BANK FOR
INTERNATIONAL SETTLEMENTS

FIFTIETH ANNUAL REPORT

1st APRIL 1979 – 31st MARCH 1980

BASLE

9th June 1980

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FIFTIETH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 9th June 1980

Ladies and Gentlemen,

I have the honour to submit herewith the fiftieth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1979 and ended on 31st March 1980.

The net profit for the year amounted to 50,977,378 gold francs, after transfer of 3,989,054 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit of some 44,775,000 gold francs for the preceding year and about 38,781,000 gold francs for the financial year 1977–78. (To permit a comparison of the results for the last three financial years, the figures for 1977–78 and 1978–79 have been recalculated to the nearest thousand gold francs on the new conversion basis of US$ 208 per fine ounce of gold adopted in June 1979.)

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 14,648,234 gold francs in payment of an annual dividend of 110 Swiss francs per share, together with the sum of 3,329,144 gold francs in payment of a special non-recurring dividend of 25 Swiss francs per share to mark the fiftieth anniversary of the Bank.

The Board further recommends that 13,200,000 gold francs be transferred to the General Reserve Fund, 1,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 18,800,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the combined dividend will be payable to shareholders on 1st July 1980.

Viewed broadly, the past year has seen a general resurgence of inflation, accompanied by a new oil price shock and sharp increases in the prices of internationally traded commodities. In introducing this Report, Chapter I points to the similarities and differences between the new inflationary phase and the earlier one which in 1973–74 brought the first oil shock, and it concludes that the western industrial economies may be in a better position this time to bring the outburst of inflation under early control. Chapter II analyses the sources and international transmission mechanisms of recent inflationary developments and discusses the stiffening of policy attitudes towards inflation and the new policy strategies designed to cope with it. Chapter III examines the contribution of changes in relative demand pressure to the external adjustment process in different countries and looks as well at changes in demand components, trends in energy and oil consumption and the relationship between fixed capital investment and productivity. Chapter IV confirms, on the basis of long-term money-supply growth, the optimism expressed in Chapter I concerning the prospects for containing inflation, and it goes on to examine the development of new techniques of monetary policy designed to reinforce the efficacy of monetary policy. Turning to international economic relations, Chapter V compares the relative success of balance-of-payments adjustment policies over recent years and then analyses the re-emergence of large surpluses in the oil-exporting countries, and the problems of "recycling" these surpluses to deficit countries. Chapter VI surveys the international credit and capital markets, which provide the main channel for such recycling, and relates these developments to current Euro-currency market policy issues. Chapter VII surveys the international monetary scene. The first half presents an account of developments in the foreign exchange and gold markets, and in gold production. The second half of the chapter assesses the changes in the quantity and nature of international liquidity. Chapter VIII deals with the Bank's own activities during the financial year, the Balance Sheet and the financial results. The Conclusion of the Report places the current world economic outlook in long-term perspective and draws policy conclusions pointing towards the need for a more credible, consistent attack on worldwide inflation.

I. THE NEW OIL SHOCK AND THE RESURGENCE OF INFLATION: A REPETITION OF 1974?

Two facts stand out clearly from economic developments in 1979 and the early months of 1980: an oil price rise which in real terms has been of the same order of magnitude as that of 1973–74, and an acceleration of inflation in all industrial countries. In both respects the analogy with the period of the first oil shock has grown progressively closer, certainly much closer than could have been foreseen a year ago.

The main points of similarity can be outlined as follows. The oil price increase has a dual, seemingly paradoxical effect on the oil-importing countries. On the one hand, it directly raises the level of prices. When this happens in the context of a cyclical upswing, it adds momentum to a rising trend that was already on its way. On the other hand, it levies a tax on the oil-importing countries, diminishes their real income, and therefore has a deflationary influence on their expenditure. Internationally these influences are reflected in a deterioration in these countries' terms of trade and a growing external imbalance between them and the oil exporters.

Thus, at first sight oil-importing countries are today facing exactly the same interconnected policy dilemmas as they were six years ago. They could fight inflation by restraining demand, thereby running the risk of aggravating the inevitable deflationary influence of the oil shock. Alternatively, they could choose to sustain domestic demand and thus fuel price inflation. There is an external aspect to this domestic policy dilemma: adjustment, or financing the deliberately accepted external deficit. And, in the longer run, all countries face the major problem of what policies are best suited to promoting fundamental adjustment, in real terms, to the rising trend of energy prices.

The global outcome will of course depend on whether all countries opt for the same kind of policies or whether they react differently. If all countries were to try in equal degree to fight inflation and to adjust their external payments, the likely outcome would be a synchronised world recession, abating inflation rates and a decline in the OPEC payments surplus. If only some were to follow this course of action, while others sustained domestic demand and accepted their external deficits, the recession would probably be less deep and possibly short, but there would be no significant — i.e. lasting — success in the fight against inflation. Moreover, there could be exchange rate tensions among oil importers or, even worse, widening divergences between exchange and inflation rate developments.

That the world, and in particular the oil-importing industrial world, would appear to be confronted with the same problems a second time within a decade suggests that it failed to master them properly six years ago. Two good reasons could be advanced for passing such a thoroughly pessimistic judgement on our policy performances since the earlier oil shock.

The first is that even before the latest round of oil price increases inflation — as measured by yearly changes in the consumer price index — was running on average at a rate of about 7 per cent. in the Group of Ten countries and Switzerland and at an even higher rate within the OECD area as a whole. And this average masks the increasingly wide dispersion of national inflation rates: only countries whose exchange rates had appreciated substantially had managed to bring their inflation rates down to well within the single-digit range. At the same time, the prices of non-oil commodities had also begun rising at an unsustainable pace.

A second reason for pessimism could be found in the sudden upsurge of oil prices. How is it that the Iranian supply shock led to such a substantial and apparently permanent oil price increase? Does this not prove that there has so far been no real adjustment to the rising price of energy? Or, phrased otherwise, must it not be said that world demand for oil has remained sufficiently firm in relation to supply to strengthen the hand of oil producers in the exercise of their oligopolistic price-fixing power?

The main theme running through this Report is that there are elements of strength as well as of weakness in the current situation; that the combination of these elements gives a framework different from that of 1974; and that this difference warrants a less roundly pessimistic view than that advanced above. While policies pursued over the last six years have been far from satisfactory in all countries and in all respects, lessons have nevertheless been learned, and policies have been, or are being, adjusted accordingly. On balance, therefore, the situation calls for a more qualified and probably somewhat less negative assessment of the short-term world economic outlook than one that simply insists on the superficial similarities between 1980 and 1974.

Elements of strength in the world economy.

The first set of qualifications concerns the origin and the nature of the present inflationary process in the western industrial world (Chapter II). Except in the United States, and to some extent in Italy and the United Kingdom, the acceleration of consumer price increases since the early months of 1979 cannot be attributed principally to inflationary pressures of domestic origin. Practically nowhere have nominal and real wage increases even remotely approached the high rates recorded during the early 1970s. Admittedly, it can be argued that monetary policies, as measured by the growth of monetary aggregates, have until recently been insufficiently restrictive to bring the rate of inflation down to an acceptable level. Nevertheless, during recent years monetary aggregates in the majority of industrial countries have been growing more slowly than they were prior to the 1973–74 oil crisis (Chapter IV). The current acceleration in consumer price inflation should therefore be ascribed to a greater extent than in 1973–74 to developments in the international commodity and energy markets. This is not to say, however, that events in those markets should be regarded as a once-and-for-all external shock, due to supply failures and political uncertainties. They are not. But even if they should be considered "endogenous" to the world economy, and even if such a judgement were to imply that the industrial world as a whole cannot sustain the growth rates experienced in 1978–79 without triggering commodity price booms, a fairly optimistic conclusion may still be drawn in one respect: namely, that there is less danger today than in 1973–74 of a generalised upward spiralling of prices and wages.

Moderate optimism on this score is warranted by a second set of observations concerning current policy attitudes towards inflation. Here the contrast with 1973–74 is even sharper and more generally valid than in the case of the sources and the transmission mechanisms of inflation. In 1973–74 the main industrial countries were far from unanimous in assigning priority to the fight against inflation: in fact, the majority of them opted, for a while at least, in favour of supporting domestic demand. Over the past year the dominant trend in policies has shifted very much in favour of combating inflation. This can be seen primarily in the decidedly restrictive stance taken in monetary policies — even in the United States, where the need was greatest (Chapter II). But fiscal policies have also become, or are becoming, more restrictive (Chapter III). Equally significant is the fact that a great deal of attention has been devoted in the major countries to improving the operational techniques and instruments of monetary control (Chapter IV). This is notably the case in the United States, where past failure to bring monetary variables under adequate control was attributable as much to the shortcomings of control techniques in a rapidly changing, highly innovative institutional environment as to weakness in the authorities' policy stance. Elsewhere, too, as a combined result of more conservative monetary policies and changes in control techniques there has been a sharp rise in interest rates. In many countries these have reached record high nominal levels, and even substantial real levels if nominal rates are compared with the current pace of price increases.

A third factor of strength in the world economy in 1980 compared with 1974 is the more balanced distribution of current-account deficits (Chapter V). Roughly speaking, one-third of the counterpart deficits to the huge OPEC surplus are likely to be located this year in the Federal Republic of Germany, Japan and the United States. This is to be compared with the situation in 1974, when deficits were very heavily concentrated in some large European countries — notably the United Kingdom and Italy — whose external positions had already been weak well before the oil price rise. In short — the case of the United States apart — the biggest current-account deficits today are those of the two large industrial countries whose inflation record has been the best over recent years, while the external position of the more inflationary countries has remained relatively strong. This pattern of payments imbalances has been brought about both by shifts in the relative pressure of domestic demand — partly under the impact of deliberately differentiated fiscal policies — and by the gradual adjustment of exports and imports to earlier changes in real exchange rates. It confirms in a reassuring way the effectiveness of balance-of-payments adjustment policies.

The new payments pattern should prove helpful, in the present circumstances, in two distinct respects. Firstly, because it is unlikely, if it holds, to set in motion disruptive exchange rate movements of the kind and of the intensity experienced in the wake of the first oil crisis. It is worth remembering that the divergent trends of intra-European exchange and inflation rates, which were such a headache for policy-makers in 1976 and 1977, had their origin in the contrasting initial policy reactions to the first oil shock. At that time the least inflationary country, Germany, together with Japan and the United States, concentrated on fighting inflation, while some of the other large countries, including from 1977 onwards the United States, attached more importance to maintaining output and employment. That persistent anti-inflationary policies paid off while compromise efforts ended up by failing on all counts goes a long way towards explaining the widely shared anti-inflationary leaning of current policies. As suggested below, this change in policy attitudes may perhaps lead to other problems, but for the time being it will certainly help to prevent the triggering of "vicious" and "virtuous" exchange and inflation rate developments.

Secondly, the current pattern of payments imbalances makes financing relatively easier. The United States, Japan and Germany are obviously creditworthy borrowers, and lending to them would ease the recycling burden of international banks. But these three countries need not necessarily borrow from banks to finance their current-account deficits. Japan and Germany can run down their foreign exchange reserves — as they have already done on a substantial scale. All three could pay for their deficits by issuing debt denominated in their own currency, in direct deals with OPEC countries running large surpluses. In both cases financing would require no intermediation, and would therefore not lead to an additional increase in banks' balance sheets, so leaving more room for the recycling of the OPEC surplus towards other deficit countries.

The international monetary scene (Chapter VII) presents two other elements of strength, additional to, or interconnected with, those derived from the balance-of-payments picture.

One is that, quite apart from the cases of countries that have managed to accumulate substantial foreign exchange reserves from previous surpluses, external reserves are generally higher than six years ago, particularly if gold holdings are valued at market-related prices. While — in view of the large OPEC surplus — it would be difficult to argue that international liquidity is excessive, there is clearly some scope for using reserves to finance external deficits. At the same time, the IMF is also in a much better liquidity position, and will be even more so once the seventh general quota increase becomes effective.

The other additional element of strength lies in the revised attitudes of most industrial countries towards exchange rate fluctuations. The western industrial world confronted the 1974 oil crisis with the newly acquired belief that floating exchange rates were better suited to the 1970s than the Bretton Woods system of pegged but adjustable rates. We now know that this change of mind did a lot of damage in its exaggeration. Admittedly, it would have been exceedingly difficult to muddle through the first oil shock with the kind of exchange rate rigidity the Bretton Woods system had grown into. But it is also true that the new attitude of authorities in several countries towards exchange rate developments was partially responsible both for the "vicious circle" developments in Europe and for the repeated dollar crises of more recent years. This attitude has now been revised. There is a formal commitment to ensuring exchange rate stability within the EMS; and, while no such commitment has been undertaken outside the EMS, domestic monetary policy measures explicitly taken with balance-of-payments considerations in mind and large-scale official interventions clearly show that authorities *do* care about the exchange rate.

Finally, it would be wrong to assume that there has so far been no real adjustment at all to the increase in the energy prices which took place in 1973–74 (Chapter III). In fact, between 1973 and 1978 savings in total energy use, in relation to gross national product, ranged from 2 per cent. in Italy to 5–8 per cent. in Canada, the United States and Germany and 9–12 per cent. in the United Kingdom, France and Japan. During the same period oil saving was even more substantial in all these countries, with the sole exception of the United States, where it was negligible.

To sum up: weaker inflationary pressures of domestic origin in the majority of countries, a better balanced pattern of external payments, success in energy and oil saving and, above all, a widely shared commitment to fighting inflation and promoting greater exchange rate stability are those positive features of the western industrial world in 1980 which make this year different from 1974.

The problem areas.

Not all the differences, however, can be viewed in a positive light. There are numerous reasons for concern, three of which deserve to be singled out.

The first is the special position of the United States, mentioned above, as regards the origin of inflation. There can be little doubt that the steady acceleration of US inflation rates for more than three years must be ascribed to a very large extent to inflationary pressures of domestic origin. This fact, combined with the length of the process of deteriorating price performance and the historically very high current inflation rate, suggests that policies devised to bring inflation under control will have to be more determined and longer-lasting in the United States than in some other industrial countries. And this cannot happen without painful adjustments both in the United States and in the rest of the world.

A second cause for concern is precisely the combination of the positive features of the current situation — or, more specifically, the simultaneous commitments to giving priority to the fight against inflation, especially through the use of tight monetary policies, and to ensuring relative exchange rate stability.

On a more technical plane, the rather belated acceptance of greater variability of interest rates — at historically high levels — may for a time make it more difficult internationally to co-ordinate policies devised to combat exchange rate instability. In today's turbulent monetary atmosphere, it is by no means certain how markets will interpret changes in interest rates and in interest rate differentials, and circumstances may arise in which even very heavy official interventions will be unable to prevent sudden and sizable exchange rate fluctuations. This has, in fact, already happened during the spring of 1980.

But, more fundamentally, it is worth bearing in mind that conversion to the doctrine of greater exchange rate stability has its origin in the generally disappointing, inflation-breeding experience of excessive depreciations and *not* in any disappointment with the experience of "orderly" and "moderate" appreciations. This asymmetrical frame of mind, coupled with the generalised use of tight monetary policies and high nominal interest rates, potentially provides the ingredients for a process of competitive exchange rate appreciations which could lead to a synchronised, deep downturn in the world economy. To put this concern provocatively, it can be said that in the past "virtuous" circles went hand in hand with "vicious" circles. As a consequence countries undertaking early adjustment did not break the momentum of the world economy; and when, at a later stage, countries caught in a "vicious" circle were forced into restrictive policies, the "early adjusters" were ready to accept a fair dose of domestic expansion. Could Germany and Japan have afforded to grow as fast as they have done recently if they had not brought down their inflation rates in the first place — thanks, partially at least, to the appreciation of their currencies?

A third reason for concern is the simple and obvious fact that six years have elapsed since 1974, six years that have been very different from those preceding the first oil shock.

On the domestic side, expansion over this period has on average been considerably slower than before in all industrial countries except the United States; the earlier upward trend in productive investment expenditure has been broken; productivity increases have declined to disturbingly low rates, especially in the United States; unemployment has remained high in many countries; and, last but not least, public-sector deficits are much higher today than they were in 1974, thus substantially reducing the scope for counter-deflationary fiscal policy, should governments decide to resort to such a policy in the event of a deep recession.

A dominant fact of the international economy has been the sharp expansion of international banking and the major contribution made by the private banking system to the recycling of the OPEC surplus in 1975–76 and, throughout the period, to the financing of countries' external deficits. As a result, the share of international operations in banks' balance sheets has greatly increased, and so has their exposure to country risks both globally and in respect of a certain number of major deficit countries. The most important among these are large, middle-income LDCs whose indebtedness has risen considerably. To what extent will the banks be willing to expand their international activity further and to take up a substantial part of the burden of recycling the new OPEC surplus, especially after 1980, when such a need is most likely to arise? To what extent should they be encouraged to do so?

II. INFLATION AND UNEMPLOYMENT.

Over the past eighteen months, for the second time in less than a decade, inflation has seriously intensified on a worldwide scale. This time, much as in 1973–74, the disturbances derived partly, indeed in many countries largely, from international sources, reflecting sharp increases in the prices of primary commodities, most importantly oil. And this time, too, the inflationary outburst was closely associated with a general strengthening of global demand, though unemployment has remained high in most countries. Moreover, much as in 1972–73, the strong growth of economic activity at the global level — strong, at least, relative to what international markets for oil and other commodities would accommodate at stable prices — was to some extent an undesired consequence of earlier efforts by the industrial countries to co-ordinate growth, improve the pattern of trade and payments and achieve more stable exchange rates. In the 1972–73 experience the undesired outcome had been partly the result of failing to perceive the strength of the multiplier effects of synchronised expansionary policies. In 1978–79 the outcome would have been less undesirable had the US economy slowed down according to expectations as expansion gained strength in Europe and Japan.

Though the new inflationary episode has broadly resembled that of 1972–74, two important, interrelated differences may be singled out.

Firstly, compared with the earlier period, the rates of growth of money supplies and real wage earnings have up to now been held within relatively modest bounds. While this difference can in part be explained by the higher rates of productivity growth achieved earlier in the 1970s, it would seem to suggest a better prospect this time of bringing about an appropriate adjustment of real incomes to the new external disturbances.

Secondly, the policy reactions to the 1978–80 developments have revealed some striking new attitudes. In differing degrees, but in most major countries, the main features include: high priority given to combating inflation, with efforts focused on containing the secondary repercussions of the large externally induced cost increases; a willingness to assume the implied risks in terms of a slowdown or contraction in economic activity; stronger emphasis on medium-term structural measures designed to reduce unemployment by encouraging investment, higher productivity and labour mobility; macro-economic strategies involving a mix of greater budget discipline and in some cases incomes policies, but with monetary policy as the main vehicle of restraint; and, in this last context, a greater willingness to accept high interest rates, with a number of countries pursuing monetary targets, partly with a view to curbing inflationary expectations.

In the spring of 1980 there were signs that these policies were beginning to bear fruit, even though domestic inflation rates had not yet turned downwards. The further strong tightening of US policy in March, together with gathering evidence of recessionary tendencies in the United States, contributed to declines in the prices of many international commodities.

This chapter gives an account of the resurgence of inflation in the major industrial countries and seeks to place it in the perspective of the 1970s as a whole. Summary accounts are also given of the shifting scene with respect to policy attitudes and strategies.

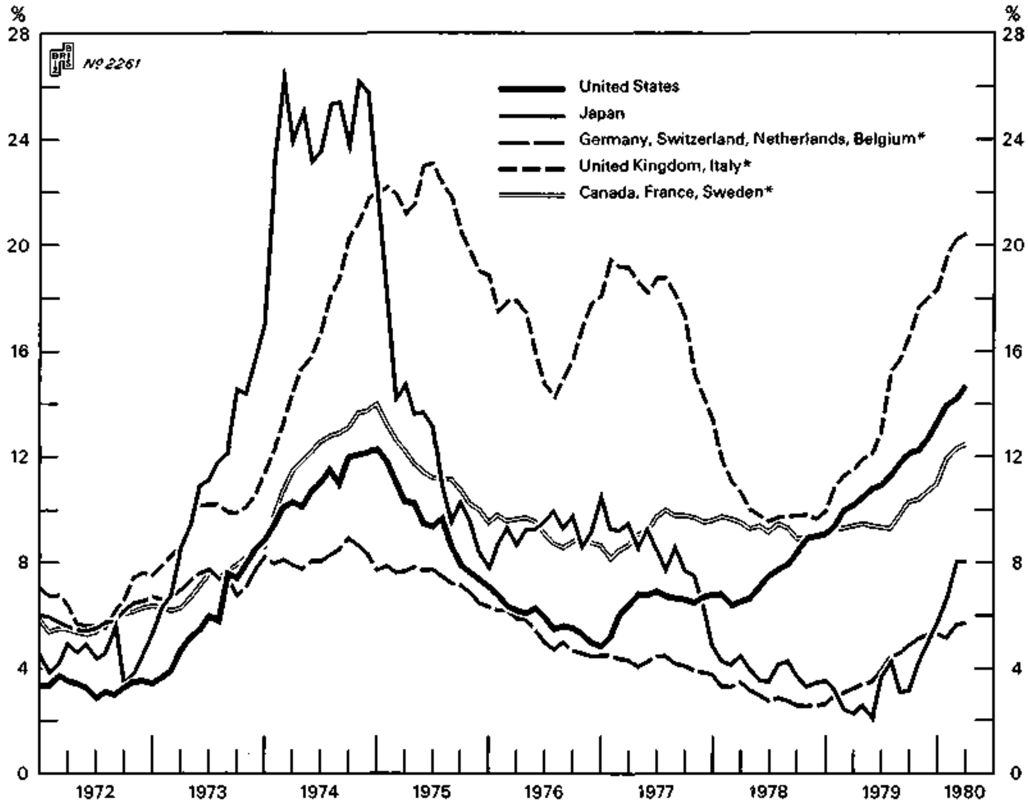
The intensification of world inflation.

After slowing down further in 1978, in all industrialised countries except the United States, the rise in consumer prices quickened sharply everywhere last year. By March 1980 inflation in the Group of Ten countries and Switzerland was running at 12.5 per cent. on a weighted average basis, compared with 7 per cent. at the end of 1978.

The intensification of inflation began first in the United States (see graph below). An acceleration of consumer prices in early 1977 largely reflected movements in food costs, excluding which the pace of inflation would have been about the same during 1977 as during 1976. In 1978, however, as the US expansion

Consumer price inflation.

Changes over twelve months, in percentages.



* Weighted averages with the weights proportional to gross national products for the year 1975.

continued into its fourth year, the escalation spread to unit labour costs and became broadly based. During 1979 US consumer prices rose by more than 13 per cent., or by more than 11 per cent. excluding the costs of purchasing and financing homes, which the US index treats in an unusual manner. In early 1980 inflation rates moved substantially higher. Phased decontrol of domestic oil prices, which began to take effect in June 1979, had little impact on consumer prices last year but is expected to add about 1 per cent. a year to the consumer price level in 1980 and 1981.

Outside the United States consumer prices began to speed up sharply in late 1978 or early 1979. In the United Kingdom the rate of consumer price inflation doubled during 1979 following the breakdown of the Labour Government's incomes policy during the winter of 1978–79 and the decision of the new Conservative Government to increase the rate of value added taxation to a uniform 15 per cent., which directly added about 3 or 4 per cent. to the consumer price index around mid-year. In Italy consumers faced a near-doubling of inflation rates last year to more than 20 per cent. per annum by early 1980. The acceleration in consumer prices has been more moderate in Canada, France and Sweden, but inflation has nevertheless reached or come close to double figures in all three countries. In the traditionally low-inflation European economies and Japan consumer price inflation has intensified to year-on-year rates in excess of 5 per cent., although the Swiss inflation rate dropped below that level in early 1980.

The widespread acceleration in consumer prices was generally preceded by sharp advances in wholesale prices which, except in countries with appreciating

Wholesale and consumer prices.

Countries	Wholesale prices[1]					Consumer prices				
	changes over twelve months ending									
	1976 Dec.	1977 Dec.	1978 Dec.	1979 Dec.	1980 March	1976 Dec.	1977 Dec.	1978 Dec.	1979 Dec.	1980 March
	in percentages									
United States	3.3	3.7	17.2	17.3	6.1[2]	4.8	6.8	9.0	13.3	14.7
United Kingdom	27.2	1.6	5.2	26.4	25.7[2]	15.1	12.1	8.4	17.2	21.8[2]
Italy	31.4	9.5	9.3	21.1	22.4	21.8	14.9	11.9	19.8	21.2[2]
Canada	5.1	8.2	11.3	15.4	13.4	5.8	9.5	8.4	9.8	9.2[2]
France	20.3	0.5	7.2	10.8	7.7	9.9	9.0	9.7	11.8	13.7
Sweden	9.4	10.7	6.4	15.9	17.4	9.6	12.7	7.4	9.8	13.5
Japan	5.3	−10.4	−9.1	60.5	73.7	10.4	4.8	3.5	5.8	8.0
Germany	4.9	−1.9	0.7	14.5	17.2[3]	3.7	3.5	2.5	5.4	5.8[2]
Switzerland	1.2	−2.8	−3.9	6.1	6.1[2]	1.3	1.1	0.7	5.1	4.1[2]
Belgium	5.5	−2.7	4.1	8.1	8.8	7.6	6.3	3.9	5.1	6.4[2]
Netherlands	3.8	2.5	−6.0	22.8	.	8.5	5.2	3.9	4.8	6.4[2]
Austria	6.8	1.3	1.8	5.3	8.4[2]	7.2	4.2	3.7	4.7	5.9[2]
Denmark	11.5	5.9	−5.3	54.6	69.2	13.1	12.2	7.2	11.8	13.9
Finland	14.1	−3.4	2.3	11.9	14.1[3]	12.3	11.9	6.4	8.6	10.7[2]
Norway	8.0	−5.1	0.0	13.5	12.0	8.0	9.1	8.1	4.7	9.0[2]
Ireland	21.7	10.6	10.4	10.6	.	20.6[4]	10.8[4]	7.9[4]	16.0[4]	15.5[4]
Spain	21.7	20.8	5.3	.	.	19.8	26.4	16.4	15.5	16.3

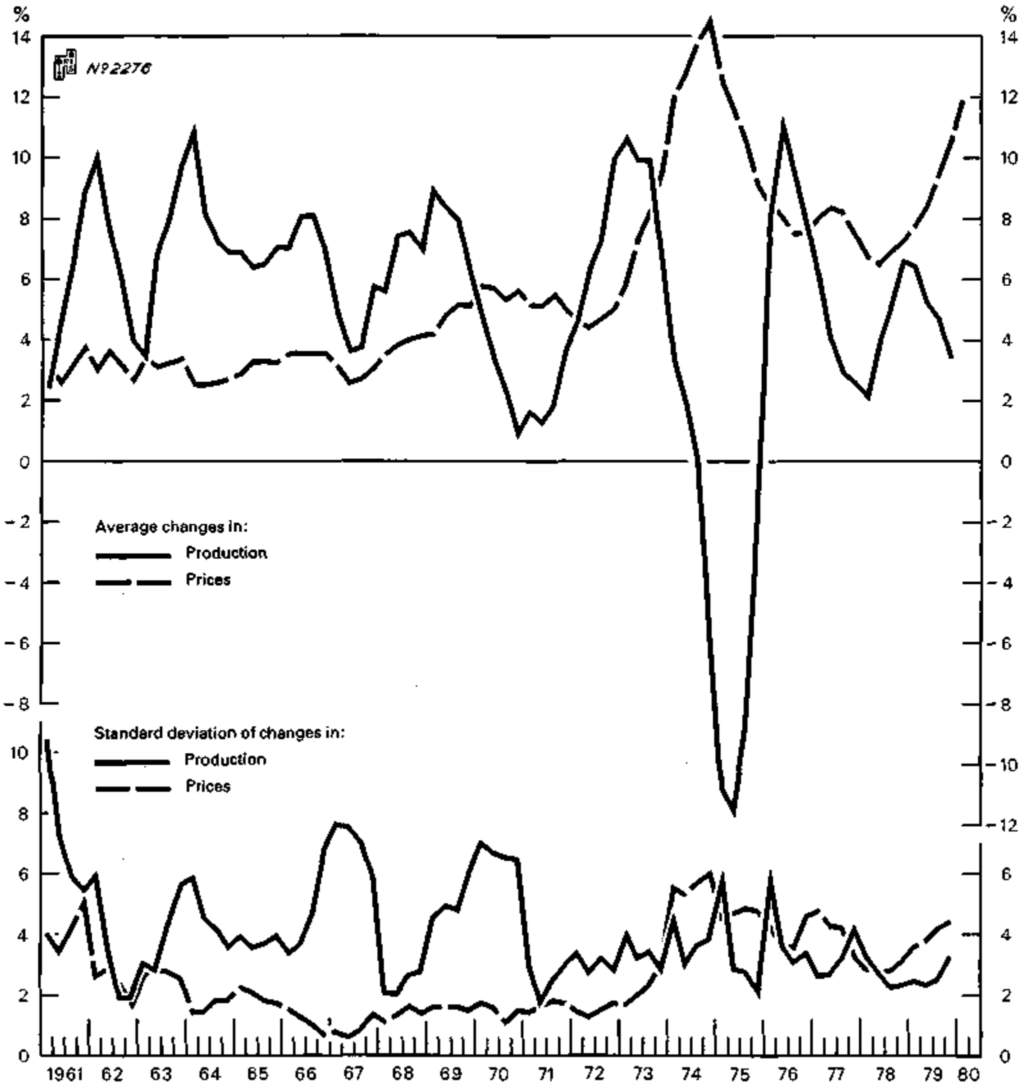
[1] Manufacturing input prices, where available. [2] April. [3] February. [4] Middle of quarter.

currencies, began early in 1978. As a leading indicator, the behaviour of wholesale prices during early 1980 suggested that for many countries consumer price inflation had not yet reached its peak.

