side, combined in some cases with regulations limiting price adjustments, exerted a continuing squeeze on profits. Profitability has also been significantly influenced in some countries by exchange depreciation or appreciation.

Then why, at least in countries where profits have made a good recovery, did business fixed investment fail to pick up sooner? One consideration, already alluded to, is that the rate of return on capital is still historically quite low in many countries, particularly when measured in relation to the cost of capital. Last year, according to preliminary estimates for the United Kingdom, the pre-tax rate of return on capital earned by industrial and commercial companies was only a little above the low of 3.5 per cent. to which it had plunged in 1975. In the years 1964–66 it had averaged 11.0 per cent. but declined fairly steadily thereafter. In the United States, while there has been more of an improvement, the situation is still not conducive to a revitalisation of investment. There the post-tax rate of return on capital earned by non-financial corporations is estimated to have risen to 5 per cent. in 1976 from 3.5 per cent. in 1974, but it was still well below the average of 8.0 per cent. recorded over the period 1964–66. This is not surprising, considering that there is still a high degree of unused capacity and that the replacement cost of capital goods has risen sharply in recent years. This has been confirmed in all instances where the principles of inflation accounting, however diversely defined, have been applied to corporate accounts.

A second reason is that companies in most countries have taken advantage of their higher profits to strengthen their financial positions. Over many years of accelerating inflation companies had gradually burdened themselves with large amounts of fixed-interest debt, much of which was at short term. Thus, as the recession deepened and profits plummeted, many of them were faced with severe cash-flow and debt-servicing problems. As a consequence, companies have recently pursued unusually cautious financial policies, using their profits largely to retire debt and strengthen their liquidity positions.

Looking ahead, there is unlikely to be a revitalisation of business fixed investment unless the *expected* profitability of new investment improves materially. Here a number of uncertainties have emerged in recent years and continue to weigh heavily on investment decisions.

One major uncertainty has been the matter of price expectations. In this respect changes in the inflationary climate over the past two years or so have on balance had a depressive effect on the incentive to invest. From the mid-1960s onwards, with inflationary expectations gathering force while real interest rates remained low, the upward course of prices was apparently a strong stimulus to investment, particularly in sectors where speculative gains could be sizable, such as construction projects of all kinds. But then, after the 1973 inflationary boom and the subsequent rise in energy prices, two things happened. One was that national authorities, particularly those in the United States, Germany and Japan, gave high priority to the need to bring down inflation. The other was that there were large changes in relative prices, implying an increase in the variance of prices about their mean course. Indeed, the uncertainty as to whether inflation will accelerate or decelerate seems to lie close to the root of companies' reluctance to invest. In an acceleration of inflation they risk being caught between rising costs and renewed policy restraint measures, while a deceleration of inflation implies being saddled with a heavier burden of debt than earlier expected. And since current rates of inflation (even where they are down to a single digit) have in the past proved to be inherently unstable, only a gradual return to greater price stability — i.e. to near-zero inflation — will allow the resumption of investment growth on a sound, sustainable basis.

A related source of uncertainty lies in the flexibility of exchange rates. Compared with the fixed-rate system, business firms dealing in internationally traded goods now face new unknowns with respect to their market shares and prices received or paid in their domestic currencies. It is true, of course, that flexible exchange rates may help to avert the kind of cumulative investment distortions that can develop when exchange rates are kept fixed too long at unrealistic levels. And indeed, one reason for the weakness in fixed investment in some countries is that their exchange rates have over recent years appreciated to more appropriate levels. More generally, however, flexible rates inject an additional element of price and market uncertainty that may itself act as a general deterrent to investment decisions.

In terms of production costs as well, uncertainties seem to have multiplied. Higher fuel prices have altered the relative efficiency of many production techniques, and it is far from clear how these prices will settle down in relation to other factor prices. Similarly, there is great uncertainty about raw-material prices, whose considerable volatility in the 1970s may have retarded investment in primary processing industries.

Within the governmental framework itself, a number of developments of recent origin have weakened the incentive to invest. Here one may mention the impact of new environmental constraints, uncertainties surrounding present and future energy policies and, in some countries, the lack of political stability. All these add up to cautious attitudes towards new investment.

In some countries, fortunately, the investment climate has recently been improving, but the recovery pattern is rather mixed. In the United States corporate profitability and balance-sheet structures are now much stronger and plant utilisation rates have also increased. According to recent indicators, new capital appropriations have moved to record high levels and nominal plant and equipment outlays are expected to rise by 15 per cent. or more in 1977. In the United Kingdom the real volume of manufacturing investment is expected to increase by over 10 per cent. this year. In Germany, too, investment in machinery, equipment and industrial buildings, which increased by 6.9 per cent. in 1976, is forecast to rise by perhaps 7–8 per cent. again this year. In France investment this year is expected to go up by 12 per cent. in nominal terms, and 4 per cent. in real terms, in relation to 1976. In Canada machinery and equipment investment picked up in late 1976, but industrial construction was severely depressed. In Japan the recovery of business fixed investment has proceeded very slowly, hampered by large excess capacity and uncertainties on both the supply and demand sides, and is forecast to rise in the current fiscal year by only 5 per cent. in current-price terms and to decline slightly in real terms.

Clearly, the factors inhibiting fixed investment vary in importance from country to country, and policies designed to counteract their influence must be adapted accordingly. But there are sufficient similarities within the western industrial world to warrant some general conclusions. First, policies should aim at re-establishing adequate "real" profitability on capital already invested. Without a more normal flow of *current* profits, there will be no increase in capital expenditure. Yet even higher current profits are not enough in themselves: the depth and duration of the recession, the sectoral imbalances, excess capacities and the numerous uncertainties listed above have badly shaken the confidence of decision-makers in the ability of western industrial countries to resume non-inflationary, balanced growth. Hence the need for devising policies which would help restore this confidence. Chapter IV will discuss the rôle of monetary policy in this respect. Let us now turn to the question whether there is scope for stimulating final demand through discretionary fiscal policy.

Fiscal policy and demand management.

Last year public-sector deficits receded somewhat from their unprecedentedly high levels in 1975. This outcome was mainly ascribable to the progress of economic recovery and the correspondingly reduced impact of the automatic stabilisers. Moreover, national authorities were generally very cautious in applying further discretionary fiscal stimuli after about the spring of 1975. Some of them, fearful of the extraordinary size of their deficits, sought deliberately to reduce them, often within the context of a medium-term programme. Last year, therefore, fiscal policy took a moderately restrictive turn, which may itself have been a significant factor in the economic pause after mid-year.

Despite large margins of economic slack in most countries, outsize public-sector deficits have, for better or worse, become a serious inhibiting factor in discretionary demand stimulation. But the extent to which this is true varies from country to country, depending on the size and origins of the deficits, the balance-of-payments situation, the existing degree of economic slack, the sensitivity of price expectations to expansionary fiscal action and official priorities with respect to inflation and unemployment.

How are these large public-sector deficits to be explained? And how is it that, in spite of these deficits, there remains so much economic slack? The most important single factor, of course, was the depth of the post-1973 recession, which automatically caused tax revenues to fall off sharply and necessitated large transfer payments in the form of unemployment insurance and other social benefits. Moreover, in varying degrees national authorities introduced discretionary policies, partly with a view to cushioning the deflationary impact of higher oil prices on private disposable income. As the accompanying table shows, the public sector's net financial deficit increased sharply in most countries from 1973 to 1975.

General government: Total expenditure and net financial deficit.[1]

Countries	Total expenditure					Net financial deficit (—)				
	1965	1970	1973	1975	1976	1965	1970	1973	1975	1976
	as a percentage of gross domestic product									
Netherlands	34.8	44.8	48.1	55.4	57.4	— 0.8	— 0.8	1.1	— 1.8	.
Sweden	34.6	41.6	50.3[2]	51.3	54.8	4.5	4.7	3.9[2]	0.7	3.0
United Kingdom	35.3	38.5	40.6	46.1	.	— 2.1	2.6	— 3.6	— 5.2	— 5.0
Italy	32.9	32.7	40.0[2]	48.2	46.2	— 3.2	— 3.1	— 6.4	—13.3	— 9.2
Germany	36.0	36.9	39.7[2]	46.7	45.9	— 0.4	0.5	1.5	— 5.8	— 4.0
Belgium	32.1	36.2	38.8	45.2	.	.	— 2.4	— 3.7	— 4.4	.
France	37.3	38.8[2]	38.5	39.4	41.7	0.4	1.0[2]	1.0	— 2.3	— 1.5
Canada	28.1	34.6	35.1	40.1	39.7	0.4	0.9	1.1	— 2.5	— 2.3
United States	27.5	31.9	31.2	35.2	34.3	0.1	— 1.0	0.5	— 4.3	— 2.7
Switzerland	20.9	22.4[2]	24.6	27.2	30.5	— 0.9	— 0.5	— 1.6	— 1.6	— 2.4
Japan	19.6	18.5	20.6	25.0	.	— 2.8[3]	— 0.8[3]	— 2.8[3]	— 7.4[3]	— 7.6[3]

[1] Based on national sources. Definitions vary from country to country. [2] New series. [3] Including public enterprises.

Already in 1973, even before the recession began, three countries were faced with large public-sector deficits, ranging from just over 3½ per cent. of gross domestic product in Belgium and the United Kingdom to nearly 6½ per cent. in Italy. In all three countries, but especially the United Kingdom and Italy, this outcome marked a deterioration compared with the previous cycle, measured from peak to peak. Hence, as far as these countries are concerned, the large public-sector deficits of recent years would appear to reflect a substantial element of structural imbalance.

Interestingly, there appears to be no close relationship between the size of public expenditure and that of the net financial deficit. For example, looking at the peak year 1973, the three countries with large deficits had expenditure burdens amounting to about 40 per cent. of gross domestic product, while the comparable figures for Germany, Sweden and the Netherlands, which all recorded surpluses, ranged between 40 and 50 per cent. This suggests that differences in overall budgetary results are to be explained rather in terms of the ability and will to levy taxes than in terms of differences in spending propensities. By the same token, the existence of constraints on the tax side may imply that expenditures in some cases are simply too high.

At all events, concern over public-sector budgets does not relate merely to the size of the deficits but also to the size and composition of government expenditure. In practically all countries there was a large, mainly cyclical, increase in total public expenditure relative to gross domestic product between 1973 and 1975, but in many cases a strong upward trend in this relationship was already in evidence between the high-employment years 1965 and 1973 (see table). The increase in this proportion was comparatively low in Germany, France, the United States, Switzerland and Japan. All these countries, except France, have recently experienced relatively strong external current accounts. Thus, while public-sector deficits do not seem to correlate closely with balance-of-payments developments, it does appear that long-term public expenditure trends have in some cases been an influential factor.

The rise in public expenditure has been attributable more to increases in transfer payments than to the expansion of public consumption of goods and services and public investment. Of the growth in total expenditure relative to gross domestic product in the period under review, the proportion accounted for by the rise in transfer payments was over 90 per cent. in Italy and the Netherlands, 60–70 per cent. in the United States, Canada and Belgium, and 45–55 per cent. in Germany, France and the United Kingdom. In some countries, notably Austria, Canada, Sweden and the United Kingdom, public consumption of goods and services relative to gross domestic product showed a rising trend more in nominal terms than in real terms. This suggests the possibility that public-sector wages and salaries recorded comparatively large rises over the period.

Present attitudes of governments regarding demand management vary considerably from country to country, reflecting differences both in the state of their public finances and in policy objectives.

In the *United States* the new Administration introduced in early 1977 a two-year fiscal package of $31 billion designed to stimulate final demand and thus fixed investment. The first-year measures were to consist mainly of non-recurring tax rebates, a scheme abandoned in April on the grounds that the recovery was already showing sufficient strength. The other measures, which as signed into law in mid-May will involve outlays of about $20 billion, focus principally on temporary job-creating expenditure. In longer perspective, however, the Government intends to lay the main emphasis on a programme of tax and regulatory reform aimed at improving the investment climate.

In *Germany* the authorities take the view that the limits of non-inflationary fiscal stimulus have been reached and that further stimulus is in any case unnecessary. On the one hand, given that the public-sector deficit is very high by international standards and that the social security accounts are likely to remain in deficit, any deliberate further stimulus would now produce offsetting market reactions. On the other hand, expansion has been under way again since early last autumn and is believed to be proceeding satisfactorily. In these circumstances, considerable emphasis is being placed on a medium-term four-year programme of infrastructural investment, recently raised to DM 16 billion, designed to complement and encourage private fixed investment.

In *Japan* the authorities have not yet discerned any weakening in the capacity of fiscal policy to influence aggregate demand. Fiscal measures, emphasising infrastructural investment and social benefits, have been introduced several times, always in moderate doses, since 1974. New steps in late 1976 included incentives for business fixed investment and dwelling construction as well as an acceleration in public expenditure. Last year an expenditure shortfall occurred because of parliamentary delays, but in the current fiscal year expenditure is projected to rise by 17 per cent. One institutional constraint is the Government's reluctance to see bond financing rise above 30 per cent. of expenditure, while another is the aim within the context of a medium-term programme to eliminate the need for "deficit bond financing" in the general account budget.

In the *United Kingdom* growing recognition of the pitfalls of budgetary fine-tuning has led to a search for new approaches. With public expenditure rising much faster than tax revenue, the public-sector budget position shifted from a financial surplus equivalent to 2.6 per cent. of gross domestic product in 1970 to a deficit of 5.0 per cent. in 1976. Probably no more than half of this deficit can be explained in cyclical terms, and the Government has been seeking, largely by means of a medium-term programme of expenditure retrenchment, to bring down the overall size of the deficit. But in March 1977, with unemployment rising to record levels and the balance-of-payments outlook much improved, the Chancellor of the Exchequer introduced budget concessions equivalent in a full year to approximately 1.7 per cent. of gross domestic product. However, about two-fifths of the proposed concessions were made conditional upon the satisfactory conclusion of a new pay policy agreement to take effect in August.

In *Italy*, too, the public-sector budget position has deteriorated sharply, rising from a net financial deficit equivalent to about 3 per cent. of gross domestic product in 1970 to one of about 13 per cent. in 1975. This was partly due to cyclical factors and steps taken to soften the impact of a large oil deficit. But a number of burdensome structural changes also occurred, such as improved social benefits, a substantial rise in public-sector wages and salaries, the indexation of some types of expenditure, a failure to adapt public-utility prices to costs and, finally, a large growth in subsidies to public enterprises. As the main effect of these changes was to increase personal disposable income, consumption and imports, the principal medium-term task will be to reduce the deficit and make room for productive investment. In the autumn of 1976 a number of austerity measures were taken, largely of a budgetary nature, and in April 1977 budgetary retrenchment figured prominently in the Government's letter of intent for an IMF loan. In particular, the aim is to bring down the public sector's cash deficit from 13.4 to 9.7 per cent. of gross domestic product.

This diverse picture of budget problems and aims carries over to other countries as well. In France, where the public is highly sensitive to signs of fiscal imbalance, the Government's stabilisation plan last September was directed towards bringing about a quick return to budgetary equilibrium, though it is now expected that a deficit of Fr.fr. 13 billion will emerge in 1977. In Belgium and the Netherlands strong trend increases in transfer payments and debt interest, with their attendant financing problems, are seen as contributing to both demand and cost inflation, and medium-term plans call for greater restraint on expenditure. In Sweden and Canada, both of which sought to sustain demand after the oil crisis, fiscal action has recently moved along different lines. In Sweden the public sector's stimulatory impact dropped off sharply from 1974 to 1976, while in Canada budget policies in 1975 and 1976 included a large measure of discretionary stimulus.

What general policy inferences can be drawn from this diversity of experiences? Is pessimism regarding demand management justified? Or should one accept the view of those who, in the presence of slack overall demand, are in favour of additional fiscal stimulus? To give even a highly tentative answer to these difficult questions, certain distinctions need to be drawn.

In its free-wheeling, fine-tuning sense, demand management should indeed be renounced. This is not only because of uncertainties concerning its relative impact on prices and output, but also because we are simply unable to foresee accurately the near-term course of economic activity. And in this state of ignorance — which is unlikely soon to disappear — shifts in fiscal stimulus tend only to increase uncertainty. To give a specific example, when the German Government *forecasts* 5 per cent. growth in real gross national product for 1977 — after 5.4 per cent. growth in 1976 — while some other forecasters believe that growth *will be* only 3–4 per cent., it would be unwise to ask Germany to increase its deficit spending. We must acknowledge that forecasting has all too often proved unreliable and that, with inflationary excesses so vivid in everybody's memory, a fundamental change in German fiscal policy might be a mistake. It would run the risk of seriously undermining confidence in a country whose policies have counted as one of the rare successes in the western industrial world.

This does not, however, amount to endorsing the extreme view that government deficits should be reduced irrespective of the degree of employment — that is, where these deficits have emerged as a result of deficient private-sector demand. There has been no evidence of "crowding-out" since the beginning of the recession. Clearly, where inflation is still rapid and the balance of payments in deficit, fiscal policy should remain or become relatively restrictive. But where the rate of inflation is slackening and where there are no external constraints, there is no justification for a discretionary short-term reduction in the public sector's borrowing requirement. Such a reduction should be the spontaneous result of the upswing of the economy. And one could even argue — with two important provisos — that deficit spending should be increased, particularly in the so-called "strong" countries, if and when it appears relatively certain that private demand has become stagnant. This has not happened so far; but governments in these countries should make it clear that in such circumstances they would not hesitate to undertake fiscal expansion. While it is true that rising government spending in 1973–74 — in the midst of clear-cut demand inflation — proved disastrous for many countries, a budgetary stimulus in the context of stagnant private demand and high unemployment need not have the same consequences.

The first proviso to this "stand-by" policy recommendation is that any discretionary demand stimulation should give priority to investment over consumption. This may be unpopular in the short run, but it is the only way to ensure long-term full employment. The second is that since in many countries the level of taxation seems to have reached the limits of economic and social tolerance, and since there is justifiable concern over the global size of government expenditure, the increase in the public sector's borrowing requirement should take the form of tax cuts rather than of additional government spending.

To create a climate of confidence, fiscal policy should above all aim at longer-term objectives. As some cyclical disturbances are unavoidable, the authorities should refuse to be goaded into reacting immediately at the slightest sign of faltering recovery, but should rather focus their attention on the need to maintain the economy on a moderate growth path. What has to be borne in mind is that business firms' investment decisions are based on medium to long-term projections. And these decisions will be positive only if there is confidence that government policy will avoid the pitfalls of stop-go reactions and stick to declared medium to long-term objectives.

III. INFLATION AND UNEMPLOYMENT.

Side by side with mounting unease over slack activity and persisting unemployment, considerable concern has emerged in recent months about near-term price prospects. It seems that the fight against inflation is now running up against certain deep-seated barriers, while some backsliding may in any case have to be expected should recovery regain momentum. It may well be, therefore, that the western industrial countries are entering a critical phase in the behaviour of prices and wages. This uncomfortable prospect, however, does not detract from the fact that some countries have up to now made considerable progress in bringing inflation under control. Nor does it imply that efforts to counteract inflation have become ineffective and should be abandoned. If anything, these efforts may have to be strengthened.

Price inflation: Recent trends and present prospects.

In surveying recent developments, it is no longer easy, as in the past, to generalise about international inflationary tendencies. The principal reason is that the change-over from a system of essentially fixed exchange rates to one of managed floating has been associated with a marked increase in the dispersion of countries' inflation rates. Thus, whereas in 1972 the rise in consumer prices in the fifteen countries shown in the table below ranged from 3.4 per cent. for the United States to 7.9 per cent. for the Netherlands, in 1976 the increases were scattered over a

Consumer prices.

Countries	Twelve-month rates of change to						
	1972 December	1973 December	1974 December	1975 December	1976 June	1976 December	1977 March
	in percentages						
Austria	7.6	7.8	9.7	6.8	7.5	7.2	5.0
Belgium	6.4	7.3	15.7	11.0	9.4	7.6	7.0[1]
Canada	5.1	9.1	12.5	9.5	7.8	5.8	7.6[1]
Denmark	7.1	12.6	15.5	9.6	7.7	7.7	8.6
Finland	7.3	14.1	16.9	18.1	13.8	12.3	11.6[2]
France	6.9	8.5	15.2	9.6	9.2	9.9	9.1
Germany	6.3	7.8	5.9	5.4	4.5	3.9	3.8[1]
Italy	7.4	12.5	24.5	11.1	16.3	22.0	21.8
Japan	5.3	19.0	22.0	7.7	9.5	10.4	9.4
Netherlands	7.9	8.2	10.9	9.1	9.4	8.3	6.8[1]
Spain	7.3	14.2	17.9	14.1	19.0	19.8	21.2[3]
Sweden	6.2	7.5	11.6	8.9	11.1	9.6	9.5
Switzerland	6.9	11.9	7.6	3.4	1.1	1.3	1.1[1]
United Kingdom	7.7	10.6	19.2	24.9	13.3	15.1	17.5[1]
United States	3.4	8.8	12.2	7.0	5.9	4.7	6.8[1]

[1] April. [2] February. [3] January.

much wider range, falling between 1.3 per cent. for Switzerland and 22.0 per cent. for Italy.

Viewed individually, however, a number of countries made notable further headway in squeezing out inflation in 1976. For the third year in succession, Germany and Switzerland cut back the rise in consumer prices, thus reducing inflation rates to well below those experienced under fixed exchange rates. Similarly, for the second year running, the United States, Canada, Belgium, Denmark and the Netherlands brought down price inflation — to rates not very different from those recorded in 1972. However, rises in consumer prices in France, Japan and Sweden, after declining during 1975, flattened out during 1976 at rates still well above those prevailing in 1972. In Italy, on the other hand, consumer price inflation accelerated over most of 1976, largely reversing the progress of the previous year. In the United Kingdom, following a dramatic reduction in early 1976, inflation speeded up again in the second half of the year. In early 1977 the rise in consumer prices in France began to slow down under the influence of the September 1976 stabilisation programme, but in the United States and Canada it spurted ahead again, partly owing to adverse weather conditions.

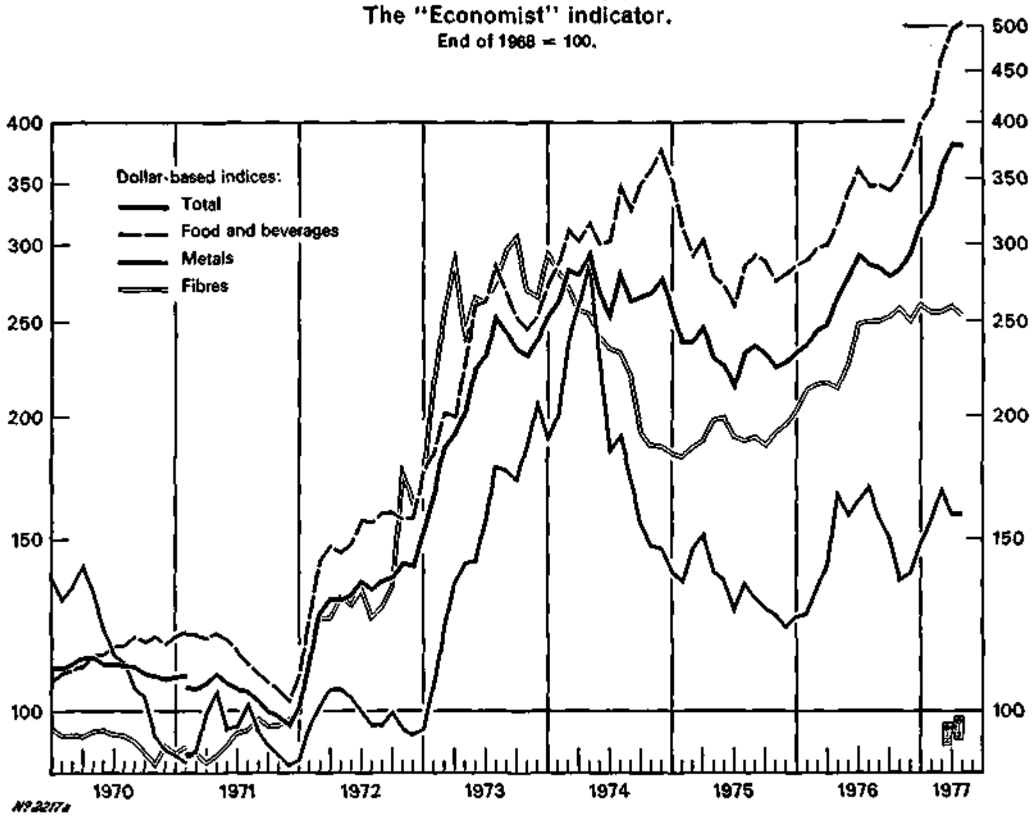
The factors impinging on individual countries' price levels can be examined under three headings. The first concerns developments in the international commodity markets, especially for industrial materials. In these markets world demand conditions are still the principal determinant in setting prices which, for the individual countries, are largely of an exogenous nature. Secondly, consideration must be given to exchange rate changes as a source as well as a reflection of domestic price movements. Thirdly, inflation rates may be influenced by a variety of domestic factors, whether of a demand, cost or institutional nature.

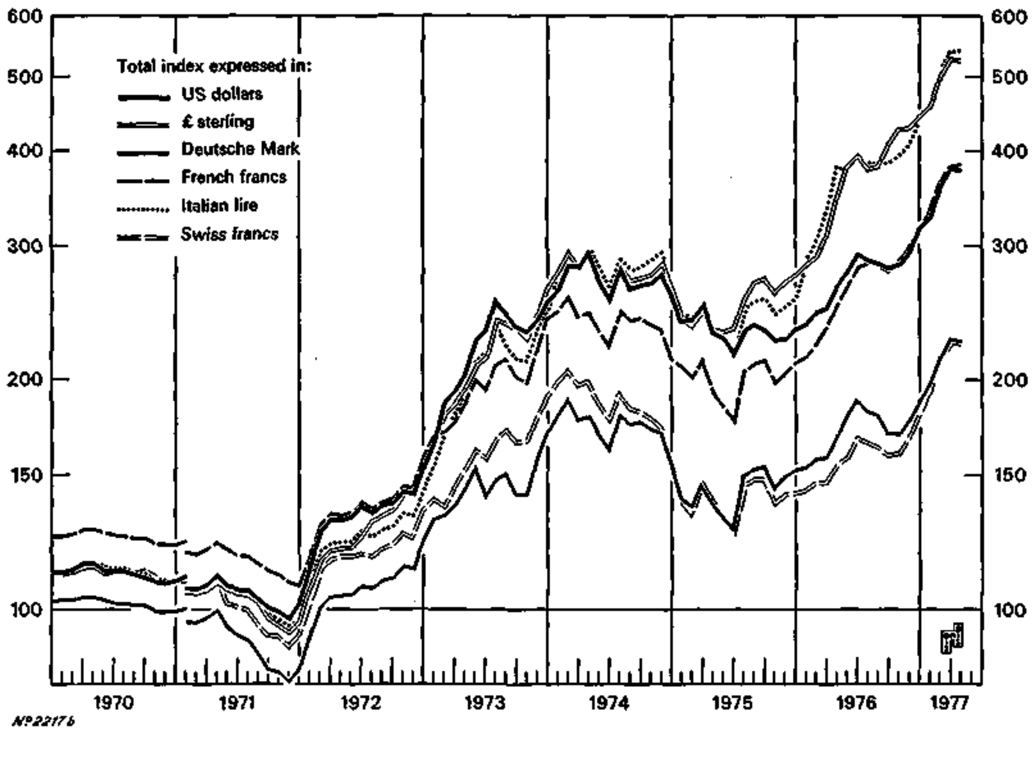
International commodity prices: Will history repeat itself?

One reason for current unease with respect to inflation has been the apparently high sensitivity of international commodity prices to changes in world demand over recent years. At the 1975 trough of world recession, commodity prices had dropped off sharply from their peak levels of early 1974, and even in the early spring of 1976 they were still well below their previous peaks. The benefit of declining industrial-material prices, in particular, gradually filtered through to domestic consumer prices, thus contributing to the better performance recorded in most countries over the past year. Of course, the impact of the movements in commodity prices on individual countries depended on the development of their exchange rates, as can be seen in the lower section of the graph.

Around the middle of 1975, however, commodity prices began on average to rise again, largely in response to the turn-round in the inventory cycle. Increases were initially recorded by beverages and fibres, but by late 1975 metal prices had begun to rise as well. By mid-1976 the "Economist" index had recovered a large part of its previous losses. From about July, however, markets for industrial materials began to weaken, and the decline continued irregularly until late in the

World-market commodity prices:
The "Economist" indicator.
End of 1968 = 100.





year. The widespread pause in economic activity was, with little doubt, the main factor behind this reversal of trend. In addition, ample supplies of meat and high worldwide grain production had a strong restraining influence on food prices throughout 1976.

The latest phase commenced around the turn of the year. Once more, with the quickening of activity in Germany, Japan and the United States, commodity prices have climbed upwards, in some cases fairly strongly. In the food and beverage sector special factors have again been at work. With coffee supplies sharply reduced by climatic setbacks, coffee prices soared, dragging up prices of cocoa and tea as well; recently, however, they have fallen back somewhat. Metal prices, after returning to their earlier 1976 peaks, have also subsided a little. Finally, the price of crude oil, not included in the "Economist" index, was again increased at the beginning of 1977, this time on a two-tier basis by 5–10 per cent.

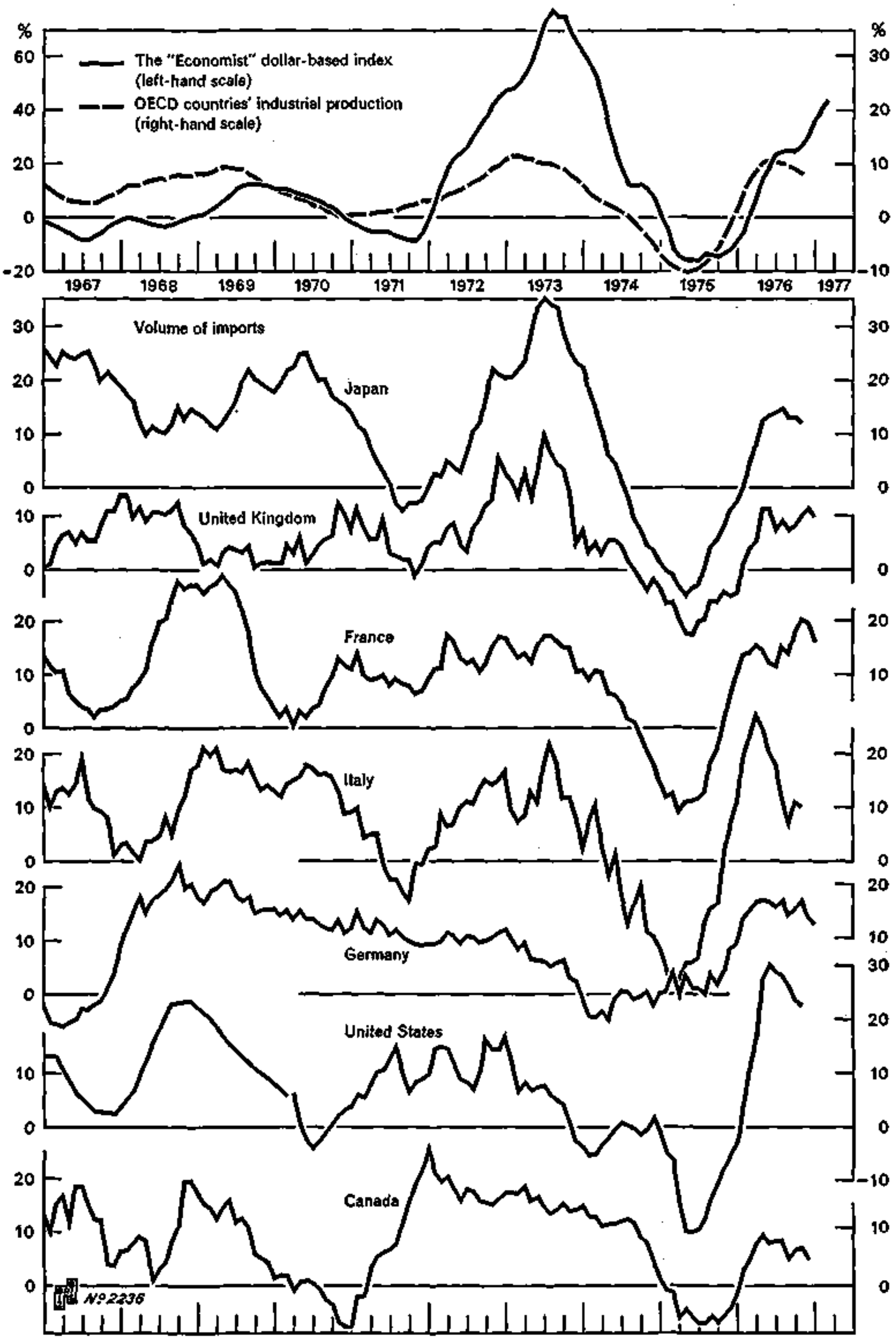
From the standpoint of domestic inflation, the renewed rise in international commodity prices has been a cause of concern. But these prices cannot be viewed solely in this light, because they are also a vital factor in the export earnings of the primary producing countries, many of which now find themselves burdened with large external deficits and debt-servicing obligations. Here the important point is that greater cyclical steadiness in commodity prices, and more stable terms of trade for the primary producing countries, would actually be welcome. It is not a gradual rise in such prices that is undesirable but rather the highly disruptive swings of the kind witnessed since 1971.

The main ground for concern is whether, as recovery progresses, a rise in commodity prices might get out of hand, leading to a repeat performance of the inflationary outbreak of 1973–74. To evaluate the current situation, it may be useful briefly to reconsider the sources of the previous commodity boom. As is now well known, international commodity prices recorded a threefold rise over the two-year period 1972–73, and the price of crude oil was raised by a multiple of four in late 1973. In earlier worldwide cyclical booms, such as the strong expansion of 1968–69, commodity prices had also risen, though by a completely different order of magnitude.

A fundamental difference between the two periods seems to be that the international synchronisation of the upswing was greater in the later cycle than in the earlier one. As the graph shows, the upswing in OECD industrial production was steeper and more pronounced in the years 1972–73 than it was in 1968–69. The greater synchronisation is also reflected in the nearly parallel movement of real imports by the principal countries in the later period, compared with the widely disparate movement in the earlier one. In 1973 the peak twelve-month rate of increase in commodity prices coincided almost exactly with the peak rate of increase in imports into Japan, the United Kingdom, France and Italy, while in Germany, the United States and Canada the rate of import growth was declining but still high.

Besides the synchronisation factor, other forces were also at work. One was that the unexpectedly steep rise in consumption in 1972–73, after several years of

International commodity prices and the volume of imports.
Changes over twelve months.*



* Calculated on the basis of 5-month moving averages of unadjusted monthly data.

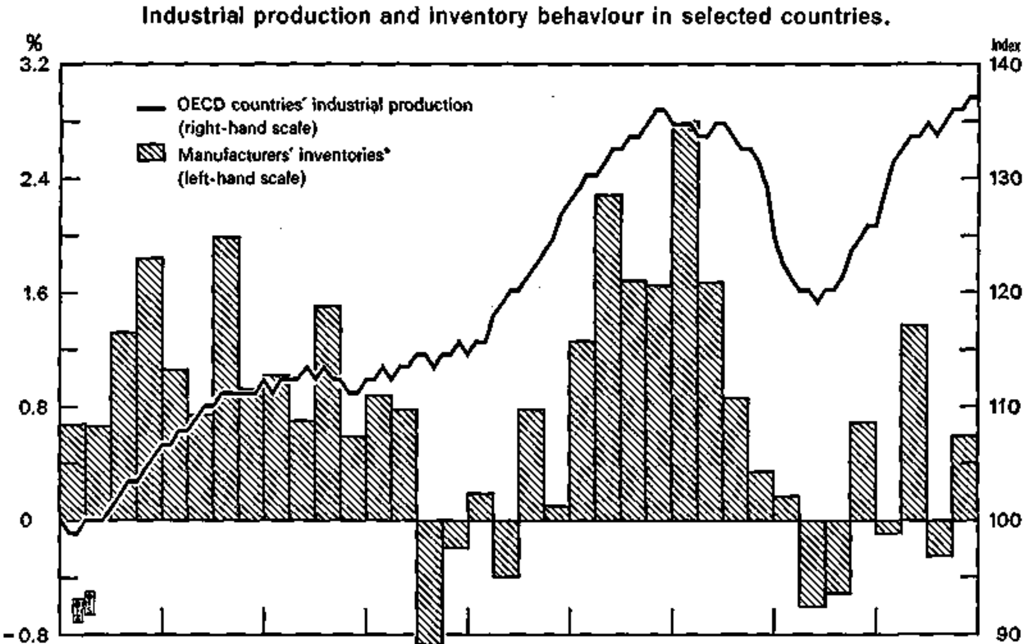
low investment, led to production bottlenecks, especially in some of the basic industries, and may have contributed to a high marginal propensity to import. Another was the grain crop shortfalls experienced in 1972 and 1974, which sharply curtailed supplies in relation to growing demand. Still another was the widespread speculative buying of commodities, often as a hedge against exchange rate uncertainties under floating as well as against rising prices.

These observations pose a fundamental question: is it likely that a high degree of demand synchronisation will be repeated this time round?

It seems improbable, at least a priori, that a closely synchronised, rapid expansion lies ahead. The many countries now faced with large external deficits and financing problems have little choice but to restrain domestic demand and await an export-led recovery. A number of them will in any case want to act along these lines, because they no longer entertain any illusion that flexible exchange rates imply greater freedom to pursue domestically orientated policies. Finally, the countries under less external constraint, particularly the United States, Germany and Japan, are following much more cautious expansionary paths than in the previous upswing. Admittedly, just such a synchronised upswing appeared to be under way up to the middle of 1976. However, the main element of this advance, common to most countries, was an extensive re-stocking of final goods inventories after their earlier decline.

There is also the question whether there is likely to be any major recurrence of the heavy speculative buying of commodities that occurred during the 1972–74 price boom. One important factor at the time was the hedging and speculative

Industrial production and inventory behaviour in selected countries.



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* Percentage changes from previous quarter of a composite, deflated index of inventories of US manufacturers and raw-material inventories of Japanese and UK manufacturers.

activity prompted by widely fluctuating exchange rates, accentuated in some cases by increasing difficulties in securing raw-material supplies. A tangible aspect of the situation was the accumulation and hoarding of large stocks of raw materials by manufacturers.

In major countries where measures of changes in real inventories are available — Japan, the United Kingdom and the United States — raw-material inventories were run up dramatically in 1973 and the first half of 1974. In each of these countries inventories had been stagnant during the preceding eighteen months. The reversal of this cautious inventory behaviour first exacerbated and then prolonged the pressures on commodity prices already stemming from the intense world demand for finished goods.

Unusually large raw-material stocks were built up again during the second quarter of 1976 and prices moved sharply upwards. But this episode was brief and apparently less widespread geographically than during the previous boom. Moreover, it does not appear likely that speculative hoarding of raw materials will reassert itself during the coming phase of world economic recovery. Raw-material stocks, in relation to sales, are much higher now than at the end of 1972 — the increase being particularly large in the case of Japan.

Exchange rates and domestic inflation.

It is too early to pass judgement on the net inflationary implications of floating exchange rates for the world as a whole. One possible inflationary effect is that traders, faced with greater uncertainty, add a risk premium to their prices — but this should be a small, once-for-all effect. Another is alleged to be that individual countries, feeling themselves able to manage with smaller reserves, behave for a time in a more inflationary way — an argument discussed, and dismissed, in Chapter VII. A third possibility, given that domestic prices and wages tend to be flexible in the upward direction only, lies in a kind of international "ratchet" effect. But this would be most likely to happen in a world in which individual exchange rates tended to move fairly strongly and both up and down; and it would imply that accelerating inflation in some countries cannot be matched by deceleration in others. While this third argument has plausibility, it is not yet established that a floating rate system is, on balance, more inflationary than a fixed rate one.

It is nonetheless true that, since the move to generalised floating in early 1973, both exchange rates and inflation rates have fanned out over a wide spectrum. By and large, this development reflects the simple fact that, freed of their obligation to intervene in the exchange markets, individual countries have become directly responsible for their own monetary behaviour. The disparate exercise of this responsibility must be put down partly to national differences of an economic, social and political nature and partly to differences in certain transmission mechanisms (e.g. indexation arrangements) at work in some countries. In these circumstances, therefore, the move to a floating régime has inevitably led to a greater dispersion of inflation rates.

Incontrovertibly, flexible exchange rates do compel countries to "swallow their own inflation". But have rate movements done more than this? Have they tended actually to aggravate underlying differences in inflationary propensities? This appears clearly to have been the case. At one extreme, countries with strong anti-inflationary leanings, with reputations for forceful policy management, have found that appreciation has reinforced the direct domestic impact of their policies. As a by-product of these policies, usually focusing on monetary control, appreciation has tended to "lead" relative changes in purchasing power parity, thus helping by lower domestic-currency prices of internationally traded goods to quicken the decline in domestic price inflation. At the other extreme, countries where policy action has been hamstrung by social and political constraints have been exposed to a kind of depreciation/inflation spiral, with each decline in the exchange rate tending to feed back as a new domestic inflationary impulse.

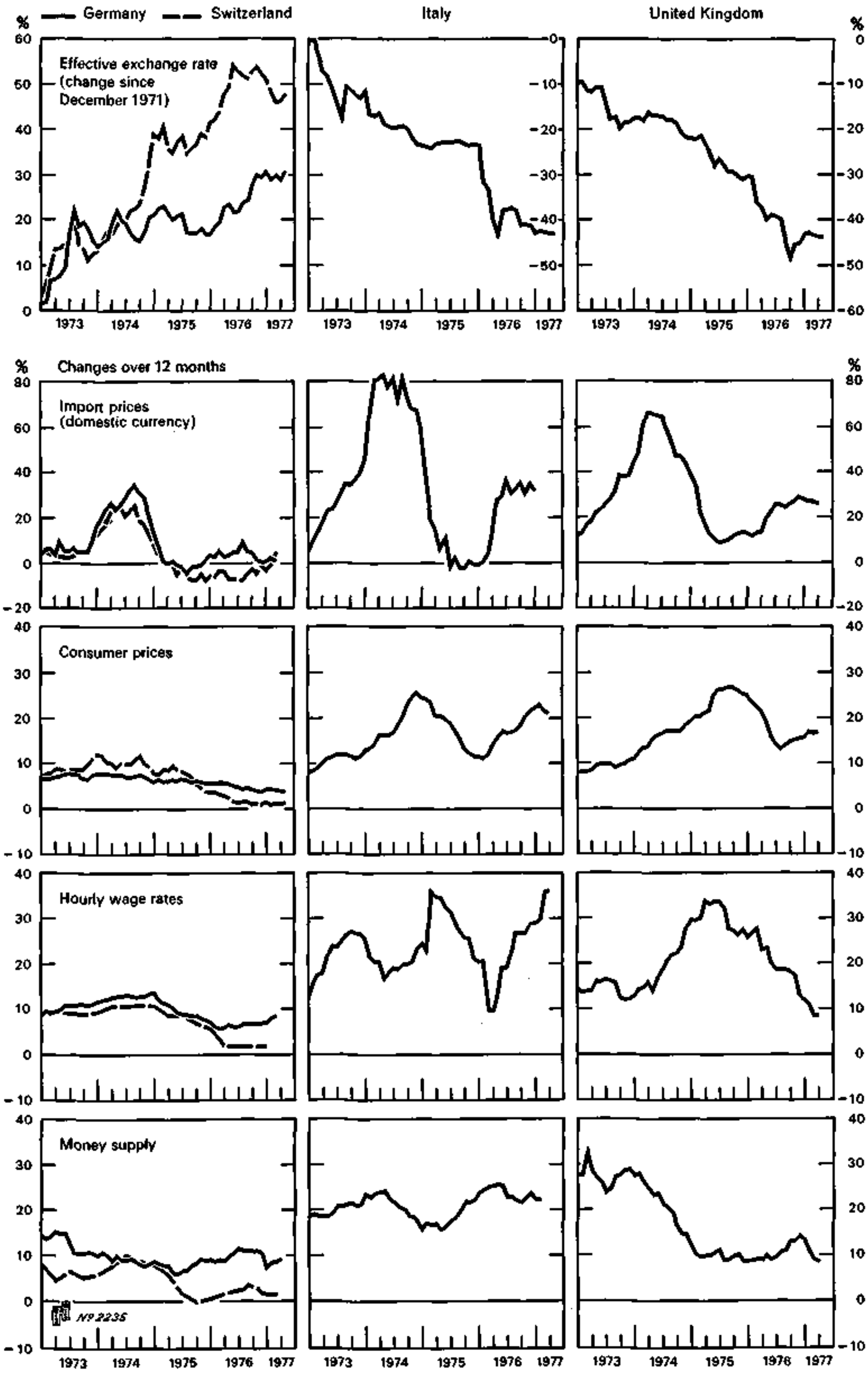
In their initial phase, therefore, floating exchange rates have lent themselves to "virtuous" circles of appreciation/price stability and "vicious" circles of depreciation/price inflation. To say this is not to imply that a country caught in such a vicious circle cannot break out of it or should not be expected to do so. But it is the counsel of perfection to insist, while denying the existence of such divisive tendencies, that the weaker countries have only to adopt strong policies in order to set matters right. Their problems of adjustment, difficult in any case, are complicated under floating by expectational effects and "overshooting", in which rate declines are subsequently validated by the inflationary process that they set in motion domestically.

What has happened so far may well reflect a transitional phase of a protracted process of international adjustment and adaptation. Typically, the countries emerging from the recession with high inflation rates are those where institutional arrangements for the maintenance of real incomes, such as formal or de facto indexation of wages and social benefits, have been very ill-suited to the exigencies of adjustment under floating. However, any modification of such arrangements usually involves slow, painful political adaptations and requires wide public support or acquiescence. In some circumstances, moreover, the successful application of stabilisation measures may critically depend on the support of the international economic community.

Evidence bearing on this line of argument may be found in the contrasting floating rate experiences of the four countries shown in the accompanying graph. Germany and Switzerland represent the virtuous circle case, while Italy and the United Kingdom illustrate episodes of the vicious circle phenomenon.

The first striking fact to emerge from these graphs is that both the United Kingdom and Italy got *into* the vicious circle because of domestic developments. In the case of the United Kingdom the responsibility lies principally with monetary policy: one need not be an orthodox monetarist to regard the 30 per cent. rise in the money supply (M_3) in 1973 as the main factor behind the sharp decline in the value of sterling during the same year. However, the situation was seriously aggravated for a time by the "threshold" system of wage indexation that came into operation in the spring of 1974 but was terminated in the course of 1975. In Italy

Exchange rates, prices, wages and the money supply.



the money supply (M_2) was already expanding at an excessive rate in 1973 (and more so in early 1974), but the wage explosion during the same year also played an important rôle in weakening the lira on the foreign exchanges. In both Germany and Switzerland, by contrast, the growth in broad money supply and the increase in wages remained relatively moderate during that critical year; this fact, taken in conjunction with the tight policies pursued earlier, helps to explain the initially strong appreciation of both currencies.

