BANK FOR
INTERNATIONAL SETTLEMENTS

FORTY-NINTH ANNUAL REPORT

1st APRIL 1978 – 31st MARCH 1979

BASLE

11th June 1979

TABLE OF CONTENTS

LIST OF TABLES AND GRAPHS

(Graphs are indicated by an asterisk)

Page

International Trade and Payments

The International Credit and Capital Markets

The International Monetary Scene

Page

Activities of the Bank

FORTY-NINTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 11th June 1979

Ladies and Gentlemen,

I have the honour to submit herewith the forty-ninth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1978 and ended on 31st March 1979.

The net profit for the year amounted to 220,576,151 gold francs, after transfer of 1,716,058 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit of 191,050,134 gold francs for the preceding year and 167,920,050 gold francs for the financial year 1976–77.

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 79,576,151 gold francs in payment of a dividend of 110 Swiss francs per share.

The Board further recommends that 56,400,000 gold francs be transferred to the General Reserve Fund, 8,000,000 gold francs to the Special Dividend Reserve Fund, and the remainder of 76,600,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1978–79 will be payable to shareholders on 1st July 1979.

Details of the Bank's activities during the financial year, as well as of the Balance Sheet and the financial results, are contained in Chapter VIII of the Report.

I. CURRENCY UNREST AND INFLATION IN THE WESTERN INDUSTRIAL COUNTRIES.

Two series of developments have preoccupied the central banks of the industrial world in the past year: currency unrest, brought under control around the end of 1978 and followed by stabilisation during the first few months of 1979; and, more recently, signs of a generalised resurgence of inflation. Both these developments were symptomatic of deep-rooted underlying problems. The currency unrest was a reflection of earlier major imbalances and, in particular, of the huge US balance-of-payments deficit. The acceleration of price increases, for its part, raises doubts concerning the ability of the world economy to grow at a relatively fast pace without rekindling inflation. Policy reactions to the currency upheavals have so far proved successful, but in regard to inflation they have remained inconclusive, to say the least. Preoccupation with exchange markets and price trends will continue to shape domestic and international monetary policies in ways which may have far-reaching consequences not only for the countries directly concerned but for the entire world economy. It is for these reasons that the main emphasis of this Report has been placed on an analysis of currency unrest and inflation. The object of this introductory chapter is to explain these reasons in detail.

The 1978 dollar crisis.

The first quarter of 1978 and the months of September and October witnessed exchange-market turmoil on a scale comparable only to that which had led to the final collapse, in early 1973, of the Bretton Woods system of pegged exchange rates. The main feature of this currency unrest was a sharp decline in the exchange rate of the US dollar against all other major currencies, both the traditionally strong ones and the rest, with the single exception of the Canadian dollar. While these currencies did not all appreciate at the same speed or to the same extent (the latest round of appreciations started with the yen, proceeded with the Swiss franc and ended with the Deutsche Mark, the latter exacerbating earlier tensions within the "snake"), their upward movement was sufficiently general to warrant defining this period of currency unrest as a genuine dollar crisis.

There are two facts that deserve careful consideration in the analysis of this crisis. The first is that it happened while all the major currencies were floating — not freely, admittedly, but floating nevertheless. It thus contrasted sharply with the crises of 1971 and early 1973, both of which took place under a régime of pegged rates. At that time many economists — and even some central bankers — had come to believe that floating rates, whatever their shortcomings, had at least one virtue, namely that they did not allow exchange crises to occur. Experience with floating rates since 1973 has brought about a progressive revision of these views, culminating in the reaction of the US authorities to last year's events, which included not only a sharp depreciation of the dollar, but also hectic exchange rate fluctuations and situations in which market participants simply found themselves without counterparts.

The immediate and obvious conclusion to be drawn from the analysis of exchange rate developments in 1978 is that neither the pegged nor the floating system can work properly when there is a loss of confidence in the internal and external value of the main international reserve and trading currency. This Report takes the view — already foreshadowed in the warning sounded two years ago about the dangers inherent in the then emerging large US external imbalance — that, whatever the exchange rate system, neither the United States nor the world can live with a large and persistent US current-account deficit. For the case of the United States differs sharply from that of other countries in several respects: firstly, in the dollar's rôle as a reserve and trading currency, which means that a substantial amount of dollar-denominated financial assets is held outside the United States; secondly, in the complete freedom that Americans have enjoyed since January 1974 with regard to external capital transactions; thirdly, in the fact that the total amount of dollars held by residents and non-residents represents a large portion of the world money supply. As a result, the dollar rate has become particularly sensitive to decisions taken by holders of liquid portfolios to diversify into, or out of, other currencies. Therefore, a loss of confidence in the dollar due to a large current-account deficit is likely to lead to a disorderly and excessive depreciation, fuelling inflation in the United States and causing excessive appreciations elsewhere — not to mention its impact on the prices of oil and other commodities.

A corollary of this argument, however, is that the world also needs to avoid large and persistent current-account surpluses run by the OPEC countries or by certain industrial countries: for, if not the United States, who will assume the counterpart deficits over and above the "normal" — i.e. sustainable — deficits of the non-oil LDCs?

The second fact that has to be borne in mind when drawing lessons from the dollar crisis is that the currency unrest came to a climax precisely at a moment when there were clear signs — not just forecasts — that the world as a whole was moving towards a more balanced pattern of current external accounts than at any time since the 1973–74 oil crisis. The OPEC surplus was shrinking to a manageable size; many former deficit countries were running surpluses; the deficit on the US current account was being gradually reduced; and even Japan's "real" current balance was moving towards equilibrium, with the "money" balance lagging behind as a result of the sharp but presumably temporary upswing in the terms of trade. The fact that the markets did not recognise these improvements until the turn of the year cannot simply be ascribed to a lack of information or perception. The information was publicly available and the markets are not so myopic. What was lacking was conclusive evidence that the US authorities really did care about the internal and external value of the dollar. That evidence was supplied by the measures announced on 1st November, which signalled a deliberate tightening of monetary policy in response to external constraints as well as a firm commitment to intervene in the exchange markets. After a few months' testing, the markets came to the conclusion that the US authorities, jointly with those of the other countries concerned, were determined to keep the situation under control. Hence the change in market sentiment and the remarkable reversal of speculative capital flows during the early months of 1979.

This Report welcomes the general recognition that what is needed in order to avoid exchange crises, and especially a dollar crisis, is both a sustainable pattern of external balances and credible public commitments to exchange rate stability — in other words, a combination of sound fundamentals and willingness to intervene decisively in the foreign exchange markets. *Both* are essential and neither will suffice by itself. After having been tested, the commitment to intervention has now become a fact. What is still needed is confirmation that current accounts will continue to move in the right direction. Unfortunately, more recent developments are bound to temper the optimism that would have been justified on the basis of events in 1978. The upsurge in oil prices will undoubtedly strengthen the OPEC surplus, raising again the tricky question of who is to shoulder the burden of the corresponding deficits. The difficulty is compounded by the resurgence of inflation, which may prompt policy responses that will slow down, or even reverse, the process of adjustment of external balances. This question is taken up again below and in the Conclusion.

The US authorities' commitment to large-scale intervention also has implications for the longer-term development of the international monetary system. One of the components of the new US policy has been the acquisition of foreign exchange reserves not only through swaps with central banks but also through borrowing from the IMF and, on a medium-term basis, in the German and Swiss domestic markets. This has been a small, official step towards a multiple reserve currency system, which would become even more explicit if the United States were to acquire exchange reserves through market intervention.

Another, less direct, consequence of the dollar crisis has been the establishment of the European Monetary System. It can, of course, be argued that for countries closely linked to one another through trade the attempt to create a zone of relative exchange rate stability is only natural. But it is equally safe to assume that the dollar crisis has played a powerful rôle in demonstrating the desirability of such an attempt in a destabilised world. In its present form the EMS is still no more than a clearly defined and detailed set of rules for exchange-market intervention and a more or less widely shared hope that central rate adjustments will not only be smooth and well-timed but will, indeed, be made less necessary through a convergence of policies and performances. Even this modest scheme can help to restore calm in intra-European exchange markets if member countries are willing to follow the rules of the game. In the longer run, however, the EMS could become more than a zone of relative stability: it could become a partner of the United States in shaping a common dollar intervention policy, thus promoting greater exchange rate stability in the world as a whole.

The resurgence of inflation.

While it seems proper to strike a cautiously optimistic note when considering the change in official attitudes towards the stabilisation of exchange rates and the resultant calm in the foreign exchange markets during the early months of 1979, there would seem to be little or no cause for optimism in the face of the more recent deterioration in price performances.

A re-acceleration of inflation has been perceptible in most industrial countries. It has been under way for over two years in the United States; more recently, it has manifested itself at consumer price level in the United Kingdom, Italy, Germany and Switzerland; both in these countries and in many others there has been a noticeable upturn in wholesale prices. Last but not least, many commodity prices, particularly those of industrial raw materials and of oil, have registered substantial increases. These price developments raise disturbing questions.

Firstly, in many instances they have been occurring in countries with, by conventional standards, large margins of unused capacity and substantial unemployment. The single major exception to this general rule is the United States, where for some time there have been clear signs of excess demand for goods, services and even labour. Does this mean that conventional measures of excess capacity and unemployment have become misleading? Or, in view of persisting inflationary expectations can one any longer resort to the now somewhat discredited but so tempting distinction between demand-pull and cost-push inflation? The same dilemma applies to primary commodities, the prices of which have recorded sharp increases on the world markets even when productive capacities — except in the case of oil — seem to have been far from fully utilised.

A second disturbing factor is that some of the most unexpected and sudden increases in consumer or wholesale prices have taken place in countries which had earlier been most successful in bringing inflation under control. This is particularly true of Germany and Switzerland, and to a lesser extent of Japan, where the deceleration of inflation was more recent, though quite spectacular. As the recent revival of inflation in these countries has coincided with the decline in the effective exchange rates of their currencies, the question that naturally springs to mind is whether their past successes were not partly ascribable to currency appreciation rather than to real control of domestically generated inflation. For how else could recent import price increases have been transmitted with such speed, and so fully, to domestic prices? Or do these price increases simply confirm the old assumption that prices are rigid downwards but flexible upwards — thus demonstrating the "ratchet effect" of exchange rate fluctuations?

Finally, most disturbing of all is the widespread nature of the resurgence of inflation. The fact that inflation has been accelerating in most countries in one form or another points to the existence of equally general, common causes and at the same time rather discredits the complacent search for ad hoc explanations. Is one common cause to be found in the faster growth of money supplies? Should the blame be put on an unduly rapid expansion of international liquidity? Or, more modestly, should the responsibility be laid on the sharp reversal of the industrial countries' terms of trade, which has put an end to the fools' paradise in which some of these countries have been living for the past two years?

This Report tries to offer tentative but, it is hoped, plausible answers to some of these questions. Implicitly, the authorities have already been giving their own answers by contemplating or actually adopting counter-inflationary policy measures. At the international level, the main focus of concern has been the actual or potential inflationary impact of the very rapid expansion of foreign exchange reserves over the last few years, and — a concurrent phenomenon — the equally fast growth of international bank lending. Should steps be taken to moderate the growth of international bank lending in general, and its Euro-currency component in particular?

Concern with domestic inflation is far more advanced, and has given rise to a series of policy measures. Since last autumn, monetary policy in the United States has assumed a more restrictive stance in response to the deteriorating price performance of the US economy. Two of the largest traditional surplus countries — Germany and Japan — have raised their discount rates and seem to be only too happy that the reversal of capital flows which occurred in the first few months of 1979 has relieved them of the heavy burden of mopping up the excess liquidity created by their intervention in support of the dollar last year. Other countries do not yet seem to have applied the brakes strongly; but nor had they ever fully released them. Many of them are sticking to their monetary targets, which clearly exercise a restraining impact, as do the incomes and wages policies which have remained in force, directly or indirectly, in a number of countries.

It need hardly be stressed that inflation is a bad thing for any economy considered individually. It leads to unjust distortions in income distribution and creates a climate of uncertainty which erodes the basis for rational investment decisions oriented towards real growth. Anti-inflationary policy measures are therefore highly welcome. But they should be co-ordinated internationally so as to prevent the resurgence of payments imbalances and a repetition of currency crises. One of the main themes running through this Report — and more fully developed in the Conclusion — is that the recent oil price increases and the boom in the market for industrial raw materials, coupled with the revival of inflation in individual countries, foreshadow new dangers. These forces may produce a constellation of cyclical developments and policies, which, without bringing *world* inflation immediately under control, may undermine the process of current-account adjustment which started a year ago, hence leading simultaneously to renewed currency unrest *and* a major recession. This could well happen if restrictive measures were concentrated in the traditionally conservative, strong-currency countries rather than in the United States.

Structure of the Report.

Chapter II sums up the recent development of output in the main industrial countries by analysing the behaviour of the components of global demand. It makes three broad points. Firstly, that while there is no convincing evidence to substantiate generalised pessimism concerning the working of demand management, different approaches to the rôle of demand management in an inflationary world have been one of the major causes of payments imbalances between industrial countries — and have hence presumably contributed to currency unrest. Secondly, that more recently demand management has on the whole made a positive contribution to the successful process of balance-of-payments adjustment in both the deficit and the surplus countries. Thirdly, that with the resurgence of inflation and the poor productivity performance of many countries the scope for the further expansion of demand has been curtailed.

Chapter III calls attention first to the pronounced changes in the pattern of inflation rates that have occurred over the past two years. It then examines some of the possible reasons for the strong resurgence of US inflation and the related decline in the dollar. It goes on to discuss the elements of "vicious" and "virtuous" circles in exchange rate/inflation movements which last year accentuated exchange-market turbulence and amplified inflation differentials. Policy changes since late 1978 have interrupted, and to some extent reversed, these movements. But a major implication is that, in a highly interdependent world under floating exchange rates, the US economy no longer seems in a position to move strongly out of line, in terms of real output and prices, with the rest of the world. Moreover, given the sensitivity of prices and wages to demand and cost impulses, the industrial countries may have to resign themselves to cautious policies of growth. From this it also follows that they must renew their efforts to cope with unemployment — in many countries still severe — by means of structural measures designed to improve skills, increase labour mobility and encourage investment and productivity.

Developments in monetary and credit markets (Chapter IV) reflected the sharp divergences which had emerged in countries' economic policies and performances. They were also strongly influenced, however, by the changing fortunes of the dollar and, more recently, by the general worsening of the outlook for inflation. The chapter explains why, despite the use of monetary targets, US monetary policy and total credit flows accommodated a rapid growth of nominal domestic demand, with interest rates rising by little more than the inflation rate. Other countries, particularly Germany, Switzerland and Japan, had been more successful in stabilising and gradually bringing down their rates of monetary expansion. However, as a result of the dollar's decline, exacerbated by large shifts in international currency portfolios, their monetary policies came increasingly into conflict with their desire to limit excessive swings in exchange rates and to maintain the momentum of recovery. One consequence was an increased emphasis in monetary policies on currency stability. Another was a shift to a somewhat more restrictive stance of monetary policy, first in the United States and then, as the dollar strengthened and signs of inflation appeared, also in Germany, Japan and Switzerland. In most of the other industrial countries, meanwhile, monetary policy had been kept on a fairly cautious track which still seemed broadly consistent with both domestic and external considerations.

Chapter V, which discusses balance-of-payments developments, has two principal themes: first, the reduction of the oil-exporting countries' current payments surplus in 1978, which produced a world balance-of-payments pattern for last year not dissimilar to that which prevailed before the 1973 oil price increases; secondly, the very large payments imbalances in the Group of Ten countries and Switzerland last year, together with the progressive movement towards a better balanced position in that group which occurred during the course of the year and in the early part of 1979, particularly in Japan and the United States, but which was obscured for a time by the terms-of-trade effects of exchange rate movements. More recently, a fresh disequilibrating element has entered the picture, following the renewed increases in the price of oil and other primary commodities. These will raise the oil-exporting countries' surplus again and may complicate the achievement of continued progress towards better balance between the main industrial countries.

Chapter VI traces the development of the international financial markets, which in the field of bank credit was characterised last year by the coincidence of very rapid growth with extremely easy market conditions. It seeks to explore the forces behind this development, such as the shifting pattern of international payments imbalances and the liquidity-creating effects of the huge US official settlements deficit. Particular attention is paid to the rôle of the banks in currency unrest and, conversely, to the influence of the exchange rate uncertainties on the performance of the individual market sectors.

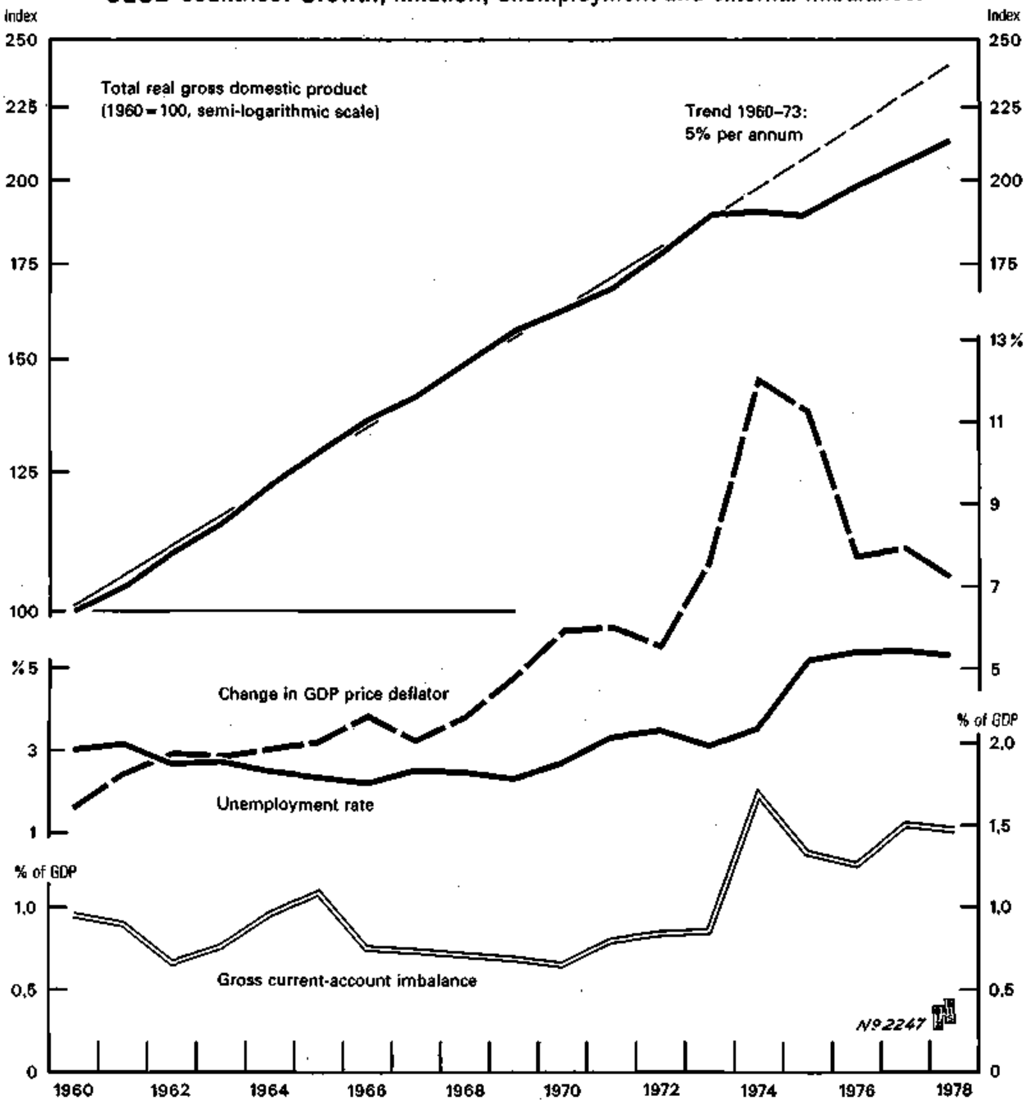
In Chapter VII, which deals with the principal developments in the international monetary system during the period under review, the focus of attention is on two themes: first, last year's major currency crisis, centring on the weakness of the dollar, and the related changes in official attitudes and policies towards greater emphasis on exchange rate stability, as expressed most notably in the measures which the US authorities announced last November, but also in the actions of the Swiss authorities and in the setting-up of the new European Monetary System; secondly, the continuing rapid growth of international liquidity last year, associated to a large extent with the dollar crisis, and the policy problems which this may raise.

The Conclusion sums up the main policy recommendations.

II. OUTPUT AND DEMAND IN THE WESTERN INDUSTRIAL COUNTRIES.

Taking the year as a whole, 1978 appears at first sight to have witnessed remarkably little change in the overall economic situation. As the graph shows, the OECD area registered a rate of output growth almost identical to that in 1977 — around 3 ½ per cent. However, despite the fact that this was below the rate of growth of productive potential recorded prior to the oil crisis, the average level of unemployment hardly changed at all. Nor did the average rate of domestic inflation — as measured by GDP deflators — decelerate much further, as might have been hoped in the light of the continuing high level of unemployment and of the weakness of

OECD countries: Growth, inflation, unemployment and external imbalance.



commodity prices, at least for the first half of the year. The degree of gross current-account imbalance of the OECD countries also remained appreciably larger than during the pre-1973 period, even though the surplus of the major oil-exporting countries fell to below $10 billion, compared with about $65 billion in 1974.

However, when one begins to look both at performance during the year and at divergences between countries, significant changes become apparent. Thus, the US economy remained surprisingly strong throughout the year, with GNP growth slowing only to about 4 per cent. from 5 per cent. the previous year. Elsewhere there was an acceleration, led in Europe first by the United Kingdom and then by Germany. In Japan the acceleration was marginal in output terms, but in terms of domestic demand it was appreciable — from 4 to 7 per cent. This move towards more convergent behaviour tended to swing real net export balances in the direction of greater equilibrium. It did not, however, do so sufficiently, or early enough, to prevent a serious outbreak of currency instability in the second half of the year (in which, of course, other factors also played a rôle), which resulted in a significant depreciation of the dollar.

Larger industrial countries:
Changes in real gross national product and its components.

Countries	Years (4th quarter)	Real gross national product	Final demand*	Consumption		Gross fixed investment			Exports	Imports
				private	public	private		public		
						non-residential	residential			
		annual percentage rates of change in year to fourth quarter								
United States	1975	2.4	3.4	5.1	1.9	− 9.9	6.6	7.6	− 1.2	− 7.1
	1976	4.6	4.1	5.7	0.8	8.6	23.6	−13.0	4.6	18.9
	1977	5.5	4.9	4.8	5.5	9.1	15.3	2.5	− 1.3	10.3
	1978	4.3	4.4	4.1	0.4	8.5	− 0.2	9.6	16.4	9.4
Japan	1975	3.4	3.5	4.4	5.8	− 4.2	7.9	0.1	− 0.9	− 8.6
	1976	5.0	4.2	4.1	2.2	2.9	− 3.0	− 3.4	21.7	14.7
	1977	5.7	6.3	3.7	5.1	1.5	5.8	22.3	5.5	− 3.3
	1978	5.8	5.6	6.5	5.2	11.9	8.0	21.8	− 2.5	20.6
Germany	1975	1.6	2.1	4.1	5.1	7.2	− 2.7	− 2.5	− 1.0	6.4
	1976	4.1	2.6	3.0	0.0	5.5	8.3	− 3.9	11.0	13.1
	1977	2.8	3.5	3.2	2.3	4.6	1.7	1.4	3.1	1.6
	1978	3.7	3.2	3.5	2.8	10.3	3.4	6.7	5.4	10.0
France	1975	2.2	3.6	7.3	1.1		2.3		− 0.7	6.4
	1976	4.9	1.8	2.6	2.7		4.7		10.1	15.7
	1977	2.7	3.6	2.3	0.2		− 1.8		6.4	3.7
	1978	4.4	2.4	4.1	1.2		1.4		6.0	10.3
United Kingdom	1975	− 0.6	1.0	− 3.1	5.0	− 4.9	− 0.2	− 3.1	1.8	− 7.2
	1976	4.5	2.0	2.8	0.3	2.0	− 6.3	−13.4	9.3	6.0
	1977	2.3	2.1	− 0.6	0.0	7.4	10.6	−16.7	2.9	− 4.3
	1978	1.5	2.4	5.4	1.7	3.5	0.2	−12.6	3.9	8.0
Italy	1975	0.6	.	2.3			−11.4		10.3	5.9
	1976	6.3	.	4.3			7.4		12.3	5.7
	1977	− 1.4	.	−2.6			− 5.1		3.1	− 3.6
	1978	5.6	.	5.7			5.2		7.7	4.6
Canada	1975	2.8	7.2	8.8	2.6	7.8	18.0	− 1.3	− 3.4	− 1.8
	1976	4.6	3.2	5.8	1.2	− 1.2	2.6	− 7.7	9.0	7.0
	1977	3.5	3.6	1.2	2.6	− 0.3	− 6.2	8.3	8.1	− 0.5
	1978	3.1	1.7	2.9	1.5	5.7	− 3.7	0.4	10.5	11.9

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

Developments in total demand.

Broadly speaking, the industrial countries as a whole experienced only a minor net stimulus from abroad during 1978, virtually all of which appeared in the form of an improvement in the terms of trade. This improvement gave some relief in the field of cost pressures and real incomes, although towards the end of the year it looked as though the effect was being reversed as commodity prices began to move up again. In addition, those countries, notably the United States and Canada, whose currencies depreciated sharply, found the potential gain wiped out, while countries with appreciating exchange rates found the terms-of-trade gains magnified.

Other industrial countries:
Changes in real gross national product and its components.

Countries	Years	Real gross national product	Final demand[1]	Consumption		Gross fixed investment			Exports	Imports
						private				
				private	public	non-residential	residential	public		
		annual changes, in percentages								
Austria	1975	— 1.5	1.6	3.0	3.7	— 5.0[2]	— 4.5[3]	. [4]	— 3.7	— 5.8
	1976	6.2	1.6	4.6	3.7	9.7[2]	2.0[3]	. [4]	12.2	20.7
	1977	3.7	4.2	6.2	1.9	11.3[2]	2.5[3]	. [4]	6.1	9.5
	1978	1.4	2.1	— 1.5	2.1	— 7.0[2]	2.6[3]	. [4]	6.4	— 1.3
Belgium . . .	1975	— 2.0	1.0	0.3	5.2	— 0.5	— 4.1	. [4]	— 8.8	— 9.9
	1976	5.8	4.8	6.0	5.0	— 2.4	16.1	. [4]	8.4	9.2
	1977	1.2	1.3	2.1	3.4	— 1.3	0.6	. [4]	3.5	4.4
	1978	2.2	2.5	1.6	6.5	3.9	— 5.0	. [4]	3.5	3.1
Denmark . . .	1975	— 1.2	.	3.7	5.3	—12.4	—16.8	— 1.9	— 2.4	— 4.2
	1976	6.3	.	5.5	5.1	13.9	25.4	2.8	3.4	16.8
	1977	1.9	.	0.4	3.1	1.0	—10.0	— 1.5	4.6	— 1.2
	1978	1.0	.	— 0.8	3.8	1.0	— 2.0	3.5	3.8	1.7
Finland	1975	0.9	1.0	3.7	6.4	12.1	— 3.6	5.5	—14.0	0.4
	1976	0.3	2.7	0.5	4.7	—10.7	—11.5	— 2.0	13.7	— 3.3
	1977	0.4	2.5	— 2.2	4.7	— 8.7	4.2	— 2.2	9.9	— 6.0
	1978	2.3	2.9	0.0	5.0	— 8.0	— 0.3	1.5	8.4	— 3.0
Netherlands .	1975	— 0.9	2.0	3.4	3.9	— 7.5	— 7.5	7.7	— 3.0	— 4.1
	1976	4.5	2.8	3.8	4.0	14.7	2.5	— 1.9	10.6	10.9
	1977	2.4	2.3	4.3	3.6	— 3.1	15.9	— 7.5	— 2.1	3.6
	1978	2.3	4.2	4.5	1.3	6.2	3.0	— 2.0	2.8	5.8
Norway	1975	5.5	6.6	5.0	6.2	14.2	7.8	10.0	3.0	5.4
	1976	6.8	6.9	6.4	6.5	13.1	2.5	3.8	11.3	12.3
	1977	3.6	5.2	4.7	9.8	1.0	4.6	5.9	3.8	2.8
	1978	3.5	4.6	— 2.5	3.7	—21.3	0.3	9.1	8.8	—12.5
Spain	1975	0.7	1.4	1.8	6.0	— 2.9[2]	— 2.0[3]	. [4]	— 1.3	— 2.6
	1976	2.0	2.6	2.8	5.5	1.7[2]	— 3.9[3]	. [4]	9.4	5.7
	1977	2.6	2.4	0.2	4.5	— 2.2[2]	— 1.0[3]	. [4]	10.4	— 5.3
	1978	2.9	2.6	0.7	7.4	— 9.3[2]	— 2.4[3]	. [4]	13.4	— 5.8
Sweden . . .	1975	0.7	— 0.7	3.0	4.9	— 1.7	— 0.1	1.0	—11.5	— 1.6
	1976	1.2	2.1	4.1	4.2	1.4	— 8.8	— 0.3	4.7	7.4
	1977	— 2.5	0.9	— 0.6	2.3	— 4.9	— 2.5	— 0.2	0.6	— 3.3
	1978	2.5	2.9	— 1.1	3.2	—15.9	18.6	5.4	7.0	— 6.0
Switzerland . .	1975	— 7.7	— 3.2	— 2.9	0.7	—17.7[2]	—11.1[3]	. [4]	— 6.8	—14.3
	1976	— 1.2	— 1.2	0.5	4.0	—14.6[2]	— 8.6[3]	. [4]	10.1	11.2
	1977	2.7	3.0	2.8	— 0.1	4.1[2]	0.2[3]	. [4]	9.4	8.5
	1978	1.2	1.1	1.8	2.2	6.0[2]	1.0[3]	. [4]	5.4	9.6

[1] Equals change in real gross national product minus net investment in inventories. [2] Machinery and equipment. [3] Total construction. [4] Included in private investment.

Domestically — and again speaking in very broad terms — the major influences on short-term movements in total demand come from changes in the balance of saving and investment in both the private and public sectors. The latter — which is basically a measure of fiscal policy — certainly provided some modest stimulus on average outside the United States and should do so again this year. The two most publicised cases were, of course, Japan and Germany, though in fact several other countries in Europe turned towards a rather greater degree of fiscal expansiveness after two years which had witnessed a certain amount of retrenchment. In the private sector, however, there seems to have been little change in net spending behaviour on the whole. Household-sector savings ratios showed no major movement, though the balance was upwards — that is, contractionary. In the corporate sector, investment spending was reasonably strong, particularly in Germany, Japan, the Netherlands and the United States. On the other hand, part of the terms-of-trade gain mentioned in the previous paragraph, as well as part of the slowdown in wage-cost increases (e.g. in Germany, Japan and Italy) probably went to support profits rather than being wholly passed on in slower price rises. This may have provided some of the long-awaited encouragement to larger investment outlays. In the United Kingdom, where wage-cost increases accelerated last year, price/cost relationships moved in the other direction.

Consumer expenditure. The volume of consumer spending in the industrial countries probably rose on average by about 3½ per cent. last year, much the same as in 1977. In the major countries alone, the figure was slightly higher. The tables on page 14 roughly demonstrate the main influences affecting the movement of real spending in the seven largest industrial countries over the past two years. In four of the countries shown there was some deceleration in earnings growth per employee last year, especially in Italy and Canada, while in the United States and France earnings growth was steady, but in the United Kingdom there was some acceleration. However, in all cases there was further growth in numbers employed, particularly in North America, so that the rise in nominal pre-tax income was still relatively strong. Indeed, because of the large employment gain, nominal income growth accelerated slightly in the United States, as it did too in the United Kingdom. The real spending power of these income changes is affected by both price movements and net tax changes. In most countries, consumer price increases were somewhat lower last year, reflecting in part favourable movements in import prices (column 4). This is the terms-of-trade effect already referred to. The effect was magnified for some countries by currency appreciation, especially in Japan, Germany and Switzerland, while for the United States and Canada exchange rate depreciation worked in the other direction. In fact import price rises accelerated last year in Canada, and for both countries the rise in consumer prices was greater than in 1977. Thus the changes in real income before tax (see lower table), which on the whole were quite large, had different causes in different countries. For the United States the rise was nearly as big as in 1977 — there was no favourable terms-of-trade effect, but nominal income growth was large, in particular because of the growth of employment. In Canada a fairly pronounced decline in earnings increases, together with a faster rise in import prices, reduced the real pre-tax income gain. In Japan and the United Kingdom there were sharp accelerations in such gains, due largely in the former case

Earnings and prices.

Countries	Annual changes in									
	Average earnings (1)		Civilian employment (2)		(1) x (2) (3)		Import prices (4)		Consumer prices (5)	
	1977	1978	1977	1978	1977	1978	1977	1978	1977	1978
	in percentages									
United States . .	8.6	8.6	3.5	4.2	12.4	13.2	8.2	8.7	6.5	7.7
Japan.	9.5	6.9	1.3	1.2	10.9	8.2	−2.9	−17.9	8.1	3.8
Germany	7.5	5.1	−0.2	0.2	7.3	5.3	1.4	− 4.0	3.9	2.6
France	12.7	13.1	0.8	0.6	13.6	13.8	11.7	0.9	9.5	9.3
United Kingdom.	10.3	14.5	0.4	0.1	10.7	14.6	16.3	4.3	15.9	8.3
Canada	10.8	7.2	1.9	3.3	12.9	10.7	11.7	12.6	8.0	9.0
Italy	27.9	16.2	1.0	0.4	29.2	16.7	16.0	5.2	18.1	12.5

to terms-of-trade movements and in the latter to these as well as to an acceleration of earnings and a stable exchange rate. In Germany the terms-of-trade gain to consumers was accompanied by slower wage inflation, while in Italy the remarkable success in slowing down nominal wage increases had a marked effect on real income.

Changes in net social benefits and direct taxes generally contributed positively to the growth of real disposable income last year, except in the United States and, to a lesser extent, Japan. It should be borne in mind, of course, that this is only one part of fiscal policy, which is discussed in more detail below. Other items of public expenditure are omitted, as are indirect tax changes and other revenue changes. Nevertheless, it is via the measure given in column 2 that fiscal policy most affects consumers directly. Interestingly there was little or no effect from this source in Japan, fiscal stimulus coming largely through public expenditure increases instead.

Disposable income and consumer spending.

Countries	Change in real income before tax (1)		Effect of change in net direct taxes* (2)		Change in real personal disposable income (3)		Effect of change in savings ratio (4)		Change in consumer spending (5)	
	1977	1978	1977	1978	1977	1978	1977	1978	1977	1978
	annual percentage changes									
United States . .	5.5	5.1	−1.1	−0.9	4.2	4.3	0.6	−0.2	4.7	4.0
Japan.	2.6	4.2	0.0	−0.3	2.6	3.5	1.2	0.8	4.2	4.9
Germany	3.3	2.6	−0.3	0.6	1.8	3.8	1.0	0.0	3.1	3.8
France	3.7	4.1	−0.1	1.2	3.8	4.9	−0.9	−0.9	2.4	4.0
United Kingdom.	−4.5	5.8	0.6	1.5	−1.8	6.4	0.8	−0.7	−0.9	5.5
Canada	4.5	1.6	1.0	1.5	2.7	2.8	0.1	−0.2	2.8	3.1
Italy	9.4	3.7	−1.2	0.3	1.7	4.0	−2.1	−0.9	1.5	2.6

* As a percentage of disposable income.

Note: The individual columns do not include all the factors influencing changes in consumer spending; in particular changes in net property income and income from self-employment are omitted.

And in the United States the effect was again negative, as it had been in 1977. In this case, however, much of the apparent tightening of fiscal stance against the personal sector was no doubt automatic, increases in employment and earnings raising tax receipts and a large fall in unemployment reducing social security outgoings. Social security taxes were, however, also increased on a discretionary basis. Elsewhere, the fiscal system added moderately to the growth of real personal disposable income, although on average the change compared with the preceding year was not great.

Finally, changes in savings behaviour were contractionary on balance last year, compared with some positive impact in 1977. In the United States the savings ratio had already fallen back to a relatively low level in 1976 from the post-oil-crisis peak. The United States seems to be the only country in which consumer behaviour has moved, in response to inflation, towards a "buy now rather than later" attitude, and consumer borrowing has reached record proportions. However, it is also true that demographic factors there are encouraging low net savings behaviour: there has been a bulge in the proportion of young married couples in the age group where borrowing is normally relatively high, e.g. for buying and furnishing a home. This phenomenon reflects the "baby boom" in the early post-war period. In Germany, too, the savings ratio has returned to more normal levels, though here it may be the decline in inflation which is an important factor, in that the real value of past financial savings is not being eroded so quickly. In both these countries it is difficult to foresee any further stimulus to consumer spending from this source, though in the United States the demographic development mentioned above is going to intensify for some considerable time to come. Elsewhere, it remains to be seen whether the threat of renewed inflation will encourage spending or revive some degree of cautious behaviour in the household sector.

Ratios of personal savings to disposable income.*

Countries	1974	1975	1976	1977	1978
	in percentages				
United States	7.3	7.7	5.7	5.1	5.3
Canada	9.9	10.9	10.8	10.7	10.9
Japan	23.7	22.5	22.4	21.2	20.4
France	17.4	18.6	16.4	17.3	18.2
Germany	16.1	16.4	14.7	13.7	13.7
Italy	21.3	25.4	23.7	25.8	26.7
United Kingdom	14.3	15.0	14.5	13.7	14.4

* Based on national sources and BIS estimates.

Private investment. In the industrial countries as a group private non-residential fixed investment showed only a moderate further increase last year as most countries continued to experience low rates of profit compared with historical averages, as well as relatively low rates of capacity utilisation. There were, however, appreciable increases in the United States, Germany and Japan.

The exchange rate changes during 1978 gave rise to fears about profitability in the countries with appreciating exchange rates. At the height of the exchange rate turbulence it seemed that export profitability might be seriously reduced. In turn this might have led to cutbacks in investment spending and hence to some cancelling-out of the fiscal attempts to stimulate domestic demand after the Bonn summit. This fear was particularly acute in Switzerland and Japan.

Broadly speaking, an appreciation of the exchange rate greater than the inflation differential between the country concerned and the rest of the world will tend to put pressure on profit margins in export and import-competing industries. This will be offset to some extent by a reduction in the prices of imported materials and components, and for the non-traded goods sector the fall in import costs will increase profit margins to the extent that it is not passed through to final prices. (As has been noted above, it seems that in some countries final buyers did in fact benefit to some degree last year from both currency appreciation and relatively favourable commodity prices.) Thus it is not a priori clear what will happen to profit margins over the economy as a whole when the real exchange rate changes. Unfortunately, data in this area are rather inadequate, but, judging from the movements in costs and prices in manufacturing, it seems that profit margins were not greatly affected last year in the appreciating countries, while they rose in Canada and the United States — the two major countries whose currencies depreciated. In Japan there has been remarkable success in holding down unit labour costs, which last year were only 1 per cent. higher than in 1975, and in Germany profit margins probably rose. In Switzerland, however, there may have been some decline.

This is not to say that the exchange rate changes will not have affected investment. In none of the appreciating countries did domestic costs fall by the full amount of the appreciation, so that, with the margin of profit not changing much, relative price competitiveness was severely affected, which is simply another way of saying that "real" exchange rates changed. The loss of relative price competitiveness may be expected to affect export and import-competing sales, of course, and in fact export orders in Japan had already fallen by nearly a quarter by the end of last year. It seems, therefore, that if investment spending is going to be affected by the currency appreciations of last year, it will be via lower actual and expected sales. That is, it will be lower-than-optimal capacity utilisation rates rather than profit margins which will be the dominant factor. Put another way, the necessary adjustment of real foreign balances in the surplus countries will be accompanied by lower demand pressures unless domestic demand is a strong enough offset to maintain or increase capacity utilisation rates, thus ensuring that the volume of profits, as well as profits per unit of output, will be sufficient to justify further increases in capital spending. It is in this context, among others, that the net demand effects of the public sector are important.

Fiscal policy.

Outside the United States there was probably on average some movement towards fiscal stimulus last year after retrenchment in 1977. The accompanying table shows that for most countries in Europe, and for Japan, the deficit in the finances of the general-government sector (which excludes public corporations) increased as

General-government financial balances[1] and unemployment.

Countries	Items	Annual changes					Annual averages	
		1974	1975	1976	1977	1978	1974	1978
		in percentages						
United States . .	Unemployment	0.7	2.9	−0.8	−0.7	−1.0	5.6	6.0
	Financial surplus	−0.7	−4.0	2.2	1.0	0.9	−0.2	− 0.1
Japan	Unemployment[2]	0.6	0.5	0.0	0.1	0.0	1.2	0.5
	Financial surplus	−1.0	1.1	−1.0	−1.1	−1.3	−3.8	− 6.1
Germany	Unemployment	1.3	2.1	0.0	−0.1	−0.2	2.6	4.4
	Financial surplus	−2.5	−4.4	2.1	1.0	−0.1	−1.3	− 2.7
France	Unemployment	0.2	1.6	0.4	0.6	0.4	2.3	5.3
	Financial surplus	−0.3	−2.8	1.8	−0.9	−0.8	0.6	− 2.1
United Kingdom .	Unemployment	−0.2	1.4	1.5	0.4	0.0	2.4	5.7
	Financial surplus	−1.4	−0.8	−0.2	1.8	−1.0	−2.6	− 4.0
Italy	Unemployment	−0.6	0.4	0.3	0.8	0.4	4.9	7.0
	Financial surplus	0.5	−5.8	2.6	1.0	−2.5	−5.9	−10.6
Canada	Unemployment	−0.2	1.6	0.2	0.9	0.3	5.4	8.4
	Financial surplus	0.9	−4.3	0.6	−0.8	−0.9	1.9	− 3.5
Belgium.	Unemployment	0.4	2.7	1.8	1.4	0.6	4.0	10.5
	Financial surplus	−1.5	−1.8	−0.8	−0.4	−0.2	−4.0	− 7.2
Netherlands. . .	Unemployment	0.9	1.6	0.3	−0.2	−0.1	3.6	5.2
	Financial surplus	−1.2	−3.1	0.4	0.7	−0.2	−0.1	− 2.3
Sweden.	Unemployment	−0.5	−0.4	0.0	0.2	0.4	2.0	2.2
	Financial surplus	−2.3	0.7	0.9	−3.4	−1.7	1.9	− 1.6
Denmark	Unemployment	1.4	2.6	0.1	1.1	0.8	2.0	6.6
	Financial surplus	−1.4	−6.9	1.9	0.0	0.2	4.5	− 0.2
Norway	Unemployment	−0.2	0.5	0.0	−0.2	0.2	0.6	1.1
	Financial surplus	−1.1	−1.9	−1.9	−1.8	−0.4	4.7	− 1.3

[1] Excludes public corporations. The financial surplus or deficit (—) is the difference, in the national accounts sense, between general-government saving and its own investment, i.e. its net lending to other sectors. The figures are presented as percentages of GNP. [2] For Japan the pressure-of-demand indicator used is the ratio of labour demand to labour supply, with the sign of the changes reversed.

a proportion of gross national product. In the United States it was further reduced towards zero. However, as is well known, it is not possible to judge changes in the thrust of fiscal policy solely from movements in budget deficits. The budget balance both affects the economy and is affected by the economy. Thus, it may be that a widening of the budget deficit merely reflects weak developments in the private and external sectors; similarly, a narrowing of the deficit may just reflect autonomous strength elsewhere. With this in mind, the table also shows changes in the main indicator of demand pressure — in all cases except Japan, changes in the unemployment rate. To the extent that the two figures for each country move in opposite directions (unemployment falling and the budget gap being reduced or vice versa) it is not possible to say, from these data alone, whether fiscal policy is exerting an independent (or discretionary) effect on the economy or whether it is merely reflecting autonomous developments within it.

To measure fiscal stimulus more precisely one would need for each country an econometric model sufficiently detailed to allow calculation of the budget balance on a constant pressure-of-demand basis. This is done, for example, for the United States in the "high-employment" budget balance, which seems to indicate that, although most of the decline in the budget deficit there since 1975 has been an automatic response to the recovery, there was also a significant discretionary tightening of fiscal policy in 1976 and again last year.

Elsewhere last year, the figures in the table show in many cases contrary movements in demand pressure and the budget position, making it difficult to be quite sure of the stance of policy. In Germany, however, although the pressure of demand rose moderately for the year as a whole, the budget gap widened slightly, indicating an expansive policy. In Japan, too, although there was little change in the pressure of demand, the deficit widened further by a relatively large amount. In both these cases the change in fiscal stance during the year was greater than the annual figures suggest, because the outcome of the Bonn summit in mid-year led to policy changes in the second half. In addition, as the table on page 11 above makes clear, much of the stimulus in these countries derives from public expenditure on investment goods. Thus there is little doubt that fiscal demand management turned to moderate stimulus last year in these two countries, as it apparently also did in the United Kingdom, Sweden and Italy.

Relative pressures of domestic demand and external adjustment.

One of the more important features of the world economic scene since 1975 has been the growing extent of cyclical divergence between the industrial countries. On the one hand, demand and output in the United States have recovered substantially and continuously while, on the other, some countries have lagged far behind. The notable examples in the latter class are Japan, Switzerland and Italy, and, on an appreciably smaller scale, Germany. Perhaps not surprisingly, these divergent developments have been accompanied by an increasing degree of external imbalance among the industrial countries themselves, even though the imbalance between oil-exporting and oil-importing countries as a whole had diminished to modest proportions by 1978.

The obvious questions which arise are: to what extent have divergent movements in domestic demand been at the root of these developments, and what rôle have exchange rates played? Why, under a floating rate régime, did exchange rates not move to produce more current-account equilibrium? Or, given that exchange rate changes affect real exports and imports with a lag and that for a time capital movements may in some cases work in a disequilibrating direction, is it too much to expect the effects of exchange rate changes fully to offset short-term cyclical influences on current accounts? And does this increase the risk that at some stage — perhaps as in the autumn of last year — exchange rates may "overshoot" the levels needed to restore equilibrium (however defined), and even have perverse feedback effects on domestic demand developments? Finally, to the extent that we have moved into a world in which, by earlier standards, countries tend to pursue policies which may result in a greater average dispersion of demand pressures (e.g. with the strong anti-inflation countries maintaining a higher margin of slack than previously over the cycle as a whole), does this not make it difficult, if not impossible, to think in terms of "equilibrium" rates? In other words, what does it mean to speak of "overshooting" if some of the demand pressure divergence turns out to be more secular than cyclical?

Clearly, it is not possible to answer these questions at all precisely, but the following graphs do offer some clues. Broadly speaking, they provide a measure of the relative movement of real domestic demand in the main industrial countries and set this against the real net foreign balance — that is, net exports of goods and services at constant prices. In addition, for those countries in which there have been major changes, an index of the real effective exchange rate is given — that is, an indication of relative price movements corrected for exchange rate changes.

The figures for the relative domestic demand indicator were calculated as follows. The exponential trend line of real demand between 1965 and 1973 was first measured for each country and then notionally projected over the period 1974–78. The percentage deviations of actual demand from its previous trend were then calculated year by year for each country over these later years, and the simple unweighted average across all countries taken for each year. This average shortfall below previous trends was then fixed as the zero line in the upper sections of the graphs and the deviation of each country from the average performance was plotted as the demand line.

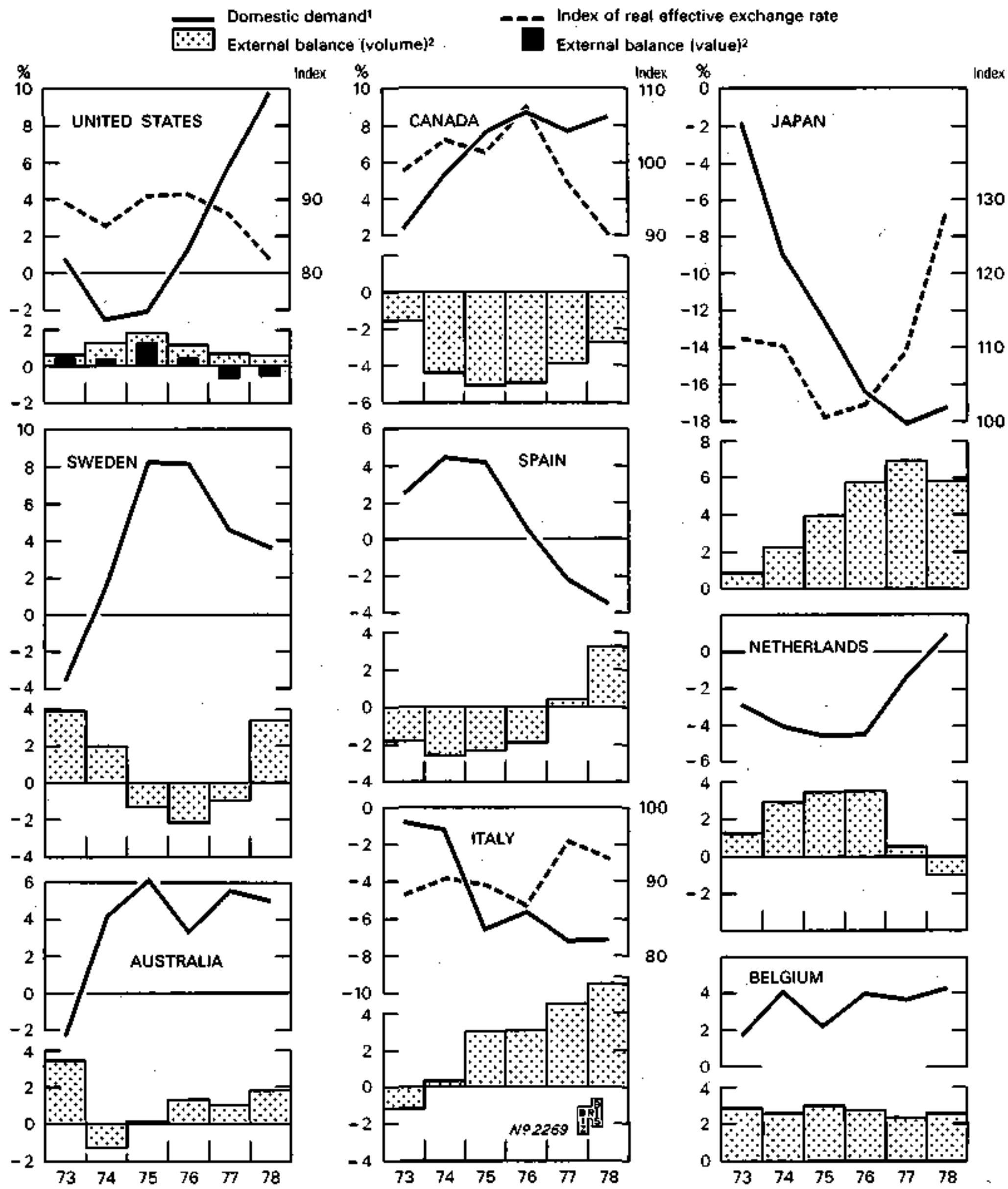
The real foreign balance figures shown are of net exports of goods and services at constant prices as a percentage of real gross national product. They are thus a major component of external current-account positions, which, in addition to reflecting terms-of-trade effects, also include such non-trade items as net transfers and net property income. For purposes of illustration, the panel for the United States also shows the overall current-account position as a proportion of nominal gross national product, thus making clear the shift into overall current deficit in 1977 and 1978.

The graphs show a rather remarkable degree of inverse relationship between movements in relative demand pressures and changes in real net exports — remarkable because many other factors may be presumed to affect external positions too, for instance, exchange rate and relative price changes, trend movements in non-price competitiveness and trade composition effects. The latter are, of course, excluded from the calculations when relative demand pressures are measured in so simple a way as is done here. However, some influences can be noted: for example, the Canadian real balance has improved over the past two or three years despite little change in relative domestic demand. This presumably reflects the fact that the US recovery has particularly affected Canada, a large proportion of whose exports goes to the United States, though devaluation of the Canadian dollar has no doubt played a rôle too. Similarly, the acceleration in the German recovery last year seems to have especially benefited some of its major European trading partners, such as Italy, France and Belgium.

For Norway and the United Kingdom, too, it should be borne in mind that the external position has increasingly benefited, over the years shown, from the coming-on-stream of North Sea oil production — a development which has little to do with demand pressures or relative prices.

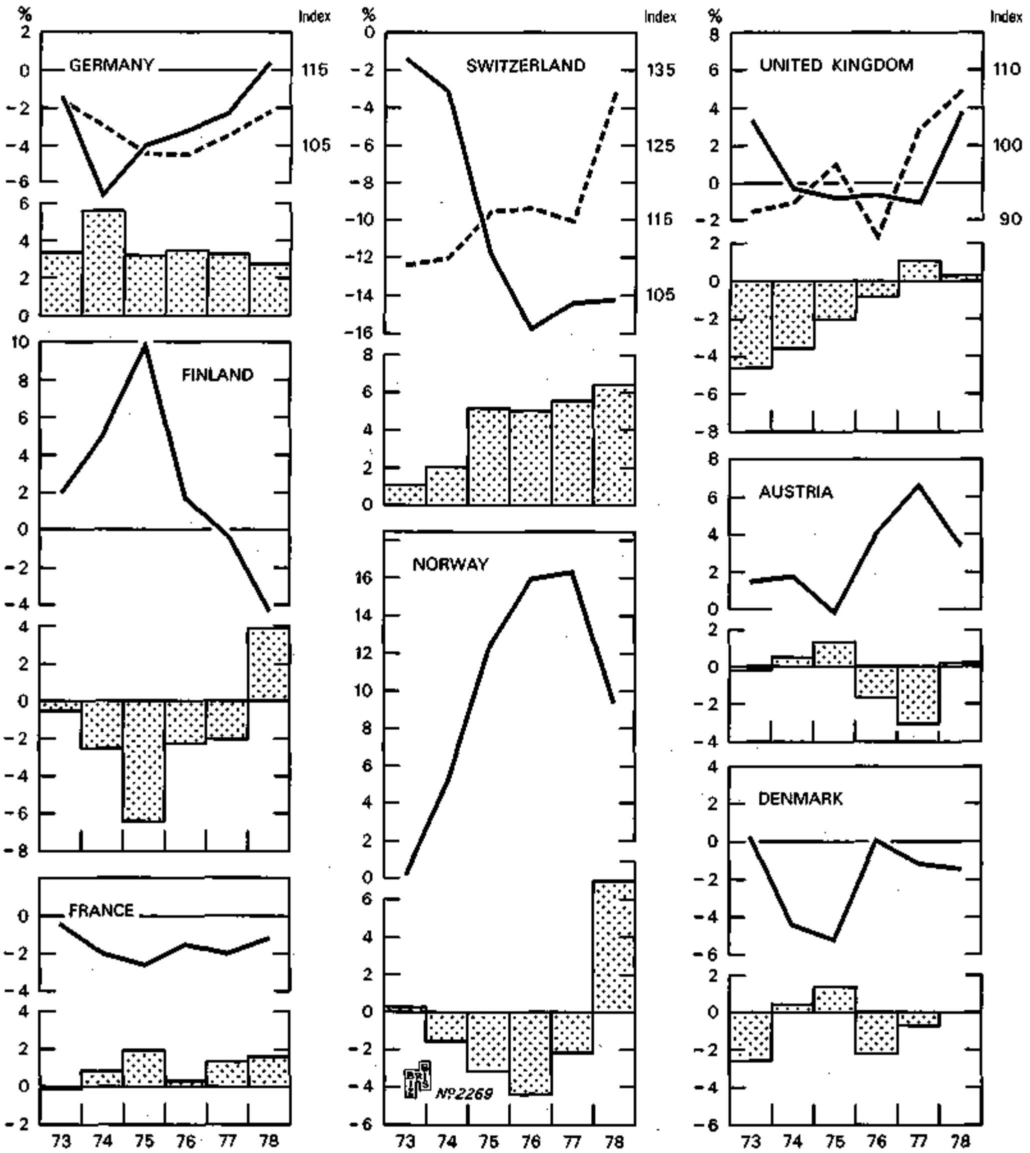
As far as changes in price competitiveness — or real effective exchange rates — are concerned, the graphs show that there was little major movement anyway before 1978, so that for most of the period shown it is perhaps not too surprising that

Relative demand pressures and real foreign balances.



relative demand pressures dominated the real foreign balances. However, relative price changes affect real exports and imports only with a lag — often a long one. The United States, of course, experienced a considerable devaluation in the two years prior to 1973, the first year shown, so that the improvement in its real external position in 1974 and 1975 no doubt owed something to delayed effects from this source, as well as to a somewhat deeper recession than the average. Relative price competitiveness also improved in Japan in 1974 and 1975, an improvement which

Relative demand pressures and real foreign balances (contd.).



[1] See text on page 19 for explanation. [2] Expressed as percentages of gross national product.

compounded the effects of the movement in relative demand pressures. Part of the explanation is probably the perception that the oil price/terms-of-trade shock was particularly severe for Japan. The Japanese real external position was also affected last year by administrative measures — in particular the programme of "emergency imports" which came into effect towards the end of the year. For the United Kingdom, too, the further worsening of relative price competitiveness last year also seems anomalous, both in the light of the consumer boom which pushed up demand very sharply and the (no doubt connected) worsening of the real net export balance. The further build-up of North Sea oil production is at least a partial explanation of this apparent anomaly; and appreciation did help to reduce inflation, though not to avoid labour-market difficulties during the winter, which had an opposite effect.

It is probably not too much to draw from the evidence in the graphs the conclusion that, whatever other factors can theoretically affect the volumes of real exports and imports, it is changes in relative demand pressures (by comparison with previous trends) that have in the event been dominant over the last six years. And this has been so despite the move to a régime of floating exchange rates.

It is no doubt also true that, whatever the relative rôles played by net public and private-sector demands, the end result, so far as total demand was concerned, reflected in large measure the different approaches of the respective authorities to the problems of inflation and unemployment. Thus the US Administration deliberately chose expansion in order quickly to reduce unemployment and, as a side-effect, it no doubt helped other countries towards the same end. The direct effect of the US expansion, of course, worked through import demand, but it was also hoped that, by helping to remove balance-of-payments constraints, it would enable other countries to add to demand by expansive policies of their own. The first route was obviously effective, as the graphs demonstrate, but the second one was not. Instead of inducing the same degree of expansion, the US lead tended to be reflected in a greater degree of external imbalance between the industrial countries themselves, just as the overall imbalance with OPEC was diminishing. And this in turn merely reflected the fact that other countries had different views about how to reduce unemployment on an enduring basis. In particular, Germany and Switzerland saw the elimination of inflation as a prerequisite for establishing sound growth. Japan, too, had the same view to some extent, though the sharp slowdown there also reflected the desire to reduce industrial growth and its more harmful side-effects, as well as to have a strong external position to alleviate somewhat its extreme dependence on other countries for vital raw-material supplies.

Simplifying drastically, one might say that, faced with the inflationary recession, produced in part by the oil crisis, the United States and various other countries sought to return by means of conventional expansionary policies to higher levels of employment. Others, especially in Europe, chose the more cautious course of first restoring a satisfactory semblance of price stability. Obviously, this is a case not only of differing weights of emphasis being placed on the two policy objectives — both of them desirable in themselves — but of differing analytical points of view as well. But what the evidence presented here demonstrates quite clearly is that, with the current degree of interdependence in the world economy, the pursuit of divergent demand-management policies creates considerable external imbalance. And for the time being, at least, it remains to be resolved how these imbalances are to be corrected — whether by exchange rates or by more convergent demand-management policies.

It may be that exchange rates did not change much early in the US expansion (and the simultaneous move into large current deficit) simply because the conjunctural divergence was viewed as cyclical, short-term and reversible. However, by the autumn of last year, there were signs that the dispersion of inflation rates was also about to increase again (as discussed more fully in the next chapter). Thus, although Germany was by that time beginning to move above the average so far as domestic demand was concerned (see the graph on page 21), the continued divergences elsewhere, as well as inflation fears, were sufficient (together with other factors discussed in Chapter III) to trigger a large change in real effective exchange rates.

There were, however, indications that these rate changes might have perverse effects on real domestic demand, and especially on business investment, in addition to their well-known perverse, but temporary, effects on nominal trade balances via the J-curve mechanism. Such fears were voiced particularly in Japan and Germany, but, as the graph on page 21 shows, the United Kingdom may also have been an example of a different kind. A relatively strong exchange rate tends to lower import prices and, as has been noted above, this tends to increase consumer spending power. In the United Kingdom the consumer boom last year no doubt received at least marginal support from the strong rate. But with demand turning up anyway, and real net exports declining, the growing loss of competitiveness of the industrial sector became a matter of increasing concern.

For Japan and Switzerland especially, the problem was rather the reverse. Real net exports had been strong for some time as domestic demand remained weak, and so the large appreciations were, in this sense, justified. But what was feared was that, while the rate changes would work in the "right" direction on trade volumes, they might serve to lower domestic demand still further. In the event the appreciations did not bite significantly into profit margins and even led to increases in consumers' real purchasing power. But, as the adjustment process is still under way, there is still a possibility that exports will weaken further in the months ahead. Whether this will imply a need for further measures of domestic stimulus, if only as a support to the adjustment process, will depend upon the strength of the present upswing in domestic demand. A considerable amount of policy stimulus is already in the pipeline in Japan and Germany from the demand-management measures of last year. But, whatever the risks of renewed slowdown, many national authorities are not likely to swerve far from their concern over the rekindling of inflation and their already large budget deficits. Hence the problems involved in demand management, and in differing national attitudes towards them, have by no means disappeared.

The demand-management dilemma.

Although countries reacted differently to the post-oil-crisis situation — with the consequences for external equilibrium just discussed — these different reactions were in virtually all cases reactions to the same underlying problem. This was the simultaneous co-existence of high inflation and high unemployment or, in more technical terms, the worsening, or even disappearance, of the "trade-off" in policy management between price increases and resource utilisation. In the short run, demand-management policies on their own could be directed at only one of these difficulties at a time; and, as already mentioned, countries took different views on which should be given priority. The results were perhaps as might have been expected — a rapid increase in nominal demand in the United States, with unemployment falling and inflation speeding up, and rather the opposite tendencies elsewhere. The extent to which these policy stances contributed to divergent price developments is discussed in the next chapter. However, it is worth remarking here that one important route was via exchange rate changes and not just via differential demand pressures. Thus, even in those countries in which the margin of slack remained large and exchange appreciation helped to lower inflation, the domestic component of inflation remained in some cases stubbornly and disturbingly high. And during the winter, even in those countries which (via exchange appreciation) had experienced particularly favourable changes in import costs, the external element of cost inflation was again threatening anti-inflation efforts as commodity, and especially oil, prices began to move up again quite sharply. In these circumstances governments are likely to be particularly sensitive to the risk of adding any element of demand inflation on top of cost increases already known — especially as in most cases budget deficits remain very high and may even be increasing.

At first sight, the figures shown in the table below for one measure of the budget gap — general-government net lending — seem contradictory. For the countries which followed anti-inflationary "caution" are seen to have continuing large, and even increasing, public deficits, as have many other countries, while on the other hand the US general-government deficit has been substantially reduced. What is more, as the full effects of last year's measures are felt, the deficits may increase again this year in Germany and Japan, and possibly elsewhere.