The graph below shows the behaviour of inflation in longer-term perspective. Perhaps the most striking feature is the contrast that emerges from the lower panel. On the one hand, the dispersion of inflation rates among the industrial countries, as measured by their standard deviation, has substantially increased since the advent of floating exchange rates in the early 1970s. The wider divergence of inflation rates can be attributed basically to the differences in the policy strategies that

Industrial production and consumer prices in the Group of Ten countries and Switzerland.*

Changes over four quarters, in percentages.



* Averages and standard deviations are weighted on the basis of gross national products for the year 1975.

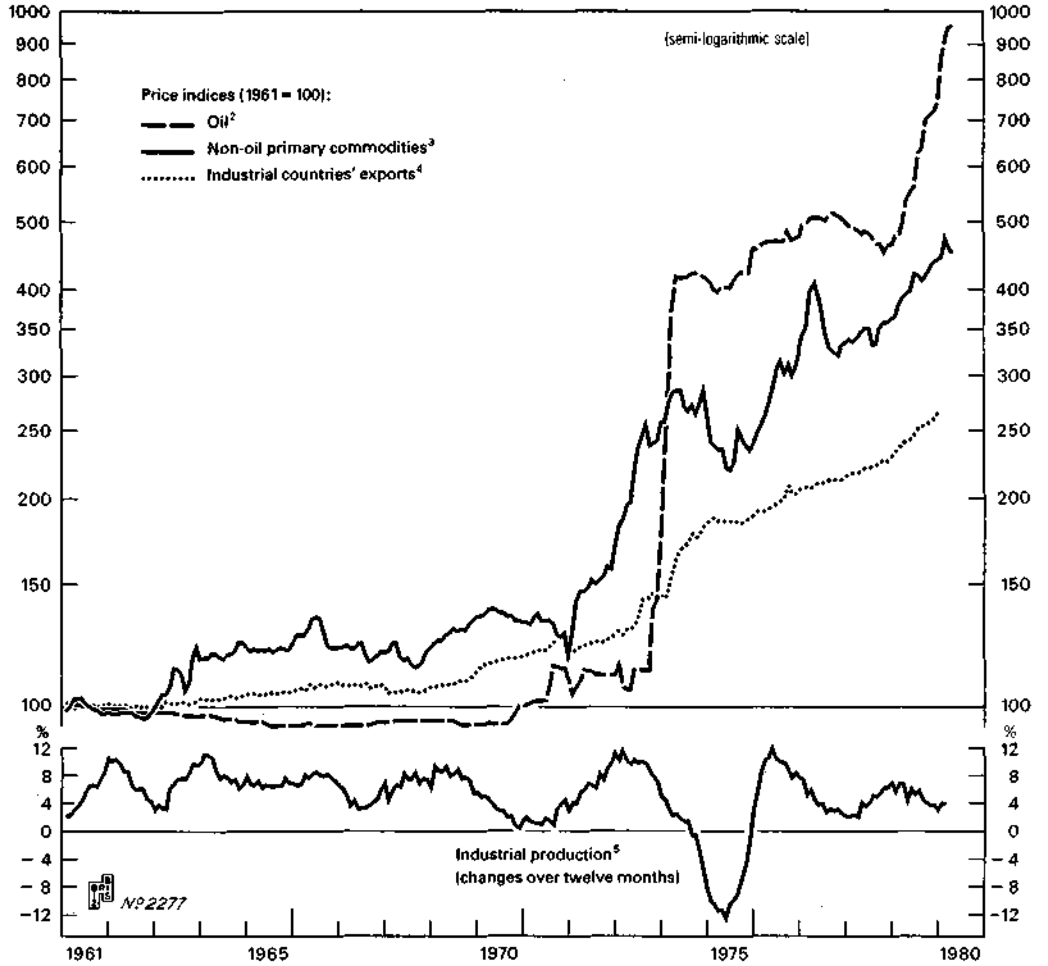
countries chose to pursue in the inflationary environment of the 1970s, and the acceptance of flexible rates may have become more or less inevitable under such conditions. On the other hand, since the end of the period of fixed exchange rates the growth rates of industrial production appear to have become more synchronised. This development may have had little to do with floating rates as such. It reflects the concerted efforts of countries to reflate following the general realignment of exchange rates in December 1971 and then the worldwide impact of recession following the oil and commodity price rises of 1973–74. A subsequent expansion, which became widespread in 1978–79, contributed to a new oil shock and commodity price boom which have again led to policy adjustments that are likely to cause a generalised weakening of economic activity.

The international sources of inflation.

In the public's eyes the intensification of inflation last year was predominantly associated with oil price developments. However, a sharp acceleration in the prices of other commodities was another major source of upward price pressure from the international markets. The huge oil price increases must be attributed in large part to the more aggressive pricing policy of OPEC producers and the reduction in market supply following the crisis in Iran. But, much as in 1972–73, the further growth of demand in the industrial economies facilitated the oil price adjustments, just as it tended to drive up the prices of other internationally traded commodities.

The graph on page 14 illustrates the correlations between certain international price indicators and world demand as measured by an index of industrial production for the Group of Ten countries and Switzerland. Following a period of weakness in 1977, the strong growth of aggregate demand in Europe and Japan, superimposed upon continued growth in the United States and Canada, was accompanied by a renewed spurt in the prices of commodities other than oil around the beginning of 1978. By the end of 1979 the "Economist" indicator for all items (expressed in SDRs) had risen by 100 per cent. since its trough during the world recession in 1975, by more than 50 per cent. since its mid-1974 peak and by about 250 per cent. since the beginning of the decade. By comparison, industrial production in the Group of Ten countries and Switzerland had expanded by a much lower 30 per cent. since the recession trough, by less than 15 per cent. since late 1976 (when it recovered to where it had previously peaked in mid-1974) and by less than 40 per cent. over the decade. Moreover, the moderate expansion of economic activity during the 1970s also contributed to rapid inflation of commodity prices in relative terms, as the graph suggests. Such experience contrasts sharply with that of the two previous decades, when the prices of oil and other commodities remained relatively stable. One implication is that the capacity to supply commodities is apparently no longer expanding in parallel with the trend growth of world demand. In this respect the world economy seems to have become more prone to generating "international shocks", with prices of oil and other commodities rising more rapidly in response to the growth of world demand and thereby inducing more cautious attitudes towards expansionary macro-economic policies and more positive attitudes towards energy conservation.

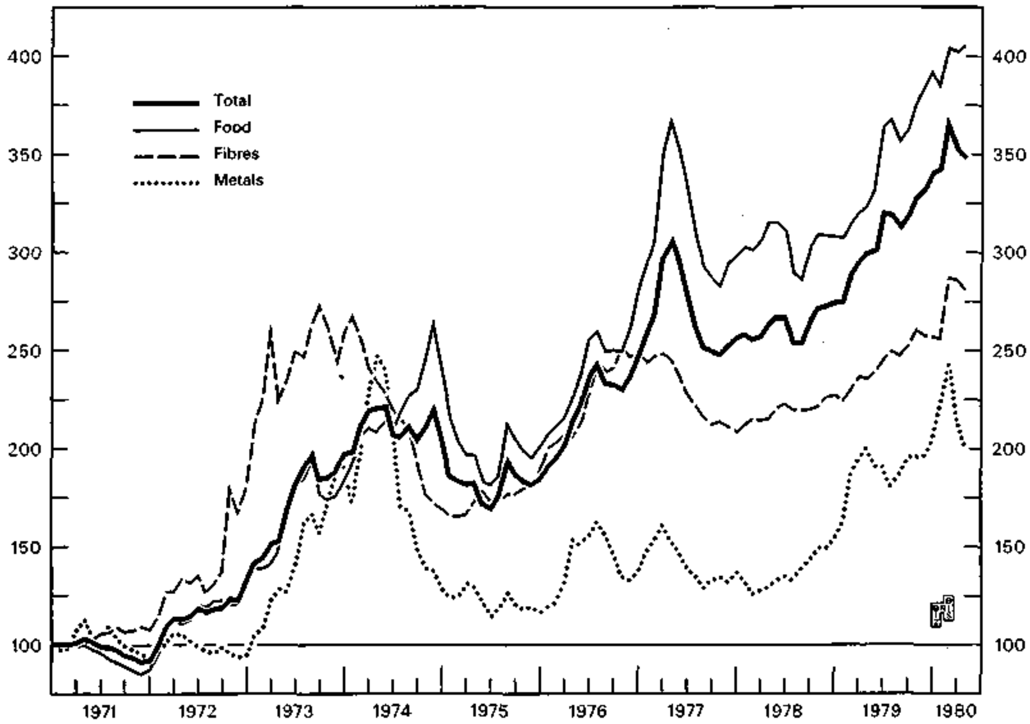
Industrial production and international prices.[1]



[1] Prices are expressed in SDRs for 1971–80 and in US dollars for 1961–70. [2] Price index of petroleum and petroleum products, as published by the Institute for Economic Research in Hamburg (HWWA). [3] The "Economist" indicator for all items. [4] Unit value index of industrial countries' exports, based on IMF data. [5] Weighted arithmetic average of changes in industrial production for the Group of Ten countries and Switzerland. Weights are based on gross national products for the year 1975.

In the case of commodities other than oil, the price acceleration during 1978 and 1979 resulted in a 50 per cent. rise in the "Economist" indicator for metals (expressed in SDRs), a 30 per cent. rise for foods and close to a 25 per cent. increase for fibres (see graph on facing page). Though the strength of global demand was a major underlying factor, the prices of some commodities were also pushed up by supply developments and by the emergence of new sources of demand. Poor weather conditions in the Soviet Union led to substantial crop reductions that contributed to a rise in grain and sugar prices. Moreover, part of the large increase in sugar prices last year can be attributed to the revelation in early March that Brazil intended to direct 40 per cent. of its estimated 1979–80 crop, or roughly 5 per cent. of the world crop, into the production of alcohol fuel.

World-market commodity prices:
The "Economist" indicator, expressed in SDRs.
December 1970 = 100.



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By the end of last summer commodity markets had also been hit by a wave of apparently speculative interest, with tremendous increases in turnover volumes. Prices of gold and other precious metals skyrocketed, while prices of other commodities were also affected significantly by efforts to find attractive stores of value. Fundamentally, the rise in speculative demand was a response to rising inflation, which lowered expected real yields on money-denominated claims and at the same time created greater uncertainty about these yields, in particular because of doubts about policy responses and the unpredictability of exchange rates. In the first six weeks of 1980 the "Economist" indicator for all items rose by another 10 per cent., led by a 25 per cent. rise in metals prices. In mid-February, however, metals prices turned sharply downwards while prices of foods and fibres began to fall slowly. As a consequence, by mid-April metals prices were below the levels at which they started in 1980 and the price indicator for all items had fallen back most of the way it had climbed since the beginning of the year.

Needless to say, the doubling of oil prices in 1979 overshadowed the rises in other commodity prices. At the beginning of the year, the rise in oil prices was prompted by a curtailment of supplies from Iran and the desire of OPEC producers to realign their terms of trade, which had declined since 1974. But as the year progressed, the strength of global demand for oil — both to support economic activity and to expand stockpiles in oil-importing countries — encouraged OPEC to push prices far higher. Indeed, despite enormous price increases, OPEC was able to sell more oil in 1979 than in 1978. By aggressively raising prices to take advantage of the strengthening demand for oil in the industrialised countries, the OPEC producers posed a more lasting threat to stability in the global economy. The rise in oil prices had a substantial direct impact on wholesale and consumer price levels. These direct price effects, which have not yet worked through fully, threatened in turn to lead to higher nominal wage demands and further price increases as a result of efforts to preserve real wages and profits. Policy authorities were thus confronted with the painful decision of how much to accommodate and how much to resist private-sector efforts to recapture the real incomes that higher oil prices had eroded. Accommodation could limit recessionary tendencies but would risk a permanent rise in inflation. Resistance could limit inflation but would risk a downturn in economic activity.

In absolute terms, last year's rise in the price of oil was as substantial as the increase that took place in 1973–74. The price of a barrel of Saudi Arabian marker crude, traditionally the basis for OPEC pricing comparisons, started the year at $13.34 and stood at $26 at the beginning of 1980. Significantly, this was the lower limit of actual OPEC price increases during the year. Indeed, the more moderate Saudi Arabian attitude to pricing decisions was counterbalanced by pressures from the more aggressive OPEC members, so that at the beginning of 1980 North African and Iranian producers were selling oil at between $30 and $34 per barrel. Furthermore, in the course of last year official OPEC prices came increasingly to understate the average purchase price as a growing proportion of output was shifted from the contract to the spot market. In the latter half of 1979 prices on the spot market were fully 50 per cent. higher than Saudi Arabian contract prices. In addition, pressures were sustained by adjustments of OPEC oil production, which kept supply conditions tight. During early 1980 spot oil prices declined temporarily. In May the OPEC Oil Ministers proposed for higher-level consideration a formula that would adjust oil prices at regular quarterly intervals by amounts that would be indexed to inflation rates and real growth rates within major oil-consuming countries as well as to fluctuations in the value of a basket of currencies.

Exchange rates, export and import prices and the terms of trade.

Because exchange rates remained relatively stable during 1979, the steep increases in the prices of oil and other commodities were transmitted to the industrial economies more evenly than would otherwise have been the case. Moreover, since increases in commodity prices have exceeded those in the prices of finished goods, the industrial economies' terms of trade have deteriorated since the end of 1978. The industrial world's inflation problem has thus been exacerbated by relative price developments and its purchasing power in international markets has been reduced.

The comparative stability of exchange rates during 1979, which is discussed in Chapter VII, was in marked contrast to the experience of earlier years, when extreme exchange rate fluctuations had confronted the various economies with notably different external pressures. Among the Group of Ten countries and Switzerland, the only unstable currencies in 1979 were the yen and, to a lesser extent, the pound sterling. Apart from these two cases, accordingly, exchange rate movements as such appear to have had little significant effect on domestic inflation rates last year. In the case of Japan, the trade-weighted depreciation of the yen is estimated by the authorities to have accounted for one-fifth of the 16 per cent. rise in the wholesale prices of domestic output during 1979. In the United Kingdom, by contrast, the appreciation of sterling had a moderating effect on costs and prices last year. In early 1980 exchange rates abruptly became more volatile as the dollar appreciated strongly against the continental European currencies during March and then declined substantially in April.

The development of import and export unit values in 1979 reflected the general increase in price pressures from oil and other commodities. In many countries declining trends in the domestic-currency values of imports and exports were reversed in 1979; elsewhere rising trends became much sharper. As shown in the following table, import unit costs for the Group of Ten countries and Switzerland increased very slightly on average in 1978, but rose by more than 23 per cent. in 1979. Export unit costs, after increasing on average by about 4 per cent. annually in 1977 and 1978, rose by nearly 15 per cent. last year. Reflecting the relative stability of exchange rates, the dispersions or standard deviations of the rates of change declined last year in relation to the averages; on the import side the dispersion narrowed in absolute terms if the figures for Japan are excluded.

While last year's widespread increase in the prices of traded goods underscored the industrial world's inflation problem, the rapid rise of commodity prices in relation to finished goods prices has led to a sharp deterioration in the terms of trade of most

Changes in import and export unit values for the Group of Ten countries and Switzerland.*

Items	1976 4th quarter	1977 4th quarter	1978 4th quarter	1979 4th quarter
	changes over four quarters, in percentages			
Average:				
Import unit values	9.4	5.6	0.8	23.4
Export unit values	8.9	4.4	4.0	15.0
Average (excluding Japan):				
Import unit values	10.1	7.2	2.6	18.6
Export unit values	9.6	5.3	5.0	14.3
Standard deviation:				
Import unit values	11.1	8.3	9.1	16.3
Export unit values	9.4	5.6	5.9	6.1
Standard deviation (excluding Japan):				
Import unit values	11.4	6.7	7.1	5.3
Export unit values	9.5	4.8	5.2	5.9

* Unweighted averages and standard deviations of percentage changes in unit values expressed in domestic currency units.

of the major industrial countries. Downward shifts in the terms of trade last year were particularly severe in the United States, Japan and Germany. By contrast, the terms of trade have improved over the past year for Canada, which is self-sufficient in oil and gas and a major exporter of commodities. This improvement has not insulated Canada from higher domestic prices for oil and other commodities, although political resistance to shifts in the regional distribution of incomes has kept domestic oil prices from rising to international levels and has thereby repressed the oil-related component of inflation.

In a broad sense, recent movements in the terms of trade have resembled the experience associated with the steep rise in the prices of oil and other commodities in 1973–74. Following an initial sharp deterioration during that period, the terms of trade of most of the industrial countries improved somewhat during the latter part of 1974 and in 1975. To some extent, however, the improvement reflected a rise in export prices which came about not as a result of increased demand for the industrial countries' exports but rather as an indirect result of intensified internal cost inflation. Thus, if the industrialised world is this time more successful in curbing the further inflationary consequences of the international price shock, the improvement in its terms of trade may be less than was experienced during 1974–75.

International disturbances and domestic wage and price adjustment.

In a highly interdependent world, inflation in any single country derives from a mixture of external and internal impulses. A notable feature of the 1970s is the extent to which national inflation rates have reflected global price disturbances related to oil, food and other commodities. Again in the present round of inflation, external increases in prices have been a predominant force. But in various countries, particularly the United States, Italy and the United Kingdom, internal developments have also been a major factor.

A revealing gauge of the size of last year's external price shock is the first-round effect on consumer prices of the higher costs of energy and other primary products. This measure includes the impact on consumer prices of energy items other than OPEC oil, for which prices have risen, and in some cases are still rising, in sympathy with last year's rise in OPEC oil prices. Conceptually, input/output coefficients could be used to quantify the impact on consumer prices before any indexed or induced increases in wages feed back through higher unit labour costs into still higher prices of consumer goods. In the absence of input/output information, first-round effects of higher energy prices can be roughly estimated by using the share of energy products in consumer expenditure, which for most industrial countries is between 6 and 9 per cent. Thus, if the doubling of OPEC prices in 1979 were ultimately to raise consumer energy prices by one-third to one-half, which historical experience suggests to be a reasonable assumption, the first-round effect on consumer price levels could be an increase of 2 to 4½ per cent. In addition, based on an estimate that primary products other than energy have an input weight of 10 or 15 per cent. in the final output of consumer goods, the rise in non-energy commodity prices in 1979 could be assumed to have an impact of 1 to 3 per cent. on consumer price levels.

In terms of input/output relationships industrial economies are fairly equally exposed to external shocks emanating from the markets for primary commodities, including oil. However, in those which are relatively dependent on trade, exchange rate movements may increase the volatility of internal prices and wages. The table below shows that most of the Group of Ten countries and Switzerland have become much more open to international trade since the general return to currency convertibility in 1958. Highly open economies such as Belgium and the Netherlands must typically adapt their policies very flexibly in acting to offset any untoward external pressures. This exposure helps to explain why the smaller, open economies have usually tended to keep their exchange rates closely aligned with those of larger neighbouring countries.

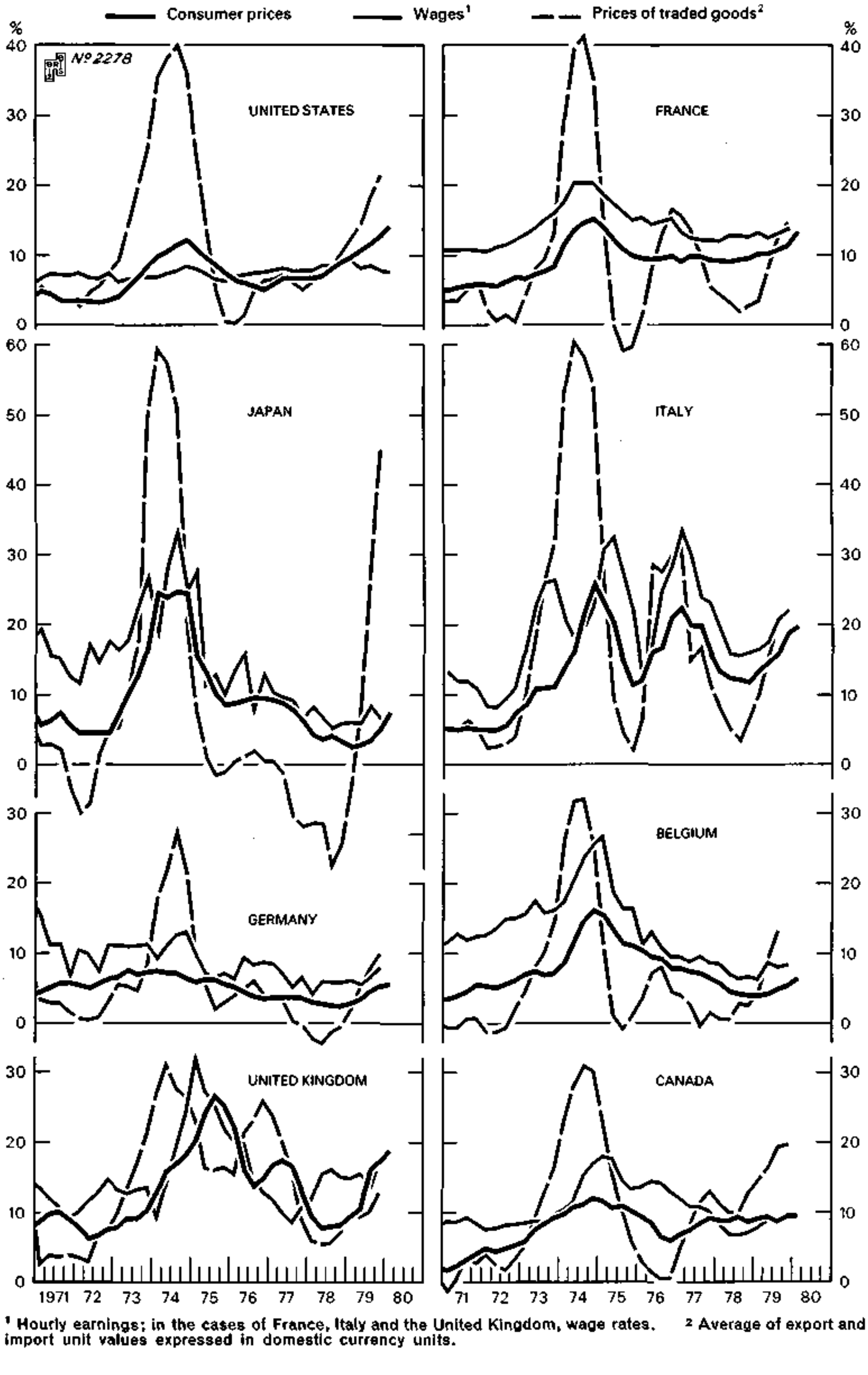
Openness to international trade.

Countries	Average of exports plus imports of goods and services		
	1958	1968	1978
	as a percentage of gross national product		
Belgium	31	39	51
Canada	18	21	25
France	13	14	20
Germany	20	21	26
Italy	12	16	24
Japan	11	10	10
Netherlands	47	44	47
Sweden	23	22	28
Switzerland	27	30	34
United Kingdom	20	21	29
United States	5	5	10

During the period 1979–80 an overriding object of domestic policy has been to limit the secondary wage/price repercussions of inflationary impulses coming from the traded goods sector. As shown in the graph on page 20, nominal wages have in recent years moved up less than consumer prices in the United States and Canada. Viewed positively, this is consistent with the need to slow down the inflationary spiral, particularly where there has been a loss of real income imposed from outside. Viewed negatively, the sharp decline in real wages is producing incipient pressures for a wage rebound, thus complicating the problem of reducing the inflation rate in the short run. In other countries, however, the tendency has been rather for wages to adjust upwards as consumer prices have risen. Indexation has often played a rôle in these adjustments, either through formal arrangements, as in Italy and Belgium, or on a de facto basis, as is now a widespread phenomenon.

As can also be seen in the graph, the variability of traded goods prices, represented by the average of export and import unit values in domestic currency, has been much greater than that of domestic wages and prices in the 1970s. Equally noteworthy is the extent to which the rate of increase in consumer prices has seemed to coincide with or follow that in traded goods prices. The biggest disturbance

Prices of traded goods, wages and consumer prices.
Changes over four quarters, in percentages.



¹ Hourly earnings; in the cases of France, Italy and the United Kingdom, wage rates. ² Average of export and import unit values expressed in domestic currency units.

was that associated with the first oil shock and international commodity price boom of 1973–74, and the initial effects of a similar development are clearly apparent from 1978 onwards.

It is also evident that after 1974 countries generally succeeded in gradually reducing the rates of increase in wages and prices. However, in the case of the United Kingdom and Italy, and to a lesser extent France, the disruptive effects of the 1974–75 recession subsequently contributed to exchange rate crises which interrupted progress towards greater price and wage stability. Broadly speaking, the relative success or failure of individual countries in controlling inflation tended to be accentuated by, or channelled through, movements in exchange rates. Thus, by 1978 countries such as Germany, Japan and Belgium were experiencing much lower rates of inflation than those which had implemented policies that led to currency depreciation.

In most countries wages have adjusted fairly closely in line with consumer prices over lengthy periods. Yet, as the graph on page 20 shows, there is still considerable independence of wage movements in individual countries, and the 1970s have brought further episodes of wage "explosions". In Italy, for example, wages increased sharply ahead of prices in 1972–73. In the United Kingdom wages have tended to lead price developments over much of the period up to 1977–78. This was most clearly the case in 1973–74, although at the same time formal indexation clauses in the Government's incomes policy helped quickly to translate retail price increases into large nominal wage gains.

Real earnings in industry.[1]

Countries	1965–72 annual average change	Changes over twelve months ending							
		1973 Dec.	1974 Dec.	1975 Dec.	1976 Dec.	1977 Dec.	1978 Dec.	1979 Dec.	1980 latest month
		in percentages							
United States	1.8	2.0	−3.2	−0.8	2.8	0.7	0.2	−4.6	−5.8[2]
Canada	3.6	0.4	3.6	3.6	6.5	0.1	−1.7	−0.4	0.3[3]
Japan	7.3	9.5	1.2	0.7	2.4	2.0	1.6	0.7	−0.6[3]
Germany	5.7	2.3	6.5	0.3	5.6	4.5	*1.5*	*0.8*	*0.3*[3]
France	*4.6*	*6.8*	*4.4*	*4.7*	*4.7*	2.8	*2.6*	*1.8*	.
United Kingdom	2.8	3.7	7.0	−3.4	−2.4	−0.8	5.9	1.6	0.3[2]
Italy	*7.2*	*11.7*	*−1.0*	8.2	5.8	7.0	3.8	2.3	*1.1*[2]
Belgium	5.7	8.2	8.4	4.7	1.8	2.3	2.6	3.0	1.6[2]
Netherlands	*4.3*	*5.0*	*5.6*	*3.7*	*−0.1*	*1.3*	*1.1*	−0.5	*−1.1*[2]
Sweden	4.7	1.0	1.9	9.0	1.3	−3.4	−1.2	−1.3	−3.0[4]
Switzerland	1.7	−2.4	5.2	2.7	−0.2	1.0	3.0	−2.4	.
Austria	4.7	3.9	5.1	3.4	0.0	0.2	1.0	2.3	.
Denmark	5.0	10.7	5.6	3.9	−1.5	−1.8	2.7	1.4	.
Finland	5.1	4.6	6.6	−0.8	1.5	−3.6	2.5	3.1[5]	.
Norway	3.7	3.1	9.1	5.9	7.9	−0.1	−1.2	−3.3	.
Ireland	5.3	7.5	4.7	10.8	−2.7	3.7	5.2	.	.
Spain	6.5	9.5	7.5	12.2	10.8	0.1	9.8	7.8	.

[1] Nominal earnings deflated by consumer prices. Figures in italics are based on wage rates. [2] March. [3] February. [4] January. [5] September.

A worrying feature of the present situation, as indicated above, is the threat that wage-earners in some countries may try to recapture the losses in real incomes that they have suffered in recent years. As the table above shows, real wages, i.e. nominal wage earnings adjusted for inflation, actually declined last year in four of the Group of Ten countries and in Switzerland, while in other industrialised countries the increases were relatively low by historical standards.

To judge by recent increases in prices at the wholesale level, additional strong pressures may be expected on consumer prices in the period ahead. In these circumstances inflation will be influenced by the particular characteristics of wage/price mechanisms in individual countries, including the direct rôles that governments choose to play in the income-setting process. However, much will ultimately also depend on the basic objectives of the authorities and their resolve in restraining demand growth.

The graph on the next page shows the combinations of unemployment and consumer price inflation recorded in eight countries during the last twenty years. These combinations can be viewed to reflect shifting "Phillips curve" relationships in which unemployment, as a proxy for the balance of aggregate demand and supply, normally varies inversely with the rate of inflation.