Thus the two pairs of countries found themselves in drastically different situations when the worldwide rise in prices occurred in 1973–74; the consequences are demonstrated by the behaviour of import prices (measured by average value indices) expressed in domestic currencies. Admittedly, even Germany and Switzerland had to "absorb" import price increases reaching rates of 25–35 per cent., but during the same period the rate of increase went as high as 80 per cent. in Italy and 60 per cent. in the United Kingdom. It is no wonder that the inflation in consumer prices and wages in the latter two countries reached a much faster rate in 1974–75 than in Germany or Switzerland.

The experience of more recent years provides a vivid demonstration of how difficult it is to get *out* of the vicious circle unless governments can and will use all the policy tools at their disposal — including intervention in the foreign exchange market. The emphasis is on the word *all* — for intervention alone is obviously not an alternative to an appropriate domestic policy.

Italy applied monetary restrictions in 1974 with success: by early 1975 the rate of growth in the money supply had fallen to 16 per cent. At the same time the depreciation of the lira slowed down, partly under the influence of market interventions. With additional help coming from falling commodity prices, the result was a marked deceleration in the rise of consumer prices in 1975.

Wages were not brought under control, however; during the first half of 1975 the twelve-month increase rose to more than 30 per cent., aggravated by new concessions granted in respect of Italy's comprehensive system of wage indexation. At the same time, monetary policy again became expansionary, and by the end of the year the monetary aggregates were once more growing as fast as during the winter of 1973–74. In these circumstances the pegging of the lira turned out to be a hopeless exercise, and the removal of the peg in January 1976 was inevitably followed by a sharp depreciation of the Italian currency. This resulted in a rapid rise in import prices followed by a renewed bout of inflation, first in consumer prices and then in wages.

The lesson to be drawn from the Italian experience is obvious. The respite provided by the relative stabilisation of the lira over the past year should be used to cut back both wage inflation and the fast growth of monetary aggregates in order to enable Italy to break out of the vicious circle. The Italian Government's recent letter of intent to the IMF indicates that this urgent task is being accorded high priority in current policy deliberations. While a number of initiatives have already been launched, it remains to be seen how far the authorities will succeed in further developing, and finding acceptance for, a far-reaching stabilisation programme of the kind needed in the present circumstances.

The case of the United Kingdom is similar in one respect: the recent acceleration in consumer price inflation was closely associated with the depreciation of the pound sterling in 1976 and the simultaneous rise in import prices. But here the similarity ends, because for some time now domestic developments have not been actively feeding inflation. Slack demand and the adoption of an incomes policy enabled the United Kingdom to achieve a dramatic reduction in the rate of inflation from the autumn of 1975 to the summer of 1976. The 1976 fall in the external value of sterling was ascribable primarily to the conversion of sterling balances by holders abroad rather than to an excess supply of sterling in the hands of residents. Since early 1975 the rate of growth in the money supply has averaged about 10–12 per cent., which is only a little higher than the corresponding figures for Germany. This implies a substantial decline in real money balances. Moreover, by the early months of 1977 the twelve-month increase in wages had fallen to about 10 per cent. The implication of this — together with the better performance of sterling since late 1976 — is that Britain now stands a fair chance of being able to break out of the vicious circle, provided, of course, that the voluntary pay restraint policy can be extended on a satisfactory basis when the present phase comes to an end in August.

Prices, wages and profits: The domestic aspects.

It is generally the case that monetary and fiscal policies, through their effect on aggregate demand, do after a time exert a strong influence on price and wage behaviour. As these policies are discussed elsewhere in the Report, and as the economic situation last year was everywhere characterised by slack demand and high unemployment, this section focuses on other domestic aspects of the inflationary process.

Against the background of diverse movements in international commodity prices, and even more divergent fluctuations in exchange rates, the main components of the major countries' cost of living changed in a disparate manner last year. Very broadly, following with a lag the decline in primary commodity prices, the domestic prices of manufactured goods and, in some cases, those of food rose more slowly during 1975–76. But with world commodity prices again moving upwards for quite some time, it must be expected that these rises will continue to filter through to prices at the consumer level.

The movements in the major price components help to identify some of the principal domestic sources of inflation. For example, the index of food prices rose considerably less than the overall index in the United States and Canada, whereas in France, Italy and the United Kingdom it went up by more, mainly as a reflection of a 7½ per cent. rise in the European Community's agricultural support prices. Moreover, much of western Europe was plagued last summer by severe drought conditions, while in North America harvests were generally quite favourable. More recently, however, severe climatic setbacks in the United States have given an upward push to food prices in that country. In the European Community, on the other hand, the increase in agricultural support prices is being held down in 1977 to 3½ per cent.

Consumer prices: Movements in major components.

Countries	Twelve months to March	All items	Food	Non-food commodities	Services[1]
		in percentages			
United States	1974	10.3	18.2	8.0	7.7
	1975	10.3	7.7	11.4	11.0
	1976	6.2	4.3	5.0	9.0
	1977	6.4	5.8	6.2	7.2
Canada	1974	10.4	18.7	7.3	7.3
	1975	11.3	12.6	12.2	12.8
	1976	9.0	6.7	7.8	14.3
	1977	7.4	4.7	6.9	10.1
Japan	1974	22.9	27.0	25.0	14.9
	1975	14.9	15.6	11.1	18.7
	1976	8.3	8.5	4.3	14.5
	1977	9.4	8.7	7.0	15.1
Germany	1974	7.2	6.0	9.8	7.2
	1975	5.9	5.2	6.7	7.3
	1976	5.4	7.4	4.4	5.0
	1977	3.9	2.6	3.0	4.7
France	1974	12.2	12.5	13.3	10.4
	1975	13.5	11.7	14.8	13.4
	1976	9.6	11.0	7.4	12.1
	1977	9.1	11.6	6.6	10.4
United Kingdom	1974	13.3	17.9	10.9	9.3
	1975	21.4	25.6	23.1	20.1
	1976	19.8	15.4	19.4	30.5
	1977	16.7	21.8	15.7	11.7
Italy	1974	16.0	14.4	24.5	9.4
	1975	20.3	22.1	19.5	18.3
	1976	13.9	14.4	11.8	15.5
	1977	21.8	19.9[2]	25.8[2]	15.0[2]

[1] Excluding rent, except for France and Italy. [2] February.

In the services sector prices have risen more slowly in most countries over the past year or two. However, with the notable exception of Italy and the United Kingdom, price increases for services continued to be high last year relative to the average rises for other cost-of-living components. This is no doubt mainly a reflection of the relatively low rate of productivity growth in the services sector.

The principal domestic element influencing the pace of inflation is, of course, the interaction of wages and prices. Last year, as shown in the table below, the range of increases in nominal earnings (or wage rates) was extremely wide, extending from around 2 per cent. in Switzerland to nearly 33 per cent. in Spain. In the majority of countries, however, the growth of nominal earnings slowed down, in most cases for the second consecutive year. The main exceptions were Italy and Spain, but elsewhere too — in Germany and the United States — new contract settlements have pointed to a certain firming of wage behaviour. The same was true for Canada and France, despite stabilisation programmes designed to bring down the rate of increase.

Progress in reducing unduly high rates of wage increase was particularly marked in Belgium, Denmark, Finland, the Netherlands and the United Kingdom.

Except in Finland and the United Kingdom, this process appears to have resulted last year from a virtuous circle of exchange appreciation, decelerating price inflation and falling wage claims. Moreover, in all these countries government prices and incomes policies, though differing widely in scope and nature, can claim much credit for the improvement. While in Sweden nominal earnings rose much less than in the previous year, this rise must be seen as the second phase of an unusually large two-year settlement negotiated in the spring of 1975.

Earnings in industry: Nominal and real.

Countries	Nominal earnings[1]				Real earnings[1]			
	1969–73 average	1974	1975	1976	1969–73 average	1974	1975	1976
	in percentages							
Austria . . .	7.9	15.3	10.4	7.2	2.2	5.1	3.6	—
Belgium. . .	12.9	24.4	16.2	9.5	7.2	7.5	4.7	1.8
Canada . . .	8.4	16.6	13.8	12.9	3.8	3.6	3.9	6.7
Denmark . .	15.1	21.6	14.8	11.9	7.2	5.3	4.7	3.9
Finland . . .	13.9	24.6	17.2	14.3	6.4	6.6	− 0.8	1.8
France . . .	*11.7*	*20.3*	*14.8*	*15.1*	*4.8*	*4.4*	*4.7*	*4.7*
Germany . .	*12.7*	*13.3*	*7.0*	*6.6*	*7.4*	*7.0*	*1.5*	*2.6*
Italy	*15.9*	*24.0*	*20.3*	*28.9*	*8.4*	*− 0.4*	*8.2*	*5.7*
Japan. . . .	19.6	25.6	14.5	11.2	7.7	3.0	6.3	0.7
Netherlands[2]	12.5	16.6	13.9	8.0	4.9	5.1	4.4	− 0.3
Spain	16.4	30.7	27.4	32.7	7.5	10.9	11.7	10.6
Sweden . .	10.3	13.7	18.7	11.0	3.6	1.9	9.0	1.3
Switzerland .	7.8	*10.7*	5.7	*1.7*	*1.2*	*2.9*	*2.2*	*0.4*
United Kingdom .	12.1	27.6	20.7	12.3	4.1	7.0	− 3.4	− 2.4
United States	6.6	8.7	8.8	7.0	1.0	− 3.1	− 0.2	2.2

[1] Changes from December to December in monthly, weekly or hourly earnings, except for figures in italics, which are wage rates. [2] October.

In assessing the goals and impact of price/wage policies, it is important to consider the behaviour of *real* earnings. The comparative behaviour of real wages cannot be judged by a single yardstick, for trend rates of increase in labour productivity for the economy as a whole vary considerably from country to country. The result is a similar variation in the scope for growth in real compensation to workers. The table on page 47 illustrates the dispersion in productivity trends, although depressed levels of production last year may substantially distort the underlying rate of productivity growth in some countries. However, industrial countries have in recent times had two strong reasons for retarding or even temporarily reversing the normal advance in real earnings — namely a sharp deterioration in their terms of trade and, in a number of cases, a prolonged squeeze on the returns on capital investment.

The deterioration in their terms of trade caused by higher prices for oil has required some gradual cutback in real income growth for the industrial countries — sufficient to provide an increasing flow of exports to the oil-producing countries. The necessary external adjustment was aggravated for some countries by an existing need to correct an overvaluation of their currencies, while in countries such as Germany and Switzerland a prior undervaluation of the currency alleviated the overall adjustment burden. In all cases, it was inevitable that a substantial part of the cut in real income would have to be borne by the large share of national income going to labour.

Meanwhile, the origins of depressed rates of return in the industrial countries could be traced to very high wage increases in the late 1960s and early 1970s. In many countries exchange rate revaluations and domestic price controls prevented firms from fully recouping these costs through increased prices. The resulting distortion in factor prices was most clearly signalled by the squeeze on profits even at the crest of the 1972–73 expansion. Thus, on domestic grounds alone, many countries saw a need to correct the distribution of income from labour to capital.

Over the past year or two, the growth of real earnings has slowed down substantially in many industrial countries. These declines suggest that internal adjustments to less favourable terms of trade and a revival in profitability have been taking place, although cyclical factors somewhat obscure the underlying improvement in profits. However, while the containment of real wage increases has helped to resolve certain structural problems, it may complicate the cyclical problem of aggregate demand management. In particular, as profitability recovers, it is important that a pick-up in investment should not lag far behind. Otherwise, the slower growth in labour incomes will simply weaken consumption and contribute to overall economic sluggishness.

In Germany and the United States real earnings rose moderately last year, while in Japan and Switzerland they remained virtually unchanged. All these countries have relied primarily on demand-management policies to contain the wage/price spiral.

Much the same improvement seems to have occurred in the Benelux and Scandinavian countries. While none of these countries has a formal incomes policy, each has had recourse to measures comprising elements of such a policy. All have relied to some degree on price-control regulations, at least as regards prior notification procedures and limits on the extent to which cost increases can be passed on. And, where wage-indexation arrangements have played an important rôle, efforts have been made to modify these arrangements. Thus, Belgium suspended indexation for a time in respect of higher incomes, and the Netherlands has also sought to adjust the degree of indexation. In Denmark a new wage agreement in the spring of 1977 provided for adjustments which, excluding wage drift, amounted in nominal terms to only 6 per cent.

The United Kingdom exemplifies the case of a country that, until 1975, had "financed" an excess of real wage growth relative to productivity gains by a growing external deficit and, against a background of price controls, by a sharp constriction of profits. However, the significant reduction in real earnings since 1975 has gone some way towards correcting this situation. Most of the improvement stemmed from the first two phases of incomes policy, which set general limits for pay increases, but larger-than-expected depreciation and inflation also played a rôle. The cumulative influence of such real-wage adjustments may now facilitate a much more rapid recovery in employment than would otherwise have been possible. The Government is now seeking to extend the pay policy for another year, though on a more flexible basis, and in its March 1977 budget offered tax cuts conditional upon such an extension.

The recent behaviour of real wages in Italy casts some useful light upon the question of the wage/price spiral. In the context of the recent negotiations for an IMF loan, considerable attention was focused on Italy's comprehensive wage-indexation arrangements (the "scala mobile" scheme), and the Government has sought, with limited success, to render its application more selective. As elsewhere, such a system can seriously compound the problem of inflation when an initial price increase derives from changes in supply conditions, indirect taxation and public-service prices or from adverse shifts in the terms of trade. In Italy, however, a critical obstacle to the containment of labour costs in recent years has been the size of negotiated wage settlements superimposed on the cost-of-living adjustments.

As far as wage indexation is concerned, therefore, the basic question is whether it can be adapted flexibly to changing national circumstances. For in normal circumstances, free of exogenous price disturbances, wage indexation has been found by some European countries to have a calming effect on labour markets. Similarly, the use of cost-of-living escalators in the United States, where they have come increasingly to replace deferred nominal rises in multi-year wage contracts, has helped to restrain wage increases over the past two years. Fortunately, however, the wider use of such escalators occurred after the dollar devaluations and the subsequent sharp rises in world-market oil and commodity prices.

Cyclical and structural unemployment.

In most countries idle labour continues to be a very serious problem and is expected to remain so for some time. The measurement of unemployment, and the assessment of its many dimensions, is a complicated matter. Even on the most superficial level — that indicated by overall rates of unemployment — the coverage of the available indices is very different from country to country, and there are no reliable comparisons of the amount of short-time working. Thus, the rates of unemployment shown in the table below are significant only for indicating trends in each country individually — and even then with qualifications.

These data make it clear, however, that, even though industrial output has returned to around its previous peak levels, recent unemployment rates remain generally well above the maximum annual rates recorded from 1957 to 1973. This is partly to be explained by the exceptional depth of the recession and duration of the recovery, both seen as part of a "growth" depression in which productive potential has continued to rise (Chapter II). Another cause is factor price imbalance, which has induced firms to hold back on fixed investment, reduce their work force and lean towards investments of a labour-saving nature.

In some countries, for example the United States and Canada, the rapid rise in the labour force in recent years helps to explain the severity of unemployment,

Unemployment rates.[1]

Countries	Highest annual average rate during 1957–65	Highest annual average rate during 1966–73	1974 December	1975 December	1976 June	1976 December	1977 April
	in percentages						
Belgium	6.3	4.5	5.3	8.7	8.1	9.8	9.5
Canada	7.1	6.4	5.9	7.0	7.0	7.4	8.3
France	1.4	2.2	2.9	4.4	4.1	4.3	4.8
Germany	3.5	2.1	3.6	4.8	4.6	4.4	4.6
Italy	8.2	3.9	3.1	3.5	3.8	3.9[2]	.
Japan	1.5	1.4	1.7	2.1	2.1	1.9	1.9[3]
Netherlands	2.3	2.7	4.0	5.4	5.6	5.2	5.1
Sweden	2.5	2.0	1.5	1.6	1.5	1.5	1.8[3]
Switzerland	—	—	0.1	1.0	0.7	0.6	0.5
United Kingdom	2.4	3.8	2.8	5.0	5.4	5.6	5.6
United States	6.8	5.9	7.2	8.3	7.5	7.8	7.0

[1] As percentages of the civilian labour force (in Belgium the insured labour force). Seasonally adjusted series except for Belgium, Italy, Sweden and Switzerland. [2] October. [3] February.

especially among young people and women. Often workers who drop out of the labour force at an earlier stage of the cycle re-enter as recovery progresses, thus swelling the unemployment statistics even as employment increases. In the current recovery the United States and Italy have experienced such phenomena, with both employment levels and the civilian labour force expanding fairly briskly since mid-1976. However, in other industrial countries, employment growth has been sluggish and the labour force has grown very little. Indeed, the declining trend of the labour force in Germany and Switzerland over recent years has helped to keep the rate of unemployment much lower than it would otherwise have been.

Since December 1975 the unemployment rate has fallen off in the United States, the Netherlands and Germany, but it is still unusually high in all three countries. There has also been a decline from already low levels in Japan, where employers traditionally seek to avoid lay-offs, and in Switzerland, where there has been a sizable net outflow of foreign workers. In other countries, however, unemployment has further increased over the past year or so.

As regards macro-economic policy, governments have generally responded rather cautiously to the disappointing development of the employment picture. While this is partly due to their concern about inflation and external balance, it also reflects the view that the unemployment problem is to some extent a structural one not amenable to demand management. The structural elements have to do mainly with the difficulties being experienced in certain industries or geographical areas, but they also stem partly from the changing age distribution and composition of the labour force.

In these circumstances, therefore, governments have turned increasingly to selective measures in trying to cope with unemployment. Some of these measures are designed principally to cushion the impact of unemployment on particular groups of individuals and have consisted largely of improvements in the amount

Active labour force, employment and productivity.

Countries	1961-70 Active labour force[1]	1961-70 Civilian employment	1961-70 Productivity[2]	1970-76 Active labour force[1]	1970-76 Civilian employment	1970-76 Productivity[2]
	annual compound growth rate, in percentages					
Austria	− 1.2	0.3	4.4	− 0.1[3]	− 0.2[3]	4.0[3]
Belgium	0.5	0.8	4.1	2.3[3]	0.4[3]	3.4[3]
Canada	2.7	3.0	2.4	3.5	3.2	1.4
Denmark	1.3	1.4	3.3	0.9[3]	0.2[3]	2.1[3]
Finland	0.3	0.2	4.7	0.7[3]	0.2	3.3
France	0.8	1.0	4.7	0.9[3]	− 0.2	4.0
Germany	—	0.2	4.6	− 0.4	− 1.1	3.5
Italy	− 0.9	− 0.7	5.8	0.6	0.3	2.6
Japan	1.4	1.4	8.7	0.7[3]	0.5	5.1
Netherlands	1.2	1.2	4.4	0.4[3]	− 0.2[3]	3.2[3]
Norway	0.7	1.5	3.3	2.5	1.7	1.9
Spain	0.8	0.8	6.6	0.9[3]	0.3	4.5
Sweden	0.7	0.8	3.6	1.0	1.0	1.1
Switzerland	0.9	0.9	3.5	− 1.7	− 2.0	2.6
United Kingdom	0.2	0.1	2.7	0.5	—	1.6
United States	1.8	2.0	2.2	2.0	1.8	0.9

[1] The active labour force comprises the civilian labour force, both employed and unemployed, and the armed forces. [2] The change in real gross national product per employed civilian worker. [3] 1975.

and duration of unemployment benefits. In some countries these benefits have come to be quite generous — so much so that they have been criticised as constituting a disincentive to job-seeking and work. Be that as it may, they have helped to make prolonged high rates of unemployment socially and politically more bearable than they would otherwise have been.

In certain of the Scandinavian countries, where exports of primary and semi-finished products are important, stockbuilding has been subsidised in order to sustain employment. However, with the world recession lasting longer than expected, these programmes have run into difficulties. In Sweden, where subsidies helped last year to maintain stockbuilding at almost 2 per cent. of the gross national product, the programme is now being reduced. Similar planned cutbacks in Norway have been postponed.

For many countries a major weapon in tackling unemployment has been selective initiatives in the field of fixed investment. A number of them have laid considerable stress on job-creating public works of a conventional nature, often in areas of high unemployment or slow growth. Some, however, have taken the broader form of a medium-term public investment programme, with the principal emphasis on infrastructural outlays (Germany) or investment in nationalised industries (France). In the Netherlands the Government has proposed a medium-term investment policy designed to promote job-creating investments up to 1980. This programme, which aims primarily at reducing private investment costs, features among other things a system of premiums that vary according to the type and location of the investment undertaken. At a further remove, private investment incentives of familiar kinds — for example tax credits, depreciation allowances, interest subsidies — have been introduced or strengthened in a number of countries. And at least two countries (the Netherlands and the United Kingdom) have made certain tax adjustments to reduce the effects of inflation on taxable profits.

Inflation and unemployment: The policy choices.

The cumulative losses entailed in the large-scale underemployment of manpower and resources have been a matter of growing concern and impatience. According to one body of opinion, the fight against inflation has become excessively costly in terms of real output and employment, while yielding little further benefit in lowering price and wage pressures. In these terms, there is a pressing need for more active demand-management policies, particularly in the leading countries, aimed at moving back fairly quickly to high levels of activity.

This Report, while fully acknowledging the gravity of the unemployment problem, does not subscribe to this view. It recognises a rôle for prudent demand management aiming at reasonably steady growth rates, as well as for selective measures to promote more investment, better training, increased mobility and, generally, higher employment. But basically it sides more with the thesis that the accelerating inflation of the 1960s and early 1970s was largely the outcome of the extreme preoccupation with sustaining full employment while neglecting the potential effects of tight labour markets and capacity shortages on the stability of prices. Moreover, it sees the resultant high and more variable rates of inflation, together with the extremely sensitive inflationary expectations that these have engendered, as having themselves been a major cause of demand weakness and unemployment. Finally, it takes the view that, while the propagation of inflation is at present very much a reflection of persisting cost-push elements, the memory of demand-pull dangers is still vivid and not far below the surface.

The reasons underlying these views are discussed in various parts of the Report. The conclusion is that present-day markets have become keenly attuned to fears of inflation. In the financial sphere, any strengthening of inflationary expectations now leads investors to run for liquidity, thus tending to raise long-term interest rates and reduce the availability of long-term capital for investment. In the industrial sector, capital expenditure by business firms is discouraged in two ways: first, by the fear of being caught between rising costs and a new phase of policy restraint — or, worse, being subjected to a new régime of price controls; secondly, by the experience that inflation itself creates additional uncertainties. The rate of inflation goes up or down but it never stays stable; moreover, a high *average* rate of inflation almost certainly entails an increased variance of individual price changes. In the household sector, inflation has come to be associated with income and job uncertainties, as well as with losses in the purchasing power of holdings of financial assets, and has thus prompted less spending and more saving.

In these circumstances it has become increasingly perilous for policy-making authorities to ignore the inflationary consequences of their actions. If they do so, market reactions may render their interventions self-defeating, leaving the inflation/unemployment dilemma even more acute than before. In assessing the "costs" of inflation, therefore, one has to consider the extent to which inflation itself is a cause of unemployment. Nor should one minimise the more familiar costs associated with distributional inequities, inefficiencies and distortions in resource allocation and the social and political disorder stemming from the continual jockeying for position in terms of income shares.

But what are the alternatives? Have the long-sustained efforts to bring down inflation rates been as futile as is sometimes made out? In fact, progress has been far from negligible. Whereas in 1974 most industrial countries recorded increases in consumer prices of between 10 and 25 per cent., a large number of them had reduced these rates by the spring of 1977 to between 6 and 9 per cent., with price inflation in Germany and Switzerland being already well below this range. It seems clear, too, that slack demand and labour-market conditions did have a beneficial effect — that associated with the so-called Phillips curve — in damping down inflation. Moreover, in Germany and the United States this progress has for two years now been combined with an appreciable reduction in unemployment, and other countries may be approaching a turning-point in this regard. Finally, profits, which in many countries had become severely depressed when demand-pull changed over to cost-push inflation, appear in some countries to have improved markedly over the past year or two. But in all these respects there is still some distance to be travelled and time and patience are needed.

As far as demand management is concerned, therefore, it would appear desirable for countries to continue to aim at moderate, sustained growth. For those in balance-of-payments difficulties, *domestic* demand expansion should lag behind that elsewhere in order to make room for an export-led recovery. Moreover, experience has repeatedly shown that exchange rate depreciation, while perhaps a necessary complement to such a policy, is never a substitute for it.

A policy of moderate growth is clearly not a do-nothing policy. It implies an assured expansion, within reasonable limits, of the monetary aggregates, and this in turn may imply, though at a gradually diminishing rate, some monetary financing of public-sector deficits. However, it would mean that, if demand management alone is relied upon, considerable further time will be needed before satisfactory levels of employment can be restored.

How might countries speed up this process? One way could be by committing themselves publicly to certain broad goals with respect to lowering or containing inflation. These goals, if made credible, could help to establish the expectational framework needed for a faster return to domestic equilibrium.

In addition, progress towards resolving the inflation/unemployment dilemma could be speeded up in many cases by what can be broadly defined as an incomes policy. Under this heading or the even broader one of a consensus approach to income distribution, understandings reached for limited periods can do much to establish the prerequisites for stable growth. As seen earlier, the wide international differences in inflation rates are attributable more to differences in indigenous transmission or propagation mechanisms than in the initial inflationary impulses themselves.

Of course, inflationary mechanisms and habits are often deeply entrenched and highly resistant to change. This is particularly so with respect to blanket wage-indexation arrangements, whether formal or de facto, but it is also evident in the reluctance to accept needed adjustments in real incomes or in relative prices and wages. Yet there are circumstances in which such adjustments would be highly appropriate. Such is the case, for example, in the event of a national real income loss because of a deterioration in the terms of trade through, for example, higher oil or commodity prices. It can be equally necessary where, as in many countries, a growing squeeze on profitability has seriously impaired the incentive for business firms to undertake job-creating investment.

From the standpoint of the groups concerned — labour and management in particular — the acceptance of greater moderation in wage and price behaviour is obviously not easy. This is especially true if, as is now the case in a number of countries, there is an evident need to increase the relative share of profits as a basis for higher investment and growth. But even such relative adjustments, where policy-making authorities can establish a good case for them, may bring tangible benefits all round within a short time span. For, in the absence of appropriate wage/price behaviour, the authorities' only means of resisting inflation is to restrain aggregate demand, which inevitably results in weaker market conditions and unemployment. By the same token, with any given policy of demand management, more moderation in wage and price increases implies greater scope for increases in real incomes and employment. In addition, such moderation may also imply more freedom for the authorities to introduce additional measures of demand stimulus.

IV. DOMESTIC CREDIT MARKETS AND MONETARY POLICY.

The imprint of weak economic recovery was clearly visible in all the major financial markets last year. Yet there were marked differences from one country to another, stemming from divergences in rates of inflation and from the continuing polarisation of economies with respect to the strength of their external positions.

As for the similarities between countries, the restructuring of over-extended balance sheets continued generally to be a financial preoccupation in the enterprise sector, though there has been some revival in short-term business borrowing in countries where the recovery has regained strength. At the same time, the personal sector increased its borrowing but continued to accumulate liquid assets at a high rate. The improvement in private-sector liquidity was associated with further public-sector deficits, which generally fell back somewhat from their 1975 peaks but were nevertheless very large by previous standards.

The differences from country to country were reflected in the different orientations of monetary policies. In those countries with relatively low rates of inflation and basically strong external positions — the United States, Germany, Japan and Switzerland — stable monetary policies were designed to bring about a further moderation of inflation but also to accommodate the cyclical recovery. In virtually all other countries external weakness — mostly mirroring domestic imbalances — necessitated a marked tightening of monetary policy. In some countries the monetary defences could be partially dismantled once disturbances in exchange markets had passed. But in others increased awareness of external vulnerability has continued to influence monetary policies.

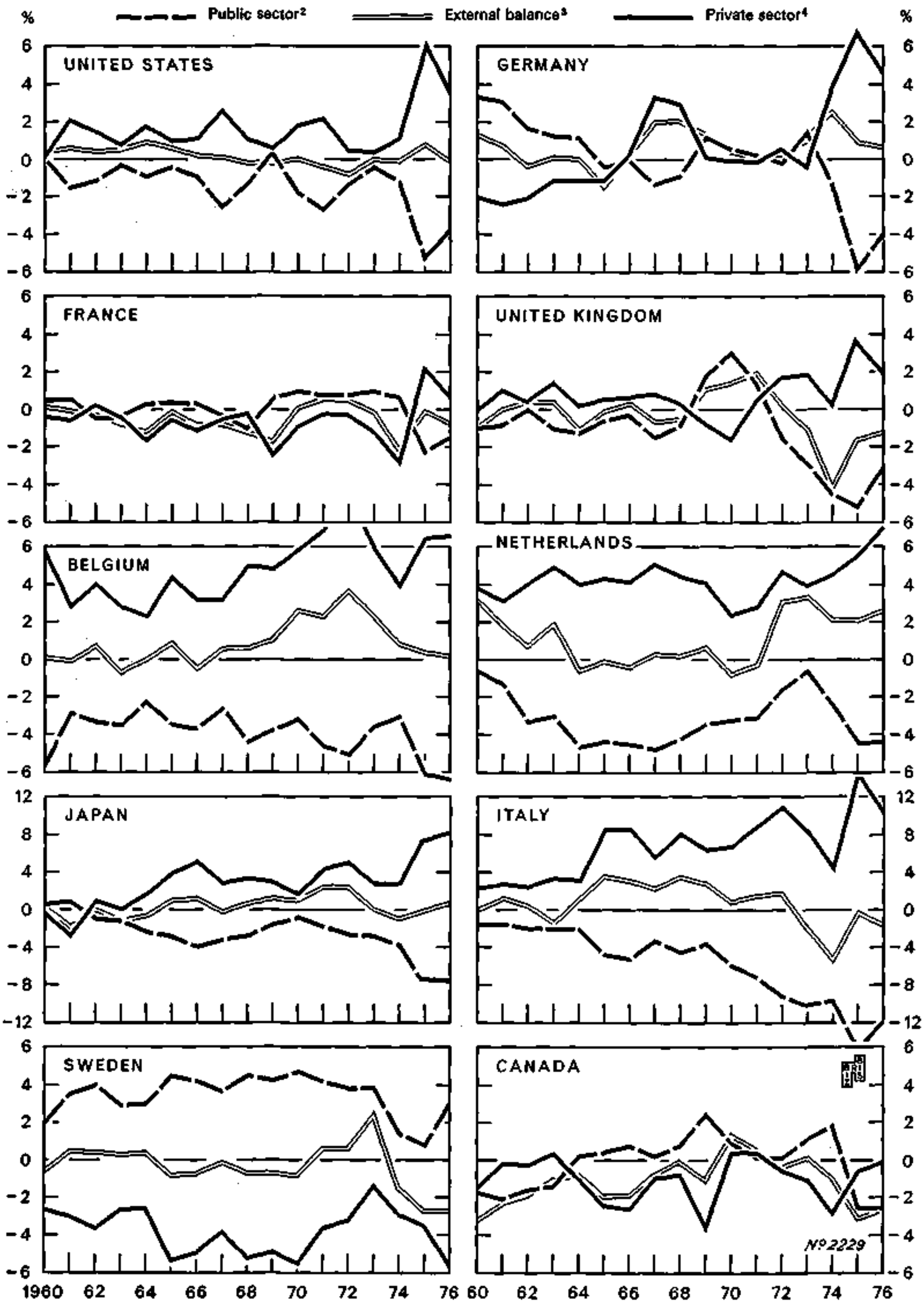
The divergences in countries' positions and monetary policies were clearly reflected in the behaviour of interest rates. The steep slide of both long and short-term rates in 1975 was followed last year in the first group of countries by near-stability or moderate further falls, though since the beginning of 1977 short-term rates have firmed in some markets. In other countries, however, rates moved back up to establish new peaks and remained comparatively high, except where the reversal of the external position was very marked.

The pattern of sectoral financial positions.

With economic recovery the abnormal pattern of financial balances seen earlier during the deep recession began to reverse itself. Key influences were the turn in the stock cycle, some recovery in business profits, the decline in personal savings ratios and the impact of rising activity levels on government budget deficits.

Almost everywhere the public-sector deficit contracted somewhat last year from the record levels reached in 1975 (see Chapter II), Japan, Belgium and the

Financial surpluses and deficits by sector.[1]
As a percentage of gross national product.



[1] Based on national sources. [2] Combined public authorities. For Belgium and the Netherlands, financing requirement including some borrowing for lending purposes. [3] Financial surplus (+) of the domestic economy vis-à-vis the rest of the world. [4] Calculated as a residual.

Netherlands being notable exceptions. To a large extent, of course, this development was reflected in a decline in the private sector's financial surplus, which, however, still remained very high by historical standards. In the graph external balances approximately represent current-account positions, with a positive sign indicating a surplus for the country concerned.

Over the years there seems to have been a clear, positive relationship between movements in public-sector balances and those in the external current-account position in the United Kingdom and the Netherlands — though it has been less close recently than in earlier years. To some observers this has suggested that the budgetary position is a key determinant of the external balance. In Italy the deterioration in the external position since the mid-1960s seems to be related to the adverse trend in the public finances. Of course, in recent years public-sector deficits have been deliberately accepted in a number of countries as a domestic counterpart of external oil-related deficits. In most countries, however, changes in external current-account positions appear usually to have been more related to fluctuations in the private-sector surplus, while, moving counter to both, the public-sector deficit appears to have constituted a stabilising element.

Over the past two or three years public-sector deficits have, besides helping to sustain demand, made a major contribution to financial restructuring by enabling households, enterprises and financial institutions to acquire sound assets while moderating their own borrowing. In particular, the growth of security claims on the public sector made a useful addition to the second-line liquidity of the economy without contributing unduly to monetary growth and inflationary potential. But where public-sector deficits contributed to excess money creation or to external imbalance, they have been less beneficial and in some cases positively harmful.

Within the private sector the corporate-sector deficit, which had been cut back sharply in 1975, expanded again last year in many countries as gross investment (including stockbuilding) picked up. The personal sector's financial surplus fell in a number of countries between 1975 and 1976 but in a long-term perspective remained high everywhere.

The financing of the corporate sector. Last year patterns of financing in the corporate sector were still influenced by efforts to restore cash flow and improve balance-sheet positions. In a number of countries these had deteriorated progressively over many years and had then been eroded further during the 1972–74 inflationary boom. Though the restructuring process is now far advanced in many countries, companies are generally still showing reluctance to speed up their investment activity.

Some of the remarkable shifts in corporate financing in recent years are illustrated in the table below. (For Germany the figures relate to the enterprise sector excluding housing.) Broadly speaking, the 1972–74 period of weakening internal financing capacity, heavy short-term borrowing and deteriorating liquidity positions was followed over the next two years by a marked swing from short to long-term borrowing and a fast accumulation of liquidity. At the same time, reliance on external financing fell substantially, reflecting at first a cutback in investment but then, increasingly, the generation of internal financing resources. This improvement seems to have begun earliest and gone furthest in the United States and Germany, but a considerable strengthening is also apparent in the other countries. In making comparisons with earlier years it should be borne in mind that the figures for 1975 and 1976 are expressed in relationship to very depressed levels of gross national product.

Corporate sector: Saving, investment and financial transactions.

Countries	Years or annual average	Gross saving and capital transfers	Gross invest-ment (—)	Financial deficit (—)	Corresponding changes in liquid assets[1]	short-term indebted-ness[2] (increase—)	long-term indebted-ness[3] (increase—)	other claims[4] (net)
		as a percentage of gross national product						
United States	1963–65	7.9	— 8.3	— 0.4	0.5	— 1.1	— 1.4	1.6
	1973	6.4	— 9.5	— 3.1	0.5	— 2.7	— 2.9	2.0
	1974	5.5	— 9.5	— 4.0	0.2	— 3.1	— 2.8	1.7
	1975	6.8	— 6.3	0.5	1.2	0.8	— 3.3	1.8
	1976	7.2	— 8.2	— 1.0	1.3	— 0.3	— 2.8	0.8
Japan. . . .	1963–65	11.9	— 18.1	— 6.2	7.1	— 13.9	— 2.5	3.1
	1973	12.9	— 19.1	— 6.2	4.4	— 13.6	— 1.8	4.8
	1974	10.9	— 18.6	— 7.7	2.4	— 9.9	— 1.1	0.9
	1975	8.8	— 12.4	— 3.6	4.4	— 10.3	— 1.9	4.2
	1976	.	.	— 3.2	4.3	— 9.1	— 1.2	2.8
Germany[5] . .	1963–65	12.5	— 16.8	— 4.3	0.9	— 1.2	— 3.2	— 0.8
	1973	11.4	— 15.4	— 4.0	1.5	— 0.9	— 2.7	— 1.9
	1974	10.6	— 13.1	— 2.5	0.4	— 1.5	— 2.3	0.9
	1975	11.1	— 12.1	— 1.0	1.6	0.9	— 3.2	— 0.3
	1976	12.3	— 13.7	— 1.4	1.5	— 1.0	— 3.1	1.2
France . . .	1973	7.4	— 12.3	— 4.9	1.4	— 3.5	— 4.4	1.6
	1974	6.0	— 12.7	— 6.7	1.8	— 6.1	— 4.8	2.4
	1975	5.6	— 9.0	— 3.4	2.2	— 0.6	— 5.7	0.7
	1976	6.1	— 11.4	— 5.3	0.7	— 1.9	— 6.3	2.2
United Kingdom .	1963–65	8.8	— 8.6	0.2	0.5	— 1.8	— 1.8	3.3
	1973	11.5	— 11.5	0.0	3.6	— 6.2	— 1.5	4.1
	1974	10.7	— 14.6	— 3.9	0.1	— 5.4	— 0.1	1.5
	1975	8.8	— 9.1	— 0.3	2.4	— 0.6	— 1.5	— 0.6
	1976	10.0	— 10.5	— 0.5	1.5	— 2.1	— 1.3	1.4

[1] Mainly deposits and short-term paper. In the United States includes all government securities. [2] Includes all bank loans except mortgages in the United States, long-term bank loans in Germany and medium and long-term credits in France. Includes some loans from non-bank financial institutions and for the United States and Germany issues of short-term market paper. [3] Mainly issues of bonds and equities but in some cases also mortgage loans and long-term credits. [4] Mainly non-market claims, notably trade credit and participation transactions with non-residents. Includes the statistical discrepancy. [5] Enterprise sector excluding housing.

The improvement in balance-sheet positions seems to have offset the sharp weakening of the early 1970s but not to have restored the full strength of earlier years. For example, the ratio of the deposit and government-security holdings of US corporations to their total current liabilities rose from an unprecedentedly low figure of less than 0.16 in late 1974 to reach nearly 0.20 by mid-1976, which approximately restored the liquidity standards that had prevailed in the 1969–71 period. In the early 1960s, however, the ratio had stood at over 0.35. In the United Kingdom the ratio of commercial and industrial companies' liquid assets to their bank advances rose gradually during 1975 and 1976 but in late 1976 was still much lower than it had been at any time prior to 1973. Of course, continuing inflation may have induced companies to economise on their holdings of liquid balances. In Germany corporate financial assets seem to have increased considerably, the rise last year partly taking the form of acquisitions of securities; however, debt/equity ratios are now much higher than they were in the 1960s. In Japan the strengthening of corporate finances was associated with moderate short-term borrowing for the third year running.

The restructuring process being quite advanced, at least in the United States and Germany, there was some revival during the year in short-term borrowing — which was used, together with internally generated funds, to finance a modest increase in business investment. With the financial worries of recent years still a vivid memory, the reluctance to suffer another deterioration in balance-sheet positions may help to explain why business capital spending has, in fact, remained rather weak.

Enterprises continued last year to draw fairly heavily on capital-market funds. In the United States public bond issues by domestic corporations, at $26 billion, reached about 85 per cent. of the record 1975 volume and — of particular benefit to lower-rated industrial corporations — private placements of debt securities increased by 50 per cent. to over $15 billion. The total volume of stock issues, at $11 billion, was about the same as in 1975, though the pace of offerings slowed down in the second half of the year. In France, Germany and the United Kingdom, too, share issues last year fell only slightly below the high 1975 volumes. Net bond issues by the enterprise sector ran at high rates in France but — as in 1975 — were small or even negative in Germany and the United Kingdom. In Japan net issues of bonds by corporations (other than electricity undertakings) fell to about one-quarter of the 1975 level and the volume of equity issues was approximately halved.

At an unusually late stage in the recovery process, corporate demand for bank credit strengthened in some countries last year. In the United States business loans from banks, after falling for two years, moved up in the autumn. In Germany there was a quickening in business borrowing from banks, particularly at long term, which may have been related to the comparatively good increase in fixed investment in that country. A strengthening of business borrowing from banks could be observed in France, Italy, Belgium, the Netherlands and the United Kingdom. In most cases, however, the rise did not seem to portend a sustained recovery of fixed investment but was instead associated with re-stocking, continuing inflation and temporary factors. In Japan business demand for bank credit seems so far to have remained fairly weak.

Borrowing and lending in the personal sector. Last year the personal sector's net financial investment (i.e. net recorded financial transactions) declined in the United States, Germany and France, reflecting a slow growth of disposable income and a pick-up in consumer spending, but it increased further in Japan and the United Kingdom. These divergent developments were mainly associated with differences

Personal sector: Changes in financial assets and liabilities.

Countries	Years or annual average	Net financial investment	financial liabilities (increase —)	Corresponding changes in financial assets: total	currency and deposits[1]	money-market paper and securities[2]	other
		as a percentage of gross national product					
United States[3]	1963–65	2.6	— 5.7	8.3	5.0	0.5	2.8
	1973	3.8	— 7.2	11.0	6.2	1.6	3.2
	1974	5.5	— 4.2	9.7	4.5	2.1	3.1
	1975	6.9	— 4.1	11.0	6.0	1.4	3.6
	1976	4.9	— 6.0	10.9	6.6	0.3	4.0
Japan	1963–65	8.2	— 4.7	12.9	9.8	1.7	1.4
	1973	8.9	—10.1	19.0	15.0	1.5	2.5
	1974	10.5	— 4.8	15.3	12.0	1.3	2.0
	1975	10.8	— 7.2	18.0	13.3	2.2	2.5
	1976	11.5	— 6.4	17.9	12.9	2.5	2.5
Germany[4]	1963–65	2.7	— 4.2	6.9	4.6	1.2	1.1
	1973	3.1	— 5.0	8.1	5.2	1.5	1.4
	1974	5.4	— 2.6	8.0	5.5	1.1	1.4
	1975	6.8	— 2.7	9.5	7.0	1.0	1.5
	1976	5.2	— 3.3	8.5	5.2	1.9	1.4
France	1973	3.6	— 6.4	10.0	7.3	1.4	1.3
	1974	4.6	— 5.0	9.6	7.5	0.1	2.0
	1975	6.7	— 3.1	9.8	8.9	0.1	0.8
	1976	5.4	— 4.9	10.3	9.0	0.5	0.8
United Kingdom	1963–65	3.4	— 2.6	6.0	4.0	— 1.5	3.5
	1973	5.2	— 5.8	11.0	8.6	— 1.6	4.0
	1974	7.8	— 2.9	10.7	6.7	0.0	4.0
	1975	5.3	— 3.3	8.6	4.7	— 0.4	4.3
	1976	6.1	— 4.2	10.3	4.8	0.9	4.6

[1] Includes funds placed with savings institutions providing housing loans and, in the case of Japan and the United Kingdom, trust claims and liquid national savings respectively. [2] Includes unit trust claims. [3] Households plus farm and non-farm unincorporated enterprises. [4] Household and housing sector combined. Excludes unincorporated enterprises.

in the strength of the revival in borrowing. Asset accumulation remained high or increased in all countries.

An upturn in short-term consumer credit in conjunction with spending on consumer durables was, of course, a normal cyclical phenomenon. Striking, too, was the strong rise in mortgage borrowing evident last year in the United States, Germany, the United Kingdom and Japan. However, in the current cycle, much of this borrowing was associated with the transfer of existing dwellings and even with non-housing expenditures. In relation to gross national product total personal-sector borrowing last year was quite modest compared with the 1972–73 upswing but it nevertheless accounted for much of the increase in total bank credit. In the United States, for instance, consumer and real-estate loans represented three-quarters of the total growth of bank lending. In addition, the non-bank financial institutions also expanded their mortgage lending substantially. In fact, the rise in borrowing by households virtually offset the effect on total credit-market flows of last year's decline in government borrowing.

Asset accumulation in the personal sector, though falling slightly in relation to the gross national product in three of the countries included in the table, was still very large by historical standards. In all countries, indeed, personal-sector asset accumulation throughout the 1970s has been far more substantial in relation to gross national product than it was in the early 1960s. In the 1972–73 expansion, however, household borrowing was at high levels and it was not until the recession set in that the sector's net financial surplus became large.

In Germany, the United Kingdom and to a lesser extent in France and Japan, there was some shift towards investment in securities last year, particularly in government paper. In the United States, however, the earlier trend away from money-market and security investments continued. Insurance claims, traditionally a large proportion of recorded personal-sector asset accumulation in the United States and the United Kingdom, seem to have increased in importance over the last two years in many countries, probably reflecting efforts to compensate for the erosion of the real value of claims brought about by inflation.

But deposits again accounted for a large share of personal-sector asset accumulation. Households' acquisitions of liquid claims, which had increased so strongly when high rates of inflation were cutting sharply into the value of existing financial assets, slowed down somewhat last year in most countries where inflation rates were falling. It is interesting to note, however, that in relation to gross national product the accumulation of liquid assets by households in the United Kingdom has proceeded at a much slower rate in the last two inflationary years than during the 1973–74 phase of monetary explosion.

The financing of public-sector borrowing requirements. Reflecting the contraction in budget deficits, declines occurred last year in central-government and overall public-sector financing requirements, which include borrowing for lending purposes. Among major countries, only Japan, Belgium and the Netherlands recorded further increases. Everywhere, however, the requirements were much larger in relation to gross national product than they had been before the recession. The table on the following page gives a rough breakdown of the financing relating to the central government, except in the case of Germany where it applies to all public authorities other than the social security system.

Financing from domestic non-bank sources increased last year in the Netherlands, while in France and the United Kingdom it covered a much larger proportion of the reduced amount of finance required. In France a long-term government loan was issued and considerable success was enjoyed by a new form of Treasury bill for public subscription with interest rates set to increase progressively over time. In the United Kingdom sales of gilts to the non-bank sector were very large, particularly towards the end of the year. Sales of government securities to domestic non-banks also increased in Japan and again reached fairly high levels in the United States, Germany and Belgium. In some countries sales of short-term securities continued to account for a large part of the total, but in the United States, in particular, strong efforts were made to lengthen the maturity of the public debt.