The key to the apparent puzzle is, of course, the behaviour of the other sectors of the economy — which for this purpose is best summed up by their equivalent financial balances, that is, their net spending (borrowing) or net financial savings behaviour (see page 25). For each country the balances of the four sectors shown must sum to zero, questions of statistical discrepancies and incomplete coverage aside; for every borrower there must be a lender.

General-government financial balances, 1966–78.

Countries	1966–69	1970–73	1974	1975	1976	1977	1978
	in percentages of gross national product/gross domestic product						
United States	− 0.3	− 0.5	− 0.2	− 4.2	− 2.0	− 1.0	− 0.1
Japan	− 2.7	− 2.1	− 3.8	− 2.7	− 3.7	− 4.8	− 6.1
Germany	− 0.3	0.2	− 1.3	− 5.7	− 3.6	− 2.6	− 2.7
France	0.0	0.9	0.6	− 2.2	− 0.4	− 1.3	− 2.1
United Kingdom	0.1	− 0.2	− 4.0	− 4.8	− 5.0	− 3.2	− 4.2
Italy	− 3.0	− 5.5	− 5.9	−11.7	− 9.1	− 8.1	−10.6
Canada.	1.0	0.5	1.9	− 2.4	− 1.8	− 2.6	− 3.5
Belgium	− 1.5	− 2.2	− 4.0	− 5.8	− 6.6	− 7.0	− 7.2
Netherlands	− 0.9	0.0	− 0.1	− 3.2	− 2.8	− 2.1	− 2.3
Sweden	3.9	4.6	1.9	2.6	3.5	0.1	− 1.6
Denmark	1.3	3.9	4.5	− 2.3	− 0.4	− 0.4	− 0.2
Norway.	3.5	3.1	4.7	2.8	0.9	− 0.9	− 1.3

Source: OECD National Accounts and BIS estimates. See footnote 1 to table on page 17.

The table shows quite clearly for the United States the recovery in net spending by both the household and corporate sectors which has allowed the public-sector deficit to be cut back — no doubt largely automatically as tax revenues rose with activity and unemployment fell. Indeed, so strong has the recovery been that, as has been noted, demand spilled over into a current balance-of-payments deficit (that is, a surplus for the rest of the world). The only remarkable feature of this otherwise classic recovery, led largely by housing and consumer spending, is the especially strong rôle played by households. In contrast, the recovery of corporate investment relative to internal saving has been rather weak. Household spending, it might be added, has been further stimulated over the past two years by the renewed intensification of inflationary expectations.

In most other countries, however, private-sector net spending has not taken off in the same way despite apparently large public-sector stimuli. This, of course, has raised question marks over the effectiveness of fiscal policy and has even led to fears that the private sector is being somehow "crowded out", despite large margins of unused resources. Others would say that the large deficits are simply the obverse element of the private sector's unusually cautious behaviour under conditions of continuing but declining inflation. Thus, in the case of households (and contrary to the situation in the United States), caution has been prompted by fears of inflation's effects on the real values of financial assets and, in the case of

Sectoral financial balances.

Countries	Sectors	1973	1974	1975	1976	1977	1978
		as a percentage of gross national product					
United States	Public	− 0.4	− 1.1	− 5.2	− 3.0	− 2.0	− 1.2
	Households	4.0	4.2	5.0	3.1	2.0	1.9
	Corporations	− 4.4	− 4.3	− 0.5	− 0.7	− 1.8	− 2.5
	Rest of world	0.0	0.2	− 0.8	0.1	1.1	1.2
Japan	Public	− 2.9	− 3.7	− 7.3	− 7.4	− 7.2	− 8.9
	Households	8.8	10.3	10.5	11.4	10.4	10.9
	Corporations	− 7.6	− 6.5	− 4.1	− 3.9	− 2.6	− 1.0
	Rest of world	0.0	1.0	0.1	− 0.6	− 1.5	− 1.7
Germany	Public	1.2	− 1.4	− 5.8	− 3.6	− 2.6	− 2.7
	Households	3.4	6.0	7.1	5.3	4.2	3.2
	Corporations	− 3.8	− 2.9	− 1.1	− 1.6	− 1.7	− 1.7
	Rest of world	− 1.2	− 2.6	− 1.0	− 0.8	− 0.7	− 1.2
United Kingdom. . .	Public	− 4.2	− 6.7	− 8.5	− 7.6	− 4.5	− 5.2
	Households	4.4	7.2	7.8	7.3	6.5	6.9
	Corporations	− 2.9	− 7.1	− 1.9	− 1.9	− 2.4	− 2.5
	Rest of world	1.7	5.0	2.0	1.0	− 0.2	− 0.2
France	Public	0.9	0.6	− 2.2	− 0.4	− 1.2	− 2.3
	Households	3.5	3.7	5.7	3.5	4.5	6.7
	Corporations	− 5.1	− 6.9	− 3.6	− 5.1	− 4.8	− 4.1
	Rest of world	0.2	2.4	0.2	2.0	1.2	0.9
Italy	Public	−10.2	− 9.6	−12.4	− 9.2	− 8.9	−10.9
	Households	15.5	13.2	16.1	13.8	15.3	17.9
	Corporations	− 7.4	− 9.6	− 7.2	− 6.9	− 5.1	− 4.1
	Rest of world	1.8	5.1	0.3	1.5	− 1.1	− 2.4
Canada.	Public	1.0	1.6	− 3.0	− 2.1	− 2.7	− 3.6
	Households	4.8	5.3	5.6	4.6	5.3	5.6
	Corporations	− 5.4	− 7.1	− 5.5	− 5.2	− 4.5	− 4.7
	Rest of world	− 0.8	1.0	2.9	2.0	2.0	2.3

corporations, by low profit margins and low current and expected sales. But in Germany the strategy of returning to price stability began to pay off last year; fixed investment rose appreciably in the wake of a recovery in business profitability, and household net spending behaviour has returned to more normal rates. In the United Kingdom, on the other hand, wages ran ahead of prices in the first half of the year and corporations were impelled to have increased recourse to borrowed funds. The household sector, which was largely the beneficiary of this shift, apparently spent the whole of the concomitant increase in real income.

For many countries other than the United States a crucial question now is whether the recovery which became apparent last winter is continuing on a self-sustaining basis. But before turning to the latest available statistics for the current year, one other development of the last few years deserves some consideration — the behaviour of productivity.

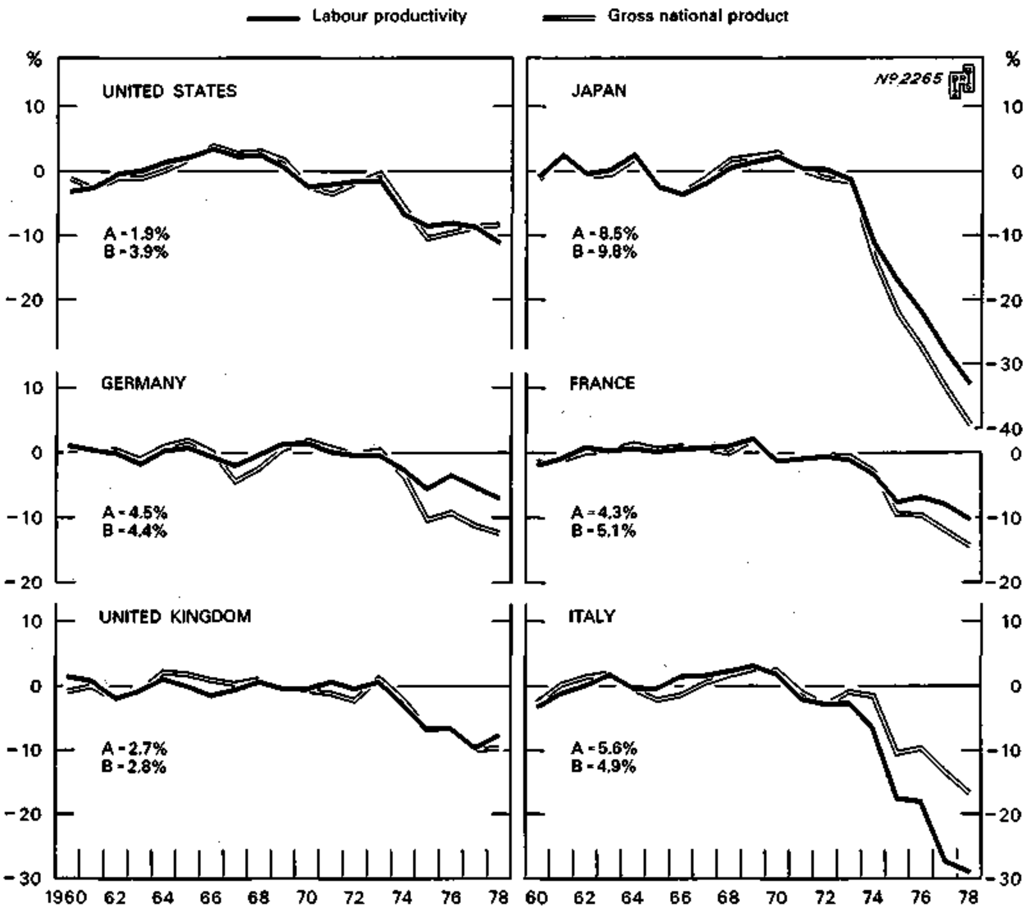
The decline in productivity growth.

One of the more remarkable, and puzzling, features of economic developments in recent years has been the poor showing of productivity. It seems, too, that this disappointing pattern continued in 1978. Productivity, of course, slumped sharply in 1974 and 1975 as the severe recession set in (see graph), but although there was some rebound in 1976 as the recovery began, it has since given way again to weaker performance. Output growth has also been weak by comparison with previous trends so that, so long as all countries were suffering from the unusually deep recession, it seemed that much, if not all, of the productivity shortfall could be blamed on this factor alone.

However, developments in the United States suggest now that other factors have been at work. For the recovery in employment there has been truly remarkable: by the end of last year some 10 million (12 per cent.) more people were employed than at the previous demand peak in 1973. Although labour-force developments (discussed in Chapter III) have prevented this achievement from being reflected in a low rate of unemployment by previous standards, there can be little doubt that for all practical purposes the United States is now at (cyclical) full employment. But output has also only grown by 12 per cent. since 1973 — which is to say that productivity in 1978 was scarcely any higher than in 1973. With the economy now at a cyclical peak, it necessarily follows that none of this shortfall below previous trends (some 10 per cent. by 1978) can be ascribed to cyclical factors. And there is a further puzzle. The strong rise in employment flies in the face of fears expressed after the oil price explosion that the large change in the relative price of energy, together with low investment (and therefore capacity) growth, would effectively lower the capital stock and thus limit employment opportunities, at least in the short to medium term.

Elsewhere there is no doubt still a cyclical component in the productivity shortfall. In some countries this effect is being deliberately reinforced by job subsidisation schemes, e.g. in France and the United Kingdom, though in the latter case this is being somewhat offset in productivity terms by the build-up of North

The growth of labour productivity and gross national product*: Deviations from 1960-73 trend.



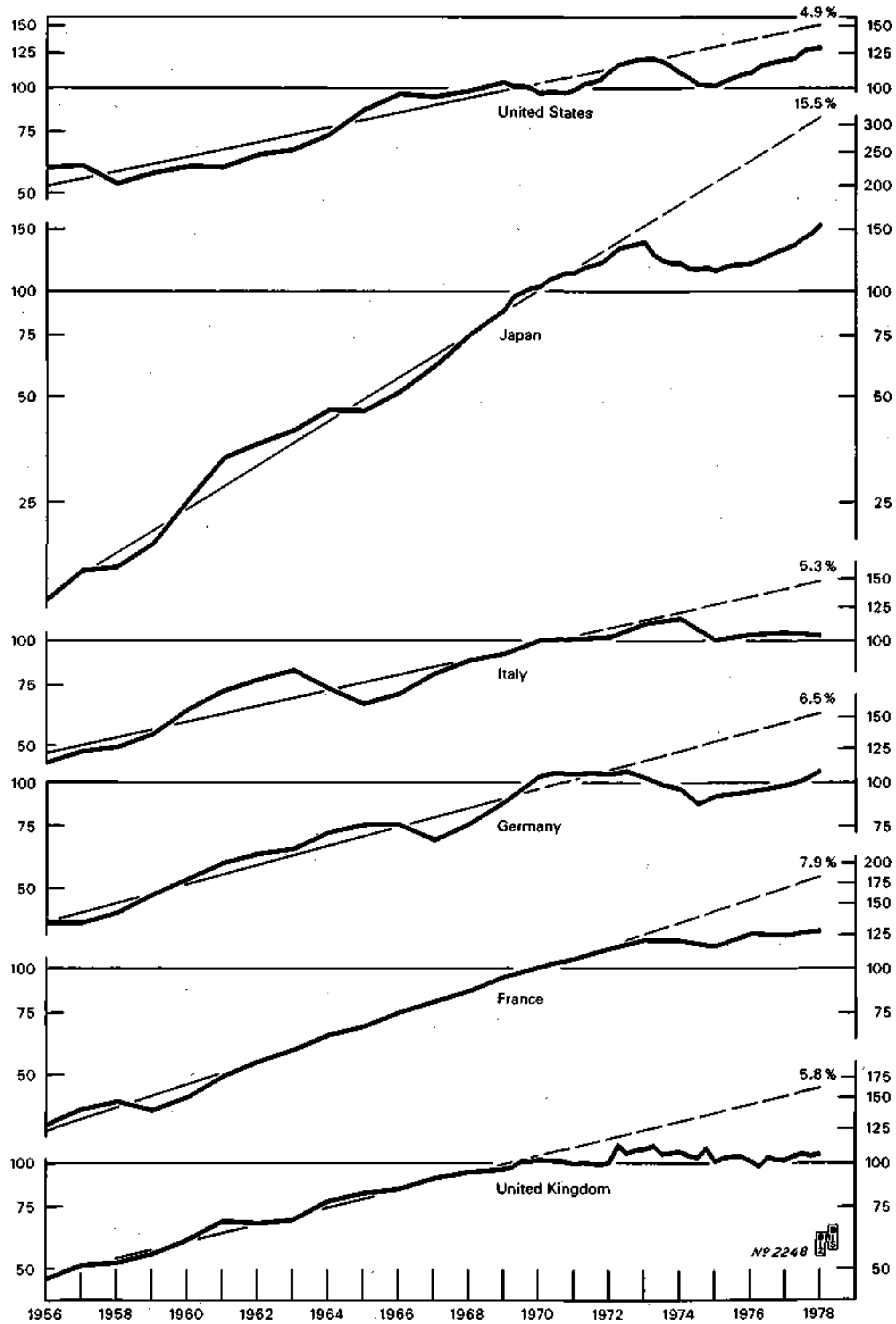
* Inset figures equal 1960–73 growth rates of (A) overall labour productivity (i.e. gross national product divided by total employment) and (B) gross national product.

Sea oil production. In Japan, too, a deliberate attempt is being made to devote an increasing proportion of resources to social infrastructure spending and environmental protection. And in many countries the shift of labour from the land to higher-productivity employment is slowing down, or has already come to an end. This is probably not the case, however, so far as the shift towards employment in services (which — conventionally — show low rates of productivity growth) is concerned, though it is not clear that the speed of this movement has actually quickened since 1973.

Nevertheless, the US experience may also hold clues to some other factors which may be at work more generally. For example, the US productivity shortfall seems to be heavily concentrated in the mining and construction industries and in the public utilities rather than in manufacturing. It is in such industries that one might well expect to see the sharpest effects from increasing government regulation in the fields of safety control and environmental protection, as well as any consequences of higher energy prices. Such factors might also reasonably be

The real growth of non-residential fixed investment.*

Annual and quarterly indices: 1970 = 100 (semi-logarithmic scale).



* Includes public-sector investment. Trend lines relate to the years 1955–73.

expected only to lower the level of measured productivity once and for all rather than the trend rate of increase.

Low rates of industrial investment growth by comparison with previous experience have also been a feature of the past five years or more in most countries (see graph on page 28), especially when one bears in mind the increasing proportion devoted to pollution control, etc. However, as already noted, the US experience rather curiously suggests that this slowdown has not affected the "employment potential" of that economy. If anything, investment must have been "labour-using" rather than "labour-saving". But with labour costs relatively high as a proportion of value added, one might have expected quite the reverse — a greater degree of economising in labour and a corresponding fall in employment possibilities, especially as the volume of investment itself was relatively low. For the United States at least the recent behaviour of investment, coupled with high labour costs, is something of an enigma in itself, and does not appear to offer any help in explaining the low productivity growth of recent years.

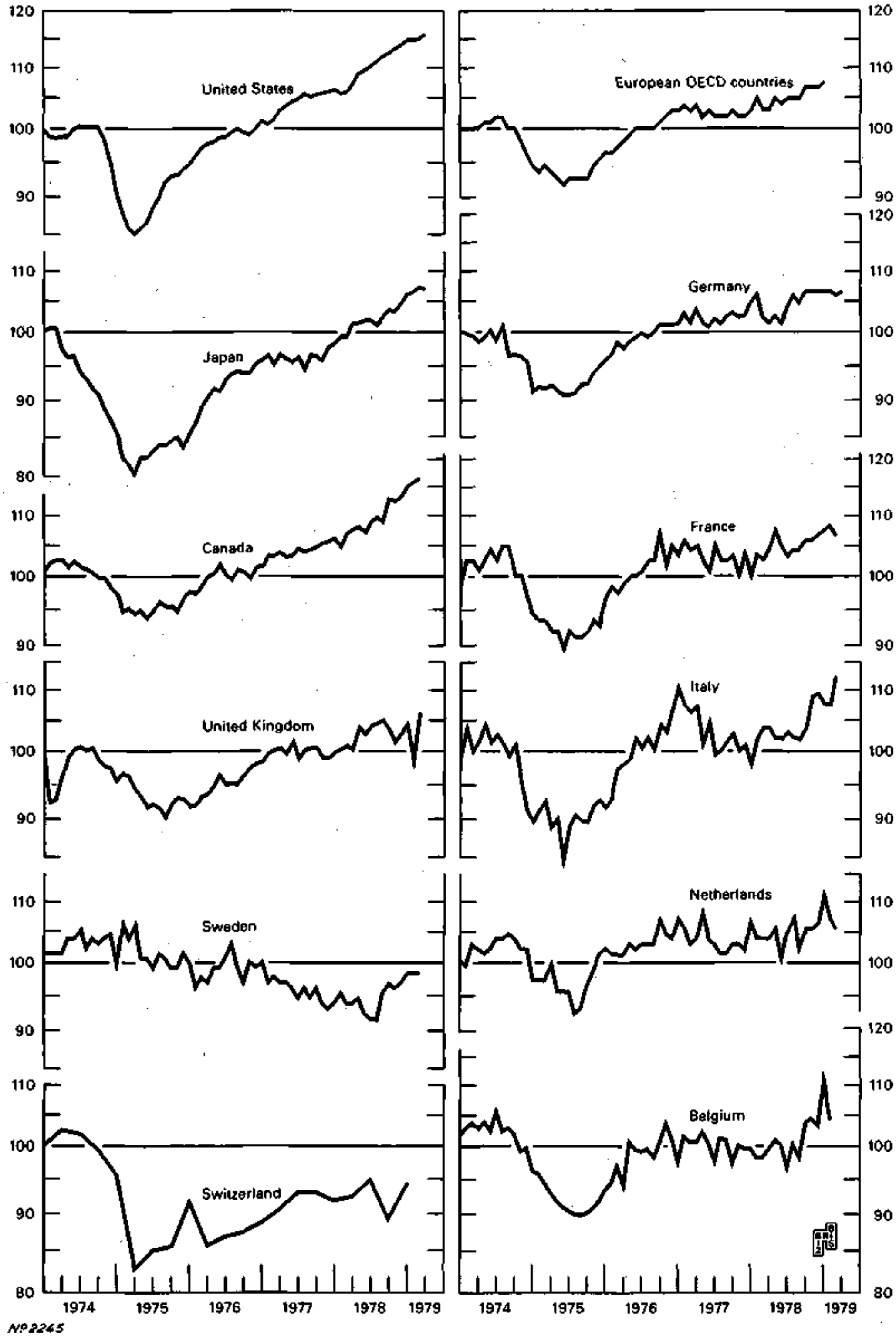
In all, it is difficult to avoid the conclusion that, although cyclical influences are no doubt still present outside the United States, there has also been some permanent decline in productivity below previous trends. To the extent that this reflects increased safety and environmental protection, what might be termed "real welfare" will not, of course, have been affected to the same extent as potential gross national product. However, these developments may also tend to worsen inflation by making unit labour costs higher than otherwise. In addition, if governments set demand-management policies in the light of previous rates of productive potential growth, there is a risk of over-expansive postures and demand inflation. For example, although fiscal plans were made less expansionary in the United States early last year as continued strength in the labour market became apparent, the Administration was still surprised by the size of the further rise in employment which occurred. Elsewhere, however, there can be little doubt that economies were still operating with varying degrees of slack — that is, output developments in 1978 continued to be heavily influenced by factors affecting aggregate demand.

Developments early in 1979.

Towards the end of the year there were signs of a renewed upturn in Europe — an upturn which was very quickly reflected in the commodity markets, where metals prices in particular began to move up sharply, as did the oil price. The important question is, of course, to what extent this improvement is going to continue, and with it the trend towards more convergent behaviour and, even, higher average levels of employment.

Unfortunately, because of the normal data delays and disturbances caused by both bad weather and strikes during the winter, it is not yet possible to draw very firm conclusions from the figures available. The movements in industrial production shown in the graph are in many cases quite remarkable, though they run only to February or March at the latest. Especially fast growth is seen in some smaller European countries, Italy and Canada. In Germany the figures are affected by the bad weather last winter, though in the labour market further falls in

Industrial production.
Fourth quarter 1973 = 100 (seasonally adjusted, semi-logarithmic scale).



unemployment have continued and, as the table shows, the volume of retail sales was appreciably stronger early in 1979. There are also signs of pressure in the construction sector, and this is the case, too, in Switzerland, though there unemployment has increased slightly. Unemployment has also risen somewhat in France despite some moderate resumption of output growth and strong retail sales. After last year's very strong consumer boom, growth in the United Kingdom may be tapering off following the inflationary pressures of the winter, and in Japan there are signs that the exchange rate appreciation is having strong contractionary effects via the volumes of exports and imports.

Volume of retail sales.[1]

Countries	1976	1977	1978 year	1978 1st quarter	1978 2nd quarter	1978 3rd quarter	1978 4th quarter	1979 latest month available
	indices, 1975 = 100							
United States	105.0	110.1	114.1	111.3	113.3	114.5	117.3	115.5[2]
Canada	103.5	103.3	105.9	105.0	105.6	107.1	105.9	109.6[3]
Germany	102.8	106.8	110.3	109.9	109.9	111.1	109.9	113.2[4]
Japan	96.9	98.1	103.8	99.3	103.8	107.8	105.9	106.9[4]
France	102.7	102.8	104.8	103.9	104.5	105.8	104.5	110.5[3]
United Kingdom	99.8	97.1	102.3	99.7	101.1	103.8	104.7	103.7[2]
Italy	103.9	105.0	108.1	96.9	105.5	100.5	129.2	.
Netherlands	102.0	105.4	107.9	110.0	107.6	106.6	107.7	108.1[4]
Belgium	103	107	109	109	109	110	111	.
Sweden	103.4	101.8	98.7	99.0	98.4	98.5	99.0	100.0[3]
Denmark	105	105	104	103	102	105	105	104[3]
Switzerland	98.0	100.3	96.5	98.2	98.5	94.7	95.7	97.6[3]

[1] Seasonally adjusted except for Italy. [2] March. [3] February. [4] January.

Activity in the United States, however, has remained at a high level — especially if it is borne in mind that the figures for production early in the year were affected by the weather, and that the fourth quarter had already registered a growth rate of 6.9 per cent. per annum in total output. Household expenditures on both consumption and real estate have continued to be very strong as inflation has accelerated. And on top of this the devaluation of the dollar will have set in motion expansionary adjustments in export and import volumes.

In sum, it is probably true to say that on average an appreciable recovery in domestic demand has begun in Europe, but the signs are less strong in Japan and Switzerland. However, these developments have taken place against the background of a US economy which was unexpectedly buoyant. One policy question is whether a slowdown in the US economy might risk killing off the nascent recovery elsewhere. Historically, at least, de-synchronised cyclical movements have not been uncommon. But, at the same time, even before any appreciable inroad has been made into unemployment levels outside the United States, inflation appears to be worsening again, thus underlining the fact that the basic problem facing demand-management policy is still with us.

Conclusion.

For the current year the dilemma of fiscal policy will certainly not be mitigated and may well be heightened by external-sector developments. The rise in oil and other commodity prices, though of uncertain extent, will undoubtedly worsen cost inflation and, to the extent that the OPEC surplus increases again, it will have contractionary implications for demand in the oil-importing world. In addition, for countries other than the United States, the foreign balance adjustments involved in the currency realignments of last year, and possibly also slower growth in the United States, will exert some restraining effect on aggregate demand.

One reaction is to say that private-sector demand has been rising, not least in the investment sector, and may act as a sufficient offset. Should it falter, however, deficits may not quickly be reduced by rising activity as has happened in the United States. Moreover, apart from the fact that more world industrial demand would be likely to raise international commodity and perhaps oil prices further, many countries feel themselves to be in a delicate situation so far as domestic wage-cost inflation is concerned and would hesitate to take further stimulative measures. The outstanding example recently has, of course, been the breakdown of incomes policy in the United Kingdom last winter, but wage-cost pressures, even in the many countries where they declined last year, are not far below the surface. Although only a few countries are beginning to be concerned about renewed demand pressures given the high average levels of unemployment, it may be that wage negotiations are affected (even if somewhat irrationally) by the scale of budgetary shortfall. That is, to the extent that negotiators take the budget deficit as an indicator of future inflation even at times of high unemployment, increased deficits may have unfortunate effects on inflation. And to the extent that rising inflation renews cautious private-sector behaviour, there is some risk that any further discretionary fiscal stimulus would simply be ineffective.

Much more important as an influence on actual fiscal policy, however, will be the acceleration in inflation which has already been observed. With unemployment still a problem almost everywhere, it is this upturn in inflation, together with the emergence of another incipient OPEC surplus, which is currently heightening the demand-management dilemma. It is not necessarily that governments are shifting the subjective weights which they attach to the two "bads" of unemployment and inflation, it is merely that the renewed increase in the latter almost inevitably swings the thrust of policy towards a greater emphasis on inflation control. It is partly for this reason that the following chapter examines inflationary developments in considerable detail.

III. INFLATION AND UNEMPLOYMENT.

A major development over the past two years has been the strongly divergent movement of inflation rates in the United States, on the one hand, and most western European countries and Japan on the other. In 1978 this movement accelerated, to some extent because of domestic demand and supply factors but largely because of the further sharp, partly unanticipated, depreciation of the US dollar in the exchange markets. The decline of the dollar, together with the corresponding appreciation of various other currencies, had domestic price effects which accentuated the growing divergences in relative price performance. And this process naturally helped to steepen the dollar's downward slide. The main dynamic force appears to have been the increasing relative strength of US demand conditions, which contributed domestically to a resurgence of inflation and a heightening of inflationary expectations.

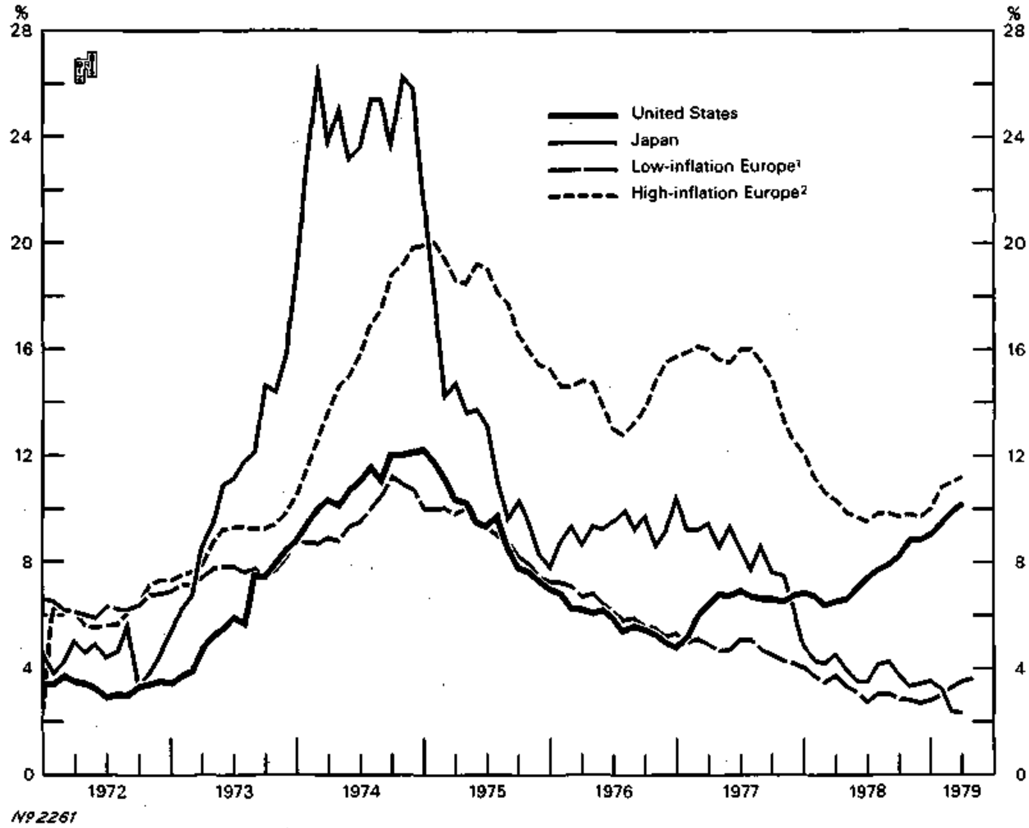
By early 1979 there was a growing tendency for relative inflation rates to become more convergent — though in the disquieting sense that outside the United States inflation seemed to be speeding up again and threatening to spread among countries. There were three broad reasons for this new tendency. One was simply that, with greater exchange rate stability from late 1978, countries whose currencies had earlier been appreciating began to lose the benefits associated with lower import prices. Secondly, the continuing, though still moderate, recovery of demand outside the United States, combined with persistently buoyant US demand conditions, had begun to drive up international commodity prices quite rapidly. Finally, the disturbed international oil supply situation, together with new OPEC pricing decisions, imparted significant additional inflationary impulses. All three of these developments were conducive to a strengthening of externally generated inflationary influences. The question of how countries will react to this new threat is still open.

Changing patterns of consumer price inflation.

Since the beginning of 1977 consumer price inflation in the major industrial countries has developed along remarkably different lines, mainly reflecting differences in policy objectives. Largely contrary to expectations, the inflation rate in the United States, after slowing down more or less in line with other countries in 1975 and 1976, accelerated sharply again in the first half of 1977, during most of 1978 and in early 1979. Elsewhere, the rate of price increase continued to decline on a scale that was equally unanticipated, though by the turn of the year the slowdown had flattened out in some countries and had been reversed in others, where prices had begun to rise at a disturbing pace.

Perhaps the main reason for the divergent trend in 1977 and 1978 lay in the growing differences in the pressure of domestic demand, as discussed in Chapter II. Already in the course of 1976 the pressure of domestic demand in the United States had begun to exceed that in other countries and it continued to strengthen in relative terms thereafter. Consumer prices, which on a December-to-December basis had

Consumer price inflation.
Changes over twelve months, in percentages.



[1] Unweighted arithmetic average for Belgium, Germany, the Netherlands and Switzerland. [2] Unweighted arithmetic average for France, Italy and the United Kingdom.

risen by only 4.8 per cent. in 1976, went up by 6.8 per cent. in 1977 and 9.0 per cent. last year. In the three months ending March 1979 they rose at an annual rate of 13 per cent.

In Canada the inflationary situation also worsened in 1977, with consumer prices rising by 9.5 per cent., against only 5.8 per cent. in 1976. After some temporary improvement early last year, the rate of price increase picked up speed again.

As the graph shows, consumer price performance in the United States, which in the years 1975–76 had been closely in line with that of the low-inflation countries of western Europe, moved away onto an upward path that took it close to the average rate of price increase in the high-inflation countries of Europe by the end of 1978. Meanwhile Japan, whose inflation rate of over 20 per cent. in 1974 was far above those recorded elsewhere, managed by early 1978 to bring it into line with the downward course being followed by Europe's low-inflation countries. And even the high-inflation countries of Europe cut back their average rate of inflation from 16 to 10 per cent. over the twelve months to the middle of 1978.

The scale of these divergent movements was quite remarkable and indeed surprising. Differences in demand pressures were, as already mentioned, an important

Changes in consumer prices.

Countries	Annual averages		Twelve months ending					
	1969–73	1974–78	1975 Dec.	1976 Dec.	1977 Dec.	1978 June	1978 Dec.	1979 April
	increases, in percentages							
United States	4.9	8.0	7.0	4.8	6.8	7.4	9.0	10.2*
Canada	4.6	9.2	9.5	5.8	9.5	7.2	8.4	9.3*
Japan	7.5	11.5	7.7	10.4	4.8	3.5	3.5	2.3*
Germany	5.3	4.8	5.4	3.9	3.5	2.4	2.4	3.5
France	6.1	10.8	9.6	9.9	9.0	9.0	9.7	10.1*
United Kingdom	8.0	16.2	24.9	15.1	12.1	7.4	8.4	10.1
Italy	3.6	17.0	11.1	21.8	14.9	12.2	11.9	14.3
Austria	5.7	6.9	6.8	7.2	4.2	3.2	3.7	3.5
Belgium	5.2	9.2	11.0	7.6	6.3	3.7	3.9	3.9
Denmark	6.4	11.0	9.6	13.1	12.2	10.5	7.1	7.1*
Finland	6.9	13.9	18.1	12.3	11.9	7.5	5.9	7.4*
Netherlands	6.7	7.9	9.1	8.5	5.2	3.4	3.9	4.3
Norway	7.9	9.5	11.0	8.0	9.1	7.4	8.1	4.9*
Spain	8.4	18.9	14.1	19.8	26.4	20.7	16.5	15.8*
Sweden	6.8	10.3	8.9	9.6	12.7	9.1	7.4	5.9
Switzerland	6.4	4.1	3.4	1.3	1.1	1.1	0.8	2.6

* March.

factor, and also the related differences in labour-market conditions and unemployment rates, but they hardly offer a sufficient explanation. Moreover, autonomous wage pressures do not appear to have played a major rôle in most countries — the United Kingdom being an exception — in changing the course of relative price behaviour. Instead, as reflected in the graph on page 37, increases in wage rates and earnings appear to have adapted themselves in the main to changing inflation rates. Special factors do not seem to have played a substantial rôle either, although it is noteworthy that overall productivity gains were low and that food prices during 1978 recorded exceptionally large increases of 12 and 13 per cent. in the United States and Canada respectively.

Apart from relative changes in demand pressures, the main additional cause of the differences in price performance was the pronounced movement in exchange rates, especially in relation to the US dollar. In short, exchange rate changes, largely through the influence they exert directly on the domestic-currency costs of imports of food and raw materials, as well as indirectly on the prices of tradable goods, have tended to magnify divergences in underlying inflationary performance, and to this extent a stabilisation of exchange rates might well contribute to some convergence of inflation rates.

Such a convergence, though at a higher average rate of inflation, has begun to appear in the behaviour of consumer prices in recent months. As the table shows, consumer prices in the early months of 1979 have significantly accelerated in three of the four low-inflation countries, Belgium being the exception. Among the high-inflation European countries, the speeding-up has been even more marked. In contrast, consumer price inflation in Japan has continued to slow down, perhaps in lagged response to the earlier sharp appreciation of the yen.

Sensitive price indicators, domestic and international.

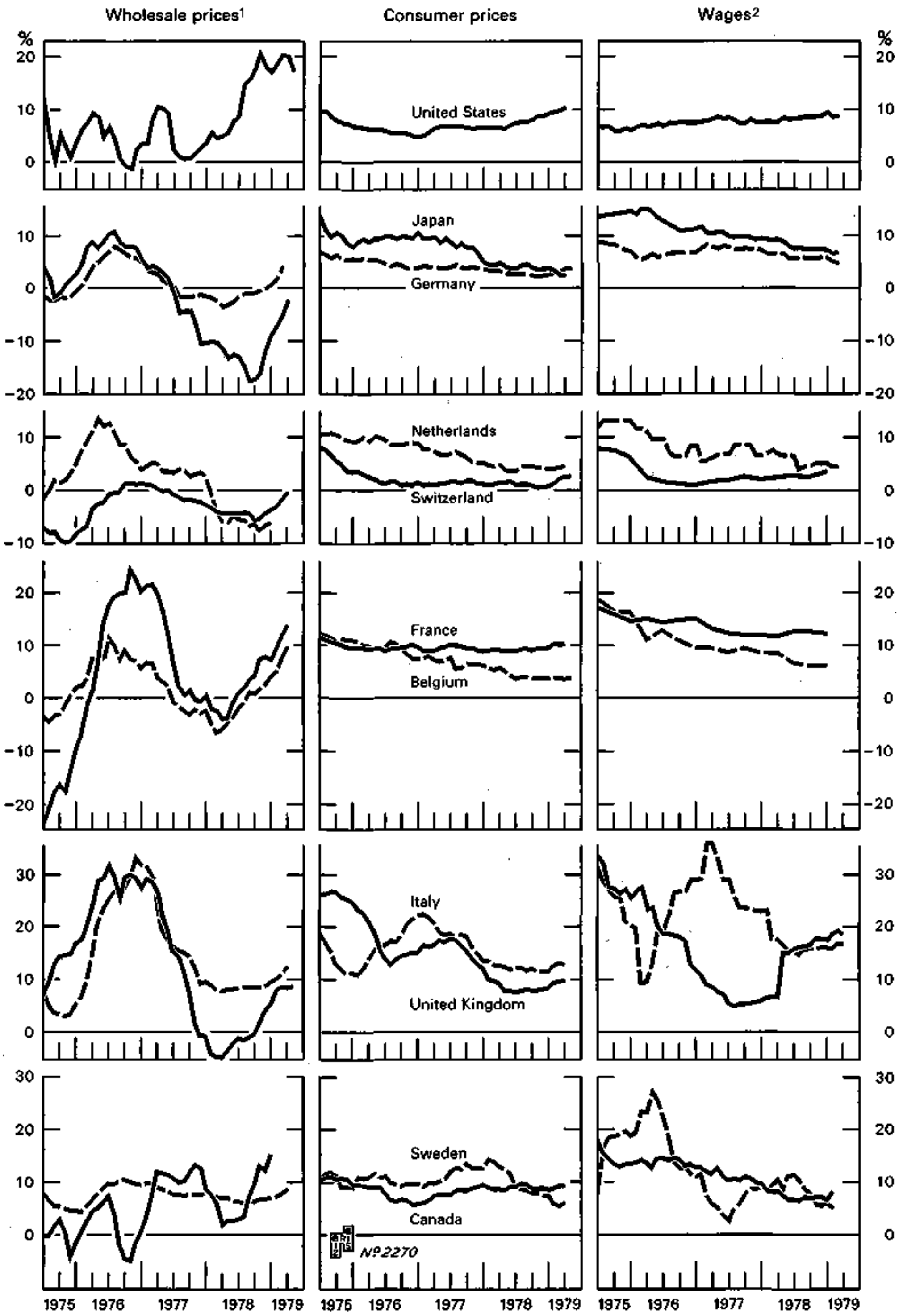
A good deal of the recent concern about renewed inflationary pressures has been occasioned not so much by the behaviour of consumer prices, which lag behind other developments, but by the early warnings already given by wholesale prices and the prices of international commodities and oil. As shown in the accompanying graph, the twelve-month rate of change in wholesale prices turned upwards around the middle of 1978, though in some cases prices remained for a time below their level of a year earlier. By the turn of the year, however, the movement in a number of countries, such as the United Kingdom, France, Italy and Belgium, was strongly positive, and substantial rises were also being recorded in such countries as Germany, Switzerland and Japan. In the United States wholesale prices had already been accelerating steadily since the autumn of 1977 and by late 1978 were about 20 per cent. higher than a year earlier. On a more moderate scale, the increase in Canada followed that in the United States, while in Sweden the acceleration in late 1978 started from an already fairly high level. Wherever possible, these indications refer to wholesale prices at the input stage of production, although input prices admittedly fluctuate more widely than those at the output level.

Turning now to international commodity prices, the "Economist" dollar-based indicator (excluding oil) has shown a steady uptrend, though with pronounced short-term fluctuations, since the trough of the recession in 1975. In the intervening period the total index has almost doubled and has also risen by about one-third in relation to its 1974 peak during the preceding upswing. These increases occurred, it may be noted, during a period in which economic recovery outside the United States was generally hesitant and faltering. Moreover, depending on market arrangements, the rising trend of prices in US dollar terms may have been influenced by the decline in the exchange value of the dollar. Over the period as a whole, and more particularly since late 1976, food prices have recorded the largest increase, but since late 1977 fibre prices have risen steadily and metals prices have recovered sharply from very depressed, in some cases unprofitable, levels.

Oil prices in US dollar terms have moved a good deal higher since their sharp increase in 1973–74. In mid-December the OPEC member countries announced their decision to raise the price of Arab light crude oil by 14.5 per cent. The increase was to be introduced in quarterly steps, boosting the price of light crude to $14.55 per barrel by the fourth quarter of 1979. But in March, in the wake of the upheaval in Iran, the OPEC countries decided that the full planned increase should come into effect as from the second quarter of 1979 and that, in addition, some countries would be free to charge premium prices higher than the mutually agreed basic price.

This pricing decision was made after Iranian oil production had fallen from a peak of over 6 million barrels per day to less than one million barrels. The shortfall, which was only partly compensated by increased Saudi Arabian production, led to a tightening of supply conditions and to substantial increases in the price of oil on the open market between December 1978 and March 1979. While some observers take consolation from the fact that in percentage terms the increase is small compared with the fourfold rise in 1973–74, it is nonetheless considerable and it implies a further serious upward ratcheting of international price relationships.

Prices and wages.
Changes over twelve months, in percentages.



[1] Based on input prices for manufacturing industry, where possible. [2] Hourly earnings in the case of Canada, Japan, Sweden, Switzerland and the United States; for other countries, wage rates.

To put commodity price developments in the perspective of both the earlier divergence of inflation rates and their current convergence and increase, the "Economist" dollar-based index has been recalculated in the lower graph to show the index as viewed from the vantage point of countries other than the United States in terms of their own currencies. Thus, since late 1977 the total commodity index expressed in Deutsche Mark has remained very stable, while that in yen has dropped to a lower level. These differentiated movements, as expressed in terms of actual import prices, have helped to account for the differences in consumer price behaviour already observed.

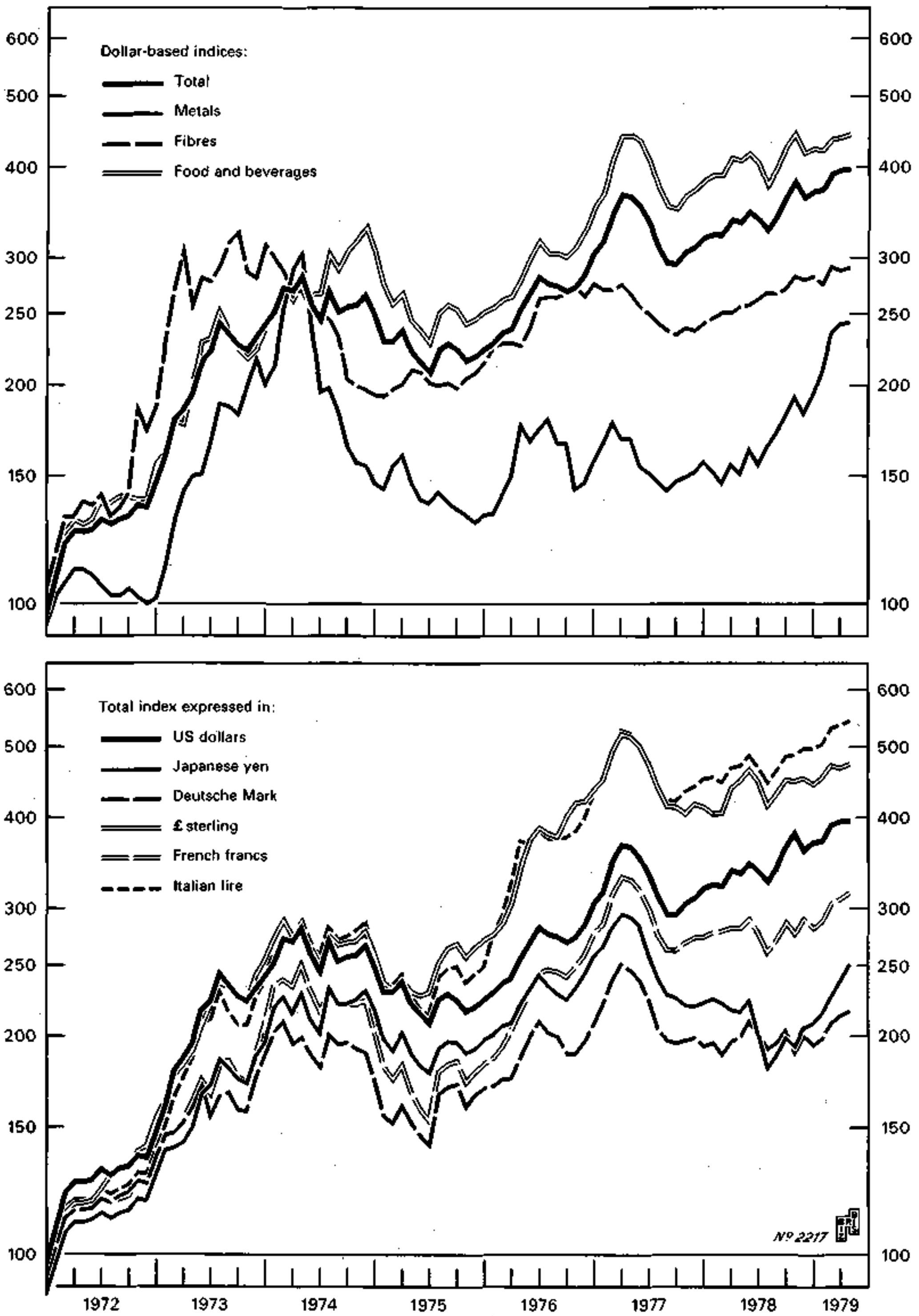
International commodity prices fell back somewhat in the late spring and early summer of 1978, but subsequently bounded upwards, rising by over 20 per cent. in US dollar terms between mid-1978 and April 1979. As exchange rates had become more stable in the meantime, these increases began to feed quickly into domestic price structures at the wholesale level. Moreover, while the extent of the increases varied according to the currency concerned, practically all countries witnessed some increase during the period in question.

In view of these developments, widespread concern has emerged about a possible speeding-up of inflation in countries where it had been slowly brought under better control. One interpretation, from the viewpoint of the international economy, is that incipient economic recovery in Europe, centring mainly in Germany, is being superimposed on a high level of activity in the United States and a continuing upswing in Japan and Canada. If this is so, the long-predicted slowdown of the US economy might relieve demand pressures on internationally traded goods and permit a relatively non-inflationary advance to proceed both in the United States and elsewhere.

This interpretation raises the interesting question of whether, if international commodity prices are to remain fairly stable, it is still possible to have the major industrial countries expanding relatively rapidly at the same time. By way of qualification it must be said that the reasons for the recent sharp adjustment of prices are not yet clear. It has happened before that a sudden upsurge in prices is followed shortly afterwards by a relapse. Moreover, it is possible that the recent volatility of exchange rates, particularly of the US dollar, has encouraged widespread speculation in commodities, much as in 1973–74 after the flexible rate system became generalised. Again, some of the price increases, particularly in the metals area, may largely reflect attempts on the part of producers to restore profit margins to satisfactory levels. But with all these qualifications there still seem to be grounds for concern about the inflationary implications of the rising level of world demand, a development which has only just become perceptible outside the United States. Or, to put it another way, there is reason to suppose that, after a protracted period of world stagflation, the investment needed to keep international commodities in elastic supply may have been lacking.

Much now seems to depend on the course of nominal demand in the United States. In early 1979, despite distortions caused by a severe winter, the economy still appeared to be operating at high levels of capacity, with bottleneck situations beginning to emerge in certain sectors. Notwithstanding the authorities' efforts to

World-market commodity prices:
The "Economist" indicator.
1971 = 100.



slow down the economy while at the same time avoiding a recession, it was not yet clear what turn activity would actually take. On the one hand, with the further acceleration of inflation and with fixed business investment still quite strong, the possibility emerged of rising international commodity prices sparking off a new cycle of inventory investment, especially as stocks had been kept at very low levels. On the other hand, the Administration's decision in April 1979 to proceed with plans to deregulate the prices of domestic oil, together with its continued effort to apply fiscal and monetary restraint, might help to bring about the overall demand restraint that has been needed. In view of the particular importance of US developments over the past two years, it seems appropriate to examine in some detail the evolution of policy attitudes and the difficulties encountered during that period.

The resurgence of inflation in the United States.

From an international standpoint, two of the most disturbing events of the past year were the further acceleration of US inflation and the related precipitous decline in the exchange value of the dollar. In retrospect, it seems clear that a major causal factor was the expansionary policy stance adopted in earlier years. Against the background of a historically high unemployment rate, which averaged 8.5 per cent. in 1975, the authorities apparently felt impelled to pursue fiscal and monetary policies along conventional lines.

In view of the high unemployment figure, and with the capacity utilisation rate in manufacturing standing at just over 71 per cent. in early 1975, the authorities believed there was ample room for demand-management stimulus without a serious risk of reviving inflation. Even a year later, in the spring of 1976, they saw little evidence to contradict this hypothesis. The year-on-year increase in producer prices for finished goods was only 4.2 per cent. in 1976 and unit labour costs rose by no more than 5 per cent. The capacity utilisation rate in manufacturing, at 80 per cent. in 1976, was still well below the 87.5 per cent. peak recorded in 1973.

Given the seemingly broad scope for expansionary demand-management policy, the crucial question is why inflation returned with such force. It must first be noted that the choice of policy instruments following the 1974 recession was different from that of several other major industrial countries. On the whole, up to November 1978 at least, monetary policy in the United States was designed primarily to facilitate domestic economic expansion, while in several other large countries, Japan and Germany in particular, it was aimed more at reducing inflation and safeguarding the exchange value of the currency.

US fiscal policy, while apparently quite expansionary in terms of the absolute size of the Federal Government's budget deficit, became more contractionary as time passed, with the deficit falling from 4.6 per cent. of the gross national product in 1975 to 1.4 per cent. in 1978. This development contrasted with those in Germany and Japan, where budgets were only gradually made more effectively expansionary in the face of a clear need to stimulate demand. Hence, in contrast to the United States, these two countries appeared to concentrate fiscal policy on moderate domestic growth while relying on monetary policy, shielded by exchange rate appreciation, as a means of gradually lowering the rate of inflation.

The exchange value of the dollar did not initially present a special problem. As time went on, however, US policy attitudes towards expansion, the significant overshooting of the monetary targets and the ready availability of credit helped to rekindle inflationary expectations and exacerbate the decline in the dollar's international value. It has been estimated that this decline added a full percentage point to US consumer price inflation in 1978. Its impact may have been even greater if account is taken of indirect effects, such as the tendency of import-competing industries to raise prices as a result of reduced foreign competition. Given the dollar's international importance, exchange-market developments reinforced inflationary expectations and made the US inflation problem an increasingly intractable one.

In assessing the inflationary outlook, the US authorities may also have been misled by existing indicators of capital and labour-market tightness. In all industrial countries general measures of labour and capital stock utilisation, such as the capacity utilisation rate and the aggregate unemployment rate, play a key rôle in helping policy-makers to assess the scope for counter-cyclical policy, be it monetary or fiscal. Yet these broad aggregative indicators have lost some of their credibility as guides to the state of labour and capital stock utilisation. In the United States substantial changes in the composition of the labour force have made historical comparisons of the unemployment rate increasingly tenuous. It is also uncertain to what extent higher energy prices have effectively reduced the economic size of US capital stock and hence the non-inflationary utilisation threshold. But although the conventional capacity utilisation indicator had risen to 82.5 per cent. in manufacturing in 1977, the authorities still seemed reluctant to tighten the monetary reins.

Nominal wage increases were not considered to point clearly to a resurgence of inflation either. Earnings per hour in the private business sector rose by 9.3 per cent. in 1978, only marginally higher than the 8.7 per cent. increase recorded in 1976. The major surprise, apparently, was the unexpectedly poor productivity performance in 1977 and again in 1978. The increase in output per man-hour in the private business sector dropped off from 3.6 per cent. in 1976 to 0.4 per cent. in 1978, resulting in a strong advance in unit labour costs. Indeed, at 8.9 per cent. in 1978, the rise was almost 4 percentage points more than just two years earlier — 3 points of which were thus accounted for by the decline in productivity.

Moreover, food prices, after recording an unusually low rate of increase early in the recovery period, particularly in 1976, accelerated abruptly in 1978. Of course, a large relative rise in one price component need not lead to an increase in the general price level, but in a world of administered prices such a tendency is difficult to offset. Thus, with the food price component moving up steeply by almost 12 per cent. in 1978, as against a rise of less than 1 per cent. in 1976, the overall consumer index was strongly affected.

Two further factors, though non-quantifiable, may be mentioned in this context. One is the difficulty experienced by the authorities in assessing the force of their own monetary stimulus to final demand. Institutional and technological changes in money management, particularly in 1974 and 1975, but again in late

1978, may have led to some underestimation of the impact of monetary expansion. This difficulty, together with the use of interest rates as intermediate targets during periods of pronounced swings in inflation rates, complicated the task of assessing the potential inflationary influence of a given monetary stimulus. A second uncertainty was the apparent instability of the trade-off between unemployment and inflation. There is a growing body of evidence which suggests that the trade-off may be shorter-lived, more unstable and less favourable than previously and that no long-run trade-off exists. Thus, a monetary stimulus to demand may fairly quickly drain off into price increases, with little or no long-term net benefit in terms of lower unemployment. While this argument is obviously conjectural and subject to debate, it appears that US policy tacitly assumed the existence of a greater trade-off than did the policy-makers of Germany and Japan who gave more priority to reducing their inflation rates.

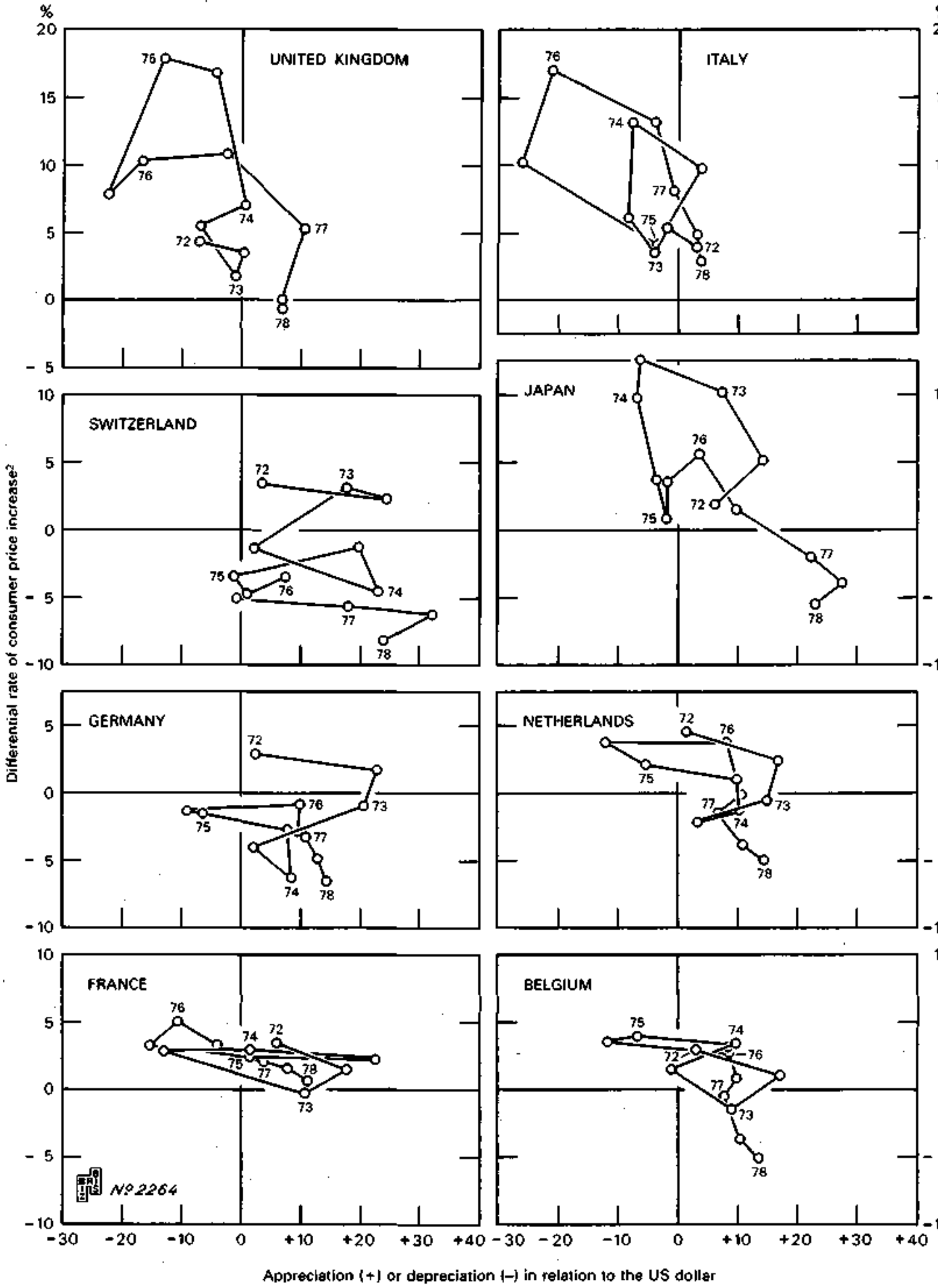
With the United States fostering, or acceding to, more expansionary policies than those pursued elsewhere, inflation rates showed increasing divergence, and the differences were magnified by inflationary feedbacks stemming from the unexpectedly large decline in the exchange value of the dollar. Although the United States has become more open in terms of trade and capital flows since the late 1960s, its domestic prices have been relatively insensitive to swings in exchange rates of modest proportions. In the event, the exchange rate impact on US inflation appears to have been considerably larger than anticipated.

The strong expectational element influencing exchange rates and the apparent willingness of other countries, particularly Germany and Japan, to accept a marked appreciation in their exchange rates accentuated the deterioration in the US price performance. In one sense, flexible exchange rates were performing much as to be expected insofar as they were adjusting to significantly different demand-management policies. In other words, the exchange markets were to a large extent reflecting the major difference in economic goals that has existed since the severe US recession in 1974–75. What was unexpected was the unusual degree to which exchange rates actually moved and the inflationary feedback generated by exchange rate changes. Thus, it is the pronounced movement in market exchange rates, with only slow underlying real adjustment, that has distinguished the most recent recovery from corresponding periods of earlier cycles.

The interaction of exchange rates and domestic prices.

It has been argued above that relatively strong US demand pressures as from 1976, together with the return to higher inflation rates from 1977 onwards, contributed to the decline of the dollar. In turn, the dollar's depreciation led to an exacerbation of emerging US inflation, while concurrently helping to reduce the rate of inflation elsewhere. This interpretation is a variant of the now familiar theory of "vicious" and "virtuous" circles of exchange rate/inflation behaviour. It may be illustrated with the help of the following graph, in which individual country performance is measured at six-month intervals relative to that of the United States. The horizontal axis shows twelve-month rates of appreciation or depreciation relative to the US dollar, and the vertical axis shows the differential

Inflation differentials and exchange rate movements: Comparisons vis-à-vis the United States.[1]



[1] Twelve-month rates of change shown at six-month intervals from end-1972 to end-1978. [2] Positive figure denotes higher inflation rate relative to the United States.

between the twelve-month rates of consumer price increase in the country in question and those in the United States. Such comparisons seem warranted because the resurgence of inflation was mainly a US phenomenon, because recent exchange rate changes occurred mainly in relation to the US dollar and because these changes have been "exogenously" influenced by expectations and the level of confidence. Another reason is that the prices of some internationally traded commodities, particularly oil, are fixed in terms of dollars.

In relation to the United States, other countries experienced, from about the middle of 1976 onwards, a marked improvement in their exchange rate performance, which was then followed, with a time-lag, by an improvement in their comparative price behaviour too. In practically all the countries shown in the graph, the sequence of events, reflected in the tendency of the observation points to move in a clockwise direction, was an initial appreciation, or decline in the rate of depreciation, with relative price performance then tending to show increasingly good results in combination with a further appreciation of the exchange rate. For the United States, the sequence was just the opposite, with the initial depreciation of the dollar being followed in time by a progressive deterioration in price performance and further depreciation.

Once it has got under way, there are no necessary equilibrating limits to the interactive process between exchange rates and prices, though Swiss experience has shown that consumer prices are unlikely on average actually to fall in absolute terms. It is possible, in other words, for inflation rates to move increasingly far apart as long as the monetary authorities are prepared to accommodate the process. In practice, however, the authorities at some point feel impelled to take action to interrupt the process by changing the degree of monetary stimulus. The responsibility for adjustment measures falls, more often than not, mainly on the country locked into a vicious circle of depreciation and inflation. In the United Kingdom, for example, relative price performance deteriorated quite sharply over the two years to the end of 1975, and the counter-clockwise movement shown on the graph, culminating in substantial depreciation in 1976, is one example of the vicious circle at work. The stabilisation measures adopted by the United Kingdom in late 1976 and early 1977, which relied partly on incomes policy and an international financial package, helped for a time to turn the vicious circle into a virtuous one. Similarly, Italy has experienced two complete cycles of alternating behaviour, with domestic price behaviour sometimes leading, and sometimes following, that of exchange rates. By contrast, Germany, Switzerland and Japan, by intervening last year to prevent an excessive appreciation of their currencies, had to accede to more expansionary monetary policies and thus to greater risks of inflation.

It is true, of course, that inflation differentials and exchange rate variations are both responsive to relative differences in economic performance and policy stance. However, as exchange rates are highly sensitive to changes in expectations, shifts in confidence, adjustments in portfolio positions and risk preferences, their movements may at times, and under certain conditions, assume an independent life of their own. This is often referred to as "overshooting", in the sense that rates have moved by more than seems justified in terms of inflation differentials, current or prospective. And to the extent that overshooting occurs, exchange rates may themselves amplify inflation differentials through their immediate effects on the prices of tradable goods. The end result has been that domestic rates of inflation have been very sensitive in the short run to relative monetary conditions, but in the reverse direction from that experienced under stable or fixed exchange rates.

As the graph shows, a number of countries were in a very strong position relative to the United States at the end of 1978. In Japan, Switzerland and, within the European "snake", Germany, Belgium and the Netherlands, the twelve-month currency appreciation in terms of the US dollar ranged from about 15 to 25 per cent. and the relative inflation advantage was between 5 and 8 per cent. As might be expected, the pattern of exchange rate/price performance in the case of Belgium and the Netherlands was very similar to that of Germany, thus demonstrating that a small open economy can strengthen its anti-inflationary efforts by pegging its exchange rate to a strong currency. All of these countries, it may be added, have put inflation control at the forefront of their policies, and they have hesitated to introduce active measures aimed at a return to high rates of growth.