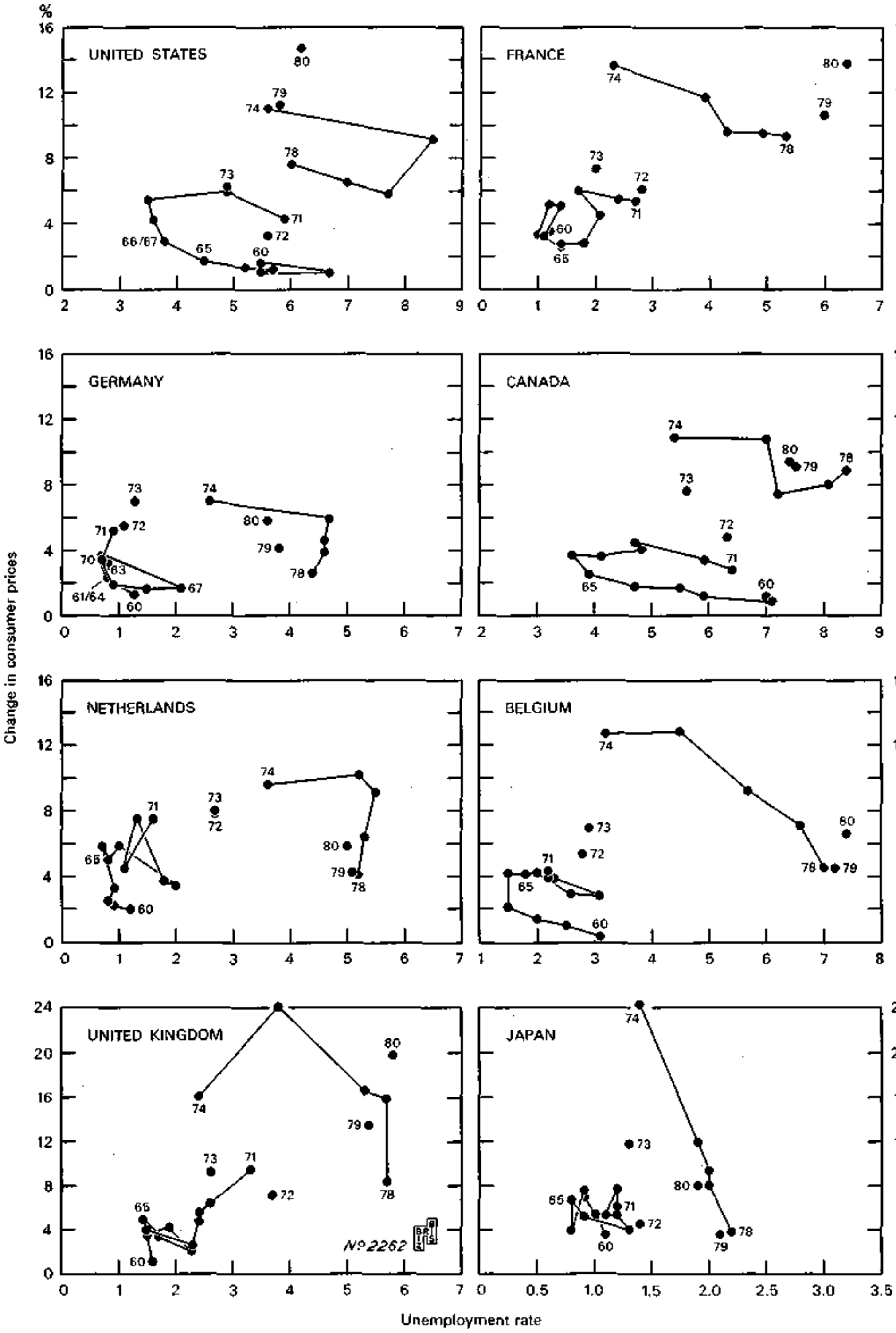
Focusing on experience since the world recession of 1974–75, the graph illustrates the success of various countries — Germany, Japan, Belgium and the Netherlands — in bringing inflation rates down to, or even below, the levels that preceded the world economic boom of 1972–73. Despite substantial differences in the processes by which wages and prices are determined, each of these countries implemented policies which helped to dampen inflation. Some attempted more forcefully than others to influence the processes as well as the outcomes of wage and price adjustment. Notably, a common element in all four cases was currency appreciation. Occurring in advance of actual price developments, these exchange rate movements attested to the fact that policy strategies were convincing. Thus, the exchange rate response reinforced the policy pressures on inflation rates, or channelled the pressures via the external sector.

Other countries have been less successful in reducing inflation in the period since the last world recession. In the United States this reflected policy decisions to promote economic expansion, which combined with exchange rate depreciation to reduce unemployment substantially, but at the cost of a renewed intensification of domestic price rises. Similarly, the depreciation of sterling up to the end of 1976 accentuated the strong inflationary pressures in the United Kingdom during that period. Since then, however, sterling's appreciation has helped dampen inflationary impulses. In Canada and France high levels of unemployment have persisted and may have helped keep inflation rates lower than they would otherwise have been.

Ominously, a striking phenomenon reflected in the graph is the tendency in all countries for the inflation/unemployment "trade-off" to shift adversely during the boom periods of the world economy. This occurred during the late 1960s and even more markedly in 1972–73. Although for each country the strength of domestic demand has contributed to such shifts during these phases, the highly synchronised

Inflation and unemployment.

Annual averages.*



* The points for 1980 are based on the latest monthly data.

international business cycle, and the stimulus it has given during the periods of boom to the prices of oil and other commodities, has been a major factor. Policies have responded to international price rises in an anti-inflationary direction, but they have not been sufficiently strong or persistent to prevent the accompanying permanent upward shifts in inflationary expectations during booms in activity. In the subsequent phases of recession and rising unemployment, inflation has, in fact, tended to abate, to different degrees in different countries, but the new upswing has usually started at a higher rate of inflation and/or unemployment than the previous one. It is particularly noteworthy that among the five countries that by 1978 had succeeded in bringing inflation rates down near to or below 1971 levels, none had been able to bring unemployment much below its 1975 rate, and in each unemployment remained substantially above the level of 1971.

A further shift in the inflation/unemployment "trade-off" seems recently to have been under way in some countries, notably the United States, France, Belgium and the United Kingdom. Other countries, among them Germany and Japan, have so far been able to resist such a movement.

Shifting strategies for combating inflation.

In the light of their experiences following the 1973–74 outburst of global inflation, policy-makers have this time generally tended to give much greater weight than before to the need to prevent the spread and intensification of inflationary forces. Although unemployment is still high, and in some cases increasing, the policy focus everywhere has been on containing the momentum of price/wage inflation. With public-sector borrowing requirements persistently large and with widespread concern that these might contribute to excessive monetary growth, many of the industrial countries have taken steps to tighten their fiscal policies, as described in Chapter III. Moreover, despite some disillusionment with incomes policies, a number of countries have continued, by means appropriate to their institutional framework, to try directly to influence the course of wages and prices. But the most striking feature of current policy attitudes has been the general stiffening of the stance of monetary policy, as discussed in Chapter IV. The authorities appear determined to put a firm brake on inflationary expectations, even at the risk of sharply slowing or reversing the growth of economic activity.

In the short-term context, the rapid new flare-up of inflationary pressures has considerably narrowed the policy options open to national authorities. Faced with the need to curb demand sharply and quickly, the authorities have sought to minimise the adverse effects on employment by attempting to induce a radical change in inflationary expectations. In addition to explaining carefully their short-term aims to cut back inflation, they have sought to put more emphasis on medium-term policies aimed at maintaining steady progress towards greater stability. In this context a place is found for the "supply side" approach to combating inflation, i.e. for structural measures designed to increase output in relation to demand. Practically all countries are seeking ways to reverse the declining trend of productivity, in particular by encouraging higher rates of capital formation, promoting work incentives, increasing labour mobility and providing better training opportunities.

The policy reactions to the intensification of inflation have been remarkably similar. Broadly speaking, these reactions may be characterised as a return to monetary conservatism, and they reflect, among other things, growing doubts about the validity of gradualist policies aimed at having the best of both worlds: maintaining high output while seeking a gradual return to price stability. Too often such policies have induced perverse expectations of still higher inflation, since they have encouraged individuals and businesses greatly to extend their time horizons with respect to the expected duration of inflation. It is noteworthy, finally, that the similarities between different countries' monetary/fiscal responses have not been a result of explicit policy co-ordination, except within the context of the European Monetary System, but rather of the common inflationary threat. Because of a general concern to avoid the inflationary consequences of currency depreciation, the sharp rise in US interest rates probably induced many countries to increase their own interest rates faster and further than they would otherwise have done. In March 1980, however, by which time a number of European countries had become reluctant to restrain economic activity further, new belt-tightening and credit-control measures by the United States led to a marked, but short-lived, appreciation of the dollar against the continental European currencies. The policy dilemma for these countries was eased in the course of April as the dollar fell back and US interest rates turned suddenly and sharply downwards.

The following paragraphs give a brief account of policy attitudes and strategies as they have recently evolved in a number of major countries.

In mid-1978, as international commodity prices were beginning their sharp climb, the *United States* was caught up in a serious problem of home-grown inflation. With a vigorous expansion under way since mid-1975 and with price inflation on the increase since early 1977, the economy was proving to be stubbornly resistant to official restraint. Though the reasons for this are hard to pinpoint, one contributory factor was the growing strength of inflationary expectations combined with the ready availability of credit. Rapid financial innovation, together with major regulatory changes since the mid-1960s, had created a highly elastic credit system in which interest rates had become the major restraining factor. But in real terms interest rates were low.

The present policy strategy of the US authorities began to take shape in late 1978. Capacity utilisation was by then perceived to be high and official concern was shifting increasingly away from unemployment towards inflation. In October of that year fiscal policy was tightened and the system of price and pay norms was strengthened. At the beginning of November, following a lengthy, steep slide of the dollar, the authorities adopted a policy of active exchange-market intervention, supported by higher interest rates and borrowing in foreign currencies. These measures marked a new departure in US policy attitudes towards the exchange rate. In the course of 1979, as inflation continued to mount, both budget and monetary actions edged towards greater restraint, but it was not until early autumn that interest rates were again increased sharply. A major package of monetary tightening was introduced on 6th October, and the operational focus of policy shifted from money-market interest rates to the quantitative regulation of bank reserves. The shift in operational strategy reflected a stronger resolve to keep the growth of the monetary aggregates on target, in the knowledge that interest rates would vary more widely in the process.

New difficulties emerged in early 1980. Sharp increases in prices at both producer and consumer levels, together with growing doubts about the restrictiveness of fiscal policy as reflected in the new budget, added to uncertainties regarding the resolve of the authorities. At this point a further restraint programme became inevitable and was introduced in March. In the monetary field a major programme of direct credit control was launched. Although designed specifically to supplement, rather than replace, reliance on bank reserve management and high interest rates, the programme temporarily provided the Federal Reserve with broad new authority. In addition, budget expenditure cuts and a tax on oil imports were proposed to reinforce these monetary measures. Subsequently, the banks' prime lending rate reached 20 per cent. before the credit-rationing implications of the new monetary programme, together with growing signs of a slide into recession, quickly transformed the monetary scene in mid-April.

In the *United Kingdom* the Conservative Government which was elected in May 1979 reaffirmed the economic policy objectives of low inflation and low unemployment in the medium term but sharply redefined economic policy strategies around greater reliance on market mechanisms. In its June budget and in subsequent policy statements the Government presented its strategy in terms of several basic elements. Heavy reliance was placed on monetary policy progressively to lower the rate of growth of the money supply and, by limiting nominal demand, to squeeze inflation out of the system. As a second element, fiscal policy was tightened to help reduce inflation both through the direct curtailment of demand and through the easing of pressures to finance fiscal deficits by monetary means. Government expenditure was to be reduced in real terms in 1980–81 and priorities within the budget were to be shifted away from public-sector investment expenditure. A medium-term rationale for limiting the public-sector borrowing requirement was to encourage private investment and productivity growth. Consistently, a third basic element of the Government's policy strategy was to increase incentives for private-sector activity by altering the tax mechanism to shift the emphasis from direct income taxation to the more neutral form of value added taxation.

The most striking departure in UK policy strategy was the Government's decision to refrain from direct involvement in pay negotiations and to return to a system of free collective bargaining. Instead, it made a strong commitment to tight monetary and fiscal policies and repeatedly reaffirmed its unwillingness to finance rapid inflation, making it clear that this required the private sector to limit wage claims if a rise in unemployment were to be avoided. The adoption of such an invisible incomes policy reflected both the Government's "laissez-faire" philosophy and the unsuccessful visible incomes policies of previous governments. As an adjunct to the Government's anti-inflation policy, the pound sterling has been allowed to appreciate.

The test of the British policy strategy began with the start of the new round of pay bargaining in the autumn. A major steel strike that spanned the first quarter of 1980 led to a settlement which did not itself lower the trend of wage growth but which did give an indication of the substantial loss of earnings that labour may suffer in any future attempts to achieve similar wage gains. This message has been reinforced both by a sharp rise in the unemployment rate to a post-war high in early 1980 and by the new budget measures which the Government announced at the end of March. The new budget, which was designed to clamp down further on inflationary expectations, provided a medium-term financial strategy running to 1983–84. The strategy includes a steady lowering of monetary growth rates and plans for restricting public spending.

In *Germany* policy attitudes have traditionally been strongly anti-inflationary and the past year was no exception. New measures, mainly monetary, were designed to dampen at least in part the expansionary impact of the previous year's policy actions. During the early part of 1979 the fiscal measures of 1978 had begun to reduce unemployment while moving the current account towards deficit. In addition, in the second half of 1978 the Bundesbank had intervened directly in the exchange markets and held interest rates low in an effort to moderate the Deutsche Mark's appreciation against the dollar. As a result, the monetary growth rate in 1978 significantly exceeded its target value, increasing the economy's potential for inflation.

During 1979 the German authorities became increasingly concerned both to slow down domestic expansion and to limit downward pressure on the Deutsche Mark as a means of preventing a further aggravation of inflation. Interest rates were pushed higher in the course of the year and the Bundesbank aimed for the lower end of its monetary target band. The target band had been chosen to give the Bundesbank flexibility in using interest rates to counter exchange-market pressures and to satisfy the liquidity demands of the domestic economy. The German authorities see the level of the band as having an influence on inflationary expectations and thereby on wage settlements, and concern has arisen as actual settlements in the early 1980 wage round have exceeded official projections that take account of the prevailing target band. By early 1980 the growing size of the current-account balance-of-payments deficit was also a major source of concern. A number of steps, including further increases in interest rates, were taken to ensure its smooth financing, but a medium-term aim of policy is to reduce it.

As elsewhere, attitudes towards the rôle of fiscal policy have shifted somewhat in Germany over recent years, with increasing emphasis on using fiscal measures to increase the efficiency and competitiveness of the economy over the medium term and reduced reliance on fiscal policy as an anti-cyclical instrument. This change in policy attitudes reflects both growing concern to encourage productivity growth and, consistently, a desire to reduce the size of public-sector borrowing requirements in order to ease pressures on the cost of borrowing to finance private investment.

In *Japan* policy attitudes and strategies during recent years have been strongly influenced by the external accounts and the exchange rate. The end of 1978 thus marked the beginning of a major shift in the focus of Japanese policy, as the current-account surplus dropped sharply from its third-quarter peak and, following the measures taken by the United States in November to support the dollar, the yen began to depreciate steadily. Earlier the authorities had sought to correct the large external surplus by accepting a substantial appreciation of the yen and by stimulating domestic recovery. By the beginning of 1979, however, wholesale prices had started a sharp ascent, and attention shifted quickly to the need to combat inflation.

The intensification of inflation in 1979, though partly the result of growing domestic demand, primarily reflected the considerable depreciation of the yen and the rise in oil and commodity prices. As a consequence, the costs of raw-material inputs for Japanese manufacturing industry rose about ten times as fast as consumer prices during the year. In these circumstances the authorities have sought to influence the outcome of wage and price decisions by means of moral suasion. With business profits relatively high, corporations were asked to absorb part of the increase in the cost of materials and energy. Labour was asked to agree to nominal wage adjustments which would be moderate in relation to consumer price increases. As indexation arrangements are not built into the Japanese structure of wage bargaining, there was some expectation, based on experience over the past two years, that the spring 1980 round of increases would not aggravate existing inflationary tensions. Indeed, wage increases in 1978 and 1979 were substantially lower than the rise in labour productivity in the manufacturing sector. In addition, the authorities have gradually tightened monetary policy through higher interest rates and stricter "window guidance" control over the expansion of bank credit, have intervened heavily in the exchange markets to bolster the yen and have taken measures to encourage capital inflows. Moreover, mounting official concern about the persistence of large budget deficits, together with a willingness to accept some slowdown in real growth, has led to the formulation of plans for a cutback in the growth of public-sector spending in the 1980–81 budget.

In March 1980 the Japanese authorities introduced a new defence package for the yen. A strong yen is seen as a crucial ingredient of efforts to control inflation — and vice versa.

In *France* policy strategy has continued to bear the imprint of the Barre plan, which was adopted in 1976 as a medium-term programme aimed at lowering the inflation rate, improving the financial position of enterprises and restoring balance both in the Government's budget and in the external accounts. At an early stage a more realistic policy of pricing for public-sector services was introduced. Then, following measures to promote price competition in 1978, when most industrial prices were freed from direct controls, the prices of most private services and commercial profit margins were also freed in the course of 1979. At the same time, efforts were made to alleviate unemployment among the young, among workers over the age of forty-five and among the chronically unemployed.

Inflation intensified less in France than in most other countries during 1979. In part, this reflected a new attitude of reluctantly accepting a high rate of unemployment, although the authorities did take certain measures during the summer to support activity. But real growth objectives have remained moderate, and the stability of the franc has received explicit policy priority as part of a general effort to reduce inflation. The authorities attach great importance to the success of the European Monetary System and, more generally, have in recent years shown a willingness to accept substantial movements in interest rates. While monetary policy objectives are defined in terms of a money-supply growth target, this target is considered consistent with exchange rate stability. In pursuing it, considerable emphasis is placed on budgetary restraint and on the quantitative control of credit to the private sector. Particular efforts have been made to promote exports, and as a rule export credit has been exempted from the banks' lending ceilings.

In *Italy* real activity last year expanded at a brisk pace, the current balance of payments recorded another surplus and the lira remained strong. However, with inflation continuing at a higher rate than in most other industrial countries and with unemployment also uncomfortably high, the Italian economy was in a poor position to face a new oil shock.

In August 1979 the new coalition Government outlined an economic programme with emphasis on increasing labour productivity and stepping up job-creating capital formation. At the beginning of October it announced its budget proposals and policy guidelines for 1980, suggesting the adoption of stimulative fiscal policies to brake the economic slowdown; these proposals, however, were debated for half a year and substantially amended before being approved by Parliament. By contrast, monetary policy had been shifting to a course of increasingly severe restraint, and substantial increases in the discount rate were announced in early October and December. Though the public sector has a remarkably large deficit, the financing of which accounts for more than half of domestic credit expansion, monetary restraint on private-sector lending has borne the brunt of anti-inflationary policy. In this context the authorities have not hesitated to apply severe quantitative credit ceilings and to impose very high interest rates. Given the sensitivity of wages to price increases via widespread indexation, considerable priority is attached to exchange rate stability.

In *Switzerland* the National Bank pursued its objective of price stabilisation by holding monetary expansion to target growth rates for several years beginning in 1975. However, as a consequence of the authorities' coming quite close to hitting their target in the first three years, and of achieving price stability in the process, the Swiss franc became extremely attractive to foreign investors. From mid-1977 until September 1978 the franc appreciated dramatically, reducing the competitiveness of Swiss export industries. Accordingly, in October 1978 the Swiss authorities abandoned their monetary target in favour of an exchange rate target and intervened in the following months to reduce the value of the Swiss franc by roughly 25 per cent. in terms of the Deutsche Mark. Nevertheless, the Swiss authorities consider the control of monetary growth rates essential to price stability in the medium term and, following a period of relatively stable exchange rates, a new target growth rate was announced in late 1979, this time for the monetary base. With the appreciation of the dollar in early 1980 the monetary authorities became increasingly concerned about the value of the Swiss franc and announced their intention to prevent it from depreciating vis-à-vis the Deutsche Mark beyond a rate of Sw.fr. 0.95 = DM 1.

In *Belgium* the authorities are strongly concerned to limit the country's growing current-account deficit and to avoid exposing the highly open economy to the considerable inflationary consequences of exchange rate depreciation. The continued periodic fragility of the balance of payments reflects several factors. Belgian exports have been depressed by a comparatively high level of domestic costs, while imports have risen sharply as personal incomes have increased with relatively rapid real wage growth and rising government transfer payments.

The size of the public-sector borrowing requirement, which has expanded steadily and substantially since 1975, when it was already at a high level, has also become a major concern of the Belgian authorities. Renewed efforts are therefore being made to reduce public expenditure, while in the monetary sphere the authorities have repeatedly demonstrated their willingness to defend the Belgian franc by means of flexible, large adjustments in interest rates.

In *Canada* the monetary authorities have continued to adhere to a policy of gradually reducing monetary growth to lower inflation over the longer run. During the past year serious efforts have been made to reduce public spending and, notably, domestic interest rates were adjusted roughly in line with US interest rates in order to limit fluctuations in the exchange rate between the Canadian and US dollars. With the Canadian tradable goods sector now operating at high capacity, additional strengthening of its international competitiveness would offer little real benefit in the short run, and in early 1980 further downward pressure on the Canadian dollar was firmly resisted. Being a large exporter of primary products, Canada has experienced inflationary impulses from the export sector as well as through imports over the past year. When a similar development occurred in 1973–74 a marked rise in business and agricultural profits was followed, with a lag, by a sharp increase in wages, leading ultimately to the application of direct price and wage controls. The retention of controls on crude oil prices has this time moderated the immediate price impact of the external inflationary impulse.

The problems of unemployment and productivity.

At the beginning of last year policy strategies in most industrialised countries other than the United States were oriented towards reducing unemployment. By the end of the year all these countries had adopted strategies that could lead in the short run to greater economic slack, and in most cases the shift towards more conservative policy attitudes implied a medium-term outlook of slow growth and, judged by past standards, persisting high unemployment. In this context it has become increasingly important to attack the problems of structural unemployment and sluggish productivity growth. Efforts to ease structural bottlenecks in labour markets could allow real economic growth to proceed faster and further in the medium term without generating new inflationary pressures. Efforts to promote productivity could also increase the scope for a non-inflationary expansion of output and incomes.

The following table outlines the recent development of unemployment rates in the Group of Ten countries and Switzerland. In many of these countries unemployment rates changed very little in 1979, though they declined by a full percentage point in Canada and roughly half a percentage point in Germany and Sweden, while rising by half a percentage point in France. In the first quarter of 1980 unemployment rates rose sharply in the United States, Canada and the United Kingdom. Compared with the historical norms that prevailed prior to the international price shock of

Unemployment rates.[1]

Countries	1957–73 highest	annual rate average	1976 December	1977 December	1978 December	1979 December	1980 April
	in percentages						
United States	6.8	5.0	7.7	6.2	5.9	5.9	7.0
Canada	7.1	5.5	7.5	8.5	8.1	7.1	7.5
Japan	1.5	1.1	1.7	2.1	2.2	2.0	1.9[2]
Germany	3.7	1.4	4.4	4.5	4.1	3.5	3.6[2]
France	2.7	1.6	4.3	5.2	5.7	6.3	6.3[3]
United Kingdom	3.8	2.2	5.6	5.9	5.5	5.4	6.0
Italy[4]	8.2	4.0	6.8	7.1	7.6	7.7	.
Belgium[4]	6.3	3.7	6.5	7.3	7.5	7.7	7.3
Netherlands	2.7	1.5	5.2	5.2	5.2	5.0	5.1
Sweden	2.5	1.5	1.5	1.8	2.1	1.7	1.8[2]
Switzerland	0.1	0.0	0.6	0.4	0.4	0.3	0.2

[1] Seasonally adjusted series except for Belgium, Italy, Sweden and Switzerland. [2] March. [3] February.
[4] New series as from December 1976.

1973–74, the rates are now uniformly high. However, they have become somewhat difficult to assess owing to changes in the composition and characteristics of the labour force. Despite relatively high unemployment rates, some countries have reported shortages of many types of labour skills.

Another alarming feature of economic performance in some industrial countries is the sluggishness with which productivity has grown during recent years. Not only has real income growth been disappointing, shortfalls in productivity growth have in addition contributed indirectly to inflation in countries in which policies were formulated on the basis of over-optimistic expectations. As shown in the table on page 32, following a rebound in 1976 as the industrial economies began to recover from recession, productivity growth in subsequent years has for the most part been well below the norms that prevailed during the 1963–73 period. Although in Germany and Italy economy-wide productivity grew more rapidly in 1979 than during 1978, it fell in the United States and Canada last year, after remaining virtually stagnant during 1978. In the manufacturing sector, however, the picture looks rather better, with substantial increases in productivity being recorded in Japan, France, Germany and Italy in 1979. Part of the productivity problem would therefore seem to reflect a continuing shift in the employed labour force from manufacturing industry, where man-hour productivity is relatively high, towards the service industries, where it is lower on average. The reasons underlying these developments, particularly in their relation to trends in fixed capital investment, are discussed in some detail in the following chapter.

In the context of high and rising unemployment and sluggish productivity growth, policy discussions have devoted increasing attention to measures that would strengthen the "supply side" of the economy in the medium term. A number of countries have taken steps to deal with structural unemployment, in part to lighten

Employment and labour productivity.

Countries		Employment					Labour productivity*				
		1963–73 average	1976	1977	1978	1979	1963–73 average	1976	1977	1978	1979
		annual averages, percentage changes									
United States	Total economy	2.1	3.1	3.4	4.1	2.2	1.6	2.5	1.7	0.1	−0.4
	Manufacturing	1.7	3.7	3.6	4.0	2.5	2.8	4.4	3.1	0.6	2.4
Canada	Total economy	3.1	2.1	1.8	3.3	4.0	2.4	3.3	0.6	0.1	−1.0
	Manufacturing	2.2	1.0	0.0	1.6	3.9	4.2	4.3	2.7	5.7	−0.4
Japan	Total economy	1.4	0.9	1.4	1.2	1.3	8.7	5.5	4.0	4.7	4.6
	Manufacturing	2.7	0.0	−0.4	−1.0	0.5	11.7	12.3	5.1	8.0	12.1
United Kingdom	Total economy	0.1	−0.5	0.2	0.4	0.6	2.9	2.6	2.2	2.6	1.0
	Manufacturing	−0.6	−3.1	0.3	−0.5	−1.3	4.2	4.9	0.6	1.6	.
France	Total economy	0.8	0.5	1.0	0.0	.	5.5	4.6	3.2	3.5	.
	Manufacturing	1.0	−1.1	−0.8	−2.1	−1.4	.	9.2	5.1	4.6	6.0
Germany	Total economy	0.0	−1.1	−0.2	0.7	1.3	4.8	6.2	2.8	2.7	3.1
	Manufacturing	0.5	−2.4	−0.8	−0.6	0.4	5.8	8.9	4.5	3.2	5.0
Italy	Total economy	−0.3	0.8	1.1	0.4	0.1	5.1	5.1	0.8	2.1	4.8
	Manufacturing	0.4	−1.4	1.0	−0.8	0.3	5.7	9.0	−0.9	3.0	8.9

* In the case of manufacturing industry, adjusted for the number of hours worked.

the unemployment burden of disadvantaged groups but also to prevent or relieve labour bottlenecks.

The discussion of supply-side policies for reviving productivity growth has been complicated by the difficulty of accounting statistically for the productivity slowdown, particularly in the United States. Considerable support has emerged for stimulating investment, particularly in the energy sector where it would serve a multiple purpose. In the United Kingdom changes in the tax structure have been implemented to increase incentives for private-sector activity. A number of countries, France being a notable example, have taken steps to rationalise production in declining industries and to increase reliance on market price mechanisms in the allocation of productive resources. These changes may have contributed to the recent improvement in the productivity performance of the manufacturing sector in certain countries.

In some countries action to deal with structural unemployment and sluggish productivity growth has recently been limited by the desire to tighten the reins on public-sector budgets. While it may be necessary to limit such action in the short run as part of the resolute effort to brake inflationary expectations quickly, increasing attention to these problems will be required in the years ahead, particularly if the industrial economies are able to achieve no better than slow growth while seeking to avoid new inflationary pressures.

III. DEMAND, OUTPUT AND FISCAL POLICY.

A major feature of economic developments last year was the slowing-down of real growth in the United States and the concurrent economic expansion elsewhere, led by Germany and Japan. This change in relative positions, which was much along the lines envisaged at the Bonn Summit in July 1978, had some very positive elements. It did materially contribute both to the emergence of a more balanced pattern of external current accounts and to the maintenance of more stable exchange rates. At the same time, however, the adjustment in relative growth rates occurred at a level of aggregate international demand that was too high, particularly when account is taken of existing supply conditions in world markets for oil and commodities. The outcome was a sharp, and largely unexpected, acceleration of inflation in all the industrial countries.

Among other things, the experience of the past year points to some of the risks inherent in international efforts to co-ordinate demand policies. Part of the problem, perhaps, was that the adjustment in relative positions would, in time, largely have occurred anyway as a result of previous changes in real exchange rates. Another difficulty, however, was that domestic demand in the United States did not fall back as much as had been expected. To some extent it may have been expenditure reactions to inflation itself that bolstered the overall pressure of US demand, a possibility which gave rise to increasing concern among policy-makers as the year progressed. As this chapter describes, one response of governments to the new inflationary situation has been to move more generally towards fiscal restraint, a development which intensified during the early months of 1980. This, combined with monetary restraint and the deflationary impact of the new OPEC surplus, has now brought corresponding signs of impending recession.