Central-government recourse to monetary financing decreased in absolute terms last year in France, Germany and the United States, but it increased in

Government financing.[1]

Items	Years	Belgium	France	Germany	Italy	Japan	Nether-lands	United Kingdom	United States
		as a percentage of gross national product							
Public-sector financing requirement[2] . . .	1973	3.8	−0.5	1.0[3]	11.2	.	1.4	4.0[4]	1.0
	1974	3.8	0.1	2.7[3]	9.7	. .	2.7	5.8[4]	1.7
	1975	5.9	3.6	6.3[3]	14.7	.	5.2	7.5[4]	6.1
	1976	6.6	1.7	4.3[3]	11.8	.	5.1	5.0[4]	4.3
Central-government financing requirement . . .	1973	4.0	−0.6	0.3	9.1	0.8	−0.3	3.2[5]	1.0
	1974	3.7	−0.3	1.0	8.6	2.0	0.6	4.2[5]	1.3
	1975	5.8	3.0	3.3	12.4	3.7	3.1	8.1[5]	5.7
	1976	5.9	1.1	2.7	9.5	4.8	3.7	5.6[5]	4.0
met by:									
Central bank	1973	−0.03	−0.47	−0.15[3]	6.08	1.11	−1.06		0.65
	1974	0.16	0.17	−0.17[3]	6.44	2.27	−0.96		0.14
	1975	−0.03	1.38	0.69[3]	4.75[6]	1.47	0.05		0.25
	1976	0.76	0.74	−0.31[3]	5.84[6]	0.66	0.47	1.66	0.47
								0.11	
								1.98	
Banks	1973	2.30	−0.54	0.81[3]	1.05	−0.22	−0.47	−0.15	−0.56
	1974	1.26	−0.03	2.16[3]	1.55	−0.26	0.16		0.16
	1975	1.35	0.81	4.32[3]	4.18	1.38	0.88		2.00
	1976	1.72	−0.33	3.41[3]	0.46	2.40	0.86		0.96
Other domestic sources.	1973	1.89		0.24[3]	1.83		1.24	2.25	0.88
	1974	2.31		0.66[3]	0.58		1.38	2.29	0.83
	1975	4.52		1.04[3]	3.46		2.20	5.58	2.94
	1976	3.43	0.36	0.65[3]	3.19	−0.11	2.53	4.60	2.15
			−0.48			0.00			
Foreign sources . .	1973	−0.20	0.86	0.06[3]	0.13	0.81	—	−0.75[7]	0.02[7]
	1974	−0.08	0.69	0.08[3]	0.01	1.72	—	1.79[7]	0.16[7]
	1975	−0.07		0.28[3]	—		—	0.48[7]	0.51[7]
	1976	—		0.56[3]	0.01		−0.13	1.11[7]	0.46[7]

[1] Net changes in borrowing and cash balances, including borrowing for lending purposes. Partly based on BIS estimates. [2] Central government, local authorities and the social security system, on a cash basis. [3] All public authorities other than social security. [4] Excludes financing of public corporations. [5] Includes central-government lending to public corporations (equivalent to approximately 1.3 per cent. of GNP in 1976). [6] Only short-term debt relevant for the monetary base. [7] Includes drawings on (+) and additions to (—) official external monetary reserves.

Belgium and the Netherlands and remained an important source of government financing in all countries other than the United Kingdom, where there was a remarkable turn-round in the situation. Credit from the banking system covered over one-third of the total requirement in Belgium, France, the Netherlands and the United States and over two-thirds in Germany and Japan. In Italy nearly two-thirds of the central government's financing requirement was covered by borrowing from the central bank.

Foreign sources of funds covered some of the total financing requirement in the United States and even more in the United Kingdom. The unusually large figure for Germany reflects both loans raised by the public authorities from foreign banks and the sale of government paper by German banks to non-residents.

In some countries, notably the United States, Germany and Japan, large government financing requirements do not appear up to now to have led to undue pressure on interest rates or excessive monetary creation. Government recourse to the banking system, though large, seems merely to have counterbalanced the weakness of private credit demand, thus helping to keep monetary expansion on a fairly even course. Moreover, extensive recourse to the capital market did not, except temporarily, prove inconsistent with a stable or downward trend in interest rates. In fact, expectations of receding interest rates, by leading to increased sales of government securities, facilitated monetary control. It has been suggested that aggressive government borrowing at long term prevented interest rates from falling as much as they might otherwise have done, thus discouraging private investment (see Chapter II), but against this must be set the beneficial effect of the deficits in sustaining demand and improving private-sector liquidity in the broad sense.

In some of the other countries extensive monetary financing of the public sector seems to have again posed problems of monetary control and to have contributed to inflationary pressures and external weakness. The fact that it was in the more vulnerable countries that interest rates did rise seems to underline the key influence on them of closely related expectations regarding inflation and exchange rate developments. Indeed, the uncertainty of the interest rate outlook at times contributed to the difficulty of financing budget deficits by non-monetary means. In some high-inflation countries the limited issue of public debt instruments with some form of variable interest rate has recently been under consideration as a way of reducing the uncertainties faced by both borrowers and lenders in making long-term financial commitments. Such a loan was announced in the United Kingdom for issue in late May.

Monetary developments and policies.

Continuing inflation and external imbalances have substantially narrowed the monetary policy options which seem to be open to the various countries. On the one hand, it has become increasingly accepted that the attempt to apply strong monetary stimulus is likely to result in high rates of inflation in the medium term and, in a context of extreme sensitivity to inflation, may do little to stimulate output in the short run. On the other hand, in all but a few countries weak external positions have seemed increasingly to call for policies of monetary restraint. At all events, the stance of monetary policy last year seems in the so-called strong countries to have been no more than accommodative while in most others it was largely restrictive.

Monetary policy. In the United States, Germany, Japan and Switzerland monetary policies with a distinct medium-term orientation were continued with little change from the previous year. Except in Japan, the central aim was to stabilise the growth of the money supply. In the United States the Federal Reserve continued regularly to set medium-term targets for monetary growth. The basic intention was to lower the targets as inflation abated, but only minor changes were made last year. In Germany the aim in 1975 had been an 8 per cent. growth in central-bank money, and the same target, though on an annual average basis, was maintained for 1976 and 1977. In Switzerland a 6 per cent. target for the average growth in M_1 in 1976 was followed by a 5 per cent. target for 1977. In Japan the authorities kept "window guidance" ceilings on bank credit expansion in force as a precaution, even though the demand for bank credit was weak. In setting them and in influencing the financing of the Government's borrowing requirement, the authorities were guided by forecasts of monetary expansion, albeit unpublished ones.

Policies which were largely designed to consolidate the progress already made in dampening inflation left only limited scope for stimulating demand in the short run. However, by not reducing the targets commensurately with the decline in inflation and by applying them with some flexibility, the authorities sought to provide scope for expanding economic activity.

Changes in the setting of policy instruments during the year reflected this moderately permissive attitude, which was no doubt influenced by concern about the pause in growth during the second half of 1976. After a period of rapid monetary expansion the US authorities conducted restrictive open-market operations in the summer. Thereafter, they were more accommodating, providing the banks with sufficient reserves to meet the still limited demand for bank credit. The easier stance was also signalled in traditional ways by a lowering of the banks' reserve requirements in August and December and a cut in the discount rate from 5½ to 5¼ per cent. in November. In Germany the pattern during the year was somewhat different. The authorities increased the banks' reserve requirements in the spring and took open-market action in the autumn of 1976 to rein in the banks' free reserves, thus counteracting the expansionary influence of official exchange-market intervention under the joint currency float arrangements and changes in government deposits at the Bundesbank. The banks' rediscount quotas were raised in two stages in March and June 1977 as technical steps to help ensure adequate monetary expansion. In Japan "window guidance" ceilings were eased during the year and the discount rate was brought down from 6½ to 5 per cent. in two stages in March and April 1977.

In other countries, most of which had higher rates of inflation, actual or potential external weakness had by last year come to be considered a significant constraint on monetary policies. With long-standing external current-account deficits likely to continue or increase, and external indebtedness in some cases high, the attractiveness of financing deficits by officially inspired borrowing abroad had diminished. Monetary authorities had also become increasingly aware of the risk that exchange depreciation could give a sharp boost to domestic inflation.

The deep-rooted problems of Italy and the United Kingdom seem to have been compounded by recent difficulties of monetary control. In Italy, where the Government's finances and privileged export credit facilities had caused an explosion of the monetary base, the lira began to fall sharply in early 1976, touching off a vigorous wage/price spiral. The emergency measures adopted last year — including the 50 per cent. import deposit requirement, increases in banks' reserve requirements and a progressive increase in the discount rate from 6 per cent. at the beginning of the year to 15 per cent. in October — helped to slow down the expansion of the free element of the monetary base. But the Treasury deficit was still enormous and private demand for bank credit expanded strongly. With the authorities having long sought to moderate the rise in interest rates, quantitative credit ceilings had to be imposed in an effort to prevent the increase in total domestic credit from substantially exceeding the Lit. 29,500 billion limit set for the year. The ceilings have been extended to cover the period ending March 1978.

In the United Kingdom interest rates had been lowered at the beginning of 1976. When sterling came under pressure in the spring, domestic credit expansion accelerated and, though held back for a time by outflows of funds, monetary expansion moved up to very high rates in the third quarter. The Bank of England's minimum lending rate had been raised by 2½ percentage points in April–May but, though sterling remained under intermittent pressure, the authorities were reluctant to encourage a further rise in interest rates. Finally, however, in September–November calls for special deposits were announced, marginal reserve requirements on banks' interest-bearing deposits ("the corset") were reintroduced and the minimum lending rate was increased to 15 per cent.

After the announcement of international support arrangements, sentiment in the sterling and gilt markets was sharply reversed. In a context of capital inflows and a declining public-sector borrowing requirement, domestic credit and the money supply actually contracted in early 1977. This counterbalanced the acceleration which took place during the summer of 1976, so that by mid-April 1977 the twelve-month rate of increase in the sterling money supply (M_3) fell to only 7.5 per cent. The authorities sought at times to moderate the decline in interest rates. But by mid-May 1977 the minimum lending rate had been reduced to 8 per cent., prompting some discussion as to whether, given the continuing high rate of inflation, interest rates were not perhaps coming down too fast and too far.

In France, where the underlying economic problems had been less severe, the authorities encouraged high money-market rates in order to limit the depreciation of the franc and signalled this policy by increasing the discount rate from 8 to 10½ per cent. between July and September. They also took measures in the autumn to help moderate domestic inflationary forces: the norms for bank credit expansion were tightened, a reserve requirement on the increase in bank lending was reintroduced and a 12½ per cent. upper limit on the growth of the money supply during 1977 was announced.

But it was those countries whose currencies were linked to the Deutsche Mark in the European joint float that gave the highest priority to resisting exchange-market pressures on their currencies, permitting or encouraging domestic interest rates to rise to the extent necessary for this purpose. During periods of turbulence within the "snake" in March–April and July–October, the authorities in Belgium, for instance, permitted their sales of foreign exchange to bring about a tightening of money-market conditions and enhanced this effect by limiting the availability and raising the cost of central-bank credit. In the process, the day-to-day money rate, which had stood at 4 per cent. in January, reached a peak of 18.5 per cent. at the beginning of October before retreating to an average of 7.4 per cent. in December. In the Netherlands, too, money-market restraint techniques were used to help counter speculation against the guilder which arose for a time between July and October. With the external current account basically strong, however, the policy of encouraging capital outflows by relatively low domestic interest rates was soon restored and, following a sharp acceleration in monetary expansion, ceilings on bank lending were introduced in the spring of 1977. In Denmark and Sweden defensive measures included ceilings on bank credit designed partly to divert credit demand to foreign sources.

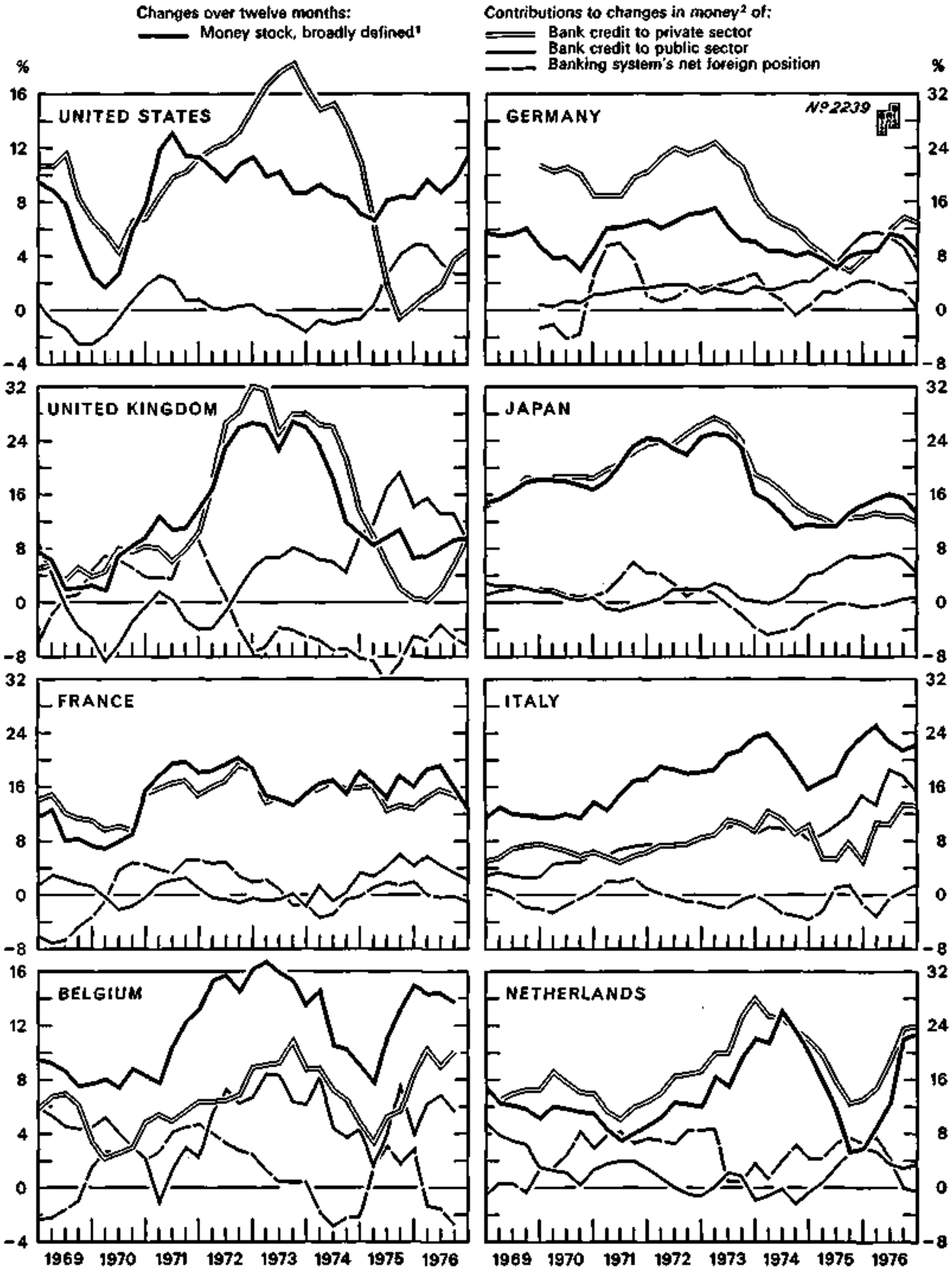
Developments in monetary aggregates. Rates of growth in the money stock have generally continued to fluctuate over a wide range. In many countries twelve-month rates of growth in the broad money stock moved upwards in late 1975 and during the first half of 1976 to reach levels which, in the Benelux countries, France and Italy, were close to the previous peaks recorded in the early 1970s. With Italy, the Netherlands and the United States the principal exceptions, there was a considerable slowdown in most countries in late 1976 and early 1977, reflecting the pause in the recovery and in many cases restrictive policies, together with the calming of exchange-market conditions. In the United States, Germany and Japan monetary growth rates remained fairly moderate by past standards, but those in most other countries continue to reflect the high underlying rates of inflation.

Credit to the public sector is still a major factor in monetary expansion. Its contribution to monetary growth fell last year in France, Germany, the United States and the United Kingdom — reflecting, in varying degrees, a contraction of public-sector deficits and increased recourse to non-monetary financing — but rose further in Belgium and Italy. In France and the Netherlands bank credit to the public sector, together with public-sector borrowing abroad, accounted for less than one-fifth of domestic credit expansion last year, but in the other countries its contribution ranged from about one-third to over one-half.

Bank credit to the private sector recovered or accelerated quite sharply last year, notwithstanding the modest pace of the economic revival. In some cases, as explained earlier, the expansion reflected mortgage and consumer lending as well as bank credit to companies for purposes of stockbuilding and financial restructuring. But it is significant that there was a pronounced rise in some of the countries which experienced external payments difficulties during the year. Apart from the influence of relatively high rates of inflation, an expansion of bank credit seems to have occurred in conjunction with outflows of funds (or shifts in the terms of external commercial payments) and unusual rises in the relative return on domestic money-market assets. In such cases the large increase in domestic credit was directly associated with the external weakness. It was reflected, moreover, in the negative impact of the external sector on money creation in these countries as well as in pressure on exchange rates.

The tendency last year for a recovery in credit to the private sector partially to supplant bank lending to the public sector as a source of money creation can be seen in longer-term perspective in the graph opposite. The curves show twelve-month percentage changes in broad money aggregates and the contribution to these movements of twelve-month changes in the various counterparts.

Changes in the money stock and the contributions of its counterparts.



[1] Based on national sources. For Germany and the United Kingdom M_3; for other countries M_2 (money plus quasi-money). [2] The percentage contributions of the counterparts add up to the percentage change in money, except for differences due to balance-sheet items not shown — the principal one being domestic non-monetary liabilities of banks.

In the United States there has long been a tendency for bank lending to the public and private sectors to move in opposite directions, the former complementing the latter in a broadly anti-cyclical way. In most other countries developments in the money stock have, as a general rule, closely reflected fluctuations in credit to the private sector. In France, Japan and Germany, in particular, a strong counter-cyclical rôle played by credit to the public sector was a rather novel feature of the recent recession. In Italy and the United Kingdom, on the other hand, monetary financing of the public sector had been following an upward trend for some time. In Belgium and the Netherlands the contribution to money creation of credit to the public sector was large in 1975 and 1976 but not unprecedented. Somewhat surprisingly, changes over the years in credit to the public sector in Belgium seem at times to have been positively correlated with those in credit to the private sector.

The external counterpart of changes in the money supply is, broadly speaking, a measure of the overall balance-of-payments position. In the long run there has been a tendency in a number of countries for wide fluctuations in domestic credit expansion (total bank lending to the private and public sectors) to be mirrored in opposite movements in the external counterpart. This tendency is discernible not only in the years when exchange rates were rigidly fixed but also in the recent period. But whereas in the United Kingdom changes in the external counterpart appear often to be negatively related to those in bank lending to the public sector, in Italy they seem rather to be inversely associated with movements in credit to the private sector. However, as a long-term trend, the growing monetary financing of the public sector in Italy has also been associated with the adverse movement of the external balance. Inverse relationships between domestic credit expansion and the external position are clearly evident in Belgium and the Netherlands, and have been in earlier years in France. Some such relationship, admittedly much less clear-cut, seems to have existed in Germany also, at least until the time of floating. In some cases these relationships may reflect the fact that outflows or inflows of funds (or changes in the current account of the balance of payments) in response to non-monetary forces increased or decreased the economy's need for credit from domestic banks. But more often they seem to have resulted from incentives to inflows or outflows of funds arising from domestic monetary policies which were significantly tighter or more lax than those being followed in key centres elsewhere.

The use of monetary targets: Problems and policies.

The practice of establishing and publishing official targets for the growth of monetary aggregates has been adopted by monetary authorities in quite a number of countries in recent years. This approach has been employed since 1975 in the United States, Germany, Switzerland and Canada, and last year norms were published for the first time in France and the United Kingdom. In the Netherlands the authorities have formulated an objective for the growth of money expressed in terms of the relationship between the latter and the rate of expansion of net national income.

Published monetary targets and actual rates of monetary expansion.

Country	Monetary aggregate	Target period	Target	Actual result
			increase as a percentage	
Canada	M_1	II/1975 — II/1976	10—15	12.0[1]
		February–April 1976 — II/1977	8—12	.
France	M_2	12 months ending December 1976	—	12.8
		12 months ending December 1977	12.5[2]	.
Germany	Central-bank money	1975 average — 1976 average	8.0	9.2
		1976 average — 1977 average	8.0	.
Switzerland	M_1	1975 average — 1976 average	6.0	8.0
		1976 average — 1977 average	5.0	.
United Kingdom	Domestic credit expansion	12 months to mid-April 1977	*£9.0 billion*[2]	*£4.2 billion*
		12 months to mid-April 1978	*£7.7 billion*[2]	.
	Sterling money supply (M_3)	12 months to mid-April 1977	9—13[3]	7.5
		12 months to mid-April 1978	9—13[3]	.
United States[4] . .	M_1	I/1976 — I/1977	4.5— 7.0	6.1
		I/1977 — I/1978	4.5— 6.5	.
	M_2	I/1976 — I/1977	7.5—10.0	10.8
		I/1977 — I/1978	7.0— 9.5	.
	M_3	I/1976 — I/1977	9.0—12.0	12.7[5]
		I/1977 — I/1978	8.5—11.0	.

[1] Rate of expansion from II/1975 to February–April 1976, a period chosen to avoid the influence of postal strikes. [2] Upper limit. [3] Range stated to be consistent with the target for DCE. [4] Medium-range targets. [5] March estimated.

The above table compares the norms announced with the actual expansion of the variables concerned in the most recent completed period and sets out the norms for the current period.

In the United States the Federal Reserve has regularly announced target ranges for the growth of M_1, M_2 and M_3 during overlapping twelve-month periods ending in successive calendar quarters. The ranges allow for some margin of error and the targets can be varied over time to provide both for a gradual slowdown in the underlying rate of inflation in the economy and for changes in the public's preferences for different types of monetary assets. With a view to steering monetary growth along the medium-term course so established, short-term tolerance limits are set at the monthly meetings of the Open Market Committee in order to guide the System Account Manager in market operations. These limits cover overlapping two-month periods and refer to the average growth of the three monetary aggregates and to the Federal funds rate. The relative importance attached to the achievement of the targets for the different aggregates has changed from time to time.

In Germany 8 per cent. targets were established for the annual average increase in the central-bank money stock in both 1976 and 1977. In announcing the target for 1977 the authorities explicitly stated that in view of the strong expansion in central-bank money in late 1976 an 8 per cent. increase on an annual average basis implied a rise of only 6–7 per cent. in the course of the year. Central-bank money is defined in Germany as the currency in circulation plus banks' required reserve holdings in respect of liabilities to residents calculated on the basis of unchanged coefficients. Hence, although it is an item in the central bank's balance sheet, central-bank money cannot be controlled in a precise or direct way by the monetary authorities in the short run. It is influenced instead by action affecting banks' free reserves and the cost of central-bank credit. In effect, central-bank money is a weighted sum of the components of the broad money supply, the weights for the deposit elements being equivalent to the reserve ratios. These differ according to the type of deposit in a way which to some extent reflects differences in the degree of their liquidity. Once established, the targets for the year have not so far been changed subsequently.

In Canada target ranges have been set for M_1: a consideration which influenced the choice of this aggregate was that the behaviour of other aggregates depends significantly on changes in differentials between interest rates, some of which are determined by institutional factors outside the direct control of the authorities in the short run. The lower end of the range of each of the targets announced so far has corresponded to the limit on wage increases under the Government's incomes policy for the period concerned, while the upper limit has provided what is considered to be an adequate margin for manoeuvre. In seeking to achieve its target, the Bank of Canada relies mainly on its ability to influence money-market rates of interest. In Switzerland the target variable is also M_1, but the target values have changed little over time.

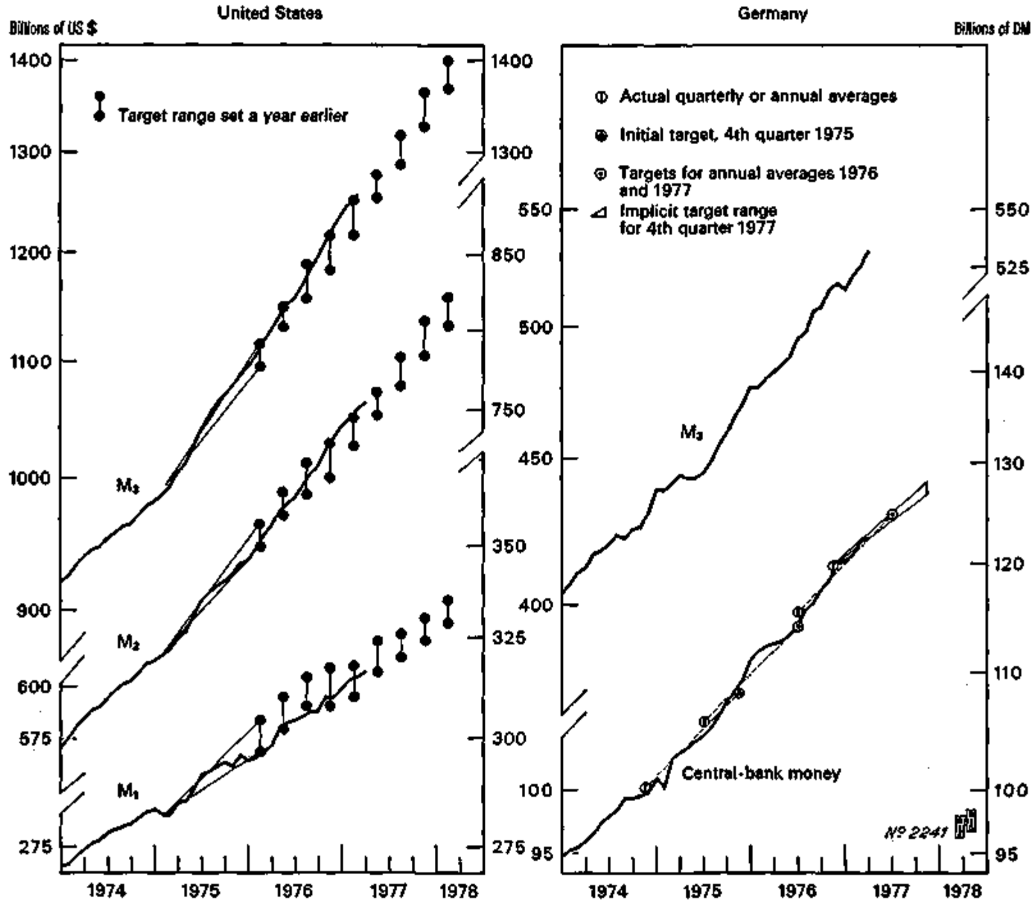
In France a 12½ per cent. upper limit in respect of the growth of M_2 in the course of 1977 was announced in September 1976 by the Government as part of an economic stabilisation programme which included, inter alia, steps to reduce the budget deficit and restrictive norms for bank credit expansion. The target figure was slightly less than the official estimate of the growth of nominal gross national product between 1976 and 1977 and proved to be a close approximation to the rate of monetary expansion actually recorded in 1976. In the United Kingdom a 12 per cent. norm for the growth of M_3 during the fiscal year ending March 1977 was announced by the Chancellor in July 1976 along with cuts in government expenditure designed to reduce the public-sector borrowing requirement. This norm was superseded last December by limits on domestic credit expansion set, in agreement with the IMF, at £9.0 and 7.7 billion for the twelve months to mid-April 1977 and 1978 respectively. Given the assumptions concerning the development of the balance of payments, these targets were considered to be consistent with a 9–13 per cent. growth of M_3, redefined to include only sterling elements.

In the Netherlands the authorities have for many years attached importance to the development of M_2 in relation to net national income (the "national liquidity ratio"). This ratio rose from 37.5 to 41 per cent. in the course of 1976 and the Netherlands Bank has stated that a reduction of at least 1 percentage point per year should be aimed at between now and 1980. In Italy, it may be added, a limit has been set in agreement with the IMF in respect of the expansion of credit granted through both bank and non-bank channels. It has been fixed at Lit. 30,000 billion for the twelve months ending March 1978. On the basis of assumptions regarding the balance of payments and the economy's acquisitions of non-monetary assets, an implicit norm for the expansion of money may be deduced from this limit.

Finally, it should be noted that in addition to these published targets unpublished monetary targets or forecasts — to which varying degrees of importance are attached — are now being formulated as a guide for monetary policy in several European countries and in Japan.

Actual results: How close to the mark? Actual monetary expansion over the target periods is compared with the original objectives in the table on page 65. For the United States and Germany the course of monetary expansion in relation to the targets is compared in the following graph.

The United States and Germany:
Monetary targets and the growth of money.



Although monetary expansion was fairly moderate and stable in both these countries, technical difficulties in exercising monetary control and the need to take other objectives into account caused the growth of the money stock to move relatively far off course at times. In the United States the growth of M_1 occasionally fell below the lower limit of its target range, while that of M_2 and M_3 tended to move beyond the upper boundaries. These divergences seem to have been influenced by the development of new negotiable savings deposits, by regulatory changes and by relative declines in interest rates on short-term securities. In Germany constraints imposed by the European joint float arrangements seem to have contributed to a temporary swelling of bank reserves and, indirectly, to an acceleration in the growth of central-bank money. However, though the authorities were aware of this at an early stage, they deliberately refrained from taking more restrictive action. In Switzerland, too, the authorities permitted the expansion of M_1 to exceed a target which, considered in relation to the rate of inflation, may itself have seemed liberal. However, the rise reflected, at least in part, an increased propensity to hold cash balances as interest rates came down: the growth of M_2 was very moderate.

In Canada the growth of M_1 displayed a persistent tendency to fall below the lower limit of the target range and the authorities responded by progressively lowering Bank rate. In the United Kingdom monetary expansion accelerated sharply in the summer of 1976, but when sentiment in the gilt-edged and foreign exchange market changed, domestic credit expansion began to contract and the growth of the money supply slowed down markedly. Over the whole of the twelve-month period ending mid-April 1977, domestic credit expansion was well within its designated limit and the growth of sterling M_3 was also well below the lower end of its normative range.

The problems of targeting. Although a great many central banks have now adopted monetary norms, each has been at pains to point out, when announcing or explaining targets, that a wide range of considerations other than the growth of money would continue to be taken into account in the formulation of monetary policy. Indeed, the approach is beset with difficulties and limitations.

For instance, it is nowhere possible to control monetary growth very precisely on a week-to-week or even month-to-month basis. Short-run fluctuations have been quite large in countries where the authorities have sought to achieve their target mainly by influencing money-market interest rates and bank reserves, as well as in countries where they have relied on more or less direct controls on monetary financing of the public sector and bank credit to the economy. In the short run the money supply may be affected in unpredictable ways by shifts in Treasury accounts, external payments and clearing balances. The public's preferences for cash or various types of bank deposits may change, as may bank attitudes to the holding of free or borrowed reserves. Sudden large swings in sentiment in the exchange markets, disturbances looming in private credit markets and changes in the willingness of the public to acquire government securities — especially where public-sector deficits are chronically large — may affect the ability of the authorities to control the development of the money supply in the short run and, indeed, the appropriateness of doing so.

It is often argued that for purposes of stabilising or bringing down rates of inflation the inevitable short-run fluctuations in monetary expansion may not matter much. It is not easy, however, to distinguish between random disturbances and emerging trends. Moreover, with regard to interest rates and exchange rates, which are of vital importance where inflation is concerned (see Chapter III), the authorities are in something of a dilemma. The attempt to keep monetary growth within narrow limits in the short run may at times result in sizable fluctuations in interest rates and, as a consequence, in exchange rates. It is also true, however, that the failure of the authorities to keep the growth of money closely in line with their published targets can itself be destabilising.

Over a slightly longer period of time the income velocity of money tends, of course, to vary systematically over the trade cycle. The main reason for this is that the public's preferences for different types of monetary assets are influenced by differences in interest yields, and to some extent this factor can be taken into account in setting and revising monetary targets. But not fully, for some of the interest rates involved are set by custom, agreement or regulation and may change from time to time independently of monetary conditions.

Moreover, as a result of the economic disturbances of recent years and, indeed, of the new emphasis on policies deliberately orientated towards steering the aggregates, the demand for money seems to have become more difficult to predict in many countries. It may be noted that efforts to bring the expansion of the broad monetary aggregates under control following their explosion in 1972–73 were associated in many countries with an atypically slow fall, or even a rise, in the income velocity of circulation of the money supply. To some extent, no doubt, this was a reaction to earlier declines in velocity that had been equally atypical. Against this background the question may arise whether some countries are now placing too much reliance on the capacity of velocity to rise cyclically and thereby help finance the upswing in output. It has been pointed out, in particular, that even when prospective inflation is taken into account, long-term interest rates in some countries with moderate inflation rates seem unusually high at present and that this may be tending to delay a recovery in investment. According to one view, slightly easier monetary policies in these countries might have permitted real interest rates to come down. The alternative view is that policies less restrictive than the ones actually followed would have been less successful in calming inflationary expectations and would merely have hindered the decline in nominal interest rates.

The relationships between the expansion of the various monetary aggregates on the one hand and developments in the price level and economic activity on the other may also change as a result of structural developments and innovations in the financial system. For instance, the greater willingness of banks to provide money-transfer facilities in respect of interest-bearing deposits seems in some countries to have increased the income velocity of circulation of M_1 in recent years. In principle, problems associated with changing relationships among the various types of assets can to a large extent be avoided by choosing a very broad aggregate as the target variable, though this may imply the use of targets that are not very amenable to official influence. Moreover, even an aggregate of this sort will be affected by shifts in preferences between deposit assets and securities.

Norms for domestic credit expansion. For a variety of good reasons, attention in recent years has been focused more on developments in the money supply than in changes in total bank credit. However, in some circumstances there are cogent reasons for also keeping a check on developments in the total assets of the monetary system. Apart from variations in the non-monetary liabilities of the banks, the difference between the change in bank credit and that in the broad money supply mainly reflects changes in the external position of the banking system or, broadly speaking, the overall external balance of the economy.

In fact, norms for broad bank credit aggregates are similar in most respects to norms for the growth of the money supply, but they embrace, in addition, domestic monetary impulses which are transmitted into external deficits and surpluses and not into domestic money expansion. In circumstances where the authorities intervene to support the exchange rate, domestic credit expansion is a more relevant control variable than the money supply. Restrictive norms for domestic credit expansion may be particularly appropriate for countries which need to give high priority to correcting external deficits. Since external financing of the public sector may help to support the exchange rate and contribute to expansionary monetary impulses in much the same way as use of official foreign exchange reserves, it may be appropriate to include it in domestic credit expansion, as is done in the United Kingdom. The difference between changes in domestic credit expansion and those in the money stock will then reflect, on the external side, the current-account balance plus net private capital flows.

The usefulness of monetary norms. The adoption by central banks of the monetary norms approach to monetary policy seems to have had less to do with short-term objectives than with the awareness that rates of monetary expansion tend to be closely reflected in rates of inflation over the longer run.

In addition, nominal interest rates had become manifestly unreliable as indicators of the stance of monetary policy in inflationary conditions, and it was considered that developments in the monetary aggregates could provide a useful yardstick even in countries where interest rates continued to be the major tactical instrument of policy.

Equally important, the announcement of targets has also enabled the monetary authorities in a number of countries to exercise more influence over the sources of money creation and to convey to the public their firm intention of bringing rates of inflation down. Policies orientated towards control of the monetary aggregates seem to have been particularly effective in bringing down rates of inflation in the United States, Germany and Switzerland. In Germany, for instance, the targets apparently exerted a moderating influence on wage claims in annual negotiations, and more recently, in France and the United Kingdom, the adoption of monetary norms has helped to express the authorities' resolve to reduce the public-sector deficit. In recent years the outlook for increases in the general price level has obviously played a growing rôle in wage and price formation throughout the economy. In these circumstances monetary targets could contribute in a useful and fairly direct way towards stabilising and moderating inflationary expectations. And they have also helped to underline the consequences, in terms of output and unemployment, of wage and price increases beyond the limits compatible with the norms.

On the other hand, experience also shows that many economies, particularly the more open ones with vulnerable external positions, may need to pay close attention not only to the growth of the money supply but also to other indicators, including domestic credit expansion. While the risk of exchange-market pressures may be considerably reduced by conscientious efforts to adhere to restrictive monetary norms, many countries have found it useful also to influence interest rate differentials directly. However, to be effective the differential ought to be large enough to take account of differences in countries' prospective rates of inflation. Even so, given that exchange markets react to a variety of short-term factors, crisis situations cannot be excluded. In such circumstances some countries have found it advantageous, on balance, temporarily to countenance very high levels of domestic rates.

Interest rates.

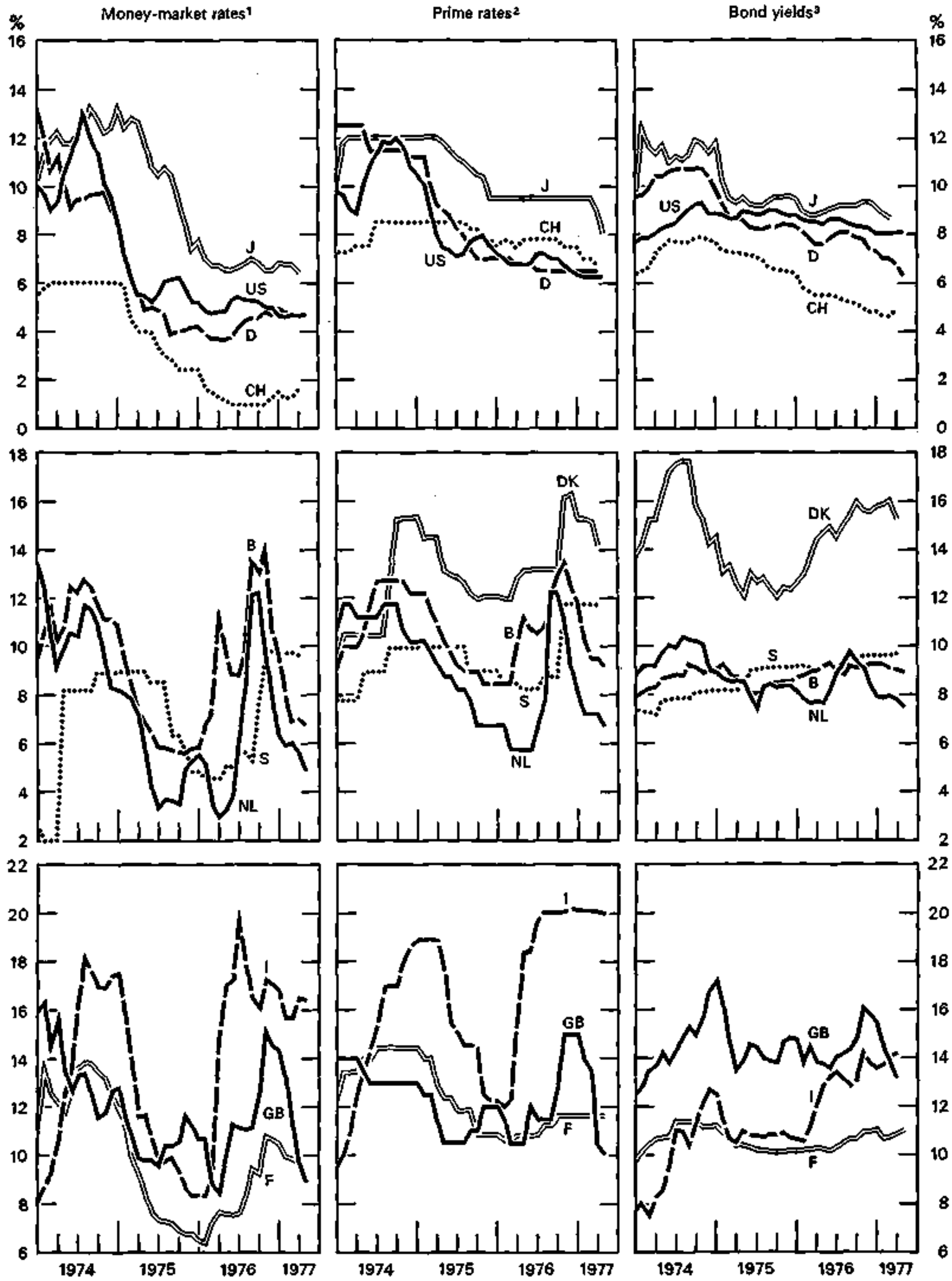
After a sharp slide in 1975 interest rates in the strong countries generally edged down further last year under the influence of the pause in recovery, the calming of inflationary sentiment and the generally accommodative stance of monetary policy. Money-market rates fluctuated within a narrow range, and their movements, which were not co-ordinated among countries, largely reflected modifications in the stance of monetary policy. In the United States a downward tendency was interrupted for a time in the spring, when the Federal Reserve took action to slow the growth of the money supply. Short-term rates turned up again in early 1977, partly in reaction to the strengthening of the economic recovery. In Germany the three-month interbank rate fell to a trough in early 1976 but rose by about 1 percentage point between April and July when measures were taken to tighten bank liquidity. In Japan the call-money rate edged up for a time in the summer and again around the turn of the year but moved downwards this spring. Banks' prime lending rates in the United States rose briefly in the summer of 1976 in sympathy with money-market rates, but then fell back and were not adjusted upwards again until May 1977. In Germany the lower range of rates quoted in respect of large current-account credits fell in the spring of 1976 and thereafter changed very little. In Japan banks' minimum overdraft rates, which are linked to the discount rate, were not changed in 1976 but were lowered in the spring of 1977. Fluctuations in short-term rates were reflected only to a very limited extent in capital-market yields, which displayed a downward tendency in all countries.

An unusual aspect of the situation in the United States, Germany and Japan is that interest rates continued to fall for so long during a phase of cyclical recovery. In most cases long and short-term interest rates still stand well below the levels they had reached at the beginning of the expansion. Though the weakness of the recovery may have been one factor, this development mainly reflected the progressive downward revision of inflationary expectations as current rates of inflation moderated.

In a number of other countries the pattern of movements in short-term interest rates was dominated by exchange-market developments and the efforts made by the authorities to defend currencies against depreciation.

Among the "snake" countries, whose currencies were affected in very different ways by the crisis in March 1976, money-market rates in Belgium and the

Short and long-term interest rates.



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Note: B = Belgium, DK = Denmark, F = France, D = Germany, I = Italy, J = Japan, NL = Netherlands, S = Sweden, CH = Switzerland, GB = United Kingdom and US = United States.

¹ Representative rates. (For the United States, Federal funds; for Japan, call money; for France, day-to-day money; for Italy, interbank sight deposits; for other countries three-month money-market instruments.) ² Minimum rates charged by commercial banks for cash credits to first-class borrowers. For Denmark, average lending rate; for Germany, lower end of range for large current-account credits. ³ Representative rates. (For the United States, Aaa corporate bonds; for Denmark, mainly mortgage bonds; for Belgium, the Netherlands and the United Kingdom, government bonds; for other countries various other public-sector bonds.)

Netherlands moved in opposite directions in the January–June period. In the autumn crisis, however, when both currencies were temporarily on the defensive, money-market rates in both countries bounded up to levels close to their mid-1974 peaks. Thereafter they came down rapidly and by the spring of 1977 were at much the same level as in the early months of 1976. In the Netherlands, for instance, the rate on Treasury loans to local authorities stood in April 1977 at about 4.9 per cent. on a monthly average basis. In the course of 1976 it had touched a low of 3 per cent. in March and then reached a peak of over 12 per cent. in September. In Denmark and Sweden short-term interest rates also moved up steeply in the September crisis but have moved downwards since that time.

In the United Kingdom money-market rates fell by some 3 percentage points between October 1975 and March 1976 but rose by about the same amount in April–May and by another 1 or 2 points in September. After a further steep rise the three-month interbank rate reached 15.2 per cent. by the end of October. Then the tide turned and, though the authorities to some extent resisted the decline in market rates, three-month money traded at only 8.75 per cent. by the end of April 1977. In Italy short-term interest rates rose very steeply between January and June, the interbank rate going up from 8.3 to 19.7 per cent. Subsequently, a decline occurred, but it was limited and irregular. In France the swings during the year were much less marked: the day-to-day money rate was ratcheted up in successive periods of external weakness from around 6 per cent. in January to about 10 per cent. in December. In early 1977, however, some decline was evident.

In most of these countries the banks' prime lending rates followed an irregular course rather similar to that of money-market rates, though the swings were, of course, smaller. A notable exception was Italy, where the prime lending rate moved up from 12 per cent. in February to 20 per cent. in July and stayed at or above that level into the spring of this year. A different type of exception was France, where on domestic grounds the rise in bank lending rates was kept to very modest proportions, though this seems to have had an adverse influence on bank profitability. In Belgium, the Netherlands and the United Kingdom prime rates had by early 1977 approximately returned to their levels of a year earlier.

Bond yields rose considerably during the year as a whole in Italy and Denmark, and in the Netherlands and the United Kingdom they recorded a short-lived rise in the second half of the year. In France and Belgium long-term rates scarcely reacted to the swings in money-market rates but rose slightly on balance.

It is not possible either from the domestic or international point of view to judge the appropriateness of a country's interest rates without taking into account its prospective rate of inflation. Domestically, if interest rates are too low relative to expected inflation, inflation tends to persist along with all its contractionary effects on economic activity as discussed in Chapter III. Externally, there will be an incentive for outflows of funds, partly because expectations as to exchange rate movements and relative rates of inflation will be closely linked. In countries where rates of inflation are still high, credible restraint programmes should give scope for a return to a more normal level of nominal interest rates, but only insofar as inflationary anticipations are revised downwards.

V. INTERNATIONAL TRADE AND PAYMENTS.

Although the vast global payments imbalances which had characterised the two preceding years persisted in 1976, some more encouraging tendencies became evident both in world trade and in some individual countries' balances of payments. Firstly, the recovery in the industrial countries brought a resumption of world trade growth. The upsurge was particularly vigorous during the first half of 1976 and despite the moderate pace of recent business expansion it is still progressing at a historically satisfactory rate. Secondly, some significant adjustments took place in the balance-of-payments positions of individual countries and others are likely to occur during 1977. Last but not least, and notwithstanding problems in some individual countries, there seem in general to have been no major difficulties in financing the persistent imbalances.

More than three years have now elapsed since the oil price increases in the winter of 1973–74 set in motion the great upheaval in the world's balance-of-payments structure. The concluding part of this chapter sums up the events of these three years and discusses the chances of adjustment for the main groups of countries with imbalances.

World trade.