In France the exchange rate/inflation pattern has borne certain similarities to that of the "snake" countries, though at a generally higher rate of inflation and with differences associated with interruptions in the French link with the "snake". France withdrew from the arrangement during the period from January 1974 to July 1975 and left the system again as from March 1976.

Like France, the United Kingdom and Italy have had high indigenous rates of inflation. Even though the recent appreciation of their currencies against the dollar has helped their inflation performance, consumer price inflation in France and the United Kingdom is running at an annual rate of about 10 per cent. and in Italy at close to 14 per cent. Inflationary expectations in these countries are still deeply ingrained and formal or de facto indexation arrangements have helped to perpetuate the inflationary process.

Though tempting, it would be risky to draw conclusions about the sustainability of the exchange rate relationships and the inflation differentials that have emerged over the past two or three years. On the one hand, it looks as if the appreciation of various currencies against the US dollar had by late 1978 run far ahead of the changes that would have been warranted by purchasing-power-parity considerations alone. On the other hand, confidence factors have changed, as reflected in currency diversification tendencies, and policy attitudes towards exchange rate management may also have altered. Moreover, with the launching of the EMS arrangements, a new initiative has been set in motion to enlarge the European area of exchange rate stability. In view of the greater interest that many countries — including the United States — now have in reducing the unexpected variability of exchange rates, the most that can be said is that exchange rate fluctuations may diminish. Other things being equal, this implies a tendency towards greater convergence of inflation rates and a new policy challenge to those countries which significantly reduced inflation through currency appreciation.

Wages, prices, productivity and unemployment.

In previous sections much has been said about the rôle of exchange rate changes in aiding or hampering countries in their efforts to control inflation.

However, the process is a complicated one, as it depends largely upon how the domestic price/wage mechanism responds to beneficial or adverse price effects originating from abroad. And of course this is only one factor among others helping to explain international differences in inflation performance.

It has mainly been countries benefiting from the appreciation of their currencies that have succeeded over the past two years in reducing their inflation rates to satisfactorily low levels. The table below shows that these same countries — Japan, Germany, Austria, Belgium, the Netherlands and Switzerland — have also been very successful in bringing down, or keeping at a low level, the nominal growth of industrial earnings or wage rates. In all of them, moreover, real earnings after adjustment for current price inflation showed modest gains.

But some other countries have also managed to reduce their inflation rates to appreciably lower levels — often even in the aftermath of exchange rate depreciation. These include Sweden, Norway, Finland and Denmark, whose inflation rates in early 1979 ranged from about 5 to 7 per cent. In these cases, too, growing moderation in nominal wage gains may be observed, and in some instances, particularly in 1978 in Canada, Denmark, Finland and Sweden, it is evident that increases in real earnings have been low or negative. Thus, these countries, partly within the context of programmes to stabilise their currencies, succeeded in damping down the inflationary spiral despite adverse external circumstances. An example to the contrary, of course, is the United States, where nominal earnings speeded up in 1978 in the wake of the earlier acceleration of inflation and decline of the dollar.

A third group consists of such countries as France, Italy and the United Kingdom, where inflation rates have recently increased again and are running at about 10 per cent. and more. Each of these countries, it may be added, has benefited

Nominal and real earnings in industry.

Countries	Nominal earnings*					Real earnings				
	1974	1975	1976	1977	1978	1974	1975	1976	1977	1978
	changes from December to December, in percentages									
United States	8.6	8.1	7.7	7.4	9.3	−3.2	−0.8	2.8	0.6	0.3
Canada	16.6	13.4	12.7	9.6	6.8	3.6	3.6	6.5	0.1	−1.5
Japan	25.6	14.5	11.2	9.3	7.0	3.0	6.3	0.7	4.3	3.4
Germany	16.4	5.9	7.2	9.3	5.7	9.9	0.5	3.2	5.6	3.2
France	*20.3*	*14.8*	*15.1*	*12.1*	*12.6*	*4.4*	*4.7*	*4.7*	2.8	2.6
Italy	*24.0*	*20.2*	*28.7*	*22.9*	*16.1*	*−1.0*	*8.2*	*5.7*	*7.0*	3.8
United Kingdom	27.6	20.7	12.3	11.2	15.0	7.0	−3.4	−2.4	−0.8	6.1
Austria	15.3	10.4	7.2	4.4	4.7	5.1	3.4	0.0	0.2	1.0
Belgium	24.4	16.2	9.5	8.7	6.3	7.5	4.7	1.8	2.3	2.3
Denmark	22.0	13.9	11.4	10.2	9.7	5.6	3.9	−1.5	−1.8	2.4
Finland	24.6	17.2	14.0	7.9	5.7	6.6	−0.8	1.5	−3.6	−0.2
Netherlands	*17.1*	*13.1*	*8.4*	*6.5*	*5.0*	*5.6*	*3.7*	*−0.1*	*1.2*	*1.1*
Spain	31.3	26.5	29.8	27.0	26.1	11.4	10.9	8.3	0.5	8.2
Sweden	13.7	18.7	11.0	8.9	6.1	1.9	9.0	1.3	−3.4	−1.2
Switzerland	13.2	6.2	1.1	2.1	3.7	5.2	2.7	−0.2	1.0	2.9

* Monthly, weekly or hourly earnings, except for figures in italics, which refer to wage rates.

appreciably from exchange rate strength relative to the US dollar over the past year or two. But, as the foregoing table shows, nominal earnings or wage rate increases in 1978 ranged from 13 to 16 per cent. In France and Italy the substantial real wage gains recorded throughout the 1970s have probably entailed a significant erosion of business profits. In the United Kingdom the earlier progress made in reducing inflation by means of incomes policy, which implied some gradual reduction in real income, was halted by the sharp rise in real earnings in 1978.

More generally, it is possible that high rates of unemployment and slack labour-market conditions have exerted some downward pressure on prices and wages in many countries over recent years. But to what extent this has been the case is a debatable matter. Last year measured rates of unemployment continued to be very high by past standards in most countries. Although unemployment declined substantially in the United States, and to some extent also in Germany and Canada, it increased further in such countries as Belgium, France and Italy.

Unemployment rates.[1]

Countries	1957–73 highest annual rate	1957–73 average annual rate	1975 December	1976 December	1977 December	1978 June	1978 December	1979 April
	in percentages							
United States.	6.8	5.0	8.2	7.7	6.3	5.8	5.9	5.8
Canada . . .	7.1	5.5	7.0	7.5	8.5	8.5	8.1	7.9
Japan	1.5	1.1	2.0	1.7	2.1	2.4	2.3	2.1[2]
Germany . . .	3.7	1.4	4.9	4.4	4.5	4.4	4.1	3.9
France	2.7	1.6	4.2	4.3	5.2	5.2	5.8	6.0[2]
United Kingdom . .	3.8	2.2	5.0	5.6	6.0	5.7	5.5	5.5
Italy[3]	8.2	4.0	3.5	6.8	7.1	7.1	7.4	7.4[4]
Belgium . . .	6.3	3.7	8.7	9.8	11.0	9.9	11.1	11.0[2]
Netherlands .	2.7	1.5	5.5	5.2	5.1	5.1	5.3	5.1[2]
Sweden . . .	2.5	1.5	1.6	1.5	1.8	2.1	2.1	2.0
Switzerland .	0.0	0.0	0.9	0.6	0.4	0.3	0.4	0.4

[1] As a percentage of the civilian labour force (in Belgium the insured labour force). Seasonally adjusted series except for Belgium, Sweden and Switzerland. [2] March. [3] New series as from December 1976. [4] February.

In considering this question, one major concern of policy is the trade-off between unemployment and inflation, the broad implication being that in formulating demand-management policy the authorities must strike a compromise between two desired objectives. Thus, a reduction in unemployment can be achieved only at the cost of more inflation, while a reduction in inflation is possible only at the cost of more unemployment. As shown in the graph, such a relationship seemed to exist in various countries in the 1960s. But since that time, and particularly since the oil crisis of 1973–74, countries have generally been faced with both rapid inflation and high unemployment.

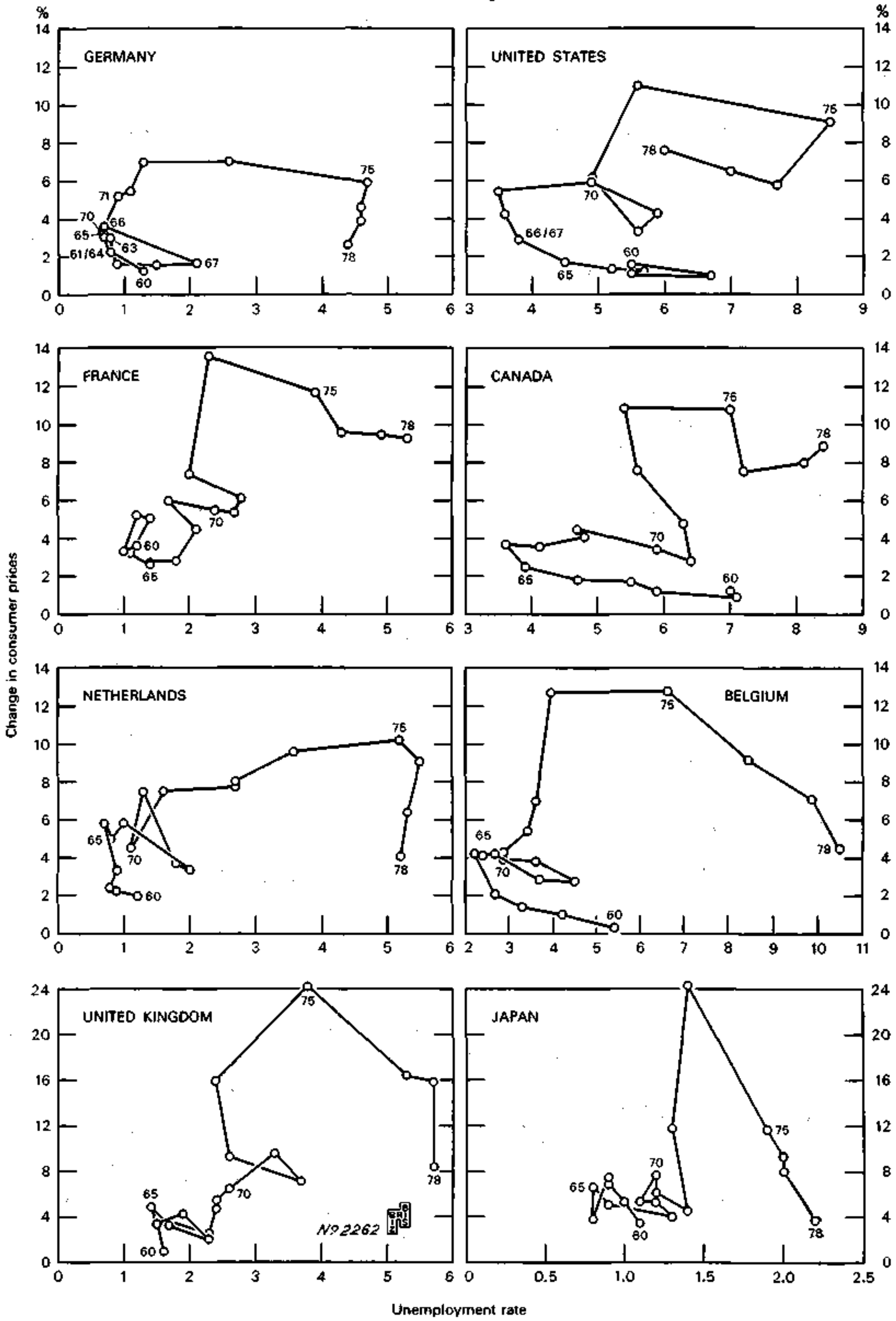
As the graph shows, inflation rates have generally receded since the trough of the recession in 1975, in some cases by substantial amounts. Interestingly, in the countries with currencies appreciating in dollar terms — Germany, Switzerland, Japan, the Netherlands and, more recently, the United Kingdom — inflation rates have fallen quickly with little or no significant changes in the level of unemployment. It might have been expected that a sharp decline in the inflation rate would be accompanied by some relative inflexibility of wages. This would have implied higher real wages and might possibly have curbed the demand for labour, thus leading to higher unemployment. As discussed above, however, wage adjustments kept fairly well in line with price movements in the appreciating countries and short-term increases in unemployment were largely avoided. In France and Belgium the decline in inflation has been accompanied by considerable increases in unemployment, but this may partly reflect structural difficulties in such industries as steel and textiles.

Has the historic relationship between inflation and unemployment changed in some fundamental way? And is it now the case that inflation is itself a cause of unemployment? Some of the arguments regarding these important questions have been discussed in previous Annual Reports. Here it is sufficient to say that national authorities would all like to reduce unemployment to a minimum over the long run, but hold widely differing views on the way in which this objective may be achieved. One approach, consistent with the inflation/unemployment trade-off thesis, is exemplified by US expansionary policy over the past two or three years. In the event unemployment was sharply reduced, but the costs in terms of inflation proved much higher than had been anticipated. Another approach, as followed in Germany and Japan, has leaned to the view that the taming of inflation is a precondition for returning to sustainable long-term growth.

If anything, the experience of recent years, including the inflationary outcome of the US upswing, has tended to confirm the need for cautious policies in pursuing expansion. One reason for this is that structural factors in both industry and the labour market have intruded with great force in the 1970s. Another is that, because expectations have become more finely attuned to underlying economic conditions, economic agents in goods, labour and financial markets now tend to respond to discretionary policy stimuli in ways that quickly activate inflation. To put it another way, private-market price expectations have become increasingly sensitive in recent years to changes in demand-management policies, and to some extent this appears to have lessened the predictability of private-market responses to such changes.

With regard to the first point, it may be noted that overall measures of unemployment no longer appear to be a good indication of the general economic situation. In many countries the authorities consider that they reflect large elements of structural unemployment not amenable to reduction by means of conventional demand-management stimulus. In some countries structural problems have emerged in industries affected by the rapid growth of competition from new overseas sources and by global problems of over-supply in older industries. These problems, which are evident in such industries as steel, shipbuilding, textiles and electronics, have often been made more intractable by related local difficulties of labour immobility. In many countries the skills offered have been inappropriate to the needs of the economy and particular difficulties have been encountered in reducing unemployment among young and female workers. Between 1973 and 1977, for example, the number of young people under 25 years of age rose significantly as a proportion of the

Unemployment and consumer prices, 1960–78.
Annual averages.



unemployed in the United Kingdom (from 25 to 46 per cent.), Belgium (22 to 34 per cent.), the Netherlands (29 to 37 per cent.) and Germany (23 to 29 per cent.), while remaining structurally high (between 40 and 60 per cent.) in the United States, Canada, France, Italy and Sweden. The proportion of females among the unemployed has also risen significantly in such countries as Canada, Italy and the United Kingdom. Moreover, in western Europe — and in apparent contrast with the United States — firms have seemed reluctant to take on labour owing to the strong commitment this may imply in terms of job security regardless of economic conditions. Finally, in some cases unemployment rates may have been swollen somewhat by the effects of unemployment insurance schemes.

As to the second point, the principal difficulty has been experienced in the area of price/cost relationships. It is not that national authorities see unemployment as a means of combating inflation, but rather that they see no way of stimulating demand without at the same time setting off a new spiral of price/wage inflation. Some countries have sought to overcome this difficulty by recourse to some form of incomes policy, but their efforts have met with mixed results. In the most recent case — that of the United States — the use of voluntary price/wage guidelines seems to have run into difficulties and the outcome is not yet clear. In the United Kingdom a great deal was achieved through the incomes policies in effect from 1975 to 1978, but events since last summer have shown how hard it is to maintain the framework of such a policy and to shift flexibly to new pay norms. In recent experience, perhaps the greatest success has been achieved by countries that have been able to follow a determined policy of reducing inflation. In some of these countries — Germany and Japan again being examples — the authorities appear to have been instrumental in encouraging negotiations to proceed in terms of real rather than nominal magnitudes.

Employment and labour productivity.

Countries		Total employment[1]					Labour productivity[2]				
		1974	1975	1976	1977	1978	1974	1975	1976	1977	1978
		annual averages, percentage changes									
United States	Total economy	1.6	−1.3	3.1	3.4	4.1	−2.9	0.2	2.4	1.4	−0.2
	Manufacturing	−0.1	−8.6	3.7	3.4	3.5	1.5	1.0	4.7	1.6	2.4
Canada . . .	Total economy	4.3	0.9	2.1	1.8	3.3	−0.7	0.5	3.4	0.8	0.1
	Manufacturing	3.0	−5.6	1.4	−1.4	1.0	1.9	1.0	3.4	5.5	3.6
Japan	Total economy	−0.4	−0.3	0.9	1.4	1.2	−0.1	1.7	5.5	4.1	4.3
	Manufacturing	−0.5	−5.4	−2.7	−1.8	−3.0	1.3	−3.1	10.3	5.7	8.8
United	Total economy	0.4	−0.5	−0.7	0.5	0.1	−2.1	−1.2	4.3	0.8	3.2
Kingdom .	Manufacturing	0.6	−4.9	−3.2	1.5	−0.6	−1.4	1.1	5.3	−0.6	4.4
France . . .	Total economy	0.8	−1.9	0.6	0.8	0.6	2.0	2.2	4.0	2.2	2.2
	Manufacturing	−2.6	−1.1	−1.1	0.8	−2.0	6.7	−5.1	11.2	3.5	4.9
Germany . .	Total economy	−1.9	−3.4	−0.9	−0.2	0.6	2.3	1.5	6.0	3.0	2.5
	Manufacturing	−2.6	−6.7	−2.4	−0.8	−0.6	3.0	4.9	8.7	2.6	2.8
Italy	Total economy	2.2	0.6	0.6	1.0	0.4	2.0	−4.0	5.1	0.7	1.9
	Manufacturing	2.9	0.2	−1.2	−5.8	−1.0	0.9	−3.9	6.8	5.7	3.0

[1] For France and Italy, civilian employment only. [2] In the case of manufacturing industry, adjusted for the number of hours worked.

By what mechanism can cautious demand-management policies be expected to lead ultimately to a resumption of growth? In countries that have pursued this path, the main assumption seems to have been that inflationary expectations would be gradually reduced and satisfactory cost/price relationships restored. In this way profitability would improve and fixed investment outlays would rise. Of course, there can be no certainty that such a strategy will prove successful. On the whole, however, it has appeared over the past year to be working out this way in a number of countries, not least Germany and Japan. One contributory factor — a largely unexpected and perhaps transient one — was the terms-of-trade benefit deriving from exchange appreciation. More fundamentally, it is a question of the behaviour of earnings in relation to labour productivity.

As pointed out in Chapter II, labour productivity gains in the economy as a whole have been disappointingly low in a number of countries in recent years. In the United States and Canada, for example, overall labour productivity has on average shown only negligible increases since 1973, while there have been unusually large gains in total employment. Elsewhere, particularly in France, Germany and Japan, increases in overall productivity have been more impressive, though with much smaller additions to the active labour force. However, when one looks at labour productivity in the manufacturing sector alone, with adjustments to allow for hours worked, the picture changes appreciably. In general, the labour productivity gains are there seen to be higher, in some cases substantially so, and have usually been accompanied by marked relative shifts in the labour force from manufacturing to other sectors, mainly services. In the absence of satisfactory price indices of manufacturing output with which to compare these data, it is difficult to be precise about the implications for profitability. However, crude comparisons with the changes in real earnings in industry (i.e. nominal earnings adjusted for the rise in consumer prices) leave a firm impression of well sustained or improved profitability in industry last year in many countries, except apparently in Italy and the United Kingdom.

Some implications of recent developments.

Developments over the past year or two have shed new light on the inflationary process, the international transmission mechanism and the problem of policy co-ordination among countries.

On the national level, the experience of the United States has been particularly revealing. As events have shown, it is not possible for a country, especially a large reserve-currency country, to rely on floating exchange rates as a means of pursuing independent domestic policies without adverse external repercussions. The relative strength of US domestic demand, together with the domestically induced resurgence of price inflation, contributed through the decline in the dollar to strong inflationary feedbacks in an already overheating economy. Hence, despite the wider benefits implicit in its earlier "locomotive" rôle, the US economy no longer seems to be in a position to sustain a level of domestic demand significantly higher than that existing elsewhere. Whether this is a basic weakness of the flexible exchange rate system is not yet clear. The outcome will depend on the ability of other major industrial economies to maintain their growth more independently than in the past.

Elsewhere, it has been encouraging to see the extent to which countries pursuing cautious expansionary policies have been able further to reduce inflation and, it is to be hoped, inflationary expectations as well. Admittedly, the countries with appreciating currencies have had the greatest success in this regard; however, the domestic price benefits to be derived in this way are not available to all countries, nor to any one country for an indefinite period. Interestingly, the United States itself, by its lapse into high rates of inflation and external deficit, has made it easier for other countries to bring down their own inflation rates through appreciation. But just as exchange rates can "overshoot", so too can inflation differentials. The greater exchange rate stability observed since late 1978 will, in effect, bring to light the underlying price performance of the strong-currency countries.

It would be wrong, however, to associate price performance too closely with exchange rate movements. In the first place, a number of other countries, such as Finland, Norway and Sweden, have made substantial progress in the fight against inflation even though on occasion they have had to accept some exchange depreciation. In the second place, an appreciating currency brings only transitory improvement on the prices front unless the price benefits can also be translated into better performance with respect to wage earnings. On this score, a number of countries, with appreciating currencies or otherwise, have registered successes in lowering both price inflation and the rate of nominal wage increases. Slack labour-market conditions may have contributed to this, but so too did the authorities' persistent efforts to encourage reasonable negotiated wage settlements. The major setback occurred in the United Kingdom, but nominal wage gains have also continued to be stubbornly high in France and Italy.

Another implication is that sensitive response mechanisms are, in a sense, already mortared into the price/wage structure, in the form either of de facto and formal indexation arrangements or of adaptive behaviour based on past experience. Just as earnings behaviour has adapted with considerable flexibility to a decelerating rate of price inflation, so may the reverse process quickly set in if inflation again accelerates. Higher rates of inflation may also unhinge existing wage differentials and stimulate more aggressive wage bargaining. In addition, the dynamics of the modern inflationary process are such that it is very difficult to bring the rate down in an acceptable and sustainable manner over any reasonably short period. Again, US experience over the past two years has tended to confirm earlier misgivings in all these respects. It is no wonder, therefore, that the authorities in many countries are very sensitive to any rekindling of inflation and ready to react quickly. Such sensitivity may be particularly acute where a rapid decline in inflation has been achieved with the help of currency appreciation and hence some reversion to a higher underlying inflation rate is feared.

Recent experience also lends support to views which have put increasing emphasis on "supply side" problems. For a variety of structural reasons, it would appear that excess capacity and effective unemployment may be significantly less than suggested by the conventional statistical aggregates. Among the factors involved have been changes in relative prices (particularly for energy supplies), low rates of fixed investment in the 1970s and low labour mobility linked partly to slower growth. Moreover, owing to uncertainties regarding price/cost relationships, and in some cases because of high real wages, firms have been reluctant to hire additional labour. It must be remembered, too, that the protracted period of high inflation rates created its own distortions, and that an extended phase of price deceleration, however gradual, has tended to lay these bare.

On the international level, supply inelasticities also seem to be an important constraining factor in the present situation. As we have seen, with demand still expanding in North America and Japan, the renewed recovery of demand and output that began in western Europe last summer appears to have contributed to the sharp rise in world commodity prices that has occurred since that time, and even to higher oil prices. Some change in overall demand conditions, induced perhaps by a slowing-down of the US economy, could alter this picture, but the broader implications are not favourable. It would appear that the industrial countries can no longer expand very fast as a group without touching off a substantial rise in the prices of internationally traded commodities.

On both international and domestic grounds, therefore, the industrial world may have to be content with lower rates of growth than it was accustomed to in the past. Moreover, to avoid disruptive movements in exchange rates, these rates of growth — or, more specifically, the degree of demand pressure and capacity utilisation — should be more uniform than has recently been the case. Finally, countries should energetically pursue "supply side" policies aimed at encouraging investment, increasing labour mobility and eliminating structural imbalances.

IV. DOMESTIC MONETARY AND CREDIT DEVELOPMENTS AND POLICIES.

Monetary and financial developments in the industrial countries last year bore the imprint of the cyclical divergences discussed in the preceding chapters. In most cases the medium-term aim of monetary policy was still to help moderate inflation by gradually bringing down rates of monetary expansion and/or by supporting the domestic currency in the exchange markets. In the event, however, US monetary policy accommodated a rapid growth of total credit and a strong economic recovery. In consequence, the US dollar suffered a sharp decline and currency appreciation became a real threat to the still weak economic upturn in a number of other countries. In the context of large-scale exchange-market interventions, monetary expansion quickened in Germany, Japan and Switzerland.

The situation changed after November, when a significant further rise in US interest rates helped to strengthen the dollar and established the preconditions for a moderate tightening of monetary policy in several countries. By early 1979 accelerating inflation had become a central concern of the monetary authorities in the majority of the industrial countries.

Monetary developments and policy problems.

The monetary aggregates. Since the early 1970s the pace of monetary expansion in most of the industrial countries has slowed down considerably. This can be

Rates of expansion of the money supply.

Countries	Narrow money supply (M_1)						Broad money supply[1]					
	Averages[2]			Four quarters ending			Averages[2]			Four quarters ending		
	1966–69	1970–73	1974–77	1976 IV	1977 IV	1978 IV	1966–69	1970–73	1974–77	1976 IV	1977 IV	1978 IV
	In percentages											
United States	5.2	6.5	5.8	5.8	7.9	7.3	7.0	9.6	9.2	10.9	9.8	8.5
Japan	16.0	22.1	10.6	14.6	6.0	12.3	16.5	20.8	12.6	14.2	10.6	12.6
Germany	6.4	8.6	10.7	6.4	10.5	13.5	10.6	11.2	9.2	9.7	10.3	11.3
France	5.1	10.4	11.6	10.7	9.4	11.9	10.7	15.9	15.3	14.2	13.0	12.8
United Kingdom	2.8	9.6	15.4	13.5	19.1	15.0	5.6	18.2	8.7	10.6	7.0	13.6
Italy	13.9	21.3	16.3	21.6	20.9	25.3	12.7	17.3	20.4	21.5	20.9	23.1
Canada	6.8	11.7	9.9	2.5	10.5	11.1	9.8	12.0	14.6	12.7	12.2	12.5
Belgium	4.8	10.7	8.5	8.2	9.1	8.8	8.3	12.8	11.0	12.6	8.3	9.7
Netherlands	8.0	11.2	12.8	7.2	14.4	3.4	10.1	13.2	12.8	21.3	6.4	5.5
Sweden	8.8	10.6	13.3	8.6	11.3	15.2	.	10.1	9.1	6.9	8.1	16.3
Switzerland	5.8	9.4	4.5	7.5	5.1	22.5	9.2	6.9	4.1	1.9	6.9	7.7

[1] For Germany, M_3; for the United Kingdom, sterling M_3; for other countries, M_2. [2] Compound annual growth rates based on average fourth-quarter levels.

seen most clearly in the broad monetary aggregates, which are generally less subject than the narrow ones to fluctuations induced merely by changes in interest rate differentials. As shown in the table, the growth rate of the broad money supply was lower in the period 1974–77 than in the years 1970–73 in all the industrial countries except Italy and Canada.

This development largely reflects the fact that efforts to stabilise and bring down monetary growth rates have become a deliberate element of policy in a number of countries as a result of the rapid inflation experienced in the early 1970s. By the summer of 1978 norms or projections for the growth of the monetary aggregates had been adopted and published by eight of the Group of Ten countries and Switzerland — the aim generally being to help modify expectations of price increases and to consolidate progress made in reducing the rate of inflation. For technical and institutional reasons, of course, the operational targets varied widely from country to country. Other countries continued to consider that their stabilisation efforts would be better served by laying emphasis on interest rates and exchange rates.

By previous standards monetary expansion was unusually rapid in the early 1970s and by and large it continues to be quite fast. In many cases, however, this is broadly consistent with the view that the curtailment of money growth has to be gradual in order to avoid economic disruption. To a degree the recent high rates of monetary expansion in such countries as France, the United Kingdom and Canada reflect this gradualist approach. More disquieting is the fact that the US rate of monetary expansion in 1976 and 1977 was scarcely below its peak in the early 1970s at a time when the rate of growth of the broad money supply in Germany and Japan had slowed down considerably. Last year, however, the favourable performance of these countries was interrupted largely by exchange-market developments, which caused monetary expansion to accelerate again.

In seeking to curb the growth of the money supply, countries have been influenced by three main considerations. The first was a desire to avoid upward pressure on interest rates which could jeopardise the recovery of the domestic economy. This gave rise to the well-known dilemma with which the US authorities were faced between 1976 and 1978 and which also came to play a rôle in Germany. The second was a reluctance to accept an excessive currency appreciation which would also tend to depress domestic economic activity, mainly through its effects on exports. This was the problem which confronted the German and Swiss authorities in a very acute form last year but which has also emerged from time to time in the United Kingdom. The third was an awareness of the purely technical difficulties of establishing and implementing monetary control objectives. Here, two of the major difficulties encountered last year were large international shifts in currency portfolios and destabilising reactions in government security markets to short-run or random departures of monetary expansion from the target course.

Interest rate developments. In the United States nominal interest rates on money-market instruments and bank prime lending rates rose quite steeply last year, with the latter going up from 8 per cent. in March 1978 to 11¾ per cent. twelve months later. In Germany and Japan, by contrast, these rates recorded a slight decline in early 1978 and then remained practically stable until the spring of 1979, when a modest rise was encouraged in both countries by increases in discount rates. What is striking, however, is that the rise in US rates was so heavily concentrated at the end of 1978 after the dollar had declined. Until then the Federal Reserve had sought to moderate the rise in interest rates through open-market operations even though the rate of expansion of the narrowly defined money supply was running consistently above the upper limit of the authorities' target range. Moreover, adjustments in Federal Reserve discount rates tended to follow increases in market rates instead of leading them.

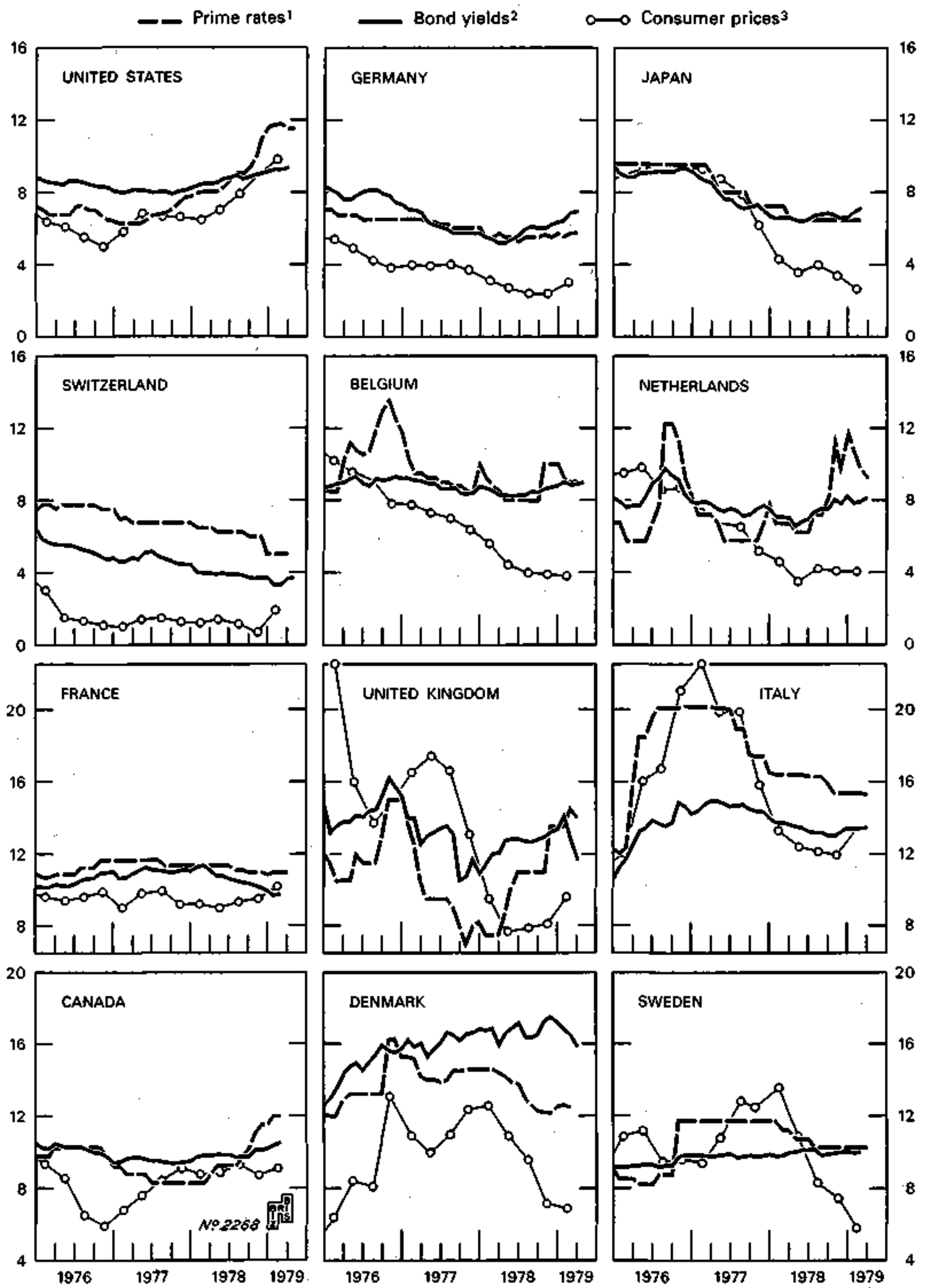
It is also interesting to compare prime rates with rates of inflation in the countries concerned. In the United States the margin by which prime rates exceeded the rate of inflation seems to have been falling until November, whereas it was rising in Germany and Japan. A similar tendency for "real" interest rates to remain relatively low in the United States is evident in the capital market.

In Japan nominal bond yields edged up in the summer and autumn of 1978 and in Germany they actually went up by over 1½ percentage points between March 1978 and March 1979 — a larger rise, in absolute terms, than was recorded in US yields during this period. The authorities' ability to influence these rates directly may be limited, at least in countries with broad capital markets, and the divergence in "real" bond yields may simply have reflected market expectations that rates of inflation would tend to converge in the long run. Yet it seems unlikely that the increase in yields in Germany was entirely due to this factor. Until at least early 1979 rises in yields may not have been an accurate reflection of the wishes of the authorities, given their desire to foster the domestic economic recovery and to ward off pressure on the Mark. During most of 1978 policies with respect to bank liquidity were fairly generous. However, the large government borrowing requirement, together with a recovery of private demand for credit, weighed on the markets. In Switzerland bond yields moved down but, as in Germany and Japan, remained fairly high in relation to the rate of inflation.

In the United Kingdom interest rates at both short and long term rose steeply in the course of 1978. The main reasons were the worsening prospects for wage and price stability and the fact that the authorities encouraged a rise to ensure that sales of gilts were sufficient to keep monetary expansion in line with the targets. In early 1979, however, a sharp downward correction took place when the outlook for sterling and for monetary control improved.

In most other European countries movements in interest rates last year were linked in varying degrees to exchange-market developments. Money-market rates and bank prime lending rates edged down in France, Italy and Denmark, although in the last two countries they remained relatively high. In Belgium and the Netherlands, on the other hand, rates rose steeply for a time in the autumn when the stable relationship between these currencies and the Deutsche Mark was once again tested in the exchange markets. Bond yields declined somewhat in France and remained stable in Italy but rose in Belgium and the Netherlands, apparently in sympathy with the trend in Germany. In early 1979 nominal yields showed some tendency to converge in countries that were linking their currencies in the context of the European Monetary System. The fact that in nearly all these countries

Prime rates, bond yields and changes in consumer prices.



[1] 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.) [2] Representative rates. (For the United States, Aaa corporate bonds; for Denmark, mainly mortgage bonds; for Sweden, industrial loans; for Belgium, the Netherlands and the United Kingdom, government bonds; for other countries, various other public-sector bonds.) [3] Year-to-year changes based on quarterly average data.

bond yields remained comfortably above the domestic rate of increase in consumer prices may have been partly due to market forces but it also generally reflected the authorities' deliberate intention — born in some cases of unpleasant previous experiences — to ensure that the external flank was protected.

The United States: Policy priorities and monetary control.

From early 1975 to November 1978 US monetary policy appeared to be directed mainly at sustaining growth and reducing unemployment. Although the monetary target ranges were gradually lowered, the aggregates continued to grow quite rapidly, leading to substantial overshooting in the case of the narrow money supply. This may have contributed to the growing impression that the US authorities were attaching too little importance to reducing inflation and the external deficit.

The stabilisation measures taken on 1st November 1978 came none too soon; however, they seemed to mark a new departure in US policy, particularly with respect to the international position of the dollar. Now, quite clearly, the external effects of policy, and the domestic inflationary implications of external developments, moved more to the forefront.

This shift of emphasis gave rise to a new concern: how to use monetary policy to help bring about a decisive slowdown in inflation without moving abruptly into recession. The problem does not lie simply in the determination displayed by the authorities; it also springs from continuing institutional changes which have made it difficult to measure and control the degree of monetary stimulus.

The problem of control stems partly from the fact that the acceleration in inflation and higher nominal interest rates have induced the private sector to redouble its efforts to economise on idle cash balances. Furthermore, a variety of institutional and regulatory changes have altered the relative attractiveness of different types of bank and non-bank deposits and stimulated the growth of money-market mutual funds. In the long run such changes merely cause an upward trend in the velocity of the narrowly defined money supply. In the short run, however, they blur the distinction between alternative concepts of money and create problems for policies oriented towards control of the money supply. Another problem, which is not confined to the United States, is that propensities to save and invest also appear to have displayed unexpected variability.

What the intermediate targets of monetary policy should be depends on the relative stability of monetary and real behavioural relationships. It is usually agreed that if monetary relationships, in particular the demand for money, are thought to be more stable and predictable than saving and expenditure relationships in a given set of circumstances, control of the money supply can be expected to yield better economic results than the control of interest rates. The reverse will be true, of course, when monetary relationships appear less stable than expenditure relationships. There is no simple rule which suggests that the targeting of the money supply is preferable in all circumstances. Nevertheless, the high and variable rates of inflation characteristic of the 1970s have rendered monetary policies oriented towards nominal interest rates especially problematical. It has become more difficult to ascertain the level of real interest rates, which is the relevant factor in real saving, consumption and investment decisions.

Admittedly the US monetary authorities have faced many other operational uncertainties in recent years. As far as the money stock is concerned, a proliferation of regulatory changes and innovations has considerably reduced the differences between non-interest-bearing demand deposits on the one hand and interest-bearing time and savings deposits on the other. A number of these changes, such as the introduction, from 1972 onwards, of so-called negotiable order of withdrawal (NOW) accounts at mutual savings banks and demand deposit accounts at some mutual savings banks and savings and loan associations, involved the creation of deposit facilities which served as good substitutes for ordinary commercial-bank demand deposit accounts. In addition, the introduction of facilities for making pre-authorised transfers from savings accounts at commercial banks to demand deposit accounts and the provision of savings account facilities at commercial banks for government bodies and businesses gave these accounts new liquidity characteristics. Further regulatory changes in 1978 permitted commercial banks to make automatic transfers between savings deposits and demand deposits, but the legal validity of these changes is under review. As a result of these and other changes the distinction between savings and demand deposits has become very fine indeed.

Other regulatory changes also altered the impact that policy-induced changes in interest rates have on financial flows and the economy. In mid-1978 commercial banks and thrift institutions were permitted to offer six-month money-market certificates in denominations attractive to holders of savings deposits who were sensitive to interest rate differentials. To a large extent the new certificates were intended to help insulate the housing market from a loss of mortgage funds. At the same time, however, such measures blunt the ability of the monetary authorities to reduce aggregate demand by restricting the funds available to deposit institutions. Greater emphasis on rationing the amount of credit provided by the commercial banks and thrift institutions by means of interest rate mechanisms, rather than in the quantitative way implied by interest rate ceilings on deposits, may have altered the impact of interest rate increases of a given size on total credit flows and aggregate spending.

Monetary control may also have been weakened by the commercial banks' use of techniques of "liabilities management" and their growing dependence on non-deposit liabilities. In particular the use of security repurchase agreements, whereby a bank essentially sells to non-banks a security in its portfolio under an agreement to repurchase it at a future date, could have reduced recorded demand deposit balances. The importance of the growth of these repurchase agreements was indicated by the recent proposal to make them subject to reserve requirements. The increasingly efficient use of demand deposit balances by businesses utilising electronic and computer technology also appears to have contributed, at certain times, to keeping reported monetary growth rates below those of comparable earlier periods of cyclical revival.

The problem of monetary control may also have been complicated by the shrinkage of membership in the Federal Reserve System. Commercial banks outside the Federal Reserve System are subject to lower reserve requirements than those within it, and in many cases their reserves may be held in interest-bearing forms.

While due allowance must be made for these numerous technical and institutional factors, it appears nonetheless true that until late 1978 the US monetary authorities laid greater stress on sustaining expansion than on reducing inflation. On the one hand, the changes in the institutional environment have perforce removed some of the trigger mechanisms of credit rationing, particularly in the housing market, that used to be a predictable element of real monetary restraint. On the other hand, with monetary restraint now more dependent on the level of interest rates, there has been great uncertainty as to how high rates would have to be pushed in order to achieve the desired degree of tightness. What is certain is that there has been no "credit crunch" of the kind witnessed in the 1960s, although nominal interest rates are now thought to be comparatively high. The monetary authorities appear to assume that holding them at about this level will contribute to a gradual slowing-down of the real economy — a "soft landing".

Exchange-market problems and monetary policies.

As a result of US developments last year, a central problem for other countries was how to adapt their monetary policies to instability in the exchange markets, particularly that for the dollar.

The severity of the dilemma faced and the responses to it differed widely, with countries essentially falling into three broad groups. In the first were Germany, Japan and Switzerland, whose currencies bore the brunt of the dollar's weakness and which ultimately responded first to upward and then more recently to downward pressures on their currencies mainly by undertaking massive exchange-market intervention. In the second group were a large number of countries whose higher underlying rates of inflation apparently made their currencies a less attractive refuge from the dollar. For instance, France, the United Kingdom and Italy were able, through a combination of interest rate adjustments, moderate exchange-market intervention and moderate exchange rate appreciation, to limit the impact of external developments on domestic monetary conditions. A third group consisted of the smaller countries in the European joint float, which accepted fairly tight money-market conditions for some time as the price of having their currencies appreciate with the Deutsche Mark.

In *Germany* the Bundesbank had added substantially to its reserves in late 1977 and early 1978. Following a brief respite in April and May, intervention purchases of dollars and "snake" currencies rose to a new peak in October. Though it was clear by the summer that the annual average growth in central-bank money (currency plus banks' required reserves against domestic liabilities calculated at unchanged ratios) would exceed the 8 per cent. target for the year, the authorities not only refrained from attempting to sterilise the inflows but even took action to increase banks' free reserves further. No doubt one aim was to avoid upward pressures on interest rates which might have encouraged further inflows, but another consideration seems to have been the weakness of the domestic economy and the belief that the appreciation of the Deutsche Mark could be depended upon to slow the pace of inflation. A total rise of 11 per cent. in central-bank money in the course of 1978 was more than accounted for by the Bundesbank's net purchases of foreign exchange, which contributed 15 percentage points. These purchases were equivalent to over 3 per cent. of the broad money stock. The contribution to monetary expansion in 1978 made by the external item in the monetary survey was less than that, however, as a large part of the inflows involved non-resident funds which entered via the banks and which are not counted in the domestic money supply.

As the economic recovery strengthened, the authorities became increasingly concerned at the possibility of new domestic and imported inflationary pressures, partly as a result of more stable exchange rate relationships in the European Monetary System. While taking advantage of the strength of the dollar in early 1979 to sell foreign exchange totalling the equivalent of over DM 7 billion in February–March, from November 1978 onwards the Bundesbank took measures to tighten bank liquidity, raising the discount rate from 3 to 4 per cent. in March. The monetary target set for 1979 seems to imply that no attempt will be made to reverse the overrun in 1978 but that the authorities will endeavour to avoid a repetition of that experience.

In *Switzerland* the authorities were at first very reluctant to jeopardise the achievement of their monetary objectives through large-scale exchange-market intervention and sought with little success to ward off pressures on the Swiss franc by direct controls on non-resident placements in Switzerland and action to bring down interest rates. By the end of September the effective exchange rate of the Swiss franc stood 30 per cent. higher than a year earlier in real terms — at a level clearly intolerable for the domestic economy if it came to be regarded as permanent. Convinced that they were faced with a shift of large but uncertain proportions in the demand for Swiss francs, the authorities decided to abandon their monetary target, at least temporarily, announcing that they would intervene in the exchange market to the extent necessary to restore the Swiss franc to a rate "clearly over Sw.fr. 0.80 per Deutsche Mark" and hold it at that level. The purpose was to give the exchange market what seemed to have become a necessary basis for stable expectations even at the risk of a resurgence of inflation in Switzerland. Reflecting mainly the large-scale intervention required to stabilise the exchange rate, the rise in the National Bank's foreign exchange reserves (net of swaps with the banks) contributed 20 percentage points to the growth of the adjusted monetary base in the course of 1978 and was equivalent to 10.7 per cent. of the volume of M_1 at the beginning of the year. Despite substantial sales of sterilisation certificates to the banks, the adjusted monetary base grew by 21 per cent., following a rise of 26 per cent. in 1977, likewise due to official purchases of foreign exchange. In early 1979, however, the authorities were able to absorb liquidity on a considerable scale through sales of dollars.

In *Japan* the authorities' periodic efforts to resist the appreciation of the yen led to an increase of 44 per cent. in the official reserves in 1978 as a whole. The expansion of reserve money, at 15 per cent. compared with 8½ per cent. in 1977, was quite substantial. That it was not higher still was partly due to the large amount of government securities which the authorities sold to the banks and the public. The impact of inflows of funds on the growth of the money supply was in the event fairly limited.

Exchange-market developments in Italy, France and the United Kingdom were on the whole less dramatic, though each of these countries faced periods of fairly strong upward pressure on their currencies. In *Italy* interest rates were kept fairly high and the effective exchange rate of the lira was allowed to decline slightly. A considerable rise in the external reserves and the repayment of officially inspired balance-of-payments borrowing — in themselves very welcome — nevertheless contributed 14 percentage points to a 24 per cent. increase in the monetary base (excluding postal deposits). In *France* the authorities were able, by adapting interest rates and public-sector borrowing abroad, to keep the effective exchange rate fairly stable while avoiding excessive monetary expansion. Intervention purchases of foreign exchange were, it is true, substantial at times and for the year as a whole the rise in the Bank of France's external position, originally expected to be neutral, contributed nearly one percentage point to the increase in the broad money supply. In the *United Kingdom* both the external value of the currency and interest rates fluctuated markedly during the year. Reflecting mainly developments in the spring of 1978 when sterling was weak, public-sector external financing (including movements in the official reserves) exerted a contractionary influence on monetary expansion in 1978 as a whole.

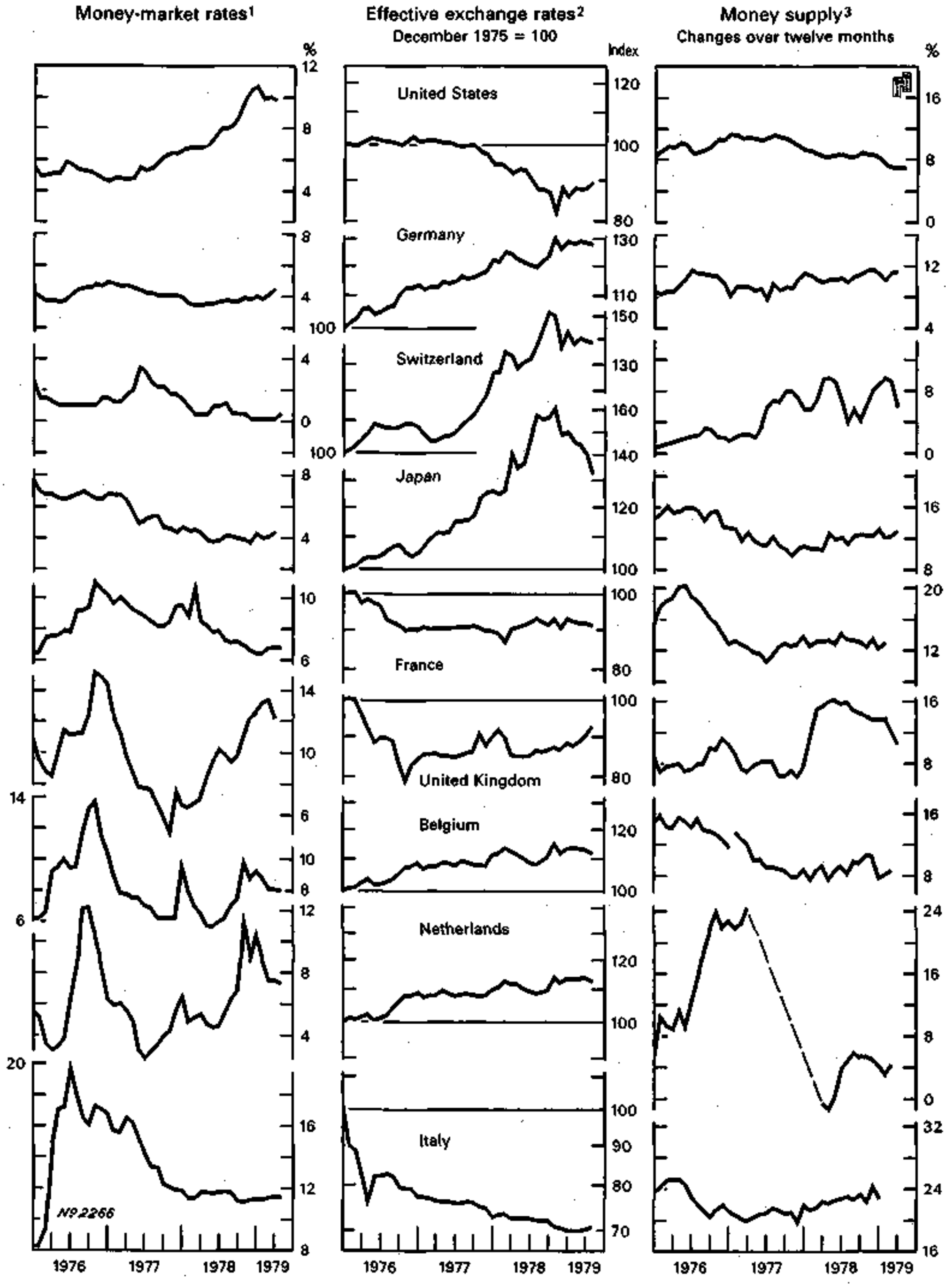
Of the "snake" countries, *Belgium* and the *Netherlands* again had resort to the by now familiar technique of permitting flexible adjustments in money-market conditions to protect their currencies in the exchange market, encouraging short-term interest rates to rise to whatever level seemed necessary for the purpose. To achieve this end they reinforced the restrictive effect of outflows of funds by reducing the refinancing facilities available to banks and raising their cost, particularly in respect of additional borrowing. For October–December 1978 the Belgian authorities also imposed a ceiling on bank credit and introduced provisions to prevent banks from disposing of government securities. Sharp rises in money-market interest rates were, as usual, reflected in temporarily higher charges for bank credit — which itself helped to limit outflows of funds — but capital-market yields could be shielded to a considerable extent. In 1978 as a whole the official reserves of both countries registered a slight decline.

New policy conflicts: Monetary expansion, interest rates and exchange rates.

Far from disappearing, the classic dilemma — that of a conflict between domestic and external objectives — seems to have re-emerged under floating exchange rates in a new guise. The conflicts involved can be viewed in terms of the relationship between rates of monetary expansion, interest rates and exchange rates. With inflation being gradually brought down, the countries which were most successful in curbing monetary expansion also experienced declines in interest rates and appreciating exchange rates.

What the graph on page 63 reveals, however, is the difficulty countries have had in stabilising all three variables simultaneously. Over the past two or three

Short-term interest rates, effective exchange rates and rates of monetary expansion.



[1] Representative rates. (For Japan, call money; for France, one-month interbank rate; for Italy, interbank sight deposits; for Belgium, four-month certificates; for other countries, three-month money-market instruments.)
[2] Bank of England data; semi-logarithmic scale. [3] For Germany, M_3; for the United Kingdom, sterling M_3; for other countries, M_2.

years Japan and, until recently, Germany and Switzerland have experienced fairly stable and moderate rates of expansion of the broad money supply, while their rates of interest — as indicated by sensitive money-market rates — remained almost static or recorded only moderate declines, except in Switzerland where they reached zero. Though the currencies of these countries could have been expected to appreciate, the actual rise was far greater than had been anticipated by the authorities or, apparently, by the market. In the United States rates of monetary expansion, though seemingly moderate by comparison with some other countries, were associated with relatively high rates of nominal aggregate demand. Short-term interest rates rose steeply last year, but not soon enough to keep monetary expansion on course. And, in the event, the increase in interest rates was by no means as fast or as large as those experienced at times in countries which have sought more consistently to stabilise their currencies in the exchange markets.

Some countries — France, for instance, and in 1978 also Italy and the United Kingdom — have been fairly successful in stabilising the effective exchange rate of their currencies by steering a middle course between the dollar and the strong currencies — as have been Belgium, the Netherlands and Denmark in achieving their more ambitious objective of stabilising their currencies against one another and (apart from occasional adjustments) the Deutsche Mark. But all these countries have had to accept very large swings in interest rates and in some cases in the money supply too. In Denmark and Italy interest rates have been less variable than in the other countries but their levels have been kept extraordinarily high.

The difficulties which the authorities may encounter in attempting to reconcile their stabilisation goals for the money supply and interest rates are well documented. But the recent problems they have had in attempting also to meet exchange rate objectives, when confronted with unanticipated economic or financial developments at home or abroad, add a striking new dimension. In addition to causing great uncertainties, exchange rate movements may overshoot differences in monetary developments and relative prices. If, say, in response to expansionary monetary impulses from abroad, some currencies appreciate too much, a contractionary influence may be exerted on aggregate demand in the countries concerned. And if, in these circumstances, countries feel compelled to intervene heavily, then clearly the monetary impulse will be transmitted as under a more stable rate régime. Flexible exchange rates may fail, therefore, to permit monetary developments in individual countries to be insulated as easily as had once been expected — at least in some quarters.

Overshooting of exchange rates is not a new phenomenon and there are a number of reasons why it might be expected to recur from time to time under a system of floating rates. In recent years Italy and the United Kingdom, for instance, suffered from an apparent tendency for their exchange rates to depreciate ahead of developments in relative monetary conditions in a way which seemed to be contributing directly to their inflation. But in those years the concomitant tendencies for the exchange rates of some other currencies to rise were moderate in scope. Indeed, with rates of inflation high everywhere and with price/cost adjustments apparently occurring with increasing speed, modest exchange rate appreciation came to be widely regarded as helpful in bringing down domestic rates of inflation — in some countries monetary policy was actually designed to encourage this. It had always been recognised, however, that an excessively rapid appreciation could have very damaging effects on a country's competitive position and, if it came to be regarded by entrepreneurs as permanent, on its output and employment levels. Unlike the depreciation of less important currencies, last year's decline in the dollar did entail a substantial rise in the effective exchange rates of many other currencies. Moreover, since the ones most affected were those of countries where rates of inflation were already quite modest, it seemed unlikely that prices and wages could bear the full burden of adjustment.

That the dollar's decline last year was so large may reflect a number of factors. Exchange rates are determined in asset markets where a variety of forces come into play. With trade flows and economic activity normally quite slow to adjust to changes in relative prices, markets for financial assets have to bear the brunt of the adjustment in the short run. Financial markets seem not only to respond to the state of the external accounts and to current policy developments but to allow, in addition, for the expectation that differences in policy approaches and economic developments will continue well into the future. At the same time markets' judgements of policies evidently respond not only to proclaimed intentions but also to the varying credibility of monetary authorities with differing records of effectiveness in the struggle against inflation. Moreover, uncertainties in the exchange markets may simply have become so great last year that participants were unwilling to take positions in support of the dollar.

The situation was aggravated by the fact that the dollar plays a large rôle as an international trading and reserve currency and is widely held by residents of foreign countries. Thus, foreign holders experienced a steep decline in the value of their dollar balances — measured in domestic currencies or in terms of their purchasing power — which to some extent may have depressed their own spending. Furthermore, they seem to have reacted to the dollar's decline by attempting to diversify their currency portfolios. Only a movement of this sort could account for the strength of the upward pressures experienced by the Deutsche Mark, the Swiss franc and the yen. To some extent these shifts in portfolios may be irreversible and there is much uncertainty as to how far the process still has to run.

Government and private-sector financing.

A composite picture of monetary expansion set in relation to developments in the banking system's net foreign assets and in bank credit to the domestic economy is given in the table below. In most cases figures for changes are based on flow data that exclude valuation changes, which can be substantial for the foreign item in particular.

The most notable difference between credit developments in the United States and those in other countries lies in the trend of credit to public authorities. It should be noted, however, that the US figures include only commercial banks' holdings of Treasury securities, which they cut back last year to help finance a 12½ per cent.

Changes in the broad money stock and the contributions of domestic credit and external counterparts.[1]

Country	Broad money stock[2]			Net foreign assets[3]			Credit to public authorities[4]			Credit to enterprises and individuals[5]		
	1976	1977	1978	1976	1977	1978	1976	1977	1978	1976	1977	1978
	Dec.–Dec. in percentages			contributions to the change in money stock[6]								
United States	11.4	9.3	8.3	–0.2	–4.0	–1.7	2.8	–0.3	–0.9	6.9	12.2	12.9
Japan	13.5	11.1	13.1	0.7	1.7	1.0	4.4	3.6	6.1	12.0	9.0	10.1
Germany	8.2	11.2	11.0	1.7	1.9	1.2	5.9	4.8	6.1	12.7	12.9	15.1
France	12.8	13.9	12.3	–1.1	0.6	0.9	2.1	0.1	0.3	13.9	13.2	13.3
United Kingdom	10.6	7.7	13.5	–5.7	9.7	1.1	9.3	–6.3	5.4	9.6	8.0	10.5
Italy	21.1	21.9	22.6	–0.6	1.7	4.1	11.0	11.2	14.1	14.6	7.3	5.3
Belgium	13.1	9.1	7.8	–2.1	–0.5	–4.8	8.6	4.6	9.7	8.1	9.3	6.0
Netherlands	25.0	3.6	4.2	0.8	–1.2	4.8	3.7	1.5	3.6	8.2	24.4	30.4
Denmark	11.5	9.8	6.7	–8.9	–2.9	–0.9	7.7	4.5	3.2	13.6	9.0	5.9
Sweden	6.0	9.0	17.7	–1.5	1.8	–1.4	–0.8	4.4	10.7	10.7	12.8	11.9
Canada	14.1	11.6	12.5	–1.0	–0.5	–0.8	1.1	0.9	0.9	15.1	12.5	13.0

[1] Based on national sources. [2] For Germany M_3; for the United Kingdom sterling M_3; for other countries M_2. [3] For France the Bank of France only; for the United Kingdom includes public-sector borrowing abroad (—); for the United States includes official assets, liabilities to foreign official institutions (—) and other bank-reported claims vis-à-vis non-residents (net). [4] For the United States commercial-bank holdings of Treasury securities only; for France and Denmark central government only; for the United Kingdom public sector including public-sector borrowing abroad; for Canada commercial-bank credit only. [5] For the United States and Canada commercial-bank credit only. [6] The percentage contributions of the counterparts add up to the percentage change in the money stock, except for differences due to balance-sheet items not shown — the principal one being domestic non-monetary liabilities of banks.

expansion of other loans and investments. Even this rise, following a large increase in 1977, gives no indication of the real strength of credit demand in the United States, since bank credit to business decelerated in the course of last year, and an expansion of mortgage credit, borrowing from finance companies and issues of commercial paper increasingly set the pace. In all the other countries, except France and Canada, bank credit to the public sector rose very strongly last year, making — in most cases — a significantly larger contribution to monetary expansion than in 1977.

Bank credit to enterprises and individuals expanded fairly rapidly in the United Kingdom, where a consumption-led boom was running its course. Moreover, in addition to the rise in ordinary bank lending, there was a large increase in acceptance credits, which banks could use to pass on financing burdens to non-banks instead of incurring heavy penalties by expanding their interest-bearing liabilities. In early 1979, when the pressures exerted by the supplementary special deposit requirement became less severe, bank lending accelerated sharply. Bank credit to the private sector also expanded strongly in Germany and the Netherlands, a sharp rise in credit for housing construction, real estate and consumption being followed, at least in Germany, by a gradual revival of business borrowing, which heralded a fairly general recovery in economic activity. In Germany banks cut their bond purchases to increase their lending, in which short-term credits played a growing rôle. The increase in unused credit commitments, moreover, was over 30 per cent. greater than in 1977 in the case of discount and current-account facilities and more than twice as large as in 1977 in the case of longer-term loans. In Switzerland construction credit rose by 33 per cent. last year. In Japan, too, though business demand for credit remained fairly weak, a sharp rise in lending for speculative purposes, including real estate, construction and trade, was noted towards the end of 1978. Of course, a rise in housing construction had led a general economic recovery in these countries on previous occasions, but it is hard to believe that last year's large rise in credit for housing and real estate was not influenced by fears of the re-emergence of inflation. In the other industrial countries the expansion in private demand for credit was fairly modest, mainly reflecting continuing weakness of the economy.

Credit ceilings were in effect last year in Japan, France, Italy, the Netherlands and Denmark, and during the last two months of the year in Belgium. In a few cases — notably that of Italy — they reflected the need, given the enormous government borrowing requirement, to ration credit to the private sector as a means of overall liquidity control. In Italy the ceilings were liberalised somewhat in early 1979 in order to support the economic recovery. But credit ceilings did not operate restrictively last year in France, where lending generally remained within the norms (which have been tightened somewhat for 1979), or Japan, where the ceilings effectively endorsed the lending projections of the banks until the final quarter of 1978. For the first two quarters of 1979 "window guidance" was tightened in a selective effort to limit lending for non-manufacturing activities. In the Netherlands the ceiling related to lending financed from monetary resources. The banks were able to expand their credits as sharply as they did, while remaining generally within the ceiling, only by having extensive recourse to the capital market and by accepting large amounts of savings deposits.

In considering the implications of bank credit-granting for the money supply, it has to be borne in mind that in the United States banks' managed liabilities, including certificates of deposit, began to grow very rapidly from the autumn of 1978 onwards. At the same time, banks also obtained funds on a considerable scale under security repurchase agreements (often on an overnight basis but not included in the money supply) and from an enormous rise in Federal Reserve float. They also sharply stepped up their Euro-dollar borrowings around the turn of the year, but their claims on banks abroad seem to have risen even more sharply in this period. In Germany and Japan, too, the growth of long-term liabilities was as usual a fairly large counterpart of credit-granting, thus helping to limit the expansion of the broad money supply.

Government financing. Public-authority (or public-sector) borrowing requirements, which in principle reflect deficits on a national accounts basis plus lending to the economy for policy purposes, had narrowed progressively in a number of countries since 1975. But last year they widened again in most countries other than the United States, where there was a further decline. In relation to gross national product these requirements were particularly large in Italy (where the sharp increase reflected earlier delays in approving tax measures), in Japan and in Belgium, where the rise has continued unabated since 1973. Broadly similar developments are evident in central-government financing requirements, which, except in Japan, accounted for the bulk of the broader public-authority or public-sector requirement last year. In the United States the state and local governments remained in surplus even though the "taxpayers' revolt" was beginning to erode the strength of their finances.