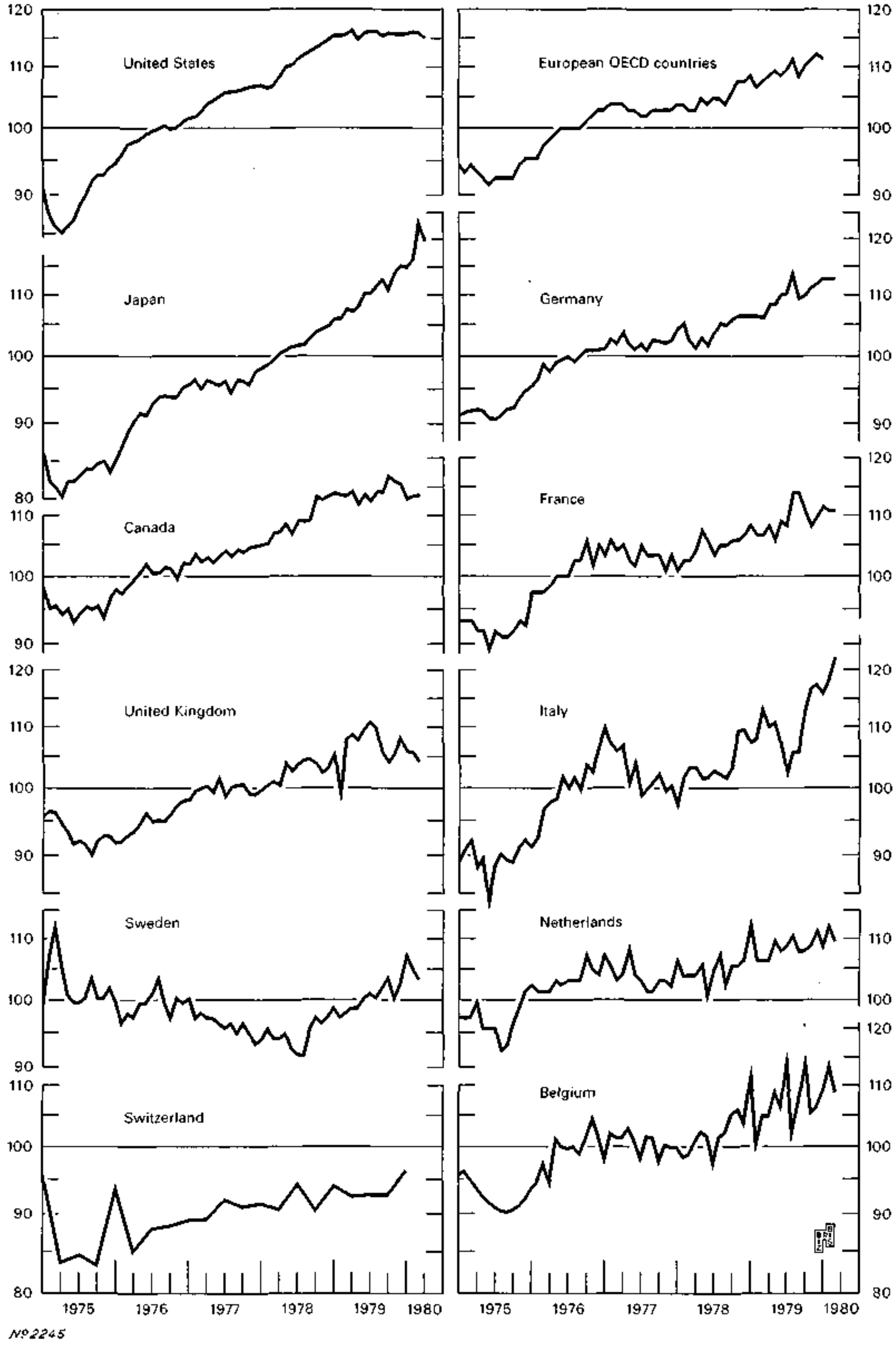
The worsening oil situation has also raised once again, and in more pressing form, the question of the fundamental longer-term adjustment required in the energy field. In addition, the poor productivity performance registered more generally since 1973 has added to the concern felt in many countries about the relatively low rates of business investment growth since the first oil shock. The main thrust of policies in this respect has come to focus on the elimination of inflation as the most hopeful method of improving the climate for capital investment.

Output and the components of demand.

1979 is a difficult year to characterise as far as economic developments are concerned. On the one hand, the rate of growth of total output in the industrial countries slowed down from nearly 4 per cent. in 1978 to just over 3 per cent. — the smallest increase since the trough of the recession in 1975. On the other, this increase was stronger than had either been expected or even, in the case of the United States,

Industrial production.

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



desired. This was particularly true towards the end of the year, when the combined effects of the new oil crisis and some tightening of fiscal and monetary policy might generally have been expected to result in a weaker performance. As the graph of industrial production shows, however, the momentum of growth — in part stimulated by fiscal policy changes in 1978 — continued unabated in western Europe and Japan throughout the year. And in the United States there was no change at the end of the year in the essentially flat trend of production that had become established earlier. A partial explanation for this may be that some activity was carried over into the second half of the year as a result of the severe weather early in 1979. More significant, however, was the persistence of the American consumer in the face of

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

Countries	Years	Real gross national product	Consumption		Gross fixed investment			Exports	Imports	Changes in stocks[1]
			private	public	private non-residential	private residential	public			
		annual changes, in percentages								
United States . .	1976	5.9	5.9	1.3	4.8	23.2	— 6.6	6.8	19.1	0.5
	1977	5.3	5.0	3.2	8.7	20.7	— 6.5	2.4	9.7	1.0
	1978	4.4	4.5	1.1	8.4	4.2	6.9	10.7	11.0	1.1
	1979	2.3	2.6	1.3	6.2	— 5.7	— 6.2	10.1	4.5	0.7
	1979 IV	1.0	1.6	0.8	3.4	— 7.0	— 2.8	9.2	3.1	0.1
Japan . . .	1976	6.5	4.5	3.6	1.4	8.6	2.8	20.0	8.0	0.8
	1977	5.4	3.8	4.0	3.1	1.5	12.3	11.2	3.5	0.6
	1978	6.0	5.5	5.9	7.0	6.1	18.3	1.9	8.2	0.6
	1979	6.0	5.9	4.6	16.5	— 2.4	3.2	6.6	18.1	1.1
	1979 IV	6.4	4.1	2.5	11.3	— 5.0	0.5	18.5	9.4	1.1
Germany . .	1976	5.3	3.4	2.0	6.7	6.2	— 3.0	11.5	11.1	1.4
	1977	2.6	3.1	0.6	7.1	3.0	— 4.3	4.3	4.7	1.1
	1978	3.5	3.5	3.9	6.8	4.2	7.7	4.4	5.9	0.8
	1979	4.4	2.8	2.8	9.5	8.6	5.0	5.0	10.2	2.4
	1979 IV	4.4	2.6	2.8		9.9		3.6	8.8	1.9
France . . .	1976	5.1	5.6	6.1	6.1	— 1.3	.[2]	10.7	20.7	1.3
	1977	2.9	3.1	0.4	0.1	— 2.7	.[2]	8.4	2.0	1.2
	1978	3.7	4.5	7.8	2.6	— 1.6	.[2]	6.4	6.3	0.7
	1979	3.4	3.4	5.0	3.6	1.2	.[2]	7.6	11.9	1.7
	1979 IV	3.9	3.0	1.3		4.9		8.2	8.4	2.6
United Kingdom .	1976	3.6	0.2	1.9	3.0	— 0.2	— 2.3[3]	9.1	4.2	0.4
	1977	0.8	— 1.3	— 1.0	9.4	— 6.8	—13.6[3]	6.6	1.0	1.1
	1978	3.1	5.5	2.0	7.4	13.9	— 8.9[3]	1.9	3.7	0.7
	1979	0.6	4.5	1.1	— 0.2	—15.2	— 2.5[3]	2.0	11.0	1.7
	1979 IV	— 1.0	2.8	0.2	— 0.8	— 1.1	1.0[3]	3.5	14.0	0.9
Italy	1976	5.9	3.5	2.6	4.4	— 3.4	.[2]	13.2	15.4	2.6
	1977	1.9	2.3	2.3	— 0.9	1.2	.[2]	6.7	— 0.2	1.2
	1978	2.6	2.9	1.8	— 0.6	1.2	.[2]	10.1	8.1	0.9
	1979	5.0	5.1	2.7	5.7	1.2	.[2]	8.9	14.0	2.0
	1979 IV	5.1	6.4			4.0		0.9	4.2	.
Canada . .	1976	5.4	6.3	1.6	— 0.4	19.3	— 6.5	9.3	8.3	0.8
	1977	2.4	2.9	2.9	1.2	— 5.1	— 0.3	7.0	2.2	0.2
	1978	3.4	3.0	1.3	1.0	— 4.6	2.2	9.3	4.1	0.4
	1979	2.9	2.3	— 0.9	10.4	— 7.4	— 0.2	3.0	5.6	1.6
	1979 IV	2.1	1.5	— 1.8	12.8	— 6.0	— 1.1	— 0.5	0.0	1.4

[1] As a percentage of previous year's gross national product. [2] Included in the private sector. [3] Includes public corporations.

declining real income growth — a persistence which was mirrored in a sharp fall in the saving ratio in the course of the year.

Even so, the entire decline in the industrial countries' overall growth rate was arithmetically accounted for by the United States, where gross national product rose by only 2¼ per cent., compared with nearly 4½ per cent. in 1978. Between fourth quarters, the increase in output was only 1 per cent. Elsewhere, on average, growth was marginally faster last year — nearly 4 per cent., compared with 3¾ per cent. — though this result masks rather disparate developments from one country to another. As the tables show, growth accelerated moderately in Germany, as it did more strongly in Italy, Austria and the Scandinavian countries with the exception of Norway. In the United Kingdom, however, the growth rate fell back sharply as the loss of international competitiveness intensified and as anti-inflation policies were strengthened. Growth in Canada was also below that achieved in 1978.

Much of the demand for output in the industrial countries came from the private sector last year. The case of the historically low and falling American savings ratio was almost certainly unique; nevertheless, despite the real income effects of the rising oil price and the concomitant re-emergence of the OPEC surplus, there were appreciable absolute increases in consumer spending in Japan, Italy and the United Kingdom. In Germany a rise of nearly 3 per cent. was recorded and, among the smaller countries, Austria, Belgium, Finland and Sweden also saw a fairly rapid acceleration in consumption growth. In part, of course, this relatively strong performance reflected the effects of those fiscal relaxations in 1978 which had benefited the personal sector, even though these measures began to be reversed as 1979 wore on. In the United Kingdom, unfortunately, consumption growth was also assisted by an acceleration of wage inflation, despite tight monetary and fiscal policies, and the personal saving ratio even rose.

In addition to consumption, private business investment also rose appreciably in many countries. This was especially true in Japan, Germany and Canada, where capacity utilisation rates rose and profits improved. Not surprisingly, the growth in real business investment outlays decelerated somewhat in the United States, but even so the rate of increase was well over 5 per cent.

In the United States, too, private residential investment began to decline. However, with the earlier removal of certain constraints on the market for housing finance, this sector did not face a sharp rundown in the actual availability of finance, as had happened on several previous occasions. Consequently, although the cost of mortgage finance rose appreciably (at least in terms of nominal interest rates) the downturn in housing expenditure did not come as early, and was not as severe, as might have been the case. In this way, the housing sector probably also contributed to the apparent reluctance of the American economy to enter a recession "on time". Elsewhere, with interest rates likewise rising sharply, housing investment was mostly weak — Germany and Switzerland being the only major exceptions — and in the case of the United Kingdom it fell sharply.

Probably more important as a restraining factor on overall demand last year was the slower growth of direct public-sector demand on real resources — both capital and current. As the tables show, this was generally the case among the major countries, and within that category there was a particularly sharp slowdown in the growth of public investment in Japan.

In contrast, a fairly strong positive contribution came from stockbuilding last year, except in the United States. In those countries in which final (non-stock) demand slowed down, the increase in stocks may in part have been involuntary, though this is unlikely to have been true of Japan and Germany, and hedge and speculative buying was no doubt a factor as commodity prices rose. Nevertheless,

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	1976	6.2	1.6	4.6	3.7	10.5	1.3	. [2]	12.2	20.7
	1977	3.7	4.2	6.2	1.9	11.1	2.6	. [2]	6.1	9.5
	1978	1.5	0.9	− 3.4	3.0	− 9.5	2.2	. [2]	5.7	− 2.4
	1979	5.2	5.0	5.1	3.0	10.0	1.0	. [2]	10.9	10.3
Belgium . . .	1976	5.4	4.4	5.4	4.1	− 2.0	15.7	7.1	9.4	9.9
	1977	0.9	1.0	2.1	3.4	− 1.6	− 0.6	− 0.2	14.0	15.5
	1978	2.5	2.8	2.4	6.4	3.2	2.7	− 2.9	3.9	4.1
	1979	3.3	2.5	3.6	3.0	4.2	− 8.0	6.0	6.1	6.8
Denmark . . .	1976	7.0	4.7	7.2	2.4	21.4	27.3	− 0.9	4.5	16.5
	1977	1.9	2.0	0.4	3.1	0.5	−10.5	− 5.1	4.7	− 1.2
	1978	1.3	1.1	− 0.8	5.5	0.9	3.5	3.1	3.8	1.6
	1979	3.5	1.7	3.0	5.4	4.0	− 8.0	− 0.5	8.6	5.5
Finland	1976	0.3	2.7	0.9	5.6	− 9.6	− 8.2	− 4.6[3]	14.7	− 3.5
	1977	0.4	1.8	− 1.4	4.1	−10.6	4.9	− 0.1[3]	9.4	− 6.3
	1978	1.4	2.3	1.2	5.0	−15.6	− 1.3	2.0[3]	8.0	− 3.8
	1979	6.6	2.9	5.3	3.5	8.3	− 2.5	− 0.9[3]	9.0	16.8
Netherlands .	1976	5.3	3.7	5.7	4.0	− 6.2	2.5	0.5	10.1	10.3
	1977	2.8	3.3	4.9	3.4	18.2	15.8	−12.8	− 1.5	3.0
	1978	2.4	1.8	3.7	2.4	5.2	2.5	− 3.6	3.5	6.5
	1979	2.3	2.8	2.5	4.5	3.2	− 6.0	2.0	7.2	6.5
Norway	1976	6.8	6.9	6.1	7.4	13.1	2.5	3.8	11.3	12.3
	1977	3.6	5.7	6.9	4.9	3.5	2.9	5.4	3.6	3.4
	1978	3.0	4.7	− 3.8	4.4	−21.4	8.1	5.4	8.7	−13.5
	1979	3.7	0.4	0.5	2.4	−11.4	5.9	−10.0	6.9	1.0
Spain	1976	3.0	3.0	4.3	5.3		− 2.0		14.4	10.3
	1977	2.6	3.6	1.9	3.7		− 1.2		9.6	− 5.5
	1978	2.5	2.1	2.1	5.5		− 4.0		11.0	− 0.8
	1979	1.6	1.3	1.9	5.0		− 0.4		5.5	9.0
Sweden . . .	1976	1.3	2.2	4.0	4.4	1.4	− 8.8	0.8	4.7	7.4
	1977	− 2.5	0.9	− 0.9	2.6	− 5.0	− 2.1	− 0.1	0.6	− 3.3
	1978	2.4	3.5	− 0.7	3.2	−19.7	17.9	1.0	7.6	− 6.4
	1979	4.1	2.5	2.3	4.5	9.1	1.5	7.1	6.3	10.8
Switzerland . .	1976	− 0.6	− 1.9	1.1	2.7	− 9.8	−13.6	. [2]	9.3	11.5
	1977	2.8	3.0	3.0	0.5	0.4	7.0	. [2]	9.2	8.5
	1978	0.2	− 0.4	2.2	1.6	1.8	15.1	. [2]	4.1	11.4
	1979	0.7	0.9	1.5	1.0	6.4	10.0	. [2]	2.0	6.0

[1] Equals change in real gross national product minus net investment in inventories. [2] Included in the private sector. [3] Includes public enterprises.

the scale of the build-up was large enough to cast some doubt on earlier hopes that the emergence of a substantial overhang (in relation to sales) might be avoided, and with it a very sharp correction such as occurred in 1974–75.

The final item of gross national product as calculated from the expenditure side is the real foreign balance — net exports of goods and services. For the industrial countries as a whole the change in this item was mildly negative last year by about ½ per cent. of gross national product. This was largely due to a marked acceleration in import growth, fed by domestic demand and, especially in the United Kingdom, Switzerland, Japan and Germany, changes in price competitiveness. The growth of exports was generally quite strong and in many cases faster than in 1978. It should be borne in mind, however, that much of the net deflationary impact of the industrial countries' external balance appeared as an adverse movement in the terms of trade (basically a rise in import prices) and hence affected *real* disposable income in the private sector, with demand effects already subsumed in the discussion of private-sector spending.

Among the major countries, the United States was the only exception to the general adverse movement of real net exports. The slackening of domestic demand found its reflection in an appreciable slowdown in the volume growth of imports from 11 to 4½ per cent., while real exports continued to increase at an annual rate of 10 per cent. From the import side, therefore, the stimulus given to world demand by the US economy tapered off last year.

Elsewhere, the Japanese and German domestic expansions drew in imports at an accelerated pace, but in the Canadian case the deterioration in the external balance was primarily the result of a fall in the growth of exports to its major market over the border. The United Kingdom's case was somewhat anomalous: the real foreign balance declined by an amount equivalent to no less than 2½ per cent. of gross national product, North Sea oil notwithstanding. The foreign balance thus accounted, arithmetically, for most of the slowdown in output growth to a mere ½ per cent. The major reason for this seems to lie with the worsening competitive position — probably in terms of both price and non-price factors. On the price side the further substantial loss of competitiveness resulted from a combination of accelerating wage costs and a rising exchange rate which, from this point of view, compounded the problem — although from that of import costs it simultaneously helped to relieve inflationary pressures.

Judging by the data for industrial production (see the graph on page 34) and certain leading indicators, the early months of 1980 seem to have brought some early signs of an incipient slowdown in output growth. However, at the time of writing, these signs are not general and, even where they are fairly clear — in the United States, the United Kingdom and Canada — the movements have not yet assumed the scale of 1974–75. In Japan and continental western Europe industrial production apparently continued to move ahead quite rapidly after the turn of the year. But in the important case of the United States and in the United Kingdom, the level of unemployment has begun to rise sharply. With the demand-restraining effects of domestic policy changes and of the OPEC surplus both intensifying, it may not be long before qualitatively similar movements become established elsewhere.

The behaviour of personal saving and the revival of inflation.

From the standpoint of aggregate global demand, one of the major unforeseen developments of 1979 was the behaviour of personal saving, particularly in the United States, where rising inflationary expectations were an important factor. In this respect, spending reactions to the current oil shock have up to now contrasted rather sharply with those in 1973–75.

In fact the movement of saving ratios in the major countries last year seems on average to have been slightly downward, thus exerting some expansionary effect on demand. Germany and, especially, the United Kingdom appear to have been the main exceptions to this generalisation. Nevertheless, outside the United States saving still remained very high by historical standards, even in those countries such as Italy and the United Kingdom where inflation was particularly virulent. There thus remains a sharp dichotomy between the behaviour of consumers in the United States and those elsewhere — a dichotomy which probably reflects in part the two possible, but contradictory, responses to inflation. On the one hand, to the extent that inflation erodes the real value of the stock of personal-sector financial assets (that is, real rates of interest become negative at the same time as high nominal rates depress capital values) savers might wish to set aside a larger proportion of income in order to maintain the real stock at the desired level. On the other hand, however, losses of real value incurred by holding financial assets might encourage individuals to diversify portfolios considerably in the direction of real assets, such as houses, considered to be good hedges against inflation. Or purchases of consumer durables and other non-perishable goods might be brought forward and, as there must be some limit to this, there could also simply be an increase in spending for immediate enjoyment.

The figures for the United States suggest that, in contrast to their behaviour in 1973–75, consumers there have leant towards the second of these alternative reactions. However, the fall in the saving ratio last year of less than half a percentage point does not at first sight look very dramatic. Nevertheless, when the trend *during* the year is examined, there is clearly greater cause for concern. The figures are of course also significant if only because they were an important trigger in March this year of further policy measures, both in the fiscal and credit control fields. The Administration acted for a mixture of reasons. On the one hand, given the

Ratios of personal saving to disposable income.

Countries	1975	1976	1977	1978	1979
	in percentages				
United States	7.7	5.8	5.0	4.9	4.5
Canada	10.9	10.2	10.0	10.4	10.3
Japan	22.5	22.4	21.1	20.1	19.5
France	18.6	16.4	16.9	17.8	16.7
Germany	16.4	14.7	13.7	13.8	14.6
Italy	25.4	23.7	25.8	26.4	26.7
United Kingdom	14.0	13.4	13.3	14.2	15.8

objective of stimulating net exports and business fixed investment, the pressure of other demand components was being kept too high, with obvious implications for inflation. Perhaps more important, the downward trend in the saving figures was evidence of a growing inflationary psychology and gave rise to fears that the situation was getting out of hand. Indeed, preliminary figures suggest that saving fell even further in the early months of this year. The accompanying rise in consumer indebtedness to what was felt to be an unsound level was also viewed with concern, given the risk of a subsequent overly sharp deflationary reaction which would unnecessarily deepen the expected recession. Nevertheless, it is fairly usual for saving to fall somewhat at a time of pressure on real disposable incomes. And as the figures show, the pressures on consumers in the course of last year were fairly strong in this respect. In other words, the declining saving trend during the year may also have owed something to real income developments even though inflationary factors were clearly dominant.

Households' income and saving in the United States.

Items	1960–69	1970–74	1975	1976	1977	1978	1979	1979 1st quarter	1979 2nd quarter	1979 3rd quarter	1979 4th quarter
	in percentages										
Saving ratio[1] . . .	5.9	7.3	7.7	5.8	5.0	4.9	4.5	5.0	5.4	4.3	3.5
Financial saving ratio[2]	3.7	5.8	7.1	4.5	3.0	2.8	2.8	2.8	3.8	2.6	2.0
Real disposable income[3].	4.1	3.4	2.1	3.7	4.2	4.6	2.3	4.2	2.8	1.8	0.5

[1] Ratios of personal saving to disposable income on a national accounts basis. [2] Gross saving minus physical investment (mainly consumer durable goods and residential construction) on a flow-of-funds basis. [3] Annual rates of change in real personal disposable income.

Relative demand pressures and external adjustment.

In last year's Report it was noted that the de-synchronisation of cyclical positions appeared to have been a major contributor to current-account imbalances among the industrial countries. In particular, the boom in the United States from 1975 onwards contrasted sharply with cyclical developments in Japan, Switzerland and Germany. The resulting surpluses in these latter countries and the US deficit, it was suggested, had been one of the causes of the currency unrest that came to a head in 1978.

In 1979, however, the process appears to have started to unwind itself: relative demand pressures began to be reversed at the same time as the lagged effects of earlier exchange rate changes began to make themselves felt on external balances. In turn, the foreign exchange markets themselves were calmer last year. It should be stressed, however, that the present analysis is confined to the balance on goods and services in volume terms, as are the foreign balances shown in the graphs on pages 42 and 43. The other major feature of 1979 — the oil-induced worsening of terms of trade and the accompanying general deterioration of industrial countries' current balances — is not considered here. Chapter V deals more fully with the overall payments picture.

As previously, relative demand pressure has been measured by comparing, for each country, the deviation of total domestic demand from the pre-1973 trend with the average deviation for all the countries considered. The process is a rough attempt to allow for the fact that demand pressure depends not only on the current growth rate but also on productive capacity — for which the historical growth is a proxy. (Because of the very sharp re-orientation of growth in Japan, however, the pre-1973 trend was not used for measuring deviations in the later period. Instead, the average growth in 1973–79 was taken.) The graphs show once again how apparently pervasive is the influence of demand, though with exchange rate effects also working in the direction of greater adjustment last year it is not possible to distinguish, from the graphs alone, their relative contributions.

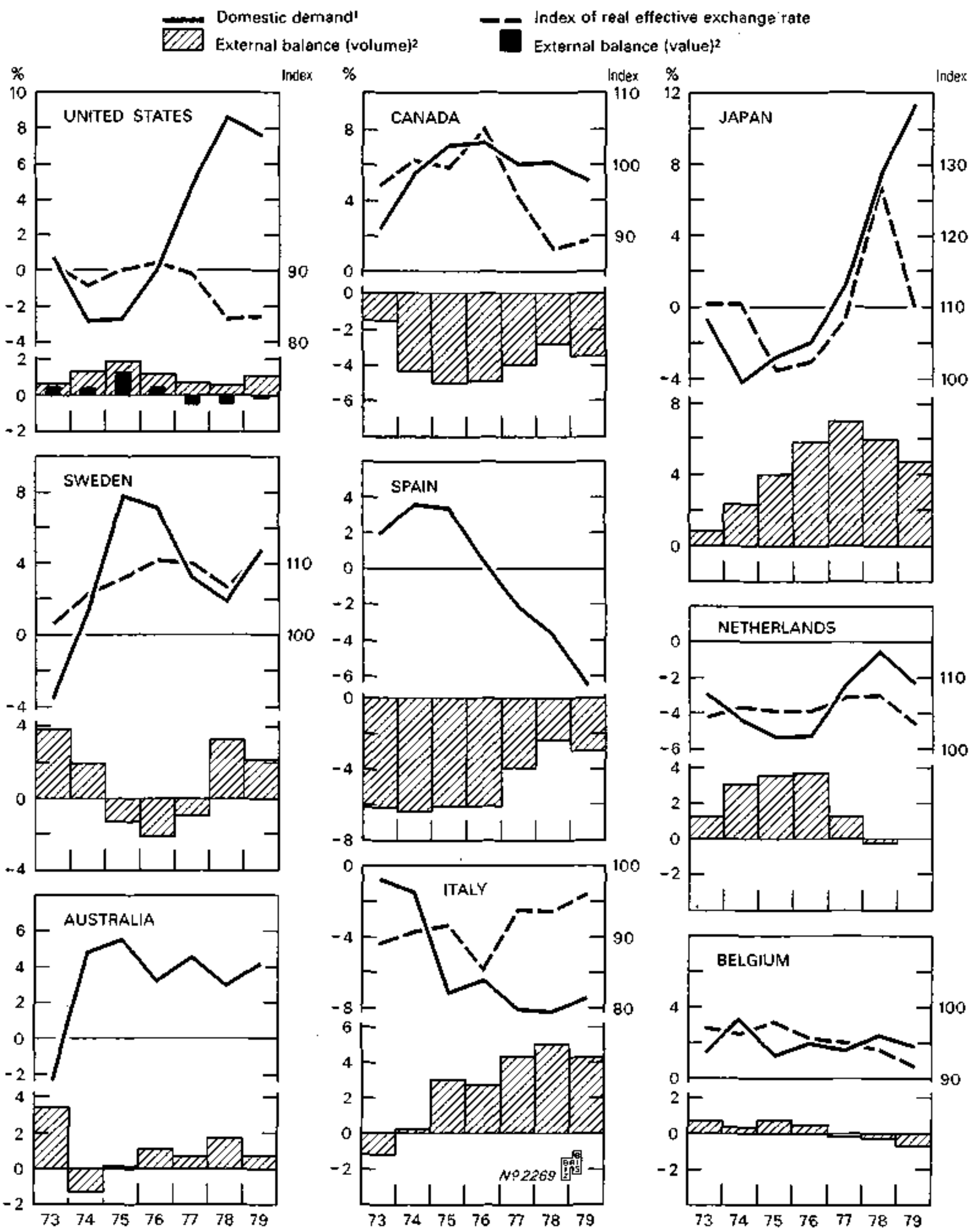
The most significant change occurred, of course, in the United States, where, following two years of improving price competitiveness, the growth of domestic demand slackened from nearly 4½ per cent. in 1978 to less than 2 per cent. last year. On the other side, in Japan and Germany the acceleration of demand growth was somewhat less marked — from 7 to 7½ per cent. and from 4 to 5¾ per cent. respectively. In both cases, however, the real foreign balance fell appreciably as a percentage of gross national product — by 1¼ per cent. In Germany, the appreciation of the Deutsche Mark clearly contributed to this result. In the Japanese case the adjustment was no doubt also helped by the lagged effects of the rise in the exchange rate in 1978, even though this was largely reversed last year. There may also have been some continuing effects from the "emergency" import programme and from the voluntary restraint on certain exports, both of which of course became less appropriate as the year progressed.

In Switzerland there was a particularly large downward adjustment in real net exports of almost 2 per cent. of gross national product. However, none of this was apparently due to the cyclical situation, as domestic demand grew by only 2½ per cent., compared with a little more than 3 per cent. in 1978. Although the Swiss franc weakened during the course of last year, its high average level must have accounted for virtually all of the external adjustment achieved.

Elsewhere, among countries which were already registering overall current-account deficits in 1978 (in current prices), cyclical demand developments last year helped towards some adjustment — for example in the Netherlands and Norway. As Italy enjoyed a comfortable current surplus, it was able (at least from this standpoint) to permit a fairly sharp acceleration in demand from 2 to 6 per cent. The sharpest turn-round in demand occurred in Sweden, however, where the change from a fall of 2 per cent. to a rise of 5½ per cent. helped produce a current-account deficit last year.