1976 was a year of rapid growth in world trade. With demand from the industrial countries as the main driving force, it expanded by 11½ per cent. in real terms — a rather dramatic reversal of the 4½ per cent. decline recorded in 1975. In value terms the contrast between the two years was less sharp, since the average price of internationally traded goods rose in dollar terms by only 1 per cent. in 1976, as against 8 per cent. the year before; nevertheless, the $106 billion increase in the dollar value of world trade was two and a half times as great as in 1975 and brought total world trade turnover close to the $1,000 billion mark. Looking at developments during the course of last year, the growth of trade volume was most rapid in the first half, when it reached an annual rate of 14 per cent.; but even in the second six months, when it reacted to the weakening of expansion in the industrial countries, the growth rate on an annual basis was 8 per cent. — equal to the annual average for the 1960s.

The cyclical recovery within the *developed areas* of the world (described in Chapter II) has been accompanied by strong import demand. Between the second half of 1975 and the first half of 1976, industrial production in these areas rose at an annual rate of 15 per cent., helping to generate even faster import growth; and in the second half, despite a sharp falling-off in the rate of industrial expansion, import demand remained strong, rising at an annual rate of 11 per cent. This was partly because stocks continued to be rebuilt, although less rapidly than at the turn of the cycle, and partly because of precautionary oil imports ahead of the end-year price increase. Taking 1976 as a whole, the volume of imports into the developed countries

World trade.

Areas	Exports (f.o.b.)				Imports (c.i.f.)			
	1975	1976 Year	1976 1st half	1976 2nd half	1975	1976 Year	1976 1st half	1976 2nd half
	in billions of US dollars (volume indices 1974 = 100 in brackets)							
Developed areas								
Western Europe:								
EEC	295.0	323.3	156.3	167.0	297.9	337.2	163.9	173.3
Other countries	70.1	76.5	37.3	39.2	97.9	104.3	49.9	54.4
Total	365.1	399.8	193.6	206.2	395.8	441.5	213.8	227.7
	(94.7)	*(105.2)*	*(104.2)*	*(106.1)*	*(94.8)*	*(106.8)*	*(106.0)*	*(107.6)*
United States	107.6	115.0	57.0	58.0	103.4	129.6	61.0	68.6
Canada	33.8	40.2	20.0	20.2	38.4	40.6	20.8	19.8
Japan	55.8	67.3	30.8	36.5	57.9	64.8	30.7	34.1
Other countries[1]	24.8	26.1	12.7	13.4	26.7	27.0	13.5	13.5
Total developed areas	587.1	648.4	314.1	334.3	620.2	703.5	339.8	363.7
	(96.4)	*(106.8)*	*(105.3)*	*(108.2)*	*(92.5)*	*(104.8)*	*(102.5)*	*(107.1)*
Developing areas								
OPEC[2]	111	133	62	71	54	68	31	37
	(85)	*(97)*	*(90)*	*(103)*	*(144)*	*(177)*	*(163)*	*(191)*
Other areas	97	111	53	58	131	135	66	69
	(103)	*(109)*	*(108)*	*(110)*	*(95)*	*(96)*	*(97)*	*(95)*
Total developing areas	208	244	115	129	185	203	97	106
	(97)	*(106)*	*(103)*	*(108)*	*(106)*	*(115)*	*(112)*	*(119)*
Centrally planned economies[3]	85	94	44	50	100	104	51	53
Grand total[4]	880	986	473	513	905	1,011	488	523
	(96)	*(106)*	*(104)*	*(108)*	*(95)*	*(107)*	*(105)*	*(109)*

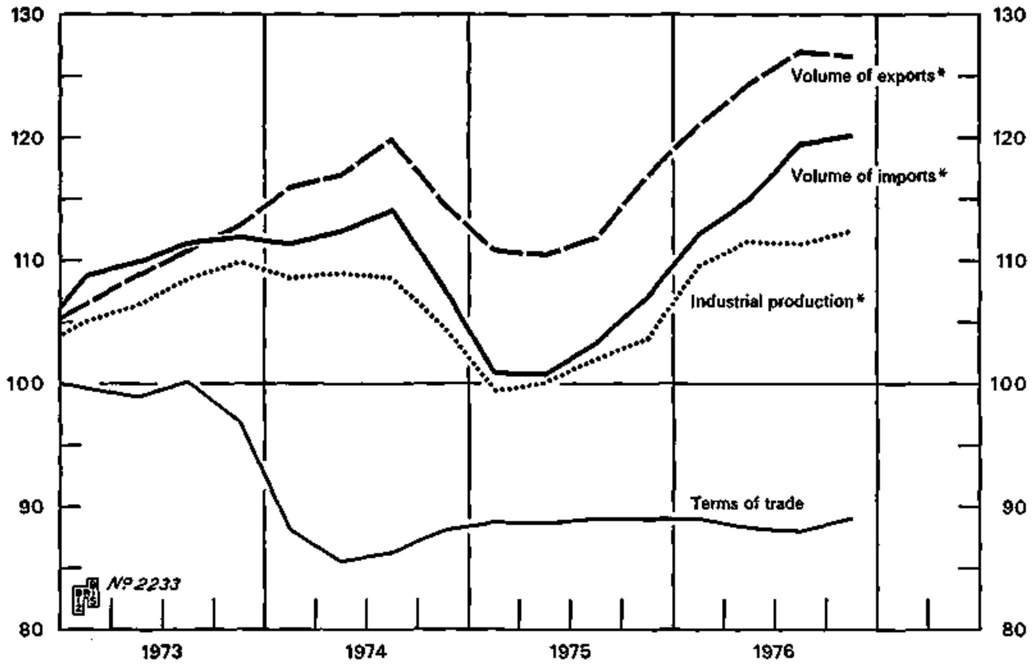
[1] Australia, Israel, New Zealand, South Africa. [2] Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela. [3] Bulgaria, People's Republic of China, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania and USSR. [4] Volume index excludes centrally planned economies.

rose by over 13 per cent., while industrial production in these countries increased by 10 per cent.

In a considerable number of cases developed countries' import growth rates, indicated below in brackets, were more than twice as fast as the rise in their industrial production. This was true not only of countries whose economies were relatively buoyant, such as the United States and Austria (23 per cent. each), France (21 per cent.), Germany (16½ per cent.) and Australia (13 per cent.), but also of others where domestic conditions were sluggish, such as Switzerland (13½ per cent.), Sweden (7 per cent.) and the United Kingdom (6 per cent.). Among the major countries, the only exception to the general pattern was Japan, whose 10½ per cent. import growth rate fell short of the increase in industrial production. Of the smaller developed countries, some which were striving to reduce their current payments deficits, such as Finland, South Africa and Yugoslavia, registered declines in import volume.

The other expansionary influence on world trade in 1976 was the import demand of the *OPEC countries*, which increased by a further 23 per cent. in real terms. Although this represented a sharp deceleration compared with 1974 and 1975, in value terms the rise came to $14 billion, about the same as in 1974 but

Developed areas:
Industrial production, volume and terms of trade, 1973-76.
Quarterly indices: Second half 1972 = 100.



* Seasonally adjusted.

one-third short of the 1975 figure. Moreover, the boost to oil revenues in the second half of 1976 was accompanied by a renewed strengthening of OPEC import demand, which appears to have been sustained in the early months of this year. The United States, Japan and Germany continued to dominate the OPEC market in 1976, supplying almost 60 per cent. of the dollar value of imports originating from the Group of Ten and Switzerland. The most significant improvements in market shares were, however, recorded by Germany, Sweden and Switzerland, largely at the expense of Japan and France.

In contrast to the expansionary factors noted above, the import demand of the *non-oil developing countries* and — in their trading relations with developed countries — that of the *centrally planned economies* remained weak. The non-oil developing countries remained under great pressure to reduce their external deficits, but the recovery in their export revenues meant that the burden of adjustment was no longer placed entirely upon domestic growth and imports. After contributing to the overall decline of world trade in 1975 through a 5 per cent. volume contraction, their imports recorded a slight increase last year.

In the eastern European centrally planned economies, several years of rapidly growing imports from western industrial economies had produced sharply widening deficits vis-à-vis those countries. Financial pressures brought a reversal of this trend in 1976, with several countries — Bulgaria, Hungary, Poland and Rumania — cutting back the value of their imports from the West. On the other hand, despite its deficit, the German Democratic Republic increased its imports from developed countries at almost as fast a pace as in 1975. In addition, the USSR, benefiting from a greater degree of flexibility on the export side on account of oil, and Czechoslovakia, with only limited foreign indebtedness, allowed their imports to expand further. The total value of imports into the eastern European economies from developed countries rose by less than 3 per cent. to $28 billion in 1976, implying that there may even have been a fall in real terms. Within the eastern European area, the dollar value of trade turnover is estimated to have risen by about 10 per cent. last year, substantially less than in 1975. This was mainly the result of much smaller price increases, especially for raw materials and fuels. An even greater reduction in imports from western developed countries was achieved by China in 1976; at just over $4 billion, their value was down by almost one-quarter.

On the export side, too, the pattern of growth in 1976 was largely a reflection of the industrial recovery; a good deal of the resultant import demand was met by the developed countries themselves, but demand for raw materials and fuels was also significantly higher. The developed countries' total exports rose by 11 per cent. in volume, somewhat less than the growth of their imports. But although as a group they thus exercised a net expansionary influence on the rest of the world, the opposite was true in many individual cases. In some of the countries of this latter group, such as Canada and the United Kingdom and, among the smaller economies, Finland, Israel, New Zealand and Yugoslavia, this reflected in part the impact of the adjustment process on imports; in Japan, on the other hand, the key factor was a 23 per cent. volume increase in exports. Thus, within the developed areas of the world the net expansionary boost to world trade was provided by a rather limited group of major countries, including the United States (whose exports rose by only 3½ per cent.), France, Germany and Italy.

The strength of industrial demand for raw materials and fuels was felt by all the other main groups of countries. The volume of exports from non-oil developing countries rose by 6 per cent. in 1976, continuing the recovery that had got under way in the second half of the previous year. Similarly, the demand for oil strengthened, with OPEC exports showing a rise of 13 per cent. Underlying this were two main factors: sharply increased sales to the United States, whose own production continued to fall back; and heavy shipments of oil towards the end of the year in anticipation of the increase in OPEC prices. At the same time, the centrally planned economies improved their export performance, both in raw materials and manufactured goods; the USSR, for instance, increased the volume of its oil exports to non-communist countries by no less than 44 per cent. Taken together, the eastern European countries raised the value of their exports to developed market economies by 16 per cent. to nearly $20 billion, implying that there was a significant rise in volume.

The very modest increase in the average dollar price of internationally traded goods during 1976 was due to a number of factors, including the persistence of excess capacity in manufacturing industry, generally good world harvests and the better overall performance of the dollar in the exchange markets. To some extent the effect of the latter development was to understate last year's rise in trade prices, since it meant that the continued increase in many countries' export prices in domestic currency terms was only partially reflected in the dollar figures.

Last year's overall stability of trade prices masked a number of movements in relative prices and hence in the terms of trade of different countries or economic groups. Thus, industrial recovery was accompanied by a surge in raw-material prices, the "Economist" dollar index rising by 18 per cent. in 1976. However, spot commodity prices usually reflect transactions at the margin, and the export prices of non-oil primary producers rose by a more modest 7½ per cent. on average. Oil prices rose, year on year, by 6 per cent., partly a reflection of the October 1975 OPEC increase, and partly the effect of stronger demand pushing the market price from a discount to a premium on the "marker" price. In all, price developments in 1976 resulted in a small terms-of-trade loss for the developed countries. The most significant changes were deteriorations of 10 and 7 per cent. for South Africa and Spain, and gains of between 5 and 7 per cent. respectively for Switzerland, New Zealand and Ireland. As a counterpart, the terms of trade of the non-oil developing countries improved by 5 per cent. — reversing less than one-third of the adverse movement in 1974 and 1975 — and those of OPEC by 3½ per cent. despite the view that the purchasing power of these countries' revenues declined sharply in 1976.

Balances of payments.

The world current-account balance-of-payments situation in 1976 was dominated by two developments: an increase in the OPEC current-account surplus from $35 to 45 billion; and a redistribution of the overall deficit of the rest of the world. The developed countries' combined deficit rose from $12 to 29 billion, while that of the non-oil developing countries declined by about $12 billion, from $32 to 20 billion, and, to judge from their trade account, that of the centrally planned economies by $4 billion to about $5 billion.

Within these various groups there continued to be wide differences in performance last year. Among the *OPEC countries,* the increase in demand for oil from the industrial countries, together with the further rise in oil prices, meant that the total surplus was more evenly distributed than in 1975, with only Algeria and Indonesia registering significant current deficits. A major portion of the total OPEC current-account surplus continued to accrue to the "low absorbers" — Saudi Arabia, Kuwait and the United Arab Emirates; but in addition a number of countries with a higher capacity to absorb imports — including Algeria, Iran, Iraq and Libya — improved their current-account positions last year. In contrast, extra spending on imports outweighed the increase in oil revenues in Indonesia, Nigeria and Venezuela.

In the *developed areas,* three-quarters of the $17 billion increase in the combined current deficit was accounted for by the United States, whose 1975 surplus of $11.7 billion was replaced by a small deficit. Other evidence of a better balance among the members of the Group of Ten included a reduction of nearly $1 billion in Germany's surplus, the conversion of the BLEU surplus into a modest deficit, and reductions in the deficits of the United Kingdom and, to a lesser extent, Canada. On the other hand, the combined deficits of France, Italy and Sweden increased from $2.3 to 11.1 billion. More recently, signs of improvement have begun to appear in the first two of these countries, while since early 1977 the United Kingdom has been more or less in balance and the Canadian deficit has declined further.

International current-account transactions.[1]

Countries and areas	Trade balance (f.o.b.)			Services and transfers			Current balance		
	1974	1975	1976	1974	1975	1976	1974	1975	1976
	in billions of US dollars								
Developed areas									
BLEU[2]	0.9	0.5	− 0.9	0	0.2	0.6	0.9	0.7	− 0.3
Canada	1.7	− 0.6	1.2	− 3.2	− 4.3	− 5.6	− 1.5	− 4.9	− 4.4
France	− 3.9	1.5	− 4.4	− 2.0	− 1.5	− 1.3	− 5.9	0	− 5.7
Germany	22.2	17.7	16.4	−12.4	−13.8	−13.4	9.8	3.9	3.0
Italy	− 8.5	− 1.2	− 4.0	0.5	0.5	1.1	− 8.0	− 0.7	− 2.9
Japan	1.4	5.0	9.9	− 6.1	− 5.7	− 6.2	− 4.7	− 0.7	3.7
Netherlands	0.7	1.0	1.2	1.3	0.6	1.2	2.0	1.6	2.4
Sweden	0.7	0.8	0.5	− 1.6	− 2.4	− 3.0	− 0.9	− 1.6	− 2.5
Switzerland	− 2.0	0.2	0.6	2.2	2.4	2.8	0.2	2.6	3.4
United Kingdom	−12.2	− 7.2	− 6.4	4.3	3.5	3.9	− 7.9	− 3.7	− 2.5
United States	− 5.4	9.0	− 9.2	4.9[3]	2.7	8.6	− 0.5[3]	11.7	− 0.6
Group of Ten and Switzerland	− 4.4	26.7	4.9	−12.1	−17.8	−11.3	−16.5	8.9	− 6.4
Other countries	−27.2	−27.8	−28.0	8.8	7.2	5.4	−18.4	−20.6	−22.6
Total developed areas	−31.6	− 1.1	−23.1	− 3.3	−10.6	− 5.9	−34.9	−11.7	−29.0
of which: OECD[4]	*−25.5*	*6.2*	*−18.2*	*− 5.2*	*−12.2*	*− 7.9*	*−30.7*	*− 6.0*	*−26.1*
Developing areas[5]									
OPEC	90	62	71	−25	−27	−26	65	35	45
Other areas	−16	−22	−12	− 9	−10	− 8	−25	−32	−20
Total developing areas	74	40	59	−34	−37	−34	40	3	25
Centrally planned economies	− 3	− 9	− 5	.	.	.	.	.	.

[1] On a transactions basis. [2] Partly on a cash basis; exports and imports partly c.i.f. [3] Excluding special US Government grants amounting to $3.1 billion. [4] Total developed areas excluding Israel, South Africa and Yugoslavia. [5] Partly estimated.

In the group of smaller developed countries the total deficit rose by a further $2 billion last year, to reach $22½ billion, which is equivalent to 4½ per cent. of their combined GNP. Only a few of these countries managed to improve on their previous year's performance, the most notable example being Yugoslavia, which moved dramatically from a deficit of more than $1 billion to a small surplus — the first recorded by any member of this group since 1973. Finland and Israel both reduced their current deficits by about $1 billion, although at $1.1 and 1.3 billion respectively these were still very large. South Africa and New Zealand achieved smaller improvements. More than offsetting these positive developments, however, a combined deterioration of $4 billion was experienced on current account by Denmark, Austria and Norway, whose deficits amounted to $1.9, 1.5 and 3.7 billion respectively. In addition, those of Spain and Australia both widened by almost $1 billion, to $4.4 and 1.5 billion.

The $12 billion reduction in the combined current payments deficit of the *non-oil developing countries* last year reflected favourable volume and price developments. While much of the improvement came from the expansion of world trade, a not insignificant part reflected the attempts of a number of these countries to reduce their deficits through demand management or direct controls on imports. In particular, substantial progress appears to have been made by the Asian countries, aided by good harvests and growing manufacturing capabilities; the most spectacular case was that of India, whose current balance, excluding official transfers, swung from a $1.1 billion deficit in 1975 to a $1.2 billion surplus last year. Other countries, including South Korea and Taiwan, also significantly improved their current payments positions.

In Latin America, corrective measures enforced by financial circumstances in Argentina and Chile had already met with some success by 1976, but in general, both in that area and elsewhere in the developing world outside Asia, many countries had delayed the necessary adjustment, preferring to accumulate large current deficits while the external financial going was good. Consequently, substantial deficits remained in 1976 in countries such as Brazil, Mexico, Morocco, Egypt and the Philippines. Between them, these five accounted for one-half of the combined deficit of the non-oil developing countries last year.

In the *centrally planned group of countries,* the progressively widening trade deficit with developed countries was brought under control in 1976, mainly as a result of import restraint. Eastern Europe's deficit fell from $9 to 7 billion, the major improvements occurring in the USSR, Poland and Rumania. More than three-quarters of the 1976 deficit was borne by the first two of these countries. Finally, it is estimated that China reduced its trade deficit vis-à-vis the western developed areas in 1976 to $1.2 billion, half the previous year's figure, and that its overall trade account shifted from balance to a $1 billion surplus.

Developments in individual countries. By far the largest swing on current account in 1976 was experienced by the *United States,* where the 1975 surplus of $11.7 billion gave way to a $0.6 billion deficit. Reflecting a continuation of relatively faster expansion in the United States, as well as increasing US dependence on imported oil, the adverse shift in the trade balance was even larger, from a $9 billion surplus to a $9.2 billion deficit. The value of total imports (f.o.b.) rose by nearly $26 to 124 billion and their volume by 23 per cent. Fuel imports, which rose by almost one-quarter in real terms to reach $37 billion in current prices, accounted for one-third of the total increase; but the much larger category of non-oil imports also rose by 24 per cent., with the most rapid increases being shown by industrial materials, motor vehicles and other consumer goods. Imports from non-oil developing countries, especially in Asia, were appreciably higher, while more than three-quarters of the $11.4 billion increase in imports from developed countries was supplied by Canada and Japan. Exports rose by $7.6 to 114.7 billion.

In volume terms the increase was a modest 3½ per cent., well short of the growth in world trade. Agricultural exports registered a small advance to $23.4 billion, a 12 per cent. volume increase — including higher deliveries to drought-affected Europe — having been largely offset by lower prices as a result of good harvests elsewhere. More significantly perhaps, the $6.5 billion increase in non-agricultural exports represented a rise of only 1 per cent. in volume terms; deliveries of capital goods showed a decline from 1975, reflecting low levels of fixed investment elsewhere.

The weakness on trade account in 1976 was partially offset by a strong recovery in the invisible balance, where the surplus rose from $2.7 to 8.6 billion. Net investment income was up from $6 to 10.5 billion, largely reflecting higher profits in the petroleum sector and the effects of the earlier upsurge in bank lending overseas; in addition, receipts from military sales and contracts rose by $1.3 billion.

A large part of the deterioration on current account was offset by developments on capital account, the balance having shifted from a $7 billion net outflow in 1975 to zero last year. Nearly all of this change can be accounted for by the increase from $4.6 to 10.5 billion in unidentified net capital inflows. Identified capital transactions produced a net outflow of $10.5 billion in 1976, $1.1 billion less than the year before. Within this fairly stable total there were two broadly offsetting changes in 1976: a substantial increase in outflows of US private capital, with net outflows on portfolio account doubling from $3.7 to 7.4 billion, mainly as a result of a further sharp rise in foreign bond issues in the United States; and a substantially higher level of foreign capital inflows, largely explained by prepayments for armaments and increased purchases of Treasury securities by private non-residents.

The deterioration in the US foreign trade account was virtually continuous during 1976, with the result that the $4.3 billion trade surplus recorded in the second half of 1975 had given way by the corresponding period of 1976 to a $6.4 billion deficit. In the first quarter of 1977 the trade balance worsened still further to a seasonally adjusted deficit of $6.9 billion. Sharply increased fuel deliveries necessitated by the extremely severe winter contributed to a 7 per cent. increase in import volume, while at the same time exports actually declined.

After the United States, *France* suffered the largest deterioration on current account in 1976, moving from balance to a $5.7 billion deficit. Furthermore, the net inflow of capital declined sharply from $5.2 to 1.7 billion, causing a dramatic swing of more than $9 billion in the overall balance to a deficit of $4 billion.

The change on current account mirrored closely the shift in the foreign trade balance from a $1.5 billion surplus to a $4.4 billion deficit. The volume of imports rose by nearly 21 per cent., more than twice as fast as that of exports; imports, particularly those of manufactured goods and industrial materials, were strongly stimulated by the consumption-led domestic economic recovery, while the summer drought adversely affected the balance of trade in agricultural goods, as well as adding to fuel imports. In addition to the widening of the real trade gap, the terms of trade worsened by over 2 per cent. during the latter half of the year, partly as a result of the depreciation of the franc. On capital account, the $3.5 billion decline in total net inflows occurred despite an increase from $2.8 to 4.5 billion in net foreign borrowing by French corporations. In the rest of the capital account, net inflows of short-term non-banking funds fell by $2.4 billion, while net outflows on portfolio transactions and long-term trade credits went up by about $1 billion each.

Near the end of the year the current-account balance began to improve and in the first quarter of 1977 imports levelled off to produce a sharp fall in the trade deficit to $1 billion.

Italy also experienced a setback on current external account in 1976, the deficit widening from $0.7 to 2.9 billion. While the balance on invisible transactions improved by $0.6 billion, the foreign trade deficit more than trebled, from $1.2 to 4 billion. Exports showed a 12 per cent. volume gain year on year, but the strength of domestic demand caused imports to grow even faster, by over 15 per cent. In addition, the trade balance was adversely affected by a 4 per cent. worsening of the terms of trade, partly due to the decline of the lira. The seasonally adjusted growth of import volume during the year was intermittent; after rising strongly in the first quarter, it flattened out in the second quarter — when an import deposit scheme was reintroduced — and actually fell by nearly 3 per cent. in the third before rebounding in the final quarter by 13 per cent. Consequently, although exports rose fairly steadily throughout the year, the seasonally adjusted trade deficit in the second half of the year was even larger than in the first half.

Contrary to what happened in France, Italy's capital account improved last year from net outflows of $1.4 billion to net inflows of $1.5 billion. The progressive tightening of monetary policy during the year, the import deposit scheme and the tax on foreign currency purchases introduced in October together produced a very large swing in net trade credits, from an outflow of $0.3 billion to an inflow of $2 billion.

Reacting to the previous quarter's very sharp rise, imports fell back in the first three months of 1977 and there was a substantial decline in the current deficit.

In 1976 the current-account surplus of *Germany* contracted further to $3 billion — less than one-third of its 1974 peak. While the customary large invisibles deficit fell slightly, from $13.8 to 13.4 billion, the even larger trade surplus declined by $1.3 to 16.4 billion. The 13½ per cent. growth in export volume not only more than reversed the 10½ per cent. fall recorded in 1975 but also exceeded the growth of world trade, suggesting that German exports remained competitive. Exports of consumer and semi-finished goods expanded vigorously, the most buoyant markets being those of OPEC and EEC countries, the dollar value of German exports to which went up by 21 and 19 per cent. respectively. On the import side, growth was even stronger, amounting to 16½ per cent. in real terms; while in part this reflected the relative strength of the German economic recovery, the fact that imports rose nearly three times as fast as real GNP indicates the improved competitive position of foreign suppliers on the German market. The volume of capital goods imports rose by 21 per cent., including an even larger increase in imports of motor vehicles. Imports from the United States and the United Kingdom

Developed countries: Balances of payments.[1]

Countries	Years	Current balance	Capital balance	Overall balance[2]	Adjustments[3]	Adjusted overall balance (= total external monetary movements)[4]
		in millions of US dollars				
Austria	1975	− 320	+ 1,350	+ 1,030	− 90	+ 940
	1976	− 1,510	+ 510	− 1,000	− 70	− 1,070
Belgium-Luxembourg[5]	1975	+ 700	+ 840	+ 1,540	+ 20	+ 1,560
	1976	− 280	− 60	− 340	+ 280	− 60
Canada	1975	− 4,900	+ 3,400	− 1,500	+ 140	− 1,360
	1976	− 4,370	+ 4,840	+ 470	+ 270	+ 740
Denmark	1975	− 490	+ 130	− 360	+ 30	− 330
	1976	− 1,910	+ 1,980	+ 70	+ 70	+ 140
Finland	1975	− 2,180	+ 1,750	− 430	− 10	− 440
	1976	− 1,140	+ 930	− 210	− 10	− 220
France	1975	0	+ 5,200	+ 5,200	− 180	+ 5,020
	1976	− 5,710	+ 1,680	− 4,030	+ 520	− 3,510
Germany	1975	+ 3,890	− 3,630	+ 260	− 800	− 540
	1976	+ 3,040	− 2,280	+ 760	+ 80	+ 840
Greece[5]	1975	− 1,090	+ 630	− 460	.	− 460
	1976	− 1,090	+ 1,040	− 50	.	− 50
Ireland	1975	− 70	+ 350	+ 280	− 40	+ 240
	1976	− 340	+ 480	+ 140	+ 80	+ 220
Italy	1975	− 650	− 1,370	− 2,020	+ 90	− 1,930
	1976	− 2,860	+ 1,500	− 1,360	+ 350	− 1,010
Japan	1975	− 680	− 1,940	− 2,620	− 130	− 2,750
	1976	+ 3,700	− 790	+ 2,910	+ 10	+ 2,920
Netherlands	1975	+ 1,590	− 1,320	+ 270	+ 630	+ 900
	1976	+ 2,370	− 3,620	− 1,250	+ 610	− 640
Norway	1975	− 2,460	+ 2,820	+ 360	− 290	+ 70
	1976	− 3,720	+ 3,580	− 140	+ 310	+ 170
Portugal[6]	1975	− 820	− 190	− 1,010	− 140	− 1,150
	1976	− 1,230	+ 260	− 970	− 50	− 1,020
Spain	1975	− 3,540	+ 2,000	− 1,540	0	− 1,540
	1976	− 4,440	+ 2,610	− 1,830	− 200	− 2,030
Sweden	1975	− 1,630	+ 2,880	+ 1,250	− 280	+ 970
	1976	− 2,470	+ 1,740	− 730	− 70	− 800
Switzerland	1975	+ 2,590	+ 2,600	+ 5,190	.	+ 5,190
	1976	+ 3,440	− 760	+ 2,680	.	+ 2,680
Turkey	1975	− 1,880	+ 240	− 1,640	.	− 1,640
	1976	− 2,000	+ 80	− 1,920	.	− 1,920
United Kingdom	1975	− 3,710	+ 210	− 3,500	+ 100	− 3,400
	1976	− 2,550	− 1,270	− 3,820	+ 90	− 3,730
United States	1975	+ 11,700	− 7,050	+ 4,650	+ 30	+ 4,680
	1976	− 600	− 20	− 620	+ 50	− 570
Yugoslavia	1975	− 1,040	+ 780	− 260	.	− 260
	1976	+ 150	+ 810	+ 960	.	+ 960

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 mainly due to valuation adjustments and discrepancies in coverage. [4] Equal to the sum of the last two columns in the table on page 88. [5] Partly on a cash basis. [6] Metropolitan Portugal vis-à-vis the rest of the world.

expanded strongly, as did those from centrally planned economies and non-oil developing countries, the latter including a larger volume of finished goods in addition to the usual raw materials.

On capital account, the net outflow of $2.3 billion in 1976 was $1.4 billion lower than in the previous year. There were substantial shifts in the pattern of capital flows, the most notable being the sharp curtailment of net exports of long-term capital from $6.8 billion in 1975 to virtually zero. This was the result of two factors: purchases (partly speculative) of German securities produced a net inflow of $1.5 billion on portfolio account, after a $1.7 billion net outflow in 1975; and net long-term banking outflows came down from $4.6 to 1.5 billion. These developments were to a considerable extent offset by a $5.1 billion swing in net short-term capital movements, to produce an outflow of $2.1 billion. This resulted largely from a turn-round in trade credits. For the year as a whole, Germany had an overall payments surplus of $0.8 billion, compared with one of less than $0.3 billion in 1975.

As well as declining between 1975 and 1976, Germany's current-account surplus also fell during the course of last year, from $1.2 to 0.4 billion between the first and final quarters, despite stable quarterly trade surpluses of around $4 billion. In the first quarter of 1977, with no change in the level of the trade surplus, the current-account surplus rose to $0.8 billion.

The current accounts of *Belgium-Luxembourg* and *Sweden* both deteriorated by close on $1 billion in 1976, recording deficits of $0.3 and 2.5 billion respectively. In the case of Belgium-Luxembourg the shift into deficit was wholly attributable to trade, with a partly offsetting improvement on invisibles account. The $0.8 billion capital inflow of 1975 gave way to a small outflow, and the overall balance moved from a surplus of $1.5 billion to a deficit of $0.3 billion. Sweden's increased current deficit was largely the result of higher net payments for invisibles, especially in the investment income and travel categories. Although long-term borrowing continued close to the previous year's level of $2.5 billion, there were higher net outflows on account of direct investment, trade credits and loan repayments, so that total net capital inflows dropped from $2.9 to 1.7 billion. Consequently, Sweden's overall balance also deteriorated sharply from a $1.2 billion surplus to a $0.7 billion deficit.

Among the industrial countries whose current-account positions improved last year, *Japan* registered by far the largest gain. Its current balance shifted by $4.4 billion to a surplus of $3.7 billion, the first since 1972, a moderate increase in the invisibles deficit to $6.2 billion having been dwarfed by a doubling of the trade surplus to nearly $10 billion. With the help of highly competitive pricing — on the average, dollar export prices in 1976 were still below those prevailing two years earlier — export volume rose by over 23 per cent.; sales of consumer durables, machinery and vehicles to other industrial countries, especially the United States, increased very rapidly during the first half of the year, but then flattened out as the general industrial recovery weakened. By contrast, imports grew steadily throughout 1976, but were only 10½ per cent. higher year on year, and still significantly below 1973 levels.

On capital account, the net outflow shrank further to \$0.8 billion. This followed a three-year period in which the cumulative outflow had amounted to over \$14 billion. Net long-term capital exports increased from \$0.3 to 1 billion, as net outflows in respect of direct investment, trade credits and other loans all rose; but these movements were more than offset by the reversal of short-term flows, including unidentified items, from a \$1.7 billion outflow in 1975 to small net receipts in 1976. Consequently, the overall balance shifted from a deficit of \$2.6 billion to a surplus of \$2.9 billion.

On a seasonally adjusted basis, more than two-thirds of the 1976 current surplus was recorded in the first six months. But its decline from \$2.6 to 1.1 billion in the second half of the year was followed by a renewed upsurge of exports which resulted in a current surplus of \$2 billion in the first quarter of 1977.

The current-account deficit of the *United Kingdom* fell by a further \$1.2 to 2.5 billion in 1976. On trade account, the volume growth of both exports and imports was slow by comparison with most other industrial countries. Year on year, exports rose by 8 per cent., with deliveries to EEC and OPEC countries showing the largest gains. Most of the increase occurred in the first half of the year in parallel with the world recovery; this momentum was not maintained in the second half, however, despite the progressive depreciation of sterling from March onwards. Import volume grew by just 6 per cent., to reach a level only slightly higher than that recorded in 1973. The turn in the stock cycle boosted imports of industrial materials, while imports of vehicles rose sharply. Domestic oil production generated import savings of \$1 billion, compared with only \$100 million in 1975; but equipment imports and debt-servicing costs meant that North Sea operations continued to have a negative influence on current account in 1976, although towards the end of the year this gap was rapidly closing. All in all, the trade deficit came down from \$7.2 to 6.4 billion. In contrast to the trade account, invisibles clearly benefited from sterling's decline in 1976, the surplus rising by \$0.4 to 3.9 billion as increased net receipts from travel, investment income and other private services more than offset higher public-sector outgoings for debt interest and transfers.

On capital account, the previous year's small net inflow gave way to a \$1.3 billion deficit. In the private sector the deterioration was broadly based, an obvious contributory factor being the leads and lags associated with the weakness of sterling. The net inflow in respect of private direct and portfolio investment fell from \$1.6 to 0.6 billion, while net short-term funds, including trade credits and the balancing item, switched from an inflow of \$0.6 billion to an outflow of \$0.5 billion. On the other hand, the official long-term capital account (excluding official borrowing under the exchange cover scheme, which is treated as a financing item) moved from a deficit of over \$0.5 billion to a small surplus in 1976, partly reflecting renewed purchases of government stocks by private non-residents towards the end of the year. The deterioration on capital account pushed the overall balance further into deficit, from \$3.5 billion in 1975 to \$3.8 billion in 1976.

During the course of the first quarter of 1977 further improvements in the net oil balance and on invisibles account brought the current external account into equilibrium. For the quarter as a whole there was still a current-account deficit of \$0.5 billion — with the seasonally adjusted volume of exports flat, while that of imports rose by 3 per cent. — but the whole of this occurred in January. And in April, when exports rose quite sharply, the current external account showed a significant surplus.

Among the countries with persistent surpluses, Switzerland and the Netherlands both improved their current-account positions further in 1976. In *Switzerland* the surplus rose from \$2.6 to 3.4 billion, with trade and invisibles contributing equally to the increase. The whole of the \$0.4 billion increase in the trade surplus to \$0.6 billion stemmed from a 5 per cent. terms-of-trade gain, for despite continuing domestic recession the growth in imports was fairly rapid (13½ per cent. in real terms), and exceeded that in exports (11½ per cent.). On invisibles account, most of the gain stemmed from higher net investment income. On capital account, the policy of encouraging capital exports was continued on a larger scale than in 1975, issues of foreign long-term bonds (net of repayments) and medium-term Swiss franc notes rising from \$3.5 to 5.2 billion. At the same time, net inflows of other forms of capital, mainly short-term or unidentified items, fell back sharply, so that the capital balance shifted from net inflows of \$2.6 billion to net outflows of \$0.8 billion. Consequently, the overall surplus, although still large at \$2.7 billion, was almost halved by comparison with 1975. The *Netherlands'* current-account surplus increased by \$0.8 to 2.4 billion in 1976 as a result of a recovery in net invisible receipts, especially investment income and official transactions, and a small volume improvement on trade account. On capital account, the total net outflow amounted to over \$3.6 billion, almost three times the previous year's figure; net banking and other long-term credits to non-residents went up from \$0.7 to 2.2 billion and net outflows for direct and portfolio investment also rose sharply. Consequently, the overall balance swung from a surplus of \$0.3 billion to a deficit of \$1.3 billion.

Canada also achieved a small current-account improvement in 1976, although the deficit, at \$4.4 billion, remained large. Benefiting from the US expansion, the trade account improved by \$1.8 billion to a surplus of \$1.2 billion; this was, however, largely offset by higher debt-service payments and travel expenditure. On capital account, Canada attracted funds on a very large scale in 1976; net long-term inflows rose from \$4 to 7.7 billion, wholly on account of funds raised in New York and on international markets. With a part of these funds being reinvested abroad at short term, the overall balance moved from a \$1.5 billion deficit to a \$0.5 billion surplus.

Financing of surpluses and deficits.

Developed countries. The largest external monetary surplus among the Group of Ten countries in 1976 was that of \$2.9 billion registered by *Japan*. Net official monetary assets went up by \$3.5 billion to just over \$16 billion, while the banks' net external indebtedness increased by a further \$0.6 billion to over \$14 billion. The improvement in the official monetary sector was more than accounted for by additions of \$4 billion to dollar reserves; of that amount, \$3.5 billion accrued during the first three quarters of the year as a result of large-scale official interventions in the exchange market. These were partly in response to net inflows through the banking system, which in the first six months of the year amounted to \$1.5 billion. In the final quarter, when there was little further net official intervention, dollar reserves rose by \$0.5 billion mainly as the result of other, longer-term, assets coming to maturity. Official holdings of such assets declined over the year by altogether \$0.8 billion, while Japan's IMF reserve position increased by \$0.5 billion. In the first quarter of 1977 the overall external monetary surplus of \$0.5 billion was fully reflected in a further rise in net official monetary assets.

In *Switzerland* the external monetary surplus for 1976 was \$2.7 billion, virtually all of which went into reserves. Excluding changes in end-year swaps between the banks and the Swiss National Bank, however, net official monetary assets rose by only \$1.3 billion, the same amount as in the preceding year. Last year's reserve increase (excluding swaps) was concentrated in the first six months, when total official intervention to moderate the rise of the Swiss franc came to \$4.3 billion, of which only \$1.5 billion was returned to the market under the conversion rule for foreign capital issues in Switzerland. Following the measures adopted in June to curb the taking-up of speculative Swiss franc positions, the authorities became net sellers of foreign exchange; during the second half of the year, sales of dollars for capital export amounted to \$4.7 billion, against total official market intervention of \$3.2 billion. Adjusted to exclude end-year operations, the Swiss commercial banks' net external assets rose by \$1.4 billion in 1976; the third quarter saw a \$1.9 billion outflow through the banks, much of which was reversed in the final quarter. During the first quarter of 1977 net official assets declined by \$2 billion, almost all of which can be accounted for by the unwinding of end-year swaps with the banks.

In *Germany* the overall external monetary position, which had deteriorated by \$0.5 billion in 1975, showed a \$0.8 billion surplus last year. Within that modest surplus, net official monetary assets rose sharply by \$3.5 billion, to a large extent in response to net inflows through the banks of \$2.7 billion. There were substantial fluctuations in the official and banking sectors' external monetary positions over the year, reflecting the disturbances that occurred in the exchange markets and their unwinding. The first-quarter currency crisis added \$3.7 billion to net official assets, \$2.2 billion of which had a counterpart in banking inflows; in the second quarter a partial reversal of these movements brought a \$1.3 billion decline in net official assets and a \$1.1 billion outflow through the banks. Renewed upward pressure on the Deutsche Mark between July and October then contributed to a further \$2.2 billion increase in net official assets, accompanied by a \$1.5 billion inflow through the banks; following the October realignment of central rates within the joint float, net official assets declined by \$1.1 billion in the last two months of the year but the banks' net foreign position, owing to end-year inflows, showed on balance no change. In the first quarter of 1977, when the overall balance-of-payments surplus was \$1.2 billion, net banking outflows (partly a

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[3] Official assets (net)	Changes[3] Commercial banks (net)
		in millions of US dollars							
Austria	1975	855	3,245	310	4,410	–1,200	3,210	+ 990	– 50
	1976	850	3,005	510	4,365	–2,220	2,145	– 45	– 1,020
Belgium-Luxembourg	1975	1,780	2,725	1,415	5,920	– 850	5,070	+ 525	+ 1,035
	1976	1,780	2,155	1,405	5,340	– 330	5,010	– 580	+ 520
Canada	1975	900	3,055	1,205	5,160	– 355	4,805	– 510	– 860
	1976	880	2,475	1,505	4,860	680	5,540	– 300	+ 1,035
Denmark	1975	75	605	170	850	135	985	– 50	– 280
	1976	75	525	175	775	350	1,125	– 75	+ 215
Finland	1975	35	355	– 5	385	– 630	– 245	0	– 440
	1976	35	355	– 150	240	– 705	– 465	– 145	– 75
France	1975	14,135	6,330	1,015	21,480	.	.	+ 3,875[4]	+ 1,140
	1976	12,840	3,205	1,245	17,290	.	.	– 2,890[4]	– 620
Germany	1975	4,965	23,395	3,550	31,910	1,320	33,230	– 1,020	+ 485
	1976	4,965	25,935	4,510	35,410	–1,335	34,075	+ 3,500	– 2,655
Greece	1975	150	– 250	– 205	– 305	35	– 270	– 465	+ 5
	1976	150	– 230	– 270	– 350	35	– 315	– 45	0
Ireland	1975	20	1,415	95	1,530	– 435	1,095	+ 265	– 25
	1976	20	1,680	135	1,835	– 520	1,315	+ 305	– 85
Italy	1975	3,480	–1,645	–2,780	– 945	– 725	–1,670	– 2,505	+ 575
	1976	9,320	– 400	–2,760	6,160	–2,995	3,165	+ 1,265[4]	– 2,270
Japan	1975	865	10,355	1,325	12,545	–13,530	– 985	– 815	– 1,935
	1976	860	13,340	1,865	16,065	–14,125	1,940	+ 3,520	– 595
Netherlands	1975	2,295	3,335	1,480	7,110	500	7,610	+ 250	+ 645
	1976	2,295	3,470	1,665	7,430	– 460	6,970	+ 320	– 960
Norway	1975	40	1,820	235	2,095	– 130	1,965	+ 105	– 35
	1976	40	1,880	390	2,310	– 170	2,140	+ 215	– 40
Portugal	1975	1,135	15	10	1,160	185	1,345	– 1,075	– 75
	1976	1,125	– 865	– 190	70	250	320	– 1,090	+ 65
Spain	1975	600	5,160	– 440	5,320	–2,815	2,505	– 710	– 835
	1976	600	4,240	– 560	4,280	–3,805	475	– 1,040	– 990
Sweden	1975	235	2,560	235	3,030	735	3,765	+ 1,335	– 360
	1976	235	1,805	395	2,435	535	2,970	– 595	– 200
Switzerland	1975	3,515	6,850	95	10,460	9,450	19,910	+ 1,535	+ 3,655
	1976	3,515	9,255	290	13,060	9,525	22,585	+ 2,600	+ 75
Turkey	1975	145	–1,230	– 210	–1,295	.	.	– 1,640	.
	1976	145	–2,985	– 370	–3,210	.	.	– 1,915	.
United Kingdom	1975	890	–5,585[5]	1,205	–3,490	.	.	– 3,190	– 215[6]
	1976	890	–9,600[5]	–1,320	–10,030	.	.	– 6,540	+ 2,810[6]
United States	1975	11,600	–80,580[7]	4,550	–64,430	5,405[8]	–59,025	– 3,490	+ 8,170
	1976	11,600	–91,530[7]	6,830	–73,100	13,510[8]	–59,590	– 8,670	+ 8,105
Yugoslavia	1975	60	800	– 145	715	.	.	– 265	.
	1976	60	1,980	– 360	1,680	.	.	+ 965	.

[1] For most countries the figures do not correspond exactly to published ones. [2] In France since January 1975 and in Italy since end-1976 gold is valued at market-related prices; in one-third of the countries it is valued at the old official price of $42.22 per ounce and in the remainder via SDRs, being converted to dollars at prevailing dollar/SDR rates. [3] The sum of the last two columns is equal to the adjusted overall balance in the table on page 83. [4] Excludes changes arising from revaluation of gold. [5] Includes, as liabilities, government Euro-currency borrowing and other public-sector borrowing under the exchange cover scheme. [6] 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. [7] Equals convertible currency assets minus bank-reported liabilities to foreign official institutions. [8] Banks' short-term claims on foreigners minus their short-term liabilities to non-official foreigners.

consequence of the reversal of end-year operations) amounted to \$0.9 billion. Net official external assets therefore showed only a small increase.

Of the other Group of Ten countries, only *Canada* recorded an overall external monetary surplus last year, amounting to \$0.7 billion. Net official monetary assets declined by \$0.3 billion but the banks' net foreign position improved by \$1 billion. Within the official monetary sector, Canada's IMF reserve position went up by \$0.3 billion during the year and foreign exchange reserves by \$0.2 billion. The latter put on \$0.6 billion in the first half of the year, subsequently declining by \$0.3 billion in the third quarter as the Canadian dollar began to weaken; but the exchange market disturbances that followed the Quebec provincial elections had little net impact on the exchange reserves during the final quarter, since losses of \$0.8 billion in November were nearly all recouped in December. In the first quarter of 1977, however, intervention to support the dollar cost \$0.7 billion from the reserves.

Among the Group of Ten countries with external monetary deficits last year, the *United Kingdom* registered the largest, of \$3.7 billion. In addition there was a \$2.8 billion net outflow of funds through the banks, almost all of which can be accounted for by a run-down of official sterling balances, so that the total of net official external financing required during the year was \$6.5 billion. Oil-exporting countries reduced their official sterling holdings by \$2.4 billion, mostly in the second and third quarters. Other official sterling holdings were largely unchanged on balance, while private holdings rose by nearly \$0.5 billion. In addition to the withdrawal of sterling balances, other banking outflows included a \$1.1 billion increase in the banks' short-term sterling claims on non-residents during the first three quarters, only partly reversed in the final quarter.

The pressures on sterling emanating from the balance-of-payments deficit and the banking outflows were concentrated in the eleven months up to November. During that period official financing of \$7 billion was required; the reserves, however, fell by less than \$0.3 billion, so that virtually all the dollars sold by the authorities in the market came from various forms of foreign borrowing. The most important single element was the \$3.1 billion raised by public-sector bodies under the exchange cover scheme, almost four times the previous year's figure; in addition, \$2 billion was drawn on the IMF — more than half of it under the oil facility — and \$1.5 billion on the \$5.3 billion stand-by facility made available by monetary authorities of the Group of Ten and Switzerland and the BIS in June.

The subsequent renewal of confidence in sterling had produced a \$4.2 billion improvement in the net official monetary position by April of this year. The reserves rose by \$5 billion, only \$0.8 billion of which had a counterpart in higher official liabilities. Fresh borrowing from the IMF (\$1.2 billion) and the Euro-currency market (\$1.1 billion) was to a large extent offset by repayment of the \$1.5 billion drawn earlier on the central-bank facility.

The external monetary position of *France* also worsened substantially in 1976 although, mainly owing to upward valuation of monetary assets, the \$3.5 billion deterioration was less than the overall balance-of-payments deficit. The monetary deficit was met mainly by a reduction of \$2.9 billion in net official assets, all of which occurred in the first quarter prior to the franc's departure from the "snake". During those three months the foreign currency reserves fell by \$1.6 billion, while at the same time there was a \$1.5 billion increase in liabilities associated with support for the franc within the "snake". In April, when these liabilities were settled, foreign exchange reserves fell by \$1.3 billion. During the remainder of the year, net official assets barely changed on balance, except in July and August, when renewed support for the franc contributed to a \$0.4 billion fall in exchange reserves. In the banking sector there were net inflows of \$0.6 billion during the year. In the first quarter there was a substantial \$1.1 billion outflow, which formed part of the pressure that led to the reserve losses; subsequently, however, the banks began to attract funds, incurring net liabilities of nearly \$1.8 billion during the rest of the year, over half of these in the third quarter when domestic interest rates were stepped up sharply.