In the United States the striking element in Federal Government financing was that, as in 1977, nearly half of the requirement was met from abroad. The bulk of the funds involved represented Treasury securities acquired by foreign central banks with the dollar proceeds of their exchange-market purchases of dollars. As part of the measures announced on 1st November to support the dollar, small foreign currency loans were raised on the German, Japanese and Swiss capital markets. By the end of 1978 non-residents held one-quarter of all US Government debt due to holders other than government agencies and funds and the Federal Reserve System. As for domestic financing, the bulk last year came from individuals, from the Federal Reserve in the course of open-market operations and from state and local governments. On balance, non-financial corporations and private financial institutions reduced their holdings of Treasury securities. Given these sources of financing, it was not surprising that the requirement could be met without exerting excessive pressure on interest rates; in fact, the Treasury bill rate rose rather less than other money-market rates, mainly as a result of foreign support in the market.

In all other countries except France and Germany the borrowing requirement of the central government was larger than that of the United States as a proportion of gross national product. In most of them a substantial proportion was covered from non-bank sources. An interesting case was that of Italy, where sales of six and twelve-month Treasury bills and government bonds — some of them indexed — were very large last year. The incremental bond investment requirement imposed on the banks was relaxed after mid-year. Given the size of the deficit, the Treasury nevertheless had substantial recourse to the banks and to the central bank. In Belgium the Government again borrowed from the central bank on a considerable scale. When in the autumn its substantial requirement for funds came into conflict with the need to keep the money market tight to support the Belgian franc, it raised funds in foreign currencies for the first time in several years. In the United Kingdom the fairly large external component reflects mainly a decline in the official foreign exchange reserves. Governments in the other countries did not borrow abroad to a significant extent and were able to avoid large-scale recourse to central-bank credit. However, large amounts were borrowed from the banking system by the central government in Japan and by the public authorities other than the social security funds in Germany.

Difficulties in finding adequate government financing on a regular basis in the capital market were experienced in a number of countries, including some for which the results for the year as a whole were fairly satisfactory. In the United Kingdom, Germany and Japan the volume of issues that could be placed with non-banks contracted sharply in certain periods of the year. Various steps were taken to help ease the situation. In Germany the public authorities increased their recourse to short and medium-term borrowing, while in Japan extensive use was made of a new type of three-year issue and bonds were issued for the first time under a tender system. In the United Kingdom yields on national savings and tax reserve instruments were made more competitive and gilts only partly payable on application were issued on a considerable scale. Following the issue of one stock which turned out to be substantially underpriced, an auction procedure to be used in cases where issues were oversubscribed was announced. In each case, however, the Government

Government financing.[1]

Items	Years	Belgium	France	Germany	Italy	Japan	Nether-lands	United Kingdom	United States
		as a percentage of gross national product							
Public authorities' financing requirement[2] . . .	1975	5.8	2.2	6.6	14.6	7.0	4.8	10.2	6.7
	1976	6.6	0.4	4.5	11.2	10.0	4.9	7.5	4.1
	1977	7.0	1.3	3.1	10.2	9.2	3.9	4.2	3.1
	1978	7.4	2.1	3.2	14.8	10.6	4.6	5.2	2.7
Central-government financing requirement[3] . . .	1975	5.6	3.0	6.2	11.3	2.7	3.0	8.1	5.9
	1976	5.9	1.1	4.4	9.1	4.7	3.7	5.5	4.0
	1977	6.6	1.1	2.7	9.0	4.6	3.1	3.2	3.5
	1978	6.4	1.7	3.4	13.0	5.7	3.3	5.2	2.9
met by:									
Central bank	1975	0.1	1.4	0.6	6.6	.	0.0		0.6
	1976	0.6	0.7	0.3	6.2	.	0.5		0.7
	1977	0.6	−0.9	−0.0	−2.5	.	0.1		0.4
	1978	0.4	−1.0	−0.1	0.7	.	0.2	2.3	0.4
								−0.0	
								1.3	
Banks	1975	0.6	0.8	4.3	1.5	2.1	0.9	−0.3	1.7
	1976	1.3	−0.3	2.9	0.3	3.6	0.8		0.8
	1977	0.7	0.5	2.1	7.0	3.0	0.5		−0.0
	1978	1.6	0.7	2.7	5.1	4.0	0.5		−0.6
Other domestic sources.	1975	4.8		1.2	3.2		2.1	5.7	3.1
	1976	3.5		0.7	2.6		2.5	4.5	2.0
	1977	5.6		0.6	4.5		2.6	6.9	1.5
	1978	3.6	0.8	0.7	7.2	0.6	2.6	4.6	1.7
			0.8			1.1			
			1.5			1.6			
Foreign sources[4] . .	1975	0.0	2.0	0.3	0.0	1.7	−0.0	0.2	0.5
	1976	0.4		0.5	0.0		−0.1	1.0	0.5
	1977	−0.2		0.0	0.0		0.0	−5.1	1.6
	1978	0.8		0.1	0.0		0.0	0.9	1.4

[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.* *For Italy*, enlarged public sector as defined in the Letter of Intent to the IMF; includes borrowing requirement of some public enterprises; *for Japan*, net issues of medium and long-term government bonds and local-government bonds; also includes issues of government-guaranteed bonds and private placements of bonds by government agencies (together equivalent to 1.5 per cent. of GNP in 1978); *for United Kingdom*, includes borrowing requirement of public corporations. [3] *For Germany*, all public authorities other than social security; *for Italy*, general government; *for United Kingdom*, includes central-government lending to public corporations (equivalent to approximately 1.1 per cent. of GNP in 1978). [4] *For United Kingdom and United States*, includes increases (—) in official foreign exchange assets.

had temporarily to increase its recourse to bank credit or to draw on cash balances, and ultimately a rise in coupons had to be accepted.

In some countries, including the United Kingdom, there were indications that interest rates and official sales of government securities had begun to react in a destabilising way to changes in the outlook for government financing and the short-term variability of rates of monetary expansion. While developments of this sort clearly complicated the task of monetary control, it is not possible to establish definitely whether rises in interest rates last year should be interpreted as indicating an element of crowding-out. As mentioned above, outside North America bond yields now seem high in relation to current rates of inflation. Certainly the structure of rates which emerged in a good many European countries must have given enterprises an increased incentive to use bank credit rather than bond finance. In most of them net recourse to the bond market by non-financial enterprises has remained small or even negative.

Private-sector financial positions.

Differences in countries' cyclical positions and the changing outlook for inflation were reflected in some interesting contrasts in the pattern of private-sector credit-market activity.

In the United States business borrowing and consumer credit recorded further steep increases last year, while mortgage borrowing remained at remarkably high levels for the advanced stage of the upswing. Despite a further decline in Federal Government borrowing, total net credit flows expressed in relation to gross national product remained at the historically high levels recorded in 1977. In other countries private demand for credit was more subdued, but a strengthening was apparent in business, mortgage and consumer credit in Germany and Canada, and consumer credit expanded strongly in the United Kingdom too.

In the United States, where business investment far outpaced the rise in companies' internal resources, businesses borrowed heavily at short term but reduced their call on bond financing and held their issues of stocks to modest proportions. As a result, corporate financial ratios such as liquid assets to current liabilities and short-term debt to total debt deteriorated sharply, falling back in fact to levels comparable only with those of 1974. In the United Kingdom the finances of companies outside the North Sea oil sector also deteriorated somewhat after a strong improvement in 1977, in consequence of a surprisingly strong rate of investment and a decline in profitability.

There was a clear improvement in companies' financial positions in Japan, Germany, Canada and France. In Japan this development largely reflected the weakness of investment activity, while in Germany it came about despite a marked strengthening of corporate investment. In Japan, Germany and Canada the emphasis in the business sector was on accumulating liquid assets. In Japan there was a large rise in company holdings of short-term securities. In Germany, where enterprises benefited in various ways from inflows of funds, there was a strong rise in their holdings of time deposits. In Canada the build-up of company liquidity was partly in the form of foreign currency claims. Business borrowing in most countries other than the United States was concentrated in bank loans. However, new issues of shares reached a fairly high rate in Canada, where the share market rose strongly (albeit principally as a result of currency depreciation), and in France, where tax concessions were introduced early in 1978 to encourage private individuals to show greater interest in shares. In France total bond issues also reached fairly high levels, but this reflected mainly a rise in government issues and in the issues of semi-public borrowers, whose fund-raising activities were deflected back to the domestic market from abroad for balance-of-payments reasons.

So large was the rise in consumer and home mortgage credit under the inflationary conditions prevailing in the United States that total household debt as

Funds raised in credit markets by domestic non-financial borrowers.[1]

Countries	Years	Borrower							Total
		Public sector[2]	Business sector[2]				Household sector[2]		
			Equities	Bonds	Loans[3]	Total	Housing credit[4]	Other	
		in percentages of gross national product							
United States	1975	6.4	0.7	1.9	0.5	3.1	2.5	0.7	12.7
	1976	5.1	0.6	1.5	2.3	4.4	3.6	1.7	14.8
	1977	4.4	0.1	1.3	4.2	5.6	4.9	2.5	17.4
	1978	3.7	0.1	1.1	4.7	5.9	4.8	2.9	17.3
Germany	1975	5.9	0.4	−0.1	1.4	1.7	2.2	0.7	10.5
	1976	3.8	0.4	0.1	3.1	3.6	2.4	1.2	11.0
	1977	3.1	0.2	0.1	2.7	3.0	3.0	1.2	10.3
	1978	3.4	0.3	−0.0	2.9	3.2	3.8	1.3	11.7
Japan	1975	7.7	0.7	1.1	9.9	11.7	4.7		24.1
	1976	9.2	0.5	0.6	8.9	10.0	5.1		24.3
	1977	8.4	0.6	0.4	6.4	7.4	4.4		20.2
	1978	9.8	0.6	0.4	4.9	5.9	4.8		20.5
United Kingdom. . .	1975	10.2	1.0	0.2	0.9	2.1	3.5	−0.4	15.4
	1976	7.5	0.6	0.0	2.4	3.0	3.1	0.7	14.3
	1977	4.2	0.5	−0.1	2.4	2.8	3.0	1.1	11.1
	1978	5.2	0.5	−0.1	1.8	2.2	3.3	1.4	12.1
Canada	1975	7.6	0.5	1.3	2.5	4.3	4.4	2.0	18.3
	1976	7.7	0.6	1.2	3.4	5.2	4.7	2.1	19.7
	1977	8.0	1.2	1.7	2.6	5.5	5.7	1.6	20.8
	1978	9.7	2.2	1.3	2.2	5.7	5.4	2.0	22.8
France	1975	4.2	0.6	1.0	6.3	7.9	4.1		16.2
	1976	2.6	0.9	0.7	5.7	7.3	4.7		14.6
	1977	2.8	0.5	0.6	6.1	7.2	3.5		13.5
	1978	3.7	0.7	0.5	4.5	5.7	3.7		13.1

[1] BIS estimates, based on national data which differ conceptually from country to country. For the United States, funds raised in credit markets other than by the foreign sector; for Germany, borrowing through money-market paper, bonds, shares and loans from banks, building societies and insurance companies; for Japan, issues of securities and loans from financial institutions; for the United Kingdom, total borrowing by the sectors shown other than trade credit and intra-company investments; for Canada, funds raised by non-financial borrowers; for France, total recorded borrowing except commercial credit and equity other than shares (excluding accounting adjustments). [2] For Japan and the United Kingdom, borrowing by public enterprises is included in public-sector borrowing and for these countries and France that by unincorporated business is included in household-sector credit. [3] Includes money-market paper. [4] For Germany, total housing credit.

a proportion of personal disposable income, which prior to 1977 had never exceeded 58 per cent., had risen to over 65 per cent. by the fourth quarter of 1978. Steps to protect the mortgage market from credit restraint (see page 59) became somewhat less effective after the further rise in interest rates in November and regulatory changes in March. In the United Kingdom, too, the availability of mortgage credit was increasingly limited by the deteriorating financial position of the building societies; bank credits to individuals rose strongly but not enough to build up troublesome debt burdens. As in Canada, Germany and some other countries, where a strong rise in mortgage credit mainly served to finance transactions in existing dwellings and, indirectly, personal consumption, any corresponding tendency in the United Kingdom for personal-sector financial positions to deteriorate was probably outweighed by the sharp increase in house prices.

Monetary targets and the development of the monetary aggregates.

For those countries which were seeking to steer monetary expansion along a stable predetermined course, the circumstances of last year were extremely difficult by any standards. The United States had to cope with regulatory and institutional innovations, other countries with exchange-market turmoil. Several countries also encountered difficulties in ensuring an adequate steady flow of non-monetary financing for large government borrowing requirements, and in a few of them private demand for bank credit showed increasing strength. Problems in regulating monetary expansion were experienced not only by those countries which relied mainly on interest rate mechanisms or control of the monetary base, but also in those which made use of fairly direct measures to regulate the counterpart items to money creation in the banking system's balance sheet.

Indications of monetary expansion in relation to official norms are given in the table below and in the graph on page 73. A comparison between norms and actual developments on the basis specified in the objectives shows significant overruns in the United States for M_1 (but not, last year, for the other aggregates) and in Germany and Switzerland. In France, on the other hand, the result was only slightly in excess of the norm, while in Canada and the United Kingdom it was within the target range despite the enormous problems with which these countries had to cope during the year.

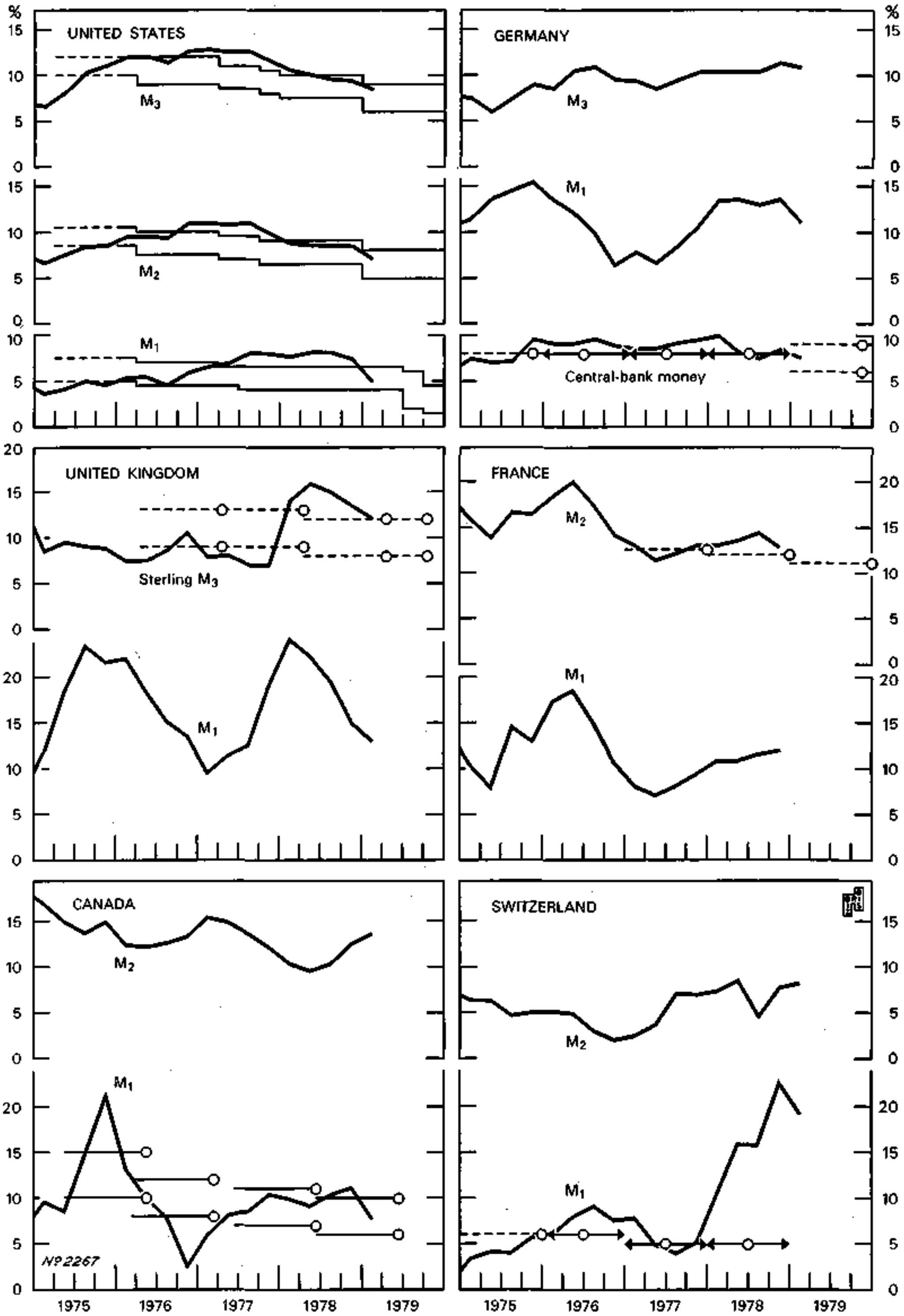
The variables to which the norms relate differ considerably from one country to another. The graph shows movements in both broad and narrow aggregates in six key countries, and for the relevant aggregates permits a comparison between developments during the year and the objectives. Monetary expansion is shown in

Monetary aggregates: Objectives and rates of expansion.

Country	Monetary aggregate	Period	Objective	Actual result
			percentage increase	
Canada	M_1	June 1977 — June 1978	7—11	8.5
		June 1978 —	6—10	5.3[1]
France	M_2	12 months to December 1978	12[2]	12.3
		12 months to December 1979	11[2]	.
Germany	Central-bank money	1977 average — 1978 average	8	11.4
		IV/1978 — IV/1979	6—9	.
Japan	M_2	III/1977 — III/1978	11—12[3]	12.1
		IV/1977 — II/1979	12—13[3]	12.3[4]
Netherlands	M_2/Net national income	End of 1976	.	41.0[5]
		End of 1980	37.0[6]	.
Switzerland	M_1	1977 average — 1978 average	5	16.2
United Kingdom	Sterling money supply (M_3)	12 months to mid-April 1979	8—12	10.4
		12 months to mid-October 1979	8—12	.
United States	M_1	IV/1977 — IV/1978	4.0—6.5	7.3
		I/1978 — II/1979	4.0—6.5	4.9[7]
		III/1978 — III/1979	2.0—6.0	.
		IV/1978 — IV/1979	1.5—4.5	.
	M_2	IV/1977 — IV/1978	6.5—9.0	8.5
		I/1978 — III/1979	6.5—9.0	7.1[7]
		IV/1978 — IV/1979	5.0—8.0	.
	M_3	IV/1977 — IV/1978	7.5—10.0	9.4
		I/1978 — III/1979	7.5—10.0	8.4[7]
		IV/1978 — IV/1979	6.0— 9.0	.

[1] June 1978–January 1979. [2] Upper limit. [3] Non-binding projection only. [4] I/1978–I/1979. [5] Actual ratio. [6] Projected ratio to be achieved by a progressive decline. [7] I/1978–I/1979.

Monetary targets and growth rates.*



* Year-to-year changes based on quarterly average data.

terms of year-to-year changes in quarterly average levels, a presentation which to some extent smooths out purely random short-term fluctuations. While the monetary objectives of a number of countries are expressed in these terms, for others the comparison must be regarded as indicative only. It should also be noted that the degree of commitment by the authorities to achieving the norm varies considerably.

The uneven course of monetary expansion during the year in most countries is very striking. In Germany excessive growth of central-bank money in relation to the norm (which was expressed in terms of an annual average) was very largely attributable to developments in the first quarter of 1978 during the first phase of the dollar's weakness, though on the basis of seasonally adjusted month-to-month changes there was a renewed acceleration after mid-year. In Switzerland, on the other hand, the expansion of M_1 exceeded the target path by a margin which increased progressively during the year.

In the United Kingdom the rate of growth of sterling M_3 accelerated alarmingly in early 1978 against a background of instability in the gilts market, a strengthening of private demand for bank credit and difficulties experienced by the authorities in monitoring the course of monetary expansion statistically. The rise remained very moderate in the summer and autumn, thanks partly to the use of the system of supplementary deposits to limit banks' interest-bearing liabilities; this did not, however, prevent the banks from participating in the granting of a substantial volume of acceptance credits which were not recorded in bank credit or the money supply. In late 1978 the rise in sterling M_3 again quickened markedly. In Japan and France monetary expansion remained on a fairly moderate, steady course, largely because the weakness of private demand for bank credit helped to offset the expansive influence of Treasury transactions and the external surplus. In France, however, restraint of monetary expansion was facilitated, to a degree fortuitously, by a large rise in personal holdings of shares and deposits at savings banks (not included in M_2) stimulated by fiscal incentives. In Canada the growth of M_1 recorded a considerable acceleration during the year, mainly as a result of the impact of postal strikes. The broad money aggregates recorded rates of expansion of between 13 and 17 per cent., part of which was due to an increase in the banks' share in total intermediation. With the Canadian dollar weakening even against the US dollar, residents' foreign currency deposits with the banks (which are included in M_3 but not in M_1 or M_2) expanded by about 55 per cent., some 10 percentage points of which must have been attributable to valuation increases in Canadian dollar terms.

Marked divergences in the pattern of expansion of different aggregates are also apparent in all the countries shown in the graph. Although rates of broad money growth can be distorted by changes in the pattern of intermediation, the growth of M_1 seems fairly generally to have been much more variable, at least over the last few years. A very striking example is that of Switzerland; last year the interest rate on current accounts became higher than those on time deposits and, in the case of certain accounts held by individuals, only slightly lower than the return on savings deposits, so that both inflows from abroad and transfers of funds from other types of domestic accounts helped to swell M_1, while the rise in M_3 (which includes time and savings deposits) remained quite stable. In Germany central-bank money may be considered a broad aggregate in that the required reserve element responds in varying degrees to changes in all types of bank deposits held by residents; this element expanded at an increasing rate in the course of last year. The dominant factor in the sharp acceleration in the growth of this aggregate early in 1978, however, was the large currency component, which, as in Switzerland, includes substantial amounts of notes and coin held abroad.

In countries where transactions balances are not remunerated explicitly, or bear comparatively modest rates of return, the large fluctuations in interest rates on alternative placements must have been a major reason for changing rates of growth in M_1 assets. Most countries which attempt to achieve targets for the narrow money supply rely mainly on influencing interest rates to do so. In some institutional contexts, at least, theoretical and empirical considerations have supported the selection of M_1 as a target variable. In other countries the authorities have preferred to set norms only for a broad monetary aggregate including a large liquid savings component. In some cases the question of the most appropriate monetary target is still under discussion.

In the light of last year's experience a number of changes have been made in countries' monetary objectives. In the United States the monetary targets were lowered significantly for 1979 — particularly those for M_1 — to take account of the various institutional changes; a new aggregate was published (M_1 plus, which comprises a variety of savings and negotiable accounts at banks and savings institutions in addition to currency and demand deposits at banks), and proposals for a more far-reaching revision of the definitions of the various aggregates were put forward. In addition, partly because the Federal Reserve's previous practice permitted "base drift" (basing the new target published each quarter on the actual level of the money stock, which was at times well above the upper level of the previous target range), the targets for 1979 will be retained until the end of the year subject to a mid-year review.

In Germany the target expressed in terms of an annual average has been replaced by a range which applies to monetary expansion between the fourth quarter of 1978 and the fourth quarter of 1979. Given the large expansion of central-bank money in the course of 1978, a target figure based on annual averages would have had to be unacceptably high in order to permit even a moderate rise in the course of 1979. The range is not designed to allow for imprecision in monetary control; it is intended to permit the authorities a degree of choice in adapting the rate of monetary expansion in the light of economic developments during the year. In Switzerland the authorities refrained from publishing a target for 1979, preferring not to announce a new target until the exchange markets had become more settled.

To permit somewhat more flexibility, the UK authorities decided to keep the targets set for twelve-month periods but to establish a new base at six-monthly intervals beginning in October. In March 1979, however, with a general election pending, the Chancellor announced in his provisional budget that the existing target would remain in effect for the time being. The targets established in the United Kingdom in October and also those published during the year in Canada and France were marginally lower than previously; in each case this was designed to convey the authorities' desire progressively to reduce rates of monetary expansion. In Japan the authorities began in the summer of 1978 to announce non-binding projections for monetary expansion over twelve-month periods ending in the following quarter. Despite the potential disadvantages of such announcements, it was considered that increased public awareness of rates of monetary expansion and their possible relationships to rates of inflation might be helpful in view of the very large budget deficit.

The difficulties countries experienced last year in keeping monetary expansion on course must to a large extent be attributed to the exceptional circumstances prevailing. One result of the experience is that increased priority in economic policy is now being given to moderating exchange rate fluctuations in the United States and also in the European countries which have joined or associated themselves with the European Monetary System. For some of the smaller countries exchange rate stabilisation may at times preclude close regulation of monetary expansion. However, it could be an equally effective means of bringing about greater price and wage stability — on condition that rates of inflation in the larger countries are brought down and kept moderate. Particularly in countries where inflation rates are relatively high, monetary policies which inspire confidence in the authorities' resolution seem likely to contribute to external as well as internal stability. Though situations vary from one country to another, it would seem that in a good many of them policies based on the use of quantitative objectives for the monetary aggregates, announced in advance, will continue to play a useful rôle.

V. INTERNATIONAL TRADE AND PAYMENTS.

World trade and payments balances during the period under review were strongly influenced by last year's major exchange rate movements and their partial reversal in the early months of 1979. For the year 1978 the overall world balance-of-payments structure was in much better balance than at any time since 1973, with the oil-exporting countries' combined current surplus reduced to less than $10 billion, the developed areas of the world no longer in current-account deficit and the combined deficit of the non-oil developing countries, though larger than in 1977, still leaving room for a continued increase in these countries' official reserves. These favourable developments were accompanied, however, by a considerable worsening of existing imbalances within the Group of Ten countries and Switzerland as a result of last year's currency crisis: the combined overall surpluses of Germany, Japan and Switzerland — measured by the increase in their net official reserves — more than doubled to $25 billion, while for the second year running the overall payments deficit of the United States exceeded $30 billion. During the second half of 1978 and in early 1979 the current-account elements in these imbalances, especially the Japanese surplus and the US deficit, showed a marked decline and, following the November 1978 decision of the US authorities to intervene decisively in the exchange markets, there were large reversals of earlier speculative capital movements. The renewed upward movement of the price of oil and other primary commodities since the end of 1978 has brought with it a fresh turn of the wheel, which will certainly put the oil-exporting countries back into substantial surplus and the developed areas of the world into deficit on current account, although not on the post-1973 scale.

World trade.

World trade developments in 1978 were, at least in terms of global changes, broadly similar to those recorded in the preceding year. The dollar value of world trade expanded by 15½ per cent., roughly 2 percentage points faster than in 1977, bringing the total to slightly more than $1,300 billion. The underlying increases in trade volume and prices, estimated at 5 and 10 per cent. respectively, were also not much different from what they had been in 1977. At the same time the growth of world trade in relation to that of output in the Group of Ten countries and Switzerland, which account for three-fifths of world trade, remained practically unchanged. However, among individual countries and groups of countries there were remarkable contrasts in volume and unit value changes between 1977 and 1978 which led to some very large changes in trade balances.

The relatively modest expansion of world trade must once again be ascribed in part to continuing slow growth rates, especially in the Group of Ten countries and Switzerland. Moreover, comparison with the pre-1973 experience indicates a clear deviation from the earlier relationship between output and world trade growth. During the decade 1963–72 the average annual rate of growth in the volume of world trade, at 9 per cent., had been double that of real gross national product in the major industrial countries. During 1977 and 1978 real gross national product of the Group of Ten countries and Switzerland rose by slightly less than 4 per cent. and the volume of world trade by no more than 5 per cent. Although some slowdown in the growth of trade in relation to output is not unusual at times of cyclical downswings, its occurrence for two consecutive years well after the trough of the recession suggests that non-cyclical factors have had a depressive influence. One of the reasons for the faster growth of world trade in relation to output in the years before the 1973–74 oil crisis may have been that new investment tended on balance to increase the degree of international specialisation in production. The widespread reduction in investment/output ratios in recent years may have weakened this source of growth. It may also be that uncertainties about the course of exchange rates, as well as the adoption of protectionist measures by some countries, have dampened the growth of world trade.

The volume of imports into the *Group of Ten countries and Switzerland* expanded in 1978 by 6½ per cent., compared with a rise of 4 per cent. the year before. Since aggregate domestic demand in these countries did not increase much faster than in 1977, the acceleration in their import growth must be explained primarily by two other factors: first, domestic demand grew more rapidly than before in countries such as the United Kingdom and Germany which have relatively high

World trade.[1]

Areas	Exports (f.o.b.)				Imports (c.i.f.)			
	1977	1978 Year	1978 1st half	1978 2nd half	1977	1978 Year	1978 1st half	1978 2nd half
	In billions of US dollars *(volume index 1976 = 100)*							
Developed areas								
Group of Ten and Switzerland	647.6 *(104.9)*	776.7 *(110.8)*	369.0 *(109.6)*	407.7 *(112.0)*	677.3 *(103.8)*	791.2 *(110.8)*	379.6 *(109.2)*	411.6 *(112.4)*
Other countries[2]	92.8 *(104.3)*	110.4 *(112.1)*	52.3 *(108.5)*	58.1 *(115.7)*	128.4 *(102.6)*	138.0 *(101.5)*	66.5 *(105.0)*	71.5 *(98.0)*
Total developed areas . .	740.4 *(104.8)*	887.1 *(111.0)*	421.3 *(109.5)*	465.8 *(112.5)*	805.7 *(103.6)*	929.2 *(109.3)*	446.1 *(108.6)*	483.1 *(110.0)*
Developing areas								
Oil-exporting countries[3] . .	150 *(99.5)*	145 *(96.0)*	70 .	75 .	87 *(122.0)*	102 *(128.0)*	51 .	51 .
Other areas	128 *(103.5)*	142 *(110.0)*	67 .	75 .	154 *(104.0)*	180 *(110.0)*	85 .	95 .
Total developing areas . .	278 *(101.5)*	287 *(102.5)*	137 *(99.0)*	150 *(106.0)*	241 *(110.0)*	282 *(116.0)*	136 *(115.0)*	146 *(117.0)*
Centrally planned economies[4]	106	121	57	64	113	133	65	68
Grand total[5] . . .	1,124 *(104.0)*	1,295 *(108.5)*	615 *(106.5)*	680 *(110.5)*	1,160 *(105.0)*	1,344 *(110.5)*	647 *(109.5)*	697 *(111.5)*

[1] Based on customs data; not directly comparable with trade figures in the table on page 82. [2] OECD countries except the Group of Ten and Switzerland, plus Israel, South Africa and Yugoslavia. [3] OPEC (Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela) plus Bahrain and Oman. [4] Bulgaria, People's Republic of China, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania and USSR. [5] Volume index excludes centrally planned economies.

ratios of imports to domestic output; secondly, some of the marked changes in exchange rates which took place after September 1977 began to affect import volumes, especially in the principal surplus countries. As a result, the growth of total imports, which in 1977 had largely reflected a 10½ per cent. rise in US imports, was much more evenly spread among members of the group last year. While imports into the United States again rose strongly, by 9½ per cent., import growth became more buoyant in most other countries. Increases of 7 per cent., 7½ per cent. and 10 per cent. respectively were attained by the principal surplus countries, namely Japan, Germany and Switzerland. At the same time import growth also picked up in those countries where it had previously been held back by domestic stabilisation programmes, accelerating in the United Kingdom to 7½ per cent., in France to 5 per cent., and in Italy, after a 2 per cent. decline in 1977, to 7½ per cent. Of the countries in this group, only Sweden recorded a contraction in its imports, which declined by 6½ per cent. — much more than in 1977.

After several years with rather precarious external positions which in some instances had worsened in 1977, the majority of *developed countries outside the Group of Ten and Switzerland* continued with, or embarked on, policies of demand restraint in 1978. Their combined imports, which had expanded by only 2½ per cent. in 1977, showed a decline of 1 per cent. last year. The overall result in 1978 was heavily influenced by the decline of imports into Austria, Finland, Spain, New Zealand, Norway and Turkey, the last-named country recording a cutback of 25 per cent. Most of the other countries in this group increased their imports only slightly, the exceptions being Ireland and Greece, where imports expanded by 16½ per cent. and 5 per cent. respectively, after similar increases the year before.

The expansion of *oil-exporting countries'* imports, after having exceeded the growth of world trade by a large margin in every year from 1974 to 1977, appears to have slowed down from 22 to only 5 per cent. between 1977 and 1978. The slowdown was particularly marked in the low-absorbing countries. While the group's lower import growth was partly the result of the interruption of imports into Iran during the last two months of 1978, it stemmed mainly from the adoption of more restrictive domestic policies directed towards greater internal and, in some cases, external stability. The need for such policies became more pressing when the revenues of most oil-exporting countries fell sharply during the first half of 1978.

The build-up of their reserves in relation to imports, and the reduction in their current balance-of-payments deficits in 1976 and 1977, enabled the *non-oil developing countries* as a group to revert to more growth-oriented policies in 1978. This shift, together with the relaxation of import restrictions in some Asian countries, was reflected in an acceleration of real import growth from 4 to about 6 per cent. However, this average result for the group as a whole covered marked differences in the import performances of individual countries and areas. In the *centrally planned economies,* where the dollar value of imports rose by 18 per cent., it appears that import volume, which had shown little change in 1977, increased by about 7 per cent.

The 1978 pattern of real export growth by major groups of countries did not in all cases match that of import growth. The biggest rise in export volume was recorded by the *developed countries outside the Group of Ten and Switzerland,* with an increase of 7½ per cent., considerably above the world average. At the other extreme were the *oil-exporting countries.* With oil output increasing in other areas of the world, and with the large drawdown of importing countries' stocks during the first half of the year not being fully offset by restocking later in the year, their combined exports shrank by 3½ per cent., after having fallen minimally in 1977. In other areas export performance was more in line with import growth. The *non-oil developing countries'* export volume expanded in 1978 by 6 per cent., 2½ percentage points faster than in the preceding year, thereby raising slightly their share in world exports; and the export volume of the *centrally planned economies* may have increased by 5 per cent., roughly as much as in 1977. Exports from the *Group of Ten countries and Switzerland* rose by 5½ per cent., somewhat more slowly than their imports. In general, demand conditions in these countries' export markets appear to have been the most important determinant of export growth; however, the increase of only 1 per cent. in Japanese exports, after a rise of 9 per cent. in 1977, seems to reflect the impact of the yen's appreciation, as well as of the direct controls on exports imposed by the Japanese Government. Exports from the United States, Canada and Italy increased markedly, by 8½, 9½ and 11 per cent. respectively. Elsewhere, however, the variation among rates of export growth was far less pronounced.

The diversity of trade volume trends in 1978 coincided with major movements in the relative prices of internationally traded goods. Market prices in dollars of primary commodities other than crude oil, which in 1977 had risen by 11½ per cent., increased by only 2½ per cent. on average last year, while the rise in the price of oil imported by developed countries came down between the two years from 8 to 1½ per cent. On the other hand, the rise in their export prices of manufactured goods accelerated from 9 to 14½ per cent. These relative price movements were translated into a terms-of-trade gain of 3½ per cent. for the Group of Ten countries and Switzerland, compared with a 1 per cent. loss in 1977. The other developed countries also experienced a small terms-of-trade improvement. Consequently, the main burden of terms-of-trade losses fell on the developing world. The non-oil developing countries suffered a 5 per cent. reduction which more than offset the gain made the year before, while the oil-exporting countries' terms of trade fell by 10 per cent.

Quantifying roughly the relative impact of volume and price effects on changes in trade balances, the substantial improvement in the collective trade balance of the Group of Ten countries and Switzerland of $15.3 billion in 1978 was more than accounted for by a $25 billion effect arising from terms-of-trade gains and from a small positive "basis effect", which more than offset the volume changes which occurred in 1978. The "basis effect" represents the impact of increases in the dollar prices of tradable goods on the dollar value of an existing trade imbalance. Excluding the United States, a very sharp contrast appears between the 1977 and 1978 evolution of the group's real and nominal trade balance; in 1977 the $18.5 billion amelioration was essentially due to volume changes, while the improvement of the same magnitude in 1978 was entirely due to prices. Moreover, although the trade balances of the three major surplus countries continued to increase in dollar terms in 1978,

The estimated impact of volume and price changes on trade balances in 1977 and 1978.

Countries and areas	Total change from previous year[1]		Attributable to					
			changes in volume		changes in terms of trade		basis effect[2]	
	1977	1978	1977	1978	1977	1978	1977	1978
	in billions of US dollars							
Group of Ten and Switzerland	− 3.3	15.3	5.1	−10.0	− 5.8	25.0	− 2.6	0.3
(excluding the United States)	*(18.5)*	*(18.4)*	*(18.2)*	*(−5.2)*	*(−0.1)*	*(20.9)*	*(0.4)*	*(2.7)*
of which:								
BLEU	− 0.2	− 0.7	0.2	− 0.2	− 0.1	0	− 0.3	− 0.5
Canada	1.1	0.4	3.1	2.4	− 1.9	− 1.9	− 0.1	− 0.1
France	1.8	3.0	3.2	0.3	− 1.0	2.9	− 0.4	− 0.2
Germany	2.9	4.1	2.2	− 2.7	− 0.8	4.1	1.5	2.7
Italy	4.2	2.1	3.5	1.2	0.9	0.9	− 0.2	0
Japan	6.3	8.6	4.4	− 4.0	1.0	10.9	0.9	1.7
Netherlands	− 2.6	− 0.9	− 2.1	− 1.6	− 0.3	0.9	− 0.2	− 0.2
Sweden	0.2	2.3	0.5	2.7	− 0.3	− 0.5	0	0.1
Switzerland	− 0.4	0.1	0.3	− 0.9	− 0.6	1.0	− 0.1	0
United Kingdom	5.2	− 0.6	2.9	− 2.4	3.0	2.6	− 0.7	− 0.8
United States	−21.8	− 3.1	−13.1	− 4.8	− 5.7	4.1	− 3.0	− 2.4
Other developed countries outside the Group of Ten and Switzerland	− 1.6	7.9	0.6	9.4	1.0	2.1	− 3.2	− 3.6
Oil-exporting countries	− 8.5	−19.5	−15.0	− 9.5	1.0	−12.0	5.5	2.0
Non-oil developing countries	1.6	−12.5	− 1.5	− 2.0	4.5	− 7.0	− 1.5	− 3.5

[1] On a customs basis; exports f.o.b., imports c.i.f.; not directly comparable with the trade balances in the table on page 82. [2] Reflects primarily the effect of changes in the general level of dollar prices of traded goods on the trade balance expressed in US dollars; calculated as a residual.

all three experienced a reduction in their real surplus — the most dramatic example being Japan, where a real deterioration of $4 billion was obliterated by a favourable price effect of $12.6 billion. The contrasting impact of volume and price factors outside the Group of Ten and Switzerland was less pronounced. The improvement of the trade account of the other developed countries was entirely due to a favourable volume effect, while in the cases of the oil-exporting and non-oil developing countries the negative terms-of-trade effects were reinforced by adverse volume trends.

The powerful effects of terms-of-trade changes on global trade positions in 1978, however, have proved to be temporary. Already during the latter part of 1978 and more markedly in early 1979 movements of relative prices of major categories of commodities indicated a partial reversal of the 1978 terms-of-trade changes. The recent rises in oil and other primary commodity prices are certainly improving the trade balance of the oil-exporting countries and the export earnings of primary producing countries.

Balances of payments.

The sizable changes which took place in merchandise trade balances in 1978 were almost fully reflected in shifts of similar magnitude in the global pattern of current payments balances. As a result, the distribution of the current-account positions of the major groups of countries in 1978 resembled more closely than in the previous four years the pre-1974 pattern. The combined current account of the Group of Ten countries and Switzerland swung from a $5 billion deficit in 1977 to a surplus of $18 billion in 1978. At the same time, the combined deficit of the other developed countries, which had averaged more than $20 billion in the years since 1974, was reduced to $11½ billion. In part, this improvement in the developed countries' current position, totalling $35 billion, was mirrored by a deterioration in the position of the non-oil developing countries. Following reductions in the two preceding years, their current deficit rebounded by an estimated $9 billion in 1978 to a total of $24 billion, largely because of the relative fall in primary product prices. In addition, the centrally planned economies' current-account deficit appears to have increased. However, the principal counterpart to the re-emergence of a substantial surplus on the major developed countries' current balance of payments

International current-account transactions.[1]

Countries and areas	Trade balance (f.o.b.)			Services and transfers			Current balance		
	1976	1977	1978	1976	1977	1978	1976	1977	1978
	In billions of US dollars								
Developed areas									
BLEU	− 0.4[2]	− 1.4[2]	− 1.1[2]	0.4[3]	0.7[3]	0.5[3]	0	− 0.7	− 0.6
Canada	1.4	2.7	3.0	− 5.2[3]	− 6.6[3]	− 7.6[3]	− 3.8	− 3.9	− 4.6
France	− 4.7	− 2.7	1.8	− 1.2	− 0.6	2.4	− 5.9	− 3.3	4.2
Germany	16.7	19.8	25.3	−13.2	−15.5	−16.3	3.5	4.3	9.0
Italy	− 4.2	− 0.1	2.9	1.4[3]	1.5[3]	3.5[3]	− 2.8	1.4	6.4
Japan	9.9	17.3	24.7	− 6.2[3]	− 6.4[3]	− 8.1[3]	3.7	10.9	16.6
Netherlands	1.6	− 0.4	− 1.0	1.1[3]	0.8[3]	− 0.4[3]	2.7	0.4	− 1.4
Sweden	0.2	0.3	2.6	− 2.4	− 3.1	− 3.6	− 2.2	− 2.8	− 1.0
Switzerland	0.4	− 0.1	0.5	3.0[3]	3.5[3]	4.6[3]	3.4	3.4	5.1
United Kingdom	− 6.4	− 3.0	− 2.3	4.4	3.6	2.8	− 2.0	0.6	0.5
United States	− 9.4	−31.1	−34.1	13.7	15.8	18.1	4.3	−15.3	−16.0
Group of Ten and Switzerland	5.1	1.3	22.3	− 4.2	− 6.3	− 4.1	0.9	− 5.0	18.2
Other countries	−27.6	−27.9	−19.0	5.0	4.5	7.6	−22.6	−23.4	−11.4
Total developed areas	−22.5	−26.6	3.3	0.8	− 1.8	3.5	−21.7	−28.4	6.8
of which: OECD[4]	*17.9*	*−23.6*	*5.6*	*− 1.0*	*− 3.3*	*1.7*	*−18.9*	*−26.9*	*7.3*
Developing areas[5]									
Oil-exporting countries	78	72	54	−41	−43	−47	37	29	7
Other areas	−12	− 9	−18	− 6	− 6	− 6	−18	−15	−24
Total developing areas	66	63	36	−47	−49	−53	19	14	−17
Centrally planned economies[5]	− 6	− 1	− 5	.	.	.	.	.	.

[1] On a transactions basis. [2] Imports partly c.i.f. [3] Excluding retained earnings on direct investment. [4] Total developed areas excluding Israel, South Africa and Yugoslavia. [5] Partly estimated; trade figures are based on customs data.

was an unexpected and rapid fall of $22 billion in the oil-exporting countries' current surplus, to only $7 billion. Thus, the oil exporters' surplus ceased to be the major destabilising factor in the world's current payments structure.

The return towards a more traditional pattern of payments balances among the main groups of countries was, in itself, a move in the direction of better equilibrium. However, it was accompanied by a worsening of imbalances within the Group of Ten countries and Switzerland. While there was, it is true, a combined improvement of $14.3 billion in the current-account positions of France, Italy and Sweden, this welcome development was quite overshadowed by the widening of the gap between the US current-account deficit and the current payments surpluses of Germany, Japan and Switzerland. The aggregate surplus of these three countries rose by $12.1 billion to $30.7 billion in 1978, while the deficit of the United States increased slightly to $16 billion. The sharp imbalance between these countries had, in fact, already emerged in the final quarter of 1977 and in dollar terms it moderated only slightly during the course of 1978.

While the extent of last year's adjustment of payments imbalances was in some respects disappointing, the dollar figures for the year as a whole that are shown in the table on page 82 do not bring out the progress made during the course of the year in reducing the principal current-account disequilibria within the Group of Ten countries — progress that continued, moreover, during the first quarter of 1979. In the case of the United States, the improvement was very marked in current dollar terms, from an unusually large seasonally adjusted deficit of $7.6 billion in the first quarter to one of $1.3 billion in the fourth quarter, although the adjustment of trade volumes remains disappointing. In the three major surplus countries, too, there has been progress towards a better balance, although for much of last year this was overlaid by the terms-of-trade effects of the dollar's weakness. The most marked improvement has been in Japan, where not only the real trade surplus, but the volume of exports, too, has been declining since the second quarter of 1978, with the result that in the first quarter of 1979 the current account, before seasonal adjustment, was in deficit. In Germany, while exports have continued to grow, although more slowly than before, the quarterly real trade surpluses of 1978 were considerably below the corresponding ones of 1977. However, in dollar terms, the quarterly current payments surplus rose appreciably during last year, before falling off in the first quarter of 1979 to $1.5 billion, well below the level of a year earlier. In Switzerland the real trade balance deteriorated in 1978, and in the first quarter of 1979 the trade deficit in dollar terms was twice what it had been a year earlier.

Progress towards better balance on current account, therefore, has been far from negligible — and following the US measures of 1st November 1978 it has been recognised by the exchange markets. Furthermore, there was a very large increase in long-term capital outflows from Japan last year, which may also be considered as a step towards better basic balance. Indeed, a current-account surplus offset by long-term capital outflows can reasonably be considered an appropriate balance-of-payments structure for industrialised countries to aim at. However, there are a number of reasons why action to moderate current-account surpluses is of primary importance. First, the persistence of long-term capital outflows on the scale required may be difficult to ensure. This is partly because of the need to take account of domestic requirements in framing monetary policy and interest rate policy; in addition, large and persistent current payments imbalances, often with concomitant inflation differentials, may (as in 1977–78) give rise to expectations of exchange rate changes that make capital flow out of deficit countries and into surplus countries. Secondly, large and persistent current payments surpluses, even if offset by long-term capital outflows, may over time pose external financing problems for the countries with the counterpart deficits. This consideration applies with particular force to surpluses run by non-OPEC countries at a time when there is again a significant OPEC current payments surplus vis-à-vis the rest of the world. For these reasons, it would be wise not to put too much reliance on capital movements rather than current-account adjustments as a way of achieving a more stable world balance-of-payments structure.

On top of last year's very large current payments imbalances within the Group of Ten countries and Switzerland there were also — with the single exception of long-term capital outflows from Japan — aggravating developments on the capital accounts of these countries' balances of payments. In the United States the overall payments deficit was twice as large as the current-account deficit, while Switzerland's net official monetary assets increased by much more than its current surplus. Moreover in Germany, too, where the reserve gain was not far from the current-account surplus, and in Japan, where it was considerably lower, there were at times during the course of the year large-scale speculative inflows of funds. The whole process came to a climax in the final quarter of the year when net capital outflows from the United States amounted to nearly $16 billion — as much as for the year as a whole. The first few months of 1979 have seen a very substantial reversal of these "perverse" capital flows, with a reflux of funds from the surplus countries into the United States large enough to have wiped out a significant part of last year's unwanted reserve gains in the surplus countries and to have enabled the United States to recoup the large sums it used in market interventions during November and December 1978.

Looking ahead, the outlook is clouded by the recent increases in the price of oil. It is true that the responses to last year's exchange rate changes should make themselves increasingly felt in 1979. In the United States, however, the influence of favourable volume trends may be partly offset by higher oil prices and, for the same reason, nearly all European countries may see their current balances worsen. The collective surplus of the Group of Ten countries and Switzerland is likely to be reduced in 1979, while the surplus of the oil-exporting countries will increase. Thus, the global pattern of current balances may move back towards the configuration more typical of the years since 1974.

Developed countries.

The current payments deficit of the *United States,* which had become very substantial in 1977, was little changed in 1978. The basis of statistical calculation has changed since last year in that net retained earnings on direct investment are now counted as a credit in the current account and a debit in the capital account:

on the new basis the current balance was in surplus by \$4.3 billion in 1976, followed by deficits of \$15.3 and 16 billion in 1977 and 1978 respectively. The deficit was at its widest in the last quarter of 1977 and the first quarter of 1978, when it averaged \$27.4 billion at a seasonally adjusted annualised rate. The quarterly deficits in the last three quarters of 1978 were running at an annualised average rate of \$11.2 billion, with a substantial improvement to \$5.4 billion in the fourth quarter. The capital account for 1978 as a whole showed large net outflows of private and non-reserve official capital, which aggravated the deleterious effects on the dollar of the current-account deficit. Identified net outflows amounted to \$26.8 billion, but there was a favourable statistical discrepancy of \$11.5 billion, and the official settlements deficit was \$31.3 billion, not significantly smaller than in 1977.

The quarterly development of the US balance of payments was far from smooth. Reflecting the phases of the dollar crisis, the major variations were in the capital

United States: Balance of payments, 1976-78.

Items	1976	1977	1978[1] Year	1978[1] 1st quarter	1978[1] 2nd quarter	1978[1] 3rd quarter	1978[1] 4th quarter
	in billions of US dollars						
Current transactions							
Merchandise exports (f.o.b.)	114.7	120.6	141.9	30.8	35.3	36.5	39.3
Merchandise imports (f.o.b.)	124.1	151.7	176.0	42.7	43.2	44.5	45.6
Trade balance	− 9.4	−31.1	−34.1	−11.9	− 7.9	− 8.0	− 6.3
Investment income, net[2]	15.9	17.5	19.9	4.8	4.6	4.9	5.6
Other services and transfers, net	− 2.2	− 1.7	− 1.8	− 0.5	− 0.1	− 0.6	− 0.6
Services and transfers	13.7	15.8	18.1	4.3	4.5	4.3	5.0
Current balance	4.3	−15.3	−16.0	− 7.6	− 3.4	− 3.7	− 1.3
Capital transactions[3]							
US Government	0.8	− 2.0	− 1.8	− 0.1	− 1.5	− 1.1	0.9
Direct investment[4]	− 7.3	− 8.9	− 9.8	− 4.2	− 2.1	− 0.5	− 3.0
Portfolio investment	− 5.7	− 1.2	0.2	− 0.1	0.3	0	0
Flows reported by US banks, n.i.e.	− 7.6	− 4.1	−14.8	− 5.7	2.2	1.3	−12.6
Other	− 2.5	− 1.5	− 0.6	− 1.7	0.5	0.9	− 0.3
Identified capital flows	−22.3	−17.7	−26.8	−11.8	− 0.6	0.6	−15.0
Statistical discrepancy	9.3	− 0.9	11.5	4.6	9.1	− 1.6	− 0.6
Capital balance	−13.0	−18.6	−15.3	− 7.2	8.5	− 1.0	−15.6
Overall balance[5]	− 8.7	−33.9	−31.3	−14.8	5.1	− 4.7	−16.9
of which, changes in:							
US official reserve assets	2.5	0.2	− 0.9	− 0.2	− 0.4	− 0.1	− 0.2
US liabilities to foreign official agencies[3]	−11.2	−34.1	−30.4	−14.6	5.5	− 4.6	−16.7

[1] Quarterly data seasonally adjusted. [2] Including net retained earnings on direct investment. [3] Because of definitional differences, some of the capital-account totals, and US liabilities to foreign official agencies, are not identical to those published by the US authorities. [4] Including the reinvestment of net retained earnings on direct investment. [5] Excludes valuation adjustments.

account — notably flows reported by banks in the United States — and in the statistical discrepancy. Unfortunately, the statistics no longer distinguish long from short-term flows through US banks, and therefore it is not possible to treat the banks' short-term position — which excludes movements in the deposits of foreign official institutions — as a financing item. In the first quarter the dollar was generally weak and the banks were net lenders abroad. Some of this lending was reversed in the second and third quarters, possibly influenced in the latter quarter by the abolition on 28th August of reserve requirements on funds borrowed abroad. But the largest change came in the fourth quarter, when the banks reported net outflows of $12.6 billion, which were more than accounted for by additional dollar claims on foreigners and which occurred mainly in November and December. Moreover, if it had not been for the first issue of DM-denominated "Carter notes" to German residents, the net outflow in the fourth quarter would have been $1.6 billion larger. Part of this outflow may have been purely seasonal, but it is likely that much of it represented a response to the increased readiness of the US authorities to intervene in foreign exchange markets to support the dollar, which enabled unwilling holders of dollar assets to cover their exchange risk without fear of triggering a large and costly fall in the dollar. By comparison, other identified non-reserve capital transactions were fairly stable, and over the year as a whole resulted in a smaller deficit than in 1977.

The current-account deficit was in fact a little larger in 1978 than in 1977, and it is therefore of some interest to look in more detail at its development in recent years. The following table shows the seasonally adjusted quarterly movements of the US balance on goods and services during 1977 and 1978, both in current dollars and, in order to abstract from the terms-of-trade effects of the dollar's depreciation and other price movements, at 1972 prices as a percentage of gross national product.

United States: Balance of trade in goods and services, 1977–78.

1977					1978				
Year	1st quarter	2nd quarter	3rd quarter	4th quarter	Year	1st quarter	2nd quarter	3rd quarter	4th quarter
in billions of US dollars at current prices, seasonally adjusted, annualised rates									
−11.1	− 8.5	− 5.9	− 7.0	−23.2	−12.0	−24.1	− 5.5	−10.7	− 7.6
at 1972 prices, expressed as a percentage of gross national product									
+ 0.7	+ 0.9	+ 0.8	+ 0.9	+ 0.2	+ 0.6	+ 0.2	+ 0.8	+ 0.7	+ 0.7

A notable feature is the size of the seasonally adjusted trade deficits in the last quarter of 1977 and the first quarter of 1978. These seem to have been mainly the result of a slowdown in exports, perhaps arising from anticipations of a further fall in the dollar. While this deterioration proved to be only temporary, many observers consider that the subsequent improvement has been less than might have been expected on the basis of past experience. The figures in the lower half of the table show that since the middle of 1977 there has not been any significant increase in net exports, in spite of the depreciation of the dollar. It is true, of course, that the beneficial effects of depreciation may be vitiated by offsetting increases in costs and prices in the depreciating country in relation to other countries, but such increases have not occurred recently in the United States. Between the second quarter of 1977 and the fourth quarter of 1978 unit labour costs in manufacturing in the United States relative to other countries fell by 11½ per cent.

Further light may be thrown on the recent evolution of the US balance on goods and services account by comparing the effects of the 1977–78 depreciation of the dollar with those of the 1971–72 and 1973 depreciations. This is done in the table below, in which post-depreciation changes in capacity utilisation and in net resources exported by the United States (as a percentage of gross national product) are traced quarter by quarter. The early benefits of the 1971–72 devaluation appear to have been used in promoting full employment in the domestic economy, since there was no improvement at all in the trade balance. In complete contrast, the depreciation of 1973 contributed hardly anything to domestic employment but did a lot for the trade balance. It may well have been assisted in this by delayed effects of the 1971–72 devaluation.

United States: Effects of dollar depreciations.

Number of quarters after beginning of depreciation[1]	Year and size of depreciation					
	1971-72 (6⅔ %)[2]		1973 (9 %)[2]		1977-78 (9 %)[2]	
	Change in		Change in		Change in	
	capacity utilisation in manufacturing[3]	volume of net exports[4]	capacity utilisation in manufacturing[3]	volume of net exports[4]	capacity utilisation in manufacturing[3]	volume of net exports[4]
1	+ 1.5	− 0.20	+ 1.5	+ 0.31	− 0.1	− 0.70
2	+ 4.0	− 0.48	+ 2.1	+ 0.56	− 1.1	− 0.72
3	+ 5.9	− 0.36	+ 2.3	+ 0.87	+ 1.2	− 0.11
4	+ 7.2	− 0.12	+ 2.2	+ 1.16	+ 2.4	− 0.27
5	+ 10.3	− 0.10	− 0.1	+ 1.34	+ 3.5	− 0.21
6	start of second episode (see next column)		-	+ 1.37	+ 3.7	− 0.30
7			− 0.3	+ 1.37		
8			− 7.1	+ 1.61		

[1] The quarter numbered 1 in each case is the first quarter in which an effective depreciation, calculated on a quarterly average basis, of more than 2 per cent. took place. In the 1971-72 episode quarter number 1 is the fourth quarter of 1971; in the 1973 episode, the first quarter of 1973; and in the most recent case, the fourth quarter of 1977. All comparisons in the table are with the quarter preceding that numbered 1. [2] The figures in brackets are the total effective depreciations of the dollar, based on the computations of the Morgan Guaranty Trust Company. They are calculated over the following periods: third quarter of 1971 to second quarter of 1972; fourth quarter of 1972 to third quarter of 1973; and third quarter of 1977 to fourth quarter of 1978. [3] Percentage change in the FRB index from that prevailing in the quarter before 1. [4] Change in the volume of net exports of goods and services as a percentage of GNP, calculated at 1972 prices.

The most recent depreciation, although similar in size to the earlier ones, seems to have done comparatively little good at all so far. The increase in capacity utilisation has been much smaller than in 1972, while the external balance has even deteriorated a little in relation to gross national product. Moreover, business-cycle developments in other countries cannot plausibly be adduced in explanation. It might be objected that since the most recent fall in the dollar has come in phases extending over a year or so and continuing into the final quarter of 1978, it is too soon to compare its results unfavourably with those of its predecessors. While this objection may apply to a comparison with what happened after the 1973 depreciation, which was more rapid, the most recent depreciation was only a little more protracted than that which took place in 1971–72. And even if, in order to allow for this difference, its results after six quarters are compared with those of the 1971–72 devaluation after five quarters, they are still relatively unimpressive. Moreover, although the trade figures for the first quarter of 1979 are encouraging, they still do not show an adjustment comparable to those achieved after the two earlier depreciations of the dollar.

In looking at the slowness of the response to the 1977–78 depreciation, the changes in the commodity composition of the trade balance between 1977 and 1978 are of some interest. Although there were improvements on foodstuffs, animal feed and beverages, as well as on petroleum and petroleum products, amounting in all to $7 billion, these are not the favourable responses that are expected from depreciation. In the other merchandise categories, where improvements might have been expected, there were deteriorations totalling $10 billion. Some of these changes for the worse might be thought to represent the effects of a worsening in the US terms of trade following the depreciation of the dollar, rather than volume movements. But in fact the terms of trade improved between 1977 and 1978 in spite of the dollar's depreciation. Thus, the response of the US trade balance to the 1977–78 depreciation has been at its most disappointing in the case of manufactured goods, a sector in which there is often great anxiety to maintain markets, and this cannot be explained as a J-curve phenomenon. To summarise, then, there has been as yet little sign of the substantial adjustment of the volume of US imports and exports that might have been expected to result from the depreciation of the dollar since mid-1977, and such improvements as have occurred have not been the expected ones.

At the beginning of 1979 it was expected that the current deficit for the year would be roughly halved, to between $8 billion and $10 billion. Although the merchandise trade figures for the first quarter did show a small improvement on the final quarter of 1978, the recent further increases in oil prices have raised the spectre of a relapse by adding another several billion dollars to the oil deficit previously expected in 1979. However, this should not be enough to prevent some, perhaps smaller, improvement in the current account this year. In the capital account there is very clear evidence of the success of the dollar support measures of 1st November 1978. In January and February alone, the reflow of funds through the banks amounted to some $12 billion, nearly all in the form of reduced claims on non-residents, and this trend continued in March and April. Nonetheless, as noted elsewhere in the Report, exchange-market stability in the longer run remains dependent on a better performance of the US current account.

In 1978 balance-of-payments developments in the three major surplus countries — *Japan, Germany and Switzerland* — were strongly influenced by the sharp decline of the dollar. All three countries experienced sizable increases in their current-account surpluses arising out of terms-of-trade improvements that more than offset reductions in the volumes of their net exports. In addition, all three received massive inflows of short-term capital, so that additions to their net official reserves were even larger than in 1977, as the monetary authorities intervened heavily to moderate the upward movement of their exchange rates.

Japan's balance of payments, while remaining in large overall surplus, showed some major changes in 1978 which, by the end of the year, had considerably

Developed countries: Balances of payments.[1]

Countries	Years	Current balance[2]	Capital balance[2]	Overall balance[3]	Adjust-ments[4]	Adjusted overall balance (=total external monetary movements)[5]
		in millions of US dollars				
Austria	1977	− 2,980	1,845	− 1,135	− 60	− 1,195
	1978	− 1,505	2,435	930	25	955
Belgium-Luxembourg	1977	− 725	− 450	− 1,175	− 770	− 1,945
	1978	− 565	− 585	− 1,150	320	− 830
Canada	1977	− 3,930	1,150	− 2,780	− 70	− 2,850
	1978	− 4,625	440	− 4,185	− 100	− 4,285
Denmark	1977	− 1,680	2,655	975	60	1,035
	1978	− 1,400	2,375	975	105	1,080
Finland	1977	− 160	200	40	60	100
	1978	585	145	730	35	765
France	1977	− 3,310	5,335	2,025	− 435	1,590
	1978	4,200	400	4,600	− 600	4,000
Germany	1977	4,320	− 3,150	1,170	− 570	600
	1978	8,960	− 4,050	4,910	− 1,130	3,780
Greece[6]	1977	− 1,275	1,055	− 220	235	15
	1978	− 1,255	915	− 340	220	− 120
Ireland	1977	− 300	290	− 10	30	20
	1978	− 310	460	150	95	245
Italy	1977	1,350	725	2,075	290	2,365
	1978	6,365	1,915	8,280	145	8,425
Japan	1977	10,920	− 2,710	8,210	− 1,110	7,100
	1978	16,625	−10,610	6,015	− 1,830	4,185
Netherlands	1977	365	− 1,600	− 1,235	260	− 975
	1978	− 1,355	− 2,360	− 3,715	225	− 3,490
Norway	1977	− 4,935	4,710	− 225	− 70	− 295
	1978	− 2,100	2,925	825	40	865
Portugal[6]	1977	− 1,505	60	− 1,445	305	− 1,140
	1978	− 740	955	215	210	425
Spain	1977	− 2,450	2,745	295	− 720	− 425
	1978	1,510	2,240	3,750	− 765	2,985
Sweden	1977	− 2,810	3,225	415	25	440
	1978	− 975	605	− 370	− 135	− 505
Switzerland	1977	3,440	1,220	4,660	.	4,660
	1978	5,145	5,055	10,200	.	10,200
Turkey	1977	− 3,385	885	− 2,500	.	− 2,500
	1978	− 1,420	810	− 610	.	− 610
United Kingdom	1977	580	9,025	9,605	− 325	9,280
	1978	500	600	1,100	− 635	465
United States	1977	−15,290	−14,440	−29,730	360	−29,370
	1978	−15,960	− 490	−16,450	2,000	−14,450
Yugoslavia	1977	− 1,600	1,770	170	.	170
	1978	− 1,015	1,390	375	.	375

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] For a large number of countries current and capital-account figures exclude retained earnings on direct investment and the corresponding reinvestment of such earnings. [3] Equal to the sum of actual transactions; excludes, wherever possible, valuation gains or losses in monetary items resulting from exchange rate movements. [4] Differences mainly due to valuation adjustments and discrepancies in coverage. [5] Equal to the sum of the last two columns in the table on page 98. [6] Partly on a cash basis.

reduced the underlying imbalance. Despite the reinforcement of administrative guidelines for export restraint and the introduction of an emergency import programme, the current payments surplus increased further, from \$10.9 to 16.6 billion. This change was more than offset, however, by a quadrupling of net long-term capital outflows, to \$12.2 billion, so that the surplus on the basic balance of payments came down from \$8.2 to 4.4 billion. Nevertheless, the increase of \$7.7 billion in net official monetary assets was larger than in 1977, owing to substantial net inflows of banking and non-banking short-term funds.