In Canada, where there was also some acceleration in domestic demand growth, the change in relative demand pressure was particularly great in relation to its main trading partner, the United States. (This is not apparent in the graph, as the calculations do not make any allowance for weighting by trade shares.) The real foreign balance therefore deteriorated, despite a considerable real devaluation of the Canadian dollar. The most anomalous case, however, remained that of the United

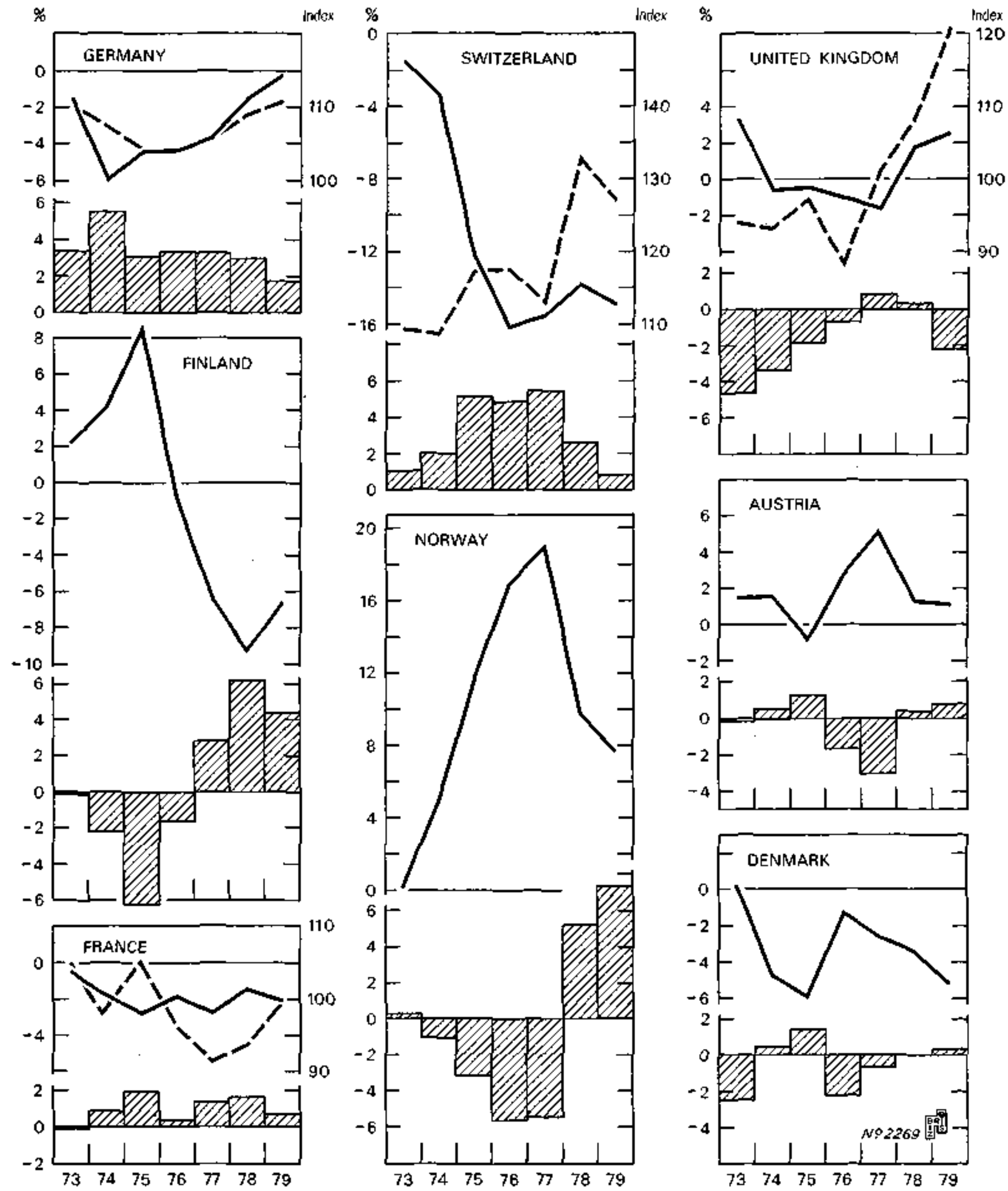
Relative demand pressures and real foreign balances.



[1] See text on page 41 for explanation. [2] As a percentage of gross national product.

Kingdom. Although real demand growth decelerated slightly, there was still a small increase in *relative* terms, a development which was compounded by a further rise in the real exchange rate — that is, by a further worsening of price competitiveness. Not surprisingly, real net exports declined sharply. The further build-up in North Sea oil production thus only offset part of a potentially even larger deterioration.

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



Note: Real effective exchange rates are shown only for the Group of Ten countries and Switzerland.

Anomalous cases aside, however, the analysis confirms that relative demand developments — in part determined by fiscal policy changes — worked firmly in the direction of better international balance last year. In particular, demand in the United States stabilised at a high level at the same time as Japan and Germany took up some of the running and, with Switzerland, saw some external adjustment via the exchange rate mechanism. Unfortunately, however, despite the differential expansion which had been sought in order to reduce the balance-of-payments constraints felt by some countries, the overall result contributed to the intensification and spread of inflation. With demand in the United States not turning down as expected, the recovery elsewhere was such as to result in a global level of demand sufficient to allow large rises in the prices of oil and other primary commodities. Thus, having fallen short of achieving sufficiently differentiated policies, authorities everywhere began to turn in varying degrees towards demand restriction.

Fiscal policy.

As has already been noted, the move towards some degree of fiscal expansion outside the United States in 1978 began to bear fruit last year in the form of an acceleration in demand growth. However, just as the earlier attempt to break out decisively from the 1974–75 recession had to be reined back in 1977 because of inflationary risks, so in 1979 there was a reversion to restraint again. It is in this sense, as already anticipated in last year's Annual Report, that persisting high demand in the United States might indirectly have tended to "crowd out" growth elsewhere. The mechanism was apparent not only in a further rise in non-oil commodity prices but also, of course, in the oil market itself. The tone of the new anti-inflationary

General-government financial balances[1] and unemployment.

Countries	Items	Annual changes					Annual averages	
		1975	1976	1977	1978	1979	1974	1979
		in percentages						
United States . .	Unemployment	2.9	−0.8	−0.7	−1.0	−0.2	5.6	5.8
	Financial surplus	−4.7	2.1	1.1	1.0	0.6	0.5	0.6
Japan	Unemployment[2]	0.6	0.0	0.1	0.0	−0.2	1.2	0.7
	Financial surplus	1.1	−0.9	−0.3	−1.6	0.3	−3.8	− 5.2
Germany	Unemployment	2.1	−0.1	−0.1	−0.2	−0.5	2.6	3.8
	Financial surplus	−4.4	2.2	1.1	−0.3	−0.1	−1.4	− 2.9
France	Unemployment	1.6	0.4	0.6	0.4	0.7	2.3	6.0
	Financial surplus	−2.8	1.7	−0.8	−1.0	0.9	0.6	− 1.4
United Kingdom .	Unemployment	1.4	1.4	0.5	0.0	−0.3	2.4	5.4
	Financial surplus	−0.8	−0.2	1.8	−1.2	1.5	−4.0	− 2.9
Italy	Unemployment	0.4	0.8	0.5	0.0	0.5	5.5	7.7
	Financial surplus	−5.8	2.6	1.0	−2.5	−0.4	−5.9	−11.0
Canada	Unemployment	1.6	0.2	0.9	0.3	−0.9	5.4	7.5
	Financial surplus	−4.2	0.6	−1.1	−1.0	1.7	1.8	− 2.2
Belgium.	Unemployment	1.3	1.2	0.9	0.4	0.2	3.2	7.2
	Financial surplus	−2.4	−0.7	−0.2	−0.5	−0.6	−2.4	− 6.8
Netherlands. . .	Unemployment	1.6	0.3	−0.2	−0.1	−0.1	3.6	5.1
	Financial surplus	−2.6	0.0	0.3	−1.5	−0.4	−0.1	− 4.3
Sweden.	Unemployment	−0.4	0.0	0.2	0.4	−0.1	2.0	2.1
	Financial surplus	1.0	1.8	−4.7	−1.3	−2.3	1.9	− 3.6
Denmark	Unemployment	3.5	0.1	1.6[3]	−1.0	−1.4	2.5	6.0
	Financial surplus	−6.9	2.1	−0.3	0.0	−0.9	4.6	− 1.4
Norway	Unemployment	0.5	0.0	−0.2	0.2	0.2	0.6	1.3
	Financial surplus	−0.2	−1.4	−4.0	−1.2	1.1	4.7	− 1.0

[1] Excluding 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. [3] Break in series.

stance of policy suggests that the policy tightening will be more severe and generalised than was the case in 1977, and possibly more so than in 1974–75.

The preceding table shows changes in the general-government budget balance expressed as a proportion of gross national product and set beside the unemployment rate as an indicator of changes in demand pressure. In examining the results one must allow for the fact that the budget balance is in part endogenous — that is, it is affected by the state of the economy as well as being an influence on that state. To the extent that the annual changes are in opposite directions, the budget surplus falling and unemployment rising or vice versa, it is not possible to tell from the table alone whether fiscal policy is exerting any independent influence on demand over and above the effects of the "automatic stabilisers".

Nevertheless, the table does show the move towards some fiscal expansion in Germany and Japan in 1978, a move which in the former country spilled over even into the average figures for 1979. In the German case, however, the mid-1979 increase in value added tax meant that policy in the second half of last year became less expansionary. In the United States, the general-government financial balance improved further last year, in fact moving into a surplus of a little more than ½ per cent. of gross national product. As demand growth slowed down and the fall in unemployment flattened out, this would imply that discretionary fiscal tightening probably intensified last year. Elsewhere, fiscal policy was clearly tightened in France and in the United Kingdom after the change of government. There was also some restriction in Norway but — at least for the year as a whole — a notably expansionary stance in Sweden and, to a lesser degree, in Denmark and the Netherlands.

Perhaps more interesting than the average figures for 1979, however, was the development of fiscal policy attitudes and responses as the year wore on — a trend which has continued and probably intensified in the first half of 1980. The response to the most recent inflationary upsurge and to the oil crisis is the most graphic demonstration yet of the change which has occurred in policy attitudes over recent years. At the time of the first oil crisis there was considerable discussion of the need to use budgetary means to offset the contraction in demand caused by the OPEC surplus. It is true that, in the event, such offsetting policies were not generally pursued, but this time the emphasis has been much more on countering current inflation and the possible secondary inflationary consequences of the oil price rise itself. It thus seems that virtually no industrial country is yet ready to adopt accommodating policies on this occasion and there may be reluctance to do so in the future. In fact, budgetary plans so far published suggest widespread moves towards restraint.

Quantitatively, the most important case is of course that of the United States. The original budget for the fiscal year 1981 (beginning on 1st October this year) was presented in January. In it there was already implicit (albeit rather late in the day) a considerable tightening of the demand thrust of budgetary policy, for although the Federal budget deficit was expected to begin increasing again, this increase was entirely due to the automatic influence of the predicted slowdown in the economy. Adjusting for this, the high-employment budget surplus, after increasing by more than $20 billion at an annual rate through 1979, was projected to rise by a further $14 billion through 1980. As a percentage of output this amounted to a total discretionary fiscal impulse of some 1½ percentage points, an estimate which would be largely unaffected by adopting a more realistic "benchmark" level of unemployment for the calculations.

Even allowing for possible estimation errors and slippage, this in itself would seem remarkable by past standards — an explicit fiscal deflation of demand in the face of official forecasts showing some degree of recession and rising unemployment. Nevertheless, with the real economy continuing to be relatively, and unexpectedly, buoyant, with sharp rises in oil and producer prices feeding into the actual price indices as well as nurturing a growing inflationary psychology, and, finally, with instability in some financial markets, the Administration saw a need to go further. Consequently, in March of this year the January budget was amended. Further spending cuts of over $4 billion were announced for fiscal 1981 and tax revenues were increased by a further $28 billion, $16 billion of which was due to the combination of a tax on imported oil and a withholding tax on interest and dividend payments and the remainder to higher than expected inflation. On the face of it, the latest package amounts to a further deflation of more than 1 per cent. of gross national product. In addition it seems to imply a move into *actual* (as opposed to cyclically adjusted) surplus in the Federal budget. Administration statements suggest, however, that if a surplus does seem likely, taxes may be relaxed sufficiently to bring the budget roughly into balance. However, in the event of a recession, which appeared by the spring of 1980 to be definitely under way, the "automatic stabilisers" of the budget might well mean some reversion to higher, not lower, deficits.

There are also signs of a further tightening of fiscal policies outside the United States. In Japan the original budget for the fiscal year to March 1981 aimed to cut the deficit by about Yen 1,000 billion — that is, a cut in the *nominal* deficit at a time of both inflation and expected economic slowdown. In March, however, this budget was superseded by further measures which included the deferred implementation of some spending projects originally scheduled for this fiscal year, as well as sharp increases in power charges. The German Federal Government also plans to reduce the budget deficit this year. Although the deficit for 1979 was less than had been expected, the underestimation was partly a result of higher than expected inflation, and, in any case, the deficit still turned out to be slightly greater than in 1978. In France the move to a more restrictive fiscal stance was highlighted by the increase in social security contributions last summer — by about 1 per cent. of gross salaries. The budget deficit is expected to decline this year by some Fr.fr. 4 billion to about 1¼ per cent. of gross national product.

It is in the United Kingdom — the birthplace of Keynes himself — that the rejection of past policy approaches has been most complete. The new Government which assumed office last year took as the main plank of its economic policy the steady reduction of the rate of growth of the money supply. Whereas during most of the period since the war fiscal policy has been used to adjust aggregate demand, with the monetary implications being a subordinate consideration, it now has the overriding task of reducing government borrowing to a level commensurate with monetary control. It is also being used in an attempt to improve the supply side of the economy, in particular through cuts in direct public spending and in rates of direct taxation and, more recently, through real cuts in, and taxation of, some short-term social security benefits. Unfortunately, however, in last year's budget the conflicting needs of a cut in government borrowing and a reduction in direct tax rates required a large compensatory rise in value added tax. This in turn, via its effect on the consumer price index, is thought by many to have aggravated wage inflation during the past winter.

The basic strategy was continued in this year's budget and complemented by the publication of a medium-term plan for the reduction of the public-sector borrowing requirement and a slowing-down of the rate of growth of the money supply. The authorities consider that such a plan will have a stronger effect on inflationary expectations than a series of one-year monetary targets. By the financial year 1983–84 the rate of money-supply growth should be down to about 6 per cent., half what it was last year, and the public-sector borrowing requirement should have been reduced accordingly to 1½ per cent. of gross national product, as against 4¾ per cent. estimated for 1979–80. Indeed, despite an official forecast of a drop in output this year of 2½ per cent. (which would be the sharpest decline in any single year since the war) the 1980 budget provides for a 1 percentage point fall in the public-sector borrowing requirement ratio. It is perhaps in this respect that the changed attitude to the rôle of fiscal policy is seen at its most pronounced.

In the past such a decline in the budget deficit would itself have been cited by most observers as a sure reason for expecting a fall in output. The new approach, however, stresses the obvious truth that even the range of monetary expansion envisaged for the end of the plan period — 4–8 per cent. — is well above any likely long-term trend in British output growth, and in this sense is not inherently restrictive. The development of real output, and of unemployment, will thus depend on the strategy's effect on inflationary expectations and on inflation itself. It will depend, in particular, upon the reactions of firms and trade unions, which in the past have often exercised their market power to force less determined governments to return to an accommodating monetary stance. It is probably no exaggeration to say therefore that economists and policy-makers have for once been offered the possibility of observing an experiment akin to those always available in the natural sciences. The outcome will no doubt have wider implications than its effect on the UK economy alone.

Returning to the more general picture, it seems that there are few, if any, exceptions to the tendency to tighten fiscal policy in response to inflation and the latest oil shock. Extreme cases apart, for many countries the strength of this tightening is probably not severe when measured by traditional standards. The principal doubt arises, rather, from the fact that so many countries are moving in the same direction at the same time. There may well be a tendency to underestimate the international multiplier consequences of generalised deflation. This was perhaps part of the explanation — mutatis mutandis — for the inflationary boom of 1972–73. In other words, given that some of the effect of a country's deflation policy "leaks" abroad and that many countries are simultaneously moving towards fiscal and monetary deflation, the risk of a cumulative international recession cannot be ignored.

At all events, the growing belief that for many years discretionary fiscal policy has had less and less expansionary effect on the real economy and has come increasingly to accommodate inflation is being put to the test. The crucial question is whether, when used in the "deflationary" sense, fiscal and monetary policies will still have a major impact on the price rather than the volume component of nominal national income. Policy-makers are under no great illusion about the risks of an unsatisfactory outcome and they have generally sought to indicate, explicitly and implicitly, the private-sector adjustment behaviour that would be consistent with a rapid reduction in inflation and minimum unemployment effects.

The second oil shock.

During 1979 the price of oil more than doubled, thus signalling a second major "oil shock" to the economies of the oil-importing world. Coming on top of the fivefold increase earlier in the decade, the absolute size of this latest rise in the oil price is probably of the same order of magnitude in real terms as that of 1973–74. In addition, there is now evidence that some major oil producers are becoming increasingly reluctant to continue to supply at a high, let alone rising, rate, despite the physical capacity to do so. This implies perhaps that, as well as the obvious effects of the latest price rise on inflation, balance-of-payments positions and real demand, the risk of an energy supply constraint on economic growth is greater now than was perceived six years ago. The need for far-reaching adjustment in the energy field has thus become more pressing, as of course has the economic incentive to make such an adjustment.

On one level, the analysis of the second oil price shock is identical to that which became fairly commonly accepted in 1974. In particular, there is again the somewhat paradoxical juxtaposition of upward pressure on prices in the oil-importing world with a contractionary effect on real demand, both in the context of an adverse impact on external current-account positions. The renewed rise in oil producers' revenues comes after an extremely rapid rise in the volume of their imports over the past six years. The ability of some of them to spend their new increase in income may therefore be limited, especially as they now have greater anxieties about the social and political effects of very rapid economic development. Furthermore, if the real oil price holds up more firmly this time, the OPEC surplus, with its deflationary-cum-inflationary effects, may prove more persistent. To take an example, the US Administration has estimated that the drag on demand as a result of the oil price rise last year was equivalent to 1½–2 per cent. of gross national product — an estimate which includes the effects of the assumed re-spending behaviour of both foreign and domestic producers. This drag probably now amounts to more than half that being planned (after the March revisions to the budget) for discretionary fiscal restraint in 1979 and 1980 combined.

For the other industrial countries the demand effects of the oil price rise alone may be somewhat greater than for the United States, and there have also been moves towards fiscal and monetary restraint on a more general scale than in 1974.

Restraint may also be forced on some non-oil developing countries unless they can secure sufficient balance-of-payments financing. Thus, taking into account the fact that the second oil shock has come on top of a situation in some European countries and Japan that was less inflationary than that in 1973, there may be grounds for hoping that the inflationary aftermath may not be so severe this time. On the other hand — but reinforcing this tendency — levels of unemployment in a number of countries were much higher in 1979 than they were in 1973, so that any renewed rise now will begin from a higher base.

A feature which distinguishes the latest oil shock from the first, however, is the greater evident reluctance of the major producers to supply oil at rates well above those needed for their own use and to pay for their non-oil imports. This in turn has raised the possibility of a resource constraint on the growth potential of the oil-importing countries. For the time being this constraint may not be very visible if a new recession develops, as is widely expected, but the issue could arise when recovery sets in. It underlines, with even greater force than previously, the pressing need for the industrial countries to take effective measures aimed at conserving energy and reducing their dependence on imported oil.

It is true of course that there must be a limit to oil price fixing, determined in part by the resource costs of producing other forms of energy. However, these costs appear to be as high as or higher than the present oil price and, in any case, the lead time for bringing significant production on stream would be long — a consideration which probably also applies to the possibility that large new sources of lower-cost conventional oil resources may be discovered. In other words, with a high oil price largely protected by the cost of alternatives, some producing countries have felt that the risks associated with holding oil in the ground were worth taking. In such cases, therefore, the supply curve may be backward sloping — the reverse of the normal conception — for the higher the price, the lower will be the volume of sales needed to pay for imports, at the same time as more oil is conserved in the ground at a higher value.

Of course, this kind of argument can be carried too far. For the oil-producing countries to cause severe economic dislocation in the industrial world while oil supplies still exist would not be in their interests either. The industrial countries remain the principal source of the wide range of imported goods and services required for development, at whatever pace is thought appropriate.

Nevertheless, with oil resources necessarily finite, the world economy is faced with the need to make fundamental adjustments in the energy sphere. What has been termed the "energy transition" — that is, away from oil and towards other energy sources, as well as conservation — seems likely to occupy the remainder of the century. While this is going on, however, the oil-importing countries will still require considerable quantities of oil. There is thus a clear need for some mutual understanding between consumers and suppliers that will ensure the requisite supplies and avoid serious dislocation. In particular, the situation suggests a need to focus more attention on the real oil price as well as to find additional investment arrangements for the producers' surpluses.

In another possible paradox akin to that of the backward sloping supply curve which has already been noted, it may well be that the greater and the faster the adjustment effort in the consumer countries the more ready will be the oil-producing countries to supply the reduced quantity of oil still demanded and therefore the less will be the risk of an energy constraint on growth. Non-economic considerations may also argue in favour of rapid adjustment, as does the obvious possibility that some countries still currently self-sufficient in energy may eventually wish to meet some of their needs by drawing on the international market.

Broadly speaking, three possible avenues of adjustment to the oil situation can be distinguished: deflation of total demand, conservation (that is, energy saving) and substitution of other energy sources. To some degree the first of these, deflation of demand, occurred after the first oil shock, both as a result of the OPEC surplus itself and because of the domestic policy response in many countries. The same may also happen this time, as most countries appear to feel the need for some dampening of demand in order to keep the inflationary effects of the oil price rise to a minimum. Nevertheless, additional deflation beyond that required for this purpose is clearly not a fundamental adjustment to the depletion of a finite resource. It is, however, true that recession will tend, at least temporarily, to reduce the demand for oil and thus alleviate the situation marginally; and even over the longer run a slower trend of real growth may be difficult to avoid.

Conservation, which may be thought of as increasing the energy productivity of the economy, is an adjustment of more permanent significance. Despite some weakening of the real oil price after 1974, the accompanying table shows that by 1978 there had already been noticeable improvements in energy efficiency as measured against real gross national product in the seven largest industrial countries.

In relation to output, savings in total energy use since 1973 ranged from 2 per cent. in Italy through 5–7½ per cent. in Canada, Germany and the United States,

Total energy and oil requirements as a proportion of gross national product.

Countries	Items	1960	1970	1975	1978
		Indices, 1973 = 100			
United States	Total	97.4	103.3	97.8	93.6
	Oil	95.6	99.5	99.4	99.0
Canada	Total	104.6	101.5	99.3	94.9
	Oil	98.7	102.4	95.0	90.5
Japan	Total	101.3	106.3	97.2	87.4
	Oil	42.6	97.2	92.7	84.0
Germany	Total	97.4	99.7	92.8	92.3
	Oil	37.3	96.2	86.1	88.4
France	Total	99.4	96.2	87.7	87.4
	Oil	44.4	84.6	83.0	78.9
United Kingdom	Total	112.9	107.4	94.0	90.9
	Oil	59.1	101.7	86.2	83.6
Italy	Total	72.6	99.7	96.2	98.0
	Oil	40.8	96.3	89.8	89.2

Source: OECD.

9 per cent. in the United Kingdom, to about 12½ per cent. in Japan and France. On the whole, savings in oil usage were greater than those in total energy use; in the case of the United States, however, oil consumption in relation to total output was only 1 per cent. lower than in 1973. Moreover, as the table below shows, the effect of savings in total energy use in the OECD countries has been more than offset by further economic growth, so that energy consumption in absolute terms has still risen since 1973. With dependence on oil within this total falling only slightly from the peak in 1973, it is not surprising that demand on OPEC oil producers had returned to a high level before the latest crisis. Part of the explanation for this, in addition to higher gross national product levels, is suggested by the data on the retail price of one oil product — petrol — when examined in relation to the overall consumer price index in the major industrial countries.

OECD countries:
Oil and energy requirements and OPEC exports.

Items	1960	1965	1970	1973	1975	1978
Total OECD energy requirements[1]	1,858	2,334	3,096	3,517	3,380	3,707
Oil as a percentage of above	38.6	44.6	50.6	53.1	51.6	52.3
Net OPEC exports of oil[2]	36	54	76	100	87	95

[1] In millions of tons of oil equivalent. [2] Index, 1973 = 100.
Sources: OECD and UNCTAD.

As the figures below show, the relative price of petrol did rise appreciably after the first oil crisis, but the increase was much smaller than the fivefold rise in the crude oil price itself. The reason is that the other components of the final price, such as transport costs, oil company and other distributors' margins and indirect taxes, did not rise in the same proportion. In addition, general inflation tended gradually to erode the initial increase in the relative price. Hence by 1979 in most countries the relative price of petrol was still below, or close to, the level of 1960. This suggests that in at least one area of oil consumption the price incentive to conservation has not yet been particularly strong. It clearly constitutes a rationale for the latest US measures, which include a further tax of $4.62 per barrel on imported crude oil despite the fact that the United States had already seen by far the largest rise in

The real retail price of petrol.

Countries	1960	1970	1974	1975	1977	1978	1979
	Indices, 1973 = 100						
United States	115	102	121	119	117	113	137
Canada	112	104	105	108	113	110	111
Japan	.	99	120	120	112	95	107
Germany	125	96	113	105	101	101	107
France	152	110	123	115	122	122	128
United Kingdom	116	112	123	135	114	100	116
Italy	129	106	135	128	154	137	128

real petrol prices last year. Not surprisingly, however, governments have proved reluctant to use the indirect tax weapon because of its effect on the overall price level. In principle, this could be mitigated by, for example, reductions in taxes on other items of expenditure.

In any case, there will be limits to how far energy conservation can be carried without having adverse effects on general economic performance, for example, in the area of labour productivity. It has been forcefully brought home to the industrial countries especially that in high-output (that is, high-productivity) economies energy is virtually as fundamental a resource as the four text-book examples of land, labour, capital and entrepreneurial organisation. It is almost certain that when all possible energy savings have been made there will still remain a large, and perhaps rising, demand for energy. For example, most high-productivity (that is, capital-intensive) production methods are always likely to require considerable inputs of energy as a complement to physical capital. It follows that, if present standards of living are to be maintained and even increased in the longer run, there will have to be a massive development of other energy sources as the world's oil reserves are depleted. It is this which largely accounts for the scale of the US energy programme announced last year, as well as government attempts elsewhere to push ahead with the development of other sources of energy such as nuclear power, often in the face of strong environmental and safety anxieties.

The real income costs of adjusting to the energy crisis are thus not just those represented by the current and prospective increase in the transfer of real resources to the oil producers and the deflationary demand policies necessary to hold back the secondary effects of higher oil prices. As the US programme demonstrates, the resource costs of developing alternative sources of energy are also very large, and adjustment will therefore require sizable investment — expenditure which might otherwise have been allocated to expanding output. On a smaller scale there is also some diversion of investment resources involved in adapting existing production processes to more efficient energy usage. Finally, to the extent that the change in the relative price of energy leads to some substitution of labour for energy and energy-intensive capital, labour productivity may be lower than would otherwise be the case.

Productivity and investment.

It seems unlikely, however, that recent productivity developments can be attributed solely to the rise in the price of energy since 1973. The rate of increase in total output per person employed did, it is true, quicken slightly in some countries last year, especially in those, such as Germany and Italy, where output growth accelerated. But even in the latter group of countries the rates of increase recorded were lower than the long-run averages prior to 1973. In some other cases there was by contrast a further marked deterioration — especially in the United States where, in through-the-year terms, total productivity actually fell by around 2 per cent. A decline was also recorded in Canada. Thus, if anything, the mystery of the generalised slowdown in productivity growth since 1973 deepened further last year. And, with it, government concern over the deteriorating trend also increased, notably in the United States. In the first place, as the previous chapter has illustrated, a declining trend exerts upward pressure on production costs, and hence on the price level. Secondly, and perhaps more importantly, it has obvious implications for real consumer incomes and living standards. At a time when these are in any case being squeezed because of the need to adjust to the changed energy situation and to curb inflation, there are fears that the struggle over real income shares could intensify, and with it the inflationary rise in nominal incomes.

Perhaps the most striking feature of the slowdown in productivity growth is its pervasiveness. As the table shows, all countries seem to have shared in the experience, albeit to varying extents, and they were all affected at the same time — namely when the recession took hold in 1974. While the deceleration has been most pronounced in Japan and least noticeable in Germany, technical progress in terms of per capita output has apparently advanced hardly at all since 1973 in the United States, Canada and the United Kingdom (leaving aside the North Sea oil sector).

Output and productivity growth.

Countries	Productivity[1]			Gross national product		
	1960–73	1973–79	1975–79[2]	1960–73	1973–79	1975–79[2]
	annual average changes, in percentages					
United States	2.1	0.2	1.0	4.1	2.5	4.5
Japan	8.8	3.4	4.7	10.2	4.1	6.0
Germany	4.4	3.2	3.8	4.5	2.4	3.9
France	4.9	2.8	2.1	5.7	3.0	3.6
United Kingdom	3.1	0.7	2.0	3.2	0.8	2.1
Italy	5.6	1.6	3.0	5.1	2.8	3.8
Canada	2.5	0.3	0.7	5.6	3.1	3.5

[1] Based on civilian employment. [2] This sub-period corresponds to the period of recovery from the 1974–75 recession.

The obvious explanations are, of course, the equally general decline in economic growth — though here the reasoning becomes somewhat circular — and the associated increase in the relative price of energy. Both of these explanations fit well as to timing, but in the case of the energy price a reaction spread out over some years might have been expected, rather than the sharp, sudden break in productivity growth that occurred in 1974. The cyclical explanation also founders particularly badly in the case of the United States. It has already been noted that for 1979 alone there is compelling evidence pointing to the persistence of cyclical effects in the cases of Germany, Italy and certain other countries. In the United States, however, given that the economy has completed a virtually full cycle since 1973, this explanation is not logically sound. It thus comes as no surprise that the Economic Report of the President should have estimated that, after adjustment for cyclical variations, productivity growth has been very poor, especially in 1974 and again after 1976. By 1979, the Report estimates, cyclically adjusted productivity was beginning to fall appreciably.

In other countries, as the above table shows, rates of productivity growth have remained below their pre-1973 trends, even after the trough of the recession had been passed in 1975. But so have output growth rates — in marked contrast to the US experience. At first sight this seems to suggest that, outside the United States, the explanation is the straightforward one of a full cyclical recovery never having materialised — especially as the country which in the past four years has grown at the rate closest to its pre-1973 performance, namely Germany, has also come closest to its earlier productivity trend. However, the normal cyclical behaviour of productivity is usually thought to be associated with variations in the pressure of demand on resources, particularly on the existing capital stock, as machinery requiring fixed amounts of labour is worked more or less intensively. It is true that in most countries the unemployment indicator of demand pressure has continued to signal low pressure (see Chapter II, page 31), but this appears to have been less true of capacity utilisation rates in manufacturing industry.

Capacity utilisation rates in manufacturing.