Despite the substantial deterioration in the current balance of payments *Italy's* external monetary deficit was halved to \$1 billion in 1976. Moreover, with net inflows of \$2.3 billion through the banks, the net official monetary position actually improved by \$1.3 billion. Over the course of the year, however, it fluctuated very considerably. In the first five months, when gross exchange reserves were so low that official intervention in the market was suspended for six weeks, the \$1.8 billion deterioration in the net official monetary position was more than accounted for by borrowing: \$1 billion was taken up from the EEC, \$0.5 billion redrawn from the Bundesbank under the 1974 loan agreement and \$0.5 billion drawn on the Federal Reserve swap line. Just before mid-year, pressures on the lira eased and during the three months June–August the net official position improved by \$2 billion, including repayment of the earlier drawing on the Federal Reserve. After a temporary setback in September the recovery continued in the final quarter, when net official assets rose by a further \$1.9 billion. The increase in the banks' net liabilities, though continuing throughout the year, was largely concentrated in the second and final quarters.

In the first three months of 1977 most of the \$1.8 billion overall payments deficit was financed by a further \$1.4 billion addition to the banks' external indebtedness. Moreover, the decline of \$0.4 billion in net official assets would have been greater but for receipts of the same size from Libya as a result of transactions with the Fiat company.

In 1976 the net external monetary position of the *United States* showed a small \$0.6 billion deterioration. The net short-term claims of the banks on non-residents rose by \$8.1 billion, while net official external liabilities went up by \$8.7 billion.

Official reserve assets rose by \$2.5 billion during the year, almost the whole of which can be attributed to the increase in the US reserve position with the IMF. For the year as a whole, foreign currency holdings rose by just \$0.2 billion, a \$1.3 billion increase in balances resulting from British, Italian and Mexican swap drawings in the first half of the year having been later mostly reversed. Liabilities to foreign official holders of dollars, on the other hand, showed a substantial \$11.2

billion increase, almost three times the previous year's figure. The whole of this rise was accounted for by countries in Asia, which includes the Middle East.

In the banking sector the net outflow of short-term funds was heavily concentrated in the first and final quarters, when it amounted to $2.8 and 5.3 billion respectively. For the year as a whole, the banks' gross short-term claims on non-residents increased by $18.8 billion, a substantial advance on the 1975 total of $11.2 billion. A large part of last year's lending appears to have been channelled to the Euro-currency market and to the branches of US banks in the Caribbean and Far Eastern offshore financial centres. At the same time most of the $10.6 billion increase in US banks' liabilities to non-official foreigners was vis-à-vis banks in the rest of the world.

In the first three months of this year the net official position deteriorated by $4.2 billion. Official assets rose by $0.4 billion, corresponding broadly to an increase in US claims under the GAB; but this was heavily outweighed by a $4.6 billion expansion in official liabilities as foreign countries' dollar reserves held in the United States rose further.

In 1976 both *Sweden* and the *Netherlands* experienced significant deteriorations in their net external monetary positions, amounting to $0.8 and 0.6 billion respectively. As in 1975, the figure for the Netherlands cannot be reconciled with balance-of-payments data, which indicate a $1.3 billion overall deficit. Sweden's deficit was met mainly out of exchange reserves, which fell by $0.7 billion. By contrast, that of the Netherlands was more than covered by short-term banking inflows, permitting a $0.3 billion increase in net official assets over the year as a whole. During the second quarter, however, large-scale outflows of funds, including $0.8 billion through the banks, caused net official assets to fall by $1.2 billion; net banking inflows of $1.8 billion during the rest of the year were accompanied by a $1.3 billion improvement in the official monetary position.

In marked contrast to 1975, the external monetary position of *Belgium-Luxembourg* deteriorated marginally last year. This small movement, amounting to $60 million, concealed a $0.5 billion short-term outflow via the banks, coupled with a slightly larger reduction in net official assets. The quarter-by-quarter movements in the net official position were volatile, reflecting the varying fortunes of the franc in the exchange market. Major falls of $1.3 and 1 billion in net official assets occurred in the first and third quarters, and were only partially offset during the rest of the year. Banking transactions formed an important counterpart to these official movements, especially during the first nine months of the year before the franc began to strengthen significantly. In the fourth quarter the banks' net liabilities registered an increase of $0.2 billion and this process continued in early 1977. Net official assets, on the other hand, rose by $0.9 billion in the final quarter and by a further $0.3 billion in the first three months of this year.

Three of the smaller developed economies, *Austria, Portugal* and *Spain,* all experienced major deteriorations in their net external positions last year. In the case of Austria, the monetary deficit of $1.1 billion was almost wholly covered by banking inflows, but those of Portugal and Spain, amounting to $1.0 and 2.0 billion respectively, both required official financing of about $1 billion. In addition, the net short-term indebtedness of Spanish banks rose by $1 billion, to a total of $3.8 billion.

Oil-exporting countries. The funds available for investment by OPEC countries are estimated to have been little changed from 1975, at $35.3 billion. Overall, the proportion of total investible funds placed at short and long term was about the same as it had been in 1975. Within these two broad categories, however, the identifiable pattern of placement of the oil exporters' funds changed somewhat in 1976. In the short-term category sterling deposits and holdings of UK Treasury bills were reduced by $2.6 billion, and liquid investments in the United States rose less than in 1975, while foreign currency deposits in the United Kingdom and elsewhere grew faster than the year before. At longer term the reduction in loans to international agencies and in the amount of funds invested under special bilateral arrangements reflected the ending of the IMF oil facility and a slowdown of OPEC aid to other developing countries. Investments in equities and real estate remained at the high levels reached in 1975, while purchases of longer-term government securities in the United States and the United Kingdom rose from $2.4 to 4.4 billion.

Oil-exporting countries: Estimated deployment of investible surpluses.[1]

Items	1974	1975	1976
	in billions of US dollars		
Bank deposits and money-market placements:			
Dollar deposits in the United States	4.0	0.6	1.6
Sterling deposits in the United Kingdom	1.7	0.2	− 1.4
Deposits in foreign currency markets	22.8	9.1	12.6
Treasury bills in the United States and the United Kingdom.	8.0	− 0.4	− 2.2
Total	36.5	9.5	10.6
Long-term investments:			
Special bilateral arrangements	11.9	12.4	10.3
Loans to international agencies	3.5	4.0	2.0
Government securities in the United States and the United Kingdom.	1.1	2.4	4.4
Other[2]	4.0	7.4	8.0
Total	20.5	26.2	24.7
Total new investments .	57.0	35.7	35.3

[1] Source: Bank of England. [2] Including equity and property investments in the United States and the United Kingdom, and foreign currency lending.

Non-oil developing countries. The estimated $12 billion reduction in the non-oil developing countries' current external deficit in 1976 significantly eased the group's financing problems. Their $20 billion deficit (which includes receipts of about $8 billion from official transfers) was more than covered by aid and other official inflows totalling $12 billion and private capital inflows of $15 billion. The corresponding figures for 1975 were $11 and 18 billion respectively. Last year's private inflows included gross new borrowings of $18 billion — $1–2 billion more than in 1975 — from banks in the Group of Ten countries and Switzerland and from Caribbean and Far Eastern branches of US banks. The developing countries' total reserves rose by nearly $11 billion and their net IMF drawings by $1.9 billion.

Current payments imbalances and the adjustment process in a longer-term perspective.

Looked at in a longer-term perspective, last year's overall balance-of-payments results, although showing some shifts of current-account balances in the right direction, followed the same broad pattern of imbalances that emerged following the 1973 oil price increases. The biggest element has of course been the current-account surplus of the OPEC countries, together with the corresponding deficit of the rest of the world, which resulted directly from those price increases. For the three years 1974–76 the cumulative OPEC current-account surplus is estimated to have amounted to $145 billion. This is an impressive amount, over fourteen times the corresponding figure for 1971–73; at the same time, as a result of the industrial recession of 1974–75 and the OPEC countries' relatively rapid capacity to absorb imports, it is significantly lower than many forecasts made at the time when oil prices were raised.

Current-account imbalances since the oil crisis.[1]

Countries and areas	Cumulative current balances			
	1971-73	1974-76	1971-73	1974-76
	in billions of US dollars		as a percentage of GNP	
Developed areas				
Germany	6.0	16.7	0.7	1.3
United States	0.3	10.6	0	0.2
Switzerland	0.6	6.2	0.6	3.8
Netherlands	3.4	6.0	2.4	2.5
BLEU	3.1	1.3	2.8	0.7
Japan	12.3	– 1.7	1.3	– 0.1
Sweden	1.7	– 5.0	1.3	– 2.5
Canada	– 0.3	– 10.8	– 0.1	– 2.2
France	0.1	– 11.6	0	– 1.2
Italy	1.8	– 11.6	0.5	– 2.4
United Kingdom	0.9	– 14.1	0.2	– 2.2
Group of Ten and Switzerland	29.9	– 14.0	0.4	– 0.1
Other countries	– 3.6	– 61.6	– 0.4	– 4.4
Total developed areas	26.3	– 75.6	0.3	– 0.6
OPEC	10	145	.	.
Other developing areas	– 20	– 77	.	.
Centrally planned economies[2]	1	– 17	.	.

[1] See footnotes to the table on page 79. [2] Excludes services and transfers.

The second major element in the post-1973 world payments disequilibrium has been the worsening of the non-oil imbalances. The most obvious aspect of this is the fact that the total of gross current-account deficits in the oil-importing world during 1974–76, at an estimated $210 billion, was almost half as large again as the cumulative OPEC surplus; moreover, most of this excess had a counterpart in cumulative current payments surpluses of $41 billion in a group of industrial countries — the BLEU, Germany, the Netherlands, Switzerland and the United

States — which should in theory have been carrying a significant proportion of the counterpart to the OPEC surplus. Japan, although having recorded a small cumulative current payments deficit for the three years 1974–76, clearly has belonged since 1976 to the group of surplus countries.

The deficit areas of the oil-importing world fall into three main groups: five major industrial countries — Canada, France, Italy, Sweden and the United Kingdom — with cumulative deficits of \$53 billion in 1974–76 against a \$4 billion cumulative surplus in the three preceding years; the rest of the developed world, whose cumulative deficits rose between the two periods from less than \$4 billion to almost \$62 billion; and the non-oil developing countries, whose total deficit went up from \$20 to 77 billion. Within these various groupings the greatest attention has been focused on the deficits of Italy and the United Kingdom — the largest in the developed world — and on the position of the non-oil developing countries. Recently, however, the United Kingdom deficit has been eliminated and that of Italy might disappear by the end of the year. As for the non-oil developing countries, the table shows that as a group they have not borne a disproportionate share of the oil imbalance; indeed, their combined deficit of \$20 billion recorded in 1976 was probably not much larger than before the oil price increase when account is taken of the intervening changes in world levels of prices and economic activity. One indication of their present position is the extent to which they have been able to add to reserves during 1976 and so far in 1977.

Developed countries outside the Group of Ten, on the other hand, have not only seen a seventeenfold increase in their combined current payments deficit between 1971–73 and 1974–76 — in relative terms larger even than the increase in the OPEC surplus — but there is as yet no sign of improvement in their overall position.

Whatever its recent brighter features, the general situation remains very unbalanced, not only between OPEC and the oil-importing countries but within the latter group too. What, then, are the prospects for attaining a better balance and what should the adjustment process be?

In considering these questions the distinction, however blurred, between oil imbalances and non-oil imbalances remains as valid as it was in January 1974, when the Committee of Twenty stressed the need for countries, in reacting to the oil price increases, not to "adopt policies which would merely aggravate the problems of other countries". Now as then, the traditional instruments of adjustment policy are not applicable to the oil imbalance. It could not be conjured away through demand-management policies in the oil-importing countries, except at the cost of an inconceivably severe recession. Nor would appreciation of OPEC currencies make much difference to the total either of these countries' foreign exchange receipts or, in the absence of import-competing industries, of their imports. While the need to pursue policies that will reduce dependence on OPEC sources of oil remains pressing, the OPEC surplus, being now concentrated mainly on the "low absorbers", is going to continue to be very large for the foreseeable future and the corresponding deficits will therefore have to be financed.

While the continuing absence of adequate energy policies undoubtedly constitutes a failure of political will-power in the oil-importing world, even more serious has been the failure to control payments imbalances that were unrelated to oil — unrelated, that is, except in the sense that the oil price increases showed very clearly, particularly in the developed world, which countries were more, and which less, able to stand up to shocks of that magnitude. The need to adjust non-oil imbalances is now more widely recognised, but opinions vary about how this should be done.

From what has already been said above it is clear that the problems of the non-oil developing countries taken as a whole are less severe than is sometimes alleged. Not only has their position worsened less than that of the deficit countries of the developed world, but their difficulties centre mainly on a relatively small number of countries. During the three years 1974–76 five countries — Brazil, Mexico, Egypt, Pakistan and Peru — accounted for about half of the non-oil developing world's $77 billion total current payments deficit. What is required, therefore, is a major adjustment effort in certain countries, together with the avoidance of new excessive deficits in the future. As regards the rôle of exchange rate movements in the developing countries, it has to be remembered that in many of them there are only limited possibilities, except in the longer run, for import substitution or for shifting factors of production from the domestic to the international sectors of their economies. The effectiveness of exchange rate depreciation in re-establishing external balance will therefore be limited. All the same, these countries will need to avoid, or correct, overvalued exchange rates if they are to keep their deficits within sustainable limits.

The biggest problems concerning the adjustment of non-oil imbalances, however, lie within the developed world, and it is among these countries therefore that the principal controversies about how to adjust have emerged. In this connection much has been heard about the need for symmetrical adjustment between surplus and deficit countries, with the latter emphasising the desirability of action by the former. In particular it is argued that the pursuit of more expansionary domestic policies by the main surplus countries would not only promote adjustment but would do so in the way that is most appropriate to the present relatively depressed state of the world economy in general. In addition, these countries are urged to act more directly on their payments surpluses through appreciation of their currencies.

To the demand-management argument, the largest surplus countries have in effect replied that their present growth rates are not unsatisfactory but that if their economies should show renewed signs of a slackening of activity they would take appropriate action. In the meantime they are not prepared to run the risk of throwing away their hard-won gains in the fight against inflation for the sake of a little extra growth. In their favour it must be said that today it is more important than ever that some countries should continue by their example to show that sound monetary and fiscal policies can bring and keep inflation under control.

So far as the exchange rate argument is concerned, developments in the surplus countries during 1976 and early 1977 have been broadly in line with the goal of achieving a better distribution of the OECD deficit. The effective exchange rates of the Deutsche Mark, the Swiss franc and the yen all appreciated, as did also those of the Belgian franc and the Dutch guilder. In other words, the surplus countries did allow their rates to go up — although the Swiss authorities called a halt to the rise of the franc in mid-1976; beyond that, it does not seem reasonable to ask surplus countries to force their rates up, nor would it be practical politics for them to attempt to do so. Moreover, since exchange rate appreciation has proved very effective in helping to bring inflation under control it may not of itself contribute to a better international payments balance, at any rate not very quickly.

For a variety of reasons, therefore, the main responsibility for initiating adjustment lies with the deficit countries. It is in the interests of stability, both domestic and international, that this should be so — and in any case there is no way of obliging the surplus countries to take it over. But this conclusion leads to others that concern the surplus as well as the deficit countries. First, the surplus countries must be ready to accept the consequences that successful adjustment by the deficit countries will have for their balances of payments. Secondly, the correction of the very large deficits at present being run by some countries is going to take time and it would be unwise, whatever the mistakes made in the past, to force the pace now. Thirdly, financing will have to be provided during this relatively extended adjustment process. And fourthly, such financing should, consistently with the previous aims, as far as possible tend to ensure that adjustment actually takes place. The implications of these conclusions for the future provision of international liquidity are taken up in Chapter VII of the Report.

VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

Owing to a combination of large balance-of-payments financing requirements, weak domestic credit demand and ample supplies of new funds, 1976 was another boom year in the international financial markets. Activity was brisk in both the banking and bond-market sectors, with the two taken together providing approximately $95 billion of net new credit.

Looking at the international banking sector on the broadest basis for which statistics are available, the gross external claims of banks in the Group of Ten countries and Switzerland and of the branches of US banks in the Caribbean and Far Eastern offshore centres rose by $105 billion, or 24 per cent., to $548 billion. Of that increase, the redepositing of funds among the reporting banks would seem to have accounted for some $35 billion. Excluding this considerable element of double-counting, total net new international bank lending may be estimated to have accelerated between 1975 and 1976 from $40 billion to $70 billion. By far the largest part of this growth was in claims on countries outside the Group of Ten and the offshore centres, which went up by $53 to 202 billion, compared with a $34 billion increase in 1975.

As in 1975, the most buoyant segment of international banking was foreign lending by US banks through their branches in the offshore centres of the Caribbean and Far East: these branches showed an increase in their external assets of $24 billion, or 47 per cent. In addition, direct foreign claims of banks in the United States rose by $21 billion, or 35 per cent.; however, $11.5 billion of this was channelled through the offshore centres and is therefore to a large extent already included in the above figures for the offshore branches of US banks.

Growth was somewhat slower, but still very considerable, in the European centres, i.e. the European Group of Ten countries and Switzerland. The external claims in both domestic and foreign currencies of banks located in those countries rose by $55.7 billion, or 19 per cent. This was more than the $50.5 billion increase registered in 1975, but the figures for both years are strongly influenced by exchange rate effects. In 1975 the easing of most European currencies against the dollar had reduced the dollar value of the banks' positions in these currencies, whereas in 1976 the renewed weakening of the dollar had the opposite effect. Excluding these valuation changes, the growth of the reporting European banks' external claims slackened from $58 billion in 1975 to $46.5 billion in 1976, or from 24 to 16 per cent.

To take the Euro-currency component of this lending, the increase in the reporting European banks' external claims in foreign currency in 1975 and 1976 amounted to $43 and 47 billion respectively. Net of valuation effects there was a slowdown from $47.5 to 41.5 billion. For a more accurate assessment of the total amount of net new Euro-currency credit intermediated by the reporting European

**Estimated lending in international markets.
Changes in external claims of banks in domestic and foreign currencies
and international bond issues.**

Lenders	Changes 1973	Changes 1974	Changes 1975	Changes 1976	Amounts outstanding 1976
	in billions of US dollars				
Banks in European Group of Ten countries	+ 62.2	+ 35.0	+ 50.5	+ 55.7	353.0
of which in foreign currency (Euro-currency market)	*+ 56.8*	*+ 26.8*	*+ 43.0*	*+ 47.2*	*305.3*
Banks in Canada and Japan	+ 5.4	+ 5.1	— 0.3	+ 5.0	39.2
Banks in the United States	+ 6.0	+ 19.5	+ 13.5	+ 20.8	80.6
Branches of US banks in offshore centres[1]	+ 14.1	+ 12.6	+ 15.0	+ 23.8	74.9
Total (all reporting banks)	+ 87.7	+ 72.2	+ 78.7	+ 105.3	547.7
minus: double-counting due to redepositing among the reporting banks	.	.	38.7	35.3	217.7
A = Net new international bank lending[2]	.	.	40.0	70.0	330.0
Euro-bond and foreign bond issues	9.9	12.3	22.0	32.9	.
minus: redemption payments and repurchases	.	.	3.5[3]	4.4[3]	.
B = Net new international bond financing	.	.	18.5	28.5	.
A+B = Total new bank and bond financing	.	.	58.5	98.5	.
minus: double-counting[4]	.	.	1.5[3]	3.5[3]	.
Total net new bank and bond financing	.	.	57.0	95.0	.

[1] Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [2] In addition to direct claims on end-users, these estimates include certain interbank positions: first, claims on banks outside the reporting area, i.e. outside the financial and offshore centres, the assumption being that these "peripheral" banks will not, in most cases, borrow the funds from banks in the financial centres simply for the purpose of redepositing them with other banks in these centres; second, claims on banks within the reporting area to the extent that these banks switch the funds into domestic currency and/or use them for direct foreign currency lending to domestic customers; third, a large portion of the foreign currency claims on banks in the country of issue of the currency in question, e.g. dollar claims of banks in London on banks in the United States; here again the assumption is that the borrowing banks obtain the funds mainly for domestic purposes and not for re-lending to other banks in the reporting area; a deduction is made, however, in respect of working balances and similar items. While the persistence of some element of double-counting in these estimates cannot be ruled out, it should be noted on the other hand that there are gaps in the statistics and the figures available at present do not cover all international bank lending. [3] These figures are based on very rough *guesses* and are inserted here mainly for purposes of illustration. But although the margins of error are large in relation to the size of the figures, they are unlikely to alter significantly the figure for total net new international financing. [4] Bonds taken up by the reporting banks, to the extent that they are included in the banking statistics as claims on non-residents; bonds issued by the reporting banks mainly for the purpose of underpinning their international lending activities.

banks, however, these figures have to be adjusted for a number of factors: redepositing among the reporting banks has to be excluded to avoid double-counting; account has to be taken of the banks' foreign currency lending to domestic non-bank customers, as well as of their switching of funds from foreign to domestic currencies. Differences in these fields, notably a larger amount of foreign currency lending to domestic non-bank customers, operated in such a way as to make the 1976 net growth of the Euro-currency market more rapid than the increase in the reporting European banks' gross external claims would suggest. Thus the net growth of the narrowly defined Euro-currency market may be estimated to have accelerated from $28 billion in 1975 to $42 billion, or from about $31 to 37 billion if valuation effects are excluded. The net total of Euro-currency credit outstanding at the end of 1976 may be put at around $247 billion.

While the continued buoyancy of international bank lending in 1976 was perhaps not entirely unexpected, the performance of the international bond market surpassed many hopes that had been placed in it at the beginning of the year. The issue volume rose by nearly 50 per cent. to $32.9 billion, thereby exceeding its 1973 level more than three times over. For purposes of comparing this figure with the data on international bank lending, it is, however, necessary to take into account redemption payments on outstanding issues and repurchases. Conversely, the growth in the reporting banks' foreign claims undoubtedly includes certain holdings of international bonds; moreover, the banks themselves were borrowing in the international bond market. After adjustment for these factors, it may be sufficient to add only about $25 billion to the $70 billion expansion of bank credit in order to obtain an estimate of the total net volume of funds channelled through the international financial markets in 1976.

The resultant figure of $95 billion for net new international lending may appear large even in relation to the sum total of about $70 billion of individual countries' current-account deficits. But these two magnitudes, though in some way loosely related, are not strictly comparable. For one thing, there was in 1976 a substantial amount of foreign borrowing by residents of surplus countries such as Germany and some of the OPEC members. At the same time there were sizable flows of new funds into the international markets from deficit countries, with the result that several countries' external financing requirements were larger than their current-account deficits. Finally, external borrowings in several countries exceeded financing needs, giving rise to substantial increases in official reserve holdings which were themselves partly invested in the international markets. On the other hand, the international markets are not the only source of balance-of-payments finance; in addition to a considerable amount of official lending, current-account imbalances were partly offset by other types of capital flows.

Main factors at work in international markets.

With the renewed widening of the OPEC countries' combined surplus, the international monetary scene in 1976 continued to be dominated by large current-account imbalances. The massive balance-of-payments financing requirements of many oil-importing countries meant that their interest rate policies and foreign exchange regulations were designed to encourage residents to have recourse to foreign borrowing; moreover, public-sector entities themselves and supranational institutions (on behalf of the deficit countries) were heavy takers of funds in the international financial markets.

In addition to the persistence of the large oil imbalance, its reshuffling among individual groups of oil-importing countries helped to fuel the demand for credit in the international markets. Countries whose current-account position deteriorated or remained very unfavourable — chiefly a number of developed countries both within and outside the Group of Ten — tended to step up their recourse to foreign borrowing; at the same time a number of countries whose current account improved in 1976 used the opportunity of favourable market conditions to rebuild their gross reserves, which in the two preceding years had declined in relation to the volume of their international transactions. This was particularly true of the non-oil developing countries, which added to reserves an amount nearly equal to the $12 billion decline in their combined current payments deficit (see Chapter VII).

Moreover, the increase in the combined OPEC surplus was not spread uniformly among oil-exporting countries. Some of the "high absorbers" among these countries substantially increased their borrowing on the international market, with the result that new lending to OPEC members also accelerated markedly in 1976. The only large group of countries whose combined new borrowings decelerated, in line with an improvement in their combined current-account position, were the eastern European countries; despite the slowdown, however, their takings remained very substantial.

Apart from this widespread borrowing related directly or indirectly to balance-of-payments considerations, recourse to the international markets in 1976 was motivated by several other factors. In some countries the fear that large anticyclical or structural budget deficits might lead to indigestion and crowding-out effects in the domestic financial markets induced the public sector to tap foreign markets. Even in a number of countries where monetary policy was not tightened for balance-of-payments reasons recourse to external borrowing was had by the private sector because of the low cost of international credit. Finally, the international market continued to be used for the financing of large investment projects.

With interest rates moving closely in line with, or even declining slightly in relation to, those prevailing in domestic markets, the international markets did not seem to have any difficulty in coping with the heavy demands made on them in 1976. Funds for new lending were amply available for a number of reasons. The banks remained very liquid despite the upswing in economic activity, particularly in those countries where monetary policy was not constrained by balance-of-payments deficits. As the recovery in domestic investment failed to materialise, they compensated for the weakness of private domestic credit demand by increasing their international lending activities. The US banks with their foreign affiliates would seem to have accounted for over half of total international bank lending in 1976. Moreover, the international lending potential of the German and Swiss banks was strengthened by the positive impact of the renewed appreciation of the Mark and Swiss franc on the dollar value of their capital base.

Funds from surplus countries were at times supplemented by hot money shifted for political or economic reasons from countries with weaker balance-of-payments positions. The reinforcement of barriers against capital flows into Switzerland helped to channel these funds to the international markets, from where they were in part re-lent to their countries of origin.

In addition to the growth in the OPEC surplus itself, confidence factors also played a part in the substantial increase in the supply of new oil funds to the international market. Partly as a result of the movement out of sterling, identified deposits by OPEC countries in the Euro-currency market accelerated sharply and there is also evidence that OPEC investors played a more important rôle in the international bond market.

Finally, for the first time since 1973, the US balance-of-payments deficit itself may be said to have contributed to the supply of funds available in the international market. With US net capital exports, including last year's substantial foreign lending by US banks, exceeding the inflow of funds from OPEC countries, and with the US current account in deficit, official dollar balances of oil-importing countries also recorded an appreciable increase in 1976. Since a number of these countries tend to place a large part of their reserve accruals outside the United States, the supply of new funds to the international markets was also boosted by official deposits from oil-importing countries, notably those of the developing world. With the US current account now in substantial deficit, this source of funds is unlikely to disappear in the near future unless there is a sharp rise in US interest rates and strong US domestic demand for bank loans.

For the banks the combination of large new supplies of domestic and international funds with the low level of credit demand from domestic customers meant that conditions in the international financial markets were in some respects those of a buyers' market. There was no shortage of potential borrowers, but since most of the demand came from countries with weak payments balances and high levels of foreign indebtedness there was a shortage of first-class borrowers. Moreover, the difficulties experienced by some developing countries in meeting their debt-service obligations added to the banks' selectiveness. As a result, there was a scramble to accommodate borrowers considered to be in the first-class category and such borrowers accordingly succeeded in moving loan conditions in their favour. The margin over LIBOR which they were charged by the banks declined from about $1\frac{3}{8}$ per cent. in 1975 to slightly below 1 per cent. in early 1977, while at the same time the average size of loans granted showed a substantial increase. On the other hand, borrowers in countries with a high level of foreign indebtedness and little prospect of an improvement in their payments balances found it increasingly difficult to obtain financial accommodation in the international markets and were, if anything, subject to tougher loan conditions than in 1975.

The question of risks.

The banks' heavy involvement in recent years in international financing and particularly in lending to developing countries has, on balance, been a stabilising factor in the world economy. It does, however, raise two major questions: how does bank lending affect the working of the international adjustment process? Have the risks borne by the banks become excessive? In view of the sharp acceleration in bank lending last year and of its further potential expansion — there are no signs of any slackening in the demand for deficit financing — both questions deserve consideration. The first is taken up in the next chapter; only the prudential problem is dealt with here.

The main point to be made in this respect is that not one but *two* parallel developments have been taking place in international bank lending. One, which has been described above, is the sheer quantitative expansion of international claims. The other is an important change in the structure of risks: a gradual shift from lending to private corporations towards loans granted to public-sector institutions or guaranteed by the borrowing country. This second development may have improved the quality of the banks' loan portfolio by diminishing the share of commercial risks; but what about the corresponding rise in the country or "sovereign" risks?

According to one view, this change in the structure of international risks borne by the banks has been sufficiently beneficial to offset the potential danger arising out of the sharp increase in the total of international commitments. The sovereign risk, so the argument goes, is after all much less dangerous than the commercial one. It consists of the possibility that balance-of-payments deficits might prevent a country from servicing its debts; in other words, that official and private borrowers in that country might be unable to obtain the foreign exchange they need to pay interest and repay the principal. There might be the additional risk that for political reasons a government halts the servicing of its own and other residents' debts to banks or other lenders abroad. But while private firms are liquidated in the event of bankruptcy, a country will hardly cease to exist as a result of external insolvency. It is therefore less likely that the claims will be wiped out altogether; the problem might instead take the form of a temporary illiquidity or the freezing of the claims. In short, the danger is one of rescheduling or a moratorium rather than bankruptcy.

Admittedly, this argument carries weight and is supported by evidence gathered from many years of banking practice: losses incurred on international loans granted to public institutions or guaranteed by sovereign countries have been much smaller than those resulting from domestic lending or from foreign lending to private customers. This is not, however, the whole story: country risks *do* add new dimensions to private banking in many ways.

Firstly, the expertise required to evaluate them is quite different from that used in assessing the creditworthiness of an individual firm. It is necessary to appraise a country's overall economic and political development and to relate the data on the amount and the structure of its external indebtedness to a number of macro-economic figures, such as current and prospective foreign exchange earnings. While all banks have long-standing experience in assessing commercial risks, this kind of evaluation has taken them into a field new to most of them. Some very large banks have responded to this challenge with speed and efficiency, but it is doubtful whether others — medium or even large-sized — are really able to cope with it.

Secondly, even if the banks acquire the necessary expertise in this new field of activity, they may run into the difficulty of obtaining appropriate information from the debtor countries. This may happen either because the debtor countries themselves are ill-equipped to supply them with the data or, alternatively, because the strong competition prevailing in international bank lending may lead to a weakening of bargaining positions resulting not only in smaller profit margins but also in less adequate information.

Thirdly, since an individual country risk may comprise a whole range of credits to individual borrowers resident in that country, the amount at stake will quite often be substantial even for the very large banks, and perhaps excessive for the not-so-large ones. Moreover, it is likely that the country will have borrowed from other banks as well; so that should a country suspend interest payments even temporarily or, worse still, enter into a formal debt moratorium, this could affect a whole series of banks simultaneously and thus trigger off a chain reaction.

Last but not least, it should not be forgotten that as a result of the much faster growth of international bank lending than of domestic credit, the structure of the balance sheet and profit and loss account of many banks has undergone a rapid change over the last few years. In itself such a change is not necessarily dangerous, provided that the organisation of the banks, especially in the area of internal control and supervision, is adapted accordingly. There is always a danger that logistics may not follow with appropriate speed the sudden acceleration of commercial growth.

The solution to these preoccupations does not lie in a move towards some sort of mandatory international banking supervision. This is simply not feasible, and probably not even desirable. As for national supervision, practice will, of course, evolve differently from country to country, according to traditions and the size of the problems. But international progress could be achieved by steering efforts in two directions. On the one hand, by improving the information on borrowing countries available to lenders: there must surely be ways and means of achieving this objective, not only by publishing more statistics but also by encouraging lenders to seek, and borrowers to supply, better figures whenever it comes to negotiating new international loans. On the other hand, since it is clear that the smooth functioning of the international economy makes it desirable that banks should continue to participate in balance-of-payments financing and as this is indeed likely to happen, there is scope for more co-operation between the banks and international institutions. In other words, official organisations should take a larger share in *future* lending. This should also help to improve the working of the adjustment process, as is pointed out in Chapter VII.

Developments in the narrowly defined Euro-currency market.

In 1976 the Euro-currency market once again demonstrated its ability to prosper under any kind of cyclical constellation. Its growth had proceeded at a well-sustained pace during 1975 at the height of the recession, and it continued to do so in 1976, the first year of recovery. The gross external assets of the banks of the eight reporting European countries rose by $47.2 billion to $305.3 billion and their liabilities by $52 billion to $310.7 billion, with the market's underlying rate of expansion showing a considerable acceleration in the course of the year. The $4.8 billion widening in their external net debtor position resulted from the banks' net use of foreign currency funds for domestic lending and reflected a pick-up in the demand for Euro-currency funds within the reporting European area itself.

As usual, most of the expansion occurred in the dollar sector of the market, with the banks' assets and liabilities in that currency advancing by $33.8 and 40.5 billion, or 18 and 21 per cent., respectively. The dollar value of the banks' other foreign currency assets and liabilities expanded by $13.4 and 11.4 billion, or 20 and 16 per cent., but, as indicated on page 97, a substantial part of these increases was

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

End of month		Dollars		Other foreign currencies						
					of which					
		Total	of which vis-à-vis non-banks	Total	vis-à-vis non-banks	Deutsche Mark	Swiss francs	Pounds sterling	Dutch guilders	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
1976	March . .	188,990	42,000	72,250	20,970	44,130	16,140	2,420	2,500	2,320
	June . . .	195,990	44,720	70,620	20,780	41,060	17,180	2,310	2,470	2,360
	Sept. . .	201,720	46,670	76,160	22,430	45,120	17,590	2,490	3,000	2,360
	Dec. . . .	224,020	50,820	81,300	22,690	46,680	17,930	2,150	3,780	2,570
Memorandum item *Positions vis-à-vis residents*										
1975	*Dec. . . .*	*66,540*	*17,410*	*22,820*	*6,580*					
1976	*March . .*	*67,020*	*17,670*	*23,940*	*6,690*					
	June . . .	*66,320*	*17,970*	*23,270*	*6,740*					
	Sept. . .	*67,200*	*19,460*	*24,830*	*7,300*					
	Dec. . . .	*74,740*	*21,330*	*26,920*	*7,560*					
					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	19,660	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
1976	March . .	189,330	25,310	70,940	7,690	40,330	15,010	3,780	3,630	3,420
	June . . .	196,140	26,250	69,740	8,000	38,160	15,790	3,730	3,620	3,160
	Sept. . .	203,300	27,630	74,680	8,500	41,540	15,960	3,920	3,580	3,100
	Dec. . . .	230,040	29,550	80,610	8,970	47,230	15,880	3,980	3,530	3,220
Memorandum item *Positions vis-à-vis residents*										
1975	*Dec. . . .*	*58,170*	*9,400*	*19,760*	*3,210*					
1976	*March . .*	*58,760*	*9,650*	*21,060*	*3,620*					
	June . . .	*57,720*	*9,560*	*20,630*	*3,820*					
	Sept. . . .	*54,300*	*9,970*	*26,040*	*4,520*					
	Dec. . . .	*64,060*	*10,660*	*23,710*	*4,290*					

[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.

due to valuation changes, resulting notably from the renewed appreciation of the dollar exchange rates of the Deutsche Mark and the Swiss franc. Despite these valuation effects, the dollar's share in total outstanding Euro-currency assets remained virtually unchanged at about 73 per cent. and the shares of the Deutsche Mark and the Swiss franc were stable at 16 and 6 per cent. respectively.

Even apart from valuation changes, the development of the banks' gross and net positions in individual currencies was influenced to a considerable extent by the exchange markets. The banks' net asset position in Deutsche Mark, for example, rose sharply during the currency unrest in the first quarter while their net liability position in sterling widened. Over the year as a whole, however, major increases occurred only in the banks' net position in Swiss francs and Dutch guilders. The banks' net assets in Swiss francs rose from $0.1 to 2 billion, the greater part of this movement occurring in the first half of the year when the franc was under strong upward pressure in the exchange market. The banks' net position in guilders shifted gradually from $1.4 billion of liabilities to $0.3 billion of assets, in spite of a temporary halt in the trend during the second quarter, when the guilder itself came under attack in the exchange markets. Needless to say, the improvement in the banks' net positions in strong currencies does not necessarily imply that the banks themselves were taking open positions; more probably it reflected their spot covering of forward sales of these currencies to customers.

With regard to the contribution of the individual centres to the growth of the market, banks in the United Kingdom accounted for $19.8 billion, or about 42 per cent., of the growth in Euro-currency assets. As in 1975, this was somewhat less than their share in outstanding positions. The main reasons for the more modest rôle of the London market-place even within the reporting European area would seem to have been the greater concentration of the US banks' new international business in New York and the Caribbean area, as well as the contraction of the UK banks' capital base for Euro-currency transactions as a result of the depreciation of sterling.

Banks in Belgium-Luxembourg and France, the two most important market centres on the Continent, recorded quite a strong expansion in their Euro-currency activities. Their external assets in foreign currency advanced by $10.4 and 9 billion respectively and their market shares each rose from 15 to about 16 per cent. The French banks' external net position shifted from $0.9 billion of assets to $0.7 billion of liabilities. This $1.6 billion inflow, which was certainly helpful in financing the country's massive current deficit, was largely the result of tailoring interest rate policy to balance-of-payments requirements.

Reflecting the economic and political uncertainties besetting the country, the external assets in foreign currency of banks in Italy showed a renewed decline in 1976, although the downward movement was partly reversed after the middle of the year. As a result, the Italian banks' market share, which some years ago had amounted to 14 per cent., shrank further from 6 to 4 per cent. Since the banks maintained their external liabilities unchanged, the decline in assets meant that their net position shifted from approximate balance to external net debts of $2.7 billion. This inflow through the banks, together with a substantial amount of official

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

			1974 Dec.	1975 Dec.	1976 March	1976 June	1976 Sept.	1976 Dec.
			in millions of US dollars					
Belgium-Luxembourg	Assets	Domestic currency	1,650	1,720	1,790	1,880	2,290	2,440
		Foreign currencies	32,210	39,070	40,900	40,680	45,230	49,420
	Liabilities	Domestic currency	2,500	2,650	2,540	2,840	2,840	3,350
		Foreign currencies	31,280	37,860	39,220	39,220	43,580	47,530
France	Assets	Domestic currency	1,080	1,180	1,160	1,170	1,400	1,450
		Foreign currencies	31,820	39,020	40,200	40,730	42,580	47,990
	Liabilities	Domestic currency	3,680	4,370	3,670	3,880	3,920	3,810
		Foreign currencies	32,510	38,110	38,820	39,650	42,520	48,660
Germany	Assets	Domestic currency	14,210	21,010	21,580	21,440	22,030	25,900
		Foreign currencies	8,360	10,640	10,240	10,940	12,000	14,330
	Liabilities	Domestic currency	11,250	13,620	15,280	13,970	15,040	17,390
		Foreign currencies	7,680	9,310	9,130	9,620	10,820	13,730
Italy	Assets	Domestic currency	600	440	380	450	340	260
		Foreign currencies	12,510	14,980	10,720	9,020	9,470	12,290
	Liabilities	Domestic currency	1,330	1,620	1,360	1,670	1,410	1,420
		Foreign currencies	13,610	15,040	11,340	10,560	11,260	14,950
Netherlands	Assets	Domestic currency	2,670	3,460	3,650	3,940	4,170	4,170
		Foreign currencies	13,350	17,350	17,460	19,170	19,350	22,000
	Liabilities	Domestic currency	2,070	2,150	2,640	3,140	3,730	4,080
		Foreign currencies	12,600	16,370	16,040	16,730	16,850	19,580
Sweden	Assets	Domestic currency	430	570	700	730	970	810
		Foreign currencies	2,060	2,570	2,840	2,750	2,760	2,920
	Liabilities	Domestic currency	510	580	520	590	690	670
		Foreign currencies	1,040	1,750	2,060	2,150	2,150	2,290
Switzerland	Assets	Domestic currency	9,160	9,070[1]	9,760	10,400	11,090	10,870
		Foreign currencies	12,300	16,260	17,880	18,300	18,850	18,370
	Liabilities	Domestic currency	8,510	4,630[1]	4,850	4,890	4,880	5,060
		Foreign currencies	10,560	12,020	12,440	12,730	12,910	15,290
United Kingdom	Assets	Domestic currency	1,850	1,700	1,770	1,920	1,980	1,800
		Foreign currencies	102,560	118,240	121,000	125,020	127,640	138,000
	Liabilities	Domestic currency	9,530	9,240	8,680	7,310	7,090	7,130
		Foreign currencies	111,490	128,210	131,220	135,220	137,890	148,620
Total	Assets	Domestic currency	31,650	39,150	40,790	41,930	44,270	47,700
		Foreign currencies	215,170	258,130	261,240	266,610	277,880	305,320
	Liabilities	Domestic currency	39,380	38,860	39,540	38,290	39,600	42,900
		Foreign currencies	220,770	258,670	260,270	265,880	277,980	310,650
Canada	Assets	Domestic currency	410	460	470	500	470	460
		Foreign currencies	13,540	13,390	14,720	15,210	16,930	17,070
	Liabilities	Domestic currency	1,610	2,010	2,110	2,090	1,920	1,960
		Foreign currencies	11,730	12,070	12,830	13,480	13,900	14,620
Japan	Assets	Domestic currency	1,370	1,530	1,690	1,820	1,900	2,080
		Foreign currencies	19,240	18,830	19,590	19,210	19,910	19,560
	Liabilities	Domestic currency	870	1,480	1,960	2,080	1,890	1,880
		Foreign currencies	24,080	25,210	26,740	27,140	27,860	27,180
United States	Assets	Domestic currency	44,980	58,330	61,940	66,460	69,720	78,770
		Foreign currencies	1,280	1,440	1,480	1,720	1,800	1,790
	Liabilities	Domestic currency[2]	59,630	58,180	58,440	61,980	63,110	69,840
		Foreign currencies	770	560	570	690	710	750
Caribbean area and the Far East[3]	Assets	Foreign currencies[4]	33,230	51,090	57,870	63,850	67,960	74,930
	Liabilities	Foreign currencies[4]	33,230	50,960	58,090	64,610	68,830	74,080

[1] Break in series due to change in coverage. [2] Excluding US Treasury bills and certificates held in custody on behalf of non-residents. [3] Figures for 1974 relate to branches of US banks in the Bahamas, Cayman Islands and Panama; data for 1975 and 1976 cover branches of US banks in Hong Kong and Singapore as well. [4] Including negligible amounts in domestic currencies.

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

			1974 Dec.	1975 Dec.	1976 March	1976 June	1976 Sept.	1976 Dec.
			in millions of US dollars					
Belgium-Luxembourg	Assets	US dollars	15,210	18,670	20,200	20,700	22,080	25,020
		Other foreign currencies	17,000	20,400	20,700	19,980	23,150	24,400
	Liabilities	US dollars	13,350	17,960	18,990	19,040	20,950	22,950
		Other foreign currencies	17,930	19,900	20,230	20,180	22,630	24,580
France	Assets	US dollars	24,210	29,690	29,110	30,540	31,640	36,180
		Other foreign currencies	7,610	9,330	11,090	10,190	10,940	11,810
	Liabilities	US dollars	22,660	27,000	26,690	28,130	30,230	36,050
		Other foreign currencies	9,860	11,110	11,930	11,520	12,290	12,610
Germany	Assets	US dollars	6,140	7,700	7,260	7,470	8,480	10,570
		Other foreign currencies	2,220	2,940	2,980	3,470	3,520	3,760
	Liabilities	US dollars	6,160	7,400	7,340	7,550	8,510	11,290
		Other foreign currencies	1,520	1,910	1,790	2,070	2,310	2,440
Italy	Assets	US dollars	9,770	12,100	8,170	6,890	6,930	9,590
		Other foreign currencies	2,740	2,880	2,550	2,130	2,540	2,700
	Liabilities	US dollars	10,440	11,830	8,680	8,060	8,430	11,660
		Other foreign currencies	3,170	3,210	2,660	2,500	2,830	3,290
Netherlands	Assets	US dollars	7,960	10,400	10,740	12,190	12,170	13,920
		Other foreign currencies	5,390	6,950	6,720	6,980	7,180	8,080
	Liabilities	US dollars	6,280	10,670	10,500	11,260	11,090	12,390
		Other foreign currencies	6,320	5,700	5,540	5,470	5,760	7,190
Sweden	Assets	US dollars	1,320	1,790	1,920	1,850	1,940	2,040
		Other foreign currencies	740	780	920	900	820	880
	Liabilities	US dollars	560	1,020	1,210	1,280	1,320	1,420
		Other foreign currencies	480	730	850	870	830	870
Switzerland	Assets	US dollars	8,930	12,890	14,130	14,430	14,720	14,120
		Other foreign currencies	3,370	3,370	3,750	3,870	4,130	4,250
	Liabilities	US dollars	6,150	9,420	9,430	9,810	9,850	11,800
		Other foreign currencies	2,410	2,600	3,010	2,920	3,060	3,490
United Kingdom	Assets	US dollars	82,690	96,940	97,460	101,920	103,760	112,580
		Other foreign currencies	19,870	21,300	23,540	23,100	23,880	25,420
	Liabilities	US dollars	88,840	104,170	106,290	111,010	112,920	122,480
		Other foreign currencies	22,650	24,040	24,930	24,210	24,970	26,140
Total	Assets	US dollars	156,230	190,180	188,990	195,990	201,720	224,020
		Other foreign currencies	58,940	67,950	72,250	70,620	76,160	81,300
	Liabilities	US dollars	156,430	189,470	189,330	196,140	203,300	230,040
		Other foreign currencies	64,340	69,200	70,940	69,740	74,680	80,610
Canada	Assets	US dollars	12,700	12,640	13,970	14,330	16,030	16,120
		Other foreign currencies	840	750	750	880	900	950
	Liabilities	US dollars	11,090	11,560	12,340	12,890	13,310	13,980
		Other foreign currencies	640	510	490	590	590	640
Japan	Assets	US dollars	17,150	16,960	17,780	17,380	18,010	17,530
		Other foreign currencies	2,090	1,870	1,810	1,830	1,900	2,030
	Liabilities	US dollars	22,960	24,340	25,730	26,200	26,920	26,200
		Other foreign currencies	1,120	870	1,010	940	940	960
Caribbean area and the Far East[1]	Assets	All foreign currencies[2] .	33,230	51,090	57,870	63,850	67,960	74,930
	Liabilities	All foreign currencies[2] .	33,230	50,960	58,090	64,610	68,830	74,080

[1] Figures for 1974 relate to branches of US banks in the Bahamas, Cayman Islands and Panama; data for 1975 and 1976 cover branches of US banks in Hong Kong and Singapore as well. [2] Including negligible amounts in domestic currencies.

borrowing, not only offset Italy's current-account deficit, but resulted in a sizable increase in official reserve holdings. It was essentially induced by new regulations requiring Italian residents to have recourse to foreign currency borrowing to finance both the prepayment of imports and delayed export receipts, as well as by a ceiling on the banks' credit expansion in lire. Under the impact of these measures the Italian banks' foreign currency credits to residents soared from $1.4 to 3.8 billion, a development which continued during the first quarter of 1977.