During the course of the year the change in the basic balance of payments was dramatic, from a \$4.3 billion surplus in the first quarter to a \$2.1 billion deficit in the fourth quarter. In part this was attributable to developments on trade account, the surplus on which fell to \$5.1 billion in the last three months of 1978 after having averaged \$6.5 billion during the preceding three quarters. However, the fourth-quarter decline in the trade surplus resulted essentially from \$1.7 billion of emergency imports. The decisive factor in the emergence of a deficit on the basic balance was the large and rapid shift in the long-term capital account, from net inflows of \$0.4 billion in the first quarter to net outflows of \$5 billion in the final quarter.

An increase of \$7.4 billion, the same as in the preceding year, boosted the 1978 trade surplus to \$24.7 billion. However, in yen terms the rise was much less spectacular. Moreover, as mentioned earlier, the trade account owed its apparent strength in 1978 to an extraordinary terms-of-trade gain of almost 15 per cent. which concealed a marked adjustment of underlying trade volume trends. The growth rate of real exports fell from 9 per cent. in 1977 to only 1 per cent. in 1978. A 7½ per cent. volume gain in the first quarter gave way to a 3 per cent. decline in the second quarter, as the impact of the export restraint programme was compounded by the dampening effects of the yen's rapid appreciation, and in the last quarter the volume of exports was nearly 5 per cent. lower than a year earlier. However, the extent of the dollar's depreciation against the yen prevented any decline in the dollar value of exports. The dollar unit value of exports rose by nearly 20 per cent. in 1978 as Japanese exporters adjusted their dollar export prices upwards in response to the appreciation of the yen, although part of the exchange rate movement was absorbed by a reduction of profit margins.

Imports expanded by 7 per cent. in real terms in 1978, after a 2½ per cent. rise the year before. However, this acceleration provides only limited evidence of responsiveness of real imports to the exchange rate change, for the following two reasons: first, the emergency import scheme alone may have added about 2½ percentage points to the growth of imports in 1978; secondly, the volume of imports was still below the 1973 peak, despite a strong upturn in industrial production to 5 per cent. above the level of five years earlier. The sluggishness of Japanese imports can be traced largely to the behaviour of two major categories of goods, raw materials and mineral fuels, which accounted for almost two-thirds of total imports in 1977. The combined volume of these imports has not risen in recent years and even in 1978, when favourable price trends prevailed and official stockpiling added to demand, raw-material imports grew by only 5 per cent. while those of mineral fuel declined by 2 per cent. The fact that in 1978 a level of industrial production well above that of 1973 was sustained with a volume of imports in these two categories that was well below the level of five years earlier is indicative of the remarkable switch to energy-saving and raw-material-saving production techniques that has occurred. Last year's rise in total import volume therefore reflected primarily the rise in purchases of manufactured goods as relative price advantages brought about by the yen's rapid appreciation permitted foreign suppliers to penetrate the Japanese market; as a result, the share of manufactured imports in total imports rose from 21 per cent. in 1977 to 25 per cent. in 1978.

On capital account the authorities' policy of promoting foreign borrowing on the Tokyo market was the principal factor behind the huge rise in net long-term capital outflows to $12.2 billion in 1978. Residents' purchases of foreign securities and foreign lending by Japanese banks generated an increasing outflow as the year went on. In total, these transactions resulted in a net outflow of $11.7 billion, almost five times the 1977 total. These outflows were supplemented by an increase in the deficit on net direct investment of $2.4 billion. The net outflow of long-term trade credit, however, which had amounted to $1.4 billion in 1977, virtually dried up last year. Net short-term capital flows, including errors and omissions but excluding the banking sector, resulted in an inflow of $1.6 billion in 1978, though the quarterly pattern was far from steady. In total, net capital exports amounted to $10.6 billion, compared with $2.7 billion in the preceding year, so that the overall surplus declined from $8.2 billion in 1977 to $6 billion in 1978.

Including valuation adjustments, the net external monetary position improved by $4.2 billion, with net short-term banking inflows of $3.5 billion and an increase in net official assets of $7.7 billion. The largest quarterly reserve increase, of $6.8 billion, occurred in the first three months of 1978, when strong speculative capital inflows were superimposed on the current surplus, and the authorities intervened on a very large scale to moderate the rise in the yen exchange rate. A reversal of capital flows in the second quarter contributed to a $1.9 billion decline in the net official position, a large part of which was offset by an increase in the following quarter. During the final quarter the net external monetary position deteriorated by $1.6 billion, but net short-term inflows of $3.3 billion through the banks boosted official reserves by $1.7 billion.

In the first quarter of 1979, when the yen's exchange rate declined sharply, the current account went into deficit by $0.5 billion, a turn-round of $3.4 billion from the preceding quarter. With long-term capital outflows remaining large, the basic balance showed a substantial deficit of $4.2 billion; net official reserves fell by $3.7 billion.

Like that of Japan, *Germany's* current payments surplus rose sharply last year, from $4.3 billion to nearly $9 billion. At the same time, and in contrast to what happened in Japan, the currency crisis caused net long-term capital outflows to decline sharply, from $5.6 to 1.1 billion, shifting the basic balance from a deficit to a $7.9 billion surplus. This surplus, together with sizable inflows of short-term funds through the banking system, led to a $10.4 billion rise in net official monetary assets.

The widening of the current surplus was entirely due to a $5.5 billion increase in the trade surplus which, at $25.3 billion, was the highest ever recorded in dollar terms. Although the customary invisibles deficit rose slightly to $16.3 billion, in domestic currency terms there was a decline of DM 2.8 billion. The principal reason for this unusual change was the recovery of net investment earnings, which had fallen sharply in 1977 when modifications in tax legislation precipitated exceptionally large remittances of profits to foreign shareholders. Other invisible transactions generally followed their traditional pattern, with the biggest rise, of $2.6 billion, being recorded in net tourist expenditure.

The increase in the trade surplus was entirely accounted for by a 3½ per cent. improvement in Germany's terms of trade. As was shown earlier, the "real" trade balance deteriorated in 1978 by roughly $2.7 billion as export and import volumes responded to changes in the phases of the business cycle in Germany and in other countries, and to changes in the international competitiveness of German goods. Real export growth decelerated by 1½ percentage points to 4 per cent., slightly less than the estimated growth of world trade. Indeed, conditions in the export sector were generally depressed and, in contrast to experience in previous cycles, this sector contributed only modestly to the upswing in domestic output in 1978. One decisive factor in this context was undoubtedly the fact that export unit values measured in Deutsche Mark remained unchanged, indicating a marked squeeze, for the second consecutive year, on German exporters' profit margins. In DM value terms, export performance varied among regional markets. The most important gains, of around 15 per cent., were achieved in sales to the United Kingdom, Japan and Switzerland, followed by increases of 10 per cent. to the United States and Belgium-Luxembourg. Exports to Norway, Spain and Sweden shrank by between 13 and 20 per cent., reflecting these countries' domestic stabilisation programmes. There were also some losses of market shares in the oil-exporting countries, whose total purchases from Germany declined by 1½ per cent.

The DM value of imports rose by 3½ per cent. in 1978; this was the result of a 3½ per cent. decline in prices and a 7½ per cent. expansion in volume. The acceleration of real import growth from less than 4 per cent. in 1977 was due in part to the recovery of domestic economic activity, but it also reflected an improvement in the competitiveness of foreign suppliers. Their relative price advantage was felt particularly in the finished goods sector, where the volume of imports rose by nearly 10 per cent.; semi-processed goods were also imported on a much larger scale in connection with a building-up of inventories. The relative weakness of raw-material imports, which declined for the second consecutive year, appears to indicate savings in the use of raw materials — a phenomenon similar to that observed recently in Japan. Certain other industrial countries, centrally planned economies and southern European countries were the most successful suppliers on the German market. At the same time, imports from the oil-exporting countries dropped in value terms by 17 per cent., largely because of the sharp decline in the

DM price of oil, but also partly because of an increase in the share of oil imports from the United Kingdom and from Norway. As a result, Germany's trade surplus with the oil-exporting countries widened substantially from $0.6 billion in 1977 to $2.6 billion in 1978.

On capital account the steep decline from $5.6 to 1.1 billion in net long-term outflows can be traced to two categories of transactions, both of which were strongly affected by last year's currency disturbances. First, and most importantly, the long-term foreign transactions of the banking sector gave rise to net inflows of $2.5 billion, in sharp contrast to net outflows of $2.7 billion the year before. In particular the banking sector's longer-term external liabilities rose by no less than $7.4 billion last year, partly as a result of large purchases by non-residents of bank certificates of indebtedness. These speculative inflows were only partly offset by a $4.3 billion increase in long-term bank credit extended to non-residents, including purchases by the banks of $1.6 billion worth of "Carter notes". Secondly, the net outflow from portfolio investment declined from $1.3 to 0.3 billion, mainly owing to larger non-resident purchases of German securities. In the rest of the long-term capital account net outflows were higher than in 1977, net direct investment rising from $1.4 to 2 billion and net official capital outflows doubling to $1.5 billion.

The modest total of net long-term capital exports was supplemented by net short-term non-banking capital outflows (including errors and omissions) of $3 billion, reversing the inflow of $2.4 billion recorded in 1977. The swing included a $3 billion decline in financial loans from abroad to the private non-bank sector. Although the deficit on identified net trade credits remained unchanged in 1978, the relatively big negative statistical discrepancy may reflect some increase in trade credits granted by German exporters. For the year as a whole Germany's overall payments surplus amounted to $4.9 billion, about four times as large in dollar terms as it had been in 1977.

Including valuation adjustments, the monetary counterparts of the overall surplus were an increase of $6.7 billion in the net short-term liabilities of the banking sector and a rise of $10.4 billion in net official assets. The bulk of the increase in net official reserves occurred during the last quarter of 1978, with $4.4 billion accruing during October alone, when the dollar crisis was at its peak, and a further $2.8 billion in the last two months of 1978. Only during the second quarter, when the dollar staged a short-lived recovery, did the monetary authorities' net reserves decline. There were net short-term outflows of $1.3 billion through the banking sector in the first quarter; thereafter net inflows rose steadily, reaching $4.7 billion in the fourth quarter.

During the first quarter of 1979 the current account recorded a surplus of $1.5 billion, compared with $2.1 billion in the corresponding period of 1978. At the same time, the surplus on the basic balance fell sharply to $1.1 billion from $3.6 billion, as net long-term capital outflows resumed. In addition, there were sizable net short-term banking and non-banking capital outflows of $6.1 billion and net official assets declined by $5 billion.

In *Switzerland* the appreciation of the franc last year and the associated exchange-market pressures helped to increase the overall balance-of-payments surplus, which in 1977 had been $4.7 billion, to $10.2 billion. The external monetary counterpart to the surplus was an improvement of $6.9 billion in the net official position and one of $3.3 billion in the banking system's net external assets.

On current external account the surplus went up from $3.4 to 5.1 billion. As usual, net receipts from services and transfers, which rose from $3.5 to 4.6 billion, were the dominant element in the current-account surplus. Net investment income, at $3.5 billion, was $1 billion higher than in 1977 and in addition net receipts on travel account, although lower than the year before in Swiss franc terms, improved in dollar terms by $0.3 to 1.5 billion. The merchandise trade account registered a surplus of $0.5 billion, after a deficit of $0.1 billion in 1977. This change was more than accounted for by a 7½ per cent. improvement in the terms of trade. On the basis of customs figures the volume changes on trade account — a 5 per cent. increase in exports and a 10 per cent. increase in imports — would on their own have produced a $0.9 billion deterioration in the foreign trade balance.

The capital account was dominated by unidentified inflows of $11.1 billion. In contrast, identified capital movements showed a deficit of $6 billion, reflecting the attractiveness to issuers of notes and bonds of the low interest rates on borrowing denominated in Swiss francs. Thus, total net capital inflows amounted to $5.1 billion, up from $1.2 billion in 1977.

In the first quarter of 1979 the Swiss merchandise trade deficit amounted to $0.5 billion, roughly double its level in the corresponding quarter of 1978. There were partial reversals of last year's inflows of funds in January and March, and the net official position deteriorated by $1.9 billion over the quarter.

The exchange rates of the other European Group of Ten countries showed much less volatility in 1978. In some countries the relative stability reflected the absence of any strong exchange-market pressure; in others the authorities intervened heavily to hold their currencies' external value between those of the major divergent currencies. Either way their balance-of-payments developments in 1978 were much less affected by the recurrent exchange-market disturbances.

Italy's current balance-of-payments surplus increased sharply in 1978 to $6.4 billion, or about 2½ per cent. of gross domestic product, from $1.4 billion the year before. The trade account improved by $3 billion, and there was an improvement of $2 billion in the balance on services and transfers. These changes may be ascribed to the relatively slow growth of domestic demand and the continuing response to the 18 per cent. effective depreciation of the lira in 1976.

The terms of trade improved by 2½ per cent. in 1978, despite the depreciation of the lira in relation to other European currencies, but this was responsible for only about $1 billion of the total improvement in the merchandise trade balance on a customs basis. The volume of merchandise exports increased by 11 per cent., while that of imports went up by only 7½ per cent. The effect of volume movements on the trade balance was, however, smaller than in 1977, when export volume rose by 7 per cent. and imports fell by 2 per cent. Moreover, there were signs that the strengthening of the trade balance was slowing down in the course of 1978.

The capital-account surplus increased to $1.9 billion in 1978 from $0.7 billion in the previous year. Net outflows of trade credit fell from $0.7 billion to $0.3 billion, and repayments of public-sector compensatory external borrowing, at $0.8 billion, were $0.2 billion higher. The largest single element in the change, however, was the improvement of $0.8 billion in net errors and omissions to a surplus of $0.3 billion. The overall surplus in 1978 was $8.3 billion, of which $7 billion was reflected in an increase in net official assets.

The current account of *France's* balance of payments improved dramatically in 1978, from a deficit of $3.3 billion to a surplus of $4.2 billion, equal to 0.9 per cent. of gross domestic product. Although there was a sharp decline in net capital inflows, the overall surplus increased from $2 to 4.6 billion.

Of the total improvement of $7.5 billion in the current balance, $3 billion was in the balance on services and transfers, which moved strongly into surplus, most notably in the fourth quarter. There were large increases in net receipts both on travel account and from services provided in connection with large engineering projects and technical co-operation with other countries. The favourable movement of $4.5 billion in the merchandise trade balance was mainly the result of an improvement of 4 per cent. in the terms of trade, with a fairly small contribution from higher net export volume. In 1977, by contrast, the improvement in the trade balance was more than accounted for by favourable volume movements, and the terms of trade worsened by 1½ per cent.

The long-term capital account moved from a surplus of $0.3 billion in 1977 to a deficit of $1.7 billion in 1978. As a consequence of the improvement in the current balance, residents' drawings on loans from abroad subject to Treasury approval fell by $2 to 3 billion, while the balances in the other main categories of long-term capital transactions were roughly the same as they had been in 1977. Net short-term inflows, including errors and omissions, fell from $5 to 2 billion. Including valuation and coverage adjustments, the net official monetary position and the commercial banks' net external short-term position improved by $2.8 and 1.2 billion respectively.

In the first quarter of 1979 the seasonally adjusted trade surplus, at $0.3 billion on a customs basis, showed little change from the average for 1978. The net official monetary position improved by $1 billion.

The current-account balance of the *United Kingdom* in 1978 closed with a small surplus of $0.5 billion, very little different from that recorded in 1977. During the course of the year, however, it showed some tendency to improve as the economic recovery slackened, and there was a seasonally adjusted surplus of $0.8 billion in the fourth quarter. Over 1978 as a whole the current balance benefited by some $2 billion from the net impact of the increase in indigenous oil and gas production and is expected to gain a further $3 billion from this source in 1979.

The terms of trade on a customs basis improved by 6 per cent. in 1978, largely because of the strength of the pound. If there had been no changes in export and import volumes, this would have improved the current account by nearly $2 billion. As it was, volume movements were adverse, with imports rising by 7½ per cent. and exports by only 4½ per cent., so that the merchandise trade balance improved by only $0.7 billion to a deficit of $2.3 billion. There were improvements in the unfavourable trade balances in non-manufactured goods, largely in the oil and agricultural sectors, but the favourable balance on manufactured goods diminished, reflecting the sensitivity of domestic demand for such goods to changes in the phase of the business cycle, and the unresponsiveness of domestic supplies. The surplus on services and transfers declined by $0.8 to 2.8 billion in 1978. Favourable movements in the balances on services and property income were more than offset by a deterioration of $1.7 billion in the balance on transfers, of which net additional official transfers to the European Communities accounted for $1 billion.

The enormous capital-account surplus of 1977, which reflected sterling's recovery from the débâcle of 1976, was naturally not repeated, and there was a small capital inflow of $0.6 billion in 1978. The overall balance thus closed with a surplus of $1.1 billion. $1.9 billion of borrowing from the IMF was repaid, together with $0.7 billion of net borrowing by public-sector bodies under various exchange cover schemes. The Government, however, raised $350 million of new funds in its own name on the New York bond market. Over the year, the net official position worsened by $2.6 billion, while the net external liabilities of the banks decreased by $3.1 billion.

At the time of writing, trade figures were not available beyond January. However, in the first quarter of 1979 there were sizable inflows of funds into sterling, and, further assisted by an allocation of $0.4 billion of special drawing rights, the United Kingdom's official reserves increased by $1.8 billion. The revaluation of the official reserves in March added a further $4.5 billion to their published value, which thus stood at $21.9 billion at the end of that month.

The current payments deficit of *Sweden,* which had reached $2.8 billion in 1977, was sharply reduced last year to $1 billion. This improvement occurred despite a $0.5 billion increase in the invisibles deficit, resulting partly from a rise in the cost of servicing the country's external debt and from extraordinary debt cancellations in 1978 in favour of certain developing countries. On trade account, although there was an adverse movement of 2½ per cent. in the terms of trade, the domestic policy changes introduced in 1977 — including restrictive demand policies and two devaluations of the krona — which were reinforced by moderate wage settlements in 1978, led to an increase in the surplus from $0.3 to 2.6 billion. The volume of merchandise exports went up by 7 per cent. and that of imports fell by 6½ per cent.

The decline in the current-account deficit reduced the need for external finance and the capital-account surplus accordingly fell from $3.2 to 0.6 billion. The overall balance was a deficit of $0.4 billion, but this was more than covered by a deterioration of $1.2 billion in the net external position of the banks; net official external assets increased by $0.7 billion.

The balance of payments of the *Belgium-Luxembourg Economic Union* — which is now calculated entirely on a transactions basis — showed no major changes from 1977. The current-account deficit was \$0.6 billion, \$0.1 billion less than the year before. There was a slight fall in the surplus on services and transfers but this was more than offset by a \$0.3 billion improvement in the trade balance, to a deficit of \$1.1 billion. Total net capital outflows increased by \$0.1 to 0.6 billion, with a turn-round of \$1 billion from net receipts to net extension of trade credit being largely offset by a reduction in long-term bank lending abroad, so that the overall deficit of \$1.1 billion was virtually the same as in 1977. The net official monetary position improved in the early part of the year as the authorities bought foreign currencies in order to pay their debts to the European Monetary Co-operation Fund, but renewed pressure on the Belgian franc in the European joint float during the summer and early autumn, which was eventually relieved by the realignment of exchange rates on 16th October, entailed the incurring of new debt. Over the year as a whole, the net official monetary position, including valuation adjustments, deteriorated by \$0.3 billion. The rest of the overall deficit was financed by a deterioration of \$0.5 billion in the banks' net external short-term position. Non-resident holdings of franc balances went up during the year by \$1.1 billion.

The balance of payments of the *Netherlands* deteriorated sharply in 1978, the overall deficit rising from \$1.2 to 3.7 billion. The current account weakened substantially for the second year in succession, to a deficit of \$1.4 billion — the first to be recorded since 1971. A widening of the trade deficit was responsible for \$0.6 billion of the current-account deterioration, real imports rising by over 5 per cent. and real exports (which had declined in 1977) by less than 2 per cent. In addition there was a \$1.2 billion deterioration on invisibles account, to a deficit of \$0.4 billion, owing mainly to increased net travel expenditure and lower net receipts from transportation and investment income.

The further weakening of the current balance of payments was accompanied by a \$1.2 billion increase in net long-term capital outflows, to a total of \$2.5 billion. Net external lending by the banks was higher than in 1977 and net inflows from portfolio investment were lower. Short-term non-bank capital movements, including unidentified items, recorded a small net inflow. Including valuation changes and adjustments for differences in coverage, the deterioration of the overall net external monetary position, at \$3.5 billion, was rather less than the overall payments deficit. Net short-term inflows through the banking system, which amounted to \$3.3 billion, covered a very large part of the overall deficit. Net official monetary assets, excluding changes arising out of the revaluation of the gold stock, declined by only \$0.2 billion.

The deficit on the current account of *Canada's* balance of payments reached \$4.6 billion in 1978, \$0.7 billion more than in 1977. The deterioration was entirely attributable to a \$1 billion widening of the deficit on invisibles, itself largely the consequence of the increasing cost of servicing Canada's external debt and of official debt cancellations benefiting developing countries. The merchandise trade surplus increased by \$0.3 billion to \$3 billion, despite a worsening of about 3½ per cent. in the terms of trade induced by the depreciation of the Canadian dollar; the favourable trade balance in semi-manufactured products showed a particularly marked increase last year.

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 . . .	1977	895	2,770	510	4,175	−3,225	950	− 190	− 1,005
	1978	960	4,370	465	5,795	−3,890	1,905	1,620	− 665
Belgium-Luxembourg	1977	1,790	2,000	1,440	5,230	−4,400	830	− 110	− 1,835
	1978	1,795	1,770	1,330	4,895	−4,895	—	− 335	− 495
Canada . . .	1977	935	1,315	1,355	3,605	− 915	2,690	− 1,255	− 1,595
	1978	1,010	1,845	1,075	3,930	−2,740	1,190	325	− 1,910[4]
Denmark . .	1977	80	1,320	205	1,605	555	2,160	830	205
	1978	90	2,845	220	3,155	85	3,240	1,550	− 470
Finland . . .	1977	40	425	− 175	290	− 655	− 365	50	50
	1978	45	905	− 60	890	− 490	400	600	165
France . . .	1977	16,720	4,060	1,185	21,965	.	.	735[5]	855
	1978	22,340	7,070	975	30,385	.	.	2,810[5]	1,190
Germany . .	1977	4,995	31,220	4,085	40,300	− 5,600	34,700	4,865	− 4,265
	1978	5,010	39,635	6,095	50,740	− 12,260	38,480	10,440	− 6,660
Greece . . .	1977	160	− 220	− 200	− 260	40	− 220	5	10
	1978	170	− 360	− 180	− 370	30	− 340	− 110	− 10
Ireland . . .	1977	20	2,215	135	2,370	−1,035	1,335	535	− 515
	1978	20	2,530	140	2,690	−1,110	1,580	320	− 75
Italy	1977	11,260	4,415	−1,775	13,900	−6,450	7,450	5,820[5]	− 3,455
	1978	14,335	10,190	− 535	23,990	−5,050	18,940	7,025[5]	1,400
Japan	1977	920	18,785	2,270	21,975	− 12,935	9,040	5,910	1,190
	1978	1,090	25,000	3,565	29,655	− 16,430	13,225	7,680	− 3,495
Netherlands .	1977	2,305	3,645	1,845	7,795	−2,230	5,565	365	− 1,340
	1978	6,490	3,620	1,140	11,250	−5,480	5,770	− 240[5]	− 3,250
Norway . . .	1977	45	1,170	400	1,615	230	1,845	− 700	405
	1978	50	2,360	395	2,805	− 95	2,710	1,190	− 325
Portugal. . .	1977	1,025	− 1,185	− 290	− 450	− 480	− 930	− 520	− 620
	1978	1,010	− 955	− 265	− 210	− 295	− 505	240	185
Spain	1977	610	5,465	− 635	5,440	−5,390	50	1,160	− 1,585
	1978	660	9,110	− 490	9,280	−6,245	3,035	3,840	− 855
Sweden . . .	1977	250	2,935	405	3,590	− 180	3,410	1,155	− 715
	1978	275	3,620	395	4,290	−1,385	2,905	700	− 1,205
Switzerland .	1977	3,515	9,740	475	13,730	13,515	27,245	670	3,990
	1978	3,515	16,750	400	20,665	16,780	37,445	6,935	3,265
Turkey . . .	1977	155	− 3,240	− 410	− 3,495	.	.	− 2,495	− 5
	1978	165	− 3,670	− 620	− 4,125	.	.	− 630	20
United Kingdom .	1977	940	4,320[6]	−3,425	1,835	.	.	11,865	− 2,585[7]
	1978	965	− 145[6]	−1,650	− 830	.	.	− 2,665	3,130[7]
United States	1977	11,720	−126,065[8]	7,575	−106,770	24,815[9]	− 81,955	− 33,540	4,170
	1978	11,670	−152,050[8]	2,605	−137,775	42,755[9]	− 95,020	− 31,090[4]	16,640[4]
Yugoslavia .	1977	65	2,030	− 245	1,850	.	.	170	.
	1978	75	2,290	− 140	2,225	.	.	375	.

[1] For most countries the figures do not correspond exactly to published ones. [2] In France, Italy and the Netherlands gold is valued at market-related prices; in one-quarter of the countries it is valued at $42.22 per ounce and in the remainder via SDRs, being converted into 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 89. [4] Owing to a break in the series the difference between the figures shown for the ends of 1977 and 1978 does not correspond to the change shown for 1978. [5] Excludes changes arising from revaluation of gold. [6] Includes, as liabilities, government foreign currency bonds and Euro-currency borrowing and other public-sector borrowing under the exchange cover scheme. [7] 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. [8] Equals convertible currency assets minus bank-reported liabilities to foreign official institutions. [9] Banks' claims on foreigners minus their liabilities to non-official foreigners.

Although interest rate policy was dominated by external considerations, the usual surplus on autonomous capital flows, which had amounted to $1.2 billion in 1977, gave way to a deficit of $2 billion in 1978. Important components of this sharp change were a reduction in the net inflow of portfolio capital from $5.1 to 2.3 billion and a widening from $0.2 to 1.8 billion of the deficit on direct investment. Unfavourable errors and omissions were $1 billion smaller than in 1977. Financing of $6.6 billion was thus required to cover the deficit on current transactions and autonomous capital flows. Of this total, $2.4 billion was provided through securities issued and loans raised by the Canadian Government in New York and Germany, while a further $2.7 billion came from drawings on revolving credits arranged by the Government with banks in Canada and abroad. Including valuation adjustments, there was a deterioration of $1.6 billion in the net external monetary position. Net official external assets went up by $0.3 billion, and the net external short-term liabilities of the banks increased by $1.9 billion.

In the *developed countries outside the Group of Ten and Switzerland* the combined current payments deficit fell very substantially in 1978, by $12 to 11.4 billion. This improvement originated largely in the merchandise trade account, generally reflecting an appreciable rise in export volumes and sizable cutbacks in import volumes as a result of restrictive domestic policies. In addition, some countries in this group experienced notable increases in their net invisibles receipts mainly due to rapidly growing net tourist income. The improvements on current account were

Current-account transactions of developed countries outside the Group of Ten and Switzerland.[1]

Countries and areas	Trade balance (f.o.b.)			Services and transfers			Current balance		
	1976	1977	1978	1976	1977	1978	1976	1977	1978
	in billions of US dollars								
Austria	− 2.54	− 3.79	− 2.98	1.07	0.81	1.47	− 1.47	− 2.98	− 1.51
Denmark	− 2.88	− 2.69	− 2.39	0.97	1.01	0.99	− 1.91	− 1.68	− 1.40
Finland	− 0.58	0.53	1.20	− 0.59	− 0.69	− 0.62	− 1.17	− 0.16	0.58
Greece[2]	− 2.69	− 3.16	− 3.50	1.60	1.88	2.25	− 1.09	− 1.28	− 1.25
Iceland	− 0.02	− 0.05	0.03	0	0	0	− 0.02	− 0.05	0.03
Ireland	− 0.62	− 0.81	− 1.03	0.30	0.51	0.72	− 0.32	− 0.30	− 0.31
Norway	− 3.49	− 4.02	− 0.58	− 0.26	− 0.91	− 1.52	− 3.75	− 4.93	− 2.10
Portugal[3]	− 2.11	− 2.52	− 2.31	0.87	1.02	1.57	− 1.24	− 1.50	− 0.74
Spain	− 7.33	− 6.22	− 4.02	3.04	3.77	5.53	− 4.29	− 2.45	1.51
Turkey	− 2.62	− 3.43	− 1.82	0.32	0.04	0.40	− 2.30	− 3.39	− 1.42
Yugoslavia	− 1.76	− 3.33	− 3.49	1.91	1.73	2.47	0.15	− 1.60	− 1.02
In western Europe	−26.64	−29.49	−20.89	9.23	9.17	13.26	−17.41	−20.32	− 7.63
Australia	2.03	1.00	0.06	− 3.48	− 3.53	− 3.96	− 1.45	− 2.53	− 3.90
New Zealand	− 0.05	0.27	0.70	− 0.70	− 0.90	− 1.10	− 0.75	− 0.63	− 0.40
South Africa	− 0.24	2.52	4.00	− 1.63	− 1.94	− 2.50	− 1.87	0.58	1.50
In the southern hemisphere	1.74	3.79	4.76	− 5.81	− 6.37	− 7.56	− 4.07	− 2.58	− 2.80
Israel	− 2.65	− 2.16	− 2.84	1.56	1.68	1.86	− 1.09	− 0.48	− 0.98
Total	−27.55	−27.86	−18.97	4.98	4.48	7.56	−22.57	−23.38	−11.41

[1] On a transactions basis. [2] On a cash basis. [3] Partly on a cash basis.

most marked in Spain, Norway, Turkey and Austria, where trade volume changes were particularly favourable, and whose positions strengthened by $4, 2.8, 2 and 1.5 billion respectively. The only substantial worsening, of $1.4 billion, occurred in Australia.

As their external financing requirements eased in 1978, while borrowing in the international markets remained easy, these countries maintained their overall net capital imports at about the level of recent years and took the opportunity to build up their official reserves by $11.8 billion — the first substantial increase since 1973. However, as gross borrowing of $9 billion from the banks in the Group of Ten countries and Switzerland and from foreign branches of US banks in the Caribbean area and the Far East was more than matched by an increase of $10.4 billion in claims on these banks, on a net basis their borrowing seems to have shifted from bank to non-bank sources.

Oil-exporting countries.

One of the most important developments in 1978 was the reduction in the oil exporters' current surplus from $29 to 7 billion. The fall in the surplus was the result of a number of factors. First, world demand for oil grew slowly, while, as in 1977, the quantity supplied from other sources grew quite fast, and stocks of oil in consuming countries were drawn down. Thus, the volume of oil exports by major oil exporters fell by about 5 per cent. Secondly, the US dollar price of most grades of oil had been maintained unchanged since 1st July 1977 and the dollar had fallen very heavily since then against most major currencies in the foreign exchange markets. Consequently, the terms of trade of the major oil exporters deteriorated by more than 10 per cent. between 1977 and 1978. Thirdly, the volume of these countries' imports continued to rise, though at a very much more modest rate than in earlier years: 5 per cent., compared with about 20 per cent. a year in 1976 and 1977 and around 40 per cent. a year in 1974 and 1975. The slowdown in import growth was most marked in the low-absorbing countries. Finally, the deficit on net services and private transfers continued to increase. The deterioration in current balances was fairly evenly divided between the high and low-absorbing countries; the low absorbers suffered a larger fall in exports, presumably as a result of Saudi Arabia's rôle as residual oil producer, while the imports of the high absorbers increased by a larger amount.

As regards the investment of last year's much smaller surplus, it should first be noted that the proceeds of the current-account surplus of the oil-exporting countries in 1978 were supplemented by borrowings of $18 billion from the international banking system, so that the sum available for investment was about $25 billion. On present indications, there seems to have been a tendency to cut back more sharply on purchases of liquid assets than on longer-term investments.

Recent oil price developments clearly mean that the oil exporters' current balance-of-payments surplus will increase substantially in 1979. Although the schedule of price increases announced by OPEC in December 1978 did no more than compensate for the terms-of-trade loss suffered by the oil-exporting countries in

1978, the interruption of oil supplies from Iran turned market conditions in the exporting countries' favour and enabled further increases and surcharges to be imposed. On top of this increase in oil prices, a small increase in the volume of oil exports is also possible.

Non-oil developing countries.

After improvements in two consecutive years, the combined current deficit of the non-oil developing countries widened by $9 billion in 1978, to reach $24 billion. When compared with the total value of world trade, this represented no more than a reversion to the position obtaining in 1976, and the easy availability of credit in the international capital market meant that there was no widespread difficulty in financing deficits.

Although there was probably a small increase in the volume of net imports, the main reason for the general deterioration in these countries' current balances was the worsening of their terms of trade by 5 per cent. This resulted from the fall in primary product prices between 1977 and 1978, which amounted to 15 per cent. on average in relation to industrial countries' export prices. However, towards the end of 1978 and in early 1979 there were clear signs of a revival in primary product prices in response to rising levels of activity in the industrial world. There was no major geographical area where widening current deficits were avoided: in relation to their imports, the deficits of African countries increased most, while Middle Eastern members of this group did comparatively well. Among the relatively advanced individual countries, Argentina and Taiwan increased their current surpluses, but South Korea went into deficit and the Brazilian deficit worsened considerably, partly as a result of the fall in coffee prices after the boom in 1977. It has been claimed that the expansion of manufacturing capacity in some of these relatively advanced countries and the ready availability of comparatively cheap labour have exacerbated the recession in the industrialised countries, and they have certainly caused difficulties in particular industries. But since the peak of the last business cycle in 1973 net demand from the non-oil developing countries for manufactured products from OECD countries has grown by perhaps 6 per cent. per annum and in 1977, the last year for which complete figures are available, the OECD area's surplus on trade in manufactured goods with this group of countries was of the order of $45 billion. Meanwhile, demand within the OECD for manufactured products has grown only a fraction as fast, so the non-oil developing countries as a group must be regarded as having had an overall stabilising effect on output in the industrial world during the recession.

The reserves of the non-oil developing countries rose by $13 billion, even more than in 1977 despite the larger current deficit. This increase was concentrated in a small number of countries, but taking the group as a whole there was, as in the previous two years, an increase in the ratio of reserves to imports. Total capital inflows were about $10 billion larger than in 1977; most of the additional flows, no doubt stimulated by the continuation of easy borrowing conditions in the international capital markets, came from non-official sources. There were small net repayments of debt to the IMF and other monetary authorities.

Centrally planned economies.

After narrowing over the two preceding years to only $1 billion in 1977, the overall trade deficit of the centrally planned economies widened to about $5 billion in 1978. The largest single deterioration, of some $3 billion, was recorded in the USSR, where there was a big increase in grain imports. The group's balance on invisible transactions probably worsened too. Interest payments on external debt will certainly have been higher than in 1977, partly on account of fresh borrowing and partly because of the rise in dollar interest rates.

In their trade with member countries of the OECD, the deficit of the centrally planned economies went up from $7 to 10 billion in 1978. Most of this increase was accounted for by China, whose imports from OECD countries rose in dollar terms by two-thirds. However, at almost $7 billion, they still account for less than one per cent. of total OECD exports. The deficit of eastern European countries with OECD countries rose by $1½ to 7 billion.

Two main elements can be identified in the financing of the combined deficit of the centrally planned economies in 1978. First, the net indebtedness of the eastern European countries to banks in the BIS reporting network increased by $7 billion. Secondly, the USSR sold some 450 tons of gold, which may have been worth about $3 billion.

VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

1978 was a hectic year in the international credit markets. This is especially true of the banking sector, where the expansion of foreign business reached unprecedented proportions. Continued weak corporate credit demand at home and, outside the United States, the liquidity-creating effects of the vast US official settlements deficit spurred on the large banks in their quest for international loan business. The result was an intensification of interbank competition and a further compression of the banks' earning margins to levels that seemed to be based on the assumption of a future without problems or losses. Borrowers, both countries in deficit and private corporations, took advantage of the extremely favourable conditions in the international loan markets not only to meet their current financing requirements but to add to their liquidity. A substantial proportion of the resultant reserve build-up was redeposited in the international banking sector, thereby reinforcing the expansionary pressures emanating from the supply side of the markets. Superimposed on this more long-term type of growth was a very strong expansion of short-term positions related to the unrest in the exchange markets, although these positions were reversed in large measure with the return of confidence in the dollar in the early months of 1979.

Main features.

As a result of these various influences, total external assets of banks in the Group of Ten countries, Austria, Denmark, Ireland and Switzerland and of the branches of US banks in offshore centres expanded by $213 billion last year, or by nearly twice as much as in 1977. However, this gross figure considerably exaggerates the acceleration in the underlying growth of the market. Firstly, the 1978 changes include for the first time the positions of banks in Austria, Denmark and Ireland, as well as certain trade-related items in the external domestic-currency assets of banks in the United Kingdom and France. Secondly, in a sense these dollar figures overstate the real increases, owing to the depreciation of the dollar. In fact, exchange rate effects may be estimated to have added about $32 billion — $14 billion more than in 1977 — to the dollar value of the banks' external assets in currencies other than the dollar. Thirdly, as a result of the importance of the relatively short-term influences associated with developments in the exchange markets, the growth of positions between the banks in the market centres was particularly pronounced. Excluding the double-counting which results from the redepositing of funds between the reporting banks, the growth of international bank credit may therefore be estimated to have accelerated from $75 billion in 1977 to "only" $110 billion in 1978, or from somewhat over $65 billion to roughly $90 billion if valuation effects are excluded. Finally, it should be stressed that even this adjusted figure of $110 billion includes not only direct credits to the non-bank sector but also the banks' use of

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

Lenders	Changes 1976	Changes 1977	Changes 1978	Amounts outstanding 1978
	In billions of US dollars			
Banks in European reporting countries[1]	+ 55.7	+ 80.6	+145.2	611.4
of which in foreign currency (Euro-currency market) .	*+ 47.2*	*+ 68.5*	*+117.2*	*502.0*
Banks in Canada and Japan	+ 4.8	+ 0.8	+ 16.3	56.1
Banks in the United States	+ 21.3	+ 11.5	+ 36.4	129.0
Branches of US banks in offshore centres[2]	*+ 23.8*	*+ 16.2*	*+ 15.4*	*106.5*
Total (all reporting banks)	+105.6	+109.1	+213.3	903.0
minus: double-counting due to redepositing among the reporting banks	35.6	34.1	103.3	363.0
A = Net new international bank lending[3]	70.0	75.0	110.0	540.0
Euro-bond and foreign bond issues	34.3	36.1	36.7	.
minus: redemptions and repurchases	4.3[4]	5.1[4]	8.2[4]	.
B = Net new international bond financing	30.0	31.0	28.5	.
A+B = Total new bank and bond financing	100.0	106.0	138.5	.
minus: double-counting[5]	3.5	4.0	6.5	.
Total net new bank and bond financing . . .	96.5	102.0	132.0	.

[1] Austria, Belgium, Luxembourg, Denmark, France, Germany, Ireland, Italy, Netherlands, Sweden, Switzerland and the United Kingdom. [2] Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [3] 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. [4] 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. [5] 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.

funds for lending to banks outside the reporting area, for inward switching, for covering open foreign exchange positions, etc.

Looking at individual market sectors, the most expansionary elements last year were foreign lending by banks in Japan and the United States. The increase of $12 billion, or 55 per cent., in the external assets of banks in Japan has to be seen in the context of the need to finance the country's large current-account surplus and to rechannel abroad the funds pouring into the country for exchange rate reasons. Conversely, the rise of $36.4 billion, or nearly 40 per cent., in the external assets of banks in the United States reflected the loss of confidence in the dollar and the resultant eagerness of the rest of the world to add to its indebtedness in that currency. A second reason for the rapid growth in the external assets of banks in the United

States was the lifting in August 1978 of reserve requirements on funds taken up from banks abroad, which induced US banks to book a larger part of their international business through their US head offices. This official step, which was prompted by exchange rate considerations, helps to explain another significant development in 1978, namely the relative slowdown in the amount of business booked by US banks through their branches in the offshore centres of the Caribbean and the Far East. The assets of these offshore branches increased by only $15.4 billion, or 17 per cent., last year, which was considerably less than direct lending from the United States or the rates of growth recorded in previous years.

In absolute figures, the largest growth in external positions, $145 billion, was recorded as usual by banks in the reporting European area, with valuation changes contributing $30 billion to this expansion. Excluding valuation effects, conventional external assets in domestic currency rose by about $16 billion, or 17 per cent., and external assets in foreign currency by roughly $99 billion, or 25 per cent. Excluding double-counting, but including foreign currency lending to domestic non-bank residents, the total amount of Euro-credit outstanding through the reporting European banks may be estimated to have expanded by $75 billion including valuation effects, or by somewhat under $60 billion after exclusion of valuation effects.

For lack of sufficiently detailed breakdowns, the figure of $213 billion for the total expansion of international bank assets does not include, inter alia, the offshore activities of banks in Bahrain or the position of non-US banks in the offshore centres of the Caribbean and the Far East. Clearly, these omissions result in a considerable understatement of the expansion of gross positions, although on a netted-out basis the gap is probably not too serious because of the closeness of the interbank links of these offshore centres with the rest of the reporting area. Nevertheless, it may be worthwhile mentioning that the gross external assets of banks in Bahrain rose by $7.7 billion, or 50 per cent., last year and those of banks in Singapore by $5.7 billion, or 28 per cent.

The international bond markets were slightly less buoyant than credit intermediation by the international banking sector, with the total volume of new issues, at $36.7 billion, marginally higher than in 1977. Allowing for the increased flow of redemption payments, the net amount of new funds raised actually declined by roughly $2.5 billion. This somewhat less expansionary performance of the issue markets was due essentially to two influences: the steep uptrend in short-term dollar interest rates, and the exchange rate uncertainties which, unlike in the banking sector, had on balance a negative impact on the volume of business. This applied particularly to the Euro-bond market where, as a result of a sharp drop in dollar issues, the market volume contracted from $19.5 to 15.9 billion. On the other hand, foreign issues in national markets expanded from $16.6 to 20.8 billion, largely as a result of very easy liquidity conditions as well as official encouragement to capital exports in the principal surplus countries. In particular, yen issues more than trebled, to $4.7 billion. By contrast with the banking sector, where the huge money exports by banks in the United States contributed to the dollar weakness, the geographical pattern of capital flows intermediated by the issue market thus had, if anything, a calming influence on the exchange markets.

The international banking sector.

Basic influences. The rapid growth in volume last year was not accompanied by a tightening of international credit conditions which, on the contrary, continued to ease. It is true that Euro-dollar interest rates rose strongly in the last nine months of the year, but this was not symptomatic of the state of the market and simply reflected the upward movement of interest rates in the United States. The premium commanded by Euro-dollar deposit rates over comparable interest rates in the United States widened only in the last three months of the year when exchange-market unrest reached a climax; expressed in relation to the absolute level of interest rates and allowing for various changes in US reserve requirements, the premium actually declined.

The ease of international credit conditions was also reflected in a further squeeze on the banks' earning margins. Syndicated loan spreads dropped to the levels prevailing in the months before the Herstatt crisis, namely ½ percentage point or even slightly less for prime borrowers and under 1 per cent. for most other credit-takers. It is not easy to see how these spreads can leave scope for building up adequate provisions against future losses. Other conditions too, such as the maturity and size of loans, have moved markedly in favour of borrowers. Indeed, the very easy state of the market induced many debtors to repay their old debts prematurely and to refinance themselves at the more favourable terms prevailing. With the front-end fees from such new loans usually credited to the banks' income for the current year, this negotiation of lower lending margins tended to have a favourable impact on the banks' profit situation last year, but is liable to impair their earning potential in the longer run.

The concurrence of a further easing of credit conditions and record growth volumes strongly suggests that the expansionary impetus emanated largely from the sources side of the market. What was the reason for this unusually liberal supply of international bank loans last year?

In several respects the scenario was quite similar to that prevailing in 1977, with the differences lying not so much in the nature as in the intensity of the various forces at work. Perhaps the most pervasive influence last year was the huge balance-of-payments outflows from the United States and their impact on monetary conditions in the rest of the world. One of the main sources of these balance-of-payments outflows was foreign lending by banks in the United States. Although domestic price developments in that country and its balance-of-payments situation might have suggested a rather restrictive stance of monetary policy, there was no major shortage of funds and, except towards the end of the year, the rise in interest rates was more nominal than real (see Chapter IV, pages 58–60). Accordingly, the banks were free to continue expanding their international loan business and when in the last few months of the year the collapse of confidence in the dollar boosted foreign demand for dollar borrowing, they had no difficulty in complying with these credit demands. As a result capital exports by banks in the United States reached very high levels in the early and late months of the year and were a major source of dollar weakness. Conversely, the reversal of a large part of these banking outflows was one of the principal reasons for the pronounced strengthening of the dollar in the early part of 1979. In addition to the large money exports by banks in the United States, 1978 saw a very substantial shift of US non-bank funds to banks abroad.

Outside the United States the money inflows and the easy stance of monetary policies imposed on the authorities of the surplus countries by exchange rate considerations provided the banks in these countries with plenty of ammunition for lending abroad. Moreover, in order to contain their own exchange-market intervention and its liquidity-creating effects, the monetary authorities tended to encourage the banks to re-export the funds which were flowing into the country for exchange rate reasons.

Apart from its impact on private liquidity, the vast US official settlements deficit boosted, of course, world official exchange reserves. Although the current-account surpluses were heavily concentrated in a few industrial countries that invest their exchange reserves predominantly in the US financial markets, international bank lending helped to share out the reserve accruals to countries that generally deposit a large part of their reserves in the Euro-markets. In this way international bank lending tended to add to the supply of its own funds.

Another broad set of influences behind the very ample supply of new bank loans was the increasing importance of the international markets as a source of growth and income for the large commercial banks. Although 1978 saw a strong pick-up in domestic credit demand for the financing of residential construction, consumer spending and small businesses, the major banks continued to be confronted with sluggish borrowing demand from their large corporate customers, which normally constitutes the core of their domestic credit business. Admittedly, investment in industry tended to strengthen, but profits recovered as well and, with ample liquidity bolsters to fall back on, the large industrial corporations felt little need for heavy recourse to domestic bank credit. Finding it difficult to achieve the desired rates of expansion at home, the major banks continued to step up their international business, particularly through their low-cost affiliates in the Euro-markets. Moreover, the freedom of the international markets from regulatory constraints that add to the cost of intermediation meant that part of the banks' credit business which would otherwise have shown up in their domestic books was accommodated through the Euro-markets.

Turning to the uses side of the markets, the demand for new credits also seems to have been well sustained, though it was not quite as buoyant as the supply. Most important of all, balance-of-payments financing requirements remained high in several groups of countries. With the sharp contraction in the OPEC surplus (see Chapter V, page 100) the combined current-account balance of the high-absorbing countries within this group shifted from rough balance in 1977 to a deficit of around $12 billion. At the same time the current-account deficit of the non-oil developing countries widened from $15 to 24 billion and eastern European countries also seem to have recorded a significant deterioration, of around $5 billion, in their combined current-account position. Correspondingly, the demand for international bank credit from these three groups of countries tended to expand strongly. On the other hand, developed countries outside the Group of Ten and Switzerland recorded a substantial reduction in their current-account deficit from roughly $23 to 11 billion and somewhat reduced their recourse to new international bank credit. Even within the Group of Ten the strengthening was not limited to the traditional surplus countries; France, Italy and Sweden were also able to achieve a very considerable improvement in their current-account balances last year.

The favourable credit conditions and aggressive "sales efforts" of the banks induced countries and private borrowers not only to meet their immediate financing requirements but to borrow also for the future when credit might be less readily obtainable. In fact, as a result of the rapid increase over recent years in their external debt-service burden and in the dollar value of their imports, and in view of the uncertainties surrounding the world economic outlook, a number of countries were apparently quite content to add to their international reserve holdings. As a result of such precautionary borrowing, the non-oil developing countries, for instance, showed a larger increase in their official reserve assets than in 1977, despite the pronounced widening of their combined current-account deficit. The much higher absolute level of dollar interest rates did not deter borrowers, since it did no more than offset the acceleration of the upward movement of international dollar prices and fears of further dollar depreciation. At the same time, the floating interest rate technique reassured borrowers that in the event of a moderation of inflationary pressures they would not be left with an unduly heavy real interest rate burden.

The influence of exchange rate unrest. Apart from these more basic influences, conditions in the Euro-currency market as well as the growth of the Euro-banks' balance sheets were during the first quarter of 1978 and in the last five months of the year heavily influenced by developments in the exchange markets. By forward sales of dollars, or by borrowing and selling dollars spot, exporters tended to cover their prospective dollar proceeds, holders of net dollar assets tried to protect the value of their portfolios and there was probably a substantial amount of outright position-taking against the dollar.

As a result of these activities, the banks in the Euro-market were at times faced with a sharp increase in the demand for dollar credits. This demand came either from the hedgers or speculators themselves, or from banks (including the Euro-banks) that absorbed the excess supply of forward dollars from their hedging or speculating customers and had to cover their resultant long forward positions by borrowing dollars and selling them spot. For similar reasons the supply of new Euro-dollar deposit funds from non-US residents tended to slow down. The ensuing excess demand for Euro-dollar funds, through its upward impact on Euro-dollar interest rates, was readily covered by capital outflows from the United States. Since for the US bank and non-bank sectors dollar lending overseas does not, in general, entail the building-up of a long position in that currency, the US financial markets tend to act as the residual supplier of funds in such situations.

Conversely, the funds switched out of dollars increased the supply of Euro-funds denominated in the currencies expected to appreciate, such as the Deutsche Mark, the Swiss franc and the Japanese yen. With foreign borrowing demand in these currencies very weak for analogous reasons — hardly anyone wanted to build up short positions in them — the increase in supply exerted a strong downward impact on interest rates in the non-dollar sector of the Euro-currency market. This meant that Euro-interest rates tended to decline in relation to domestic rates in the countries of issue of the currencies concerned, which made it profitable for bank and non-bank residents of these countries to borrow domestic currency funds in the Euro-market, provided they were not prevented from doing so by controls on capital inflows. For these borrowers incurring debts in domestic currency did not, in general, entail any exchange risks.

Thus, the currency unrest affected the balance sheets of the Euro-banks essentially in the following ways. Firstly, it increased the banks' dollar liabilities vis-à-vis the United States while boosting their dollar credits to the rest of the world. Secondly, it speeded up the growth of assets and liabilities in non-dollar currencies (except the Swiss franc, because of the Swiss capital controls); the expansion of assets was particularly pronounced vis-à-vis the countries of issue, whereas liabilities went up mainly vis-à-vis third countries. The strong impact of the various hedging and speculative operations by the banks or their customers on the growth and geographical composition of the Euro-currency market does not, however, necessarily imply that in the absence of the market the downward pressure on the dollar would have been significantly weaker. This question of the responsibility of the Euro-currency market for the excessive weakness of the dollar last year essentially boils down to whether or not capital outflows from the United States would have been materially smaller without the financing and deposit facilities provided by the market.

A conclusive and objective answer to this question cannot be given since it is impossible to specify what kind of institutional arrangements would have evolved in the absence of the Euro-currency market. Nevertheless, some general observations may be of use. Although it is quite likely that not all borrowers who had access to Euro-credits would have been able to borrow dollars directly in the United States, their banking links would probably have been able to do so. Moreover, affiliates of US banks play a key rôle in the Euro-market and borrowing from these affiliates is undoubtedly a close substitute for borrowing directly from their parents in the United States. Furthermore, in the absence of the Euro-market there would probably have been a much larger build-up over the years of non-resident dollar deposits in the United States which would have been prone to withdrawal at times of crisis. And anyhow, a large proportion of US banks' money exports in fact bypassed the Euro-currency market last year.

Nevertheless, it is difficult to deny that in the absence of the Euro-currency market dollar borrowing for the financing of hedging or speculative operations in the spot exchange markets would have been somewhat more difficult. But, since the Euro-currency market acts in this context essentially as a mechanism for shifting exchange rate pressures from the forward to the spot market, this implies that without the Euro-dollar financing facilities the downward pressure on the dollar would have been correspondingly stronger in the forward exchange markets. This greater forward weakness of the dollar would have given further stimulus to capital outflows from the United States by moving the covered interest arbitrage margins against the dollar. Significant relief for the dollar in the spot market would have been forthcoming only if, instead of giving rise to covered interest arbitrage flows, this widening of the dollar's forward discount had exercised a major discouraging effect on hedging or speculative operations directed against the dollar or had encouraged outright forward position-taking in favour of the dollar. It is not easy to imagine that under last year's conditions of extremely unstable exchange rate expectations this could actually have been the case.

Finally, it may be added that in the available Euro-currency statistics there is no evidence that the Euro-banks themselves were acting against the dollar. On the contrary, over 1978 as a whole their external net debtor position in that currency actually showed some decline. As it is very likely that outstanding net forward purchases of dollars from customers increased over this period, it would even appear that on balance, the Euro-banks extended a certain amount of support to the dollar. This does not, of course, exclude the possibility of individual banks having behaved in the opposite way or of banks occasionally having harmed the dollar through very short-term operations, such as strategically timed sales and subsequent repurchases which would not give rise to a build-up of net positions reported in the Euro-market statistics.

Total international banking flows: sources and uses.

The pronounced 1978 acceleration in the growth of the banks' external positions was due above all to a sharp expansion in inter-country claims within the reporting area itself (including the offshore centres that are part of the reporting system). After increasing by $66 billion in 1977, these intra-area claims advanced by $148 billion, although the somewhat broader coverage of the 1978 figures and stronger valuation effects overstate the extent of the acceleration. This very rapid growth in intra-area positions was due in large measure to currency unrest, which was reflected particularly in a strong expansion in dealings among the reporting banks themselves. Excluding the double-counting which tends to result from such interbank flows, new cross-border lending within the reporting area itself may be estimated to have accelerated from slightly over $30 billion in 1977 to about $45 billion.

Because of the rôle of most countries within the reporting area as market centres, the figures for claims and liabilities on these countries largely reflect their intermediary rôle and therefore do not necessarily tell very much about their importance as original suppliers and ultimate users of funds. Nevertheless, some interesting features do emerge. One is the fairly sharp increase in gross and net claims on two strong-currency countries, Germany and Japan. Claims of banks outside Germany on German bank and non-bank residents rose from $37 to 50 billion on a gross basis, or from $11.2 to 22.2 billion on an assets-minus-liabilities basis, with a substantial part of these increases occurring directly vis-à-vis the German non-bank sector. Similarly, gross claims on Japan expanded from $29.6 to 39 billion, after declining by $4.6 billion in 1977. On the other hand, claims on Switzerland, where the authorities have erected various barriers against hot money inflows, rose by only $5.2 billion and the whole of this was rechannelled abroad, with other reporting banks' liabilities to that country showing an increase of $18.4 billion. As a result the net liability position of other reporting banks vis-à-vis banks and non-banks in Switzerland rose by as much as $13.2 billion, a figure which in large part reflects the Swiss banking sector's rôle in financing the country's very sizable current-

External positions, in domestic and foreign currencies, of banks in the reporting area and of certain offshore branches of US banks.[1]

	1976 Dec.	1977 Dec. I	1977 Dec. II	1978 March	1978 June	1978 Sept.	1978 Dec.
	in billions of US dollars						
Banks' claims on:							
Group of Ten countries and Switzerland	269.5	319.5	349.9	355.4	367.6	406.0	472.7
of which: Reporting European area[2]	*192.7*	*239.5*	*268.6*	*271.0*	*279.8*	*309.2*	*362.8*
United States	*33.3*	*38.9*	*39.8*	*38.5*	*40.8*	*48.0*	*53.0*
Canada	*9.4*	*11.6*	*11.9*	*12.9*	*14.6*	*14.9*	*17.9*
Japan	*34.1*	*29.5*	*29.6*	*33.0*	*32.4*	*33.9*	*39.0*
Offshore banking centres[3]	83.5	97.8	98.9	103.6	105.7	115.6	123.8
Other countries in western Europe	42.7	56.5	40.8	43.3	44.7	47.3	50.7
Australia, New Zealand and South Africa	11.8	13.7	14.7	14.2	13.4	13.5	13.8
Eastern Europe	28.8	32.9	38.3	40.3	42.2	46.1	47.6
Oil-exporting countries	24.1	35.4	39.1	42.1	44.7	49.9	57.2
Non-oil developing countries	80.9	92.0	98.7	102.0	106.4	113.0	123.4
of which: Latin America[4]	*57.4*	*63.8*	*65.9*	*68.3*	*71.2*	*75.2*	*80.8*
Middle East	*4.4*	*4.6*	*5.2*	*4.7*	*4.8*	*5.3*	*6.6*
Other Asia	*14.7*	*18.1*	*20.5*	*21.2*	*21.7*	*22.8*	*24.8*
Other Africa	*4.4*	*5.5*	*7.1*	*7.8*	*8.7*	*9.7*	*11.2*
Unallocated[5]	6.1	9.3	9.3	10.3	10.3	11.4	13.8
Total	547.4	657.1	689.7	711.2	735.0	802.8	903.0
Banks' liabilities to:							
Group of Ten countries and Switzerland	319.6	383.6	408.5	416.5	426.5	465.3	539.3
of which: Reporting European area[2]	*240.5*	*290.1*	*314.5*	*309.1*	*320.2*	*353.9*	*409.5*
United States	*56.3*	*73.6*	*74.1*	*85.1*	*82.7*	*85.2*	*102.1*
Canada	*12.6*	*12.6*	*12.6*	*13.5*	*13.9*	*14.8*	*15.8*
Japan	*10.2*	*7.3*	*7.3*	*8.8*	*9.7*	*11.4*	*11.9*
Offshore banking centres[3]	56.0	71.3	71.5	75.3	78.9	88.4	97.1
Other countries in western Europe	32.6	38.7	25.7	27.2	29.1	34.0	35.8
Australia, New Zealand and South Africa	2.4	2.4	2.4	2.9	2.4	2.6	2.7
Eastern Europe	7.6	7.8	8.4	8.0	8.3	9.4	10.7
Oil-exporting countries	64.2	77.6	77.9	80.4	77.1	78.0	83.8
Non-oil developing countries	49.8	62.0	62.0	64.3	66.4	73.3	78.0
of which: Latin America[4]	*22.3*	*25.3*	*25.2*	*26.7*	*27.3*	*30.6*	*33.9*
Middle East	*7.3*	*10.0*	*10.0*	*10.2*	*10.8*	*12.1*	*13.8*
Other Asia	*14.9*	*20.0*	*20.1*	*21.0*	*21.8*	*23.4*	*22.9*
Other Africa	*5.3*	*6.7*	*6.7*	*6.4*	*6.5*	*7.2*	*7.4*
Unallocated[5]	11.3	14.2	14.8	11.3	12.7	14.0	17.0
Total	543.5	657.6	671.2	685.9	701.4	765.0	864.4

Note: The figures in this table are partly based on estimates.
[1] The offshore branches of US banks whose external positions are included in the figures are those located in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [2] Up to December 1977 (December I) the reporting European area covered Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. Since 1977 (December II) it also includes Austria, Denmark and Ireland. Conversely, as from 1977 (December II) positions vis-à-vis Austria, Denmark and Ireland are excluded from the positions vis-à-vis "Other developed countries". [3] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, other British West Indies. [4] Including those countries in the Caribbean area which cannot be considered as offshore banking centres. [5] Including international institutions.

account surplus and in re-exporting the various foreign funds which have flowed into the country in forms other than outright bank deposits.

As regards the development of positions vis-à-vis the principal deficit country, banks outside the United States recorded an increase of $28 billion in their liabilities

External positions, in domestic and foreign currencies, of banks in the reporting area and of certain offshore branches of US banks.[1]

In millions of US dollars,
end-December 1978.