Countries	1964-73 average	1975	1978	1979 1st quarter	1979 2nd quarter	1979 3rd quarter	1979 4th quarter
	in percentages						
United States	85.5	72.9	84.4	86.7	85.9	85.4	84.6
Japan	92.8	76.3	78.3	81.1	83.1	84.9	86.0
Germany	86.5	77.1	81.2	83.5	85.6	85.3	84.5
France	83.6	72.5	80.4	81.5	82.3	.	81.8
United Kingdom	85.0	69.0	75.0	78.0	84.0	89.0	78.0
Italy	78.5	69.3	73.1	75.8	74.8	75.5	77.1
Canada	86.7	80.8	85.7	87.4	85.8	86.2	86.9

For many countries the pressure of demand on the capital stock, after falling in 1974 and 1975, has returned to around the average levels seen before the first oil shock — a development which is very much in line with that in the United States. Consequently, above-average productivity performances might have been expected, at least once activity had recovered from the trough of the recession. The conundrum apparently remains.

The reason why utilisation rates increased may have been less that output and demand expanded than that countries' capital stocks increased less rapidly, or even fell. This is suggested by the figures below, which show the sharp and generalised break in the upward trend of business investment — that is, in the rate of gross additions to capital stocks. But while this may have served to bolster the pressure of actual demand in relation to existing productive facilities (possibly with beneficial effects for productivity), it must also be borne in mind that one of the major avenues via which new advances in technology are implemented is new investment. If the latter slows down it is reasonable to expect that technological progress in production will also gradually decelerate.

Clearly, the implications of this kind of explanation are more serious than those of the more normal cyclical depression of productivity. The latter has in the

Private non-residential fixed investment in relation to gross national product.

Countries	Average annual rate of change in: real gross national product		real private non-residential fixed investment		Share of investment in gross national product (at constant prices)		
	1960–73	1973–79	1960–73	1973–79	1960	1973	1979
	in percentages						
United States	4.1	2.5	5.4	2.1	9.0	10.6	10.4
Japan	10.2	4.1	14.0	2.2	14.0	20.1	18.0
Germany	4.5	2.4	4.6	2.7	13.4	13.7	13.8
France	5.7	3.0	7.5	1.1	11.2	13.9	12.4
United Kingdom	3.2	0.8	4.3	1.6	11.8	11.9	12.4
Italy	5.1	2.8	4.9	−1.6	12.1	11.7	8.9
Canada	5.6	3.1	5.8	4.5	13.2	13.6	14.7
Belgium	3.8	2.5	5.7	1.3	12.5	15.4	14.6
Netherlands	5.0	2.5	4.6	1.7	13.8	13.0	12.4
Sweden	3.9	1.7	4.9	−1.3	8.3	9.4	7.9
Switzerland	4.4	−0.5	5.8	−1.8	18.3	21.6	19.4

past usually been quickly reversed in the ensuing upturn. Apart from the fact that necessarily conservative policies may rule out such a recovery in the immediate future, there is also the question of whether in any case the decline in investment growth derives from more fundamental factors. In addition to slow demand growth and a sharp change in the relative price of energy, the 1970s also saw worsening cost/price relationships in many countries and high and variable inflation rates. Moreover, there was heightened uncertainty about policy responses and hence about the real costs of debt repayment and rates of market growth in the future.

In other words, an increase in the degree of risk associated with investment spending has coincided with falling profit margins. Prospective returns on new capital investment may therefore appear in many cases insufficient to cover higher risk premia requirements. High rates of inflation also bring high nominal rates of interest which deter long-term borrowing. For although, measured against current inflation rates, interest rates may appear fairly moderate now, they would, of course, become a serious burden should inflation fall appreciably. It also seems to be the case that high rates of inflation are accompanied by greater variability both of price rises themselves and of relative prices, thus confusing the normally clear signals which the market mechanism sends to potential investors in capital equipment. To the extent that factors such as these have played a rôle, slow investment growth over recent years will have contributed to slow overall growth from the demand side as well as, possibly, from the supply, or productivity, side.

The current widespread anti-inflation stance of policies offers hope now that some of these major deterrents to investment spending may be reduced. However, as the example of Germany seems to show, the re-establishment of a favourable investment climate may be a slow and painful process. It implies, above all, a gradual restoration of satisfactory cost/price relationships and other incentives. In addition, depending on the country in question, it may need the support of changes in government regulatory policies and fiscal incentives. Finally, public-sector investment of an infrastructural nature, designed to be complementary to private investment and carried out over a medium-term time scale, can helpfully stimulate private capital outlays.

Assuming that it is possible to improve the climate for investment, there are also grounds for hoping that the latent demand for investment goods is strong and that it will materialise when lower interest rates and more optimistic demand prospects become established. One simple fact that points in this direction is that fixed investment remained on a relatively flat trend in practically all the industrial countries over the whole of the 1970s. Another is that, to judge by developments in certain fields such as electronics and communications, there seems little reason to believe that technological progress as such has slowed down. Finally, the need for energy-producing and energy-saving investment will add significantly to new capital requirements in the very area where it appears that relative prices and profit margins have changed in a particularly favourable way. If, as this Report has argued, the secondary repercussions of the new inflationary shock can be contained, countries will go some way, even in a world of relatively slow growth, towards establishing the prerequisites for a satisfactory autonomous advance in fixed capital investment.

IV. MONETARY POLICY IN A CHANGING ENVIRONMENT.

In the financial markets a steep and general escalation of interest rates was the most striking development last year. Between March 1979 and March 1980 central-bank discount rates were raised in quick succession in one country after another, interest rates in domestic money markets increased by between 4 and 10 percentage points and bond yields went up by between 2 and 5 percentage points. In the spring of this year rates in most of the industrial countries stood at levels that exceeded even the previous peaks recorded earlier in the 1970s. Particularly dramatic, however, was the subsequent turn-round in the United States, where the three-month Treasury bill yield, after rising from 9½ per cent. in March 1979 to a peak of 16½ per cent. in March 1980, fell sharply back to 8½ per cent. in mid-May.

Monetary policies designed to stabilise expectations and to moderate inflation had been in place for some time in the major countries. Yet, for reasons largely of an international nature, rates of price increase have surged upwards again quite generally over the past eighteen months. Against this background, the essential question at the present time is whether, in the face of the new oil shock and higher commodity prices, monetary authorities are generally in a better position to meet this challenge than they were in 1973–74. One way of approaching this question is to consider recent developments in the money supply and in interest rates in a long-term perspective. This is done in the first part of this chapter.

Rising interest rates last year reflected the worsening price outlook and the boost to credit demand given by high or rising levels of economic activity. In addition, however, less accommodating or more restrictive monetary policies were applied concurrently in all the industrial countries, large and small, generally with limited support from fiscal or incomes policy. Demand pressures and domestic cost forces were clearly a problem in many. But most were also attempting individually to avoid currency depreciation with its potential domestic cost impacts. Developments during the year in monetary policy and in the financial markets are discussed in the second part of this chapter.

Significant changes in underlying attitudes and in the techniques of monetary policy help explain last year's rise in interest rates and, as the recent sharp rise and sudden decline in the United States have indicated, may portend greater interest rate volatility in future. A number of key countries have been placing increased reliance on quantitative criteria in the management of bank reserves, leaving money-market rates and even central-bank lending rates more freedom to move in response to changing market conditions. Also evident is a tendency to encourage more flexibility in interest rates on bank deposits and to place greater reliance on interest rate mechanisms in allocating credit. Quantitative credit controls are still widely used, however, and their introduction in the United States marked a sharp, if temporary, departure from the previous course. Some of these changes and their apparent implications are reviewed briefly in the final section of the chapter.

Monetary management and inflation in perspective.

In recent years the formulation of monetary policy in the industrial world has been influenced by the view that stable and moderate rates of monetary expansion could make a major contribution to bringing inflation under control. Partly because it had become more difficult, in an inflationary environment, to assess the restrictive impact of given levels of interest rates, quantified norms for the growth of the money supply began to play a rôle in policy deliberations in the early 1970s. In this the United States led the way, though the authorities in other countries had long been aware of the risks inherent in excessive monetary expansion.

Following the breakdown of the fixed exchange rate system and the flare-up of inflation in 1973–74, objectives for monetary expansion were adopted by a progressively wider range of countries. By last year seven of the Group of Ten countries had established such norms, although Switzerland had temporarily abandoned them. In keeping with the underlying logic of this approach the objectives had all been announced publicly with a view to influencing price expectations and generally reflected a policy aimed at bringing rates of inflation down gradually over a number of years.

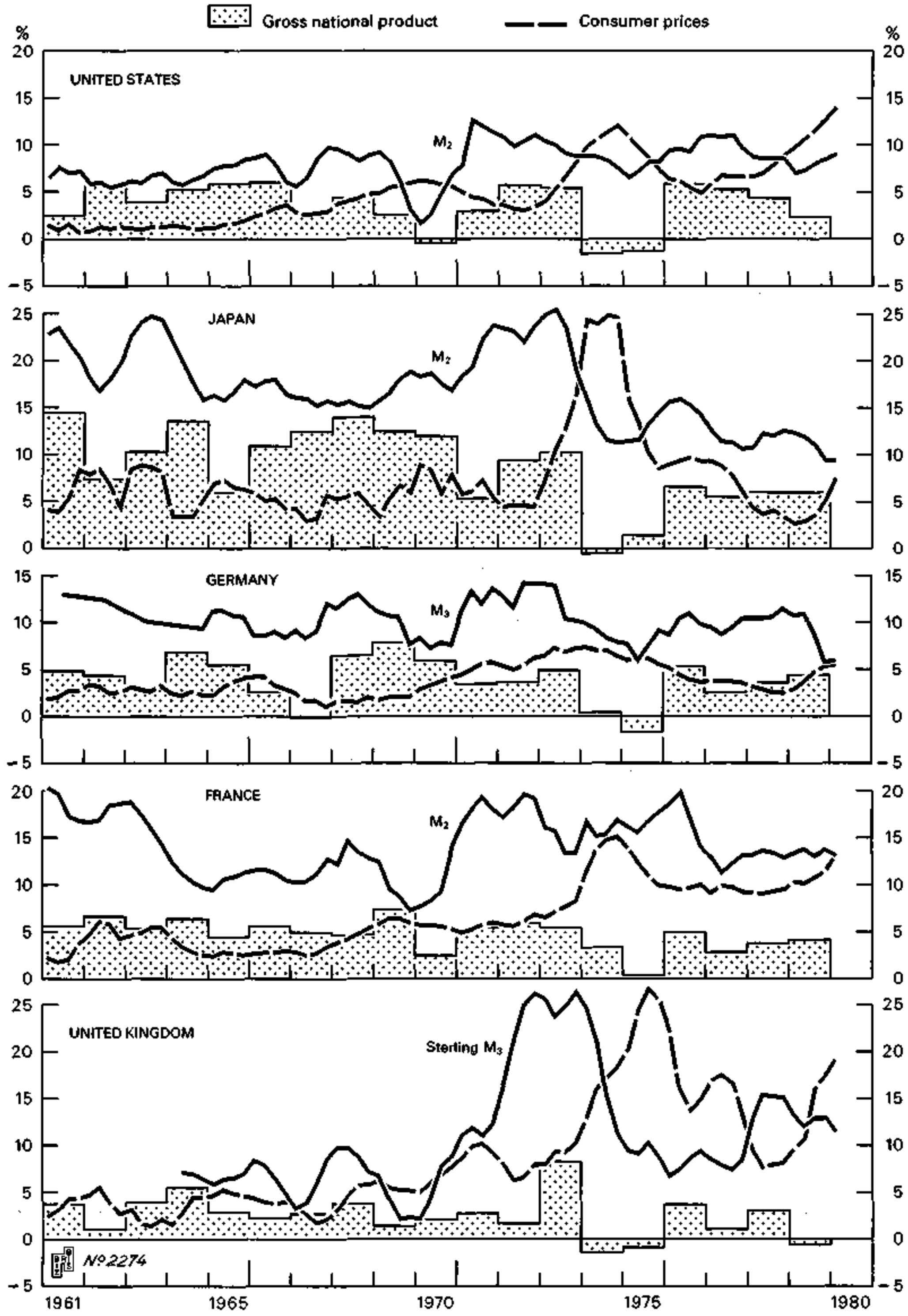
It is still too early to form a final judgement on the effectiveness of the approach. In some countries the experiment has simply been too short. In others recent changes in monetary control techniques or greater commitment on the part of the authorities to their objectives may in due course affect the results achieved. However, in view of the obvious setbacks experienced recently, it would seem useful to establish, in a longer-term context, just what has happened to the monetary variables under these policies — particularly in the last few years — and to consider how their behaviour might be related to developments in prices and output.

The monetary aggregates. In recent years rates of monetary expansion have continued to show large cyclical fluctuations in all the major industrial countries. Moreover, in many countries these rates have remained quite high by comparison with those recorded in earlier corresponding cyclical phases. This can be seen in the graph on page 59, which compares rates of increase in the broad money supply and consumer prices over a twenty-year period. To give some indication of cyclical developments in output, annual changes in real gross national product are also shown.

A continuing cyclical pattern of monetary development closely resembling earlier experiences is particularly clear in the case of the United States. Rates of growth of M_2 (according to the definition which was in general use until early 1980) did not reach their previous, 1971 peaks in any individual quarter between 1976 and 1978, but over the period as a whole the expansion was scarcely less than in 1971–73 and was greater than in the 1967–69 period which preceded the initial serious acceleration of inflation in the United States. Furthermore, while the rate of M_2 growth decreased somewhat last year, it remained slightly higher than that recorded in the 1975 trough and well above that registered in the period of severe credit restraint in 1969. Much the same can be said, it may be added, of developments in all the main aggregates which have commonly been used in the United States — broad and narrow, old and new.

Monetary expansion, changes in consumer prices and real gross national product.

Quarterly or annual averages, changes over previous year.



As from the middle of the 1970s, a renewed cyclical acceleration in rates of growth of the broad money supply can be observed in each of the other countries shown. Except in Japan, where the trend rise in output has slowed down considerably, rates of monetary expansion since 1975 have been comparable with or higher than those recorded in the 1960s. Developments in France in 1974–75 aside, however, the increase in the money supply in recent years was at least more moderate than in the early 1970s.

High recorded rates of monetary expansion can be attributed partly to fairly generous norms and partly to difficulties experienced in meeting the objectives after they had been established. In all the countries concerned the authorities subscribed to the view that inflation could be eliminated from the economy only gradually, and following the 1974–75 recession they wished to foster a sufficiently strong economic recovery to reduce unemployment substantially. Typically, in setting targets they made fairly generous allowance for "built-in" minimum rates of inflation and for optimistic actual or potential rates of growth in output. Then, in a context of uncertainty as to developments in the economy and unexpected, often sudden, disturbances in financial markets or on the foreign exchanges, monetary expansion was permitted to exceed the targets — frequently by a substantial margin. In particular, monetary authorities were faced from 1978 onwards, much as in 1974–75, with the problem of deciding whether or to what extent they should accommodate external price shocks.

To a significant degree, of course, monetary developments in the major countries after 1975 were interdependent. In the United States the authorities attempted to limit upward pressure on interest rates that might jeopardise the recovery or lead to recession. They appear to have underestimated the buoyancy of the economy and to have overestimated the restrictiveness of monetary policy. Not until November 1978, after the dollar had suffered a sharp decline in the exchange markets, were efforts made to bring policy onto a more restrictive tack. Meanwhile, various other countries were having to cope with excessive currency appreciation which was holding down domestic economic activity. Heavy exchange-market intervention was their response and strong expansion of their money supplies the result.

Monetary management everywhere had to be conducted in conditions of great uncertainty. In the context of large movements in currency preferences triggered by exchange rate fluctuations and marked shifts in the demand for transactions balances induced by rising interest rates and by regulatory changes, developments in the money supply were hard to interpret.

Despite the difficult circumstances countries faced, rates of monetary expansion outside the United States were lower in the 1976–78 period than in the two or three years immediately preceding the first oil crisis. This was true even in Germany where exchange-market intervention to prevent excessive appreciation had been large. In Japan rates of expansion of M_2 in the 1976–78 period were less than half those recorded in the early 1970s, while in France rates of growth of M_2 were brought down sharply in the course of 1976 and early 1977. In the United Kingdom sterling M_3 growth quickened markedly in 1977–78 but what followed was in no way comparable with the monetary explosion which had taken place in 1972 and 1973.

Despite these relatively favourable comparisons, it is scarcely possible to conclude, on the basis of recorded rates of monetary expansion, that the policies followed — at least until last year — were particularly restrictive.

Interest rates. Also helpful in setting recent policy developments in perspective is the comparison of movements in interest rates and year-to-year increases in consumer prices shown in the graph on page 62. While there is no generally accepted view as to how price expectations are formed, actual developments in consumer prices may be taken as a rough indicator of how expectations are moving.

As can be seen from the graph, levels of interest rates at both long and short term exceeded rates of increase in consumer prices by a comfortable margin for most of the 1960s in all the major countries. However, in the 1970s the margin became narrower on average and was negative for much of the time. Rates of inflation moved up rapidly in the early 1970s and during the 1973–75 period stood higher than the representative short and long-term interest rates shown in all the countries considered except Germany. In Japan and the United Kingdom this previously unusual relationship between the curves persisted until late 1977 (except for a brief period in 1976) and in the United Kingdom it re-emerged in the course of 1979. In the United States the current rate of inflation moved above yields on prime corporate bonds in 1979 but was higher than those on Treasury bills throughout a seven-year period extending from 1973 up to the spring of this year. Changes in the consumer price index may have overstated the underlying rate of inflation, but not by enough to change the basic picture. Following the adjustment that took place early in 1980, interest rates apparently stood higher, for a time, in relation to rates of consumer price inflation than in the 1973–75 period.

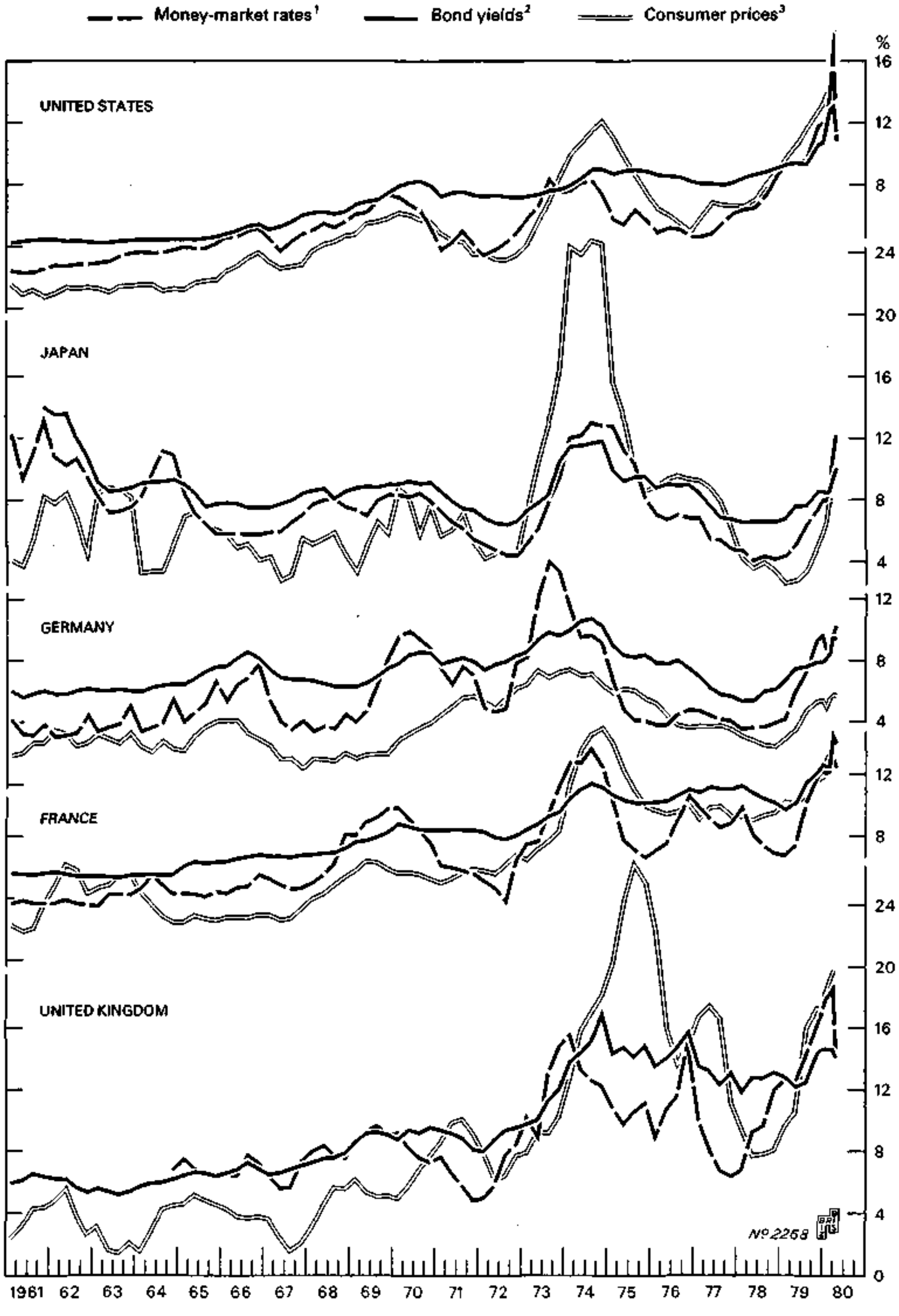
That long-term yields, in particular, should stand below current rates of price increase in periods when inflation is abnormally virulent but expected to abate is hardly surprising. In recent years market participants may have underestimated the speed with which inflation was gaining ground. But short-term rates which remain negative or very low in real terms for very long periods seem also to be indicative of a monetary policy that is consistently more accommodating than expected.

In Germany developments in the relationship between interest rates and consumer prices during the 1970s were quite different from those in the other countries. Bond yields remained well above current rates of inflation throughout the period, while real rates on three-month money-market instruments were also consistently positive except for brief intervals in 1972 and 1975–76. In 1973–74 and again in 1979 short-term interest rates moved up much more than the rate of domestic consumer price inflation, apparently in response to restrictive policies and developments in money markets abroad.

The relationship between short and long-term interest rates may itself help to reveal the thrust of policy. In the United States bond yields exceeded Treasury bill rates by an unusually large margin during the 1970–73 period and also between 1976 and 1978. This constellation may well be indicative of market expectations of rising rates, based perhaps on the belief that monetary policy was too lax and that inflation was likely to accelerate. In early 1979, however, the margin disappeared

Short and long-term interest rates and changes in consumer prices.

Quarterly averages.*



* Monthly observations for 1980.
[1] For the United States, three-month Treasury bills; for Japan, call money; for Germany, three-month interbank deposits; for France, day-to-day money; for the United Kingdom, three-month sterling interbank deposits.
[2] For the United States, Aaa corporate bonds; for Japan, Telegraph and Telephone bonds; for Germany and France, public-sector bonds; for the United Kingdom, twenty-year government bonds. [3] Year-to-year percentage changes.

and thereafter short-term rates stood above long-term rates for a remarkably protracted period. An unusually large differential in favour of long-term rates was also evident for most of the 1975–79 period in Germany, France and the United Kingdom. This phenomenon, and the subsequent emergence of an inverted yield curve in these countries, was strongly influenced by developments in the United States and on the exchange markets.

By and large, therefore, the evidence on interest rates, like that on the development of the monetary aggregates, seems to indicate that monetary policies in the major countries were not particularly restrictive in the 1975–78 period. In general terms the policies applied in those years financed high current rates of inflation, encouraged a traditional cyclical expansion in output and by their divergences contributed to exchange rate instability. Inflationary pressures were substantially reduced, for a time, in some European countries and in Japan but even in these countries monetary stabilisation efforts weakened under the impact of disruptive influences from abroad. In these circumstances monetary policy could not moderate price expectations on a lasting basis. As is explained in Chapter II, the strength of global demand and supply constraints in particular markets were partly responsible for the virulence and timing of last year's renewed upsurge in prices. But the monetary policies pursued in the industrial countries formed part of the framework in which the process of accelerating inflation developed.

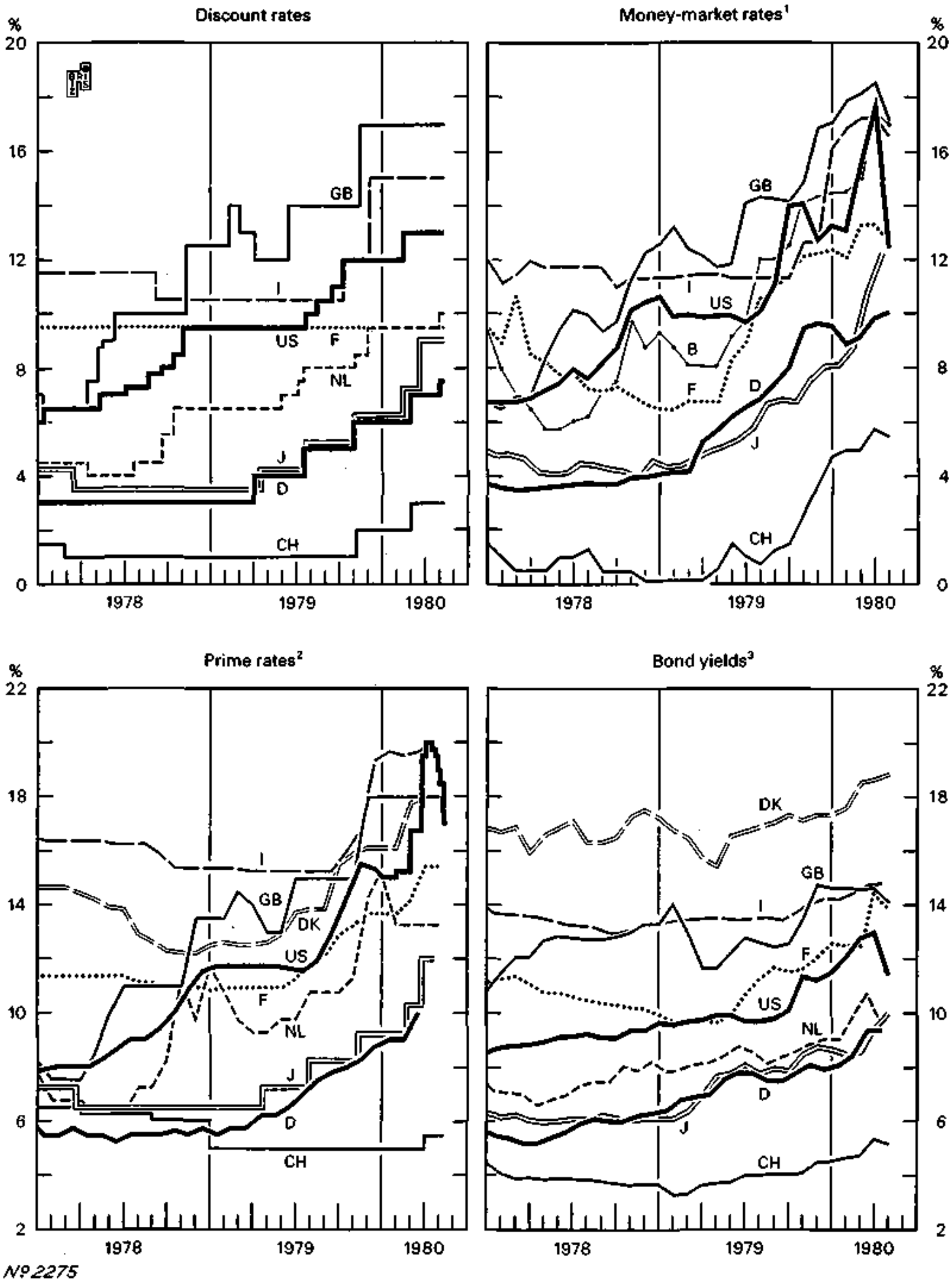
Monetary policy and financial developments in 1979–80.

Recent developments in interest rates. Last year interest rates rose sharply in nearly all industrial countries, although the course they followed was quite irregular. Typically, both money-market rates and bond yields were hoisted to higher levels by phases of sudden sharp adjustment which alternated with periods of calm. Although the timing differed significantly from one country to another, over the period extending from the beginning of 1979 to early 1980 the extent of the rise was remarkably similar in all markets, regardless of the differences in countries' current or prospective rates of inflation.

The rise in short-term interest rates that began in the United States in the spring of 1978 under conditions of strong economic recovery, accelerating inflation and attempts to curb rapid monetary expansion was given a boost by measures taken in November 1978 to support the dollar. Included in this package was a 1 percentage point increase in the discount rate, which until then had merely been adapted to developments in market rates. Money-market rates declined slightly at the beginning of 1979, however, and thereafter remained more or less stable until the summer.

Meanwhile in western Europe and Japan short-term interest rates had begun to rise quite steeply in the spring of 1979 and bond yields in most of these countries were also moving upwards. The economic recovery was gaining ground and rates of inflation were increasing in response to cost pressures of external and domestic origin. In Germany bond yields had been on an upward course since mid-1978 under the influence of strengthening demand for credit. In addition, however, the authorities took advantage of the recovery of the dollar after November 1978 to

Recent developments in interest rates.



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Note: B = Belgium, DK = Denmark, F = France, D = Germany, I = Italy, J = Japan, NL = Netherlands CH = Switzerland, GB = United Kingdom and US = United States.
[1] Representative rates. (For Belgium, four-month certificates; for France, one-month interbank deposits; for Italy, interbank sight deposits; for Japan, call money; for other countries, three-month money-market instruments.)
[2] Minimum rates charged by commercial banks for cash credits to first-class borrowers. (For Denmark, average lending rate; for Germany, lower end of range for large current-account credits.) [3] Representative rates. (For the United States, *all corporate bonds; for Denmark, mainly mortgage bonds; for the Netherlands and the United Kingdom, government bonds; for other countries, various other public-sector bonds.)*

apply policies designed to restrict monetary and credit expansion. From the spring of 1979 onwards short and long-term interest rates in Belgium, the Netherlands and France, whose currencies are linked in the European Monetary System, moved up in step with DM interest rates, but generally at a faster pace. Interest rates in the United Kingdom began to rise shortly afterwards, mainly as a result of measures to restrain monetary expansion announced in the June budget. In Japan the discount rate was increased in April and raised further in July in response to accelerating inflation and in an effort to defend the yen. In Italy interest rates were already high, so that they remained virtually stable until September.