Looking at the countries with large current-account surpluses, it may be seen that banks in Germany showed rapid growth in their Euro-currency business, with their external assets in foreign currency expanding by $3.7 billion, or 35 per cent. In addition, they built up their external assets in domestic currency by $4.9 billion. However, in contrast to preceding years, the German banks seem to have become more active as intermediaries rather than as net suppliers of funds to the international market. Owing to a sharp acceleration in the growth of their liabilities vis-à-vis non-residents, their external net creditor position in domestic and foreign currency, which had jumped from $3.6 to 8.7 billion in 1975, edged up by only $0.4 billion. Similarly, banks in Switzerland, which had been large net exporters of funds in 1975, showed only a slight increase — of $0.2 to 8.9 billion — in their external net creditor position. These figures do not, however, include the funds which the Swiss banks channel into the international market on a trustee basis. Whereas the external net positions in foreign currency of banks in Germany and Switzerland actually declined — a development which was undoubtedly related to the strength of the Deutsche Mark and the Swiss franc on the exchanges — the Dutch banks' external net creditor position in foreign currency widened from $1.0 to 2.4 billion. Most of this outflow occurred during the second quarter when pressures against the guilder were building up in the exchange market. On the other hand, the Dutch banks' external net position in guilders dropped from $1.3 to 0.1 billion in the course of the year.

Net of double-counting, the total volume of Euro-credit outstanding through the reporting European centres may be estimated to have expanded from $205 to 247 billion, or by about 20 per cent., in 1976. On the uses side of the market, the absorption of Euro-currency funds within the reporting European area picked up sharply from about $1.5 billion in 1975 to $12 billion in 1976. Direct claims on the non-bank sector rose by about $8 billion, the largest items in this increase being new Euro-currency credits to residents by banks in Italy, the United Kingdom and Switzerland of $2.4, 1.1 and 0.6 billion respectively, and $1.5 billion of new credits extended to the German non-bank sector by banks outside Germany.

Outside the reporting European area, claims on the United States went up by $1.7 billion last year after having declined by nearly the same amount in 1975; the increase in claims on the US banking sector came to more than the whole of this growth, whereas claims on the US non-bank sector contracted from $4.2 to 3.7 billion. Claims on Canada showed a similar development, rising by $1 billion last year after a $0.4 billion decrease in 1975. Claims on Japan — representing essentially loans to the Japanese banking sector — which had gone up by $2.4 billion in 1975, grew by a further $1.9 billion in the first quarter of 1976. During the rest of the year, however,

Estimated sources and uses of Euro-currency funds.

End of month	Reporting European area: Total[1]	Reporting European area: of which Non-bank[2]	United States	Canada and Japan	Other developed countries	Eastern Europe[3]	Offshore banking centres[4]	Oil-exporting countries[5]	Developing countries	Unallocated[6]	Total
	in billions of US dollars										
Uses											
1973 Dec. . . .	49.0	29.5	13.5	12.7	14.7	7.4	18.7	3.3	11.0	1.7	132.0
1974 Dec. . . .	61.5	41.3	18.2	18.2	20.4	10.1	26.7	3.5	15.7	2.7	177.0
1975 March . .	64.3	44.3	15.4	20.1	21.7	12.2	29.4	3.8	15.8	3.3	186.0
June . . .	63.6	45.0	16.1	20.2	24.3	12.8	30.5	4.3	16.8	3.4	192.0
Sept. . .	62.1	43.2	16.7	21.2	23.9	13.8	33.0	4.8	17.5	3.0	196.0
Dec. . .	63.0	43.6	16.6	20.2	25.8	15.9	35.5	5.3	19.5	3.2	205.0
1976 March . .	65.0	44.4	16.1	22.4	26.3	17.4	34.9	6.0	19.9	3.0	211.0
June . .	64.4	45.1	16.9	22.6	27.8	18.5	38.0	6.9	21.3	2.6	219.0
Sept. . . .	68.2	48.3	17.7	22.9	30.1	19.6	38.3	8.1	22.5	2.6	230.0
Dec. . . .	75.1	51.5	18.3	21.6	33.0	20.8	40.7	9.6	24.7	3.2	247.0
Sources											
1973 Dec. . . .	50.8	27.5	9.5	9.8	17.7	3.7	12.5	10.0	14.6	3.4	132.0
1974 Dec. . . .	67.8	36.2	11.9	8.7	18.5	5.1	17.8	29.1	15.5	2.6	177.0
1975 March . .	73.0	37.8	12.5	8.8	17.8	4.5	18.2	31.8	16.1	3.3	186.0
June . . .	75.7	36.5	13.3	8.1	18.3	3.8	21.3	32.5	16.1	2.9	192.0
Sept. . . .	77.3	38.0	14.3	8.9	19.4	4.5	20.5	32.3	15.5	3.3	196.0
Dec. . . .	79.5	38.5	15.4	8.3	19.9	5.4	21.8	34.6	16.2	3.9	205.0
1976 March . .	82.0	40.0	15.0	9.0	20.6	5.0	24.1	34.4	16.5	4.4	211.0
June . . .	81.2	41.0	17.4	9.8	19.3	5.2	26.8	37.4	17.1	4.8	219.0
Sept. . . .	84.3	42.7	17.4	10.0	20.6	5.3	27.0	41.1	18.9	5.4	230.0
Dec. . . .	87.6	44.7	18.8	10.5	21.3	6.4	30.1	45.2	21.3	5.8	247.0

[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 includes 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] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [4] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, West Indies. [5] Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, the United Arab Emirates, Venezuela. [6] Including positions vis-à-vis international institutions.

they declined by \$1.5 billion, a development which has to be seen in the context of the strengthening of Japan's balance-of-payments position. Moreover, there was a slowdown from \$8.9 billion in 1975 to \$5.2 billion in the funds channelled by the reporting European banks to the offshore centres.

Lending by the reporting European banks continued at a high level vis-à-vis countries outside the Group of Ten. New credit-granting accelerated vis-à-vis "Other developed countries", from \$5.4 billion in 1975 to \$7.2 billion, vis-à-vis oil-exporting countries from \$1.8 to 4.3 billion, and vis-à-vis non-oil developing countries from \$3.8 to 5.2 billion. New credit to eastern Europe went up somewhat less than in 1975, viz. by \$4.9 billion, but this still represented a rate of expansion of over 30 per cent. and raised the total outstanding to twice the amount recorded two years earlier. Moreover, it may be worthwhile noting that at the end of 1976 Euro-market claims on eastern Europe were only 16 per cent. less than total claims on developing countries.

On the sources side of the market, one significant feature was a sharp acceleration in the inflow of funds from oil-exporting countries. After increasing by \$5.5 billion in 1975, new identified deposits by these countries rose by $10.6 billion last year. Whereas in previous years London had received more than 75 per cent. of the OPEC countries' Euro-currency deposits, in 1976 nearly half of the new funds were placed in the continental European centres. The bulk of the oil funds went into the dollar sector of the Euro-market, with other deposits, notably in the Euro-Deutsche Mark sector of the market, increasing by only $1.4 billion.

Another significant feature on the sources side was a pick-up in the supply of new funds to the market by non-oil developing countries from $0.7 billion in 1975 to $5.1 billion, which was nearly as much as the increase in the banks' claims on these countries. Hence, in contrast to previous years, developing countries as a group were not major net takers of funds from the Euro-market in 1976.

A substantial acceleration from $7.1 billion to about $14 billion was also registered in the amount of new funds obtained by the Euro-market from non-European Group of Ten countries and the offshore banking centres, a development which was probably related to the recovery in the demand for Euro-currency funds within the reporting European area. The supply of new funds from the latter area itself slowed down, from about $12 billion in 1975 to roughly $8 billion. There were larger direct deposits by non-banks but, in contrast to 1975, the reporting banks themselves did not act as large-scale suppliers of new funds to the Euro-market.

Total international bank lending.

The tables on pages 112–113 and 114 provide a broad picture of the rôle of banks as international financial intermediaries. They show the total external assets and liabilities of banks in Group of Ten countries and of the foreign branches of US banks in certain offshore centres vis-à-vis individual countries and groups of countries. As already explained in last year's Annual Report, the positions recorded vis-à-vis the Group of Ten countries and the various offshore centres are strongly influenced by the part played by these countries as market centres, but they tell very little about their importance as suppliers of funds to, or users of funds from, the international market. From this point of view, the value of the tables lies primarily in the information they provide on the reporting banks' positions vis-à-vis countries that are not international financial centres themselves. Moreover, it should be noted that the figures include both long and short-term positions and positions vis-à-vis both the bank and non-bank sectors. It may be assumed, however, that the bulk even of short-term funds lent to banks located in countries that are not international financial centres are used by these banks for domestic lending, though a certain amount of on-lending to third countries cannot be excluded.

Furthermore, it should be pointed out that the figures mentioned below for the banks' positions vis-à-vis individual countries will be somewhat larger than those shown in the table on pages 112–113, since an attempt has been made here to allocate the residual items given for the individual geographical areas.

As can be seen from the table on page 114, the reporting banks' claims on non-oil developing countries (excluding offshore centres) may be estimated to have gone up by $18 to 81 billion, in comparison with an increase of about $16–17 billion in 1975. Only 29 per cent. of the 1976 lending was accounted for by the narrowly defined Euro-market; 44 per cent. was provided by the US banks' branches in the offshore centres and another 18 per cent. represented funds lent from the United States direct. Since the affiliates of US banks are also very active participants in the Euro-market, it may thus be estimated that the US banks and their foreign affiliates alone accounted for over two-thirds of new lending to developing countries in 1976. As to the geographical distribution of the credits, Latin America received $13.9 billion, or 78 per cent., whereas the reporting banks' claims on non-oil developing countries in the Middle East, "Other Asia" and "Other Africa" went up by only $1.1, 1.8 and 1.1 billion respectively. Within Latin America by far the largest borrowers were Brazil and Mexico; they took up about $6.5 and 5 billion respectively (including their estimated share in the residual item) and at the end of the year accounted for over 50 per cent. of the reporting banks' claims on non-oil developing countries. In Asia the largest borrowers were South Korea and the Philippines, receiving about $0.6 billion each.

Perhaps more surprising than the sharp 1976 increase in the reporting banks' lending to the developing world was the sharp increase in their liabilities vis-à-vis that group of countries. These had gone up by only about $3 billion in 1975, but it is estimated that in 1976 they advanced from $37 to 50 billion. Of this $13 billion increase, 40 per cent. was deposited in the narrowly defined Euro-market and about 25 per cent. each with banks in the United States and their branches in offshore centres respectively. A substantial part of these funds, particularly of those deposited in the United States and the Euro-market, undoubtedly represented official reserves, which accrued to the developing countries largely as a result of their own borrowing from banks abroad. In fact, the largest depositors were Brazil (about $3 billion) and Mexico ($1.2 billion). On the whole, however, the distribution of deposits and borrowings was not fully matched, and at $4.3 billion "Other Asia's" share in the supply of new funds was considerably larger than its share in borrowings. As a result, developing countries in "Other Asia" supplied a net amount of $2.5 billion to the market, whereas Latin America was a net taker to the extent of about $8 billion.

The reporting banks' new lending to oil-exporting countries accelerated sharply from about $3 billion in 1975 to nearly $10 billion in 1976. The largest borrowers within this group were Venezuela, Iran and Indonesia. Moreover, the above figure includes an increase of about $2 billion in claims on Bahrain, reflecting that country's emerging rôle as an offshore banking centre. Liabilities to oil-exporting countries, after having expanded by $8–9 billion in 1975, rose by $12.4 billion, or only $2.6 billion more than the banks' claims on these countries. Nearly 60 per cent. of these funds seem to have been obtained from the "low absorbers" in the Middle East, while the "high absorbers" in that area supplied over $3 billion, and approximately $1 billion was provided by Indonesia. As much as 85 per cent. of the new oil funds were deposited in the Euro-market, 12 per cent. with banks in the United States and only 5 per cent. with the US banks' branches in the offshore centres; owing to the movements out of sterling, deposits in European domestic markets showed, on balance, a decline.

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 1976.

Liabilities/assets vis-à-vis		Liabilities	Assets
Group of Ten			
Belgium-Luxembourg	HCJU	22,283	27,765
France	HCJU	30,986	27,000
Germany, Federal Rep.	HCJU	22,325	28,338
Italy	HCJU	10,206	16,749
Netherlands	HCJU	18,604	13,240
Sweden	HCJU	2,613	5,372
Switzerland	CJU	59,253	12,937
United Kingdom	HCJU	75,074	62,134
Canada	HJU	12,607	9,352
Japan	HCU	10,247	34,073
United States	HCJ	56,261	33,270
Total		320,459	270,230
Other countries in western Europe			
Andorra		54	5
Austria	CU	5,345	5,357
Cyprus		322	115
Denmark	CU	1,706	4,703
Finland	CU	1,009	3,586
Gibraltar		54	4
Greece	CJU	3,068	2,990
Iceland		75	204
Ireland	C	1,481	1,634
Liechtenstein		252	469
Malta		520	5
Monaco		22	1
Norway	CU	2,141	5,239
Portugal	CU	820	865
Spain	CU	6,348	7,773
Turkey	CJU	545	2,063
Vatican		118	—
Yugoslavia	CJU	1,818	2,223
Residual	HCJU	6,865	5,477
Total		32,563	42,723
Other developed countries			
Australia	CU	970	2,481
New Zealand	C	297	854
South Africa	CU	775	6,969
Residual	HCJ	349	1,480
Total		2,391	11,784
Eastern Europe[2]			
Albania		83	5
Bulgaria		355	1,973
Czechoslovakia		356	866
German Democratic Republic		616	3,575
Hungary		899	3,051

Liabilities/assets vis-à-vis		Liabilities	Assets
Eastern Europe (contd.)			
Poland		643	5,442
Rumania		295	732
Soviet Union	CU	3,724	10,345
Residual	HCJU	695	2,984
Total		7,666	28,973
Caribbean area			
Bahamas	JU	16,656	34,682
Barbados		37	646
Bermuda	J	3,300	893
Cayman Islands		6,079	5,970
Cuba	JU	84	1,007
Dominican Republic		7	153
Haiti		13	13
Jamaica		68	394
Neth. Antilles	U	1,711	1,421
Panama	JU	5,643	7,886
Trinidad and Tobago		398	24
West Indies (UK)		599	332
Residual	HCJU	4,935	9,839
Total		39,530	63,260
Latin America			
Argentina	JU	3,138	3,402
Belize		24	9
Bolivia		100	273
Brazil	JU	6,780	21,215
Chile	JU	718	1,093
Colombia	JU	913	1,632
Costa Rica		86	238
Ecuador	J	253	494
El Salvador		83	125
Guatemala		111	171
Guyana		35	39
Honduras		77	150
Mexico	JU	4,400	17,850
Nicaragua		55	340
Paraguay		42	57
Peru	JU	369	2,829
Surinam		135	8
Uruguay	U	505	168
Venezuela	JU	7,260	5,326
Residual	HCJU	5,440	6,860
Total		30,524	62,279
Middle East			
Oil-exporting countries:	J[3]		
a) Low absorbers: Kuwait, Qatar, Saudi Arabia and the United Arab Emirates		30,173	2,024

Liabilities/assets vis-à-vis		Liabilities	Assets
Middle East (contd.)			
b) High absorbers:			
Bahrain, Iran, Iraq, Libya and Oman		11,438	6,359
Other countries:			
Egypt	JU	2,016	1,242
Israel	JU	2,875	2,538
Jordan		510	62
Lebanon		2,582	339
Syria		497	163
Yemen		516	31
Yemen P.D. Republic		245	3
Residual[4]	HCJU	8,520	2,542
Total		59,372	15,303
Other Africa			
Afars and Issas French Territory		36	2
Algeria	J	2,150	1,746
Angola		102	30
Benin		31	3
Botswana/Lesotho		34	38
Burundi		21	7
Cameroon		77	60
Canary Islands		–	9
Central African Empire		18	2
Chad		14	5
Congo		52	51
Ethiopia		289	1
Gabon		89	273
Ghana		82	90
Guinea		13	37
Ivory Coast		386	392
Kenya	J	445	103
Liberia	J	1,091	4,400
Malagasy		59	2
Malawi		43	53
Mali		12	1
Mauritania		75	8
Mauritius		38	5
Morocco	U	728	541
Mozambique		99	2
Namibia		4	24
Niger		53	16
Nigeria	J	478	263
Rhodesia		34	37
Rwanda		71	3
Senegal		65	73
Sierra Leone		41	14
Other Africa (contd.)			
Somalia		77	3
Sudan		142	298
Swaziland		6	13
Tanzania		145	6
Togo		35	22
Tunisia		305	63
Uganda		46	15
Upper Volta		6	2
Zaire	U	364	811
Zambia	J	158	393
Residual	CU	1,153	1,776
Total		9,167	11,693
Other Asia			
Afghanistan		82	—
Bangladesh		118	4
Brunei		880	24
Burma		50	21
Cambodia		42	—
China	U	1,382	301
Fiji		31	17
French Polynesia		17	21
Hong Kong	JU	5,670	7,327
India	JU	1,103	468
Indonesia	JU	1,444	3,439
Korea N.		222	390
Korea S.	JU	2,150	3,902
Malaysia	J	1,334	945
Nepal		48	1
New Hebrides		36	93
Pakistan	J	383	162
Papua-New Guinea		85	22
Philippines	JU	1,836	2,611
Sikkim/Bhutan		17	11
Singapore	HJ	6,597	8,626
Sri Lanka		41	9
Taiwan	JU	2,330	2,561
Thailand	JU	963	1,433
Vietnam		121	47
Residual	CU	2,102	1,762
Total		29,084	34,197
International institutions	U[5]	3,939	1,162
Unallocated	HCJU	8,881	5,965
Grand total		543,576	547,569
Memorandum item:			
Oil-exporting countries	HJU	62,723	23,133

Note: A full country breakdown of the reporting banks' liabilities and assets is available only for banks in Belgium-Luxembourg, France, the Federal Republic of Germany, Italy, the Netherlands, Sweden and the United Kingdom and for the branches of US banks in the Caribbean area and the Far East. For banks in the other reporting countries — Canada, Japan, Switzerland and the United States — the country breakdown is less than complete and its extent is indicated by the use of the letters C (Canada), J (Japan), H (Switzerland) 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] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [3] Includes positions of Japanese banks vis-à-vis Kuwait, Saudi Arabia, the United Arab Emirates, Iran, Iraq and Libya only. [4] 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"). [5] Excludes, except in the case of 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 "Other countries in western Europe".

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

	1975 December	1976 March	1976 June	1976 September	1976 December
	in billions of US dollars				
Banks' claims on:					
Group of Ten countries and Switzerland	235.1	239.7	241.0	248.8	270.2
of which: Reporting European area	*165.4*	*166.6*	*166.0*	*170.8*	*193.4*
United States	*30.7*	*31.7*	*32.1*	*33.8*	*33.3*
Canada	*7.1*	*7.9*	*8.6*	*9.3*	*9.4*
Japan	*31.9*	*33.5*	*34.3*	*34.9*	*34.1*
Offshore banking centres[2]	61.9	67.2	72.5	76.8	83.7
Other countries in western Europe	31.8	32.6	35.0	38.3	42.7
Australia, New Zealand and South Africa	9.0	10.0	10.7	11.4	11.8
Eastern Europe	21.6	23.6	25.1	26.8	29.0
Oil-exporting countries	14.3	15.5	17.3	20.0	24.1
Non-oil developing countries	63.0	65.7	70.2	73.5	80.9
of which: Latin America[3]	*43.5*	*46.1*	*49.6*	*51.8*	*57.4*
Middle East	*3.3*	*3.0*	*3.2*	*3.5*	*4.4*
Other Asia	*12.9*	*13.2*	*13.9*	*14.3*	*14.7*
Other Africa	*3.3*	*3.4*	*3.5*	*3.9*	*4.4*
Unallocated[4]	5.0	5.0	4.9	4.5	5.2
Total	441.7	459.3	476.7	500.1	547.6
Banks' liabilities to:					
Group of Ten countries and Switzerland	270.1	277.8	284.3	294.4	320.5
of which: Reporting European area	*209.1*	*210.5*	*210.6*	*216.5*	*241.4*
United States	*42.0*	*45.8*	*51.9*	*54.2*	*56.3*
Canada	*9.9*	*11.3*	*11.8*	*12.6*	*12.6*
Japan	*9.1*	*10.2*	*10.0*	*11.1*	*10.2*
Offshore banking centres[2]	40.8	44.8	49.4	51.5	56.2
Other countries in western Europe	31.1	30.3	29.4	31.1	32.6
Australia, New Zealand and South Africa	2.1	2.6	2.2	2.1	2.4
Eastern Europe	6.3	5.7	6.2	6.1	7.7
Oil-exporting countries	51.8	52.4	54.6	59.1	64.2
Non-oil developing countries	36.7	37.8	41.4	43.1	49.4
of which: Latin America[3]	*16.3*	*16.5*	*17.6*	*17.7*	*22.3*
Middle East	*5.9*	*6.2*	*6.7*	*6.7*	*7.1*
Other Asia	*10.4*	*10.8*	*12.4*	*13.5*	*14.7*
Other Africa	*4.1*	*4.3*	*4.7*	*5.2*	*5.3*
Unallocated[4]	8.2	8.1	9.2	8.7	10.6
Total	447.1	459.5	476.7	496.1	543.6

Note: The figures in this table are partly based on estimates.
[1] *Foreign branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore.* [2] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, West Indies. [3] Including those countries in the Caribbean area which cannot be considered as offshore banking centres. [4] Including international institutions.

Credits to eastern Europe rose by \$7.4 billion to \$29 billion. Two-thirds of the increase was accounted for by the Euro-market, while another 19 per cent. was provided in the form of credits in domestic currency by the banks in the same reporting European countries. The largest borrowers were the Soviet Union, which (after allocation of the residual item) received over \$2.5 billion, Poland (about \$1.8 billion), the German Democratic Republic (over \$1 billion) and Hungary (about \$1 billion). The reporting banks' liabilities to eastern Europe — mainly vis-à-vis the Soviet Union — rose by \$1.4 billion.

Reflecting continued large current-account deficits and the resultant financing requirements, the reporting banks' claims on developed countries outside the Group of Ten rose by \$13.7 billion, or over one-third, to a total of \$54.5 billion. Liabilities to these countries edged up by only \$1.8 billion to \$35 billion. The largest borrowers were Spain, South Africa (about \$2.7 billion each) and Denmark (over \$2 billion).

The \$21.8 billion expansion shown in the reporting banks' assets vis-à-vis offshore centres includes increases in claims on Singapore and Hong Kong of about \$3 and 1.5 billion respectively. In addition to their rôle as offshore centres, these two countries are of course capital importers, and some part of this \$4.5 billion may therefore have been used locally. Moreover, the present reporting covers only the activities of the branches of US banks in these centres, which would seem to account for much less than 50 per cent. of business there. It is therefore likely that these two centres undertook a substantial amount of international lending, notably to the developing countries, that is not reflected in the present statistics. Moreover, the 1976 increase in claims on offshore centres includes a \$0.8 billion rise to roughly \$4.8 billion in claims on Liberia, which is really an offshore centre for shipping companies and not for banking. The parent companies of most firms registered there have their seat in the developed countries, so that the larger part of credits to Liberia actually represent claims on developed countries. The same is partly true of Panama, which is an offshore centre both for banking and for shipping companies. The reporting banks' assets vis-à-vis Panama rose by about \$1 to 8.5 billion last year.

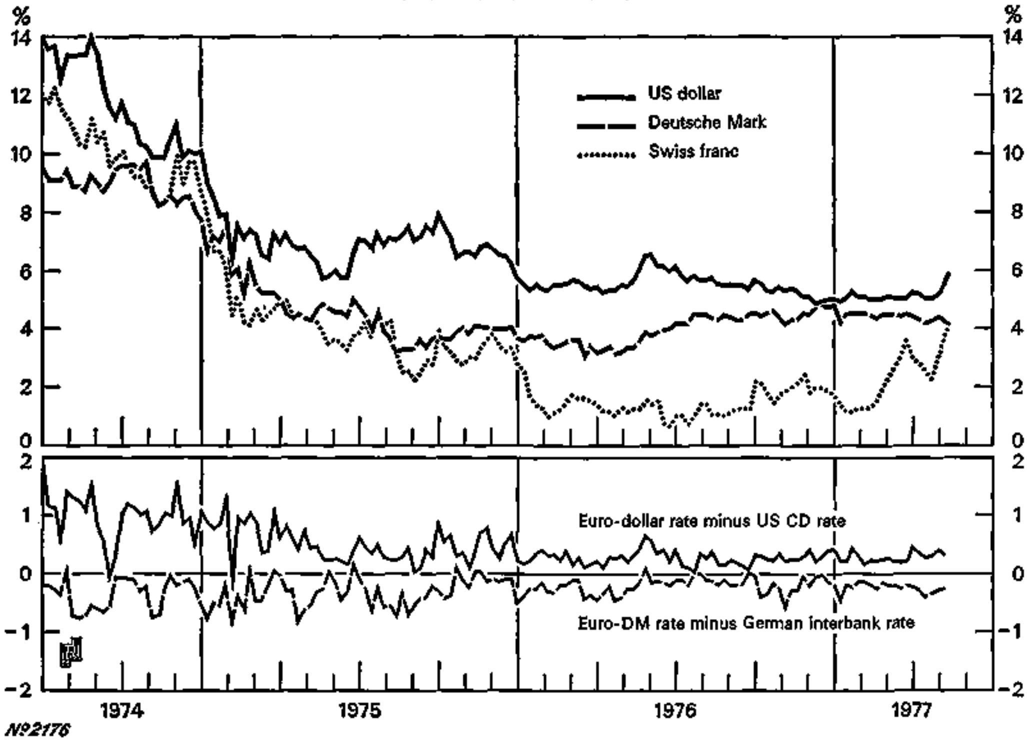
Interest rate developments.

Despite the large volume of business transacted, 1976 was a relatively calm year from the point of view of interest rates in the main sectors of the Euro-currency market. Quotations tended to follow very closely the trend of interest rates on domestic markets, where credit demand was rather subdued. Really pronounced fluctuations occurred only in some of the smaller market sectors, notably the Euro-French franc, the Euro-guilder and the Euro-sterling sectors, where exchange rate considerations were at times of overriding importance.

After staying close to 5½ per cent. in the early part of the year, three-month interbank rates on Euro-dollar deposits firmed to over 6 per cent. in May–June, when the temporary strength of the economic upswing led to some tightening of US monetary conditions. However, with the subsequent slackening in the pace of recovery, market conditions eased again and the Euro-dollar rate receded to 4⅞ per cent. in early December — its lowest level since mid-1972. It then fluctuated around 5⅛ per cent. before firming to about 5¾ per cent. in early May 1977, when the US money-market climate began to show a resemblance to that of a year earlier.

Reflecting the dissipation of fears that a strong economic recovery might soon lead to a marked tightening of credit conditions, the decline in rates for one-year Euro-dollar deposits in 1976 was more pronounced than that in shorter-term rates and resulted in a flattening of the yield curve. On the other hand, the yield differential between Euro-bond rates and Euro-dollar rates on deposits of six

Interbank rates on three-month Euro-currency deposits
and differentials over domestic rates.
Wednesday figures, in percentages per annum.



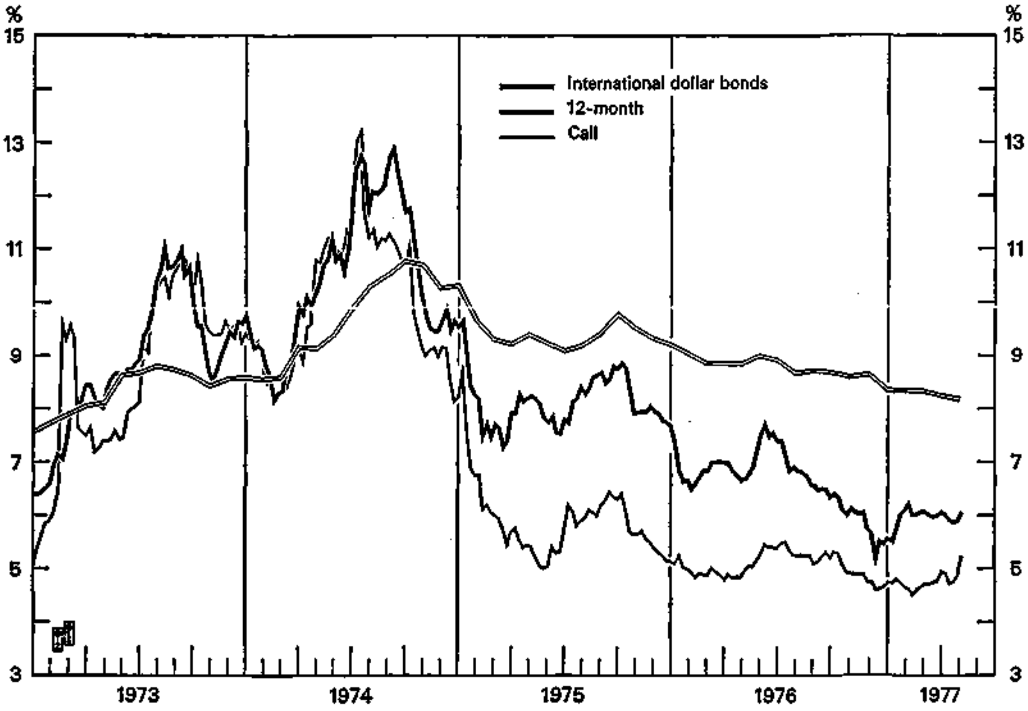
months and upwards, which was already quite substantial in 1975, widened still further.

In line with developments on the German domestic market, where capital-market yields and short-term interest rates moved in opposite directions during part of 1976, three-month Euro-Deutsche Mark rates eased somewhat in the first four months and then firmed during the rest of the year. In December they were quoted only slightly below Euro-dollar deposit rates.

The strengthening of Swiss defences against money inflows, the influence of exchange rate considerations on Swiss monetary policy and the weakness of domestic credit demand contributed to a decline in the Euro-Swiss franc rate from about 3½ per cent. in late 1975 to a low of ⅝ per cent. in the early summer of 1976. In early 1977, however, the slight weakening of the Swiss franc on the exchange markets permitted some tightening of Swiss domestic money-market conditions and by mid-May the three-month Euro-Swiss franc rate had moved up to around 4 per cent.

Euro-French franc, Euro-guilder and Euro-sterling rates were occasionally pushed up to very high levels in 1976 under the impact of speculative attacks on these three currencies. For instance, the three-month Euro-guilder rate soared from around 3 per cent. in March to a peak of about 16 per cent. in August and then gradually moved back to around 3 per cent. in May 1977, by which time the exchange markets

Euro-dollar deposit rates and Euro-dollar bond yields.
Weekly averages and end-of-month rates.



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had completely reversed their assessment of the guilder. The Euro-sterling rate jumped to a peak of 20 per cent. during the height of the exchange-market crisis in October, but with the recovery of sterling it gradually eased to about 8 per cent. in May 1977.

The international bond markets.

The weakening of inflationary expectations, the lack-lustre performance of equity markets, a gradual and steady rise in bond prices with prospects of further capital gains, and the substantial premium of bond yields over shorter-term interest rates combined to make 1976 another record year for the international bond markets. The volume of new Euro-bond issues soared by \$4.7 billion to \$14.9 billion, more than twice as high as the previous cyclical peak recorded in 1972. The fact that public issues accounted for the whole of the 1976 increase, whereas private placements actually recorded a slight decline, provides further evidence of the market's underlying strength.

Rates of expansion were equally high or even higher in respect of foreign issues in national markets, the total volume of which rose by \$6.2 billion, or over 50 per cent., to \$18 billion. As in 1975, the bulk of such borrowing was accommodated by the markets of two countries. Foreign issues in the United States rose by 52 per cent. to \$10.3 billion, well over half of which was accounted for by Canadian borrowers alone. Foreign issues in Switzerland, mostly in the form of private

International bond issues.[1]

Borrowing countries or areas	Years	Euro-bond issues: Total	Euro-bond issues of which: US dollars	Euro-bond issues of which: Deutsche Mark	Euro-bond issues of which: Private placements	Foreign issues: Total	Foreign issues of which: in United States	Foreign issues of which: in Switzerland	Foreign issues of which: Private placements
		In millions of US dollars							
Western Europe .	1974	1,430	430	370	800	1,400	360	650	1,130
	1975	4,570	1,350	1,770	1,450	2,840	840	1,760	1,360
	1976	5,440	3,750	1,200	850	4,860	1,180	3,210	2,730
Canada	1974	440	380	—	350	1,960	1,930	30	800
	1975	1,150	610	—	310	3,380	3,100	280	830
	1976	3,010	1,570	40	150	5,870	5,530	340	3,850
United States . .	1974	110	100	—	10	80	—	80	30
	1975	310	220	—	80	140	—	40	120
	1976	410	400	—	120	30	—	—	30
Other developed countries[2]. . .	1974	330	220	110	10	150	30	120	130
	1975	2,220	1,340	700	610	1,010	380	600	650
	1976	2,070	1,510	510	310	1,480	690	790	660
Rest of the world[3]	1974	140	120	—	10	790	650	20	520
	1975	470	230	90	150	480	460	20	240
	1976	1,040	450	300	160	810	600	110	200
International institutions . .	1974	2,070	1,830	160	1,760	3,410	620	90	2,650
	1975	1,460	1,060	340	840	3,980	1,980	670	1,340
	1976	2,960	2,050	730	1,710	4,960	2,270	770	1,650
Total issues placed	1974	4,520	3,080	640	2,960	7,790	3,590	990	5,260
	1975	10,200	4,810	2,890	3,440	11,830	6,760	3,370	4,540
	1976	14,930	9,730	2,780	3,300	18,010	10,270	5,220	9,120

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

placements of notes, went up by 55 per cent. to $5.2 billion. This very large total — equivalent to 9 per cent. of Switzerland's gross national product — was due to the strength of the country's balance-of-payments situation, the weakness of domestic credit demand and the large money inflows which had to be reinvested abroad.

Rising bond prices and the very large premium of bond yields over shorter-term interest rates provided a strong stimulus to activity in the secondary markets where turnover reached unprecedented levels. The favourable market climate was also reflected in a sharp increase in the average size of individual Euro-bond issues, with that of dollar issues nearly doubling to about $50 million. On the other hand, there was only a modest lengthening of maturities. Although the trend towards shorter maturities discernible since 1973 seems to have been reversed, the average term remained well under ten years and it was only in the latter part of 1976 that some prime borrowers succeeded in raising funds in the twelve to fifteen-year range. Moreover, the market appears to have become more selective, lesser addressees having occasionally to concede up to 200 basis points more than prime issuers.

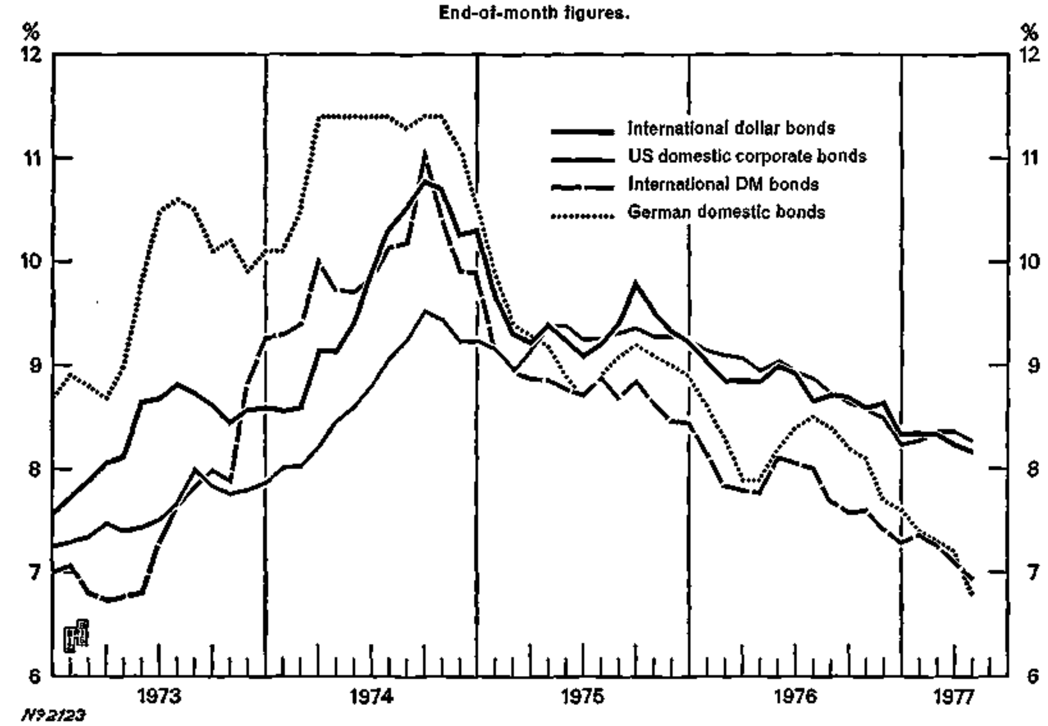
On the demand side of the international bond markets, borrowers from OECD countries continued to play a dominant rôle, their share in total issues amounting to $23 billion, or 70 per cent. Canada, which had a particularly large current-account deficit, was by far the largest receiver of funds, with public and private-sector borrowers raising $8.9 billion, nearly double the 1975 figure. France and Japan ranked second and third, with $2.7 and 2 billion respectively. Other OECD countries, such as the United Kingdom and the Scandinavian countries, were also able to meet a larger share of their financing requirements in the international bond markets. Borrowing by US residents in the international capital markets remained on a small scale.

The prominence of balance-of-payments considerations and public-sector financing requirements meant that public entities were again the largest group of borrowers in the market, their takings increasing from $10.3 billion in 1975 to $15.7 billion. But private corporations also took advantage of the favourable conditions prevailing in the international bond markets, using the proceeds largely for the improvement of their balance-sheet structures. They raised $9.3 billion, against $6.2 billion in 1975. Banks in particular, whose capital ratios had been strained in recent years by inflation and the rapid expansion in their international activities, stepped up their recourse to international bond finance, partly in the form of issues of floating rate notes. Issues by international organisations rose from $5.5 to 7.9 billion. A large proportion of the proceeds were channelled to non-oil developing countries whose capacity to tap the international capital markets directly remained fairly limited. Similarly, borrowers from eastern European countries accounted for only a very minor share of total issues and relied on bank credit for most of their external financing requirements.

Little statistical material is available on the sources of the funds supplied to the international capital markets, and especially the Euro-bond markets. It seems, however, that the banking sector itself played a major rôle, absorbing a sizable proportion of new issues. With domestic credit demand very weak, the temptation of the large yield spread between bond rates and short-term interest rates was undoubtedly hard to resist. In addition, the receptiveness of the international bond markets seems to have been enhanced, particularly in the first half of the year, by funds from weak-currency countries, which also helps to explain the very large placing power of Swiss banks. The OPEC countries, after having shown reserve in previous years, seem to have made greater use of the international bond market as an outlet for their surplus funds. Finally, the markets undoubtedly received support from the reinvestment of the growing amount of amortisation and interest payments on earlier issues.

In the Euro-bond market proper, issuing activity was strongly concentrated in the dollar sector, which benefited from the US currency's moderate strength on the exchanges and the gradual downward movement of long-term interest rates in the United States. The share of dollar issues recovered from its unusually low level of 47 per cent. in 1975 to 65 per cent., while issues in Deutsche Mark contracted from 28 to 19 per cent. After making their début in 1975, issues in Canadian dollars, encouraged by the abolition of the Canadian withholding tax on interest payments, continued to expand vigorously and pushed up their market share from 6 to 10 per cent. The share of the guilder, on the other hand, dropped from 6 to 3 per cent.,

Yields on international and domestic markets of US dollar and DM bonds.*
End-of-month figures.



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

and in view of the renewed attraction of the dollar and the weakness of certain European currencies there were hardly any issues in composite units of account.

Euro-bond yields, particularly on dollar issues, moved closely in line with coupon rates in the corresponding domestic markets. As well as illustrating the increasing intercommunication between domestic and international markets, this also shows that the Euro-bond market had no difficulty in accommodating the heavy borrowing demand. Yields on dollar bonds eased by about ¾ percentage point over the year and those on DM bonds by 1¼ per cent.

Despite some uncertainty about interest rate developments, activity in the international bond markets was well maintained in the first four months of 1977. This was especially true of the Euro-bond market, where the issue volume substantially exceeded the monthly average for 1976. Foreign issues in the United States, on the other hand, slowed down markedly, largely as a result of smaller takings by Canadian borrowers. In early May the firming of US short-term interest rates brought about a temporary change in the market climate. Dollar bond quotations eased and, with new issues selling at sharp discounts, some scheduled new loans were held off the Euro-bond market. However, by the end of the month the market seemed to have adjusted to the higher level of US short-term interest rates and there was little sign of a slackening of activity.

VII. THE INTERNATIONAL MONETARY SCENE.

This chapter reviews the major international monetary developments of the past year and a half. The first two sections describe the evolution of the exchange rates of the principal currencies and the large-scale interventions in the exchange markets undertaken by the monetary authorities of most of the leading countries, while the third section discusses the appropriate rôle of exchange rate management. The fourth section gives an account of gold production and gold-market developments last year. Lastly, the very rapid growth of global reserves in 1976 is described and explained, and the questions of the adequacy of the present level of international liquidity and of the channels through which future balance-of-payments financing should be provided are examined.

Exchange rate developments.

Most of 1976 was a period of major turbulence in the exchange markets, with a further polarisation between weak and strong currencies. There were dramatic declines in the value of the lira and sterling, together with a lesser, though still significant, weakening of the French franc and, later in the year, the Canadian dollar. At the other end of the spectrum, the Deutsche Mark and the Swiss franc appreciated strongly, though from mid-1976 onwards the latter currency began to ease again quite substantially. In addition, there were two periods of major tension within the joint float of European currencies, leading in mid-March to the withdrawal of the French franc and the suspension of the Benelux "worm" arrangement and in mid-October to differential upward adjustments of the Deutsche Mark against other participating currencies. The dollar, despite a very large deterioration in the current balance of payments of the United States, remained relatively stable on the trade-weighted basis.

More recently, conditions in the exchange markets have been much quieter. Sterling has recovered strongly since last November and the other currencies that had earlier been the weakest have mostly been much steadier too. The principal exchange rate movements so far this year have been a marked strengthening of the Japanese yen, some weakening of both the US and Canadian dollars, and a further realignment of central rates within the European joint float in April, consequent upon the decision of the Swedish authorities to devalue the krona.

Of the three major currencies that have declined sharply since the beginning of 1976, the lira was the first to weaken and, taking the whole period, it has fallen the furthest of any. The whole of the decline occurred in a little more than three months from 21st January 1976, when the virtual exhaustion of the country's exchange reserves led to a six-week suspension of official quotations for foreign currencies. Coming after more than a year during which the exchange rate had been held unchanged in the face of rapid inflation, this led to a widening of the trade-weighted post-Smithsonian depreciation of the lira from about 23½ per cent. to almost 43 per cent. by the end of April. Over about the same period the lira fell against the dollar from Lit. 687 to Lit. 916.

In early May measures were taken to stop the slide. Virtually all foreign currency purchasers were required to deposit 50 per cent. of the lira countervalue in non-interest-bearing accounts at the Bank of Italy for three months; the maximum period for conversion of export proceeds was reduced to seven days; and exporters granting foreign currency trade credits of up to 120 days were required to convert 30 per cent. of the value of such credits into lire within seven days. A rapid improvement of nearly 10 per cent. occurred in the dollar exchange rate, as well as a narrowing of the trade-weighted depreciation by some 5 percentage points. Helped by the seasonally favourable balance of payments, the lira was then steady at around those levels until late August.

Subsequently, however, the trade-weighted exchange rate gave up nearly all the gains registered since early May, ending the year over 42 per cent. below the post-Smithsonian level. Against the dollar a rather less pronounced decline brought the rate to Lit. 875 at the end of December. The renewed weakness of the lira was not halted by the announcement in October of economic stabilisation measures, tighter monetary policy and further measures aimed directly at the exchange market. These included a special tax — at first fixed at 10 per cent., subsequently reduced to 7 per cent. — on purchases of foreign exchange; an increase to 50 per cent. in the proportion of foreign currency export credits required to be financed in foreign exchange; and the prolongation of the import deposit scheme, on a gradually declining basis, until April 1977.

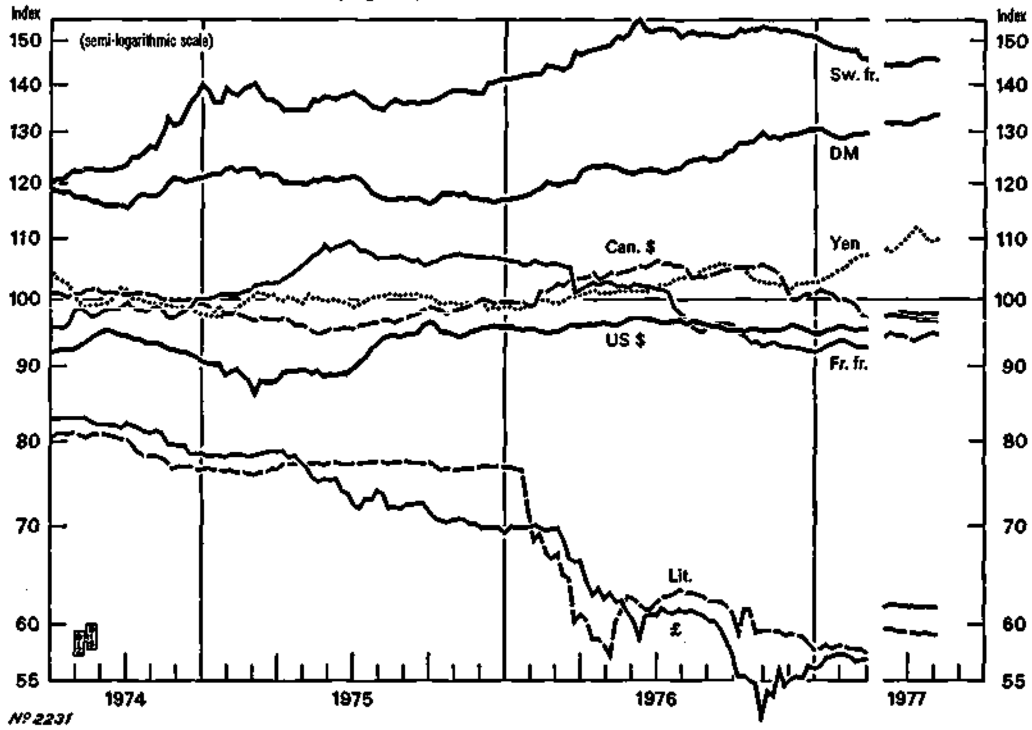
So far this year both the trade-weighted and the dollar exchange rates of the lira have remained very steady. In terms of its real cost to Italian residents in the exchange markets, however, the lira has appreciated significantly since the special tax on foreign exchange purchases was progressively abolished between 3rd January and 18th February.