Liabilities/assets vis-à-vis		Liabilities	Assets
Reporting countries			
Austria	HJU	10,372	11,754
Belgium-Luxembourg	HJU	42,283	56,785
Denmark	HJU	4,623	11,900
France	HJU	56,107	51,695
Germany, Fed. Rep.	HJU	28,035	50,216
Ireland	HJ	2,307	3,439
Italy	HJU	23,551	29,109
Netherlands	HJU	33,722	25,863
Sweden	HJU	3,616	9,775
Switzerland[2]	JU	95,356	21,865
United Kingdom	HJU	109,560	90,419
Canada	HJU	15,796	17,861
Japan	HU	11,843	36,984
United States	HJ	102,137	52,998
Total		539,308	472,663
Other countries in western Europe			
Andorra		175	4
Cyprus		518	240
Finland	U	1,640	5,140
Gibraltar		149	12
Greece	JU	4,620	4,970
Iceland		121	284
Liechtenstein		643	957
Malta		757	12
Monaco		552	341
Norway	U	3,322	8,460
Portugal	U	1,729	3,030
Spain	U	13,142	12,832
Turkey	JU	820	3,028
Vatican		100	52
Yugoslavia	JU	2,794	5,622
Residual	HJU	4,753	5,737
Total		35,834	50,721
Other developed countries			
Australia	JU	1,085	4,521
New Zealand	J	238	987
South Africa	JU	1,014	7,405
Residual	H	344	840
Total		2,681	13,753
Eastern Europe[3]			
Albania		49	—
Bulgaria	U	492	3,174
Czechoslovakia	U	629	1,985
German Dem. Rep.	U	1,195	6,168
Hungary[4]	U	901	6,450
Poland	JU	822	11,732
Rumania	JU	223	2,544
Soviet Union	JU	5,858	12,821
Residual	HJ	506	2,723
Total		10,675	47,597

Liabilities/assets vis-à-vis		Liabilities	Assets
Caribbean area			
Bahamas	JU	28,809	47,303
Barbados		74	41
Bermuda	JU	5,739	2,010
Cayman Islands[5]	U	20,715	21,051
Cuba	JU	272	1,748
Dominican Rep.		93	321
Haiti		30	22
Jamaica	U	91	527
Neth. Antilles	U	3,593	3,205
Panama	JU	10,179	14,037
Trinidad and Tobago	U	959	255
West Indies (UK)	U	221	180
Residual	HJ	1,800	2,827
Total		72,575	93,527
Latin America			
Argentina	JU	4,745	6,862
Belize		101	19
Bolivia		172	732
Brazil	JU	10,872	31,870
Chile	JU	1,371	2,805
Colombia	JU	2,280	2,105
Costa Rica		147	368
Ecuador	JU	706	2,509
El Salvador		124	204
Guatemala	U	674	421
Guyana		65	107
Honduras		99	257
Mexico	JU	6,481	23,443
Nicaragua		287	658
Paraguay		129	87
Peru	JU	861	3,400
Surinam		167	38
Uruguay	U	740	245
Venezuela	JU	9,493	13,110
Residual	HJU	4,162	4,864
Total		43,676	94,104
Middle East			
Oil-exporting countries	J[6]		
a) Low absorbers: Kuwait, Qatar, Saudi Arabia and the United Arab Emirates		33,996	6,611
b) High absorbers: Bahrain, Iran, Iraq, Libya and Oman		23,145	15,276
Other countries:			
Egypt	JU	3,421	1,603
Israel	JU	6,015	3,863
Jordan		879	152

Liabilities/assets vis-à-vis		Liabilities	Assets
Middle East (contd.)			
Lebanon	U	4,401	665
Syria	U	677	236
Yemen		1,230	61
Yemen, P.D. Republic		174	14
Residual[7]	HJU	9,187	5,052
Total		83,125	33,733
Other Africa			
Algeria	J	2,730	5,742
Angola		167	114
Benin		27	3
Botswana/Lesotho		79	60
Burundi		64	3
Cameroon		135	444
Cape Verde Islands		13	9
Central African Empire		17	4
Chad		24	38
Congo		80	219
Djibouti		87	1
Equatorial Guinea		7	13
Ethiopia		208	13
Gabon		148	822
Gambia		21	7
Ghana	U	206	256
Guinea		29	61
Guinea-Bissau		8	8
Ivory Coast		634	1,413
Kenya	J	786	430
Liberia	JU	1,700	6,270
Madagascar		66	25
Malawi		74	107
Mali		26	5
Mauritania		76	73
Mauritius		38	45
Morocco	U	930	2,210
Mozambique		83	43
Niger		31	112
Nigeria	J	718	1,771
Rhodesia		85	56
Rwanda		84	8
São Tomé and Principe		15	—
Senegal		105	204
Seychelles		30	363
Sierra Leone		93	31
Somalia		107	3
Sudan		241	680
Swaziland		40	29
Tanzania		129	149
Togo		86	237
Tunisia		512	826

Liabilities/assets vis-à-vis		Liabilities	Assets
Other Africa (contd.)			
Uganda		63	15
Upper Volta		17	9
Zaire	U	574	1,243
Zambia	J	203	461
Residual	U	1,262	1,804
Total		12,858	26,439
Other Asia			
Afghanistan		288	3
Bangladesh		141	51
Brunei		383	12
Burma		22	44
China	JU	2,413	925
Fiji		127	29
French Polynesia		8	11
Hong Kong	JU	9,200	12,675
India	JU	2,862	574
Indonesia	JU	2,720	4,553
Kampuchea		33	1
Korea N.	J	313	586
Korea S.	JU	2,547	7,044
Laos		8	2
Macao		33	—
Malaysia	JU	2,082	1,566
Nepal		75	—
New Hebrides		201	799
Pakistan	JU	752	613
Papua-New Guinea		144	80
Philippines	JU	2,251	4,029
Sikkim/Bhutan		294	181
Singapore	HJU	10,314	12,267
Sri Lanka		227	3
Taiwan	JU	4,628	4,009
Thailand	JU	1,124	2,870
US Trust Territory of the Pacific Islands		106	—
Vietnam		71	291
Residual	U	652	116
Total		44,019	53,133
International Institutions	U	7,115	4,515
Unallocated	HJU	12,485	12,794
Grand total		864,351	902,979
Memorandum item:			
Oil-exporting countries	HJU	83,822	57,241

Note: A full country breakdown of the reporting banks' liabilities and assets is available only for banks in Austria, Belgium-Luxembourg, Denmark, the Federal Republic of Germany, Italy, the Netherlands, Sweden, the United Kingdom and Canada and for the offshore branches of US banks; for Irish banks only foreign currency figures are available. For banks in the other reporting countries — Switzerland, Japan and the United States — the country breakdown is less than complete and its extent is indicated by the use of the letters H (Switzerland), J (Japan) and U (United States). The liabilities of banks in the United States exclude US Treasury bills and certificates held in custody by the banks on behalf of non-residents.

[1] Offshore branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [2] Positions vis-à-vis the BIS are included under Switzerland. [3] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [4] In any comparison of the banks' positions vis-à-vis Hungary with those vis-à-vis other eastern European countries account needs to be taken of the fact that Hungary finances virtually the whole of its foreign trade with funds raised in the international banking market, while other countries of this group finance a large part of their foreign trade through other channels. [5] Figures for the US banks' liabilities and assets vis-à-vis the Cayman Islands are estimates based on other statistical groups. [6] Includes positions of Japanese banks vis-à-vis Kuwait, Saudi Arabia, the United Arab Emirates, Iran, Iraq and Libya only. [7] Includes the positions of US banks vis-à-vis Middle Eastern countries other than Egypt, Israel, Lebanon, Syria and Libya (which is included under the residual for "Other Africa").

to US bank and non-bank residents, but claims on that country also showed a substantial increase, of $13.2 billion. The rise in claims was due in part to the removal of US reserve requirements on bank funds from abroad in August 1978, while the expansion in liabilities to the United States, which was in fact concentrated in the first and final quarters of the year, has to be seen in the context of developments in the exchange markets. About $12 billion of this increase in liabilities was to the US non-bank sector, which is apparently becoming increasingly aware of the higher yields obtainable on dollar deposits outside the United States. The $16 billion rise in liabilities to the US banking sector reflected only part of the foreign lending of banks in the United States, the greater portion of which, about $20 billion, was apparently lent directly abroad without being booked through the offshore centres or going through the banks in the Euro-market.

Turning to the banks' business with countries outside the reporting area, the growth of claims on this outside area accelerated from roughly $45 billion in 1977 to $65 billion, whereas new funds obtained from the outside area came to about $38 billion, the same order of magnitude as in 1977. This behaviour pattern of assets and liabilities, which raised the reporting banks' net creditor position vis-à-vis the outside area from $52 to 78 billion, reflected above all the changing rôle of the OPEC countries on both the sources and uses sides of the market. With the sharp contraction of the combined OPEC current-account surplus, new deposits received from these countries dropped off sharply, from $13.4 billion in 1977 to $5.9 billion; at the same time new credits to OPEC countries accelerated from $11.3 to 18.1 billion. Whereas in 1977 the OPEC group had still been a small net supplier of new funds to the international banking sector, in 1978 it became the largest net borrower, with a turn-round of over $14 billion. It should be noted, however, that these figures slightly overstate the rôle of the OPEC group as a net taker of new funds since they include an increase of about $2 billion in net claims on Bahrain; in view of Bahrain's rôle as a rapidly growing offshore centre it must be assumed that a substantial part of these funds were re-lent to non-OPEC countries.

The largest individual OPEC borrowers of new funds were Venezuela, which alone received nearly $5 billion in new credits, Algeria and Iran (about $2.5 billion each) and Nigeria (about $1.2 billion). The largest depositors of new funds were, paradoxically enough, the high-absorbing countries in the Middle East ($3.2 billion excluding Bahrain) and Venezuela ($1 billion). Saudi Arabia, the biggest depositor in terms of amounts outstanding, actually seems to have withdrawn some funds.

Over $7 billion, or more than the whole of the increase in OPEC deposits, was in non-dollar currencies, with valuation effects accounting for about $2.5 billion of this figure. Deposits in dollars declined by about $1.2 billion. On the users' side of the market, by contrast, the greater part of OPEC borrowing (i.e. about $13 billion) was in dollars, which means that in 1978 the OPEC countries effectively reduced their net creditor position vis-à-vis the international banking sector in that currency by around $14 billion.

A second major feature in 1978 was a sharp acceleration in the pace of new lending to non-oil developing countries, from $11.1 billion in 1977 to $24.7 billion, although here again the broader coverage of the 1978 figures somewhat exaggerates the change of gear. New deposits received by the reporting banks from these countries also speeded up, from \$12.2 to 16 billion. Nevertheless, developing countries, which in 1977 had been net suppliers of new funds to the international banking sector, again became net borrowers to the extent of \$8.7 billion, a development which mirrored the widening of these countries' combined current-account deficit. Latin America (excluding OPEC members) was as usual the largest borrowing region, receiving \$14.9 billion, over half of which was accounted for by Brazil alone. However, as a result of the banks' search for new borrowers, the largest relative growth in lending occurred vis-à-vis "Other Africa", with the reporting banks' claims on countries in that area expanding by \$4.1 billion, or nearly 60 per cent.

The third group outside the reporting area that sharply stepped up its recourse to international bank credit in 1978 was the countries of eastern Europe. New borrowing by these countries amounted to \$9.3 billion, more than twice as much as the year before. Their deposits, which had hardly changed in 1977, also showed a sizable increase of \$2.3 billion. Poland was the largest taker of new credits, obtaining \$2.7 billion. The Soviet Union's share amounted to only \$1.2 billion and on an assets-minus-liabilities basis this country was even a small net supplier of new funds to the international banking sector.

The only group of countries that moved against the general trend and somewhat reduced their recourse to new international bank credit were the industrial countries outside the reporting area. With balance-of-payments adjustment efforts in a number of these countries showing very positive results, new takings declined from \$10.5 billion (excluding Austria, Denmark and Ireland) in 1977 to \$9 billion, while at the same time new deposits received from these countries accelerated from \$5.1 to 10.4 billion. Spain, which was particularly successful in achieving a large improvement in its current-account balance, was alone responsible for most of this shift from net borrowing to net lending of new funds; its deposits with the reporting banks soared by \$5.2 billion, while its new borrowing amounted to only \$1.5 billion.

Developments in European market centres.

Currency composition. The external activities of banks in the European market centres continued to expand vigorously last year. Despite the weakness of the dollar the banks' external assets in that currency rose by \$71.1 billion, or 26.5 per cent., which was considerably more than in preceding years. On an assets-minus-liabilities basis the reporting banks' external net liability position in dollars showed a marginal decrease from \$10.4 to 9.1 billion; this was the result of two opposite movements: a \$7.6 billion drop in the first three quarters and a renewed widening of \$6.3 billion in the final quarter of the year, when the banks had to offset large forward purchases of dollars from their customers through sales in the spot market.

Largely as a result of the developments in the foreign exchange markets, the dollar value of the reporting European banks' gross external positions in foreign currencies other than the dollar showed an even stronger expansion, with assets in these currencies rising by \$46 billion, or nearly 40 per cent. The share of these currencies in total Euro-currency assets consequently increased from about 30 to 32.5 per cent. However, excluding the upward impact of the depreciation of the dollar on the dollar value of the banks' positions in other currencies, the increase in non-dollar assets amounted to only $27 billion, or 20 per cent. (at constant end-1978 exchange rates), and their share in total assets outstanding showed a decline from 33.5 to 32.5 per cent.

As usual, positions in Deutsche Mark accounted for the largest part of the growth in the non-dollar sector of the Euro-market. The reporting banks' assets and liabilities in that currency rose by $27.1 and 24.4 billion respectively, although about $10.7 and 10.4 billion of this expansion was due to valuation effects. For the reasons explained on pages 108–109 above, the largest borrowers of these DM funds were German bank and non-bank residents, whereas the principal suppliers were residents of other countries who wanted to build up their positions in that currency. Thus, positions vis-à-vis Germany accounted for 33 per cent. of the increase in DM assets but for only 1.5 per cent. of the expansion in DM liabilities.

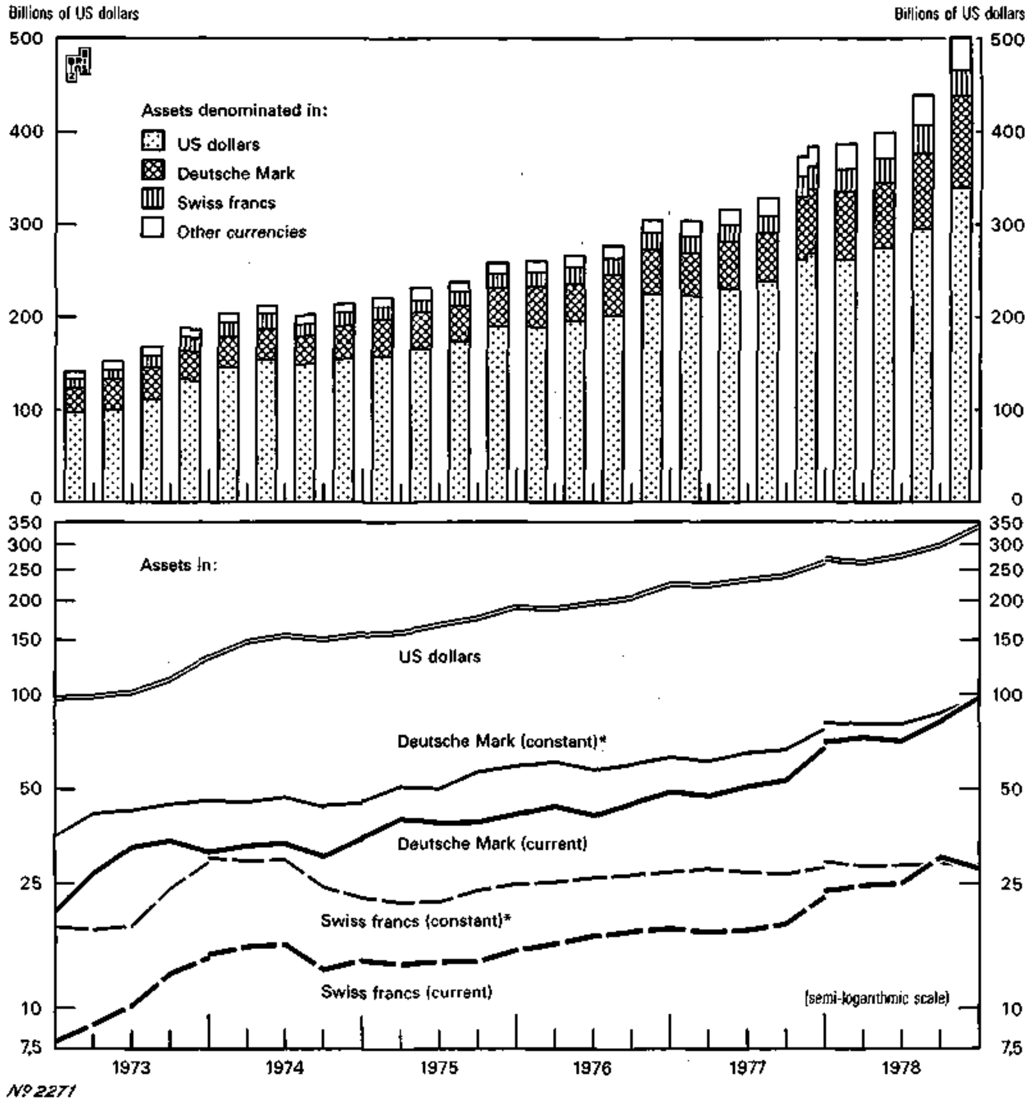
The situation was similar in the Euro-yen market, except that rates of expansion there were even more pronounced. Identified Euro-yen assets rose from $1.7 billion at the end of 1977 to $5.4 billion a year later, with valuation changes making up only $0.4 billion of this increase. Liabilities in yen soared from $2.7 to 6.2 billion. Here again, on the sources side only 3 per cent. of the new funds came from Japan, whereas on the uses side 36 per cent. of the funds were lent to Japan.

Owing to an elaborate system of defences erected by the Swiss authorities against inflows of funds, the Euro-Swiss franc market presented a very different picture. The funds could not be lent to Swiss residents because of the controls, and yet there was little demand for Swiss franc loans elsewhere in view of the exchange risks involved. As a result, the increased supply of Swiss francs to the Euro-banks was not reflected in an expansion of market volume but in a sharp drop in Euro-Swiss franc interest rates. The dollar equivalent of the banks' Euro-Swiss franc assets increased by $4.3 billion, it is true, but this was more than accounted for by valuation changes. At constant exchange rates there was a decline of $1.3 billion, largely in claims on Switzerland. At the end of the year the Euro-banks' Swiss franc claims on Switzerland accounted for only 5 per cent. of their total assets in that currency. Similarly, liabilities in Swiss francs rose by $5.2 billion in dollar terms but showed a slight decrease in Swiss franc terms. Here the share of total Euro-Swiss franc deposits held by Swiss residents amounted to about 27 per cent. Of course, these movements do not conclusively prove that the various Swiss regulations against money inflows achieved their purpose, but it puts the burden of proof on those who would argue otherwise.

The Euro-banks' positions denominated in the other major currencies behaved more like those in yen and Deutsche Mark. External assets in French francs, guilders and sterling, for example, rose by 71, 62 and 37 per cent. respectively, although here again the growth rates were somewhat inflated by valuation effects.

Leaving the Euro-currency market for the moment and turning to traditional forms of foreign lending, the reporting European banks' external assets in domestic

Currency structure of the Euro-market:
External assets in foreign currencies of reporting European banks.
Quarterly, amounts outstanding.



***At constant end-December 1978 exchange rates.**

currencies expanded by $28.1 billion; excluding valuation effects, this amounted to a real increase of about $16 billion, or 17 per cent. The largest real expansion in domestic currency lending was a 41 per cent. increase recorded by banks in France, which was largely related to foreign trade finance. Since external liabilities showed a more moderate increase, the French banks' net external creditor position in domestic currency rose from $7.2 billion at the end of 1977 to $12.5 billion. Similarly, the net external creditor position in domestic currency of banks in Switzerland widened from $8.9 to 12.5 billion. With the high negative interest rates to which foreign Swiss franc funds were subject in Switzerland, gross external liabilities even showed a slight decline in real terms. On the other hand, the net

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

End of month		Dollars: Total	Dollars: of which vis-à-vis non-banks	Other foreign currencies: Total	of which: vis-à-vis non-banks	of which: Deutsche Mark	of which: Swiss francs	of which: Pounds sterling	of which: Dutch guilders	of which: French francs
		in millions of US dollars								
						Assets				
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	6,180	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	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	Dec.. .	190,180	40,870	67,950	20,450	41,620	15,430	1,980	2,100	2,570
1976	Dec.. .	224,020	50,820	81,300	22,690	48,680	17,930	2,150	3,780	2,570
1977	March .	222,860	53,380	80,930	23,350	47,030	17,560	2,800	3,930	2,690
	June .	230,960	56,480	85,970	24,070	50,920	17,690	2,780	4,230	2,850
	Sept. .	238,670	59,850	90,430	26,090	52,710	18,490	3,720	3,830	3,370
	Dec. I .	262,430	64,660	111,370	31,040	67,510	22,560	4,420	4,210	3,270
	Dec. II[4]	268,430	65,550	116,410	31,670	70,350	23,640	5,310	4,280	3,310
1978	March .	262,540	70,330	124,710	35,140	73,500	24,500	5,260	4,850	4,230
	June .	275,460	74,150	124,550	34,000	70,650	24,910	6,160	5,010	4,490
	Sept. .	295,800	78,760	145,030	38,200	81,940	30,340	6,960	6,360	5,050
	Dec.. .	339,520	84,250	162,450	42,950	97,430	27,890	7,300	6,920	5,660
Memorandum item										
Positions vis-à-vis residents										
1976	*Dec. . .*	*74,740*	*21,330*	*26,920*	*7,560*					
1977	*Dec. I .*	*91,630*	*29,060*	*33,300*	*8,930*					
	Dec. II .	*92,330*	*29,370*	*34,790*	*9,730*					
1978	*March .*	*93,260*	*29,910*	*37,510*	*9,780*					
	June. .	*95,140*	*30,780*	*38,730*	*10,820*					
	Sept.. .	*100,600*	*30,380*	*45,260*	*12,220*					
	Dec. . .	*105,000*	*31,170*	*48,370*	*12,330*					
						Liabilities				
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	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	Dec.. .	189,470	24,280	69,200	6,690	39,940	15,290	3,140	3,550	3,350
1976	Dec.. .	230,040	29,550	80,610	8,970	47,230	15,880	3,980	3,530	3,220
1977	March .	229,080	29,410	81,090	9,530	45,880	16,340	4,510	4,060	3,380
	June .	239,670	31,160	86,400	9,480	49,640	16,540	4,330	4,610	3,650
	Sept. .	247,020	32,520	92,070	10,050	51,400	17,440	5,090	5,030	4,240
	Dec. I .	272,880	34,200	110,560	12,050	64,970	20,870	5,920	4,900	4,400
	Dec. II[4]	278,840	34,330	117,360	12,230	68,680	22,720	6,870	5,040	4,430
1978	March .	270,450	36,310	125,580	13,810	71,850	24,700	7,040	5,870	5,150
	June .	280,950	38,560	127,430	13,060	68,500	26,000	8,570	5,980	6,060
	Sept. .	298,570	39,850	149,330	14,950	79,950	31,460	9,720	7,150	7,050
	Dec.. .	348,590	44,340	162,220	16,570	93,080	27,890	10,320	7,400	7,400
Memorandum item										
Positions vis-à-vis residents										
1976	*Dec. . .*	*64,060*	*10,660*	*23,710*	*4,290*					
1977	*Dec. I .*	*74,620*	*12,080*	*29,590*	*5,330*					
	Dec. II .	*75,310*	*12,280*	*30,400*	*5,460*					
1978	*March .*	*75,350*	*12,220*	*34,000*	*6,180*					
	June. .	*78,140*	*13,780*	*33,940*	*6,080*					
	Sept.. .	*82,630*	*13,790*	*40,200*	*6,940*					
	Dec. . .	*87,690*	*14,690*	*45,060*	*7,440*					

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

external asset position of banks in Germany, which had still amounted to $7.1 billion at the end of 1977, was virtually wiped out owing to very large inflows of DM funds. On a gross basis the German banks' external liabilities in Deutsche Mark jumped by $12.2 billion, or 44 per cent., even excluding valuation effects.

Types of assets and liabilities. Returning to the Euro-currency market, $30 billion of the $117 billion increase in the reporting European banks' external assets in foreign currencies was in the form of direct claims on the non-bank sector. In addition, foreign currency credits to domestic non-bank residents rose by $4.4 billion. Of this total $34.4 billion or 25 per cent. expansion in direct claims on non-banks, $20.5 billion was in dollars, while valuation effects accounted for well over half of the $13.9 billion growth in claims in other currencies.

On the sources side of the market, $14.4 billion of the total increase of $114.6 billion in the reporting banks' external liabilities in foreign currencies came from direct non-bank deposits, which was $6.6 billion more than in 1977. In addition, foreign currency funds received from domestic depositors amounted to $4.3 billion. Of the total expansion of $18.7 billion in non-bank funds, $12.4 billion was in dollars, with liabilities to US non-bank residents accounting for only $3.7 billion of the latter figure. This shows that, contrary to the widely held belief that there was a dollar "overhang" in the Euro-market which exerted downward pressure on the external value of the dollar, private non-bank depositors, even outside the United States, not only refrained from running down their dollar balances but continued to add to them. This was true even in the fourth quarter, when confidence in the dollar reached rock-bottom.

Official depositors, which of course include the OPEC countries, behaved in a less stabilising way, however. Deposits in dollars declined by $0.4 billion, whereas those denominated in other foreign currencies rose by $9.1 billion (including about $3 billion of valuation effects). Moreover, the movements of official Euro-dollar balances in the course of 1978 mirrored fairly closely the vicissitudes of the dollar in the exchange markets. In the first quarter of the year such balances declined from $49.3 to 46.5 billion, then they rose to $50.4 billion in the following six months before dropping to $48.9 billion in the fourth quarter.

The rôle of individual market centres. The rapid growth in Euro-currency business last year was very widely spread over all the principal European market centres. Banks in the United Kingdom, whose external assets went up by twice as much as in 1977, as usual accounted for the largest share, although in terms of growth rates the 27.4 per cent. expansion was somewhat below the European average of 30.5 per cent., the result being a further slight decline in the United Kingdom's market share. This was, however, due mainly to the greater importance in London of business done in dollars and by the affiliates of US banks, whose balance sheets were not quite as buoyant as those of some of the Japanese and continental European banks.

Outside the United Kingdom the highest rates of expansion in Euro-currency assets vis-à-vis non-residents were shown by banks in Italy (50 per cent.), Belgium (38.7 per cent.), Switzerland (36.5 per cent.), the Netherlands (34.5 per cent.)

External assets and liabilities, in domestic and foreign currencies, of banks in individual reporting countries and of certain offshore branches of US banks.

			1977		1978			
			Dec. I	Dec. II	March	June	Sept.	Dec.
			in millions of US dollars					
Austria	Assets	Domestic currency		1,960	2,180	2,310	2,640	2,930
		Foreign currencies		7,440	6,810	8,000	8,710	9,580
	Liabilities	Domestic currency		540	570	670	700	830
		Foreign currencies		9,700	8,920	10,230	11,150	12,790
Belgium	Assets	Domestic currency	2,470	2,470	2,470	2,610	2,660	2,800
		Foreign currencies	22,910	22,910	24,290	24,890	28,480	31,780
	Liabilities	Domestic currency	3,790	3,790	4,330	4,410	4,040	4,730
		Foreign currencies	23,530	23,530	25,360	26,110	30,480	33,540
Luxembourg	Assets	Domestic currency	710	710	790	650	830	1,050
		Foreign currencies	44,040	44,040	46,600	46,620	52,040	58,340
	Liabilities	Domestic currency	570	570	550	600	620	730
		Foreign currencies	41,940	41,940	43,530	43,730	48,380	54,480
Denmark	Assets	Domestic currency		90	80	80	90	90
		Foreign currencies		2,060	2,180	2,170	2,760	2,840
	Liabilities	Domestic currency		260	260	270	300	390
		Foreign currencies		1,370	1,610	1,720	2,110	2,360
France	Assets	Domestic currency	2,080	11,450[1]	12,860	14,730	15,910	18,200
		Foreign currencies	62,210	62,210	58,550	59,810	66,500	80,780
	Liabilities	Domestic currency	4,220	4,220	4,840	5,000	5,100	5,700
		Foreign currencies	62,970	62,970	59,300	59,090	65,280	78,790
Germany	Assets	Domestic currency	31,450	31,450	32,500	31,840	34,160	40,340
		Foreign currencies	17,280	17,280	16,750	17,470	18,440	20,770
	Liabilities	Domestic currency	24,330	24,330	25,170	25,050	30,780	40,220
		Foreign currencies	15,230	15,230	14,590	14,780	15,670	18,880
Ireland	Assets	Domestic currency		..	..	..	..	..
		Foreign currencies		1,540	1,340	1,690	1,360	1,510
	Liabilities	Domestic currency		..	..	..	..	..
		Foreign currencies		1,690	1,690	1,960	1,830	1,810
Italy	Assets	Domestic currency	300	300	470	560	510	590
		Foreign currencies	14,780	14,780	11,220	12,110	13,100	22,160
	Liabilities	Domestic currency	1,540	1,540	1,580	1,950	2,020	2,010
		Foreign currencies	21,520	21,520	17,620	19,580	19,930	27,800
Netherlands	Assets	Domestic currency	5,240	5,240	6,000	6,820	7,770	8,490
		Foreign currencies	27,180	27,180	27,510	29,540	31,050	36,560
	Liabilities	Domestic currency	5,100	5,100	5,840	6,170	7,190	7,930
		Foreign currencies	25,470	25,470	25,230	28,450	29,100	35,550
Sweden	Assets	Domestic currency	930	930	800	990	950	860
		Foreign currencies	3,180	3,180	3,210	3,150	3,380	3,390
	Liabilities	Domestic currency	580	580	550	690	740	700
		Foreign currencies	3,410	3,410	3,850	4,000	4,430	4,520
Switzerland	Assets	Domestic currency	14,500	14,500	16,700	17,960	21,720	19,290
		Foreign currencies	23,010	23,010	24,770	25,190	29,340	31,410
	Liabilities	Domestic currency	5,650	5,650	6,040	6,750	6,840	6,820
		Foreign currencies	18,010	18,010	18,340	19,450	23,570	26,870
United Kingdom	Assets	Domestic currency	2,080	12,230[2]	12,400	13,080	14,000	14,740
		Foreign currencies	159,210	159,210	164,020	169,370	185,670	202,850
	Liabilities	Domestic currency	11,100	11,100	10,860	10,080	11,180	11,950
		Foreign currencies	171,360	171,360	175,990	179,280	195,970	213,420

Table continued on page 122.

External assets and liabilities, in dollars and other foreign currencies, of banks in individual reporting countries and of certain offshore branches of US banks.

			1977		1978			
			Dec. I	Dec. II	March	June	Sept.	Dec.
			In millions of US dollars					
Austria	Assets	US dollars		3,870	3,180	3,910	4,160	4,460
		Other foreign currencies		3,570	3,630	4,090	4,550	5,120
	Liabilities	US dollars		4,320	3,460	4,290	4,420	5,300
		Other foreign currencies		5,380	5,460	5,940	6,730	7,490
Belgium	Assets	US dollars	14,260	14,260	14,450	14,700	16,440	18,550
		Other foreign currencies	8,650	8,650	9,840	10,190	12,040	13,230
	Liabilities	US dollars	13,080	13,080	13,680	13,700	15,710	18,040
		Other foreign currencies	10,450	10,450	11,680	12,410	14,770	15,500
Luxembourg	Assets	US dollars	18,820	18,820	19,090	20,110	20,620	22,040
		Other foreign currencies	25,220	25,220	27,510	26,510	31,420	36,300
	Liabilities	US dollars	18,680	18,680	18,890	19,950	21,520	24,400
		Other foreign currencies	23,260	23,260	24,640	23,780	26,860	30,080
Denmark	Assets	US dollars		1,420	1,500	1,400	1,670	1,640
		Other foreign currencies		640	680	770	1,090	1,200
	Liabilities	US dollars		840	1,030	1,070	1,330	1,500
		Other foreign currencies		530	580	650	780	860
France	Assets	US dollars	45,160	45,160	41,920	43,390	47,350	60,210
		Other foreign currencies	17,050	17,050	16,630	16,420	19,150	20,570
	Liabilities	US dollars	44,430	44,430	39,700	39,100	40,590	53,160
		Other foreign currencies	18,540	18,540	19,600	19,990	24,690	25,630
Germany	Assets	US dollars	12,710	12,710	11,670	12,270	12,580	14,720
		Other foreign currencies	4,570	4,570	5,080	5,200	5,860	6,050
	Liabilities	US dollars	12,380	12,380	11,340	11,180	11,490	14,510
		Other foreign currencies	2,850	2,850	3,250	3,600	4,180	4,370
Ireland	Assets	US dollars		710	690	630	440	400
		Other foreign currencies		830	650	1,060	920	1,110
	Liabilities	US dollars		800	830	710	540	550
		Other foreign currencies		890	860	1,250	1,290	1,260
Italy	Assets	US dollars	11,480	11,480	8,110	9,010	9,580	17,380
		Other foreign currencies	3,300	3,300	3,110	3,100	3,520	4,780
	Liabilities	US dollars	17,010	17,010	13,460	14,990	14,630	21,840
		Other foreign currencies	4,510	4,510	4,160	4,590	5,300	5,960
Netherlands	Assets	US dollars	15,150	15,150	14,770	16,360	16,590	19,470
		Other foreign currencies	12,030	12,030	12,740	13,180	14,460	17,090
	Liabilities	US dollars	15,460	15,460	15,290	17,790	17,500	20,710
		Other foreign currencies	10,010	10,010	9,940	10,660	11,600	14,840
Sweden	Assets	US dollars	1,970	1,970	2,040	1,950	2,050	2,160
		Other foreign currencies	1,210	1,210	1,170	1,200	1,330	1,230
	Liabilities	US dollars	2,120	2,120	2,410	2,470	2,680	2,790
		Other foreign currencies	1,290	1,290	1,440	1,530	1,750	1,730
Switzerland	Assets	US dollars	17,070	17,070	17,930	18,830	20,600	21,580
		Other foreign currencies	5,940	5,940	6,840	6,360	8,740	9,830
	Liabilities	US dollars	13,130	13,130	12,930	13,920	16,030	18,540
		Other foreign currencies	4,880	4,880	5,410	5,530	7,540	8,330
United Kingdom	Assets	US dollars	125,810	125,810	127,190	132,900	143,720	156,910
		Other foreign currencies	33,400	33,400	36,830	36,470	41,950	45,940
	Liabilities	US dollars	136,590	136,590	137,430	141,780	152,130	167,250
		Other foreign currencies	34,770	34,770	38,560	37,500	43,840	46,170

Table continued on page 123.

External assets and liabilities, in domestic and foreign currencies (continued from page 120).

			1977		1978			
			Dec. I	Dec. II	March	June	Sept.	Dec.
			in millions of US dollars					
Total for European reporting countries	Assets	Domestic currency	59,780	81,320	87,250	91,630	101,240	109,380
		Foreign currencies	373,800	384,840	387,250	400,010	440,830	501,970
	Liabilities	Domestic currency	56,880	57,680	60,590	61,640	69,500	82,010
		Foreign currencies	383,440	396,200	396,030	408,380	447,900	510,810
Canada	Assets	Domestic currency	430	430	330	540	460	480
		Foreign currencies	17,720	17,720	18,940	18,980	19,500	21,890
	Liabilities	Domestic currency	2,180	2,180	1,930	2,630	2,670	2,620
		Foreign currencies	16,700	16,700	18,550	19,570	19,380	22,350
Japan	Assets	Domestic currency	3,550	3,550	4,250	5,280	6,600	7,970
		Foreign currencies	18,150	18,150	19,180	20,470	23,960	25,720
	Liabilities	Domestic currency	4,110	4,110	7,890	6,140	7,830	8,700
		Foreign currencies	24,470	24,470	25,230	24,950	26,600	30,320
United States	Assets	Domestic currency	90,200	90,200	96,450	97,850	103,630	125,120
		Foreign currencies	2,360	2,360	2,390	3,910	3,980	3,930
	Liabilities[3]	Domestic currency	77,330	77,330	78,470	78,800	87,420	97,830
		Foreign currencies	810	810	860	1,700	1,980	2,230
Offshore branches of US banks[4]	Assets	Foreign currencies[5]	91,090	91,090	95,220	96,510	102,620	106,520
	Liabilities	Foreign currencies[5]	91,660	91,660	96,370	97,570	101,700	107,480
Grand total	Assets	Domestic currency	153,940	175,500	188,280	195,100	211,930	242,950
		Foreign currencies	503,120	514,160	522,980	539,880	590,890	660,030
	Liabilities	Domestic currency	140,500	141,300	148,880	149,210	167,420	191,160
		Foreign currencies	517,080	529,840	537,040	552,170	597,560	673,190

[1] Including buyers' credits. [2] Including, in addition to loans, advances and overdrafts, all commercial bills and acceptances. [3] Excluding US Treasury bills and certificates held in custody on behalf of non-residents. [4] Offshore branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [5] Including negligible amounts in domestic currencies.

and Luxembourg (32.5 per cent.). The growth figure for Luxembourg, where by the end of the year positions in Deutsche Mark accounted for over half the dollar value of total foreign currency assets, was, however, strongly inflated by valuation effects. Well over one-third of the $14.3 billion increase in the dollar value of external assets of banks in Luxembourg occurred vis-à-vis Germany, whereas funds from Germany accounted for only about 2.5 per cent. of the increase in liabilities.

Net size of the Euro-currency market. The figure of $117 billion for the growth of the reporting European banks' external assets in foreign currencies was, as usual, strongly inflated by the kind of double-counting which arises when funds pass via more than one bank in the reporting area on their way from the original suppliers to the ultimate users. Excluding this element of duplication but allowing for the banks' use of Euro-currency funds for domestic purposes, new foreign currency funds intermediated by the reporting European banks may be estimated to have amounted to $75 billion, or to nearly $60 billion if valuation effects are excluded.

Of the total $75 billion increase in credit, roughly $26 billion, or slightly over one-third, was taken up within the reporting European area itself. Direct

External assets and liabilities, in dollars and other foreign currencies (continued from page 121).

			1977 Dec. I	1977 Dec. II	1978 March	1978 June	1978 Sept.	1978 Dec.
			in millions of US dollars					
Total for European reporting countries	Assets	US dollars	262,430	268,430	262,540	275,460	295,800	339,520
		Other foreign currencies	111,370	116,410	124,710	124,550	145,030	162,450
	Liabilities	US dollars	272,880	278,840	270,450	280,950	298,570	348,590
		Other foreign currencies	110,560	117,360	125,580	127,430	149,330	162,220
Canada	Assets	US dollars	16,480	16,480	17,660	17,950	18,230	20,430
		Other foreign currencies	1,240	1,240	1,280	1,030	1,270	1,460
	Liabilities	US dollars	15,860	15,860	17,710	18,810	18,460	21,340
		Other foreign currencies	840	840	840	760	920	1,010
Japan	Assets	US dollars	15,930	15,930	16,710	17,920	21,050	22,520
		Other foreign currencies	2,220	2,220	2,470	2,550	2,910	3,200
	Liabilities	US dollars	23,360	23,360	23,870	23,620	25,040	28,490
		Other foreign currencies	1,110	1,110	1,360	1,330	1,560	1,830
Offshore branches of US banks[1]	Assets	Foreign currencies[2]	91,090	91,090	95,220	96,510	102,620	106,520
	Liabilities	Foreign currencies[2]	91,660	91,660	96,370	97,570	101,700	107,480

[1] Offshore branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore.
[2] Including negligible amounts in domestic currencies.

claims on non-banks rose by about \$15 billion, with non-bank entities in Germany (\$5.1 billion), the United Kingdom (\$1.8 billion) and Denmark (\$1.7 billion) being the largest borrowers of funds. The biggest element in the \$11 billion of new funds absorbed by banks in the reporting area was Euro-Deutsche Mark borrowing by the German banking sector. On the sources side, the reporting European area may be estimated to have contributed about \$25 billion to the growth of the market. Non-bank funds accounted for \$14 billion of this amount, with more than half of it coming from Switzerland either in the form of trustee funds or direct non-bank deposits.

Outside the reporting area one significant development last year was the strong expansion in Euro-credits to oil and non-oil developing countries. The reporting European banks' claims on OPEC countries advanced by as much as 55 per cent., while liabilities to those countries showed only a marginal increase. As a result, the Euro-banks' net debtor position vis-à-vis OPEC countries contracted from \$38.8 billion at the end of 1977 to \$30.4 billion at the end of last year. Claims on other developing countries rose by 32 per cent., but the increase on the assets side had as its counterpart an even larger expansion in liabilities to these countries of \$10.2 billion. This meant that the net creditor position of the narrowly defined Euro-currency market vis-à-vis non-oil developing countries dwindled to the negligible figure of \$0.3 billion. Although from a prudential point of view assets and liabilities cannot, of course, be netted out, this helps to put in perspective assertions about the excessive exposure of the Euro-currency market vis-à-vis non-oil developing countries. Even in gross terms the narrowly defined Euro-currency market accounted for less than one-third of total bank claims on developing countries at the end of 1978. In fact, the bulk of both

Estimated sources and uses of Euro-currency funds.

End of month	Reporting European area[1] Total[2]	of which non-bank[3]	United States	Canada and Japan	Other developed countries	Eastern Europe[4]	Offshore banking centres[5]	Oil-exporting countries[6]	Developing countries	Unallocated[7]	Total
	in billions of US dollars										
	Uses										
1975 December .	63.0	43.6	16.5	20.2	25.8	15.9	35.6	5.3	19.5	3.2	205.0
1976 December .	74.4	51.5	18.2	21.6	33.0	20.8	40.8	9.6	24.7	3.9	247.0
1977 March . . .	78.7	56.3	17.8	21.8	34.0	20.2	42.1	11.2	24.7	4.5	255.0
June	85.4	61.8	18.9	18.8	35.5	21.4	44.3	12.7	25.5	4.5	267.0
September .	88.3	63.1	20.4	18.4	38.9	22.1	43.5	13.6	27.1	4.7	277.0
December I.	99.2	69.9	21.0	18.7	42.6	23.8	43.7	15.6	30.0	5.4	300.0
December II	110.4	77.3	21.3	18.7	30.8	25.7	43.9	15.7	30.3	3.2	300.0
1978 March . . .	115.6	80.3	18.5	20.4	31.9	27.0	43.4	17.8	31.8	3.6	310.0
June	117.8	82.3	19.6	20.8	31.9	28.5	44.6	18.6	33.7	3.5	319.0
September .	127.0	87.0	22.0	21.8	32.9	31.2	51.5	21.0	36.6	4.0	349.0
December .	136.0	92.0	24.6	24.6	34.7	31.4	55.0	24.3	40.1	4.3	375.0
	Sources										
1975 December .	79.5	39.2	15.4	8.3	19.9	5.4	21.8	34.6	16.2	3.9	205.0
1976 December .	86.7	45.5	18.8	10.5	21.3	6.4	30.1	45.2	21.3	6.7	247.0
1977 March . . .	91.7	47.0	19.4	10.5	19.8	4.7	29.6	47.8	23.4	8.1	255.0
June	97.5	48.7	23.3	8.2	19.7	4.5	31.0	51.1	24.8	6.9	267.0
September .	98.7	50.1	23.7	7.8	23.3	4.9	30.9	52.0	26.8	8.9	277.0
December I.	108.6	54.9	24.9	8.4	26.6	6.4	33.2	54.0	29.5	8.4	300.0
December II	117.3	56.0	25.4	8.4	18.8	7.0	33.4	54.5	29.6	5.6	300.0
1978 March . . .	123.2	58.6	26.9	9.6	20.0	6.6	33.9	54.5	31.3	4.0	310.0
June	131.0	62.1	26.5	9.7	21.6	6.9	35.5	51.4	33.1	3.3	319.0
September .	140.5	66.3	29.1	11.3	25.2	7.7	39.7	52.6	37.3	4.6	349.0
December .	142.5	70.1	37.0	13.0	26.2	8.8	45.4	54.7	39.8	7.6	375.0

[1] Up to December 1977 (December I) the reporting European area covered Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. Since 1977 (December II) it also includes Austria, Denmark and Ireland. Conversely, as from 1977 (December II) positions vis-à-vis Austria, Denmark and Ireland are excluded from the positions vis-à-vis "Other developed countries". [2] 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 DM from German banks). [3] On the sources side including trustee funds to the extent that they are transmitted by the Swiss banks to the other banks within the reporting area and to the extent that they are not reported as liabilities vis-à-vis non-banks outside the reporting area by the Swiss banks themselves. [4] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [5] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, other British West Indies. [6] Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, the United Arab Emirates, Venezuela. [7] Including positions vis-à-vis international institutions other than the BIS.

gross and net banking claims on the developing world resulted from conventional (and partly trade-related) lending in domestic currency, including dollar lending by banks in the United States, a substantial proportion of which is, of course, booked through the offshore centres.

The situation is different vis-à-vis eastern Europe, where the Euro-market's substantial net creditor position widened from $18.7 to 22.6 billion last year.

As regards positions vis-à-vis non-European Group of Ten countries, one significant feature last year was the large inflow of new funds from the United States. Thus, the reporting European banks' liabilities vis-à-vis that country rose by $11.6 billion, or 46 per cent., with two-thirds of the increase occurring during the last three months of the year. In addition, a substantial proportion of the $12 billion of new funds received from the offshore centres may be regarded as having originated in the United States.

Another important source of new funds were "Other developed countries". With their deposits increasing at a rate of nearly 40 per cent., the Euro-market's net creditor position vis-à-vis that group of countries declined from $12 to 8.5 billion last year.

Banks in the United States and their branches in offshore centres.

One of the most significant features of the international monetary scene last year was the sharp acceleration of outflows of banking funds from the United States. External assets reported by banks in that country rose by $36.4 billion, by far the largest increase yet recorded. Although liabilities also showed very substantial growth, the banks' net external asset position doubled from $14.5 to 29 billion. Excluding the rise in liabilities to foreign official holders, which resulted partly from the expansionary impact of the banks' own external lending activities on foreign official reserves, the increase in net claims amounted to as much as $19.4 billion.

There were four main factors responsible for this very rapid growth in gross and net external positions. Firstly, the exchange-market unrest at times boosted foreign demand for dollar borrowing. Secondly, the expansion in external assets reflected the continuing eagerness of large US commercial banks to participate in the rapidly expanding international loan market. A third influence contributing to the growth in both external assets and liabilities was the removal in August of reserve requirements on funds taken up from banks abroad, which induced the US banks to book a larger part of their international business through their head offices in the United States. A fourth influence, which affected only the liabilities side of the banks' balance sheets, was the moderate tightening of US monetary policy in the second half of the year, and especially the increases in reserve requirements on domestic CDs, which, in conjunction with the removal of reserve requirements on liabilities to banks abroad, strongly reduced the comparative cost of Euro-currency funds.

The importance of the first factor, namely exchange-market influences, was reflected in both the geographical pattern and the timing of the expansion of the banks' external assets. As much as 72.5 per cent. of the growth in assets was accounted for by claims on the wider reporting area including the offshore centres. And, as regards timing, claims on non-residents rose by $15 billion between end-September 1977 and March 1978, showed little growth during the following four months, and then soared by $29 billion in the last five months of the year. In the first quarter of 1979, when the dollar began to recuperate, this outflow was reversed to the extent of $6.2 billion. The somewhat tighter stance of US monetary policy and the changes in reserve requirements were reflected in the movement in the external liabilities of banks in the United States, which, after rising by only $3 billion in the first seven months of 1978, advanced by $19 billion during the rest of the year.

The growth in the external assets of US banks' branches in the offshore centres of the Caribbean and the Far East slowed down from 22 per cent. in 1977 to 17 per cent. Over 60 per cent. of the $15.4 billion expansion in the external assets of the offshore branches had funds from the United States as its liability counterpart. Most of the new lending was within the reporting area itself, including a $3.5 billion expansion in claims on the United States. By comparison with preceding years, credits to oil and non-oil developing countries showed only modest increases.

If the positions of banks in the United States and of their offshore branches are aggregated, claims on non-oil developing countries, largely in Latin America, rose by $7.2 billion, or by nearly twice as much as in 1977. New lending to OPEC countries amounted to $5.1 billion, up by 35 per cent. On the sources side of the banks' balance sheets, new deposits received from oil and non-oil developing countries came to $2.9 and 3.3 billion respectively.

Banks in Japan.

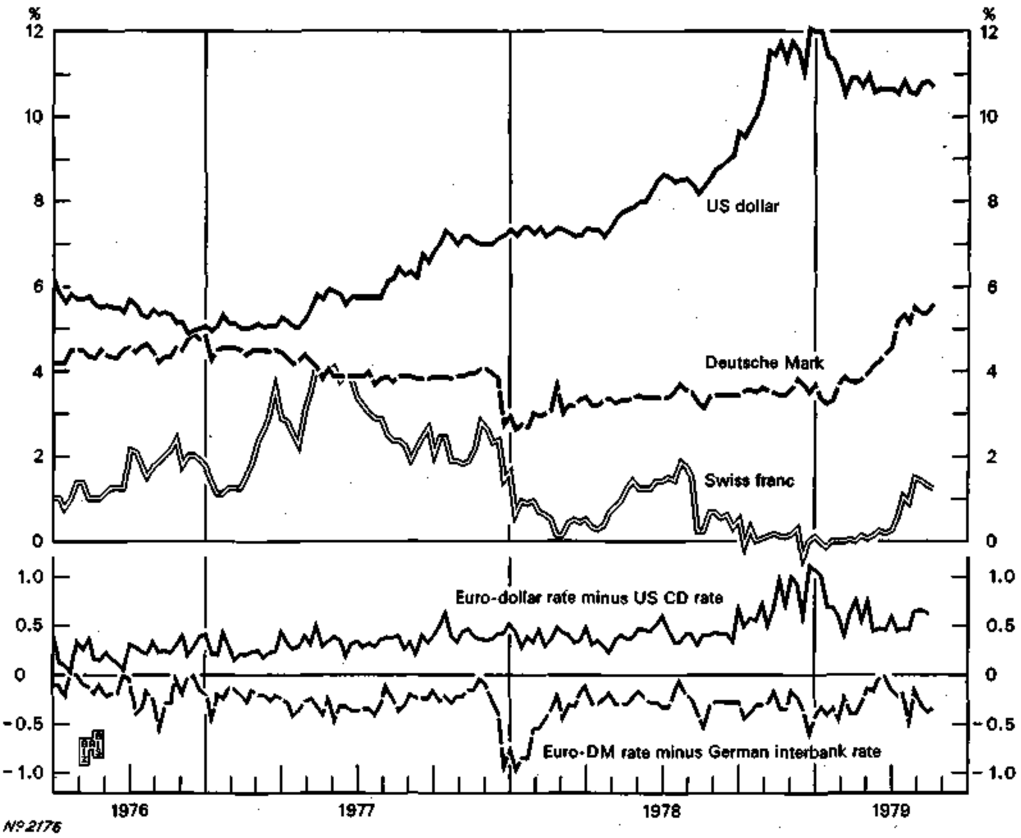
Together with the German banks, banks in Japan and their foreign affiliates played a leading rôle in international loan business last year. This showed up partly in the external assets of banks in Japan itself, which, after recording no growth in 1977, increased by $12 billion, or 55 per cent. This sharp expansion in foreign lending was due largely to the high volume of domestic liquidity resulting from the country's massive balance-of-payments surplus, coinciding with weak domestic corporate borrowing demands. Moreover, in view of the balance-of-payments and exchange rate situation, the authorities actively encouraged the banks' capital exports.

The sources side of the banks' balance sheets was at times heavily influenced by developments in the exchange markets. External liabilities in yen soared from $2 billion in September 1977 to $7.9 billion in March 1978, when the reserve requirement on increases in non-residents' free yen deposits was raised to 100 per cent. Largely as a result of this measure, yen liabilities contracted to $5.8 billion in May 1978 but subsequently went up again to $8.7 billion by the end of the year. All in all, the banks' external liabilities in domestic and foreign currency rose by $10.4 billion in 1978, leaving room for only a modest reduction in their external net debtor position from $6.9 to 5.3 billion.

Interest rate developments.

Uncovered interest differentials between Euro-dollar rates and deposit rates in the other Euro-market sectors widened markedly in the course of 1978, reaching unprecedented levels towards the end of the year. The differential between three-month Euro-dollar and Euro-Deutsche Mark rates, which had already risen from close to zero to nearly 4½ percentage points in the course of 1977, widened further to about 8¼ percentage points. In relation to Euro-Swiss franc rates, which sagged to around zero in the second half of 1978, the premium of Euro-dollar rates was even more pronounced, reaching 12 per cent. for three-month deposits around the end of the year.

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

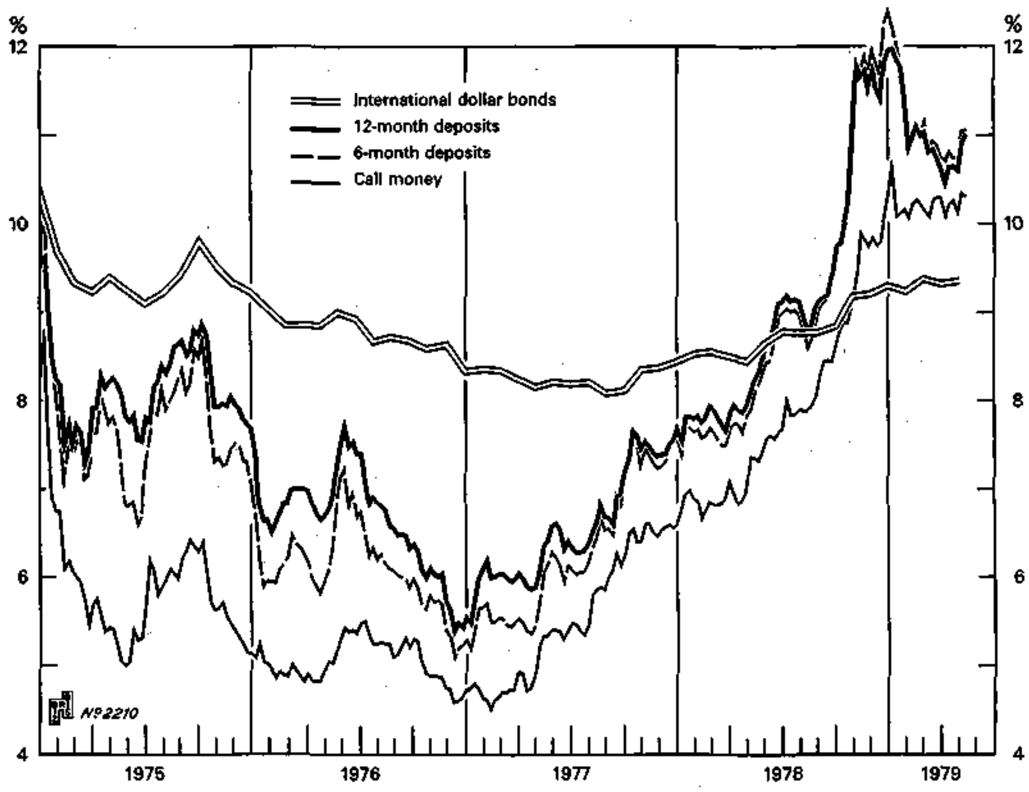


In the dollar sector, the upward movement of interest rates in the United States from late April onwards pushed three-month Euro-deposit rates from around 7¼ per cent. in the early part of 1978 to slightly above 12 per cent. around year-end, before they eased again to just under 10¾ per cent. in the course of the first quarter of 1979. Since the acceleration of US inflation rates was expected to be only a temporary phenomenon, the sharp rise in short-term dollar interest rates was associated with an emphatic reversal of the yield curve. Whereas at the beginning of 1978 three-month Euro-dollar deposit rates had been 1¼ percentage points lower than Euro-dollar bond yields, at the end of the year they stood 2¾ percentage points above them, though this premium subsequently narrowed to 1¼ percentage points in the early months of 1979.

Despite the strong upward movement in the absolute level of interest rates and the removal in August 1978 of reserve requirements on US banks' borrowing from banks abroad, the premium commanded by Euro-dollar deposit rates over comparable US yields remained fairly stable at around ⅜ percentage point in the first nine months of the year. Influenced by end-year transactions and by borrowing demand related to the turmoil in the exchange markets, it went above ½ percentage point at the end of September. Following the US measures of 1st November and the imposition of supplementary reserve requirements on large US bank certificates

Euro-dollar deposit rates and Euro-dollar bond yields.

Weekly averages and end-of-month rates.



of deposit, the premium reached 1 percentage point around the middle of November, but, with the recovery of the dollar in the exchange markets, came back down to just over ½ percentage point in the early months of 1979. Although this was still higher than in the early part of 1978, it amounted in relative terms to a sharp contraction of the premium on Euro-dollar rates, since for banks in the United States the various changes in US reserve requirements, in conjunction with the higher absolute level of dollar interest rates, must have strongly increased the cost advantage of Euro-dollar borrowing over domestic sources of funds.

Euro-Deutsche Mark rates, which in December 1977 had dropped from 4 per cent. to about 2⅞ per cent. following measures by the German authorities to limit capital inflows, moved gradually back to around 3½ per cent. by the middle of 1978. Similarly, the discount of Euro-Deutsche Mark rates in relation to German domestic interbank rates, after widening to nearly 1 percentage point around the turn of 1977, was back to its ¼ percentage point level of five months earlier by April 1978. Owing to the cancellation in June 1978 of the earlier measures to curb capital inflows, the renewed upward pressure on the Deutsche Mark against the dollar in the second half of the year did not result in more than a modest widening of this discount. In the first four months of 1979, when the recovery of the dollar permitted a tightening of German domestic liquidity conditions, Euro-Deutsche Mark rates increased from about 3⅜ to 5½ per cent.

The excessive strength of the Swiss franc in the exchange markets and the elaborate defences against capital inflows into Switzerland resulted in a drop in Euro-Swiss franc rates from 4 per cent. in early June 1977 to only ⅛ per cent. in the second half of February 1978. The somewhat calmer conditions in the exchange markets subsequently permitted Euro-Swiss franc rates to recover to above 1½ per cent. by around mid-year. However, the resurgence of very strong upward pressures on the Swiss franc and the related massive liquidity creation within Switzerland pulled Euro-Swiss franc rates down to zero or even slightly less in the last three months of the year. In view of the very liquid state of the Swiss domestic markets, Euro-Swiss franc rates stayed close to that level in the first quarter of 1979, before the much stronger exchange-market performance of the dollar finally initiated an upward movement which carried the Euro-Swiss franc deposit rate to 1½ per cent. by the end of April.

The international bond markets in 1978.

The turmoil in the exchange markets, escalating short-term dollar interest rates and the more general uncertainties associated with the acceleration of inflation in the United States were dominant influences in the development of the international bond markets last year. While these influences did not prevent the overall issue volume from matching its 1977 record — it even increased marginally by $0.6 to 36.7 billion — they had a very uneven impact on the individual market sectors. Not too surprisingly, dollar issues declined, from $20 billion in 1977 to $13.8 billion, whereas the movement away from the dollar, increasing repayment flows and the high level of liquidity in the principal markets outside the United States boosted demand for issues denominated in currencies that were expected to appreciate. As a result, the volume of non-dollar issues, notably Deutsche Mark, Swiss franc and yen bonds, rose from $16.1 to 22.9 billion.

The weakness of the dollar particularly affected the Euro-bond market, where investors are largely non-US residents and where the only major currency alternative available is the Deutsche Mark. Although Deutsche Mark issues expanded by $1.3 to 6.5 billion, this offset only part of the $4.7 billion contraction in dollar issues to $7.7 billion. Issues in other currencies showed an uneven picture and declined on balance by $0.2 to 1.7 billion. Euro-sterling issues, which had been reintroduced in late 1977, were discontinued after April and no bonds were issued in Canadian dollars during 1978 owing to the weakness of that currency. On the other hand, Euro-issues in French francs were resumed in September after a two-year pause. All in all, the total issue volume in the Euro-bond market contracted from $19.5 billion in 1977 to $15.9 billion. Owing to the increase in redemption payments, the decline in net new borrowing was even more pronounced.

The situation was quite different in the case of foreign issues in national markets, where the currency alternatives to the US dollar include the Swiss franc and the yen. Foreign issues in the United States, where the buyers are in part US residents for whom buying dollar paper does not in general entail exchange rate risks, showed only a relatively moderate contraction of $1.5 billion. This was more than offset by a $5.7 billion rise in foreign issues in other national markets, which caused the total issue volume to go up from \$16.6 to 20.8 billion. Foreign issuing activity was particularly strong in Switzerland and Japan, where the relative weakness of domestic investment, combined with the liquidity-creating effects of official intervention in the exchange markets, made for very easy financial-market conditions and where non-resident demand for such bonds was high for exchange rate reasons. In the case of Japan, moreover, the easing of restrictions on non-resident issues acted as an extra stimulus to foreign borrowing and, indeed, foreign yen issues in Japan soared from \$1.4 billion in 1977 to \$4.7 billion. Foreign issues in Switzerland rose by \$2.1 to 7.1 billion despite the imposition in early March 1978 of a 35 per cent. limit on the share that could be bought by non-residents. At this new level the issue volume in Switzerland exceeded the volume of foreign issues in the United States for the first time. Foreign issues in Germany, which are really an adjunct to the Euro-DM bond market and are almost exclusively used by international institutions, rose marginally by \$0.1 to 1.6 billion.

The development of the international bond markets in the course of 1978 reflected the vicissitudes of the exchange markets and was characterised by quick changes in market sentiment and situations. The disenchantment with dollar-denominated bonds that had developed in late 1977 culminated in February and March when investors, disappointed by the continuing depreciation of the dollar, tried to shift into strong-currency assets. Moreover, the demand for Euro-Deutsche Mark and yen bonds was boosted by the measures taken by Germany and Japan in late 1977 and the first quarter of 1978 to ward off capital inflows.

When the dollar began to show signs of recovery in April, the large yield differentials in its favour revived interest in dollar issues, while issues in other currencies suddenly began to look less attractive. With a large volume of such "low yield" issues in the pipeline, the Euro-DM bond market began to show signs of congestion and in mid-May the German Capital Market Sub-Committee decided temporarily to suspend new issues by non-resident borrowers. In addition, foreign issues in Switzerland felt the impact of the limits imposed in March on non-resident purchases of such paper.

The further rise in US short-term interest rates and the resurgence of exchange rate pressures in the course of the summer brought the convalescence of the Euro-dollar bond market to an abrupt end. The flattening and ultimate reversal of the yield curve proved very damaging to dollar bonds and, except for floating rate notes, which offered investors protection against further interest rate rises, issuing activity in the dollar sector of the Euro-bond market nearly halted in the last few months of the year. For 1978 as a whole such issues of floating rate notes totalled \$2.4 billion, accounting for 31 per cent. of Euro-dollar issues, as against a share of only 14 per cent. in 1977. The deterioration in market conditions was reflected in Euro-bond yields which, after trailing behind the rise in US domestic bond yields during the first nine months of the year, underwent a strong upward adjustment during October. At the end of the year they stood at around 9¼ per cent., up 1¼ percentage points on their level of fifteen months earlier.

The second half of 1978 was not all plain sailing for the other currency sectors either. The re-opening of the Euro-DM bond market did not find investors

International bond issues.[1]

Borrowing countries or areas	Years	Euro-bond issues				Foreign issues			
		Total	of which			Total	of which		
			US dollars	Deutsche Mark	Private place-ments		in United States	in Switzer-land	Private place-ments
		in millions of US dollars							
Western Europe.	1976	5,750	3,830	1,330	1,070	5,110	1,240	3,370	2,960
	1977	9,010	5,740	2,780	1,860	5,060	1,280	2,650	2,910
	1978	5,360	2,440	2,250	1,330	5,950	1,630	2,300	1,710
	1979/I	1,910	800	750	250	1,800	260	1,450	890
Canada	1976	3,010	1,570	40	150	6,090	5,720	370	4,060
	1977	1,950	990	410	60	3,430	2,980	360	1,830
	1978	830	470	360	380	4,020	3,230	370	1,080
	1979/I	430	430	—	30	1,580	840	480	410
United States . .	1976	400	400	—	120	30	—	—	30
	1977	1,300	1,190	10	430	220	—	20	200
	1978	1,320	970	230	200	370	—	220	150
	1979/I	860	700	40	—	160	—	60	—
Other developed countries[2]. . .	1976	2,060	1,500	510	300	1,500	710	790	680
	1977	2,080	1,450	590	320	1,450	670	660	510
	1978	2,550	920	1,590	360	2,780	410	1,740	1,930
	1979/I	570	90	470	140	870	—	870	590
Rest of the world[3]	1976	1,060	450	270	180	900	690	120	210
	1977	2,660	990	1,190	500	1,610	820	400	430
	1978	2,980	1,080	1,290	750	2,070	290	540	880
	1979/I	520	340	110	—	440	60	50	130
International institutions . .	1976	3,090	2,250	670	1,890	5,310	2,270	790	1,970
	1977	2,480	1,980	240	890	4,840	1,920	870	1,820
	1978	2,830	1,770	820	1,290	5,610	600	1,890	2,830
	1979/I	270	190	50	50	540	350	30	30
Total issues placed	1976	15,370	10,000	2,820	3,710	18,940	10,630	5,440	9,910
	1977	19,480	12,340	5,220	4,060	16,610	7,670	4,960	7,700
	1978	15,870	7,650	6,540	4,310	20,800	6,160	7,060	9,580
	1979/I	4,560	2,550	1,420	470	5,390	1,510	2,940	2,050

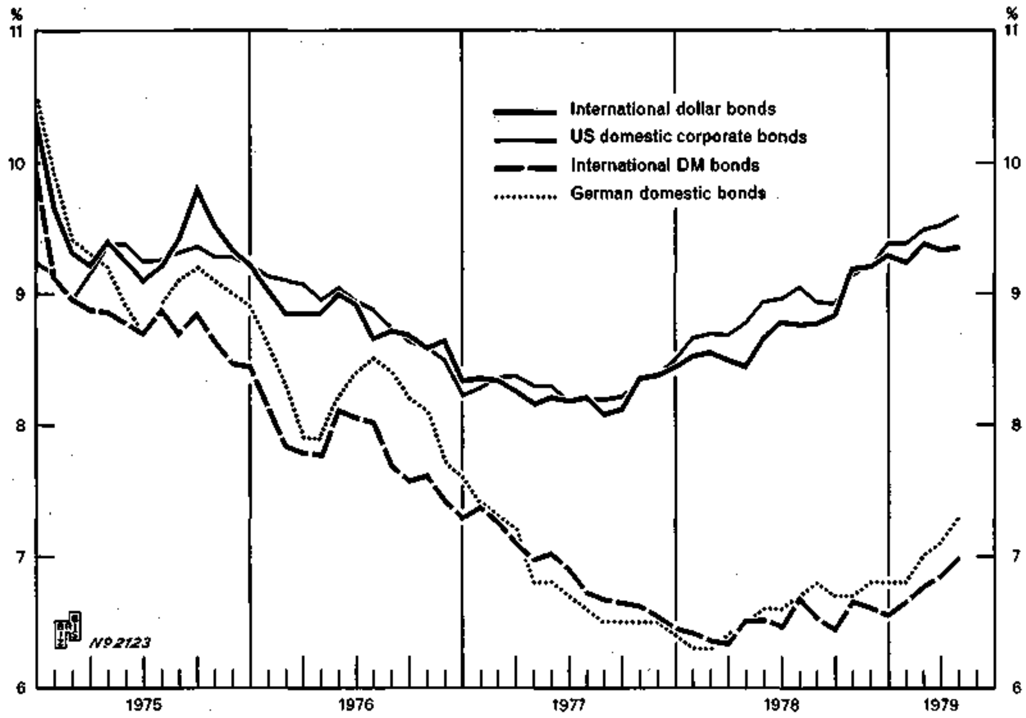
[1] Based on IBRD and OECD sources. [2] Australia, Japan, New Zealand and South Africa. [3] Including eastern European countries.

too forthcoming. However, the renewed change in the exchange-market scenario later in the summer helped to revive investors' interest, and Euro-Deutsche Mark yields eased below the yields obtainable on comparable German domestic paper. Stronger government borrowing demand and a firming of domestic bond yields during the summer took the steam out of foreign yen bonds, although the issue volume remained well above the 1977 average. Foreign issues in Switzerland staged a strong come-back in the third quarter, although borrowers' concern about the excessive strength of the Swiss franc resulted in a renewed slowdown in the last few months of the year, despite the raising to 50 per cent. of the share of foreign Swiss franc issues that could be bought by non-residents.