A new phase began quite suddenly in October. In the United States money-market interest rates had been moving upwards since July and the discount rate had been increased in stages but the dollar had been displaying renewed weakness. Following an earlier pause, monetary expansion had accelerated sharply, economic activity was unexpectedly strong and inflationary pressures were clearly intensifying. More decisive action seemed to be needed; accordingly, on 5th October the Federal Reserve announced that the discount rate was being increased from 11 to 12 per cent. as part of a package of measures which convinced the market of its determination, at least for a time. By the end of the month the Federal funds rate stood 5 percentage points higher than at mid-year and bond yields had risen by 1½ percentage points. Moreover, with authorities elsewhere reluctant to let their currencies depreciate against the dollar, interest rates abroad were drawn upwards in the slipstream of US rates. A sharp general rise in market rates occurred in nearly all countries as a result of measures which substantially raised the marginal cost of central-bank credit. In addition, between early October and mid-January official discount rates were increased in nine of the Group of Ten countries and in Switzerland — by amounts ranging up to 3 per cent. in the United Kingdom and 4½ per cent. in Italy. Increases in interest rates on bank lending quickly followed and bond yields moved up progressively.

A respite followed in early 1980, with short-term rates edging back down in some countries, but it proved to be short-lived. In the United States, with consumer price inflation accelerating further and the prospects for an economic slowdown again receding, bond prices collapsed in February and the Federal funds rate rose to a record monthly average of 14 per cent. When the Federal Reserve reacted firmly by raising the discount rate from 12 to 13 per cent. a new wave of discount rate increases soon swept across Japan, Belgium, Germany, Switzerland and Denmark. Yet another package of US fiscal and monetary restraint measures was announced in March. This time the authorities left the basic discount rate unchanged but introduced a 3 percentage point surcharge to be applied in cases of frequent recourse to borrowing from the Federal Reserve. By late March the Federal funds rate had reached nearly 20 per cent. Yields on corporate bonds stood at 14 per cent. and interest rates on three-month bankers' acceptances at 17½ per cent. In early April banks' prime lending rates reached a record 20 per cent. and mortgage loans were being offered at rates fixed at 16–17 per cent. for terms as long as twenty-five years.

Interest rates also reached remarkably high levels in the spring of 1980 in western Europe, where in most countries the rate of inflation and demand pressures were increasing, although they were still lower than in the United States. In Germany the strength of aggregate demand and the authorities' continuing efforts to prevent overheating by curbing monetary and credit expansion seem to have been the main influences. In the United Kingdom and France the authorities were also attempting to curb monetary expansion; moreover, inflation had been given a sharp boost by cost factors of domestic origin, as in Italy. In some of the smaller countries, including Belgium, the Netherlands and Denmark, interest rates seemed particularly high in relation to current rates of inflation, a fact that may have been due partly to large budget imbalances and the need to finance widening current-account deficits. In determining their interest rate policy the authorities in nearly all countries gave high priority to defending their currencies, irrespective of the state of aggregate demand in the economy, in the hope of moderating cost pressures from abroad. As money markets seem to have expected a high degree of exchange rate stability, nominal interest rates in the various countries moved up closely in step. Whereas interest rates had scarcely overtaken the rate of inflation in the United States, yields and borrowing costs had become very high in "real" terms in many other countries.

Interest rates in the United States turned down in March and early April in response to indications of emerging recession and the development of a more cautious climate in credit markets. The decline, like the preceding rise, was remarkably steep, particularly at the short end. By early May the yield on three-month bankers' acceptances was down to 9½ per cent., the prime rate had come back to 17½ per cent. and the yield on corporate bonds stood at 12 per cent. On 7th May the 3 percentage point surcharge on the discount rate applied since March in cases of frequent recourse to borrowing from the Federal Reserve was abolished. With the dollar easing in the exchange markets, modest declines in money-market rates and bond yields were recorded in most European markets. On 2nd May, however, the Bundesbank's discount and lombard lending rates were raised from 7 to 7½ per cent. and 8½ to 9½ per cent. respectively, in a move that was influenced by both quickening monetary expansion and the country's external current-account deficit. On the same day the Netherlands Bank raised its official lending rates by ½ percentage point.

Monetary policy and monetary expansion. The tightening of monetary conditions last year was to a large extent due to the greater determination displayed by key countries in applying policies primarily geared to restraining monetary expansion. Interest rate adjustments were the mechanism by which it was transmitted to virtually all countries.

Monetary objectives and the actual rates of expansion in the aggregates concerned are shown in the following table and in the graph on page 68.

Slightly lower norms or limits have been established each year in nearly all of the countries concerned, reflecting the view that their announcement would help dampen down inflationary expectations. In several cases, it is true, the base period for last year was one in which monetary expansion had exceeded the target, implying that while earlier excesses would not be reversed monetary policy should become

Monetary and credit aggregates: Objectives and rates of expansion.

Country	Monetary or credit aggregate	Period	Objective	Actual result
			percentage increase[1]	
United States . . .	M_1 old definition	IV/1978 — IV/1979	3.0— 6.0[2]	5.5
	M_1A new definition	IV/1979 — IV/1980	3.5— 6.0	.
	M_1B new definition	IV/1979 — IV/1980	4.0— 6.5	.
	M_2 old definition	IV/1978 — IV/1979	5.0— 8.0	8.3
	M_2 new definition	IV/1979 — IV/1980	6.0— 9.0	.
	M_3 old definition	IV/1978 — IV/1979	6.0— 9.0	8.1
	M_3 new definition	IV/1979 — IV/1980	6.5— 9.5	.
	Total bank credit	IV/1978 — IV/1979	7.5—10.5[3]	11.0
		IV/1979 — IV/1980	6.0— 9.0[3]	.
Japan.	M_2 + CDs	I/1978 — III/1979	12.0[4]	11.7[5]
		IV/1978 — IV/1979	11.0	11.2
		I/1979 — I/1980	10.0	10.7
		II/1979 — II/1980	10.0	.
Germany	Central-bank money	IV/1978 — IV/1979	6.0— 9.0	6.3
		IV/1979 — IV/1980	5.0— 8.0	.
France	M_2	December 1978 — December 1979	11.0	14.3
		December 1979 — December 1980	11.0	.
United Kingdom. .	Sterling M_3	October 1978 — October 1979	8.0—12.0	13.4
		June 1979 — October 1980	7.0—11.0	.
		February 1980 — April 1981	7.0—11.0	.
		April 1981 — April 1982	6.0—10.0[6]	.
		April 1982 — April 1983	5.0— 9.0[6]	.
		April 1983 — April 1984	4.0— 8.0[6]	.
Italy	Total domestic credit	December 1978 — December 1979	18.5[7]	19.0
		December 1979 — December 1980	17.0[7]	.
Netherlands. . . .	M_2/Net national income	End of 1980	slight reduction	36.6[8]
Canada	M_1	June 1978 — II/1979	6.0—10.0	7.7
		II/1979 —	5.0— 9.0	.
Switzerland	Monetary base	November 1979 — November 1980	4.0	.

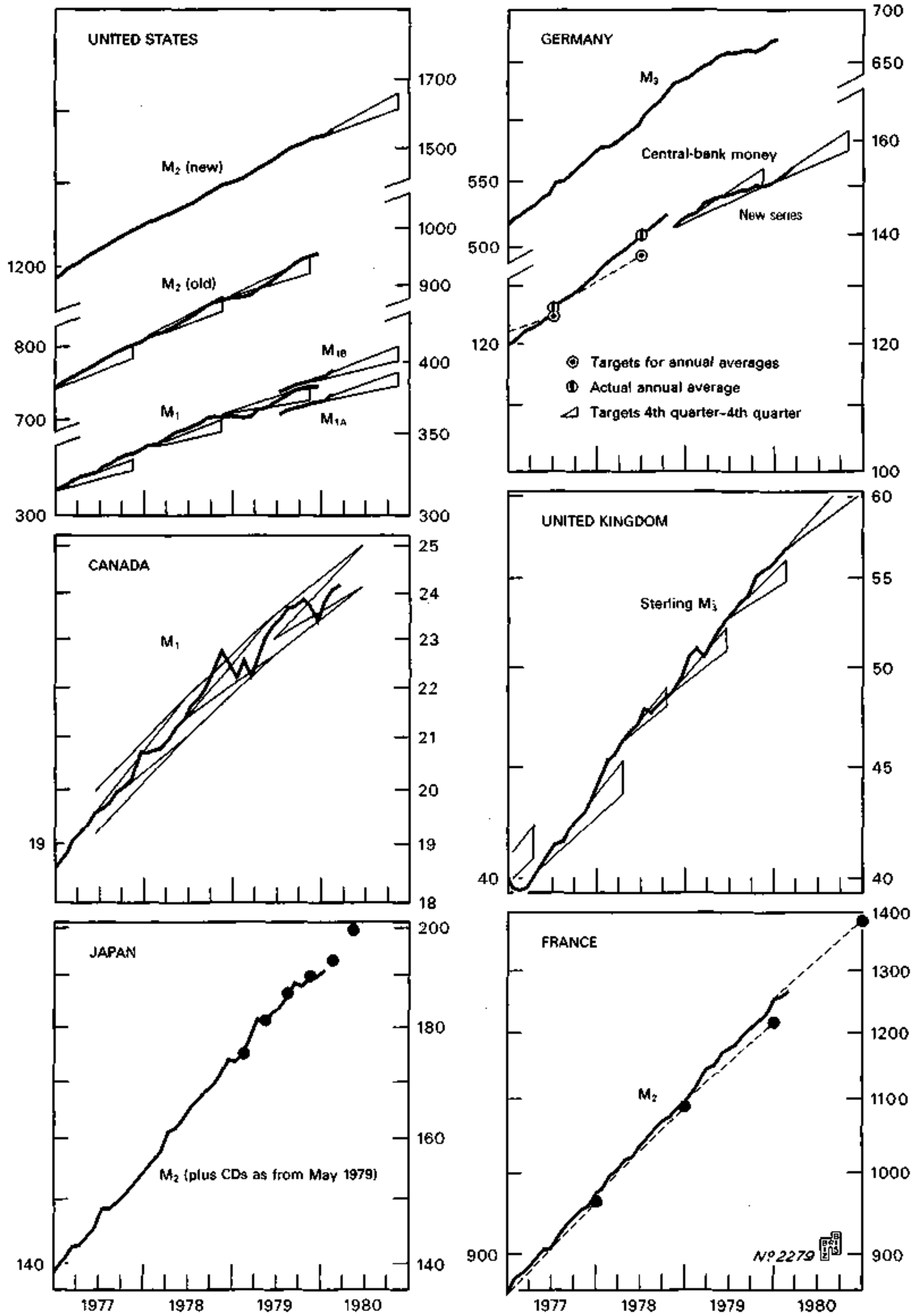
[1] At an annual rate where the period is other than a year. [2] Revised target set in October 1979 when it became clear that the use of automatic transfer services and negotiable orders of withdrawal was expanding faster than expected; the original target range was 1.5–4.5 per cent. [3] Estimate designed to be consistent with the targets for the monetary aggregates. [4] Estimated change over each four-quarter period. [5] III/1978–III/1979. [6] Medium-range plan; details subject to revision. [7] Upper limit expressed in terms of amounts: Lit. 53,000 billion in 1979, Lit. 59,000 billion in 1980. [8] End of 1979.

progressively restrictive in the course of the year. More important was the fact that no country raised its target limits to accommodate rates of inflation that turned out to be much higher than anticipated. In the event, some of them were unable fully to meet their objectives, but in the course of the year countries became more determined in their efforts to restrain monetary expansion.

In the *United States* the monetary aggregates expanded only moderately in the early months of 1979 but began to grow very rapidly in the summer. This, together with related exchange-market developments, helps to explain the timing of more restrictive policies and the succession of restraint packages introduced since October. Monetary expansion moderated in the final quarter and in 1979 as a whole M_1 was just within the target range.

In early 1980, however, the narrow aggregates moved above the authorities' new, more restrictive target ranges. In a climate of worsening inflationary sentiment

Monetary aggregates: Objectives and rates of expansion.



and growing speculative activity, the October measures — an increase in the discount rate, a marginal reserve requirement on banks' managed liabilities and a shift in operational focus to reserve base management — were buttressed first by a further increase in the discount rate in February and then by the adoption of a broad new restrictive approach in March. Business credit was made subject to quantitative guidelines and a special deposit requirement was imposed on the growth of certain types of consumer credit. The reserve requirement on managed liabilities was raised and a similar deposit requirement was introduced for banks outside the Federal Reserve System. A deposit requirement was also imposed on the growth of money-market mutual funds. While the credit limits were designed to be consistent with the targets for the aggregates and to underpin reserve management in achieving monetary restraint, the programme clearly involved an effort to restrain financial flows more generally.

In *Germany* the growth of central-bank money slowed down markedly in the course of last year. Between the fourth quarter of 1978 and the fourth quarter of 1979 its expansion was in the lower half of the official target range, which was in line with the authorities' proclaimed objectives. The Bundesbank encouraged a steep fall in banks' free liquidity early in 1979 and, when the banks increased their use of lombard credit, restricted the facilities for these loans — making them subject, for a time, to quantitative limits. Thereafter banks' reserve positions were kept on a tight leash by fine tuning.

Efforts to restrain monetary expansion were also stepped up last year in a number of countries that traditionally rely largely on direct or quantitative credit control for this purpose, while assigning only a secondary rôle to the management of bank liquidity and to interest rate policy. In *Japan*, where a tightening of the "window guidance" limits on bank credit expansion began in the first quarter of 1979, the expansion of M_2 during the year was considerably lower than in 1978. In *France* monetary expansion was faster in 1979 than in 1978 but the norms for bank lending were tightened in respect of 1980. Credit ceilings for 1980 were also made tighter than before in the *Netherlands*, which sets an objective for the ratio of the money supply to net national income, and in *Italy*, which has no target for the money supply but publishes objectives for total domestic credit creation.

In the *United Kingdom* rates of monetary expansion continued to follow a fairly erratic course last year and were frequently close to or above the upper limit of the authorities' target range. The "corset" restraint on the expansion of banks' interest-bearing eligible liabilities had served for some time to reduce recorded monetary expansion but could be circumvented by operations in acceptances. The use of this instrument came to be even more problematical after the removal of exchange controls enabled UK residents to hold deposits abroad and it is to be abolished in June 1980. Since funds diverted to the bill market will presumably reappear in the money supply, the current target may ultimately prove more restrictive than it seems. The authorities have demonstrated their willingness to accept large changes in interest rates where required for achieving monetary control. In March, moreover, the Government announced a medium-term anti-inflationary plan centred on a progressive slowing-down of monetary expansion and declared that it was prepared to cut government spending and the borrowing requirement so as to facilitate the achievement of its monetary objectives.

Last year the development of the various monetary aggregates was influenced to an unusual extent by shifts between different types of assets in response to changing interest rate differentials. Typically, firms and individuals economised on unremunerated or low-yielding transactions balances and shifted funds out of savings deposits into securities, money-market instruments and time deposits on which the interest rates are adjusted more flexibly. Shifts of this sort helped to slow down the growth of the broad aggregates to which targets apply in Germany, Japan and the United States but their impact on the narrow ones was even more marked. Last year the growth of M_1 slowed down sharply almost everywhere and was much less than that of M_2 or M_3 in nearly all countries.

In the *United States,* where considerable importance has been attached to the M_1 target, regulatory changes and financial innovations were also a major influence. In late 1978 commercial banks had been authorised to offer customers automatic transfer services for shifting deposits from savings to demand accounts and banks in New York State had been authorised to offer negotiable order of withdrawal accounts, whereby cheques could be drawn against interest-bearing deposits. The initial rapid expansion in the use of these facilities slowed down in April 1979 following a court ruling that ATS accounts were illegal and could be maintained only if Congress enacted enabling legislation. To take account of these developments the M_1 target range was raised substantially in October. Deposit flows were also influenced considerably by the popularity of six-month money-market certificates, which banks and thrift institutions had been authorised to issue as from mid-1978. Minimum denominations were as low as $10,000 and the interest return was related to the yield on six-month Treasury bills. In July 1979 a floating interest rate ceiling was also introduced for savings certificates with a maturity of four years or more and in January 1980 the maturity restriction was lowered to two and a half years. More influential last year, however, was the rapid growth of a new facility attributable to private initiative: money-market funds which offered certain transaction facilities. With a view to taking account of these developments and with the object of classifying deposits on a functional rather than on an institutional basis, a new set of monetary aggregates was defined and made the basis of the targets for 1980.

In *Canada,* too, financial innovation tended to moderate the expansion of M_1, which is the authorities' chosen target variable. New savings-account facilities offered by banks enabled individuals to economise on cheque-account balances.

In *Switzerland,* one of the first countries to publish a monetary objective, the target was abandoned for 1979 in favour of maintaining greater exchange rate stability. However, in rather different circumstances the authorities decided to announce an objective for the expansion of the monetary base in 1980.

Bank credit and the monetary survey. Against a background of inflation and economic expansion, bank credit grew very rapidly in the larger industrial countries last year, in many cases much faster than the broad money supply. The buoyant element

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

Country	Broad money stock[2]			Credit to enterprises and individuals[3]			Credit to public authorities[4]			Net foreign assets[5]		
	1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
	Dec.–Dec. in percentages			contributions to the change in the money stock[6]								
United States	9.3	8.2	8.7	12.0	15.9	13.2	—.01	—0.7	0.0	—3.9	—1.8	0.3
Japan	11.1	13.1	9.1	9.0	10.1	7.7	3.6	6.1	2.3	1.7	0.3	—2.3
Germany	11.2	11.0	6.0	12.9	15.1	17.0	4.8	6.1	4.2	1.9	1.2	—3.3
France	13.9	12.2	14.3	13.3	10.0	14.2	0.1	0.3	1.1	0.6	0.9	0.7
United Kingdom	9.3	13.3	11.7	7.9	10.7	17.1	—6.1	5.3	3.6	9.4	1.4	—6.1
Italy	21.8	22.8	20.4	7.4	5.4	8.0	11.3	14.2	7.1	1.7	4.1	1.6
Belgium	9.9	9.8	6.0	12.0	10.5	12.1	7.0	6.8	8.4	—0.4	—3.4	—9.0
Netherlands	1.7	3.7	7.3	24.4	30.4	25.7	1.8	2.3	5.7	—1.2	—4.8	—3.9
Denmark	9.8	6.7	9.9	9.0	5.9	3.2	4.5	3.2	11.1	—2.9	—0.9	—3.1
Sweden	9.0	17.2	16.5	12.8	11.9	13.5	4.4	10.7	11.0	1.8	—2.8	—4.3
Canada	11.5	12.5	17.9	16.8	20.2	24.4	1.2	1.2	—0.1	—0.6	—0.7	—1.7

[1] Based on national sources. [2] For Germany, M_3; for the United Kingdom, sterling M_3; for other countries, M_2. [3] For the United States and Canada, commercial-bank credit only. [4] For the United States, commercial-bank holdings of Treasury securities only; for France and Denmark, central government only; for the United Kingdom, bank lending to the public sector and public-sector borrowing abroad; for Canada, commercial-bank credit only. [5] 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). [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.

was credit to the private sector. The growth of bank lending to the government or public sector slowed down in most countries, though a few experienced a large rise. Quantitative restraints on credit-granting were tightened; in the United States credit guidelines were introduced for the first time. A considerable part of the increase in bank lending was financed with non-monetary funds: there was a strong expansion in banks' long-term resources or in their managed liabilities, such as certificates of deposit. A decline in the banking system's net external assets, in many cases reflecting a marked turn-around in external positions, helped to limit the impact of credit-granting on monetary expansion in most European countries and Japan.

In a context of strong demand pressures, total loans and investments of US banks expanded by 11 per cent. in 1979 (fourth quarter to fourth quarter), compared with the range of 7½–10½ per cent. that the Federal Reserve had originally expected to be consistent with the achievement of its monetary targets for the year. Commercial and industrial loans expanded by 17.8 per cent. during the year. After rising rapidly in January–September, bank credit-granting seemed to be slowing down in the final quarter of 1979 but it surged upwards again early in 1980 after the collapse of the bond market and in anticipation of the imposition of credit controls.

As for developments elsewhere, in Germany bank lending to the private sector rose by over 12 per cent., a remarkably large increase in relation to the rate of inflation. Loans for housing continued to expand strongly and short-term credits to business accelerated sharply, in reflection of both stockbuilding and, apparently, the expectation that interest rates might decline. In Japan business demand for bank credit strengthened but the actual rise in bank lending was moderate, thanks mainly to increasingly restrictive "window guidance". Substantial rises in bank credit to the private sector were recorded, however, in France, Italy, the Netherlands and Belgium, though this is not in all cases clear in the above table, which shows contributions to monetary expansion. Mortgage credit rose particularly rapidly in France. Quantitative credit controls were in force in France, Italy and the Netherlands, but banks could take advantage of leeway previously available under the ceiling, and of exemptions conceded for various types of credit. In the United Kingdom sterling lending to the private sector rose by 22.7 per cent. and in addition the "bill leak" (whereby commercial bills guaranteed by the banks were substituted for their own lending) continued at a significant rate. UK companies experienced increasing pressure on their liquidity and cash flow. In addition, the relaxation and subsequent removal of exchange controls permitted them to repay existing foreign currency loans and to invest abroad more easily.

The use of quantitative restrictions on credit-granting has always been controversial. However, many national authorities have continued to apply them on a regular basis or in special circumstances even though they are well aware of the distortion of credit flows they may cause and the potential scope for evasion. Norms or guidelines for credit-granting by banks — collectively and individually — have been in force for some years in Japan, France, Italy, the Netherlands and Denmark, though the schemes differ markedly in form, coverage and method of enforcement. In the United Kingdom the "corset" control on the banks' interest-bearing liabilities has also served directly to limit credit-granting, but it is now to be abolished in June. Other countries, one of which was until recently the United States, have persistently expressed a preference for relying on interest rate mechanisms in rationing credit and for achieving restraint if necessary.

If credit restraint exercised through market mechanisms is to be effective, interest rates must be allowed to rise to levels which are sufficiently high. In the United States there has been considerable political resistance to high interest rates, especially as they affect mortgage lending, while Federal Reserve operating procedures, which before October 1979 focused on short-term interest rates, tended to prevent interest rates from rising sufficiently and quickly. Moreover, in aiming at the monetary aggregates, the authorities have apparently failed to take sufficient account of rapid innovation in the development of financial substitutes for transactions balances. By the time interest rates had moved up sharply in early 1980, inflationary sentiment had already taken firm hold and speculation was rife. At very high rates of inflation, calculations of real interest costs and returns were also distorted by tax arrangements geared to more stable conditions. In the circumstances, the announcement of credit controls was widely seen as a confirmation of the authorities' intention to pursue vigorous restraint policies by all the means available. The restrictions on business credit were voluntary (although reporting was mandatory), those on consumer credit were selective and the programme was designed to be temporary. However, it was clearly hoped that it would help to restore confidence and gain time until more orthodox interest rate mechanisms could take effect.

Bank lending to the public sector was quite an important source of money creation last year in Belgium, Italy, the Netherlands, Denmark and Sweden, but in other countries it was generally less troublesome than before. The persistence of comparatively large government or public-sector deficits may have contributed to upward pressures on interest rates, however, and in some countries may help to explain why it is necessary to ration credit to the private sector by imposing quantitative ceilings. In some, moreover, the purchase of government securities by the non-bank private sector continues to be a very volatile element in the money-creation process and one of the chief problems encountered in efforts to stabilise the rate of monetary expansion.

In considering the relationship between credit-granting and the money supply, it has to be borne in mind that in the United States there was an increase — outside M_2 — of $50 billion in 1979 in banks' managed liabilities, comprising funds raised through certificates of deposit, Euro-dollar borrowings, repurchase agreements and the Federal funds market. This rise was equivalent to nearly half the increase in bank credit. The growth of banks' long-term non-monetary liabilities formed an unusually large counterpart of credit-granting last year in Germany and Japan, where interest rate differentials played a key rôle, and in the Netherlands, where bank credit financed by long-term resources is exempt from the credit ceilings.

External developments also help to explain why the rapid domestic credit expansion in countries other than the United States was not fully reflected in the rate of growth of the money supply. Reflecting in particular the changing strength of the dollar, official net external assets declined on balance in many countries — Italy, the United Kingdom and France being notable exceptions. Far more important in this context, however, was a deterioration in the net external position of the banks. In Germany a significant factor was the rise in the banks' external liabilities at medium term, partly reflecting increased use of the Deutsche Mark as a reserve currency. In the United Kingdom there was a substantial rise in exchange reserves in sterling and in banking and money-market liabilities in sterling to overseas holders other than monetary authorities. In Belgium the return through the banks of funds placed abroad by residents seeking to circumvent domestic interest rate restrictions and withholding taxes played a certain rôle. In early 1979 the banks in Italy had to finance strong growth in foreign currency lending to residents outside the credit ceilings. In the Netherlands the regulations limiting the banks' net external indebtedness were liberalised. A feature common to nearly all these countries, however, was a substantial external deficit on non-bank account combined with interest rate policies designed to limit its effect on the exchange rate and on the official external reserves.

Broad credit flows and financial positions. Changes in total credit flows and financial positions are closely related to developments in sectoral financial positions and, to some extent, help to explain them. The ratio of total credit flows to gross national product remained very high in the United States and rose sharply in the United Kingdom, while remaining fairly moderate by past standards in Japan, Germany and France.

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

Countries	Years	Borrower							Total
		Business sector[2]				Household sector[2]		Public sector[2]	
		Equities	Bonds	Loans[3]	Total	Housing credit[4]	Other		
		In percentages of gross national product							
United States	1972	0.9	1.1	4.7	6.7	3.5	2.0	2.5	14.7
	1973	0.6	0.8	5.9	7.3	3.6	2.5	1.7	15.1
	1974	0.3	1.5	5.1	6.9	2.5	1.1	1.9	12.4
	1975	0.6	1.9	0.6	3.1	2.5	0.8	6.5	12.9
	1976	0.6	1.5	2.4	4.5	3.6	1.7	5.0	14.8
	1977	0.1	1.3	4.2	5.6	4.9	2.5	4.1	17.1
	1978	0.1	1.1	4.8	6.0	4.9	2.8	3.6	17.3
	1979	0.1	1.1	5.4	6.6	4.6	2.2	2.3	15.7
Japan	1972	1.3	0.4	17.5	19.2	5.8		5.8	30.8
	1973	1.1	0.7	13.4	15.2	7.7		5.7	28.6
	1974	0.6	0.5	9.6	10.7	4.6		5.9	21.2
	1975	0.8	0.9	9.9	11.6	4.7		7.6	23.9
	1976	0.5	0.4	8.9	9.8	5.1		9.2	24.1
	1977	0.6	0.3	6.4	7.3	4.4		8.4	20.1
	1978	0.5	0.4	4.9	5.8	4.8		9.9	20.5
	1979	0.6	0.4	4.7	5.7	6.1		9.3	20.1
Germany	1972	0.3	0.4	6.1	6.8	4.0	1.2	1.8	13.8
	1973	0.3	0.1	3.1	3.5	4.4	0.5	1.8	10.2
	1974	0.2	0.2	3.2	3.6	2.4	0.1	2.3	8.4
	1975	0.4	−0.1	1.4	1.7	2.2	0.7	5.9	10.5
	1976	0.4	0.1	3.1	3.6	2.4	1.2	3.8	11.0
	1977	0.2	0.1	2.7	3.0	3.0	1.2	3.1	10.3
	1978	0.3	−0.1	2.9	3.1	3.8	1.4	3.4	11.7
	1979	0.3	−0.2	4.1	4.2	4.3	1.4	3.0	12.9
France	1972	0.7	0.7	5.7	7.1	5.6		1.5	14.2
	1973	0.8	0.5	4.9	6.2	4.4		1.2	11.8
	1974	0.8	0.3	6.9	8.0	3.3		1.2	12.5
	1975	0.6	1.0	6.3	7.9	4.1		4.2	16.2
	1976	0.9	0.7	5.8	7.4	4.8		2.3	14.5
	1977	0.6	0.7	5.9	7.2	3.8		3.1	14.1
	1978	0.7	0.5	4.5	5.7	3.7		3.7	13.1
	1979	0.6	0.5	3.8	4.9	4.3		1.6	10.8
United Kingdom. . .	1972	0.5	0.5	4.8	5.8	4.4	3.4	3.3	16.9
	1973	0.1	0.1	7.0	7.2	3.8	1.8	5.7	18.5
	1974	0.1	−0.1	5.5	5.5	2.7	0.0	7.6	15.8
	1975	1.0	0.2	0.9	2.1	3.5	−0.4	10.0	15.2
	1976	0.7	0.0	2.3	3.0	3.1	0.6	7.3	14.0
	1977	0.5	−0.1	2.2	2.6	3.0	1.1	4.2	10.9
	1978	0.6	−0.1	2.0	2.5	3.2	1.3	5.1	12.1
	1979	0.5	0.0	2.9	3.4	3.3	1.8	6.7	15.2

[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 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.

Borrowing by *non-financial business* was a very dynamic element in credit markets last year in the United States, Germany and the United Kingdom, but expanded at only a modest pace in France and Japan. Rising bond yields and uninspiring stock prices discouraged extensive recourse to the capital markets, so that the bulk of the increase in business borrowing took the form of bank loans. US corporations also borrowed large amounts at short term from finance companies and through the issue of commercial paper. Commercial mortgages expanded at a fair pace, but the volume of public and private bond issues declined.