The second currency to come under strong pressure in 1976 was the French franc. The pick-up of the economy following the stimulatory fiscal measures taken in late 1975 had turned the foreign trade balance into deficit, as well as arousing fears that inflation would accelerate. The outbreak of the lira crisis therefore found the franc in a vulnerable situation, which was further aggravated in early March by the weakness of sterling, and heavy reserve losses led to the decision to withdraw from the "snake" on 15th March.

Except very briefly, this did not at first lead to any significant decline in the exchange rate, which on the trade-weighted basis soon settled down about two percentage points below its earlier level. Between late May and late August, however, under the combined impact of renewed inflation fears and concern about the balance-of-payments effect of the drought, there was a further rather heavy fall in the rate. The trade-weighted post-Smithsonian appreciation of nearly 2½ per cent. turned into a depreciation of nearly 5 per cent., whilst against the dollar the rate went down from Fr.fr. 4.72 to nearly Fr.fr. 5. Expectations of corrective action by the new Government then brought some improvement in the exchange-market

Effective post-Smithsonian exchange rates.*

Friday figures, indices: 21st December 1971 = 100.



Source: Bank of England. * As from March 1977 the series was put on a new basis by extending the coverage from eleven to twenty-one currencies and updating the trade weights from 1969 to 1972.

situation; in late September and October, however, there was a further increase of over 3 percentage points in the franc's trade-weighted depreciation. At the end of the year it stood at nearly 8 per cent., a deterioration of 13 percentage points since mid-March. So far in 1977 the franc has on balance strengthened slightly and in late May the dollar rate was about Fr.fr. 4.95½.

Taking the period since end-1975 as a whole, the decline of sterling on the trade-weighted basis has been greater than that of the French franc. Moreover, the exchange-market pressures in both directions were also heavier, with a widening of the trade-weighted depreciation from 30 to nearly 49 per cent. between early March and late October followed by a strong recovery from November 1976 onwards. But for very substantial official intervention, the movements of the exchange rate in both directions would have been larger.

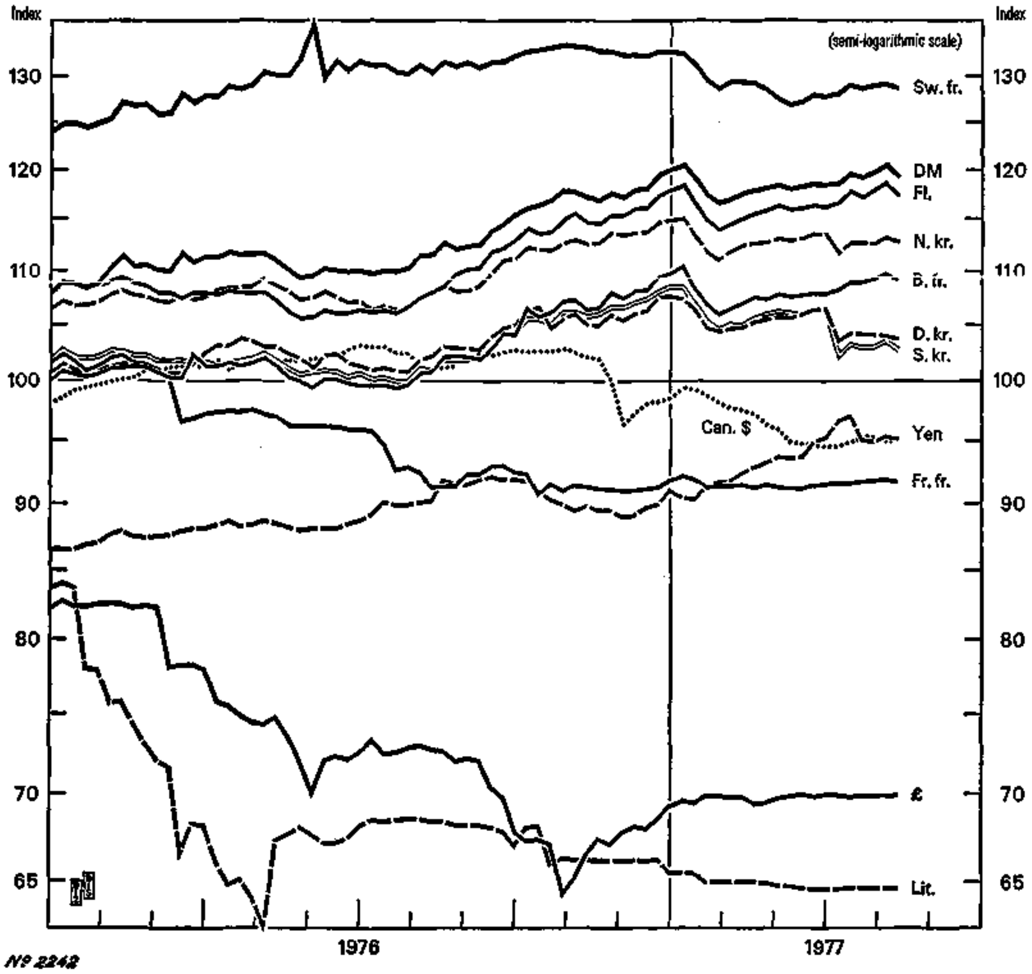
The dramatic decline of sterling began on 4th March and on the next day the pound went below $2 for the first time. Between then and early June, under the combined influence of the current payments deficit, leading and lagging by traders and very large reductions of official sterling balances in the hands of OPEC countries, it plunged to $1.70, the trade-weighted depreciation widening from 31 to nearly 42 per cent. At that point the negotiation of a $5.3 billion six-month credit facility from the central banks of the Group of Ten countries, Switzerland and the BIS, together with improved prospects for a second year of incomes policy, temporarily improved the situation. In September, however, a further sharp fall in sterling set in, the low point being reached in late October when the dollar rate touched \$1.55½ and the trade-weighted depreciation nearly 49 per cent. Neither the announcement in late September that the Government was applying to the International Monetary Fund for a \$3.9 billion stand-by credit nor the raising of the Bank of England's minimum lending rate in successive steps from 11½ to 15 per cent. succeeded in checking the decline. Among the factors which contributed to it were the revelation that official sterling balances had declined by nearly £1 billion during the second quarter and press reports in late October to the effect that the IMF considered \$1.50 an appropriate rate for the pound.

The turning-point came just at the end of October and from then on confidence in sterling steadily strengthened. Domestic interest rates stood at record levels; there were growing prospects of a successful conclusion to the negotiations for the IMF credit facility, a condition of which would be measures to reduce the public sector's financial deficit and to set limits for domestic credit expansion; negotiations were under way for a multilateral central-bank facility to protect the exchange rate from the effects of any further withdrawals of sterling balances; and in November sterling lending by UK banks to finance trade between third countries was prohibited altogether. Against that background the trade-weighted depreciation of sterling had by mid-January 1977 narrowed to below 43 per cent. and the dollar exchange rate had risen above \$1.70. With the successful conclusion of both the IMF credit in January and the sterling balances facility in February, sterling remained in strong demand but the authorities preferred to recoup earlier exchange losses rather than allow any further rise in the exchange rate.

For the Canadian dollar, too, the period under review was one of considerable volatility, reflecting large changes on the capital account of the balance of payments, with on balance a significant decline in the exchange rate, more marked against the US dollar than on the trade-weighted basis. During the first half of 1976 the Canadian dollar was very firm, an exceptional volume of long-term capital inflows more than offsetting the very large current payments deficit. By late June it had risen from US\$0.96 in August 1975 to a two-year high of almost US\$1.04, while on the trade-weighted basis a post-Smithsonian depreciation of about 3½ per cent. had turned into an appreciation of over 6 per cent.

During the following four and a half months to mid-November the rate eased a little on balance as a result of somewhat lower, though still substantial, capital inflows. The victory of the separatist party in the Quebec elections, at a time when interest rate differentials between Canada and the United States had lessened, then plunged the exchange market into great turbulence, to a considerable extent as a result of fears that Canada's capacity to borrow abroad might be seriously affected. Within three weeks the trade-weighted exchange rate fell just below its post-Smithsonian level, whilst against the US dollar the Canadian currency declined from over US\$1.02 to below US\$0.97½. After a temporary recovery to little below parity in early January this year the Canadian dollar fell to a low point of US\$0.94½ in mid-March. Since then indications that Canada's credit rating in the US capital market has not been affected, together with a Federal budget that was judged internationally as being cautious, have brought about some improvement in the rate, to US\$0.95¼ in late May.

Nominal exchange rates:
Spot quotations for selected currencies vis-à-vis the US dollar.
Wednesday figures, as indices of market rates on 19th March 1973.



Among the strong currencies, the Deutsche Mark showed the greatest further rise during the period under review. In the course of 1976 its trade-weighted appreciation widened from 16¾ to about 30 per cent., around which level it has since fluctuated narrowly. About half of this rise occurred during the first two and a half months of the year, parallel with the weakness of the lira, the French franc and the pound; most of the rest took place during September–November, when these three currencies were again depreciating and when in addition there was a minor realignment within the "snake". Against the US dollar the Deutsche Mark rose from just under DM 2.62 at the beginning of 1976 to a peak of DM 2.34½ in early January this year. After easing to over DM 2.42 in late January and early February, by late May the Deutsche Mark had strengthened again to about DM 2.36.

Reflecting the strong shift into surplus of Japan's current balance of payments, the yen rose on the trade-weighted basis during the first nine months of 1976 from a cumulative post-Smithsonian depreciation of about 1 per cent. to an appreciation of 5½ per cent. and against the dollar from Yen 305 to Yen 287. A reduction (which proved temporary) in the current payments surplus, together with uncertainties about the results of the December parliamentary elections, then brought some reaction. But the election results, together with a renewed surge of exports, carried the trade-weighted appreciation, which by early December had fallen to about 1½ per cent., to over 7 per cent. (equivalent to 8 per cent. on the new basis) in early March, and to 11½ per cent. (on the new basis) a month later. Over the same period the appreciation against the dollar amounted to 10 per cent., from about Yen 297 to just under Yen 271. By late May the trade-weighted appreciation had fallen just below 10 per cent., whilst the spot rate against the dollar had eased nearly to Yen 278.

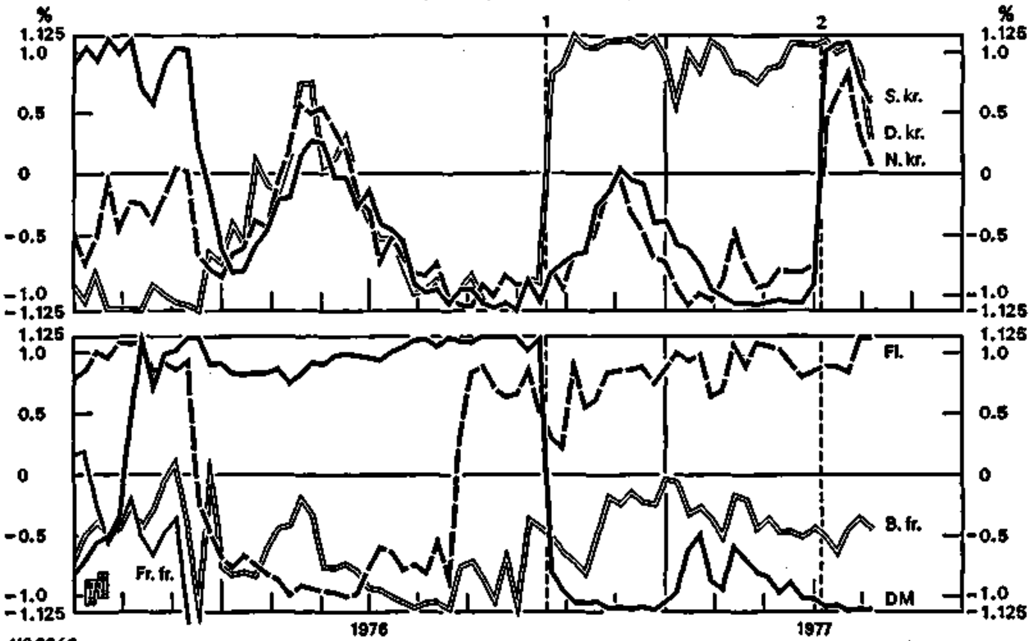
Taking the period under review as a whole, the exchange rate of the Swiss franc showed relatively little change. At the end of 1975 it stood at Sw.fr. 2.59 to the dollar and, on the trade-weighted basis, 41 per cent. above its post-Smithsonian level. Nearly seventeen months later, in late May 1977, the dollar rate was around Sw.fr. 2.51½ and the trade-weighted appreciation only a few percentage points higher than the end-1975 figure. In between those two dates, however, the franc showed very large fluctuations, despite substantial market interventions by the authorities. Between end-1975 and early June last year its trade-weighted appreciation rose by over 13 percentage points to over 54½ per cent., while against the dollar the rate moved to Sw.fr. 2.38¼, also the highest level ever reached. During that phase the franc rose strongly not only against the weak currencies, but also vis-à-vis the Deutsche Mark and other "snake" participants. By early June 1976 the DM rate had reached Sw.fr. 0.92¾, up from about parity at the beginning of the year and about 27½ per cent. above the level of two years earlier.

The authorities then announced their intention of intervening massively, if need be, to correct excessive movements of the rate and at the same time they imposed further direct controls aimed at reducing pressure on the franc. The ceilings on forward sales of francs to non-residents were drastically lowered; agreements were reached with commercial banks that the latter should not use their offices abroad for speculative transactions relating to the franc; and, in addition, the banks agreed not to make Euro-franc deposits, or other direct placements of francs, from Switzerland in the names of their offices abroad. Since then the franc has declined quite considerably. On the trade-weighted basis the downward movement had by late May 1977 reduced the post-Smithsonian appreciation to about 45½ per cent., while on the same date the rate for the Deutsche Mark was about Sw.fr. 1.07 and that for the dollar Sw.fr. 2.51½.

The effective exchange rate of the US dollar was fairly stable during the period under review. In 1976 it ranged from 2¾ per cent. below the post-Smithsonian level at the beginning of June to about 5¼ per cent. below at the end of the year, while so far in 1977 it has on balance gone down a little further. This relative stability in trade-weighted terms was, of course, the net outcome of much larger movements in both directions against individual currencies. Moreover, during the course of 1976 and the early months of 1977 the range of fluctuation of the dollar against other strong currencies was not insignificant.

This can be seen from its movements vis-à-vis the "snake" currencies, which since end-1975 can be conveniently divided into four phases. The first phase, covering the period from the beginning of 1976 until near the end of July, was one of fairly marked stability. The dollar was little affected by the European currency disturbances in early 1976; at their highest, on 1st April, the "snake" currencies were ranged between 3½ and just over 5½ per cent. and at their lowest, on 1st June, between 1 and 2¾ per cent. above the participants' nominal central dollar rates. During a second phase, from near the end of July to early January 1977, the "snake" band rose from 1¾–4 to 11¾–14 per cent. above the participants' central dollar rates, the dollar being affected first by the expectations of a DM revaluation that gave rise to tension within the "snake" and later by the easing of US interest rates. In a brief third phase, the "snake" band declined by 4 percentage points against the dollar within three weeks, but it began to recover just before the end of January and by late May 1977 the participants in the "snake" were in a band stretching from 11 to 13¼ per cent. above their nominal central dollar rates.

Movements of spot exchange rates within the joint float of European currencies.
Weekly averages, in percentages.



Nº2240

[1] Adjustments of central exchange rates on 18th October 1976. [2] Adjustments of central exchange rates on 14th April 1977.

The "snake" itself experienced two periods of major tension in 1976. In the first of these, which started immediately after the Italian authorities' withdrawal from the exchange market in January 1976, the Deutsche Mark went to the top of the band and the Danish krone was at first the weakest currency. The French franc came under very strong pressure following the sudden weakness of sterling on 4th March and ten days later the decision was taken, after severe reserve losses, to withdraw it from the "snake". At the same time pressure on the Belgian franc inside the Benelux "worm" led to this arrangement being suspended. However, firm measures by the Belgian and Danish authorities brought the crisis to an end by 22nd March.

The second period of tension, essentially resulting from expectations that Germany's lower rate of inflation would lead to a revaluation of the Deutsche Mark against other participating currencies, began in mid-July. With the Deutsche Mark at the top of the band, all the other currencies moved down to, or near, their lower limits. The Belgian franc, the Danish krone and the Dutch guilder were under the heaviest pressure and the authorities in these countries took vigorous action to defend their currencies, allowing short-term rates in their markets to rise dramatically through a combination of heavy intervention in the exchange markets and other restrictive monetary measures. Late in August the guilder responded by strengthening considerably; the Belgian franc too improved, though to a lesser extent, and in addition pressure on the Danish krone diminished. Until mid-October, however, a considerable gap continued to separate the Deutsche Mark from all the other participating currencies except the guilder, and substantial intervention was required from time to time.

An adjustment of participants' exchange rates was then decided upon, with effect from 18th October. The German authorities announced a 2 per cent. upvaluation of the Deutsche Mark which, together with downward changes of central rates by the Scandinavian participants, resulted in adjustments of 2 per cent. between the Deutsche Mark and the Benelux currencies, 3 per cent. between the Deutsche Mark and the Swedish and Norwegian currencies and 6 per cent. between the Deutsche Mark and the Danish krone. The adjustment was immediately successful, the Danish krone quickly rising to the top of the band, while the Deutsche Mark plunged towards the lower edge, subsequently replacing the Swedish and Norwegian currencies in that position. The guilder initially experienced a rather pronounced drop, but soon returned to the upper edge of the band, where it joined the Danish krone towards the turn of the year. With the Deutsche Mark under continued downward pressure from early November, the other central banks were able to repay the support received earlier from the Deutsche Bundesbank.

Early in 1977 the Deutsche Mark moved away from the lower edge of the band, its place being taken by the Norwegian krone and subsequently the Swedish krona, while the Danish krone and the Dutch guilder remained the strongest currencies. By the end of March the Deutsche Mark had joined the Swedish krona at the lower edge of the band, but no large-scale intervention was required. It was in that situation of relative calm that a further realignment of participants' currencies took place with effect from 4th April, the initiative being taken by Sweden, which was confronted with serious balance-of-payments difficulties. The central rates for the Swedish krona against the Deutsche Mark, the Belgian franc and the guilder were adjusted downwards by 6 per cent., the Norwegian and Danish currencies following half of the way with 3 per cent. downward adjustments. The Swedish krona, which during almost all of March was the weakest currency, has subsequently strengthened, its place at the bottom of the "snake" having been taken by the Deutsche Mark. For much of April the Danish krone was the strongest currency in the "snake", but since then its place has been taken by the guilder which in early May came under strong upward pressure.

Official intervention in the exchange markets.

The year 1976 and the early months of 1977 saw a very heavy volume of official intervention in the exchange markets, partly but by no means wholly related to periods of currency disturbance. The Group of Ten countries, including Switzerland, can be divided into two main categories so far as their intervention policies are concerned, according to whether they limited themselves to intervention designed merely to smooth out day-to-day market conditions or whether, in addition, they operated in the markets in a way that brought about substantial changes in their net official reserves, including official, or officially inspired, borrowing. In the interpretation of countries' reserve figures it has to be borne in mind that such changes are not always a reliable guide to the size or even, in some cases, the direction of official intervention. For example, reserves can be affected by central-bank transactions with their own governments as customers or by income from the investment of foreign exchange holdings. In addition, changes in reserves are sometimes deliberately manipulated, for instance through the use of swaps or outright forward transactions.

On the basis of the relevant data, but with these qualifications in mind, the United States belongs in the first of the categories mentioned above, as did Canada until the November 1976 provincial elections in Quebec, while all the other Group of Ten countries, including Switzerland, belong in the second. Germany, however, may be said to have a foot in both camps, belonging with the United States so far as the Deutsche Mark/dollar rate is concerned but with its fellow participants so far as interventions within the framework of the European joint float are concerned.

In the United States total interventions by the Federal Reserve Bank of New York during the twelve months ending in January 1977 are reported to have been about $1 billion. This figure includes both market sales and market purchases of foreign exchange, the great majority of which were in Deutsche Mark. Roughly half of these interventions occurred between February and May 1976, with net sales during the European currency disturbances in February and March being followed by net purchases in April and May as market conditions were reversed. Following a period of two and a half months without any intervention, the other half occurred between mid-August 1976 and end-January 1977.

During most of 1976 Canada's market interventions were of basically the same kind as those of the Federal Reserve, producing no substantial net change in official reserves, but with the difference that they were much more frequent and that the amounts involved were much larger. Since the November elections in Quebec, however, Canada has moved into the second group of countries. Between then and the end of March 1977 its foreign exchange reserves have fallen by about $0.8 billion, a decline of that amount last November having been followed by a $0.7 billion recovery in December, when the Canadian dollar strengthened temporarily, and a subsequent decline of the same size in the course of the first quarter of 1977.

Much larger cumulative reserve movements occurred in the three major countries whose currencies declined sharply in value during 1976. In Italy a cumulative deterioration of the official net external monetary position (decline in reserves plus increase in official foreign borrowing) of $1.8 billion during the first five months of the year — which included the six weeks during which there was no intervention — was followed by a cumulative net improvement of over \$3 billion during the remainder of the year. This improvement was achieved by dint of further official borrowing as well as exchange control and other administrative measures that led to foreign currency borrowing by the non-bank sector. This borrowing was an important factor behind the substantial increase in the Italian banks' net foreign liabilities which, for the year as a whole, amounted to \$2.3 billion.

In France net reserve losses of rather more than \$3 billion in less than two months were the factor that led to the decision to withdraw from the "snake" in mid-March 1976. Subsequently, intervention was on a much smaller scale, with reserve losses of \$0.4 billion during the period of pressure in July and August. In addition, however, the exchange rate also received substantial support during the year from officially encouraged foreign borrowing by French enterprises, in both the public and the private sector.

In the United Kingdom some idea of the net magnitude of official support operations for the pound between March and November 1976 may be obtained from the fact that in the course of the first eleven months of the year the sum of reserve losses and net public-sector borrowing abroad of various kinds amounted to about \$7 billion. Since the reversal of the situation towards the end of last year intervention has been very large on the other side of the market. The increase in reserves between December 1976 and April this year (excluding that part of it which resulted from further net public-sector borrowing) came to \$4.2 billion.

Both of the Group of Ten countries with independently floating currencies and a balance-of-payments surplus also intervened on a large scale during the period under review. In Japan a large part of the \$4 billion rise in exchange reserves during 1976 will have resulted from official net purchases of dollars on the market. Since November 1976, however, the substantial appreciation of the yen has been accompanied by a fairly stable level of reserves. In Switzerland the National Bank purchased a total of \$7.5 billion in the foreign exchange market during 1976, as against a corresponding figure of rather more than \$4 billion for 1975. However, this figure has to be seen in the light of the fact that the authorities continued to require that the proceeds of foreign borrowing in Switzerland be converted immediately into dollars at the National Bank. This measure was originally taken to ensure that these proceeds were in fact exported but there can be no doubt that it significantly reduced market demand for foreign exchange in Switzerland. At \$6.2 billion last year, such conversions by the authorities were only \$1.3 billion short of their total gross market purchases of foreign exchange.

Within the European joint float, last year's disturbances led to interventions, partly in participants' currencies and partly in dollars, on the largest scale seen since the "snake" came into operation in 1972. In Belgium, the net reserve position of the National Bank showed four big changes during 1976, two positive and two negative, corresponding to the two periods of tension within the "snake" and their respective aftermaths. These can be roughly seen from the quarterly movements of net reserves: losses of \$1.3 billion during the first quarter, gains of $0.7 billion in the second, further losses of $1 billion in the third quarter and gains of the same size in the final three months of the year.

In the Netherlands reserves rose by $0.6 billion in February, to a large extent reflecting the strength of the guilder inside the Benelux "worm". These gains were more than reversed between mid-March and mid-June, when reserve losses totalled $1.2 billion, and in addition net reserves fell by about $0.3 billion between late July and late August. Subsequently, when the guilder strengthened, the authorities purchased substantial amounts of foreign exchange in the market and by the end of the year the reserves were back at their end-March level.

In Sweden reserve losses of $1.1 billion occurred between June and October as a result of large-scale support given to the krona in the markets. During the final two months of the year $0.3 billion of these losses were recouped. As in some other countries, the figures do not indicate the extent of exchange rate management in the broadest sense, since the Government continued to encourage large-scale borrowing to finance the current payments deficit.

The other side of the medal to reserve losses in these four "snake" countries was the $4 billion increase in Germany's reserves last year. Total support, direct and indirect, given by Germany to its partner countries during the periods of tension in the joint float was much larger than that, amounting to $3.9 billion in the first-quarter crisis and to $3.8 billion during the July–October crisis. Partly offsetting this, there were quite marked, though smaller, declines in Germany's reserves after each of the crises within the joint float; for the most part, however, these declines did not reflect intervention by the German authorities in the exchange markets, but rather repurchases of their currencies from the Bundesbank by the monetary authorities of other participants in the joint float.

The management of exchange rates.

The foregoing account of exchange rate developments and central-bank interventions in the exchange markets shows that the controversy about the appropriate rôles of exchange rate management and exchange rate adjustment is far from ended. Those countries, first and foremost the United States, which are in favour of and practise largely unmanaged floating argue that management, understood to include large-scale official intervention, prevents exchange rates from playing their appropriate part in the adjustment process and thus contributes to the perpetuation of payments imbalances — as well as transmitting inflation from weak-currency countries to the rest of the world. On this view exchange rate instability is basically caused by differences in countries' domestic economic policies and the resulting differences between their inflation rates. Unmanaged exchange rate movements are in general said not to be an independent cause of differences in inflation rates; in particular, it is argued that depreciating currencies are not an independent source of inflationary pressure in the countries concerned.

On the other hand there is the view that markets, left to themselves, cannot be relied upon to form realistic and stable rates of exchange, owing to the great variety of influences to which they may be subject. Besides those that emanate from the basic balance of payments — a country's foreign trade and other current transactions, as well as its structural position as a net importer or exporter of long-term capital — these influences include changes in the preferences of both residents of a country and non-residents for holding assets in that country's currency as opposed to other currencies. The first of these two sets of influences is, in general, relatively slow to alter; the second, however, can produce rapid modifications of exchange-market conditions. This may happen, for example, as a result of shifts in relative short-term interest rates; or it can come about through factors affecting confidence in a currency, such as market reassessments of a country's economic and monetary policies or purely political developments.

Hence, there is a danger of unmanaged floating leading to an exchange rate level which clears the market on the basis of asset preferences but which overshoots the mark from the point of view of the basic balance of payments. This danger is increased by the fact that once changes in asset preferences disturb market equilibrium, an exchange rate may sometimes have to move a long way before market operators are convinced that there is little risk of the downward or upward movement going any further. Moreover, such overshooting, when it involves a large exchange rate movement, can itself be an independent source of current-account payments imbalances and of differences between countries' inflation rates since its price effects will typically be felt, via the changing cost of imports, more rapidly than its real effects on the basic balance of payments. In other words, overshooting can set in motion "vicious" and "virtuous" circles of exchange rate and price movements.

As is often the case with such controversies, there is truth in both points of view. It is beyond dispute that sustained exchange rate stability is incompatible with wide differences in inflation rates and that faulty domestic policies have been the most important reason for the emergence of such differences in recent years. Furthermore, official intervention, or other measures that directly affect the balance of market supply and demand for a currency, have on a number of occasions been used to accommodate such differences and to put off adjustment measures. In the absence of such measures, intervention by countries with basically weak currencies is in any case bound to come to an end some time — when reserves and credit facilities are exhausted. A good example of this was the Italian experience in 1975, when the exchange rate was maintained unchanged during more than a year's rapid inflation of domestic origin, only to fall sharply in early 1976 when no more foreign exchange was available to support it.

It can, moreover, be convincingly argued that in countries where the domestic economic and financial situation becomes, and remains for some considerable time, out of the authorities' control there is no such thing as an equilibrium exchange rate or, to put it differently, that the equilibrium rate is constantly shifting downwards. In such situations there can be substantial movements in relative exchange rates but no change in real rate relationships because the rest of the adjustment process has been missing.

It does not follow from this, however, that official intervention, or other means of exchange rate management, should be limited to smoothing out minor disturbances in the markets. By definition, exchange rate management is still required in those quite large areas of the monetary system where rates are still fixed in one way or another. This applies to the many small countries whose exchange rates are linked to a major currency, usually the dollar. And it also applies, within their own area, to the participants in the European joint float. Belgium, Denmark and the Netherlands successfully maintained their places in the "snake" last year, when their currencies came under severe pressure, through a combination of official intervention in the market, drastically restrictive monetary policies and a modest realignment of central exchange rates. These pressures arose largely out of the differences between their inflation rates and that of Germany, and their decisions to stay in the "snake" show that they believe they have a better chance of reducing those differences in a framework of fixed, but adjustable, rates between their own currencies and those of their main trading partners.

As regards the management of exchange rates that are floating independently, a distinction has to be made between countries whose inflation rates are widely different and those where they are similar. In the first group, as already mentioned, exchange rate management without the rest of the adjustment process leads to an impasse. But, equally, the rest of the adjustment process may not work without some direct official management of the rate. If the authorities in a deficit country which is making a real effort to correct the underlying situation do not support the rate, when necessary, until the corrective measures have had time to bite, market confidence may be adversely affected. This may lead to a further depreciation of the currency, thus raising both import prices and inflationary expectations and complicating the task of bringing inflation under control. Conversely, when the market takes the view that a chronic deficit country has made a major breakthrough in bringing its external position and domestic inflation under control it may be wise for the central bank to intervene in order to prevent an excessive appreciation of the currency.

However, exchange rate instability in recent years has by no means been limited to cases where inflation differentials were the underlying cause. Since 1973 Germany and the United States have experienced broadly comparable inflation rates, together with quite wide movements of the dollar/DM exchange rate — even if not on the scale of the sterling and lira depreciations or the appreciation of the Swiss franc. Nor can these movements be explained solely by differences in these countries' interest rates. During 1973–74 they were the product of major external shocks — the final breakdown of the Bretton Woods system in March 1973, the oil price increases and the removal of controls on US capital exports. And more recently still, although the dollar/DM rate has been less volatile, its movements do not appear to have reflected simply changes in relative economic or financial conditions in the two countries. Such movements are liable to have real economic costs, for example by making investment decisions more uncertain, and it is hard to see what would be lost if efforts were made to smooth them out by official intervention — the more so since movements of the dollar/DM rate have consequences for other currencies.

To a considerable extent, these differences of view among the industrial countries reflect the differences that exist between the relatively closed economies of North America and the relatively open ones of Europe. The latter are much more vulnerable than the former to both the price and real effects of exchange rate movements. There is also, under today's conditions, an understandable difference between the views of the deficit and those of the surplus countries, with the former obviously more anxious to avoid a vicious circle of currency depreciation than are the latter to avoid a regular upward movement of their currencies — although the rise of the Swiss franc had by mid-1976 gone so far that the authorities intervened very strongly to stop it. Looking more broadly at the international monetary system as a whole, for most countries a largely unmanaged exchange rate is not a feasible policy, and even in those countries where it is feasible it is not always necessarily the best policy. Exchange rate management will therefore continue to be a necessary adjunct to sound domestic policies, which means that most countries will continue to need reserves for that purpose. In other words, the breakdown of the fixed rate system has not led to a worldwide reduction in demand for reserves.

Gold production and the gold market.

After five successive years of decline, world gold production (excluding that of the USSR and other eastern European countries, mainland China and North Korea) showed a very slight increase in 1976, from 940 to 945 metric tons. At that level it stood 25 per cent. below the 1970 peak of 1,265 tons.

South African production amounted to 709 tons — one ton more than in 1975 — and had it not been for a shortage of labour towards the end of the year output would have been slightly higher still. The quantity of ore milled rose by 2.5 per cent; at the same time there was a roughly equal decline in its average gold content, though this began to increase during the latter part of the year. The South African industry's average working costs were 15.5 per cent. higher than in 1975 and the average price received by the mines for their output was 7 per cent. (23 per cent. in dollar terms) lower than the year before. Average profits from gold mining therefore fell by 31 per cent., nearly three times as much as in 1975. Between the third and fourth quarters of the year, however, profits rose by 18 per cent., reflecting the strong recovery of the market price.

Gold production in Canada and the United States also showed little change from the preceding year, at 53 and 32 tons respectively. Among other minor western gold producers, some expansion in the output of Papua-New Guinea, Colombia and the Philippines was offset by declines in certain other countries' production.

While overall western output of gold was little changed in 1976, market sales by communist countries are estimated to have risen by 200 tons, to some 350 tons. In addition, the market was also supplied with gold from western official gold stocks. These are reported to have declined by 270 tons in 1976; but this figure includes a fall of 160 tons in South Africa's gold reserve which is believed to have been essentially due to gold swaps concluded between the South African Reserve Bank

World gold production.

Countries	1929	1940	1946	1953	1970	1973	1974	1975	1976
	in metric tons								
South Africa . . .	323.9	436.9	371.0	371.4	1,000.4	855.2	758.5	708.1	709.1
Canada	60.0	165.9	88.5	126.1	74.9	60.8	52.8	51.4	52.5
United States . . .	64.0	151.4	49.0	60.9	54.2	36.6	35.1	32.7	32.2
Papua-New Guinea	.	.	.	.	0.7	22.5	22.6	19.3	21.0
Rhodesia	17.4	25.7	16.9	15.6	15.6	15.6	20.0	20.0	20.0
Ghana	6.4	27.6	18.2	22.7	22.0	22.7	19.1	17.7	16.9
Philippines	5.1	34.9	—	14.9	18.7	17.8	16.7	15.6	16.3
Australia	13.3	51.1	25.6	33.4	19.3	17.2	16.2	16.4	15.5
Colombia	4.3	19.7	13.6	13.6	6.3	6.7	8.3	9.7	12.4
Mexico	20.4	27.4	13.1	15.0	6.2	4.1	4.2	4.0	4.0
Japan.	9.3	12.6	1.3	7.1	7.9	5.9	4.2	4.3	3.1
Zaire	4.9	17.4	10.3	11.5	5.6	4.2	3.9	3.2	2.9
Total listed .	529.0	970.6	607.5	692.2	1,231.8	1,069.3	961.6	902.4	905.9
Other countries . .	41.5	194.4	59.0	62.0	35.7	38.5	39.3	39.9	40.7
Estimated world total*	570.5	1,165.0	666.5	754.2	1,267.5	1,107.8	1,000.9	942.3	946.6

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

and a group of commercial banks in March 1976 which did not have the effect of increasing market supplies of gold. Excluding the change in South Africa's gold reserve, the reported fall in western official gold stocks last year comes to 110 tons, a figure which reflects rather closely the 121 tons sold by the IMF through public auctions between June and December 1976. Adding together western gold output, estimated sales by communist countries and the reported decline in western official gold stocks excluding South Africa, total supplies of new gold coming onto the market in 1976 may be put at rather more than 1,400 tons, an increase of 25 per cent. on the 1975 figure.

Estimated sources and uses of gold.

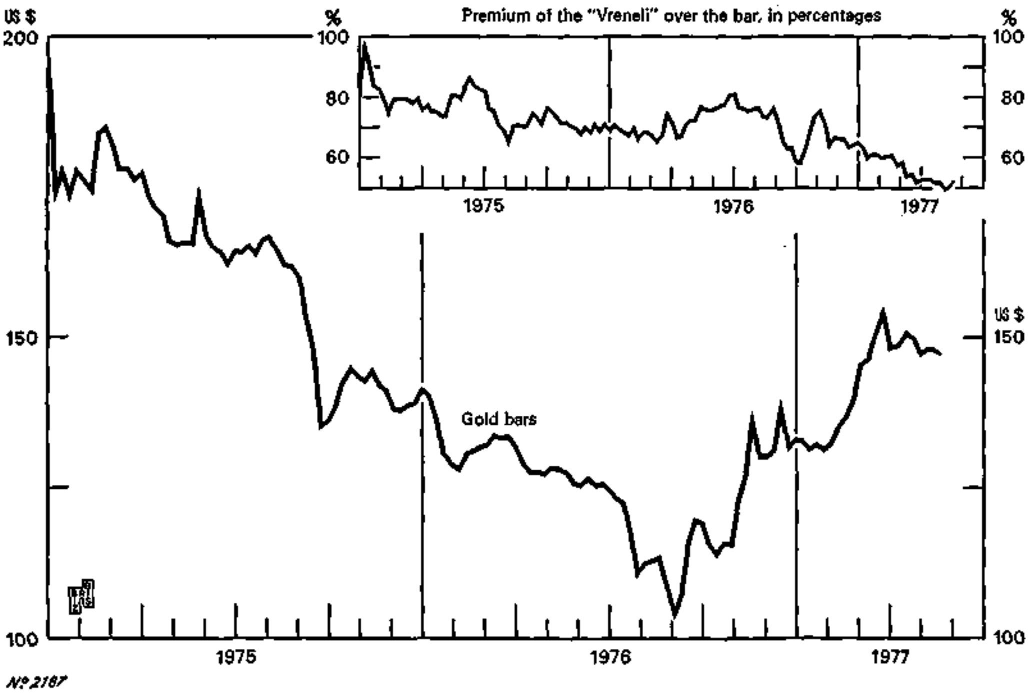
Items	1973	1974	1975	1976
	in metric tons			
Production	1,110	1,000	940	945
Estimated sales by communist countries	330	150	150	350
Decline in western official gold stocks (net)	40	35	35	110*
Total (= estimated non-monetary absorption)	1,480	1,185	1,125	1,405

* Excluding the decline of 160 tons in South Africa's gold reserve.

Taken as a whole, 1976 and the first months of 1977 were a period in which the market price of gold continued to fluctuate sharply. The decline that had begun early in 1975 continued during the first eight months of last year until the cumulative fall between end-December 1974 and end-August 1976 amounted to about $95 per ounce, or nearly 50 per cent. It has since been followed by a sharp recovery which by late March 1977 had taken prices above $150 per ounce.

This recovery was firmly based on a strong revival of demand for gold, since there was a sharp increase in market supplies between the third and fourth quarters of last year. The revival of demand has included substantial buying from the Middle East.

Gold-market prices.
Friday figures, in US dollars per fine ounce.



The year 1976 opened with a falling market as the Interim Committee of the Board of Governors of the IMF, meeting in Jamaica on 7th and 8th January, confirmed the agreement reached in August 1975, in the context of wider arrangements relating to the future of gold's monetary rôle, to sell one-sixth of the Fund's gold stock, or 778 tons, by public auction over a four-year period, with that part of the proceeds in excess of the old official price to be allocated to a Trust Fund for the benefit of low-income developing countries. Between 7th January and 22nd January the market price of gold fell by \$15 to \$124 per fine ounce. A moderate recovery took quotations up to \$134 per fine ounce in mid-March but by the end of that month they were just below the \$130 level. There then followed a period of relative price stability, with the announcement on 6th May that the IMF auctions were to begin in early June having little immediate effect on the market, but by 1st June, on the eve of the first auction, the price had slipped to just over \$126 per fine ounce.

At the first auction 24 tons were sold at a common price of \$126 per ounce, total bids having been received for more than three times that amount. The market price, after rising to just over \$127 per ounce immediately afterwards, resumed its downward trend as it became clear that indirect central-bank bidding at the auction had been very modest, to reach \$122 per fine ounce on 13th July just before the second auction. This time the auction price was $122.05 and a sharp fall in the market price, to $107.75 per fine ounce, followed at once as a consequence of quite widespread speculative selling. As bids on behalf of central banks had again been small, it was anticipated that subsequent auctions would depress the price further. In addition, it was widely expected that the USSR might shortly make substantial gold sales to replenish its foreign exchange balances. After a slight recovery towards the end of July, the market took a further downward turn from mid-August and by the end of that month quotations were only just above $103.05 per ounce, their lowest level since December 1973.

That proved to be the turning-point. A strong revival of demand then set in, with the result that by late September the market price reached $120. In November it went over $130, in February of this year it passed the $140 level and in late March reached a peak of nearly $154 per ounce. At first the reversal of the trend owed much to the covering of short positions taken up in the summer of 1976, but it subsequently broadened out into a strengthening of both industrial and investment demand, with heavy buying from the Middle East and the Far East. Fears of a revival of inflationary pressures, as well as disappointment with the performance of equity markets, probably contributed to the increase in investment demand for gold. The strength of demand during the final quarter of 1976 and into the first months of 1977 is all the more remarkable since, in addition to the regular Fund auctions of 24 tons every six weeks, this period also saw substantial sales of gold by the USSR.

In January this year the Fund carried out the first part of its four-year programme of restituting one-sixth of its gold stock to member countries at the old official price. The total amount restituted to 112 countries was 187 tons. Fears that the restitution sales might lead to market sales of the gold by some of the recipient countries caused a temporary interruption of the upward price trend on the market in January. More lasting so far has been the market's inability, after a 50 per cent. rise in little over six months, to sustain a level of prices above $150 per ounce. From the late March peak of $153.60 quotations had by the end of April come down to around $146 per ounce and in late May the price was a little below $145 per ounce. In March the Fund's auction system was changed from 24 tons once every six weeks to 16 tons on the first Wednesday of each month.

Reserves and international liquidity.

Developments in 1976 showed once again that global reserve statistics are of doubtful value for assessing the overall international liquidity situation. The identified cash surplus of the OPEC countries, and the reported increase in their reserves, was of the same order of magnitude as it had been in 1975 and at the same time balance-of-payments constraints in the rest of the world can hardly be said to have lessened; yet the estimated increase in global reserves came to $30.6 billion, over four times as much as the year before.

By categories of assets, last year's reserve growth was again concentrated in official foreign exchange holdings and IMF reserve positions, which rose by $25.4

and 5.8 billion respectively. Holdings of exchange reserves in the United States went up by \$11.2 billion last year; sterling reserves held in the United Kingdom, however, fell by \$3.8 billion, of which \$0.8 billion reflected the decline in the value of the pound and the rest withdrawals of balances by official OPEC holders. Reserves placed outside the traditional reserve centres therefore appear to have increased by \$18 billion. Of that amount, identified official deposits in the Euro-currency market, together with official deposits of foreign currencies in Canada and Japan, accounted for something over \$11 billion. And valuation changes alone, i.e. the depreciation of the US dollar, may be estimated to have increased the dollar value of reserves held in Deutsche Mark and Swiss francs by over \$1 billion. The larger expansion of IMF reserve positions in 1976 reflected the final transactions under the oil facility and the effects of the 45 per cent. extension of member countries' access to the Fund pending the coming into force of the sixth general increase in quotas.

What then is the explanation of this paradoxical-seeming acceleration of global reserve growth during 1976 in the face of the persistently large OPEC payments surplus and relatively modest OPEC reserve growth? To some extent it was a consequence of changes in the value of the US dollar rather than of transactions resulting in the creation of reserves. Thus, whereas in 1975 the appreciation of the US dollar had reduced the dollar value of non-dollar reserve assets by more than \$5 billion, in 1976 they were on balance very little affected by movements in the value of the dollar. Even allowing for this difference between the two years, however, the underlying increase in global reserves during 1976 was two and a half times as large as in 1975.

The big change between the two years was the turn-round in the reserve position of the oil-importing world, from losses of \$3.1 billion in 1975 to gains of \$21.3 billion last year. Both developed and non-oil developing countries shared in this improvement, the former's total reserves going up by \$10.5 billion, after a \$1.3 billion decline in 1975, and those of the latter group, which had fallen by \$1.8 billion in 1975, rising by a record \$10.8 billion.

As regards the non-oil developing countries, the explanation of last year's big reserve gains is to be found in the combination of a substantial decline in their current payments deficit and the continuation of foreign aid and capital inflows, including a high volume of bank borrowing, at the same levels as in 1975. Most of last year's reserve gains in this group of countries were concentrated on a relatively limited number of countries in Asia and Latin America. The largest individual gains were recorded by Brazil (\$2.5 billion), India (\$1.7 billion), Korea (\$1.4 billion), Argentina (\$1.2 billion) and Malaysia (\$0.9 billion). In addition, however, a number of other developing countries showed smaller reserve gains.

In the industrial parts of the world, however, the larger reserve gains occurred despite a deterioration on the combined current account of the balance of payments. They were made possible by a redistribution of the industrialised world's combined current deficit, together with a higher level of borrowing by deficit countries. Nearly the whole of the industrialised countries' reserve increase accrued to the Group of Ten countries and Switzerland, which together gained

Changes in global reserves, 1974–76.*

Areas and periods	Gold	Foreign exchange	IMF reserve positions	SDRs	Total
	in millions of US dollars				
Group of Ten + Switzerland					
1974	+ 520	+ 1,735	+ 1,745	+ 390	+ 4,390
1975	− 1,605	+ 945	+ 1,620	− 230	+ 730
1976	− 260	+ 5,650	+ 4,340	+ 15	+ 9,745
Amounts outstanding at end-1976	*33,555*	*70,535*	*12,715*	*7,775*	*124,580*
Other developed countries					
1974	+ 55	− 2,590	− 145	− 215	− 2,895
1975	− 220	− 1,335	− 355	− 90	− 2,000
1976	− 240	+ 690	+ 400	− 125	+ 725
Amounts outstanding at end-1976	*3,965*	*21,695*	*1,065*	*740*	*27,465*
Developing countries other than oil-exporting countries					
1974	− 50	+ 3,075	− 155	+ 5	+ 2,875
1975	− 80	− 1,430	− 100	− 215	− 1,825
1976	− 10	+11,030	− 130	− 110	+10,780
Amounts outstanding at end-1976	*2,100*	*35,500*	*480*	*1,140*	*39,220*
Total oil-importing countries					
1974	+ 525	+ 2,220	+ 1,445	+ 180	+ 4,370
1975	− 1,905	− 1,820	+ 1,165	− 535	− 3,095
1976	− 510	+17,370	+ 4,610	− 220	+21,250
Amounts outstanding at end-1976	*39,620*	*127,730*	*14,260*	*9,655*	*191,265*
Oil-exporting countries					
1974	+ 50	+31,040	+ 1,945	+ 40	+33,075
1975	− 50	+ 7,310	+ 2,785	− 50	+ 9,995
1976	+ 55	+ 8,010	+ 1,215	+ 20	+ 9,300
Amounts outstanding at end-1976	*1,505*	*59,050*	*6,350*	*400*	*67,305*
All countries					
1974	+ 575	+33,260	+ 3,390	+ 220	+37,445
1975	− 1,955	+ 5,490	+ 3,950	− 585	+ 6,900
1976	− 455	+25,380	+ 5,825	− 200	+30,550
Amounts outstanding at end-1976	*41,125*	*186,780*	*20,610*	*10,055*	*258,570*

* Including valuation changes.