As regards borrowers, one positive feature continued to be the increasing access of developing countries to the international issue markets, with the takings

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.

of these countries expanding from $4 billion in 1977 to $5 billion. The largest borrowers in this group were Brazil, Venezuela, Mexico and Algeria. Issues by international development institutions rose from $4.7 to 5.1 billion.

The OECD countries slightly reduced their recourse to international bond finance, partly as a result of the reduction in their current-account deficits and partly in view of the very favourable lending conditions available in the Euro-credit markets. Canada, which at the same time sharply stepped up its recourse to the market for international bank credits, continued to be the largest borrower, with total takings of $4.9 billion, two-thirds of which was obtained in the US market. Nevertheless, this total was $0.5 billion less than in 1977. Austria, France, Sweden and the United Kingdom, all countries that experienced a strong improvement in their balance-of-payments situation last year, also raised considerably less funds than in 1977. On the other hand, issues by Japanese borrowers, largely in the form of convertible Euro-DM paper, went up by $0.9 to 2.8 billion. Norwegian entities, the third largest group of borrowers, obtained $2.6 billion, the same amount as in 1977. US bank and non-bank corporations raised $1.7 billion, $0.2 billion more than in the year before.

In the first quarter of 1979 the remarkable recovery of the dollar and the peaking-out of US short-term interest rates restored investors' appetites for Euro-dollar bonds, with new issues amounting to $2.6 billion, as against a quarterly average of $1.9 billion in 1978. For analogous reasons, rising domestic short-term interest rates and less exuberant exchange rate expectations tended to cool off investors' enthusiasm for Euro-Deutsche Mark and foreign yen bonds. In Switzerland, on the other hand, the return to realism in exchange rate expectations helped to overcome borrowers' hesitancy, while the lifting of the restrictions on non-resident purchases of Swiss franc bonds in January supported the demand for such paper. As a result, the amount of new issues rose to $2.9 billion, or 66 per cent. above the quarterly average for 1978.

VII. THE INTERNATIONAL MONETARY SCENE.

This chapter reviews the main international monetary developments of the past year and a half. The first section deals with exchange rate developments, focusing particularly on the large decline of the dollar in 1978 and its subsequent recovery. The second section deals with the new European Monetary System and is followed by a short discussion of the implications of the major countries' intention to maintain greater stability of exchange rates in the future. The fourth section gives an account of gold production and gold-market developments. The fifth section describes the further rapid expansion of global reserves last year, which again stemmed largely from the US payments deficit and the lack of confidence in the dollar, and discusses concerns about the present level of international liquidity.

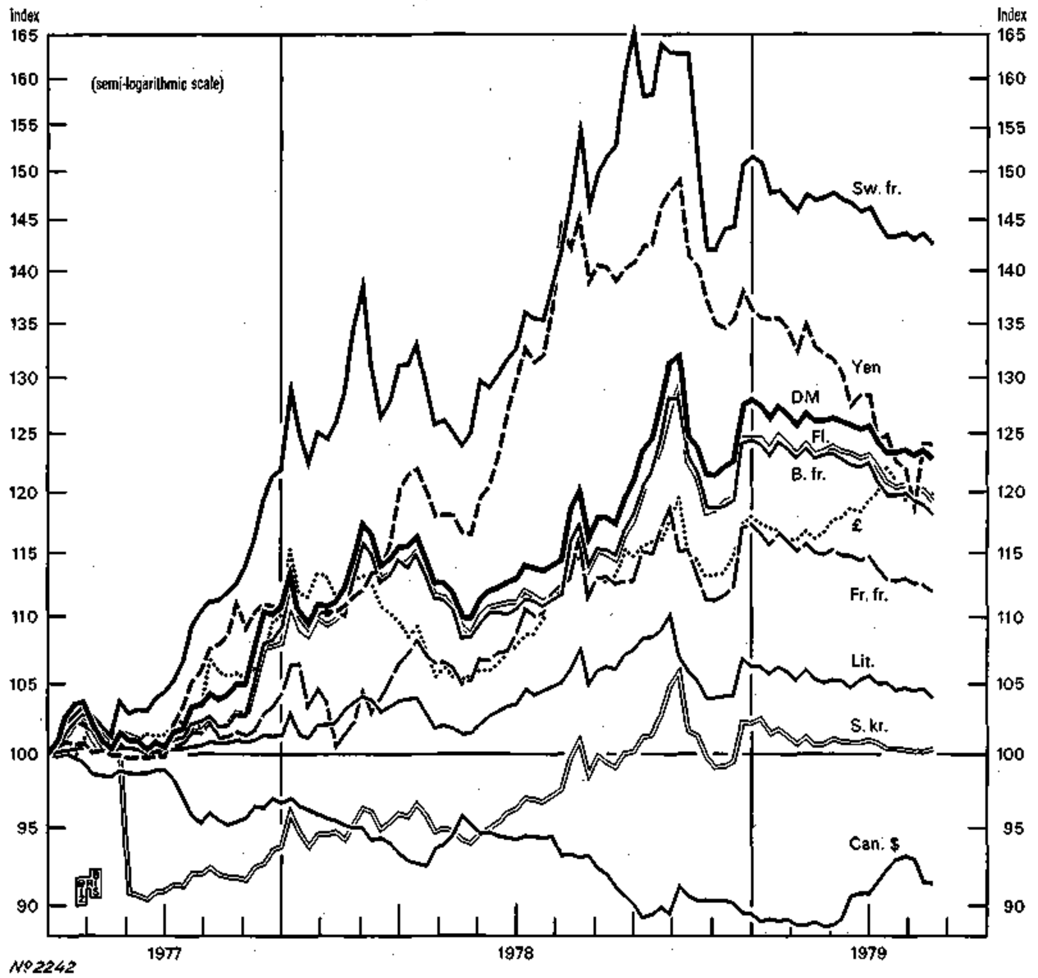
Exchange rate developments.

Large fluctuations in the exchange rates of major currencies — in fact the largest in recent history — were among the dominating events of the period under review. These currency movements, while related to fundamental imbalances that had emerged earlier, far exceeded what was necessary for international payments adjustments. Moreover, there were times when the markets were very disorderly and when, but for central-bank intervention, market participants would have had difficulty in finding counterparts. In terms of exchange rate movements the main features of this turbulence were the decline of the US dollar up to October 1978 and the appreciation of the Swiss franc, the Japanese yen and the Deutsche Mark — a repetition of the same pattern as in 1977 but on a larger scale. However, in contrast to the previous year, all other major currencies, with the exception of the Canadian dollar, also appreciated substantially against the US dollar, albeit in varying degrees.

Following the decisions of the Swiss and US authorities, in October and November 1978, to put an end to exaggerated movements of their currencies, the situation in the exchange markets has improved markedly. A large part of the exchange rate changes that had occurred earlier in the year, as well as of the "hot money" movements that had triggered them, have since been reversed. The cumulative trade-weighted depreciation of the US dollar since end-1977, which at its peak had reached 13 per cent., has since narrowed to 4½ per cent., while the trade-weighted appreciation of the yen and the Swiss franc has declined from 28 to 7 per cent. and from 22½ to 9¼ per cent. respectively. These developments, together with the introduction of the new European Monetary System in March 1979, have significantly changed the operation of the monetary system in the direction of a stronger commitment by the major countries, and the United States in particular, to exchange rate stability.

The basic causes of the sharp decline in the external value of the *US dollar* up to the end of October 1978 were rapid inflation in the United States and the large deficit in its current balance of payments. However, it was the loss of confidence provoked both by these developments and by the absence of adequate exchange-market intervention by the US authorities that was the vital factor in precipitating last year's severe dollar crisis. By the same token, it has been confidence factors, based on the change in US official attitudes towards and policies relating to the exchange rate, that have brought about the major improvement since November 1978 in the dollar's fortunes.

Nominal exchange rates:
Indices of spot quotations for selected currencies vis-à-vis the US dollar.
Wednesday figures, end-June 1977 = 100.



The weakness of the US dollar that had started in the last quarter of 1977 was temporarily halted in early January 1978, following the announcement that the Deutsche Bundesbank had opened a special swap line in favour of the US Treasury and a ½ per cent. increase in the US official discount rate. In February, however, the dollar came under pressure again and by the beginning of March its decline against the Swiss franc and the Deutsche Mark since late September 1977 had widened to 24¾ and 14½ per cent. respectively, despite heavy intervention by the German, Swiss and US authorities. At that point pressure on the dollar in the European markets subsided, following which, on 13th March, the US and German authorities announced a doubling to $4 billion of the ordinary swap line between the Federal Reserve System and the Deutsche Bundesbank, as well as arrangements for a sale by the United States to Germany of SDR 600 million. At the same time the US authorities stated their readiness, if necessary, to obtain currencies for interventions by drawing on their IMF reserve position. In the Tokyo market, however, tensions built up further during March, despite very large intervention by the Bank of Japan which brought its first-quarter reserve gain to $6.4 billion. By early April the dollar had fallen to Yen 218, at which point its decline since late September 1977 had reached 18¼ per cent. against that currency and 8½ per cent. on the trade-weighted basis.

A temporary recovery of the dollar then occurred between early April and late May. The gain in the effective exchange rate during this period amounted to 2¼ per cent., while against the Swiss franc, the Deutsche Mark and the yen, the dollar rose by 11½, 7 and 5 per cent. respectively from the low points reached earlier in the year.

Towards the end of May there began the largest and most general decline of the dollar since the introduction of floating exchange rates in March 1973. The decline started in Tokyo, spread into Europe in June and soon involved not only the traditionally strong currencies but also the French franc, the pound sterling and even the Italian lira. By late June the dollar had fallen beyond its previous low point on the trade-weighted basis and, except for a brief respite in late August, the downward movement continued throughout the summer and autumn. The crisis was essentially one of confidence. The US current payments deficit, though still substantial, had come down considerably from its late 1977 and early 1978 peak, and US monetary policy, though not severely restrictive, was being progressively tightened. What was missing was an indication from the US authorities of their will to stem the dollar's decline in the most direct way possible, by intervening in the exchange market on whatever scale might be necessary. In that situation, neither the passage of the Energy Bill in mid-October nor the announcement of an anti-inflationary package cut any ice whatsoever. By the end of October the dollar had fallen since late May by about 23, 25¼, 18½, 14¼, 13½ and 9½ per cent. respectively vis-à-vis the yen, the Swiss franc, the Deutsche Mark, the French franc, the pound sterling and the Italian lira. On the trade-weighted basis the depreciation amounted to 13 per cent. and, since September 1977, to over 18 per cent.

For the exchange market the key element in the measures announced by the US authorities on 1st November was the large-scale mobilisation of resources for exchange-market intervention. These included a $3 billion IMF drawing; SDR sales totalling $2 billion; increases in the Federal Reserve System's swap lines with the Bundesbank, the Bank of Japan and the Swiss National Bank from a total of $7.4 to 15 billion; and the intention to issue up to $10 billion worth of US Government securities denominated in foreign currencies. The decision to raise the Federal Reserve's discount rate by a full percentage point for purely external reasons further underlined the authorities' greater commitment to exchange rate stability.

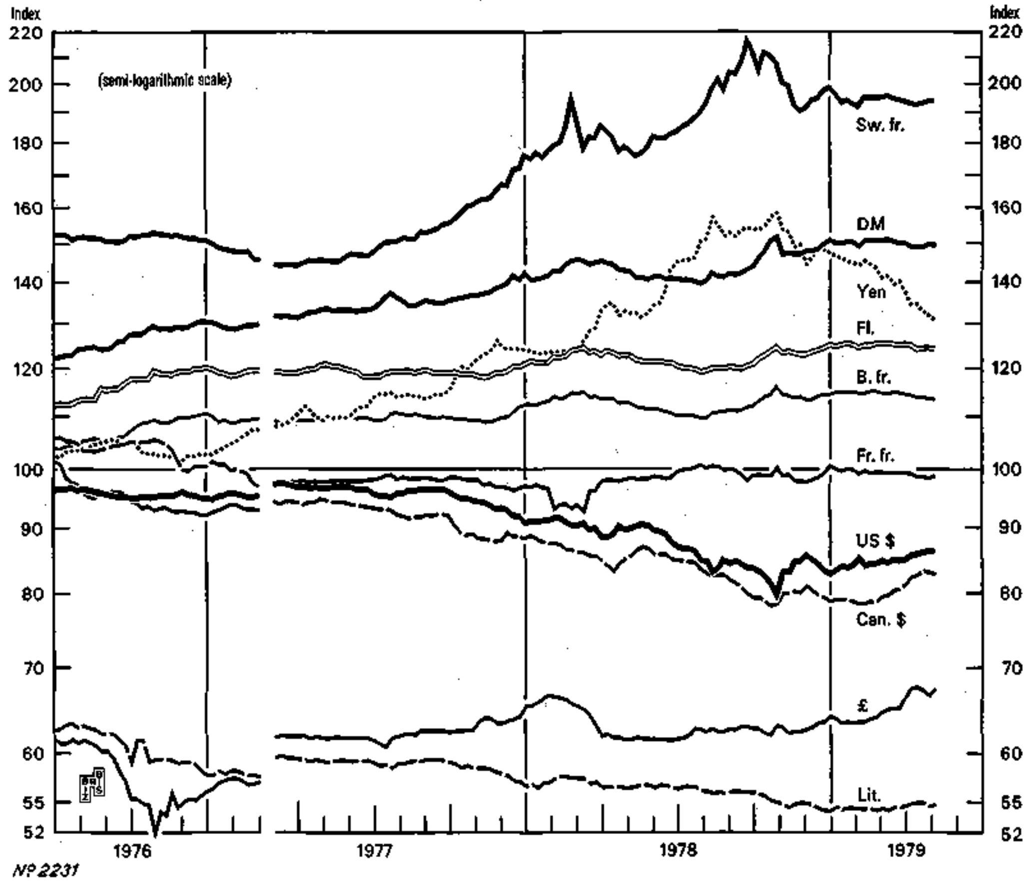
Initial market reaction was predictably sharp. On the day the measures were announced the dollar gained between 3½ and 6½ per cent. against most major currencies. Subsequently, however, the markets continued to be nervous for some time and there were occasional bursts of dollar selling, particularly in response to events in Iran and to the OPEC decision to increase oil prices. The US authorities therefore followed up their 1st November announcement by intervening massively in the exchange market, in co-ordination with the central banks of Germany, Japan and Switzerland. During the last two months of the year total market sales of foreign currencies by the US authorities amounted to the equivalent of $6.7 billion; at the same time the foreign exchange reserves of Germany, Japan and Switzerland increased by about $3.5, 2.4 and 4.4 billion respectively, largely as a result of their central banks' market interventions.

By January 1979 the point had been reached at which the dollar started to strengthen on its own, despite a further worsening of the US inflation rate. With confidence restored, interest rate differentials began to dominate the exchange markets. Reflows of funds into the dollar gained momentum in March and April, and the Japanese, German and Swiss central banks intervened on a large scale to prevent their currencies from declining too rapidly. By the end of April the US authorities had repaid virtually all of their earlier swap drawings. In mid-May the dollar stood 10 per cent. above its 1978 low point on the trade-weighted basis, while against the Deutsche Mark, the Swiss franc and the yen it had gained 11½, 19½ and 23½ per cent. respectively.

Among the currencies that appreciated during most of 1978, the *Swiss franc* experienced the largest rise. This led, in October 1978, to a marked shift in exchange rate policy, involving official intervention and other measures to limit the franc's appreciation. The 1978 rise of the franc began in February, during the first phase of dollar weakness; in the course of that month the franc appreciated by 11½ per cent., to Sw.fr. 1.77, against the dollar and by 6¾ per cent. against the Deutsche Mark. The Swiss authorities then reinforced their direct controls on capital inflows. The 10 per cent. per quarter negative interest charge on non-resident Swiss franc deposits was extended to the accounts of central banks, and the minimum balance to which it applied was reduced by 20 per cent.; a rather general ban was introduced on non-residents' acquisition of Swiss franc securities; and limits on the import of foreign bank-notes were re-introduced. The official discount rate was also lowered to 1 per cent. The franc then eased by about 11 per cent. against the dollar, and by 5½ per cent. against the Deutsche Mark, between late February and mid-May.

During the exchange-market disturbances that began in late May, the franc again appreciated not only against the dollar but also against other European currencies. At first it lagged behind the yen but by July it was advancing faster even than that currency. One factor behind the strong demand for francs was, paradoxically, the rapid pace of Swiss monetary expansion — more than three times faster than the official target of 5 per cent. for the year — which raised some doubts about the willingness of the Swiss authorities to continue intervening on a large scale in the exchange market. In fact, they took in some $2.3 billion during the third quarter of 1978, but nonetheless in late September the dollar exchange rate stood at Sw.fr. 1.459 and the DM rate at Sw.fr. 0.757. At that point the franc had risen

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.

against these two currencies by 62 and 34½ per cent. in the space of a single year and, on the trade-weighted basis, by no less than 38½ per cent.

Then, on 1st October, the Swiss National Bank announced its intention of keeping the rate of the Deutsche Mark vis-à-vis the Swiss franc clearly above the level of Sw.fr. 0.80. At the same time the controls on capital imports were slightly eased. During the first three working days of October the National Bank sold about $2 billion worth of francs to the market, bringing the dollar and DM rates back to about Sw.fr. 1.60 and Sw.fr. 0.82 respectively. Later that month the franc again rose strongly against the dollar, to less than Sw.fr. 1.50, but continued to ease against most European currencies and the yen, so that by end-October its effective exchange rate was nearly 4 per cent. below the September peak.

In the first week of November the franc lost about 9½ per cent. against the dollar. Thereafter, although there were occasional buying pressures on the franc, they were countered by forceful intervention by the Swiss and US authorities. By the end of the year the dollar exchange rate was Sw.fr. 1.62 and the DM rate Sw.fr. 0.889. The resolve of the Swiss National Bank to give strategic priority to exchange rate stability was further demonstrated in January 1979, when it was decided not to fix a monetary target for the year. Once the underlying market sentiment had changed, the 10 percentage point differential between dollar and Swiss franc interest rates began to induce outflows of funds, on a gradually increasing scale. During March and early April the National Bank sold $3.4 billion to the market and in mid-May the franc stood at Sw.fr. 1.74¼ to the dollar, 16¼ per cent. below its September 1978 peak. Against the Deutsche Mark the spot rate was Sw.fr. 0.905, 16½ per cent. below the 1978 peak. On the trade-weighted basis, the decline amounted to 10¾ per cent., so that the franc was not significantly higher than in May 1978, if account is taken of the low Swiss inflation rate.

In the case of the *Japanese yen,* the shift in the trend movement of the exchange rate since late 1978 has been even more pronounced. After a 20 per cent. appreciation on the trade-weighted basis in 1977, the yen rose by a further 8¾ per cent. during the first three and a half months of 1978, despite $5 billion of market intervention by the Japanese authorities in March, as well as a number of measures designed to stem capital inflows. After a temporary reaction, the yen was the first currency affected by the general weakness of the dollar that began to develop in late May, and during most of June and July it appreciated more than any other currency. By the end of October the dollar rate in Tokyo had fallen to Yen 176.05 — less than half its level during the Bretton Woods system. Since late May the yen had appreciated by about 30 per cent. against the dollar and 20 per cent. on the trade-weighted basis.

In November, as part of their new policies, the US authorities began for the first time to intervene in the yen market for their own account, in co-ordination with large dollar purchases by the Bank of Japan — the latter being reflected in a $2.4 billion increase in Japan's exchange reserves during November and December. By the end of the year the yen had come down almost 10 per cent. from its previous peak against the dollar, while its effective exchange rate had declined by 7 per cent. In January 1979, as in the case of the Swiss franc, earlier inflows of funds began to be reversed. By February the 100 per cent. marginal reserve requirement on non-resident free yen deposits, together with the restrictions on non-residents' purchases of Japanese securities, had been abolished. With the basic balance of payments in substantial deficit and the unwinding of earlier speculative inflows gaining momentum, further large sales of dollars by the Bank of Japan, whose reserves declined by about $7 billion during March and April, could not prevent the dollar exchange rate from reaching nearly Yen 225 in early May. At that point the yen was about 21½ per cent. below its late-October peak against the dollar, a much larger decline than that experienced by most European currencies. On the trade-weighted basis the decline since October came to about 17¾ per cent. By mid-May, however, the rate for the dollar had recovered to Yen 217.

Among the traditionally strong currencies, the movements of the *Deutsche Mark* during the period under review were considerably smaller, both against the dollar and on the trade-weighted basis, than those of the Swiss franc and the yen. Up to early March 1978 the Deutsche Mark rose by 5¾ per cent. to a peak of DM 1.99 against the dollar, and by 2¼ per cent. on the trade-weighted basis. By late May, however, it had fallen back to slightly below its end-1977 levels. The German authorities then abolished, with effect from 1st June, the 80 per cent. marginal reserve requirement on non-resident bank deposits which had been in force since 1st January 1978.

In the subsequent exchange crisis the appreciation of the Deutsche Mark lagged considerably behind that of the yen and the Swiss franc throughout June. In July the announcement at the Bremen summit of the intention to create a zone of exchange rate stability covering the whole European Community tended to divert into the French franc, sterling and the Italian lira — the three major Community currencies outside the "snake" — some of the funds that were moving out of the dollar, so that the Deutsche Mark lost ground against those currencies as well. Consequently, in mid-August it stood 10½ per cent. higher against the dollar than in late May, but 12½, 11¾ and 1 per cent. lower against the Swiss franc, the yen and the French franc respectively. On the trade-weighted basis, it had gained only ¾ per cent.

Immediately following the 1st November 1978 announcements the dollar improved from DM 1.72¾ to DM 1.90. Thereafter, the German and US authorities intervened massively whenever the demand for Deutsche Mark rose; US official sales of Deutsche Mark during November and December 1978 amounted to the equivalent of $5.7 billion. Although the dollar eased a little, to about DM 1.83 at the end of 1978, in January the earlier inflows of funds began gradually to be reversed, and by mid-May the dollar had strengthened to about DM 1.92¼. On the trade-weighted basis the Deutsche Mark was some 2½ per cent. below its end-October 1978 peak.

During the period under review the trade-weighted exchange rate of the *French franc* moved within a band of 9 per cent., with occasional sharp fluctuations of rates reflecting the fortunes of the dollar or domestic political and economic developments. The first of these fluctuations came in the first week of February 1978, when the franc declined by over 4 per cent. against the dollar and the Deutsche Mark, and by 3½ per cent. on the trade-weighted basis, in advance of the March parliamentary elections. The franc was then stabilised by large-scale official intervention — in Deutsche Mark as well as dollars — combined with a tightening of money-market conditions. After the election victory of the governing coalition parties the franc recovered strongly, and by mid-April it was higher than the end-1977 level both against the dollar and on the trade-weighted basis, by 3½ and 1 per cent. respectively.

When the dollar came on offer again in the European markets towards mid-year, the rise of the franc against the dollar lagged behind that of the yen and the Swiss franc and its effective exchange rate remained virtually unchanged during most of June. Towards the end of that month, however, French sponsorship of the proposed European Monetary System brought the franc into strong demand, so that it began to rise not only against the dollar but also to some extent against the Deutsche Mark. Between late May and mid-August it appreciated by 10¾ and 1 per cent. respectively against these two currencies. From September onwards, however, the rise of the franc against the dollar again lagged behind that of the

Deutsche Mark, so that by end-October the gain in the effective exchange rate since late May was no more than 2½ per cent.

The US November measures caused the franc to weaken against the dollar from Fr.fr. 4.02 to about Fr.fr. 4.30 within two days. Since January 1979 the effective exchange rate of the franc has been very stable. In mid-May the dollar rate was around Fr.fr. 4.44 and the trade-weighted exchange rate about 3 per cent. below its October 1978 peak.

After appreciating by 6¾ per cent. on the trade-weighted basis in 1977, the *pound sterling* gained a further 2½ per cent. on balance up to mid-May 1979. In early 1978 it had come under downward pressure; indeed, during March 1978, when the dollar was strengthening against European currencies, sterling's trade-weighted exchange rate fell by 5¼ per cent. Subsequently, it stabilised at around that level, owing mainly to a combination of vigorous intervention and a tightening of money-market rates. The underlying reserve loss in the second quarter amounted to about $2.9 billion.

When the dollar came under pressure in the early summer, sterling advanced gradually but steadily against that currency, from about $1.81 in late May to nearly $2.10 in late October, or by 16 per cent. However, since the advance of sterling was considerably less than that of the Deutsche Mark, the Swiss franc and the yen, the gain in the effective exchange rate was less than 3 per cent. Similarly, sterling's reaction to the 1st November US package was much less pronounced than those of the surplus countries' currencies. Against the dollar the pound eased to about $1.93 in early December, down 7¾ per cent. from its October peak, but the fall in the effective exchange rate never exceeded 1½ per cent.

Towards the end of 1978 the Iranian situation and the resultant oil price increases brought sterling into demand, as the United Kingdom was considered to be the least vulnerable of the major industrialised countries to these developments. By mid-April 1979 the effective exchange rate had risen by 5½ per cent. since the beginning of the year, while in the dollar market sterling stood at $2.10. Subsequently, sterling lost 1 per cent. on the trade-weighted basis by mid-May, when it stood at about $2.05.

The *Italian lira,* with a depreciation of about 3½ per cent. on the trade-weighted basis, was among the most stable of the major currencies during the period under review. The basic causes of this stability were the strong performance of the Italian current balance of payments and the reduction in the rate of price inflation. Occasional large-scale inflows of funds were absorbed by the Bank of Italy and contributed, together with the current external surplus, to a $7 billion improvement in Italy's net official monetary position in 1978. Thus, in the summer of 1978 the advance of the lira against the dollar was considerably smaller than that of other major currencies. Between late May and the end of October it rose by 10¾ per cent. against that currency, but on the trade-weighted basis it declined by about 3 per cent.

Since November 1978 the effective exchange rate has been remarkably stable, remaining within a band of 1¼ per cent. The dollar rate, however, which had fallen between May and October from Lit. 873 to Lit. 788, fluctuated between Lit. 827 and Lit. 853 in the last two months of 1978. Following the introduction of the European Monetary System on 13th March 1979, the high interest rates in Italy began to attract funds into the lira, which has for most of the time been the strongest currency in the system.

With the current balance of payments in substantial deficit, a high inflation rate and less favourable interest rate differentials vis-à-vis the US market, the *Canadian dollar*, alone among the currencies of the Group of Ten countries, depreciated sharply during much of the period under review both against the US dollar and on the trade-weighted basis. As a consequence, economic strategy shifted in two ways towards re-establishing exchange rate stability: the authorities intervened very strongly in the exchange market, so that despite official foreign currency borrowings totalling US$ 5.1 billion the reserves fell slightly during 1978; and monetary policy was increasingly geared to maintaining adequate interest rate differentials with the United States.

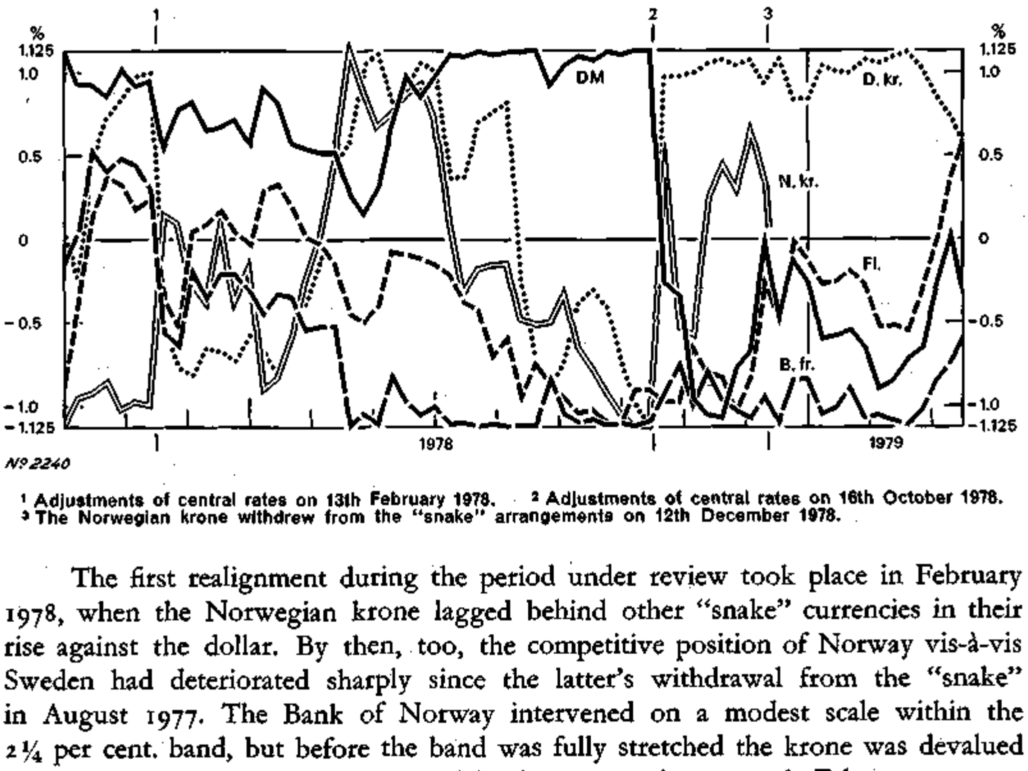
After having declined by 10 per cent. on the trade-weighted basis during 1977, the Canadian dollar lost a further 6 per cent. in the first three and a half months of 1978. At that point, in terms of the US dollar, it stood at US$ 0.87, 5 per cent. down from its end-1977 level. Following two ½ per cent. increases in the official discount rate the exchange rate strengthened by mid-May to US$ 0.90¼ and by 4½ per cent. on the trade-weighted basis. Further weakness soon set in, however, and continued during the summer. Despite an underlying reserve loss of US$ 2.2 billion during the third quarter, by early October the Canadian dollar had fallen below US$ 0.84, its lowest level against the US currency for more than forty years, and by a further 10 per cent. on the trade-weighted basis. At that point the cumulative decline of the exchange rate since end-1976 was 20½ per cent. on the trade-weighted basis and 15¼ per cent. against the US dollar. By October the official discount rate had been raised to 10¼ per cent., and the dollar stabilised from the middle of that month, allowing some modest replenishment of official reserves.

Following the US measures in November 1978, there were two further increases in the Canadian discount rate, bringing it to 11¼ per cent. by early January 1979, and in addition the authorities renewed their market support for the dollar. These actions succeeded in keeping the exchange rate fairly stable both on the trade-weighted basis and against the US dollar. At end-February 1979 the dollar's effective exchange rate was about ¾ per cent. higher than in mid-October 1978, although against the US dollar it had again declined below US$ 0.84, reflecting the recovery of the US currency. Subsequently, confidence in the Canadian dollar improved, funds began to flow in, and the exchange rate gained a further 4½ per cent. on the trade-weighted basis by mid-May, when it stood at about US$ 0.86½ against the US currency.

Since its withdrawal from the European joint float at the end of August 1977, the *Swedish krona* has been the most stable of the major currencies in terms of the effective exchange rate. During 1978 and the first four months of 1979 its effective exchange rate remained within a band of 3½ per cent., although the dollar rate fluctuated between S.kr. 4.72½ and S.kr. 4.08¼, reflecting the varying fortunes of the US currency. The stability of the krona was mainly the result of the emergence of a surplus on the Swedish foreign trade balance, and of a big reduction in the domestic inflation rate. In fact, the krona was largely untouched by last year's speculative capital flows. The Bank of Sweden reduced its official discount rate by 1½ per cent., in three steps, to 6½ per cent. by late July 1978, and added $0.7 billion to its net reserves. At mid-May 1979 the krona had appreciated by 2½ per cent. since end-1977 on the trade-weighted basis, and by 6¼ per cent. against the US dollar.

Inside the *European joint float* there were three realignments of participants' exchange rates during the period under review, including Norway's withdrawal from it, before the introduction of the new European Monetary System on 13th March 1979. Whilst, as in 1977, realignments inside the "snake" were basically the result of divergences in member countries' economic performances, they were also related to the decline of the US dollar, which affected participants' currencies to differing degrees.

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



[1] Adjustments of central rates on 13th February 1978. [2] Adjustments of central rates on 16th October 1978. [3] The Norwegian krone withdrew from the "snake" arrangements on 12th December 1978.

The first realignment during the period under review took place in February 1978, when the Norwegian krone lagged behind other "snake" currencies in their rise against the dollar. By then, too, the competitive position of Norway vis-à-vis Sweden had deteriorated sharply since the latter's withdrawal from the "snake" in August 1977. The Bank of Norway intervened on a modest scale within the 2¼ per cent. band, but before the band was fully stretched the krone was devalued by 8 per cent. against all other participating currencies on 13th February.

From July 1978 onwards the dollar crisis led to a renewal of tensions in the joint float. There were inflows of funds into Deutsche Mark not only out of dollars but out of other "snake" currencies too, in the expectation of another realignment of participants' currencies before the coming into operation of the European Monetary System. The central banks of all participating countries had to sell

Deutsche Mark to the markets, the increase in Germany's reserves from this source between end-June and mid-October amounting to over $5 billion. On 16th October the Deutsche Mark was revalued by 2 per cent. against the Belgian franc and the guilder, and by 4 per cent. against the Danish krone and the Norwegian krone.

The last of the realignments took place when, following Sweden's decision not to join the European Monetary System, the Norwegian authorities announced that they were not ready to take a decision about Norway's participation. With effect from 12th December, the krone was withdrawn from the "snake" and was pegged to a basket containing the currencies of Norway's principal trading partners.

On 13th March 1979 the "snake" was absorbed into the new European Monetary System.

The European Monetary System.

On 5th December 1978 the European Council formally took the decision to establish a European Monetary System (EMS). Its principal objective is to create closer monetary co-operation leading to a zone of monetary stability in Europe. The EMS became operative on 13th March 1979, replacing the European joint float arrangements (the "snake") set up in 1972. The decisive political impetus for a new attempt to stabilise intra-EEC exchange rates had come from a Franco-German initiative, endorsed at the Copenhagen meeting of the European Council in April 1978, the timing of which was influenced by the growing weakness of the dollar and the destabilising influence this exerted on exchange rates between EEC currencies.

The framework of the new system was laid down in an annex to the Council's Bremen communiqué, issued on 7th July 1978. It envisaged a durable and effective exchange rate system comprising all EEC currencies. The European Currency Unit (ECU), a composite of EEC currencies identical with the European Unit of Account, was to play a central rôle in the system, as a standard of reference for central exchange rates and a common denominator of claims and liabilities arising from official interventions in EEC currencies. In addition, ECU assets were to be created against the receipt of dollars and gold from participants' monetary reserves and, at a later date, also against national currencies. ECU assets were to be used as a means of settlement among EEC central banks. A European Monetary Fund (EMF) was to form the system's central institution, taking over from the European Monetary Co-operation Fund (EMCF) after a two-year transitional period.

During the negotiations which followed there were two dominant issues, both related to the degree of "discipline" that should be built into the system and its sharing between deficit and surplus countries. The first issue concerned the choice of the exchange-market intervention mechanism. One view was that intervention limits applied on either side of central exchange rates defined in terms of the ECU would result in a more equal distribution of intervention obligations between strong and weak currencies; on the other hand, countries with traditionally strong currencies feared that such a system would impose an unduly heavy burden on them and they therefore preferred a system, like that used in the "snake", of intervention limits fixed in relation to bilateral central rates between currencies. The second issue concerned the size of the increased EEC credit facilities to be associated with the system, and their distribution between medium-term conditional credit, favoured by the strong-currency countries, and short-term unconditional credit, preferred by the other countries. The agreements reached on these issues represented, on balance, a compromise between the two schools of thought: the "snake" method was adopted for defining intervention obligations, while deviations from currencies' ECU central rates were to be taken as an indicator of "divergence", carrying with them a presumption of action by the authorities concerned; on the credit issue, most of the increase was in unconditional facilities, the maximum duration of which was lengthened.

Main features of the system in the transitional period.

The main features of the system as it is now operating during the transitional period before the setting-up of the proposed European Monetary Fund are outlined below under three headings: the exchange rate mechanism; the credit facilities and the creation of ECU reserve assets; and the financing and settlement of debtor or creditor positions arising out of official intervention in participants' currencies.

(a) The exchange rate mechanism.

The exchange rate mechanism defines for participating currencies their central exchange rates, their intervention limits and the intervention procedures to be followed. Each participant undertakes to declare a central rate for its currency in terms of the ECU. The ECU is defined as a "standard basket" of fixed amounts of the nine EEC currencies. These amounts, which are shown in the table below, were determined in accordance with countries' respective shares in intra-European trade, their gross national products and their quotas in the EEC's short-term monetary support arrangements.

The ECU basket of currencies.

Currencies	Amounts of national currencies in the basket	Initial percentage shares of currencies in the basket[1]	Percentage shares of currencies in the basket on 13th March 1979	Value of the ECU in currencies on 13th March 1979[2]
Deutsche Mark	0.828	27.3	33.0	2.51064
French franc	1.15	19.5	19.8	5.79831
Pound sterling	0.0885	17.5	13.3	0.663247
Italian lira	109.0	14.0	9.5	1148.15
Dutch guilder	0.286	9.0	10.5	2.72077
Belgian franc / Luxembourg franc	3.80	8.2	9.6	39.4582
Danish krone	0.217	3.0	3.1	7.08592
Irish pound	0.00759	1.5	1.2	0.662638

[1] On 28th June 1974. [2] Central rates for currencies participating in the exchange rate mechanism; the ECU value shown for the pound sterling is that which is implied arithmetically by other currencies' central rates.

As a measure of a weighted average of EEC currencies' market exchange rates, the value of the ECU in terms of individual EEC currencies varies with changes in intra-EEC exchange rate relationships. Such changes also affect the weights of individual currencies in the basket, the initial weight structure having changed considerably over the last five years. The weights of the currencies in the basket will therefore be re-examined within six months of the start of the system and thereafter every five years or, on request, whenever the weight of any currency has changed by 25 per cent.

The ECU is not the standard of reference for the compulsory intervention limits. These are fixed on either side of each pair of currencies' bilateral central rates, the latter being derived as cross-rates from currencies' ECU central rates. The margin of fluctuation on either side of bilateral central rates is limited to 2¼ per cent. for all those currencies which were members of the "snake" at the time the system came into operation; the other EEC member countries could opt for margins of up to 6 per cent. on either side of bilateral central rates. Italy availed itself of this option.

Market interventions take place, in principle, in the currencies of countries which participate in the intervention mechanism. At the margin these interventions are compulsory and without limit as to amount. Intra-marginal interventions in participants' currencies, as well as interventions in other currencies, are subject in principle to prior concertation among all participating central banks.

In addition to the intervention limits described above, a system of "divergence indicators" applies to the movements of participating currencies. A currency reaches its "divergence threshold" whenever it deviates from its ECU central exchange rate by 75 per cent. of the deviation from that rate which would occur if it were at its upper or lower market intervention limit against all other EEC currencies simultaneously. When a currency becomes "divergent" there is a presumption that the authorities concerned will either take corrective action or explain their reasons for not doing so. It may be added that the presence in the ECU basket of the lira and the pound sterling — neither of which observes the 2¼ per cent. intervention limits in the exchange market — complicates the calculation of "divergence", by making it necessary to ascertain whether it is attributable to, or indeed being masked by, the movements of these two currencies.

(b) The credit facilities and the creation of ECUs.

For the transitional period the existing EEC credit facilities, short-term and medium-term, have been retained, but with the total of credit effectively available under them increased to ECU 25 billion, of which ECU 14 billion at short term and ECU 11 billion at medium term. Short-term credits are unconditional and run, in principle, for three months, renewable twice at the borrower's request. Drawings on the medium-term facility, which are subject to policy conditions, may be made for periods of two to five years. After the transitional period both facilities will be replaced by credits granted by the European Monetary Fund.

In addition to these credit facilities, more than ECU 23 billion have been created by member countries' central banks swapping with the EMCF 20 per cent. of their gold holdings and 20 per cent. of their gross dollar reserves against ECUs. Under these swaps, which are renewed every three months, gold is valued at the average ECU price during the six preceding months, or the ECU price on the penultimate working day of the period, whichever is the lower, and dollars at the current ECU rate. Member countries continue to manage the investment of the dollars swapped against ECUs. The volume of ECUs created through these swaps can change at the time the swaps are renewed, as a result of changes either in members' gold and dollar reserves or in the ECU value of gold and the dollar. The principal use of ECUs is in settlements between EEC central banks (see (c) below) arising out of market intervention. In addition they can be transferred between central banks in exchange for other reserve assets and sold to the EMCF to replenish members' dollar reserves. Interest is paid or charged on ECU balances, in both cases at the weighted average of EEC central banks' official discount rates, only to the extent that they are larger or smaller than the amounts a member has received under the swaps with the EMCF.

(c) Financing and settlement of intervention balances.

The basic principles governing the financing and settlement of intervention balances derive largely, but with some changes, from those applied under the "snake" arrangements. Each central bank undertakes to make its currency available for the purpose of interventions in unlimited amounts. The settlement of the resulting balances — under the so-called very short-term financing facility — falls due not later than the last working day preceding the sixteenth day of the second month following that in which the intervention took place. Financing operations are recorded in and cleared through the books of the EMCF, with claims and liabilities being denominated in ECUs.

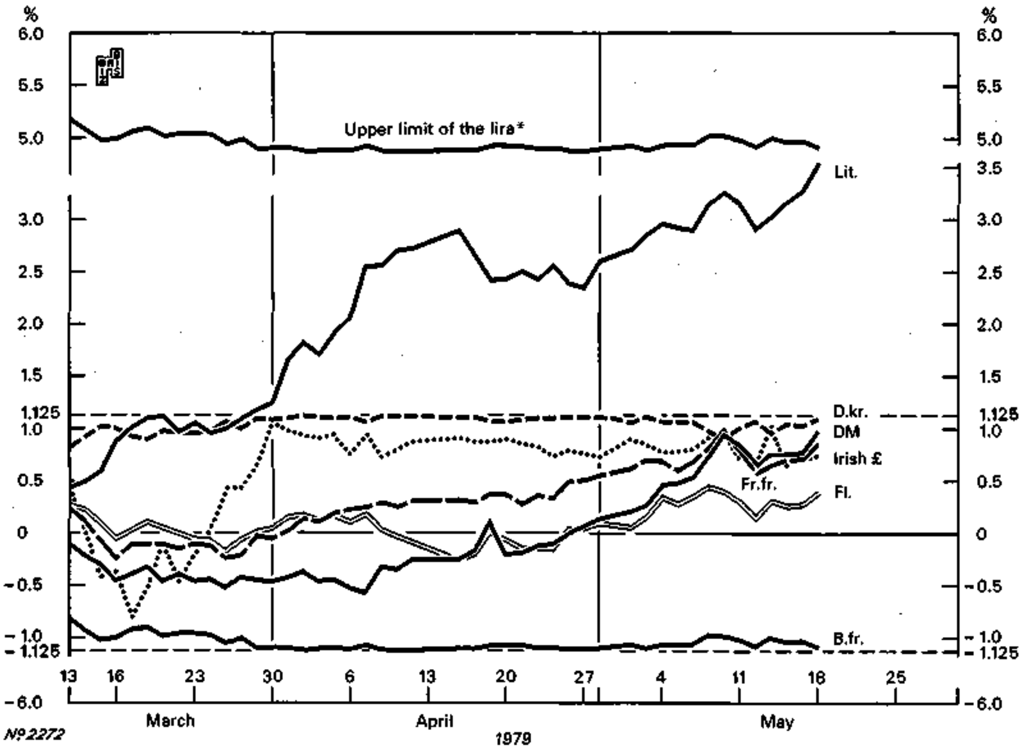
Where a country does not settle its debit balance with the EMCF by the date indicated in the previous paragraph, the same rules apply as under the "snake" arrangements: at the request of a debtor the credit will be renewed automatically for a single period of three months, provided that the amount renewed does not exceed the debtor country's quota in the EEC short-term monetary support arrangements and that renewal does not result in indebtedness being outstanding for six months consecutively. An automatically renewed debt may, with the creditor's consent, be renewed for a further three months and any debt in excess of the debtor's quota under the short-term support arrangements may, with the creditor's consent, be extended for a single period of three months.

The settlement of debts arising out of intervention is to be effected as far as possible in the creditor's currency. However, since participants' holdings of Community currencies are limited to specific amounts of working balances, repayment in this way will only be possible to the extent that a reversal of exchange-market conditions enables the debtor central bank to buy the creditor's currency in the market. Any debt not settled in the creditor's currency may be wholly or partly settled by transfers of ECU assets, although no creditor is obliged to accept such settlement in respect of more than 50 per cent. of its claims. Any remaining balance is to be settled by the use of other reserve assets, excluding gold, pro rata to the composition of the debtor's reserves. For this purpose reserves are divided into SDR-denominated reserves and currencies. Within these two categories the debtor is free to choose which reserve asset it wishes to pay in; gold may be used in settlement at a price agreed on between debtor and creditor.

The opening months of the system.

The EMS entered into operation on 13th March 1979, with the pound sterling continuing to float independently, with 6 per cent. margins on either side of bilateral central rates for the lira and 2¼ per cent. margins for all the other currencies participating in the exchange rate mechanism. The movements of participating currencies since mid-March are shown in the graph below.

Spot exchange rates in the EMS.
Daily positions, in percentages, of participants' currencies in relation to their intervention points.



* The lira's position is shown by its percentage deviation from the weakest currency within the 2¼ per cent. band; its maximum permissible position is indicated by the top line in the graph.

The first two months of the new system's existence were free of any major tensions in the exchange market, either between participating currencies or vis-à-vis the dollar. The strongest currencies were the lira, the Danish krone and the Irish pound, reflecting the high level of these countries' domestic interest rates. The Belgian franc has been consistently the weakest currency. Some intervention was needed at its bilateral margins against other participating currencies, and the franc reached its "divergence indicator" on 3rd May, at which point the National Bank of Belgium increased its official discount rate from 6 to 7 per cent.

Greater commitment to exchange rate stability by major countries.

As is evident from official reactions to last year's currency crisis, there is now a clear intention on the part of the major countries to try to maintain greater stability in the exchange markets. The most important change in that respect has certainly been the modification by the US authorities, in co-operation with the German, Japanese and Swiss authorities, of their post-March 1973 philosophy of relying on market forces to produce an equilibrium exchange rate for the dollar. The United States has now joined other major countries in acknowledging that markets, left to themselves, can produce exaggerated movements in exchange rates that are damaging to the domestic economy. It has backed that acknowledgement by adopting an intervention policy in the exchange markets aimed at correcting such exaggerated movements rather than simply dealing with disorderly market conditions. In addition, it has financed such intervention not only out of enlarged short-term swap credit lines but also — like other countries with payments deficits — through longer-term external borrowing in foreign currencies. Moreover, by raising the official discount rate by 1 per cent. on 1st November the US authorities also indicated increasing recognition of the existence of external constraints on their domestic policies.

In addition to the change of policy in the United States, the member countries of the European Community have set in place new arrangements that aim at strengthening exchange rate stability within the Common Market area, and the Swiss authorities have announced their intention to keep the Deutsche Mark well above the level of Sw.fr. 80 for DM 100. Common to these decisions is the belief, both in countries with persistently strong currencies, such as Germany and Switzerland, and in France and Italy, which had earlier withdrawn from the European joint float against the dollar, that greater stability of their exchange rates is a prerequisite for dealing with their domestic economic problems.

So far, the shift in official attitudes and policies has proved remarkably successful. The decline of the dollar was halted at once, and has since been significantly reversed; the German, Japanese and Swiss authorities saw their 1978 intervention policies justified by the subsequent outflows of funds from their currencies and the accompanying decline of their exchange rates from the late-1978 peaks; and the new European exchange rate mechanism has been operating since mid-March without major tensions appearing.

It has to be said, however, that the situation in late 1978 was particularly favourable to that success, with large oversold positions in the dollar and overbought positions in other currencies, wide interest rate differentials in favour of the dollar and clear signs of a reduction of some payments imbalances in the industrialised world. The real test of the new policies will come when circumstances are less propitious, and there are a number of reasons why it may not be easy to maintain more stable currency conditions in the future. After the repeated exchange-market crises of the past five years, the rebuilding of confidence will in any case take time and sustained efforts. And these efforts will have to be deployed in a world where inflation is still a major problem and where the oil-exporting countries' payments surplus is increasing again. In short, while the greater emphasis on exchange rate stability marks an important break with what went before, the problem for the future will be to maintain greater stability in the face of these potentially destabilising factors.

Gold production and the gold market.

In 1978 world gold production (excluding that of the USSR and other eastern European countries, mainland China and North Korea) totalled 968 metric tons, virtually the same as in the previous year. Higher output in South Africa and a number of smaller producing countries in South-East Asia compensated for some decline elsewhere, especially in other African countries and in North America.

South African production increased from 700 to 706 tons. The total quantity of ore milled, which had declined by 2.2 per cent. in 1977, rose by 4.9 per cent., while the average gold content of the ore, which had shown virtually no change in 1977 despite the rise in the price of gold, was reduced by 4 per cent. At the same time the industry's average production costs continued to escalate, though at 13.7 per cent. the increase was the lowest since 1972. Average profits jumped by 65 per cent. owing largely to the sharp increase in the market price but also in part to new arrangements introduced in April 1978 for the South African Reserve Bank's purchases of gold from the industry, which led to a once-only boost in the industry's revenues.

World gold production.

Countries	1929	1940	1946	1953	1970	1975	1976	1977	1978
	In metric tons								
South Africa . . .	323.9	436.9	371.0	371.4	1,000.4	713.4	713.4	699.9	706.4
Canada	60.0	165.9	88.5	126.1	74.9	51.4	52.6	53.9	51.6
United States . . .	64.0	151.4	49.0	60.9	54.2	32.7	32.6	34.2	30.0
Papua-New Guinea	.	.	.	.	0.7	19.0	20.2	22.8	23.5
Australia	13.3	51.1	25.6	33.4	19.3	16.4	15.7	19.4	19.9
Philippines	5.1	34.9	—	14.9	18.7	15.6	15.6	17.4	18.3
Rhodesia	17.4	25.7	16.9	15.6	15.6	20.0	20.0	20.0	18.0
Ghana	6.4	27.6	18.2	22.7	22.0	16.3	16.6	16.9	14.2
Colombia	4.3	19.7	13.6	13.6	6.3	9.7	9.3	8.2	8.0
Brazil	3.3	4.7	4.4	3.6	5.3	5.4	4.9	5.4	5.4
Japan	9.3	12.6	1.3	7.1	7.9	4.5	4.3	4.4	4.4
Zaire	4.9	17.4	10.3	11.5	5.6	3.2	2.8	2.5	2.6
Total listed .	511.9	947.9	598.8	680.8	1,230.9	907.6	908.0	905.0	902.5
Other countries . .	58.6	217.1	67.7	73.4	36.6	48.8	60.4	63.8	65.1
Estimated world total*	570.5	1,165.0	666.5	754.2	1,267.5	956.4	968.4	968.8	967.6

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

Total market supplies of new gold increased again quite significantly last year, from 1,615 to 1,745 tons. Market sales by communist countries may be estimated at 450 tons — like western production, unchanged from their 1977 level. The decline in western official gold stocks, however, at 260 tons, was considerably larger than the year before. Moreover, since that figure includes 65 tons of gold transferred last year from the Japanese Ministry of Finance to the Bank of Japan, which had previously been excluded from gold reserve statistics, total net market sales out of official gold stocks last year may be put at 325 tons — the highest annual figure recorded since the termination of the Gold Pool arrangements in March 1968.

Estimated sources and uses of gold.

Items	1975	1976	1977	1978
	in metric tons			
Production	955	970	970	970
Estimated sales by communist countries	150	350	450	450
Decline in western official gold stocks (net)	35	155[1]	195[1]	325[2]
Total (= estimated non-monetary absorption)	1,140	1,475	1,615	1,745

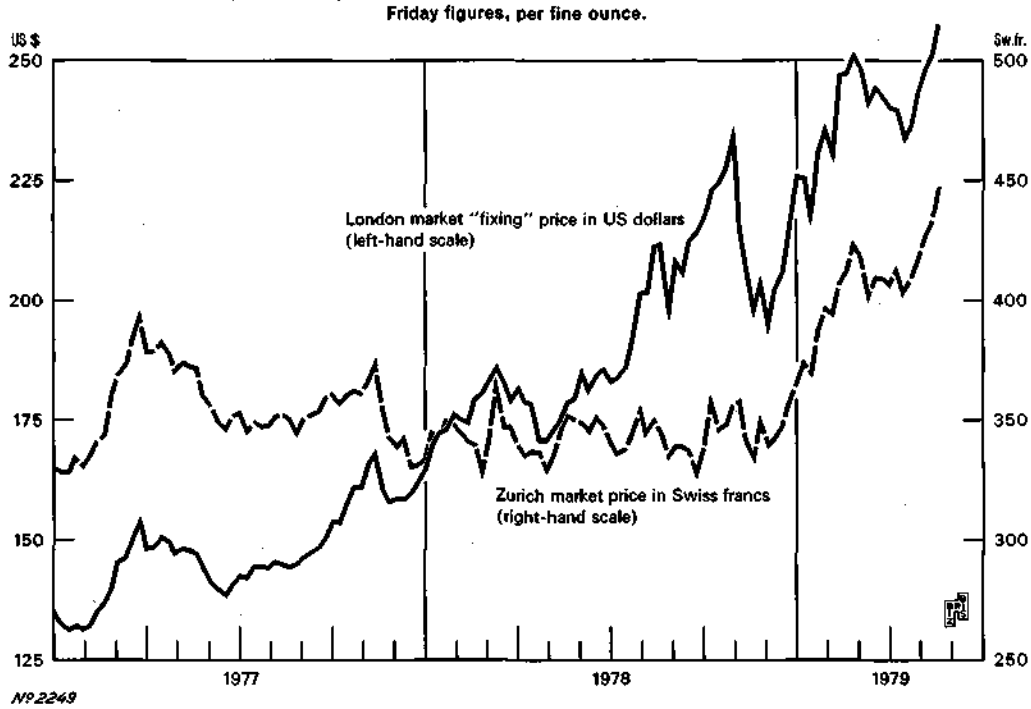
[1] Excluding the declines in South Africa's gold reserve of 160 tons in 1976 and 90 tons in 1977. [2] Excluding 65 tons of gold transferred from the Japanese Ministry of Finance to the Bank of Japan which had not previously been counted as part of world gold reserves.

Within that total IMF market sales accounted for 184 tons, about the same as the year before. The larger volume of gold coming onto the market from western official sources can therefore be attributed to sales out of certain countries' gold reserves. The most important of these was the sale of 126 tons by the US Treasury under a new auction programme which began in May 1978. The programme, which initially consisted of six auctions of 9.3 tons, was subsequently extended, with the amount sold being increased to 23.3 tons in November and, as part of the support programme for the dollar announced on 1st November, to 46.7 tons a month from December. In the light of the dollar's strengthening on the exchange markets, the monthly sales were reduced to 23.3 tons again from May 1979. Other official sales of gold during 1978 included 62 tons by Portugal and 13 tons by India. On the other hand, there were official purchases of gold during the year by a few countries.

That the gold markets were able to absorb an estimated 130 tons more of new supplies in 1978 than the year before, and to do so at sharply rising prices in dollar terms, was an indication of the extent to which last year's currency crisis, centring on the decline of confidence in the dollar, added to non-monetary demand for the metal. A large part of this increased demand was for coins, with production of Krugerrands accounting for 192 tons of gold in 1978 compared with 104 tons the previous year. Non-monetary offtake of gold bullion, too, rose last year. Demand was particularly strong from buyers in Europe, with part of the gold being re-exported as jewellery, as well as in the United States and in Japan, where restrictions on gold trading by residents were removed.

Developments in the market price of gold during the period under review may be divided into two main phases. During the first, which covered the first ten months of 1978, the movement of quotations tended to follow the varying fortunes of the dollar, with a strong upward trend in dollar terms that was clearly related to the growing lack of confidence internationally in that currency. Thus, during this period the price of gold in dollars on the London market increased by 48 per cent.,

Market prices of gold bars in US dollars and Swiss francs, 1977–79.
Friday figures, per fine ounce.



while in Swiss franc terms it hardly changed. In the second phase, which began after the US measures of 1st November 1978, the price of gold, after a brief but sharp reaction to the earlier rise, went up substantially in terms of all major currencies, in response to political events in the Middle and Far East, the increase in oil prices and renewed fears of inflation. By late May dollar quotations were well above their end-October 1978 levels, while in terms of Swiss francs the gold price had risen by about 30 per cent.

During the first two months of 1978 the weakness of the dollar pushed the London market price up from $169 per fine ounce at the beginning of the year to $190 on 8th March, the highest quotation since December 1974. The temporary strengthening of the dollar that followed brought a reaction and by 20th April, just after the US Treasury announced its auction programme, the market price was back at its early-January level. In May quotations began to move up again, helped by the reduction of the IMF's monthly auctions from 16.3 to 14.6 tons, and by the end of that month they reached $185. After another temporary reaction before the Bremen and Bonn summit meetings the upward trend resumed strongly in July as the dollar came under heavy pressure again and by mid-August quotations had reached a new peak of nearly $216.

At that point further support measures for the dollar, including the announcement of increased US Treasury gold sales, brought a drop in the market price to $198 before the end of August. But demand soon picked up again strongly in September. As the dollar crisis came to a head trading conditions in the gold market became increasingly hectic, with movements of several dollars a day in quotations, and a new peak price of $243.65 was reached on 31st October.

The measures announced by the US Government on 1st November, including the further expansion of US Treasury gold sales, brought a sharp reversal of the upward trend of gold prices. In three working days London market quotations fell by $30 to $208. Once more, however, the decline was short-lived and prices began to rise again in early December — not only in dollar terms but in terms of all major currencies. Among the influences which increased demand for gold were events in Kampuchea and Iran, and the OPEC countries' mid-December decision to raise oil prices progressively in 1979; that decision pushed the market price up from $205 to $220 in two days. The upward trend continued into 1979, when a renewal of speculative demand carried the dollar price to a new peak of $254 on 8th February. This represented a 31 per cent. rise since end-November, and, as the graph shows, the Swiss franc price rose over that period by about 25 per cent., to reach its highest level since August 1975.

The February peaks were not sustained and in the subsequent reaction quotations came down to just under $232 per ounce on 17th April. The announcement, on the following day, that the US Treasury was halving the quantity of gold sold at its monthly auctions initiated a new upward movement amid growing concern about the oil situation and world inflation. On 14th May the announcement that the IMF was reducing the amount of its monthly sales from 14.6 to 13.8 tons caused the market price to go above the early-February peak, and on 25th May quotations reached $270 per ounce.

Reserves and international liquidity.

The large current balance-of-payments deficit of the United States, together with a sizable movement of official and private funds out of the dollar, produced another massive increase in global reserves during 1978. Countries' reported total official holdings of gold (valued at SDR 35 per ounce), foreign exchange, special drawing rights and IMF reserve positions, having grown by $60.5 billion in 1977, went up by another $44.4 billion last year to reach just on $363 billion at the end of December. The recovery of confidence in the dollar during the first part of 1979 seems to have brought the expansion of global reserves to a halt. The reversal of earlier speculative inflows into Germany, Japan and Switzerland led to a reduction of over $16 billion in these countries' combined reserves during the first four months of the year, while total reserves of the Group of Ten countries and Switzerland fell by just over $8 billion during the same period.

The slowdown in reserve growth between 1977 and 1978 needs to be seen in the light of two factors that significantly affect, though in opposite directions, the totals for the two years shown in the following table. On the one hand, the slowdown in 1978 is overstated by an accounting change in Saudi Arabia which had the effect of removing $5.3 billion from that country's reported reserves. On the other hand, valuation changes arising out of the depreciation of the US dollar may be estimated to have inflated the 1978 figures for non-dollar reserves by about $10 billion, or by nearly $4 billion more than in the previous year. Excluding the effects of these two factors, the growth of global reserves may be estimated to have declined from $54.2 billion in 1977 to $34.4 billion in 1978 or, in percentage terms, from

Changes in global reserves, 1976–78.*

Areas and periods	Gold	Foreign exchange	IMF reserve positions	SDRs	Total
	In millions of US dollars				
Group of Ten + Switzerland					
1976	− 260	5,870	4,345	15	9,970
1977	1,840	34,280	1,095	− 265	36,950
1978	2,715	34,890	− 2,590	− 50	34,965
Amounts outstanding at end-1978	*38,110*	*140,030*	*11,225*	*7,460*	*196,825*
Other developed countries					
1976	− 240	550	400	− 125	585
1977	− 45	1,805	15	− 20	1,755
1978	225	10,980	320	275	11,800
Amounts outstanding at end-1978	*4,145*	*34,320*	*1,395*	*990*	*40,850*
Developing countries other than oil-exporting countries					
1976	− 90	11,025	− 135	− 110	10,690
1977	195	10,640	50	25	10,910
1978	285	11,710	395	280	12,670
Amounts outstanding at end-1978	*2,495*	*57,230*	*925*	*1,445*	*62,095*
Total oil-importing countries					
1976	− 590	17,445	4,610	− 220	21,245
1977	1,990	46,725	1,160	− 260	49,615
1978	3,225	57,580	− 1,875	505	59,435
Amounts outstanding at end-1978	*44,750*	*231,580*	*13,545*	*9,895*	*299,770*
Oil-exporting countries					
1976	75	8,000	1,220	15	9,310
1977	− 40	10,595	205	85	10,845
1978	190	−14,615	− 770	185	−15,010
Amounts outstanding at end-1978	*1,680*	*55,030*	*5,785*	*670*	*63,165*
All countries					
1976	− 515	25,445	5,830	− 205	30,555
1977	1,950	57,320	1,365	− 175	60,460
1978	3,415	42,965	− 2,645	690	44,425
Amounts outstanding at end-1978	*46,430*	*286,610*	*19,330*	*10,565*	*362,935*

* Including valuation changes.

21 to 13 per cent. It may be added that even these adjusted figures understate the degree to which reserve ease increased during both 1977 and 1978, as well as overstating the contrast between the two years, since the gold element in reserves is calculated on the basis of a constant SDR value for gold. Valuing gold reserves at market prices — which went up strongly in both years — would add $29.1 billion to the expansion of global reserves in dollar terms in 1977 and no less than $59.8 billion in 1978.

More significant than the change in the pace of reserve growth were the shifts in its distribution among the main groups of countries shown in the table. Perhaps the most striking of these developments was the $15 billion decline in the oil-exporting countries' total reserves. Even allowing for the effects of the Saudi Arabian accounting change referred to above, this contrasted sharply with the $10.8 billion increase in these countries' reserves during 1977.

In the oil-importing world total reserves increased even faster than before, by $59.4 billion, following a rise of $49.6 billion in 1977. And the distribution of these gains was in a number of respects quite different. In the first place they were much more concentrated on the three principal surplus countries. Germany, Japan and Switzerland added $31.6 billion to their reserves, thus accounting for over half of the oil-importing countries' total reserve gains. In 1977 the combined reserves of these three countries had gone up by $12.4 billion. Since these countries' reserve accruals did not ease any external constraints on their domestic policies but rather induced them to follow monetary policies which they would not have adopted on purely domestic grounds, the "unwanted" component in global reserve growth may be said to have been much larger last year than in 1977.

A further sharp contrast with 1977 was seen in the evolution of other Group of Ten countries' reserves. They increased by only $3.4 billion, less than one-seventh of the 1977 figure. This was essentially attributable to the United Kingdom, whose reserves, after a $16.8 billion increase in 1977, were allowed to decline by $4 billion in 1978, a movement which mainly reflected repayments of external debt. On the other hand, a considerable improvement in their underlying balance-of-payments position permitted the developed countries outside the Group of Ten to build up their reserve positions substantially for the first time since the 1973 oil crisis. Their official assets, which at the end of 1977 had still stood $2.6 billion below their end-1973 level, rose by $11.8 billion, or 41 per cent.

Non-oil developing countries represented an element of continuity in 1978 reserve growth. Notwithstanding a considerable deterioration in their combined current-account balance, their official reserves rose by $12.7 billion, which was rather more than in either of the two preceding years. Thus, these countries' gross reserves have more than doubled since the end of 1975. The main factor which made the 1978 rise possible was greater recourse to credit from the international banking sector; moreover, to the extent that these countries' borrowings were not effected in the United States, they helped to keep down reserve accruals in the industrial countries.

Turning to developments in individual countries, the decline in oil-exporting countries' reserves was fairly broadly spread. Even Saudi Arabia's holdings, excluding the accounting change, showed a decline of $5.3 billion, In relative terms, the sharpest decreases in this group were shown by Nigeria, whose reserves dropped from $4.3 to 1.9 billion, and by Venezuela, whose holdings went down by about 20 per cent. The only oil-exporting countries whose reserves showed a significant increase were Algeria, and Trinidad and Tobago.

In the non-oil developing world the Latin American countries, which were also by far the largest borrowers in the international banking sector, accounted for $7.6 billion, or 60 per cent., of the combined reserve increase. Brazil ($3.9 billion), Argentina ($1.8 billion), Chile ($0.7 billion) and Colombia ($0.6 billion) registered the largest gains. Official reserves of Asian developing countries rose by $4.1 billion, with India ($1.6 billion) and Singapore ($1.3 billion) the largest participants in this increase.

The very substantial reserve gains of developed countries outside the Group of Ten and Switzerland were widely spread. Spain ($4.2 billion), Austria ($1.8 billion), Denmark ($1.5 billion), Israel ($1.1 billion), Finland and Norway ($0.7 billion each) registered the largest increases.

Within the Group of Ten, by far the largest reserve accruals were, of course, registered by Germany ($13.7 billion), Japan ($10.2 billion) and Switzerland ($7.7 billion). On the other hand, substantial declines in their official holdings were recorded by the United Kingdom (see page 155 above) and the Netherlands ($0.5 billion). The dollar value of the United States' official reserve assets showed a marginal rise of $0.2 billion. Its IMF reserve position and SDR holdings went down by $5 billion, but this was rather more than offset by the increase, from near zero to $4.4 billion, in its exchange reserves resulting from official foreign currency borrowing, and by a $0.8 billion increase in the dollar value (at SDR 35 per ounce) of its gold reserves due to the depreciation of the dollar against the SDR.

Turning to the asset composition of last year's reserve growth, to an even greater extent than in the past few years it took the form of additions to official holdings of foreign exchange. The reported increase in foreign exchange reserves accounted for just on $43 billion (including valuation changes of $4.6 billion) of the global reserve growth of $44.4 billion. By type of investment, there were two main features of last year's rise in total exchange reserves: a larger proportion was placed in dollars in the United States; but at the same time nearly the whole of the increase in reserves held outside the United States was in currencies other than the dollar. These developments can best be seen by taking the total growth of exchange reserves in 1978 to be $48.3 billion, i.e. by including that part of Saudi Arabia's official exchange holdings which was removed, as a result of the accounting change already referred to, from that country's reported reserves.

On this basis, $30.2 billion of the adjusted figure of $48.3 billion for the 1978 growth of total exchange reserves was invested in dollars in the United States, as against $34.1 billion of the 1977 rise of $57.3 billion. Outside the United States, identified official deposits in the Euro-currency market rose by $10.3 billion, about the same as in 1977. After rising by $2.6 billion in 1977, identified official holdings of non-dollar currencies in their national markets went up by $6.4 billion, of which the increase in US exchange reserves accounted for $4.4 billion. Moreover, almost all of the identified increase of about $10 billion in official Euro-currency deposits last year would seem to have been in currencies other than the dollar, notably the Deutsche Mark, the Swiss franc and the yen, but with smaller increases in official holdings of a number of other currencies. In other words, nearly all of the $16.7 billion identified increase in exchange reserves held outside the United States appears to have been in currencies other than the dollar. Leaving out of account the increase in the exchange reserves of the United States, the remaining $12.3 billion growth in non-dollar exchange reserves was accounted for mainly by non-Group of Ten countries and must have constituted a very large proportion of the total expansion of $13.4 billion in those countries' official holdings of foreign exchange. This diversification of exchange reserves added at the same time to the growth of total reserves, since the surplus countries which supplied their currencies to the rest of the world did so against an increase in their own dollar reserves.

As regards other types of reserve asset, their total increased during 1978 by only $1.5 billion. Indeed, if valuation changes are excluded, there was actually a decline of $4 billion. Total official gold reserves went up by $3.4 billion in 1978, of which valuation changes accounted for $3.1 billion. In volume terms the increase amounted to 202 tons, or $0.3 billion. The principal factors affecting countries' gold reserves last year were transfers of 233 tons from the International Monetary Fund, of which 190 tons under the Fund's gold restitution programme and the remainder in the form of sales to developing countries; a transfer of 65 tons of gold not previously included in Japan's gold reserves from the Japanese Finance Ministry to the Bank of Japan; and market sales of 126 and 62 tons respectively by the US Treasury and the Bank of Portugal.

Countries' total IMF reserve positions went down by $2.6 billion last year, their first decline since 1972. Excluding valuation changes the decrease came to $4.2 billion. This development reflected in part a reduction in total net Fund credit outstanding and partly the fact that a substantial proportion of last year's repayments to the Fund reduced the net debtor positions of the countries in question rather than rebuilding their Fund reserve positions, which remained at zero.

In SDR terms repurchases by Fund members during 1978 amounted to SDR 4.8 billion, and new drawings to SDR 3.7 billion. The largest single repurchases were those of the United Kingdom (SDR 1.5 billion) and Italy (SDR 1 billion), while in addition non-oil developing countries repurchased a total of SDR 1.6 billion. On the drawings side, the largest transaction was the SDR 2.3 billion drawing by the United States in November 1978, with most of the remainder being accounted for by total new drawings of nearly SDR 1 billion by non-oil developing countries.

The dollar value of countries' total SDR holdings rose by $0.7 billion during 1978; excluding valuation effects, however, they showed no change. It may be added that the total of SDRs voluntarily transferred between Fund members rose between 1977 and 1978 from SDR 0.7 to 1.8 billion, including transfers from the United States to Germany and Japan of SDR 0.6 and 0.5 billion respectively in November 1978.

Mention may also be made of various developments during the period under review which increased, or will subsequently increase, the Fund's resources very substantially. The sixth general increase in Fund quotas, which raised their total from SDR 29.2 to 39 billion, came into effect in March 1978; the seventh general review of Fund quotas ended in December 1978 with a decision, which is now in the course of ratification by member governments, to increase Fund quotas by a further 50 per cent. to SDR 58.6 billion; and in February 1979 the SDR 7.8 billion supplementary financing facility, established for the benefit of countries with payments imbalances that are large in relation to their quotas and that require relatively long periods for their correction, came into operation.

Finally, the membership of the Fund decided in December 1978 on an SDR 4 billion a year allocation of special drawing rights for the years 1979–81. The first allocation took place in January 1979.

In the early months of 1979 the growth of global reserves seems to have slowed down considerably. As confidence in the dollar strengthened, the hot money flows which had inflated the reserves of Germany, Japan and Switzerland at various times during 1978 began to be reversed, and these three countries' combined reserves declined during the first four months of 1979 by $16.3 billion. In the rest of the Group of Ten reserves increased by $8.2 billion. US reserves went up by $2.8 billion, largely as a result of additional borrowing by the US Treasury in foreign capital markets. Sizable gains were also registered by Italy, the United Kingdom and France.

The present position with regard to international liquidity.

The rapid growth of global reserves in recent years has given rise to concern that the present level of international liquidity could refuel inflation in the world economy. On the face of it, these fears might seem to have been already validated by the sharp upturn in international raw-material prices and the renewed strength of domestic inflation rates. Is this quickening of price increases merely coincidental? Or is the present level of reserves already exerting unduly expansionary influences, which could become more pronounced if there is a more general return towards full-employment conditions in the industrialised world?

The $363 billion total of reported reserves at the end of 1978 that is shown in the table on page 154 was, in fact, roughly double the corresponding figure of $183 billion for the end of 1973. There are two reasons why the growth of the global reserve figure since end-1973 has, in itself, been giving rise to concern: first, that it followed an expansion of total reserves during the four preceding years which was in relative terms, at 133 per cent., even more rapid; secondly, that in the course of the last five years the rate of reserve growth has been accelerating, from an annual average of about $25 billion during 1974–76 to one of over $50 billion during 1977–78.

The global reserve figures by themselves, however, do not tell the whole story. They can only be assessed in the light of certain other factors, including the country distribution of the increase and the sources from which it originated. As regards the first of these factors, whereas during 1974–75 reserve growth essentially reflected the payments surplus of the oil-exporting countries, the table on page 154 shows that during the past three years the gross reserves of oil-importing countries have gone up by $130 billion to just on $300 billion. As regards the sources of reserve growth, during 1977–78 the current payments deficit of the United States, plus the total of net direct investment by the United States in the rest of the world, amounted to about $50 billion, after a small surplus for the years 1974–76. This means that, in contrast to 1974–76, about half of the 1977–78 reserve growth has come from sources which add to net liquidity in the rest of the world, without any counterpart in increased external indebtedness. It is above all this increase in the reserves of oil-importing countries, and the extent to which it has been fuelled by the basic deficit on the US balance of payments, that is at the centre of present concerns. How do these increases look when they are considered by groups of oil-importing countries?

The group that has recorded the strongest relative increase in gross reserves over the last three years — amounting to 123 per cent. — is that of the non-oil developing countries. However, this followed upon two years of near-stagnation, so that these countries' reserves declined between end-1973 and end-1978 from 37 to 34 per cent. of their total imports. At the same time they experienced a rapid growth of external indebtedness. Identified gross liabilities of non-oil developing countries to the international banking sector alone rose by $85 billion. As a result, their debt-service obligations, whether in relation to exports, to gross national product or to reserves, have shown a marked increase. In other words, while the reserve position of this group of countries has certainly eased since 1975, it has done so from a low starting-point and by very much less than the increase in external indebtedness since end-1973.

What is true of the non-oil developing countries applies also to the developed countries outside the Group of Ten. These countries' overall reserve/import ratio at the end of last year was no higher than that of the non-oil LDCs, and 14 percentage points below its end-1973 level. Moreover, the $11.8 billion expansion of these countries' gross reserve positions last year was the first of any size since the 1973 oil price increases and was much smaller than the rise in their external indebtedness over the past five years.

There remain for consideration the Group of Ten countries, including Switzerland but excluding the United States which, because of the reserve rôle of the dollar, is a case apart. In this group it is necessary to distinguish between the three countries with very strong balance-of-payments positions, i.e. Germany, Japan and Switzerland, and the other seven. The situation of the latter countries may be compared with that of the non-Group of Ten developed countries. The only year since 1973 when their combined reserves rose substantially was 1977, when they registered gains of some $23 billion; consequently, their combined reserve/import ratio has declined over the past five years from 22 to under 18 per cent., easily the lowest figure for any group of countries. For them, too, the increase in official reserves has, except in Belgium-Luxembourg and the Netherlands, been accompanied by equivalent, or in some cases much greater, additions to external indebtedness.

Turning to the three principal current-account surplus countries in the oil-importing world, i.e. Germany, Japan and Switzerland, they are the only group where there is clearly an abundance of international reserves and where there are no external constraints, either actual or potential, on domestic economic growth. A very substantial proportion of these countries' 1977–78 reserve accruals, however, did not come from surpluses in their basic balances of payments, but was "borrowed" and "temporary" in the sense that it had as a counterpart hot money inflows stemming from lack of confidence in the dollar. More recently these inflows and the associated reserve increases were in part reversed, with the result that during the first four months of 1979 these three countries' combined reserves went down by over $16 billion.

What are the conclusions to be drawn from this survey of global reserve developments in recent years? First, that the acceleration of global reserve growth during 1977–78 has certainly been associated with a rather widespread increase in reserve ease in the oil-importing countries outside the United States. Secondly, that this greater reserve ease has come in large measure from the basic deficit in the US balance of payments. Thirdly, that these developments still left oil-importing countries, with few exceptions, in a less comfortable reserve position, in relation both to imports and external indebtedness, than at the end of 1973. What of the few countries — principally the three members of the Group of Ten that have been running large and persistent payments surpluses — that constitute the exceptions to this general statement? Are their reserves an inflationary threat to the monetary system? Two considerations are particularly relevant in this connection: first, the constant exhortations to these countries to increase their spending on imports do not suggest that the rest of the world has felt threatened with inflation from that source; secondly, the recent strengthening of the dollar has, as already indicated, enabled these countries to reduce the additions to their reserves and their domestic money supplies which came from speculative capital inflows and which, for a time late last year, seemed to be a possible inflationary threat to their economies.

In general, therefore, the rapid increase in oil-importing countries' reserves since 1975 does not appear to have produced a situation of excessive reserve ease in these countries. It may be added, however, that reserve ease has increased by more than can be seen from the reserve statistics. This is partly because of the rapid rise in the market price of gold, which has certainly had an effect on the reserve positions of the main gold-holding countries. In addition, external constraints on domestic policies depend on the degree of availability of credit, as well as on the level of reserves, and very favourable conditions for borrowers have emerged in the international market for bank credit during the past two years, owing to the combination of the US payments deficit, the shrinking of oil-related payments deficits outside the United States and relatively weak domestic demand for credit in a number of industrial countries. Moreover, looking to the future, if reserve growth were to continue at the rates seen in 1977 and 1978, and for the same reasons, and if the borrowers' market for bank credit were to persist, there could indeed be cause for concern about the level of international liquidity. The return of confidence in the dollar has already, through its effects on international capital movements, slowed down the growth of global reserves. And the most important single prerequisite for avoiding a situation of excess liquidity in the future is certainly the maintenance of confidence in the dollar, based on a stronger underlying US balance-of-payments position.

Problems could also arise if the asset composition of reserves were significantly out of line with holders' preferences. If, for example, countries suddenly wanted — as happened to some extent last year — to reduce the dollar component in their reserves, this would tend to induce additional capital outflows from the United States, with liquidity-creating effects in the rest of the world and destabilising effects on exchange rates. Such shifts in preferences are not unrelated to US economic policies and to the state of the US balance of payments. In other words, the stability of the asset composition of global reserves, as well as their overall rate of growth, is closely related to the policies of the US Government.

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. 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 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 the groundwork for the monthly meetings of the Governors; a group specialising in matters relating to foreign exchange markets and intervention policies on these markets (this group, which since the beginning of 1976 has on occasion been confined to representatives from the EEC countries and at other times been extended to include participants from other industrialised countries, generally members of the Group of Ten, carries out in particular a monthly examination of the working of the concertation procedure among the central banks); a group commissioned to examine, at least twice yearly, the monetary situation in member countries and the problems raised by the co-ordination, on a Community scale, of national monetary policies; and a group entrusted with the task of promoting 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).

These committees and groups were exceptionally active in 1978–79 owing to the large amount of work associated with the establishment of the European Monetary System. Following the decision taken by the Heads of State and Government of the EEC countries at the beginning of July 1978 to create a monetary system leading to a zone of stability in Europe, the Committee of Governors and the Board of Governors of the European Monetary Co-operation Fund, whose competence and functions are closely related and complementary, intensified their deliberations with a view to finalising, within the space of a few months, the agreements and decisions laying down the operating procedures for the European Monetary System and the necessary adjustments to the reciprocal short-term credit arrangements. The preparatory work, which was carried out mainly by the Governors' Alternates and by the group of foreign exchange experts referred to in the previous paragraph, required a very large number of meetings, the majority of which were held in Basle.

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. It also participated as an observer at meetings of the Finance Ministers and central-bank Governors of the Group of Ten countries and Switzerland, and of their Deputies. Furthermore, the Bank continued to perform the functions entrusted to it in August 1964 by the Ministers and Governors of the Group of Ten countries and Switzerland 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 and Switzerland. 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, in particular providing the Secretariat for the Committee on Banking Regulations and Supervisory Practices established by the central-bank Governors of the Group of Ten countries in December 1974. In addition, the Bank prepared a "Manual on Statistics compiled by International Organisations on Countries' External Indebtedness" at the request of the central-bank Governors of the Group of Ten countries and Switzerland, and with the help of the other organisations concerned.

Finally, the Bank continued to provide the Secretariat for the Group of Computer Experts of the central banks of the Group of Ten countries and Switzerland. During the year the Group reviewed the computer applications introduced by each of its members and drew up an inventory of the software and hardware involved. The main focus of its efforts, however, was a broad analysis of the funds transfer systems in use in the major countries and an attempt to determine their likely development, notably in the light of the latest technological advances and the financial sector's assessment of the status quo. In this context the work of the International Standards Organisation in the area of message transmission continued to be followed with interest. The planning and development of the data bank for the BIS and the Group of Ten central banks have continued so that, once it has been transferred to the Bank's own premises during the final quarter of 1979, it will provide a means for the rapid exchange of monetary and economic time series among the institutions concerned.

2. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1979, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

* * *

* In this chapter the term "francs" (abbreviated to F) signifies *gold* francs, except where otherwise indicated. The gold franc is the equivalent of 0.290 322 58... grammes fine gold — Article 4 of the Statutes. Assets and liabilities in US dollars are converted on the basis of 1 gold franc = US $ 0.394 1...; all other items in currencies are converted at central or market rates against the US dollar.

At 31st March 1979 the balance-sheet total moved above the 70 billion franc mark for the first time, to stand at F 70,408,614,197
against, on 31st March 1978, F 59,334,066,542

It thus registered an increase of F 11,074,547,655
or 18.7 per cent., which is somewhat larger than that recorded in the previous financial year (10,488 million) in absolute terms, though smaller in relative terms (21.5 per cent.).

It may be noted that on this occasion the rise in the gold franc value of certain currencies accounted for only a small part of the increase in the balance-sheet total; the currencies principally involved were the Deutsche Mark, as a result of the upward adjustment of its central rate within the Community "snake" mechanism in October 1978, and also the Swiss franc.

The total of the monthly statement of account recorded only a slow overall increase between April and the end of November 1978, with fairly sharp fluctuations in both directions; thereafter the rise was steady and much more pronounced.

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
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*
1978	59,334	+10,488	+ *22*
1979	70,409	+11,075	+ *19*

The following 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) accounting entries arising from the Bank's functions as Agent for the European Monetary Co-operation Fund in connection with Community borrowing and lending and with the European Monetary System;

(iv) gold under earmark held by the BIS for the account of depositors; this item amounted to 1,020 million francs on 31st March 1979, against 1,018 million on 31st March 1978.

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			
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
1978*	1,493	57,150	691	59,334
1979*	1,634	67,967	808	70,409

* After allocation of the net profit for the year as proposed to the Annual General Meeting.

A. Capital, reserves 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 1978–79 F 576,247,193

This compares with 519.8 million francs on 31st March 1978; the difference of 56.4 million francs represents 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*

after allocation of the net profit for 1978–79 F 83,175,781

This compares with 75.2 million francs on 31st March 1978 and includes the proposed transfer of 8 million from the net profit; the amount of this Reserve Fund will accordingly be slightly higher than the gold franc equivalent of a dividend of Sw.fr. 110 per share (see item (d) below), calculated on the basis of the Swiss franc's value on 31st March 1979.

(4) *Free Reserve Fund*

after allocation of the net profit for 1978–79 F 643,718,200

This compares with 567.1 million francs on 31st March 1978, the amount it is proposed to transfer to this Fund from the net profit being 76.6 million francs.

The Bank's overall reserves after allocation of the net profit for 1978–79 thus stand at F 1,333,211,487
against 1,192.2 million francs at the beginning of the financial year, giving an increase of 141 million; it may be recalled that the rise in the overall reserves amounted to 120 million in each of the two preceding financial years, 1976–77 and 1977–78.

(c) The item "Miscellaneous" rose to F 728,127,378
from 595.4 million francs, an increase of 132.7 million; it should be noted that this item now includes the Provision for Building Purposes, which since 31st March 1967 had been recorded separately.

(d) Profit and Loss Account, *before* allocation F 220,576,151

This figure represents the net profit for the financial year 1978–79; it is 29.5 million francs higher than the net profit for the preceding financial year, which — at 191.1 million — had already been 23.2 million higher than that for the financial year 1976–77. Details of the proposed allocation of the profit for 1978–79, in accordance with the provisions of Article 51 of the Statutes, are given in Section 7 below; these proposals, to which reference has already been made in connection with the development of the reserves, provide in particular for a sum of 79,576,151 francs — against 71,050,134 francs in the preceding financial year — to be set aside in respect of the dividend of 110 Swiss francs per share to be paid on 1st July 1979; it should be noted that in terms of Swiss francs the amount of the dividend is the same per share as in the previous financial year, while in terms of gold francs it is 12 per cent. higher.

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 1978	1979	Movement
	in millions of francs		
Deposits of central banks	56,360	65,790	+ 9,430
Deposits of other depositors	790	2,177	+ 1,387
Total	57,150	67,967	+ 10,817

The increase in "Deposits of central banks" was again very marked, although in relative terms it was appreciably smaller than that recorded in the previous financial year (9,430 million and 16.7 per cent., against 10,466 million and 22.8 per cent.); it again accrued chiefly in US dollars, a small proportion of which were indexed to the special drawing right; however, deposits in Deutsche Mark also registered a further substantial rise; on the other hand, deposits in Swiss francs declined, despite the above-mentioned increase in the gold franc value of the Swiss franc; fluctuations in deposits in other currencies were small by comparison and offset one another entirely.

Whereas in the previous financial year "Deposits of other depositors" had shown a slight decline, last year they expanded very sharply, with the balance outstanding almost trebling; this movement reflected the receipt of new deposits in US dollars, indexed to the special drawing right, from international institutions; by contrast, the level of deposits in Swiss francs fell somewhat, their appreciation in terms of gold francs being exceeded by net repayments.

For the first time for several years, the preponderance of "Deposits of central banks" in the total of borrowed funds diminished, albeit only slightly; their share fell from 98.6 to 96.8 per cent., while that of "Deposits of other depositors" increased correspondingly.

BIS: Borrowed funds, by nature and term to maturity.

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
	1978	1979		1978	1979		1978	1979	
	in millions of francs								
Sight	3,708	3,941	+ 233	1,235	928	− 307	4,943	4,869	− 74
Not exceeding 3 months	159	49	− 110	37,918	48,797	+ 10,879	38,077	48,846	+ 10,769
Over 3 months	91	9	− 82	14,039	14,243	+ 204	14,130	14,252	+ 122
Total	3,958	3,999	+ 41	53,192	63,968	+ 10,776	57,150	67,967	+ 10,817

As a proportion of total borrowed resources, deposits in currencies continued to rise, moving up from 93.1 to 94.1 per cent., with a corresponding decline in the share of deposits in gold.

In terms of maturity, the share of the total accounted for by time deposits rose from 91.4 to 92.8 per cent., while that of sight deposits showed an equivalent decrease.

(a) Deposits in gold F 3,998,764,421

This figure compares with that of 3,958 million francs at the beginning of the financial year, representing an increase of 41 million, quite appreciably lower than that of 393 million recorded during the previous financial year; the increase in sight deposits was due partly to the receipt of fresh deposits in that form and partly to the reduction in the amounts involved in swaps of gold (received spot) against currencies concluded with central banks, which left on sight deposit with the Bank the gold they received back; the marked decline, particularly in relative terms, in deposits not exceeding three months was attributable to the repayment of maturing time deposits, the opportunities open to the Bank of employing gold held in this form having continued to diminish; the item in respect of deposits with more than three months to maturity was practically liquidated following the repayment at maturity of a deposit that had been placed with the Bank for a fairly long period.

(b) Deposits in currencies F 63,968,231,635

This figure compares with one of 53,192 million francs at 31st March 1978; this item, which is by far the most important on the liabilities side, thus recorded a very large increase, of 10,776 million or 20.3 per cent., broadly comparable with that observed in the previous financial year (9,823 million or 22.7 per cent.); the increase corresponds to that in funds at up to three months, the decline in sight deposits having been on much the same scale as the rise in deposits at over three months.

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				Movement	
	1978		1979			
	in millions of francs					
Sight assets						
Gold	5,069		4,987		− 82	
Currencies	329	5,398	93	5,080	− 236	− 318
Treasury bills						
Currencies		288		1,284		+ 996
Time deposits and advances						
Currencies		50,253		58,677		+ 8,424
Securities at term						
Currencies		2,456		4,258		+ 1,802
Total						
Gold	5,069		4,987		− 82	
Currencies	53,326	58,395	64,312	69,299	+ 10,986	10,904

(a) Gold F 4,986,630,778

This item had amounted to 5,069 million francs at the beginning of the financial year; the slight decline of 82 million in gold holdings was broadly attributable to the repayment of various time deposits that had been placed with the Bank, together with sales concluded by the Bank on the market; these sales followed purchases by the Bank of equivalent weights of gold by means of drawings on gold held on sight account in its books.

On the other hand, it should be mentioned that since June 1978 the Bank's gold holdings have been free of any pledge, whereas at 31st March 1978 — as was indicated at the time in Note 3 to the Balance Sheet — a portion of its holdings, namely 129 million, was still pledged.

(b) Cash on hand and on sight account with banks F 93,015,952

This figure compares with 329 million francs at 31st March 1978; the decline of 236 million was due to the withdrawal of funds that the Bank had received at short notice and which it had been obliged to keep in cash.

(c) Treasury bills F 1,284,678,208

This compares with a figure of 288 million francs at the end of the previous financial year; the increase of 996 million was very marked in both absolute and relative terms, reflecting purchases in September and October of Treasury bills payable to bearer, denominated in US dollars and issued by a foreign government.

(d) Time deposits and advances F 58,676,870,060

This figure compares with one of 50,253 million francs at 31st March 1978; this item, consisting entirely of currencies and by far the most important on the assets side, thus increased by 8,424 million, or by 16.8 per cent., compared with a rise of 9,457 million, or 23.2 per cent., in the previous financial year; as in the case of borrowed funds in currencies referred to above, the increase was primarily in US dollars but also involved Deutsche Mark, whereas assets in Swiss francs declined despite the rise in their gold franc value; it should, however, be noted that, by contrast with the movements recorded on the liabilities side, on the assets side the amounts outstanding in other currencies are larger and additional currencies are included; the reason for this is that, on receiving the above-mentioned deposits in US dollars indexed to the special drawing right, the Bank covered itself — generally spot — and subsequently invested the various currencies it had purchased.

(e) Securities at term F 4,257,798,035

This figure compares with one of 2,456 million francs at 31st March 1978; the marked expansion, of 1,802 million or almost three-quarters, corresponds to certificates of deposit denominated in US dollars and purchased on the US market.

It may be noted that, whereas at the beginning of the financial year this item had accounted for no more than 4.1 per cent. of total assets, by the end of the year it represented 6 per cent.; conversely, the share of the item "Time deposits and advances" slipped back slightly, from 84.7 to 83.3 per cent.

The following table gives a breakdown according to residual term to maturity of investments in time deposits and advances and securities at term.

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

Term	Financial years ended 31st March 1978	1979	Movement
	in millions of francs		
Not exceeding 3 months	33,663	36,208	+ 2,545
Over 3 months	19,046	26,727	+ 7,681
Total	52,709	62,935	+ 10,226

(f) Miscellaneous F 1,109,621,163

This figure compares with 939 million francs at 31st March 1978; as in previous financial years, the increase — of 171 million — was the result of book-keeping adjustments; they were on this occasion associated with the covering transactions, to which reference has already been made, in respect of the funds received in US dollars and indexed to the special drawing right; some of the currencies acquired against US dollars in the course of these operations were converted into gold francs on the basis of their central rates, resulting in temporary book losses; the purpose of the above-mentioned adjustments was to eliminate these "losses", which will be automatically reabsorbed when the SDR-linked deposits are liquidated.

Forward gold operations.

These operations, which are referred to in Note 2 to the Balance Sheet, resulted in a negative net balance (gold payable forward) of F 325,834,663 compared with a negative balance of 449 million at the beginning of the financial year; the contraction — of 123 million — in gold payable forward was due to the reduction in the weights of gold involved in swaps against various currencies concluded with central banks.

The Bank also pursued its traditional activity in the field of gold and foreign exchange operations.

* * *

In general, the Bank's operations expanded further in the course of the financial year 1978–79, though at a slightly less rapid rate than in the previous financial year.

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 Government International Loan 1930 (Young Loan).

The financial year 1978–79 for the Young Loan ended on 1st June 1979. The interest in respect of the financial year 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 1978–79 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 1977–78	1978–79	Balance after redemption
American . . .	$	91,525,000	31,235,000	2,476,000	57,814,000
Belgian	B.fr.	202,894,000	66,498,000	5,026,000	131,370,000
British	£	41,345,000	13,459,000	1,018,000	26,868,000
Dutch	Fl.	52,581,000	16,904,000	1,286,000	34,391,000
French	Fr.fr.	633,024,000	208,703,000	15,744,000	408,577,000
German . . .	DM	14,509,000	4,567,000	350,000	9,592,000
Swedish . . .	S.kr.	126,666,000	41,979,000	3,155,000	81,532,000
Swiss	Sw.fr.	58,393,000	18,719,000	1,428,000	38,246,000

* On the basis of values established by the German Federal Debt Administration for the 1st December 1978 maturity date, following the entry into force on 1st April 1978 of the Second Amendment to the Articles of Agreement of the International Monetary Fund, which abolished par values. These values do not take into account the revaluations of the Deutsche Mark in 1961 and 1969, the subsequent alterations, up to 31st March 1978, in the exchange rates of currencies of issue not involving a formal change in their par values, and thereafter the appreciation of the Deutsche Mark, the Dutch guilder and the Swiss franc in relation to the remaining currencies of issue.

The German Federal Debt Administration (Bundesschuldenverwaltung) informed the Trustee that, following the entry into force on 1st April 1978 of the Second Amendment to the Articles of Agreement of the International Monetary Fund, it had decided to apply the exchange guarantee clause attached to the Young Loan and thenceforth to calculate the amounts due to holders of conversion bonds and related coupons on the basis of Article 13(c) of the London Agreement on German External Debts of 27th February 1953. As from the 1st June 1978 maturity date, amounts payable on conversion bonds and related coupons are thus being established by the German Federal Debt Administration, from case to case, on the basis of the exchange rates of the currencies of issue of the Young Loan ruling on the market on each maturity date. The market due to be selected is that of the "least depreciated" currency of issue within the meaning of Paragraph 2(e) of Section A of Annex I to the London Agreement. Prior to the above-mentioned Amendment the German Federal Debt Administration had maintained that only par values notified to the International Monetary Fund were applicable under the exchange guarantee clause.

On the occasion of the maturities for the Loan of 1st June and 1st December 1978, the Belgian franc was, in the opinion of the German Federal Debt Administration, the "least depreciated currency", and this gave rise to a substantial upward adjustment in the amounts due to bondholders of the American, British, French and Swedish issues on 1st June 1978, and to a further small adjustment for bondholders of the American issue on 1st December 1978.

The Trustee, while welcoming the decision of the Federal Debt Administration to recalculate the amounts due to bondholders as from 1st June 1978, is nevertheless of the opinion that an adjustment should already have been made, so far as de facto depreciations of currencies are concerned, to compensate the bondholders of issues whose currency of payment has progressively depreciated in value since 1971. This question, as well as the wider one of whether de facto appreciations of currencies should similarly give rise to application of the exchange guarantee, has been brought to the attention of the governments of the countries in which issues of the Loan were made and the Trustee has requested them to take the matter up and do everything to ensure that an appropriate solution is reached.

The question whether the exchange guarantee 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 London Agreement. The final oral stage of these proceedings took place in March 1979, and the decision of the Arbitral Tribunal is expected to be delivered before the end of the current year. The Trustee hopes that this decision will pave the way for resolution of the questions still outstanding.

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 redeemed in respect of the financial years 1959 to 1977	Bonds redeemed in respect of the financial years 1978	Balance after redemption
American	$	1,667,000	1,524,000	143,000	—
Anglo-Dutch	£	856,600	801,700	54,900	—
Swiss	Sw.fr.	7,102,000	6,034,000	457,000	611,000

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 1978–79 the amounts received by the Bank for the service of the secured loans came to the equivalent of about 4 million francs in respect of interest and about 35 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 46 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 1979	Rates of interest %	Year of final maturity or redemption
1st	1954	United States	US Government	$	100,000,000	6,600,000	3⅞	1979
2nd	1955	Belgium	Caisse Générale d'Epargne et de Retraite, Brussels	B.fr.	200,000,000	45,600,000	3½	1982
3rd	1955	Germany	Westdeutsche Landesbank Girozentrale, Düsseldorf[1]	DM	50,000,000	3,970,050	3¾	1981
4th	1955	Luxembourg	Caisse d'Epargne de l'Etat, Luxembourg	B.fr.	20,000,000	4,560,000	3½	1982
				L.fr.	5,000,000	—	3½	1961
5th	1956	Saar	Landesbank Saar Girozentrale, Saarbrücken	DM	2,977,450[2]	—	4¼	1977
6th	1956	Switzerland	Public issue	Sw.fr.	50,000,000	—	4¼	1974
7th			Public issue	$	25,000,000	—	5½	1975
8th	1957	United States	Public issue	$	7,000,000	—	5	1962
9th			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	28,329,938	5⅝	1982
11th	1958	United States	Public issue	$	35,000,000	—	5	1978
12th			Public issue	$	15,000,000	—	4½	1963
13th	1960	United States	Public issue	$	25,000,000	3,550,000	5⅜	1980
14th			Public issue	$	3,300,000	—	4¾	1963
				$	3,300,000	—	4⅞	1964
				$	3,400,000	—	5	1965
15th	1961	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	45,714,770	5¼	1986
16th	1961	Netherlands	Public issue	Fl.	50,000,000	9,800,000	4½	1981

[1] The original lenders, Rheinische Girozentrale und Provinzialbank and Landesbank für Westfalen Girozentrale, were merged on 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 was set up on 6th April 1973 by the member states of the European Economic Community to administer the Community exchange rate, or "snake", arrangement introduced in April 1972 and the reciprocal credit facilities already in existence or established in connection with the "snake". These activities were extended with the conclusion, in March and April 1976, of the first Community borrowing operations, the administration of which was entrusted to the Fund, and, in particular, with the introduction of the European Monetary System (EMS) which superseded the "snake" mechanism on 13th March 1979. Details of the EMS are contained in Chapter VII, pages 144–148.

As the Fund's technical Agent, the Bank performs two main sets of functions: on the one hand, those connected with the operation of the "snake", the short-term reciprocal credit facilities and, since March 1979, the European Monetary System; and, on the other, those relating to the execution of financial operations in connection with Community borrowing and lending.

In the first case, the Bank's rôle consists principally in the following:

(1) It keeps the Fund's accounts and records therein:

- the debts and claims vis-à-vis the Fund of the EEC central banks participating in the "snake" arrangement and, since 13th March 1979, in the EMS, which arise from interventions carried out by those central banks in member countries' currencies and which are reported to the Agent;

- the immediate or periodic settlement of these very short-term debts and claims.

During the financial year 1978–79 the number and volume of accounting operations varied considerably in line with the situation on the foreign exchange markets of the EEC countries participating in the "snake". The last debts and claims in connection with this arrangement were settled at the end of May 1979.

Operations carried out in the context of the short-term monetary support arrangements are also entered in the Fund's books; operations of this kind were effected 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, which was repaid in full in the autumn of 1978.

(2) Under the EMS the Bank carries out operations associated with the creation, utilisation and remuneration of European Currency Units (ECUs), namely:

- concluding, in the name and for the account of the Fund, swap operations with each of the EEC central banks participating in the new exchange rate mechanism, involving, on the spot side, the transfer of ECUs to the institutions in question against the transfer by them of 20 per cent. of their gross gold and dollar reserves. These swap operations are renewable every three months, when the necessary adjustments will be made, firstly, to ensure that each central bank's contribution to the Fund continues to represent at least 20 per cent. of its gross gold and dollar reserve holdings immediately prior to the renewal date and, secondly, in order to take account of changes in the price of gold or in dollar rates;

- in the name of the Fund, entrusting the respective central banks with the management of the gold and dollar assets they have transferred to the Fund;

- effecting transfers of ECUs between the central banks' "ECU reserves" accounts, in particular in respect of the settlement of debts and claims arising from interventions under the EMS exchange rate mechanism and of the payment of interest calculated on the central banks' net positions in ECUs.

In its function as Agent of the Fund for the administration of borrowing and lending operations concluded by the Community in accordance with the Regulations adopted by the Council of the European Communities in February 1975, 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.

During the financial year 1978–79 the financial operations carried out by the Bank in its capacity as Agent for the Fund related solely to the payment of interest and commission. At 31st March 1979 it was administering a total of seven loan operations, amounting to US$1.6 billion and DM 0.5 billion, approximately five-sixths of the proceeds of which had been lent to Italy and the remainder to Ireland. All the borrowing and corresponding lending contracts carry a fixed rate of interest varying between 7¼ and 8¼ per cent. according to the term of the loan (over five years on average), the currency of issue and the date of conclusion of the contract.

6. Termination of the OECD Exchange Guarantee Agreement.

The Agreement concerning an Exchange Guarantee, in which eighteen member central banks of the Organisation for Economic Co-operation and Development participated, came into force on 1st January 1973, immediately following the termination of the European Monetary Agreement. Its purpose was to provide for an exchange guarantee to cover amounts held as working balances by a central bank on account with another participating central bank in the latter's national currency. The Agreement was established for an initial period of three years and was operated by the OECD. A Committee for Monetary and Foreign Exchange Matters was set up to supervise its implementation and the Bank acted as Agent in connection with its application.

During the first three years of the Agreement's existence there was only one occasion on which compensation payments were made, owing to the devaluation of a number of currencies in February 1973. As a result of a general review of the Agreement in 1975 it was concluded that the arrangements had little practical value under the system of floating rates, but it was decided to prolong the Agreement for a period of three years, from 1st January 1976 to 31st December 1978. The meetings of the Committee for Monetary and Foreign Exchange Matters were held on an ad hoc basis.

The Agreement was never activated during this period and it was decided to terminate it on 31st December 1978. The participating central banks agreed that any balances outstanding under the arrangements were to be settled without compensation.

With the termination of the Exchange Guarantee Agreement the Bank's functions as Agent also came to an end.

7. Net profits and their distribution.

The accounts for the forty-ninth financial year ended 31st March 1979 show a net operating surplus of 222,292,209 francs, compared with 204,477,506 francs for the preceding financial year and 175,776,466 francs for the financial year 1976–77. The increase recorded in the year under review reflects the considerably greater volume of the Bank's operations during this period, partially offset by a rise in the level of the Bank's costs of administration.

The Board of Directors has decided to transfer 1,716,058 francs to the Provision for Exceptional Costs of Administration. As a result of this transfer the net profit amounts to 220,576,151 francs, against 191,050,134 francs for the previous financial year and 167,920,050 francs for the financial year 1976–77. The allocation of the net profit is governed by Article 51 of the Statutes.

On the basis of this Article, the Board of Directors recommends that the net profit of 220,576,151 francs be applied by the General Meeting in the following manner:

(i) an amount of 79,576,151 francs in payment of a dividend of 110 Swiss francs per share;

(ii) an amount of 56,400,000 francs to be transferred to the General Reserve Fund;

(iii) an amount of 8,000,000 francs to be transferred to the Special Dividend Reserve Fund; and finally

(iv) an amount of 76,600,000 francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose which is in conformity with the Statutes.

The increase in the gold franc amount of the dividend this year as compared with last year reflects the appreciation of the Swiss franc in terms of gold francs.

If the above proposals are accepted, the dividend will be paid on 1st July 1979 to the shareholders whose names are contained in the Bank's share register on 20th June 1979.

The Balance Sheet, the Profit and Loss Account, and a summary statement 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, on the basis described in Note 1, a true and fair view of the state of the Bank's affairs at 31st March 1979 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.

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

On 16th January 1979 the Bank suffered a grievous loss in the death of M. Henri Deroy. M. Deroy had been a member of the Board for nearly thirty-one years and had served as its Vice-Chairman since 1st November 1970. At the meeting of the Board held on 13th February 1979 the Chairman recalled M. Deroy's remarkable professional and human qualities and his outstanding contribution to the work of the Bank throughout an exceptionally long term of office.

* * *

Baron Ansiaux, whose mandate as a member of the Board was due to expire on 7th August 1978, was re-appointed under Article 27(2) of the Statutes by M. de Strycker, Governor of the National Bank of Belgium, at the meeting of the Board held on 11th July 1978.

At the same meeting the Chairman announced that Dr. Mario Ercolani would soon relinquish his appointment as Alternate to Prof. Baffi. The Chairman expressed the Bank's appreciation of Dr. Ercolani's valuable services.

The mandate of Dr. Antonino Occhiuto as a member of the Board was due to expire on 7th November 1978. He was re-appointed under Article 27(2) of the Statutes by Prof. Baffi, Governor of the Bank of Italy, at the meeting of the Board held on 12th September 1978.

The Chairman informed the Board at the same meeting that Prof. Baffi had appointed Dr. Mario Sarcinelli to act as his Alternate in place of Dr. Ercolani.

In December 1978 Dr. Johann Schöllhorn, whose mandate as a member of the Board was due to expire on 31st December 1978, was re-appointed under Article 27(2) of the Statutes by Dr. Emminger, President of the Deutsche Bundesbank.

The mandate of Dr. Jelle Zijlstra, who had been elected to the Board under Article 27(3) of the Statutes, was due to expire on 31st March 1979. He was re-elected at the meeting of the Board held on 13th March 1979.

At the same meeting Lord O'Brien of Lothbury was elected Vice-Chairman of the Board for a period of three years from 1st March 1979 to the end of February 1982.

* * *

The sudden death of Mr. Dennis H. Stapleton on 11th October 1978 represented a great loss for the Bank. Mr. Stapleton, who had joined the Bank's Legal Service in July 1950, had been promoted to the rank of Deputy Manager on 1st December 1968 and given responsibility for the administrative work of the Bank. He had also been accorded the personal title of Deputy Secretary General on 1st January 1973. A tribute to Mr. Stapleton's very valuable and faithful services to the Bank was paid to him by the Chairman at the meeting of the Board held on 14th November 1978.

Dr. Antonio d'Aroma, who had been Secretary General of the Bank from 1st January 1962 until 31st December 1974, Assistant General Manager from 1st January 1975 until 31st December 1977 and Special Counsellor since 1st January 1978, retired at the end of September 1978. At the meeting of the Board held on 12th September 1978 the Chairman expressed to Dr. d'Aroma the gratitude of all members of the Board and their sincere appreciation of the outstanding qualities that he had shown in carrying out his important functions.

On 30th June 1978 M. Charles Altenhoff, Assistant Manager in the Banking Department, retired after almost twenty-four years of valuable and devoted service.

The Chairman announced at the Board meeting held on 13th March 1979 that the Bank had decided to promote Herr J. Mix and Dr. H.W. Mayer to the rank of Assistant Manager as from 1st April 1979.

* * *

It was with deep regret that the Bank learned of the death of Dr. Antonio Rainoni on 7th December 1978. Dr. Rainoni, who had joined the Bank in 1946, had been a Manager in the Monetary and Economic Department from 1965 until his retirement in 1976.

CONCLUSION.

Historical analogies can be a useful device for organising a discussion of policy problems, provided that they are not pushed to the point of becoming misleading. This is a principle worth bearing in mind when there is a strong temptation to draw analogies between the spring of 1979 and the winter of 1973–74. The price of oil has been raised substantially; prices of industrial raw materials, expressed in dollars, have increased by more than one-third in the space of a year; as a result, the terms of trade of industrial countries have deteriorated and their domestic inflation has accelerated; and, last but not least, we have just emerged from a period of acute currency unrest.

But the differences are still great. In 1979 the western industrial world is not standing at the end of a long period of fast expansion culminating in a synchronised cyclical boom; on the contrary, many countries have a serious unemployment problem. As for the international economy, the pattern of external payments has recently begun to move in the right direction, and many large industrial countries are in a much better position to confront the balance-of-payments consequences of an OPEC surplus than they were in 1974. Moreover, we now know from experience that even large current-account imbalances can be financed without too much trouble by the international banking system. On the other hand, the position of the US balance of payments is more precarious in 1979 than it was in 1973–74.

However, despite these marked differences between 1979 and 1973–74, a comparison is justified by the fact that in both periods the fast increase in import prices and the deterioration in terms of trade subjected industrial countries simultaneously to inflationary pressures (in terms of costs), deflationary impulses (in terms of demand) and a loss of real income, although in 1979 all these influences have so far been much weaker than in 1973–74, as have inflationary tendencies of domestic origin — with the significant exception of the United States. The upsurge of commodity prices appears to be due to the acceleration of growth in some European countries at a time when a strong US economy had already boosted demand for industrial raw materials. The increase in the price of oil is of course largely ascribable to the "external shocks" produced by the cut in Iranian supplies and the hard winter, which have again demonstrated how vulnerable the industrial world is made by relying so heavily on imported oil for its energy supplies.

The revival of European growth coming on top of the expansion in North America and Japan is still a far cry from the synchronised boom which occurred in 1972–73. Nevertheless, the western world is now facing policy problems which, though on a smaller scale, are not unlike those stemming from the 1973–74 oil crisis, and this in an environment where inflationary expectations have survived a lengthy period of less-than-full employment, where the acceleration of European growth is very recent and therefore not yet fully confirmed, and where the current account of the major reserve-currency country is still in deficit.

Perhaps the best way of illustrating the international policy dilemma is to outline two extreme scenarios for possible developments in the near future.

In the optimistic scenario the cyclical upswing in the United States dies a natural and gentle death — this is the assumption of a "soft landing". Or we may even assume, more realistically, that the US economy turns into a mild recession. The effects of this on the domestic price level would be felt only gradually; but its impact on the US trade balance and on international commodity prices would be almost instantaneous. The downturn might even have a soothing influence on the effective oil price. These external influences are, in turn, likely to have two important consequences. On the one hand, they would consolidate the dollar's recovery and put an end — certainly for the time being — to attempts to diversify out of the dollar. On the other hand, the tailing-off of the commodity and oil boom would alleviate inflationary pressures of external origin on the rest of the western world and particularly, it is to be hoped, on Germany and Japan — although this dampening effect on import prices might, of course, be partially offset by the persistent strength of the dollar. On balance, both these major countries, which have followed strongly anti-inflationary policies, would feel less inhibited about allowing domestic demand to expand. In highly simplified terms, US-induced world inflation would not "crowd out" Japanese and German growth. By the same token, however, these countries would have to bear a greater responsibility in underwriting a continuation of their expansion. This would be the best of all possible worlds: world inflation would abate, the balance-of-payments adjustment process would not be jeopardised, exchange markets could be kept calm and growth in the western industrial world as a whole would continue at a moderate rate.

In the pessimistic scenario the central assumption is that the cyclical upswing in the United States degenerates into a genuinely "overheated" inflationary boom. On this assumption, domestic prices could be expected to continue rising at a fast pace, the international commodity and oil price boom would persist and the improvement in the US current account would come to a halt or even be reversed. The renewed weakness of the dollar might to some extent insulate the countries with appreciating currencies from the rising dollar prices of commodities. But it is unlikely that such insulation would be fully effective in a climate of world inflation. These countries — especially Japan and Germany — would therefore intensify their restrictive measures in order to prevent the external inflationary impulses from being passed on to the domestic price system, and in so doing they would slow down their own domestic expansion. Japanese and German growth would thus be "crowded out" by US inflation, so that the process of external adjustment which started about a year ago would tend to be reversed. This would be the worst of all possible worlds: renewed currency unrest and international inflation culminating, with the collapse of the protracted US inflationary boom, in a major world recession.

Needless to say, neither of these extreme scenarios is likely to be realised, and, given the unpredictability of short-term cyclical developments in a world that is increasingly subject to "external shocks", it would even be hard to speculate about whether the actual outcome will more closely resemble the first or the second scenario, or whether it will simply combine elements of both. The only merit of this scenario-building exercise is to direct the attention of policy-makers to the desirability of the optimistic scenario and the dangers inherent in the pessimistic one. What should be done to prevent the world from drifting towards the latter rather than evolving towards the former?

Firstly, western countries should apply a radical policy of reducing oil imports. As was pointed out in last year's Annual Report, this could be effected through general energy-saving measures, the development of domestic oil production or the substitution of other forms of energy for oil. Given the size and urgency of the problem, all three routes will probably have to be followed. It would not matter that much if the results were forthcoming only in the medium or long run. The mere fact of policy action being taken right away, and being *seen* to be taken, could have short-term effects on the supply and hence on the price of oil.

Secondly, it is of paramount importance that in the absence of unambiguous signs of a cyclical cooling-off in the United States, i.e. in the absence of the "natural death" evoked above, the burden of restrictive measures should fall much more heavily on the United States than on the traditional surplus countries. It is true that US monetary policy has taken a more restrictive stance since last autumn, and this has probably contributed to the strength of the dollar since the turn of the year. But can it be regarded as sufficiently restrictive in an economy where domestic inflation is accelerating? After all, real interest rates are only barely positive in the United States, while they are quite high in a number of other industrial countries. And can US fiscal policy be considered sufficiently restrictive when at the height of a cyclical boom the Government is still running a deficit — though admittedly a much reduced one?

If by a combination of good fortune and the correct policies the world were to steer closer to the optimistic than to the pessimistic scenario, this would provide a welcome framework for dealing with most of the outstanding international monetary problems raised in the main body of this Report: the interrelated problems of the rapid growth of official foreign exchange reserves and the borrowers' market for international bank lending; the consolidation and further development of the EMS; and the "dollar overhang" and official reserves diversification. On the other hand, all these problems could become intractable if the world approached a situation bearing the main features of the pessimistic scenario.

To take, first of all, the interconnected problems of international reserve growth and the borrowers' market for international bank lending, it seems likely, as has been suggested in Chapter VII, that a radical improvement in the US balance of payments, as implied in the optimistic scenario, would be both a necessary and a largely sufficient condition for their resolution. If the US current account were to improve to the point of running a surplus large enough to offset the outflow of net direct investment, the net reserve position of the rest of the world would cease to improve — except for the small increase caused by the SDR allocations. If, moreover, US monetary policy remained tight enough to discourage external lending by US banks, the creation of gross reserves would probably also slow down substantially. Indeed, the simultaneous improvement in the US current and capital accounts would, in addition, temper the borrowers' bias in the Eurodollar sector of international bank lending. This would happen for two reasons: first, all other things being equal, the turn-around in the US current account would increase the financing need of the rest of the world and, secondly, the reserve losses incurred outside the United States would tend to mop up excess liquidity and reduce incentives for external lending by the banks of the surplus countries.

As for the EMS, its first months of operation have undoubtedly been helped by the greater calm in exchange markets and, in particular, by the reversal of speculative capital flows out of the strong currencies and back into the dollar. Anything approaching the optimistic scenario would create a beneficial environment for further progress, while a renewed dollar crisis would be most likely to put a strain on the structure of intra-European exchange rates.

However, consolidation and further progress within the EMS require more than the mere absence of a new dollar crisis. They require, firstly, that whatever changes in central rates become unavoidable as a result of the divergent trends in the countries participating in the EMS exchange rate mechanism should be decided upon and carried out swiftly and smoothly and, if possible, without giving a one-way option to speculators. The more recent history of the now defunct "snake" makes encouraging reading in this respect. But it must be realised that there are obstacles in the way of such decisions which can be overcome only with a combination of political will, technical skill and good luck.

The proper functioning of the EMS requires, secondly, the implementation of policies leading to a stabilisation of exchange rates. In the shorter run, monetary policy may certainly play a useful rôle in this respect, since interest rate differentials have proved themselves quite capable of offsetting the impact on exchange rates of differences in inflation rates. But it would be an illusion to believe that interest rate differentials can stabilise exchange rates in the longer run. Moreover, recent experience with monetary targeting in countries with an advanced and complex financial structure such as the United States shows that it would be equally dangerous to believe that the setting of comparable targets for monetary aggregates — even if this were politically feasible — would in itself be sufficient to produce an adequate convergence of inflation rates and lead at the same time to stable exchange rates. The co-ordination of policies should in fact cover much broader areas than the limited one of monetary policy.

Last but not least, the world needs something approaching the optimistic scenario if gradual solutions are to be found to the problems raised by the dollar overhang and, in particular, by the trend towards the diversification of official foreign exchange assets away from the dollar.

On the broadest possible definition, the dollar overhang reflects the desire of US and foreign holders of dollar-denominated financial assets to diversify their portfolios into assets denominated in other currencies. This desire has come about partly as a natural result of the gradual decline in the relative weight of the

United States in the world economy in terms of gross national product, trade and financial markets — a relative decline which is simply the counterpart of the relative increase in the importance of Japan, Germany and other major countries. The urge to diversify has been strengthened by the currency unrest and the depreciation of the dollar in relation to other reserve currencies. Official reserve diversification is only a special case of this more general problem. Central banks have been adjusting the currency composition of their foreign exchange holdings to that of their country's external debt and to the currency pattern of their foreign trade as well as for reasons of prudent portfolio management. There are clear signs of a trend in this direction, at least in the case of those central banks that did not acquire dollar balances as part of a deliberate policy of supporting the dollar rate. The trend may become more pronounced if the US authorities decide to build up their foreign exchange reserves — since, by definition, they will have to hold these reserves in currencies other than the dollar.

This development raises some thorny long-run issues concerning the fate of our international monetary arrangements. The most important of these is whether the natural drift towards a multiple reserve-currency system should be regarded as desirable, or whether it would be preferable to replace official dollar holdings by SDRs. There is no easy answer to this question, first because it obviously does not depend solely on what is desirable, but also on what is practicable, secondly because one solution need not necessarily exclude the other, and thirdly because when assessing the desirability of either of these two courses of action the basis of comparison is not a well-functioning single reserve-currency system, but a poorly managed one already comprising both de facto elements of a multiple reserve-currency system and SDRs.

Whatever the answer may be, one thing stands out quite clearly at this juncture: neither the broad problem of the dollar overhang nor the more narrowly defined one of official reserve diversification can be satisfactorily resolved unless confidence in the dollar is restored on a durable basis. This statement has two implications. First, that a US inflation rate markedly higher than that of the other major industrial countries would be bound to speed up the long-run trend of diversification out of dollars. Secondly, that a large and persistent US current-account deficit, aggravated by capital outflows, would add a "flow" problem to the "stock" problem of dollar holdings by non-residents. Diversification at such a speed and on such a scale would become unmanageable. No institutional tricks could be devised to handle the situation, and there would simply be no option left but to accept the anarchic development of new reserve centres, which would be in nobody's interest.

Any further improvement in the US balance of payments would undoubtedly raise policy problems for other western countries. They would not be able to fight inflation by relying on the appreciation of their currencies against the dollar; at the same time they would have to follow policies which would help, rather than hinder, the international adjustment process. This might turn out to be a difficult task in the presence of a strengthening OPEC surplus. On balance, nevertheless, a repetition of the 1978 dollar crisis would have immediately disruptive effects far outweighing the difficulties that would have to be faced as a result of renewed confidence in the dollar.

The broad conclusion of this Report can thus be summed up in two points. First, both for the sake of less inflationary world growth and to help resolve some of the outstanding problems of the international monetary system, the world needs a further improvement in the US balance of payments. And secondly, such an improvement, if and when it becomes apparent, imposes a duty on the strong-currency countries to conduct policies that will make the change in the US external accounts, and the implied cooling-off of the US economy, tolerable both for themselves and for the rest of the world. This is a challenging task for policy co-ordination among western industrial countries, the chances of which may perhaps look dim in the light of past experience. But what is the alternative?

René Larre

General Manager

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1979

BALANCE SHEET

ASSETS

(Before and after

		Gold francs
Gold		4,986,630,778
Cash on hand and on sight account with banks		93,015,952
Treasury bills		1,264,678,208
Time deposits and advances		
Not exceeding 3 months	34,434,042,155	
Over 3 months	24,242,827,905	
		58,676,870,060
Securities at term		
Not exceeding 3 months	1,773,808,116	
Over 3 months	2,483,989,919	
		4,257,798,035
Miscellaneous		1,109,621,163
Land, buildings and equipment		1
		70,408,614,197

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 1 gold franc = US \$ 0.394 1...; all other items in currencies are converted at central or market rates against the US dollar.

Note 2: At 31st March 1979, gold payable against currencies on forward contracts amounted to 325,834,663 gold francs.

AT 31st MARCH 1979

allocation of the year's Net Profit)

LIABILITIES

		Before allocation	After allocation
		Gold francs	Gold francs
Capital			
Authorised: 600,000 shares, each of 2,500 gold francs ...	1,500,000,000		
Issued: 481,125 shares	1,202,812,500		
of which 25% paid up		300,703,125	300,703,125
Reserves			
Legal Reserve Fund	30,070,313		30,070,313
General Reserve Fund	519,647,193		576,247,193
Special Dividend Reserve Fund	75,175,781		83,175,781
Free Reserve Fund	567,118,200		643,718,200
		1,192,211,487	1,333,211,487
Deposits (gold)			
Central banks			
Sight	3,907,620,845		
Not exceeding 3 months	49,449,781		
Over 3 months	8,611,110		
Other depositors			
Sight	33,082,685		
		3,998,764,421	3,998,764,421
Deposits (currencies)			
Central banks			
Sight	855,352,936		
Not exceeding 3 months	48,412,926,736		
Over 3 months	12,555,564,510		
Other depositors			
Sight	72,359,383		
Not exceeding 3 months	384,774,237		
Over 3 months	1,687,253,833		
		63,968,231,635	63,968,231,635
Miscellaneous		728,127,378	728,127,378
Profit and Loss Account		220,576,151	–
Dividend payable on 1st July 1979		–	79,576,151
		70,408,614,197	70,408,614,197

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, on the basis described in Note 1, a true and fair view of the state of the Bank's affairs at 31st March 1979 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, 30th April 1979

PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1979

		Gold francs
Net interest and other income ...		297,388,044
Less: Costs of administration:		
Board of Directors ...	843,503	
Management and Staff ...	53,069,564	
Office and other expenses ...	21,182,768	75,095,835
Net operating surplus ...		222,292,209
Less: Amount transferred to Provision for Exceptional Costs of Administration ...		1,716,058
Net Profit for the financial year ended 31st March 1979 ...		220,576,151
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: 110 Swiss francs per share on 481,125 shares ...		79,576,151
		141,000,000
Transfer to General Reserve Fund ...		56,400,000
		84,600,000
Transfer to Special Dividend Reserve Fund ...		8,000,000
		76,600,000
Transfer to Free Reserve Fund ...		76,600,000
		—

Movement on the Provision for Building Purposes during the financial year ended 31st March 1979

	Gold francs
Balance at 1st April 1978 ...	24,932,478
Add: Exchange difference ...	2,843,833
	27,776,311
Less: Amortisation of expenditure incurred ...	18,755,841
Balance at 31st March 1979, incorporated in Miscellaneous (Liabilities) ...	9,020,470

BOARD OF DIRECTORS

Dr. J. Zijlstra, Amsterdam	Chairman of the Board of Directors, President of the Bank
The Rt. Hon. Lord O'Brien of Lothbury, London	Vice-Chairman

Baron Ansiaux, Brussels
Prof. Paolo Baffi, Rome
Bernard Clappier, Paris
Dr. Otmar Emminger, Frankfurt a/M.
Dr. Fritz Leutwiler, Zurich
Carl-Henrik Nordlander, Stockholm
Dr. Antonino Occhiuto, Rome
The Rt. Hon. Gordon Richardson, London
Dr. Johann Schöllhorn, Kiel
Cecil de Strycker, Brussels

Alternates

Georges Janson, Brussels
Christopher W. McMahon, London, or
M.J. Balfour, London
Karl Otto Pöhl, Frankfurt a/M., or
Dr. Leonhard Gleske, Frankfurt a/M.
Dr. Mario Sarcinelli, Rome, or
Dr. Giovanni Magnifico, Rome
Marcel Théron, Paris, or
Gabriel Lefort, Paris

MANAGEMENT

René Larre	General Manager
Dr. Günther Schleiminger	Assistant General Manager
R.T.P. Hall	Head of the Banking Department
Prof. Alexandre Lamfalussy	Economic Adviser, Head of the Monetary and Economic Department
Dr. Giampietro Morelli	Secretary General, Head of Department
Maurice Toussaint	Manager
Prof. Dr. F.E. Klein	Legal Adviser

Robert Chaptinel	Deputy Manager
Dr. Warren D. McClam	Deputy Manager
M.G. Dealtry	Deputy Manager
R.G. Stevenson	Assistant Manager
Rémi Gros	Assistant Manager
André Bascoul	Assistant Manager
Paul A. Hauser	Assistant Manager
Joachim Mix	Assistant Manager
Dr. H.W. Mayer	Assistant Manager