$9.7 billion. And here the determining factor was that four-fifths of the deterioration in the Group's current balances of payments, from an $8.9 billion surplus to a $6.4 billion deficit, occurred in the United States. That country's reserves — which in practice consist almost entirely of claims on the IMF — actually rose last year by $2.4 billion, reflecting the substantial use of the dollar in Fund drawings. The deterioration of the US current payments balance left three other Group of Ten countries — Germany, Japan and Switzerland — with substantial current-account surpluses of $3.0, 3.7 and 3.4 billion respectively; very broadly, these were reflected in reserve gains of $3.8 billion each in Germany and Japan and $2.5 billion in Switzerland. France and the United Kingdom alone in this group suffered really substantial reserve losses, of $2.9 and 1.3 billion respectively, with the latter figure (thanks to substantial borrowing by the public sector) representing only a fraction of the Bank of England's total intervention during the year. And in Canada and Italy capital inflows converted current payments deficits of $4.4 and 2.9 billion into reserve gains of $0.5 and 1.9 billion respectively.

In the group of "Other developed countries", where the combined current payments deficit increased slightly to $22.6 billion, the overall improvement in the reserve position, from a loss of $2 billion to a gain of $0.7 billion, was the result of higher foreign borrowing. The largest individual reserve movements in this group last year were Yugoslavia and Ireland's gains of $1.2 and 0.3 billion and Spain and South Africa's losses of $0.8 and 0.3 billion respectively.

The OPEC countries' reserve gains in 1976 were more widely spread than they had been the year before and in addition there were some very sizable changes between the two years in the positions of individual members of the group. Saudi Arabia once more showed the biggest increase, but at $3.7 billion this was only 40 per cent. of the 1975 figure and, at the same time, it represented a much smaller proportion of total OPEC reserve growth. Iraq's reserves, which in 1975 had declined by $0.6 billion, increased last year by $1.9 billion; and four other OPEC countries also showed substantial reserve gains — Indonesia, Libya and the United Arab Emirates, with rises of about $1 billion each, and Algeria, whose reserves went up by $0.6 billion. Only two OPEC countries, as against five in 1975, lost reserves last year — Nigeria ($0.6 billion) and Venezuela ($0.3 billion). The change in Venezuela was particularly striking, as during 1975 its reserves had gone up by $2.3 billion.

In sum then, the very much larger increase of global reserves in 1976 can be attributed (valuation changes apart) to two main factors: the reduction of the non-oil developing countries' combined current payments deficit, while their total capital inflows remained unchanged; and the redistribution of the developed countries' combined current payments deficit towards the United States, which effectively reduced the developed world's payments financing needs but was accompanied by a continued high level of external borrowing by developed countries with payments deficits.

Last year's developments brought the cumulative expansion of global reserves since the beginning of the 1970s to about $180 billion — a 230 per cent. increase in seven years. One view of these enormous increases is that they have led to an excess of reserves in the system as a whole, which represents a potential inflationary threat for the future. The global picture, however, can be quite misleading, as the contrast between 1975 and 1976 shows. Even under the Bretton Woods system the degree of reserve adequacy could not be seen simply from the global reserve figures, but was rather a matter of difficult judgement — as was shown when the first decision to create SDRs was taken in 1969. With the much greater use now made of floating exchange rates such judgement has become harder still — though, as shown elsewhere in this chapter, the differences between the old and the new exchange rate arrangements can be exaggerated. There is still a large degree of exchange rate fixity in the system and, besides that, most countries with floating rates also need reserves for managing them.

Looking at the 1970s, it is not hard to find examples of excessive payments deficits being financed, and of the adjustment process being thereby delayed. But to argue from such cases to the existence of excess reserves in the system is quite another matter. There are at least three important qualifications that need to be borne in mind when looking at the global reserve growth of the 1970s. First, the major, though unquantifiable, decline in the usability of gold reserves. Secondly, the fact that reserve growth has depended entirely on an increase in international indebtedness. This bears some resemblance to what happened in the later stages of the Bretton Woods system — with the difference that the risk of excessive indebtedness could now come to apply rather widely throughout the monetary system, whereas then it was concentrated in the principal reserve centre. In the oil-importing world external debt has risen much faster than gross reserves since 1970 and to a large extent the creditors are commercial banks. Thirdly, the distribution of reserves has deteriorated. During the early years of the present decade reserve increases were heavily concentrated in a few developed countries, Germany and Japan alone absorbing nearly 40 per cent. of the 1970–72 total increase. On top of that, since the 1973 oil price increases there has been an even greater concentration in the OPEC countries, accompanied by some further maldistribution of reserves within the oil-importing areas of the world.

If reserves are not excessive, can one argue that the opposite is true, i.e. that there is a shortage of international liquidity in the system? Certainly not in the sense of there being a global reserve shortage. Experience has shown that in this area a sort of Parkinson's Law operates, under which reserves have a way of expanding to meet the deficits available for financing; as these deficits are sometimes excessive, so reserves can expand too much — but hardly too little. The liquidity problem of the Bretton Woods system was not a global reserve shortage but rather a shortage of gold at the official price fixed in 1934 and a growing excess of dollars, then convertible into gold. Something not altogether dissimilar has been happening over the past three years: many countries' external liquidity situation, taking reserves and indebtedness together, may appear insufficient, but gross reserves have expanded quite sufficiently, thanks in large part to international bank lending, to meet the financing needs of deficit countries.

The question, rather, is whether the kind of reserve expansion that has been taking place is the optimum one and whether it would not be better, both for the banks and for the working of the international adjustment process, if official balance-of-payments financing were to play a greater rôle than it has done so far. And to this question the answer is yes: what may be called the quality of international reserve creation does need to be improved.

The argument can be put in the following way. Fears have repeatedly been expressed that the banks, after the very large increase in their international lending over the past three years, will no longer be able to intermediate OPEC, or other, funds on the same scale as hitherto. Certainly their lending to some individual countries will have to slow down or, in a few cases, even come to a complete halt. But there are still plenty of oil-importing countries whose commercial creditworthiness remains good and who may be expected to prefer having recourse to the banks to taking the political step of asking for official credit. Moreover, the OPEC surplus countries will in all likelihood continue to place a significant part of their cash surpluses with banks. The latest available bank data show no sign of any falling-off, either in new OPEC deposits or in new international lending by the banks.

The banks may therefore be expected to continue playing a major rôle in intermediating OPEC funds. Nevertheless, it would not be wise to assume that they will be able to undertake as large a share of total financing in the future as in the past. Nor would it be desirable that they should do so. This is not to say that the banks have shown themselves prepared to meet any and every demand for credit, or that they do not have limits beyond which they will not accommodate individual borrowers. But competition has sometimes led them to behave in a rather uniform way; and the adjustment process to which, in the end, they subject countries considered by them to have borrowed enough tends to be rather abrupt and jerky.

Official sources of external finance will therefore need to be ready to take on a larger share of future financing. In part, this could — and it is desirable that it should — come about through an increase in official aid, grants and loans, both from OPEC countries and from those developed countries whose situation would allow it, either bilaterally or through the international development agencies. To a considerable extent, however, increased official financing would probably have to pass through international institutions that provide balance-of-payments credit. In 1974–75 a $25 billion Financial Support Fund was negotiated by the member countries of the OECD, to provide conditional medium-term credits to OECD countries in payments difficulties. It is not certain, however, whether this facility will ever become operational since the United States, which would be the largest single contributor, has not ratified the agreement. Attention has therefore been increasingly focused on the future rôle of the International Monetary Fund.

The Fund's lending activities have increased considerably in recent years. During 1974–76 total net use of its resources was $14.4 billion, rising from $3 billion in 1974 to $6.6 billion last year. At the present time the Fund's uncommitted resources in usable currencies (not counting any possible further use of the General Arrangements to Borrow) probably amount to less than $6 billion. That figure will be rather more than doubled when the sixth general increase in quotas takes effect, presumably later this year; but at the 1976 rate of disbursement it would still leave the Fund with no more than about two years' worth of lendable funds out of quota subscriptions. Nor does it look as if a further general increase in quotas could come into effect before some time in 1979 at the earliest.

On the supply side, therefore, the IMF does not at present have the resources substantially to step up, and maintain at a higher level, its contribution to the provision of international liquidity. Equally, on the demand side, a number of IMF members — in particular those with limited market creditworthiness but who will continue to require external finance — are not in a position, on the basis of their present entitlements to draw, to cover a substantial part of their needs through recourse to the Fund.

Beyond these aspects of the situation, greater recourse to IMF conditional credit could help in improving the adjustment process, by making it smoother than is apt to be the case when market financing is involved. But smooth adjustment must still be adjustment, if the future financing needs of deficit countries are to be individually manageable. This means that deficits must not be concentrated for too long in too few countries, as has tended to happen during the years since the oil price increase. These considerations led the Interim Committee of the Board of Governors of the International Monetary Fund to recognise in April 1977 the need to establish a temporary supplementary financing facility in the Fund. It is to be hoped that such a facility can be set up later in the year, thus enabling official credit to play a bigger rôle in financing payments deficits and to help in reducing deficits that are too large. If both these aims were achieved, the problems associated with financing the OPEC/non-OPEC disequilibrium, which in the foreseeable future is likely to remain substantial, would be considerably eased.

VIII. ACTIVITIES OF THE BANK.

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

During the past year the Bank has continued to play its traditional rôle in fostering international monetary co-operation. The most important of its activities in that area was the extension to the Bank of England, in February 1977, of a $3 billion medium-term stand-by credit facility (the Third Group Arrangement), backed by the central banks of Austria, Belgium, Canada, Denmark, Germany, Japan, the Netherlands, Norway, Sweden, Switzerland and the United States. The facility can be drawn on to help finance reductions in official sterling balances below the 8th December 1976 level of £2,165 million, except those resulting from the issue of UK Government foreign currency bonds to official sterling holders in exchange for their sterling, provided (in general) that the official reserves of the United Kingdom stand at less than the equivalent of $6,750 million.

In addition to the regular meetings in Basle of the Governors of the central banks of the Group of Ten countries and Switzerland and to those of the Board of Directors, the Bank has 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. In accordance with the agreement reached at the Committee's meeting on 31st August 1975 in Washington, the Bank has acted as registrar in connection with the arrangements entered into between the Group of Ten countries concerning their gold transactions.

The Bank also 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 — EEC organs which were established in May 1964 and April 1973 respectively — 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 and intervention policies on these markets (since the beginning of 1976 the composition of this group has either been confined to the EEC countries or extended to include other industrialised countries, generally members of the Group of Ten); a group commissioned to carry out periodic examinations of the monetary situation in member countries and of the problems raised by the co-ordination, on a Community scale, 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).

As in previous years, these committees and groups held a large number of regular or ad hoc meetings in 1976–77, mostly in Basle and generally in preparation for discussions among the Governors. On the basis of their work the Committee of Governors itself and the Board of Governors of the European Monetary Co-operation Fund, each within the framework of its competence and functions, which are closely related and complementary, are able to take various decisions or to prepare reports and opinions, on a regular or ad hoc basis, for the Commission of the European Communities or, more usually, for the Ministers of Finance of the EEC countries. Last year this work centred primarily around intra-Community exchange rate relationships (the functioning of the "snake", possible formulae for new systems embracing all EEC countries), the execution of financial operations connected with Community loans, and the co-ordination of monetary policies.

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 provide the Secretariat for the computer experts of the central banks of the Group of Ten countries, thereby lending its support in furthering co-operation and the exchange of information in matters relating to electronic data processing. At their meetings the experts have concentrated on examining questions concerning data-processing policies rather than on resolving technical problems connected with the implementation of new automated techniques. Most of the working parties that had been formed to study such technical questions have since been disbanded, their mandates having been fulfilled. The participating central banks have in fact for the most part completed the organisational and introductory phase of their computerisation programmes and are now giving more attention to matters of systems management and policy formulation. During a week devoted to meetings and discussions, technical and administrative officials from the central banks concerned compared the approaches of their various institutions to the division of responsibilities in data management, to project planning and to the utilisation of their human and material resources. The experts have also taken close note of developments in the fields of interbank message switching and electronic systems for international payments and of the work of the International Standards Organisation. Thanks to the continuing co-operation of the participating central banks, the experimental data bank became operational late last year; the trial period will continue for another few months in order to permit an objective assessment of the usefulness of a centralised macro-economic data 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 1977, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

* * *

The balance-sheet total at 31st March 1977 stood at the record figure of	F 48,846,308,213
against, on 31st March 1976,	F 43,425,770,553
It thus registered an increase of	F 5,420,537,660

or 12.5 per cent., which is much larger, in both absolute and relative terms, than that recorded in the previous financial year (1,486 million and 3.5 per cent.).

It may be noted that the appreciation of certain currencies, in particular the Deutsche Mark following the exchange rate adjustment which took place in October 1976, contributed only very little to the increase in the balance-sheet total.

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
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
1977	48,846	+ 5,420	+ 13

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 and lending operations;

(iv) gold under earmark held by the BIS; this item amounted to 1,311 million francs on 31st March 1977, against 1,160 million on 31st March 1976.

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* 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.

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			
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
1977*	1,373	46,934	539	48,846

* 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 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 1976–77 F 471,847,193

This compares with 423.8 million francs on 31st March 1976, the difference of 48 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

As in the previous financial year, this Reserve Fund remained unchanged.

(4) *Free Reserve Fund*

after allocation of the net profit for 1976–77 F 495,118,200

This compares with 423.1 million francs on 31st March 1976, the amount it is proposed to transfer to this Fund from the net profit being 72 million francs.

The Bank's overall reserves after allocation of the net profit for 1976–77 thus stand at F 1,072,211,487 against 952.2 million francs at the beginning of the financial year, giving an increase of 120 million; it may be recalled that the rise in the overall reserves amounted to 155 million in the financial year 1974–75 and 131 million in the financial year 1975–76.

(c) The item "Miscellaneous" rose to F 456,854,834

from 445.7 million francs on 31st March 1976, an increase of 11.2 million.

(d) Provision for Building Purposes F 34,450,867

The comparable amount on 31st March 1976 was 63 million francs; the decrease of 28.5 million francs is the result of incurred expenditure of 34.3 million francs, partially offset by an additional amount of 5 million francs which the Board of Directors decided to allocate to this Provision and by an exchange difference of 0.8 million.

(e) Profit and Loss Account, *before* allocation F 167,920,050

This figure represents the net profit for the financial year 1976–77; it is 11 million francs lower than the net profit for the preceding financial year, which came to 178.9 million. Details of the proposed allocation of the profit for 1976–77, in accordance with the provisions of Article 51 of the Statutes, 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 47,920,050 francs — against 47,876,749 francs in the preceding financial year — to be set aside in respect of the dividend of 100 Swiss francs per share (the same amount per share as last year) to be paid on 1st July 1977.

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 1976	1977	Movement
	in millions of francs		
Deposits of central banks	39,976	45,894	+ 5,918
Deposits of other depositors.	1,641	1,040	— 601
Total	41,617	46,934	+ 5,317

The increase in "Deposits of central banks" was fairly substantial, also in relative terms (14.8 per cent., against 2.9 per cent. in the previous financial year); it accrued chiefly in US dollars — which thus accounted for the major part of the expansion in the balance-sheet total — and also, though to a lesser extent, in Deutsche Mark. By comparison, movements in other currencies were on only a medium or small scale; on balance, they resulted in a slight increase.

"Deposits of other depositors" recorded a marked decline of more than one-third, owing to the repayment of funds in US dollars and Swiss francs that had been received from the market.

The combined effect of the movements in the two items analysed above was to increase further — from 96.1 to 97.8 per cent. — the preponderant share of "Deposits of central banks" in the total of borrowed funds.

BIS: Borrowed funds, by nature and term.

Term	Deposits in gold			Deposits in currencies			Total		
	Financial years ended 31st March		Movement	Financial years ended 31st March		Movement	Financial years ended 31st March		Movement
	1976	1977		1976	1977		1976	1977	
	in millions of francs								
Sight	2,568	2,509	— 59	682	753	+ 71	3,250	3,262	+ 12
Not exceeding 3 months	642	1,032	+ 390	30,233	35,523	+5,290	30,875	36,555	+5,680
Over 3 months . .	310	24	— 286	7,182	7,093	— 89	7,492	7,117	— 375
Total . . .	3,520	3,565	+ 45	38,097	43,369	+5,272	41,617	46,934	+5,317

In relation to the total of borrowed resources, the proportion of deposits in currencies showed a further slight increase, rising from 91.5 to 92.4 per cent.

(a) Deposits in gold F 3,565,454,480

This figure compares with that of 3,520 million francs at 31st March 1976, representing an increase of 45 million which virtually cancelled out the decrease of 49 million recorded during the previous financial year; whereas sight deposits declined slightly as the result of various withdrawals, time deposits rose on balance owing to the receipt of gold for periods not exceeding three months; this last item also increased because of the retransfer into that category of some deposits at over three months.

(b) Deposits in currencies F 43,368,713,370

This figure compares with that of 38,097 million francs at 31st March 1976; the sharp increase of 5,272 million (+13.8 per cent.) corresponded to that in funds at not exceeding three months, small movements in the other two items — an increase in sight deposits and a decrease in deposits at over three months — having virtually offset one another.

ASSETS (EMPLOYMENT OF RESOURCES).

The following table gives a breakdown of the main items of the assets according to their *nature*.

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

Nature	Financial years ended 31st March 1976		1977		Movement	
	in millions of francs					
Sight assets						
Gold	3,993		4,046		+ 53	
Currencies	72	4,065	81	4,127	+ 9	+ 62
Treasury bills						
Currencies		289		133		– 156
Time deposits and advances						
Gold	49		76		+ 27	
Currencies	34,530	34,579	40,720	40,796	+ 6,190	+ 6,217
Securities at term						
Currencies		4,463		3,551		– 912
Total						
Gold	4,042		4,122		+ 80	
Currencies	39,354	43,396	44,485	48,607	+ 5,131	+ 5,211

(a) Gold F 4,046,386,009

This item, consisting entirely of gold in bars, amounted to 3,993 million francs on 31st March 1976. The small increase of 53 million during the last financial year was due to the receipt of the new deposits referred to above — partially offset by the use of gold in swaps concluded against currencies and in investments.

On the other hand, it should be mentioned that, as indicated in note 3 to the Balance Sheet, the amount of gold pledged stood at 857 million francs, compared with 700 million at the beginning of the financial year, representing an increase of 157 million.

(b) Cash on hand and on sight account with banks F 81,391,493

This figure compares with 72 million francs at 31st March 1976, representing an increase of 9 million.

(c) Treasury bills F 133,521,883

This compares with a figure of 289 million francs at the end of the previous financial year; the decline of 156 million corresponds to slightly more than half the amount of the portfolio held at 31st March 1976.

(d) Time deposits and advances F 40,795,640,791

This figure compares with one of 34,579 million francs at 31st March 1976. As in the previous financial year, the increase recorded — of 6,217 million, or 18 per cent. — was quite significantly larger than the rise in total assets.

The gold component of this item rose by 27 million francs, from 49 million to 76 million, as a result of placements of gold — already referred to above — in the form of time deposits.

Time deposits and advances in currencies rose from 34,530 million francs to 40,720 million. This very substantial increase of 6,190 million involved primarily US dollars and also roughly comparable amounts of Deutsche Mark, while other movements, including a sizable contraction in Swiss francs, resulted on balance in a slight decline. It represents new investments made on numerous markets and, to a lesser extent, additional facilities extended to central banks.

(e) Securities at term F 3,550,632,459

This figure compares with one of 4,463 million francs at 31st March 1976. The reduction of 912 million, or one-fifth, broadly corresponds to the difference between, on the one hand, maturing holdings of bank certificates of deposit issued on the US market and of notes denominated in Swiss francs and, on the other, purchases of paper denominated in US dollars.

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

Term	Financial years ended 31st March		Movement
	1976	1977	
	in millions of francs		
Not exceeding 3 months	29,493	31,815	+ 2,322
Over 3 months	9,549	12,532	+ 2,983
Total	39,042	44,347	+ 5,305

The above table shows that the totals for both categories of maturity increased by fairly similar amounts in absolute terms.

(f) Miscellaneous F 238,735,577

This figure compares with 30 million francs at 31st March 1976. The sharp increase of 209 million was a result of book-keeping adjustments necessitated by the fact that the amount of swaps involving spot purchases of gold against currencies concluded at market-related prices was larger than that of swaps in the opposite direction concluded on the same basis.

Forward gold operations.

These operations, which appear under note 2 to the Balance Sheet, resulted in a positive net balance (gold receivable) of F 104,853,674 compared with one of 175 million at the end of March 1976. The decrease of 70 million was due to the fact that the total of new swaps of gold (resold forward) against currencies — swaps which made it possible temporarily to mobilise some central-bank gold reserves — was greater than that of swaps in the opposite direction.

Furthermore, the Bank began to some extent to resume its traditional activity in the field of gold operations. It also on several occasions purchased gold at the auctions held from June 1976 onwards by the International Monetary Fund and sold approximately the same quantities.

* * *

In the course of the financial year 1976–77 the Bank's operations developed in line with its balance-sheet total; the level of activity was correspondingly high.

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 1976–77 for the Young Loan ended on 1st June 1977. The interest in respect of the financial year amounted to the equivalent of about 23.3 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 1976–77 was effected partly by purchases of bonds on the market and partly by drawings. 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.

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 1975–76	Bonds purchased or drawn for redemption in respect of the financial years 1976–77	Balance after redemption
American . . .	$	67,086,000	19,519,000	1,647,000	45,920,000
Belgian	B.fr.	202,872,000	56,736,000	4,959,000	141,177,000
British	£	20,667,500	5,771,500	468,700	14,427,300
Dutch	Fl.	52,581,000	14,454,000	1,219,000	36,908,000
French	Fr.fr.	501,963,000	141,585,000	12,004,000	348,374,000
German	DM	14,509,000	3,910,000	321,000	10,278,000
Swedish . . .	S.kr.	92,780,000	26,266,000	2,249,000	64,265,000
Swiss	Sw.fr.	58,393,000	16,035,000	1,320,000	41,038,000

* Redemption value on 1st May 1977 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 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 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 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.

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		Balance after redemption
			1959 to 1975	1976	
American . . .	$	1,667,000	1,396,000	107,000	164,000
Anglo-Dutch .	£	856,600	692,100	53,600	110,900
Swiss	Sw.fr.	7,102,000	5,152,000	437,000	1,513,000

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 1976–77 the amounts received by the Bank for the service of the secured loans came to the equivalent of about 7 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 114 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 1977	Rates of interest %	Year of final maturity or redemption
1st	1954	United States	US Government	$	100,000,000	19,100,000	3⅞	1979
2nd	1955	Belgium	Caisse Générale d'Epargne et de Retraite, Brussels	B.fr.	200,000,000	66,000,000	3½	1982
3rd	1955	Germany	Westdeutsche Landesbank Girozentrale, Düsseldorf[1]	DM	50,000,000	9,694,300	3¾	1981
4th	1955	Luxembourg	Caisse d'Epargne de l'Etat, Luxembourg	B.fr. L.fr.	20,000,000 5,000,000	6,600,000 —	3½ 3½	1982 1961
5th	1956	Saar	Landesbank Saar Girozentrale, Saarbrücken	DM	2,977,450[2]	205,444	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	40,419,424	5⅜	1982
11th	1958	United States	Public issue	$	35,000,000	5,100,000	5	1978
12th	1958	United States	Public issue	$	15,000,000	—	4½	1963
13th	1960	United States	Public issue	$	25,000,000	6,850,000	5⅜	1980
14th	1960	United States	Public issue	$ $ $	3,300,000 3,300,000 3,400,000	— — —	4¾ 4⅞ 5	1963 1964 1965
15th	1961	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	56,039,034	5¼	1986
16th	1961	Netherlands	Public issue	Fl.	50,000,000	16,500,000	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 become more diversified since 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 in connection with 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 and lending.

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 keep fluctuations between their exchange rates within a margin of no more than 2.25 per cent.;
- the periodic settlement of these very short-term debts and claims;
- operations carried out in the context of the short-term monetary support arrangements; operations of this kind were entered in the Fund's books in connection with the monetary support received by the Bank of Italy between March and December 1974; they subsequently disappeared from the accounts when this short-term credit was consolidated into medium-term financial assistance; such operations could, however, reappear in the books of the Fund since in May 1976 the Bank of Italy was granted fresh monetary support of US$ 482.54 million which has not yet been drawn upon.

During the financial year 1976–77, 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 US 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 billion for an average term of over five years; ten-thirteenths of this sum was made available to Italy and three-thirteenths to Ireland. Since the conclusion of these operations in April 1976 the Bank in its capacity as Agent has, on the one hand, seen to the payment of interest falling due and, on the other hand, participated in the execution of operations to consolidate two tranches of US$ 100 million, that is to say the conversion of variable-rate bank facilities into fixed-rate credits.

Finally, again in its rôle as Agent of the Fund, the Bank has recently participated in establishing the financial and technical terms and conditions of a new US$ 500 million Community borrowing operation on behalf of Italy, which was decided upon by the Council of the European Communities in April 1977 and will be carried out in June 1977.

6. Net profits and their distribution.

The accounts for the forty-seventh financial year ended 31st March 1977 show a net operating surplus of 175,776,466 francs, as compared with 184,464,774 francs for the preceding financial year and 187,622,476 francs for the financial year 1974–75. The principal reasons for the decrease recorded in the year under review are a further 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 a further small 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 2,856,416 francs, and to the Provision for Building Purposes an amount of 5,000,000 francs. As a result of these transfers the net profit amounts to 167,920,050 francs, against 178,876,749 francs for the previous financial year and 182,063,281 francs for the financial year 1974–75. 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 167,920,050 francs be applied by the General Meeting in the following manner:

(i) an amount of 47,920,050 francs in payment of the dividend of 100 Swiss francs per share;

(ii) an amount of 48,000,000 francs to be transferred to the General Reserve Fund; and finally

(iii) an amount of 72,000,000 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.

If these proposals are accepted, the dividend will be paid on 1st July 1977 to the shareholders whose names are entered in the Bank's share register on 20th June 1977.

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 1977 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.

The mandate of Dr. Jelle Zijlstra as Chairman of the Board and President of the Bank being due to expire on 30th June 1976, he was re-elected to these offices under Article 38 of the Statutes at the meeting of the Board held on 14th June 1976 for a period of three years ending on 30th June 1979.

At the meeting of the Board held on 14th September 1976 the Chairman announced that Prof. Baffi had appointed Dr. Giovanni Magnifico to act as his Alternate in the absence of Dr. Mario Ercolani who would succeed Dr. Rinaldo Ossola as his Alternate. The Chairman expressed the Bank's gratitude to Dr. Ossola for his valuable services to the Bank.

M. Henri Deroy, whose mandate as a member of the Board was due to expire on 31st October 1976, was re-appointed under Article 27(2) of the Statutes by M. Bernard Clappier, Governor of the Bank of France, in October 1976 for a further period of three years. The mandate of M. Deroy as Vice-Chairman of the Board was also due to expire on 31st October 1976. At its meeting on 9th November 1976 the Board re-elected him under Article 38 of the Statutes for a further period of three years ending on 31st October 1979.

In November 1976 Mr. Krister Wickman relinquished his post as Governor of the Bank of Sweden and at the same time gave up his seat on the Board of Directors of the BIS. At the Board meeting held on 9th November 1976 the Chairman thanked Mr. Wickman for the eminent services he had rendered to the Bank during his term of office of nearly three years.

At the meeting of the Board held on 14th December 1976 the new Governor of the Bank of Sweden, Mr. Carl-Henrik Nordlander, was elected under Article 27(3) of the Statutes to be a member of the Board for a period of office expiring on 31st March 1978.

The mandate of Dr. Fritz Leutwiler as a member of the Board being due to expire on 31st March 1977, he was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 8th March 1977 for a further period of three years ending on 31st March 1980.

In April 1977 it was announced that, on 1st June 1977, Dr. Otmar Emminger would succeed Dr. Karl Klasen as President of the Deutsche Bundesbank; he would accordingly then become an ex-officio member of the Board in place of Dr. Klasen.

At the meeting of the Board held on 10th May 1977 the Chairman expressed the sincere and deep gratitude of all members of the Board for the outstanding services which Dr. Klasen had rendered to the Bank during a period of office of more than seven years.

Dr. Antonio Rainoni, who had joined the BIS in December 1946 and had been a Manager in the Monetary and Economic Department since April 1965, relinquished his appointment at the end of June 1976. At the Board's meeting on 14th June 1976 the Chairman thanked Dr. Rainoni on behalf of all members of the Board for the great skill and professional competence which he had always displayed in carrying out his most valuable work for the Bank.

The Chairman announced at the Board meeting held on 8th March 1977 that the Bank had decided to promote M. Charles Altenhoff to the rank of Assistant Manager as from 1st April 1977.

CONCLUSION.

A number of positive developments have occurred since the publication of last year's Annual Report. After an unexpected pause during the summer and early autumn of 1976, industrial growth has picked up again in some leading countries. The rate of inflation has been further reduced in Germany, Switzerland, Canada, Belgium, Denmark, France and the Netherlands. On the international scene, world trade has continued to recover, the distribution of payments imbalances among the oil-importing countries has improved, and international financing has in general proceeded smoothly. However, it cannot be denied that policy-makers continue to face many difficult problems.

The most pressing of these, referred to repeatedly in this Report, concerns the state of *domestic economies* in the western industrial world, in particular the coexistence of high unemployment and inflation. The degree of success achieved in fighting inflation has, to say the least, been very uneven; and although advances in this respect are still being made in some countries, short-term prospects for further progress are not very promising. At the same time, the pace of the recovery is in most cases hesitant; and even where it seems to be broadly based and relatively fast — as in the United States — it is unlikely to lead to any rapid reduction of unemployment.

Clearly, current levels of unemployment are unacceptable. Equally clearly, the only acceptable rate of inflation is a declining one. Thus the key policy problem facing governments may be reduced to two basic questions: how can recovery be sustained at a pace sufficient to cut back unemployment? And how can a steady reduction in inflation rates be achieved at the same time?

The answer to the first question should be sought mainly in strategies designed to lead to a broad revival of investment. The reasons for advancing this proposition are many and well-founded. The most important is that whereas consumption and exports have been expansionary forces, capital expenditure has been lagging behind. As a result, unemployment and excess capacities are heavily concentrated in investment goods industries. And, looking to the future, where else could the necessary stimulus to aggregate expenditure come from? The fight against inflation requires a continued moderation in wage increases. A strong global stimulus from government consumption and transfer payments is clearly undesirable at this stage. Of course, in some cases growth should be export-led; but this cannot be a recipe for the industrial countries as a group. Finally, a faster rate of capital accumulation would be a good thing in itself: it would help to ensure the future growth of productivity; it would help to remove potential capacity bottlenecks which might occur even when labour is still in plentiful supply; and, in a broader, worldwide perspective, it would enable the necessary transfer of real resources to take place from the industrial North to the non-oil LDCs.

Prospects for a revival of business investment are not all that bleak. A necessary, though not sufficient, condition is an improvement in business earnings. This condition is increasingly being met in many cases, though the profits picture varies sharply from country to country and from industry to industry. Larger cash flows have contributed to a broadening of the equity base, sounder gearing ratios and greater corporate liquidity. Moreover, in many countries financial markets have been receptive to increased long-term borrowing. Although it takes time for these processes to exert a positive influence on capital spending, especially after a long period of rapid inflation, they do gradually re-establish a healthy basis for improved investment activity. What is now needed is confidence that economic growth will be resumed without a resurgence of inflation. Confidence has been badly shaken by a deep and protracted recession, large and persistent excess capacities, sharp and unforeseen changes in relative prices and uncertainties of all kinds. Capital expenditure will expand only if businesses become convinced that the improvement in earnings will be lasting and that they can count on a reasonably steady growth in demand. The conclusion is that, since higher employment levels require a sustained recovery, and since such a recovery should be based on growing capital spending, governments will be able to reduce unemployment only if they create an environment that fosters business confidence in balanced long-term growth.

As for price behaviour, we know now that the inflationary explosion of 1973–74 originated in the synchronised world boom of the early 1970s and therefore, independently of the sharp rise in the price of oil, owed much to monetary and fiscal mismanagement in some leading industrial countries. But it is equally obvious that today's obstinately high inflation rates can no longer be explained by generalised excess demand and probably not even by occasional sectoral bottlenecks. On the contrary, they are due to upward pressure of incomes and thus of costs: in quite a few countries this upward pressure derives largely from the persistence of wage inflation; in others, where the rate of increase in earnings has slowed down markedly, the income push comes from the necessary restoration of profit margins that had earlier been severely squeezed by rising wages, deteriorating terms of trade and a collapse of final demand. While this process may be partly explained by the actions of those who have sought to protect themselves from the effects of past inflation, it is also due to the persistence of lively inflationary expectations. How else can one explain why a buyers' market for so many factors of production, goods and services has, after such a long time, had such limited impact on their prices?

The survival of these expectations has led the Report to lay special emphasis on the problem faced by those countries whose domestic price increases have been exacerbated by a depreciating currency. Admittedly, in all countries the origin of inflation can be traced back to faulty domestic policies; and where it remains virulent, it is still in most instances being accommodated by monetary expansion. It is also true that such policies are apt to foster inflationary expectations; but it would be a mistake to overlook the fact that the most powerful direct influence on expectations is the experience of inflation, and especially its acceleration — whatever its immediate origin. It is therefore a counsel of perfection to suggest that inflation can be eradicated by relying exclusively on domestic virtue while a depreciating currency, through its impact on domestic prices, continues to feed the inflationary expectations of wage-earners, entrepreneurs, consumers and investors. This may happen if, even despite appropriately restrictive monetary, fiscal and incomes policies, depreciation continues. If it is accepted that overcoming inflationary expectations should be a major policy aim, it follows that proper attention should be given to the stabilisation of exchange rates as a complement to — but never a substitute for — restrictive domestic policies.

Two general conclusions follow from these propositions. The first is that no quick remedies are available to cure the ills of unemployment and inflation. Neither business confidence in future profitability and balanced growth nor general confidence in a return to price stability can be achieved other than through patient, medium to long-term policies. The second conclusion is that inflation and unemployment are closely interdependent. Inflationary expectations have become a major factor inhibiting investment. This is because inflation in itself is a source of uncertainty: its rate may vary over time; there are wide differences in the behaviour of individual prices; and there is a strong likelihood that inflation will provoke countervailing restrictive action by the government. Conversely, an effective fight against inflation requires moderation in the rise of labour costs. But in order to avoid the risk of demand stagnation investment will have to expand sufficiently to generate employment and income and therefore increase aggregate expenditure both directly by raising demand for capital goods, and indirectly by stimulating expenditure on consumer products and services.

Medium to long-term policy strategies devised to fight inflation and unemployment will have to make use of all available policy tools, and to apply them in whatever combinations are best suited to the specific needs of individual countries. Some generalisations do, however, seem possible. They are all based on the assumption that the overriding policy objective will be to advance along a path of moderate but steady growth.

Monetary policy can play a prominent rôle by setting — and preferably announcing — quantitative targets for the growth of aggregates. For those countries that wish to intervene as little as possible in the foreign exchange market the appropriate target is the money supply, whereas for those that choose to shield their exchange rate from the full impact of market forces the target might best be defined in terms of domestic credit expansion. The mere act of setting credible targets, supported by an announced intention gradually to bring the aggregates down to more appropriate growth rates, can help substantially to dampen inflationary expectations.

As for fiscal policy, governments should avoid the extremes of fine-tuning and demand-management pessimism. Rather, they should stress their readiness to apply fiscal stimulus in the event of a clear deficiency of aggregate private demand and not simply in response to some unexpected deviation from forecast expenditure trends. If such a stimulus is required, it might be advisable to cut taxes rather than resort to a discretionary increase in spending. But there might also be scope for expanding public investment while holding back on those components — government consumption and transfer payments — that have shown such explosive growth in many countries.

Moreover, it seems that most countries will have to supplement traditional monetary and fiscal policy with measures to limit the growth of money incomes directly. This is a field in which each country will undoubtedly adopt policies appropriate to its national, political and economic environment. The solutions will range from mandatory incomes policies to broad objectives agreed through national consensus.

Finally, emphasis on global medium to long-term policies certainly does not exclude measures to alleviate the hardships caused by the concentration of unemployment in specific areas or among specific groups of people, especially the young.

Turning to the *international economy,* both the problems and their solution can be viewed in a brighter light — even though, at first sight, such relative optimism seems hardly justified. Thus, we are still faced with vast imbalances in international payments which, in aggregate terms, are unlikely to diminish, let alone disappear, in the near future. Short of drastic economies in the use of energy, the oil surplus, now heavily concentrated among a handful of low-absorbing countries, will persist. At the same time, the non-oil LDCs as a group will continue to run "structural" current-account deficits, and some imbalances are bound to remain within the group of developed countries.

These predictions are based, in the first place, on the belief that the adjustment process will be slow because exchange rate changes, while unavoidable and necessary in many instances, do not produce speedy adjustment. Obviously, they do not lead to any adjustment at all as regards the global oil surplus. In the case of non-oil LDCs, the effectiveness of depreciation is blunted by supply and demand inelasticities deriving from structural rigidities. In those developed countries — and they are in the majority — which have relatively small, widely open economies and where domestic prices and incomes respond quickly to movements in exchange rates, depreciations and appreciations by themselves only rarely lead to changes in *real* exchange rates. Effective changes in competitiveness only occur if movements in the external value of a currency are accompanied by appropriate domestic policy measures: monetary and fiscal restraint in countries with depreciating currencies, expansion in countries with appreciating ones. In the absence of such policies, the chances are that exchange rate movements will simply "pass through" the economy, with domestic inflation rates moving quickly to offset changes in the external value of the currency.

But does the current state of the world economy — and especially that of the western industrial countries — warrant the *generalised* implementation of drastic domestic adjustment policies? The answer is highly doubtful. On the one hand, with inflationary expectations still alive, it would be a great mistake to insist on the surplus countries accelerating the pace of domestic expansion simply because some observers feel that the official growth forecasts for 1977 might be erring on the high side. The surplus countries attained a position of strength as a result of prudent demand management, and they are entitled to consider domestic price stability as a major policy objective; moreover, it is in the general interest that they should do so. But it would be equally mistaken for all deficit countries to embark simultaneously on strongly restrictive policies in a climate of faltering recovery and worldwide unemployment. However, the burden of initiating adjustment will have to rest mainly on them; at the same time the period of adjustment will, in some cases, need to be an extended one.

Thus, the likely persistence of global imbalances continues to darken the world balance-of-payments outlook. But any pessimism that may be felt on that account is more than offset by the grounds that exist for optimism with regard to their financing. In the first place, the supply of balance-of-payments finance has so far responded well to the demand for it: witness the totally unforeseen acceleration of net new private international lending in 1976. This is true not only ex post — effective current-account disequilibria being financed by definition — but also in a more meaningful sense. The evidence lies in the fact that many countries with substantial current-account deficits have managed to increase their external reserves and few of them have resorted to trade restrictions. Secondly, these private financing flows may well continue on quite a large scale in the future, provided that the balance-of-payments positions of individual countries, as opposed to those of groups of countries, do not prove rigid. Happily enough, this is not mere wishful thinking; quite a few deficit countries managed to improve their external balances in 1976 and others are in the process of doing so in 1977. If this reshuffling continues, fears of a breakdown in banks' financial intermediation between the surplus and deficit countries will be considerably reduced. Thirdly, while the burden of debt servicing has risen to excessively high levels in a few countries, it does not appear to have done so in respect of the non-oil LDCs as a group. In other words, *aggregate* lending can continue at a high level, provided that adjustment takes place in those countries that have been running large deficits for some time and have thus accumulated excessive debts.

These considerations allow a reasonable degree of optimism about the future financing of payments imbalances. At the same time, however, they point to a number of directions in which policy action is called for by the international community as a whole if the banks are to continue (as the Report has argued that they should) supplying funds to deficit countries, even if on a smaller scale than in the past three years.

Two lines of action, in particular, need to be pursued. Firstly, a better flow of information on debtor countries must be provided. This could be achieved both through the efforts of international agencies and by encouraging lending banks to gather, and debtor countries to supply, more detailed, up-to-date and reliable figures on the external debt and on the level of debt-service charges borne by potential borrowers. Of course, better information does not in itself guarantee improved lending practices; nor does it eliminate risks. But it would ensure that the competitive process takes place in the light rather than in the dark. In all markets, adequate information is the basis for the proper functioning of demand and supply relationships.

Secondly, other forms of financing must be promoted which would alleviate the burden on private banks. The banks will be better able to continue acting as financial intermediaries if the liquidity risks they assume in the process of maturity transformation and their exposure vis-à-vis individual countries do not grow out of proportion.

The most obvious improvement, of course, would come from additional long-term financing. Long-term capital flows would eliminate the need for maturity transformation based on intermediary lending and would also provide a better financial framework for the transfer of real resources to the countries in "structural" deficit, whether non-oil LDCs or more developed economies engaged in a process of rapid industrialisation. Countries with persistent current-account surpluses have a duty to encourage capital exports of this kind, which could take the form of development assistance, long-term loans or direct investment.

In addition to such changes in capital movements, there is also scope for a second form of substitution, involving an enhancement of the rôle of lending by international institutions, for instance through the special facility which is being set up by the IMF or through multilateral guarantee systems such as the OECD safety-net scheme. The justification for such lending is most obvious in the case of countries whose current-account deficit and short-term indebtedness have reached levels at which the banks are reluctant to lend more. Fortunately, not many countries are in this situation. But where the problem does arise, a case can be made for longer-term lending accompanied by a firm commitment by the borrowing country to set in motion vigorous adjustment policies. For this type of conditional lending, official institutions are clearly better suited than private lenders. Moreover, conditional lending could do much to promote the kind of mobility in individual balance-of-payments positions which, as mentioned above, is a prerequisite for maintaining the adequate functioning of private financial markets.

If policies along these lines are adopted — and there is now a fair chance that they will be — there is no reason why the present institutional framework should not be able to cope with balance-of-payments financing, even if the aggregates remain impressively high. However, in a longer-term perspective, the maintenance of international order — in trade, money and finance — will depend on the ability of individual countries to deal with the basically domestic problems of inadequate growth, excessive unemployment and high inflation. It can be argued that during its last years the Bretton Woods system played some part in the worldwide inflationary boom of the early 1970s and the ensuing deep recession. But today responsibility once again rests squarely on the shoulders of domestic policy-makers. Deficit countries have learnt the hard way that downward floating will not safeguard them from unemployment but will render even more difficult the task of curbing inflation; at the same time, the surplus countries, though more successful in fighting inflation than their neighbours have been in reducing unemployment, have not managed to eliminate inflation completely, and are equally afflicted with the problem of unemployment. Thus, the need to improve our still very imperfect international monetary arrangements is no excuse for neglecting to tackle the problems of unemployment and inflation at their origins: in the domestic economies themselves.

René Larre

General Manager

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1977

BALANCE SHEET

ASSETS

(Before and after

		Gold francs
Gold		4,046,386,009
Cash on hand and on sight account with banks		81,391,493
Treasury bills		133,521,883
Time deposits and advances		
Gold		
Not exceeding 3 months	76,196,539	
Currencies		
Not exceeding 3 months	28,571,185,315	
Over 3 months	12,148,258,937	
		40,795,640,791
Securities at term		
Not exceeding 3 months	3,166,998,475	
Over 3 months	383,633,984	
		3,550,632,459
Miscellaneous		238,735,577
Land, buildings and equipment		1
		48,846,308,213

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 1977, gold receivable against currencies on forward contracts amounted to 104,853,674 gold francs.

Note 3: The equivalent of 857,287,242 gold francs' worth of gold was pledged at 31st March 1977 in connection with deposits received.

AT 31st MARCH 1977

allocation of the year's Net Profit) LIABILITIES

		Before allocation Gold francs	After allocation 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	423,847,193		471,847,193
Special Dividend Reserve Fund	75,175,781		75,175,781
Free Reserve Fund	423,118,200		495,118,200
		952,211,487	1,072,211,487
Deposits (gold)			
Central banks			
Sight	2,475,828,994		
Not exceeding 3 months	1,031,930,318		
Over 3 months	24,548,870		
Other depositors			
Sight	33,146,298		
		3,565,454,480	3,565,454,480
Deposits (currencies)			
Central banks			
Sight	723,236,042		
Not exceeding 3 months	34,694,729,766		
Over 3 months	6,943,968,978		
Other depositors			
Sight	30,097,885		
Not exceeding 3 months	828,056,666		
Over 3 months	148,624,033		
		43,368,713,370	43,368,713,370
Miscellaneous		456,854,834	456,854,834
Provision for Building Purposes		34,450,867	34,450,867
Profit and Loss Account		167,920,050	–
Dividend payable on 1st July 1977		–	47,920,050
		48,846,308,213	48,846,308,213

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 1977 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, 25th April 1977 PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT

for the financial year ended 31st March 1977

		Gold francs
Net interest and other income		214,968,470
Less: Costs of administration:		
Board of Directors	483,548	
Management and Staff	31,219,746	
Office and other expenses	7,488,710	39,192,004
Net operating surplus		175,776,466
Less: Amounts transferred to:		
Provision for Exceptional Costs of Administration	2,856,416	
Provision for Building Purposes	5,000,000	7,856,416
Net Profit for the financial year ended 31st March 1977		167,920,050

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:

Dividend: 100 Swiss francs per share on 481,125 shares	47,920,050
	120,000,000
Transfer to General Reserve Fund	48,000,000
	72,000,000
Transfer to Free Reserve Fund	72,000,000
	—

Movement on the Provision for Building Purposes during the financial year ended 31st March 1977

	Gold francs
Balance at 1st April 1976	62,965,885
Add: Exchange difference	839,784
Transfer from Profit and Loss Account	5,000,000
	68,805,669
Less: Amortisation of expenditure incurred	34,354,802
Balance at 31st March 1977 per Balance Sheet	34,450,867

BOARD OF DIRECTORS

(as at 31st March 1977)

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

Baron Ansiaux, Brussels
Prof. Paolo Baffi, Rome
Bernard Clappier, Paris
Dr. Karl Klasen, Frankfurt a/M.
Dr. Fritz Leutwiler, Zurich
Carl-Henrik Nordlander, Stockholm
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

Alternates

Dr. Otmar Emminger, Frankfurt a/M., or
Dr. Leonhard Gleske, Frankfurt a/M.
Dr. Mario Ercolani, Rome, or
Dr. Giovanni Magnifico, Rome
Georges Janson, Brussels
Christopher W. McMahon, London, or
M. J. Balfour, London
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
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
Charles Altenhoff	Assistant Manager