In the United States, where business investment was strong and profitability weakened, corporate borrowing set the pace in financial markets but remained below the previous peak in relation to gross national product. For non-financial corporations the ratio of internal funds to capital outlays fell last year to 71 per cent., which was, however, much higher than the figure of 56 per cent. recorded in 1974. Corporate liquidity has deteriorated markedly — the ratios of liquid assets to current liabilities and short-term debt to total debt are now worse than they were even in 1974, though this may in part reflect a deliberate effort to reduce idle cash balances to a minimum.

In Germany the enterprise sector showed a small deficit last year after having recorded a surplus in 1978. In Japan the deficit of the corporate sector increased. Thanks, however, to wage restraint and the upswing in economic activity, the share of profits in national income has improved considerably in these countries and also in France, where the earlier abolition of price controls was an additional factor. Though there was some deterioration during the year, firms' liquidity positions are still fairly strong in these countries. The situation is different in the United Kingdom, where companies excluding the North Sea oil sector have recently suffered a renewed deterioration in profitability attributable to weak overall demand, wage pressures and loss of competitiveness abroad due to the strength of sterling. The self-financing ratio for industrial and commercial companies stood at 70 per cent. in 1979, compared with 73 per cent. in 1978, and the ratio of current assets to current liabilities in large companies fell from 140 per cent. in mid-1978 to 71 per cent. in December 1979. The latter figure was higher than that of 44 per cent. recorded at the end of 1974, but a further deterioration cannot be ruled out.

Housing credit expanded strongly last year in many countries in conjunction with a building boom, which in varying degrees reflected the efforts of households to protect themselves against inflation. A related sharp rise in house prices was, of course, another factor. In several countries the strength of household borrowing for housing construction was masked by cutbacks in the building of rental accommodation by the public or private sectors. In most countries the rise in housing credit slowed down to some extent in the course of the year in response to rising interest rates. In the United States, however, the availability of mortgage credit was much better protected than in previous restraint periods by authorisations given to thrift institutions to raise funds at market-related interest rates. Pressures on the profitability of US savings institutions and usury ceilings on interest rates imposed by some states (though these were temporarily overridden by an Act of Congress in late 1979) placed some limits on the supply of credit, however; as in previous periods of restraint, Federal agencies provided additional bond-based finance. In the United Kingdom the availability of mortgage finance was at times restricted by the usual delays in adapting building society deposit rates to rises in market yields.

Consumer credit rose substantially in 1979 in the United States, Germany, France and the United Kingdom. In the case of the United States the previous year's record rate of increase was not equalled, however, owing to a decline in the pace of car sales. For similar reasons the expansion in consumer credit slowed down in Germany in the course of 1979. In the United Kingdom the high figure in the table for personal-sector borrowing in part reflects heavy borrowing by unincorporated enterprises.

The marked fall in the personal savings ratio in the United States, contrasting sharply with developments in other countries, was until last year attributable mainly to a rapid rise in borrowing by US households. The bulk of the increase took the form of mortgage debt, which expanded much faster than can be explained by the need to finance the growth of the housing stock. Last year, moreover, financial asset accumulation by US households declined in relation to both personal income and net worth for the first time since 1974. The growth in household financial savings also slowed down markedly in France last year. Elsewhere, however, the personal sector continued to accumulate financial assets at a high rate. Efforts to constitute down-payments for the purchase of dwellings may have been a stimulatory factor, but household acquisitions of medium and long-term deposits and/or bonds were quite high in Germany, Japan and the United Kingdom.

Some of the disparities, real and apparent, between household saving behaviour in different countries may be attributable to differences in asset and liability positions. In the United States household net worth has increased much faster than current incomes in recent years as a result of rising house prices; in relation to net worth household debt has risen only moderately. In most other industrial countries household wealth tends to be much more heavily concentrated in financial assets, the option of house purchase being less readily available. In these circumstances inflation stimulated households to rebuild depleted net worth positions, and as nominal interest rates adapted the means of so doing were provided.

Government finance. Public-authority and central-government borrowing requirements contracted further last year in the United States and remained quite modest in France. In most other countries they have shown a renewed or continuing tendency to rise over the past two years and in relation to gross national product are very high by pre-1975 standards.

Most countries were able to finance a substantial proportion of their deficit from domestic non-bank sources last year. Difficulties experienced in periods when interest rates were expected to rise were by and large resolved once the rise actually occurred. Funds from the non-bank private sector more than covered the central government's borrowing requirement in the United Kingdom and also in the United States, where non-residents, and notably foreign central banks, on balance reduced their holdings of government securities last year in sharp contrast to 1978. But whereas sales of gilts were particularly large in the United Kingdom, Treasury bills accounted for a substantial part of the rise in marketable issues in the United States. A shortening of maturities was also evident in some other countries. In Japan the newly introduced two to three-year government bonds were issued on a considerable scale. In Italy the bulk of the securities sold to non-banks last year were Treasury bills and bonds with variable interest rates. Demand for Treasury bills at times reached dramatic proportions and for the year as a whole the Treasury reduced its

Government financing.[1]

Financing requirement	Years	Belgium	France	Germany	Italy	Japan	Nether-lands	United Kingdom	United States
		as a percentage of gross national product							
Public sector[2] . . .	1975	5.9	3.6	6.6	14.6	7.0	4.8	10.1	6.7
	1977	6.7	1.3	3.0	10.2	9.2	3.6	4.2	3.3
	1978	7.2	2.3	3.2	14.9	10.7	4.0	5.2	2.7
	1979	8.9	1.6	3.5	11.6	10.2	4.9	6.8	1.8
Central government[3]	1975	5.6	3.0	6.2	11.3	2.7	3.0	8.0	5.9
	1977	6.6	1.1	2.7	9.0	4.6	3.1	3.1	3.5
	1978	6.4	1.5	3.3	14.4	5.7	3.3	5.2	2.8
	1979	7.4	1.4	3.2	11.2	5.2	4.3	5.6	1.8
met by:									
Central bank	1975	0.1	1.4	0.6	6.6	.	0.0		0.6
	1977	0.6	−0.9	−0.0	−2.5	.	0.1		0.4
	1978	0.4	−0.7	−0.1	2.3	.	0.2	2.3	0.4
	1979	1.1	0.1	0.0	0.2	.	0.8	1.3	0.4
Banks	1975	0.6	0.8	4.3	1.5	2.1	0.9	−0.3	1.7
	1977	3.9	0.5	2.1	7.0	3.0	0.5	0.1	−0.1
	1978	2.5	0.4	2.8	5.4	4.0	0.5		−0.5
	1979	3.3	−0.0	2.3	3.8	3.6	1.0		0.0
Other domestic sources.	1975	4.9		1.0	3.2		2.1	5.5	3.1
	1977	2.3		0.6	4.5		2.5	6.8	1.5
	1978	2.5	0.8	0.5	6.6	0.6	2.6	4.6	1.4
	1979	2.2	1.5	0.5	7.0	1.6	2.5	5.6	1.9
Foreign sources[4] . .	1975	0.0	1.8	0.3	0.0	1.7	–	0.2	0.5
	1977	−0.2	1.3	0.0	0.0	1.6	–	−5.0	1.6
	1978	1.0		0.1	0.1		–	0.9	1.5
	1979	0.7		0.2	0.2		–	−0.1	−0.5

[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 (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 1.4 per cent. of GNP in 1979); for the United Kingdom, includes borrowing requirement of public corporations. [3] For Germany, all public authorities other than social security institutions; for Italy, general government; for the United Kingdom, includes central-government lending to public corporations (equivalent to approximately 1.7 per cent. of GNP in 1979). [4] For the United Kingdom and the United States, includes increases (—) in official foreign exchange assets.

recourse to the Bank of Italy, thus helping to offset the influence exerted on the monetary base by the country's external surplus.

In Germany the public authorities again resorted heavily to bank borrowing, but the banks refinanced a substantial proportion at long term. Monetary financing of the public sector was extensive, however, in the Netherlands and also in Belgium, where the Government had large-scale indirect recourse to the central bank and raised a considerable volume of funds abroad.

Changing techniques of monetary policy.

In recent years problems relating to the efficacy of monetary policy have been growing in many countries.

On the one hand, monetary policy has increasingly been expected to bear the main burden of controlling economic developments, with fiscal and incomes policies giving only limited support or being relegated to an ancillary rôle. On the other hand, with the instruments and operational techniques at their disposal the monetary authorities have often felt poorly equipped to fulfil the responsibilities assigned to them. One fairly general problem, given the recent mushrooming of inflationary expectations, has been the apparent failure of high nominal interest rates to bite — raising the question whether too little was being done too late or whether the problem lay elsewhere. At the same time, with credit demand continuing to swell, policies designed simply to control the expansion of particular monetary aggregates could be thwarted by financial innovation and the development of alternative fund-raising instruments. Quantitative credit controls and non-interest-bearing reserve requirements provide a strong incentive to financial disintermediation. Yet in extreme circumstances some countries, reluctant to push interest rates higher, have relied on the use of direct controls to achieve the desired results or to restore confidence in the authorities' determination to act.

The improvement of control techniques became a central concern in the United States last year. In two major steps the Federal Reserve Board first shifted the operational focus of monetary management from short-term interest rates to the supply of bank reserves and subsequently reinforced its normal techniques with a broad-ranging credit control programme. Shortly afterwards Congress approved sweeping changes in the regulatory framework. Significant, though less fundamental, changes in the instruments of monetary control were made last year in Germany, France, Italy, Japan and Canada. In the United Kingdom far-reaching changes in the techniques of monetary management came under discussion and the Government broke new ground by publishing medium-term stabilisation objectives.

In the *United States* the Federal Reserve Board's announcement in October 1979 that in its conduct of day-to-day open-market operations it would henceforth pay more attention to changes in bank reserves and less to smoothing out fluctuations in interest rates was potentially a very significant development. The procedure of using a number of multiplier relationships to compute the volume of reserves appropriate for achieving a given money-supply target seemed likely to help overcome a traditional bias in monetary policy towards resisting cyclical swings in interest rates and accommodating shifts in the demand for money. Under the new procedures the Federal Reserve Board specified wider tolerance margins for the Federal funds rate on a weekly average basis and as a result the latter began to show very marked fluctuations from day to day. Of greater immediate importance, rising interest rate levels were rendered more acceptable in that they could be seen to be more responsive to changes in market conditions. The authorities quickly became aware, however, that instead of stabilising the supply of bank reserves they could find themselves accommodating an apparent rise in the demand for them. This was partly a reflection of the complexity of the new technique, which had to make allowances for shifts between bank liabilities subject to differing reserve requirements. An upsurge in the aggregates in February 1980 raised doubts in the market that monetary control had been improved decisively. Perhaps partly for this reason, but also on broader grounds, by March a new initiative was deemed necessary.

This time, by establishing credit guidelines, the authorities acted in a way unambiguously calculated to curb the expansion of credit. The limits on bank credit are regarded as supplementary to reserve management and interest rates in controlling the money supply. However, the ceilings were henceforth to be applied to individual banks and would have to be adapted in such a way as to make them consistent with target rates of increase in bank reserves and the money supply. Given that the expansion of bank credit had come to depend heavily on managed liabilities (some of which were still outside the money supply as redefined in February) and that other new instruments had proliferated, the authorities apparently felt it necessary to extend their policy reach beyond the monetary aggregates as such. Until March 1980, and even after bank reserves had become the instrument variable, the US monetary authorities were still relying mainly on interest rates for restraining the rise in the money supply and credit from the demand side. However, in the prevailing highly inflationary climate the introduction of credit controls may have been regarded as an alternative to further increases in interest rates, to which spending might prove insensitive and which might have unwelcome side-effects at home and abroad. Significantly, the March measures included a supplement of 3 percentage points to be added to the discount rate in certain cases, but the basic rate was left unchanged.

Shortly afterwards, Congress acted quickly to resolve long-standing regulatory issues. It authorised changes in provisions which have distorted competition and have been the focus of highly innovative attempts at circumvention in recent years. Under the "Depository Institutions Deregulation and Monetary Control Act" signed by the President in late March the Federal Reserve may, after a transition period, impose non-interest-bearing reserve requirements on all banks and savings and loan institutions throughout the country (instead of only on members of the Federal Reserve System as hitherto) and it is obliged to apply them at certain minimum levels to all accounts which could be used for effecting transactions. Supplementary reserves may also be required but these are to bear interest. The Act also authorised ATS and NOW accounts (see page 70) in all states and provided for the phasing-out over a six-year period of interest rate ceilings on deposits previously applied under Regulation Q. Other provisions overrode usury ceilings imposed by state legislatures on interest rates on mortgage, business and agricultural loans, and authorised savings and loan associations to diversify their activities into areas traditionally dominated by banks, such as consumer credit. An increase from $40,000 to $100,000 in the amount of individual deposits insured with the Federal Deposit Insurance Corporation is another change which may ultimately make deposits with financial institutions a more attractive alternative to market instruments.

Overall, the changes will help to equalise competition among financial institutions for similar types of deposits and should help to check the erosion of the institutional base on which monetary control operates. However, the provision stipulating that non-interest-bearing reserves have to be maintained in respect of specified deposit-taking activities will provide a continuing stimulus to the banks to develop techniques for avoiding the cost involved. In addition to distorting the pattern of intermediation these requirements will probably continue to influence developments in the recorded monetary aggregates, necessitating further revisions in their definition from time to time.

In *Germany* efforts were made last year to improve monetary control by managing bank reserves more actively. After banks' free liquidity had been exhausted and lombard lending had been restricted, the Bundesbank intervened almost continuously in the money market in alternating directions. The financing that banks needed to meet minimum reserve requirements was provided by it in a deliberately hesitant manner and in ways that could be reversed at short notice — by repurchase agreements in domestic securities, commercial bills and foreign assets, by swap transactions in the exchange market and by the temporary placement of public funds in the interbank market. Uncertainties as to the terms of official accommodation substantially altered the conditions under which the banking system had been operating and encouraged the banks to compete for time deposits. This in turn put upward pressure on interest rates on non-monetary assets, which helped to limit monetary expansion at a time when inflation seemed to be making more subtle interest rate mechanisms less reliable. New flexible money-market techniques were also introduced in *Italy* and the *United Kingdom,* where in both cases repurchase agreements were used for the first time to relieve bank liquidity temporarily in periods when sales of government securities had been exceptionally large.

In *Canada* the discount rate was set free to move flexibly in line with market rates as from March 1980. The policy adopted was that it should be set each week at a level ¼ percentage point above the average tender rate for three-month Treasury bills. In the prevailing circumstances the authorities had to cope not only with the impact of very volatile conditions in US markets but also with a need to avert intermittent downward pressure on the Canadian dollar in a situation in which the country's international competitiveness remained strong. The Bank of Canada is, of course, able to exert considerable influence on the Treasury bill market. Also in March the Bank of *France* announced that only a seven-day "pension" facility would be available to the banks at fixed rates and that a three and six-month facility would be available at market-related rates.

In *Italy* the availability of Treasury bills in recent years has enabled the authorities to manage bank liquidity more flexibly. Since the bills are sold to the public in small denominations, banks have also been obliged to keep deposit rates more closely in line with money-market rates. In addition, bankers' acceptances have been developed as an instrument permitting trading between banks in unutilised lending quotas under the official credit ceiling. Greater flexibility of interest rates on deposits is also an objective in *Japan.* In this respect the establishment of a one-month commercial bills market in November 1978 and the authorisation in March 1979 of the issue by banks of yen CDs for which interest rates are uncontrolled were important developments. In April 1979 the Bank of Japan and money-market dealers agreed on steps to free the determination of call-money rates and to create a market in seven-day instruments. Since October, when controls on the discount rate on two-month commercial bills were removed, all call and bill rates have been freely determined by market forces.

In the *United Kingdom* the pivotal rôle assigned to control of the monetary aggregates in the Government's overall strategy for reducing inflation has stimulated a particularly lively debate about the adequacy of existing control instruments and institutional arrangements in financial markets. The basic issues were set out by the authorities themselves in a Green Paper on monetary control published in March. While fiscal policy, gilt-edged funding and short-term interest rates may be adequate for controlling monetary expansion in the medium term, short-term swings may have undesirable effects on confidence. In view of the disadvantages of quantitative controls designed to influence bank lending and the institutional uncertainties involved in the introduction of a scheme to control the monetary base in the absence of mandatory reserve requirements, the Paper suggests an indicator system under which swings in the money supply could trigger an automatic adjustment in the Bank of England's "operative" lending rate.

None of the reforms carried out or envisaged in the larger economies amount to the establishment of a full-scale system of monetary base control. The authorities still feel that the benefits deriving from tighter control over the money-supply process might in practice be modest and more than counterbalanced by the cost of the large changes in the last-resort lending facilities and money-market arrangements that would be required. A possibly more important objection is that the extreme variability of interest rates it might entail could cause serious instability in exchange rates or would hamper efforts to stabilise them. The innovations under way do, however, seem to mark a significant move towards permitting greater flexibility in interest rates and in making changes more acceptable to the markets. If this is really the case, they will have helped to overcome what has been one of the major constraints on effective monetary control policies in the past.

V. INTERNATIONAL BALANCES OF PAYMENTS.

From the global viewpoint, two balance-of-payments developments stood out in 1979. Firstly, the current-account surplus of the oil-exporting countries, which had disappeared in 1978, was raised to $63 billion by the very large increases in the price of oil. Secondly, there were substantial shifts in the balances of payments of the largest industrial countries, eliminating or reversing earlier imbalances. In the United States there was an overall balance-of-payments surplus of $14 billion, following deficits totalling $67 billion in the two preceding years, and the deficit in the current account was virtually removed in spite of the increased cost of oil imports. In the traditional strong currency countries — Japan, Germany and Switzerland — the combined current account swung from a surplus of nearly $30 billion in 1978 to a deficit of $12 billion in 1979. Although some of these adjustments were the result of higher oil payments, a substantial part represented changes in other current-account transactions which were perhaps bigger than expected or desired. Capital flows in these three countries, and especially in Japan, were on balance adverse, and in aggregate $20 billion of official financing was required.

The financing of the current-account deficits which emerged in the oil-importing countries as the counterpart of the oil exporters' surplus generally proceeded smoothly in 1979, when for most of the year borrowing conditions in international markets were easy. Indeed, the developed countries outside the Group of Ten and Switzerland and the non-oil developing countries managed as groups to augment their reserves further, in spite of their increased current-account deficits.

In discussing these developments, the first section of the chapter focuses on the balance-of-payments consequences of the recent oil price rises and examines the adjustments in current-account balances to the 1973–74 oil price shock. The second section traces the main balance-of-payments developments in industrial countries in 1979. The final section, which deals with the financing of global payments imbalances, reviews the pattern of financing both in 1979 and during the 1974–78 period.

Oil and the international balance of payments.

The 1979 oil price rises and their impact on global payments balances. The most important influence on the global pattern of payments balances in 1979 was the sharp increase in oil prices. In December 1978 the Organisation of Petroleum Exporting Countries (OPEC) decided to raise the official price for Arabian marker crude by 5 per cent. with effect from 1st January 1979, the first increase for eighteen months. At the same time a schedule was announced which provided for further increases at the beginning of each of the following three quarters. However, this timetable was soon upset by the change in oil-market conditions which followed the sharp cutback in Iran's oil production in early 1979. Although the shortfall in Iranian output was more than offset by increased production in other OPEC countries — even in January 1979, when Iranian output was at its lowest, total OPEC output was 3.3 per cent. higher than a year earlier — concern about future availability and prices, and the low level of stocks, led to a scramble for oil and to rapidly increasing spot-market prices. Several industrial countries succeeded in reducing oil consumption in 1979. However, as these economies were more than offset by an increase in demand for stockbuilding purposes, oil-market conditions remained generally tight.

By mid-1979 the official price of Arabian marker crude had risen to $18 per barrel — 42 per cent. above its end-1978 price. By the end of the year official selling prices for oil ranged from $26 to $35 per barrel, giving an average increase of more than 100 per cent. over the end-1978 level. The increase in the average price paid by oil-importing countries was, in fact, even higher since in the course of the year a growing proportion of oil supplies was channelled through the spot market, where prices rose faster than official selling prices.

The volume of net oil imports by the oil-importing world increased by around 1 per cent. last year. Total additional payments for oil imports in 1979, which amounted to more than $65 billion, therefore essentially resulted from the increases in oil prices. The additions to the oil bills of the main groups of oil-importing countries are partly reflected in the changes between 1978 and 1979 in their combined current-account positions. As can be seen from the table on page 94, the aggregate current account of the Group of Ten countries and Switzerland swung from a $20.8 billion surplus in 1978 to a deficit of $23.5 billion in 1979; the aggregate current-account deficit of other developed countries widened by $2 billion to $14 billion; and that of the non-oil developing countries rose sharply, by $13 billion, to reach a new record of $38 billion in 1979. On the other hand, the combined merchandise trade deficit of the centrally planned economies, which had been $6 billion in 1978, was eliminated last year; however, the cost of servicing external debts will have increased in 1979, so that the improvement in their current-account position may have been fairly modest.

While the shifts in the overall pattern of current payments balances in the oil-importing world took the same direction in 1979 as in 1974, they differed markedly in relative size. At $44 billion, the deterioration in the combined current-account position of the Group of Ten countries and Switzerland between 1978 and 1979 was much larger, at any rate in current dollar terms, than the adverse swing of $25 billion that had occurred five years earlier. In the other developed countries and in the non-oil developing countries last year's deteriorations, of $2 and 13 billion respectively, were smaller in current prices, and even more so in real terms, than the shifts of $18 and 16 billion that these two groups of countries had experienced between 1973 and 1974. However, if the 1979 changes in current accounts were relatively less favourable to the Group of Ten and Switzerland and relatively more favourable to the non-oil developing countries, both the aggregate surplus of the Group of Ten countries and Switzerland and the aggregate deficit of the non-oil developing countries were larger in 1978 than they had been five years earlier. As a result, more than half of the counterpart to the 1979 OPEC surplus was borne by the non-oil developing countries, as against about 35 per cent. in 1974. The share of the Group of Ten countries and Switzerland also rose in comparison with 1974; that of the other developed countries, however, was significantly lower than before.

The counterpart to the worsening in the oil-importing world's current account in 1979 was the improvement in the OPEC countries' aggregate current account from a balanced position in 1978 to a surplus of \$63 billion, not much less than the 1974 figure. Even more striking than the sudden reappearance of such a large surplus was the fact that the magnitude of the OPEC surplus was not much less than the oil-price-induced boost to OPEC's export earnings. The holding-down of the dollar value of OPEC imports to their 1978 levels was an important departure from earlier trends and was accompanied by an estimated decline of around 12 per cent. in OPEC import volume. While this volume decline can be accounted for by the sharp drop of imports into Iran, the volume of imports into all other OPEC countries taken together was virtually unchanged in 1979, after rapid increases in previous years. OPEC's terms of trade improved by an estimated 29 per cent. last year, or more if end-1979 and end-1978 figures are compared. In any case, the improvement was much more than was needed to recoup the 1978 loss of around 11 per cent. The terms-of-trade gain, together with the cutback in import volume, raised OPEC's aggregate merchandise trade surplus to \$112 billion in 1979, in dollar terms by far the largest surplus ever recorded. This improvement more than offset the continuing deterioration in the invisibles accounts. As a result, even those OPEC countries with a relatively high absorptive capacity registered a \$27 billion current-account surplus in 1979, following a \$10 billion deficit in 1978.

The reappearance of a large OPEC payments surplus in 1979 so soon after the successful adjustment of the world balance-of-payments structure to the surplus that emerged in 1974, together with the prospect of an even larger OPEC surplus in 1980 following the increases of oil prices in 1979 and early 1980, raises the question of how the adjustment process is to take place this time. The following section summarises the main factors which led to the diminution of the OPEC surplus after the first oil price explosion. This summary is based on a comparison of OPEC's current-account position in 1973, the year before the first large OPEC current payments surplus, and 1978, when OPEC's current payments surplus had disappeared, as well as on an analysis of shifts in the components of oil-importing countries' trade balances between 1973 and 1978.

Adjustments in current-account balances to the 1973–74 oil price shock. The major reason for the elimination of the OPEC countries' current-account surplus between 1974 and 1978 was that these countries proved able to import greatly increased amounts of goods and services. Between 1973 and 1978 the volume of their oil exports barely changed, and their non-oil exports went up by only \$6 billion, so that the enormous rise in export earnings from \$40 to 146 billion stemmed almost entirely from changes in the price of oil. The fivefold expansion of import values, in contrast, reflected both price and volume increases. OPEC countries' import price index — computed from export unit values of OPEC's major trading partners — rose by roughly 75 per cent., suggesting an increase of about 180 per cent. in the volume of imports. In addition, OPEC's total net payments for services

Aggregate current-account transactions of OPEC countries, 1973–79.*

Items	1973	1974	1975	1976	1977	1978	1979
	in billions of US dollars						
Exports (f.o.b.)	40 (100)	121 (98)	113 (87)	137 (100)	151 (100)	146 (96)	217 (97)
Imports (f.o.b.)	— 21 (100)	— 38 (139)	— 58 (194)	— 71 (231)	— 89 (265)	—104 (277)	—105 (244)
Trade balance	19	83	54	66	62	42	112
Services and private transfers, net	— 12	— 14	— 19	— 26	— 31	— 37	— 43
Official transfers, net	— 1	— 2	— 4	— 4	— 5	— 5	— 6
Current account	6	67	31	36	26	0	63
of which: Countries with a relatively low absorptive capacity	5	40	24	29	24	10	36
Countries with a relatively high absorptive capacity	1	27	7	7	2	— 10	27

Note: Figures in brackets are volume indices (1973 = 100).
* Members of the Organisation of Petroleum Exporting Countries (Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela) plus Bahrain and Oman.

and private transfers tripled between 1973 and 1978 to \$37 billion, largely as a result of an increase in imports of foreign know-how and labour. The importance of real-resource transfers in reducing OPEC's current-account surplus is also clearly demonstrated by the fact that the OPEC countries as a group largely succeeded in preserving their 1974 terms-of-trade gain. While rising import prices eroded some of the initial gain, OPEC's terms of trade in 1978 were still about 110 per cent. above their 1973 level, and only 11 per cent. lower than in 1974.

The above considerations apply to the OPEC countries taken as a group. As shown in the table above, however, there was a considerable difference in the evolution of the current balances of payments of the high-absorbing and the low-absorbing OPEC countries from 1974 onwards. Countries with a relatively high absorptive capacity, that is countries where oil revenues per head of population are relatively low, enjoyed a substantial current surplus only in 1974, when their current account improved from \$1 to 27 billion. In the three ensuing years their combined current-account surplus averaged about \$5½ billion, and in 1978 a deficit of \$10 billion emerged. In contrast, countries with a relatively low absorptive capacity — Saudi Arabia, Kuwait, Libya, Qatar, the United Arab Emirates, Bahrain and Oman — sustained an average surplus of \$29 billion from 1974 to 1977 and even in 1978 their surplus amounted to \$10 billion. Financial ease, as reflected in current-account positions, appears to have been an important determinant — though certainly not the only one — of the two groups' different import behaviour. In 1974 and 1975 the volume of imports expanded by about 40 per cent. per annum in both groups; thereafter, however, import volume trends diverged markedly. Countries which continued to run substantial current payments surpluses maintained vigorous real import growth, which, albeit on a declining trend, averaged 22 per cent. during the three-year period 1976 to 1978. In the other OPEC countries, by contrast, the rate of increase in import volume dropped sharply after 1975, averaging only 8 per cent. until 1978.

The transformation into imports of the increased flow of income from oil strongly affected the structure of the supply of resources to OPEC economies. These changes, which resulted in a significant increase in OPEC countries' command over world production, can be illustrated by some rough estimates. In 1973 imports accounted for around 25 per cent. of total spending on goods and services in OPEC countries. Five years later, when these countries' total spending — measured in constant prices — had risen by an estimated 80 per cent., the share of foreign goods and services may have been as high as 40 per cent. Put another way, OPEC countries succeeded in raising their share in expenditure on total world gross national product (excluding socialist countries) from 2.5 per cent. in 1973 to possibly as much as 4 per cent. in 1978. This taking of a "larger share of the cake" meant that approximately 8 per cent. of the oil-importing world's growth in output between 1973 and 1978 was transferred to OPEC countries.

Looking more closely at the counterpart in the rest of the world to the reduction in the OPEC surplus after 1974, the following table compares the trade balances of major developed countries and groups of other oil-importing countries in 1973 and 1978 and attempts to trace the impact on them of the oil price rises

**Oil-importing countries:
Estimated changes in trade-account components between 1973 and 1978.**

Countries and areas	Trade balances[1] (f.o.b.) 1973	Trade balances[1] (f.o.b.) 1978	Changes in: trade balance I = IV+V	net oil imports[2] II	exports to OPEC III	net trade balance vis-à-vis OPEC IV = II+III	residual trade balance V = I−IV
	in billions of US dollars						
BLEU	2.1	− 1.1	− 3.2	− 1.6	1.7	0.1	− 3.3
Canada	1.9	2.5	0.6	− 2.1	1.1	− 1.0	1.6
France	1.1	− 2.4	− 3.5	− 7.5	4.7	− 2.8	− 0.7
Germany	15.8	25.4	9.6	− 8.9	10.0	1.1	8.5
Italy	− 3.4	5.6	9.0	− 5.8	5.8	0.0	9.0
Japan	3.9	26.4	22.5	−16.4	11.4	− 5.0	27.5
Netherlands	1.8	− 0.1	− 1.9	− 1.8	1.9	0.1	− 2.0
Sweden	2.3	2.7	0.4	− 1.7	0.9	− 0.8	1.2
Switzerland	− 1.8	0.4	2.2	− 0.9	1.6	0.7	1.5
United Kingdom	− 4.8	− 2.2	2.6	− 0.8	6.3	5.5	− 2.9
United States	0.8	−28.5	−29.3	−30.9	13.0	−17.9	−11.4
Total	20	29	9	−78	58	−20	29
Other developed countries[3]	−11	−20	− 9	−10	6	− 4	− 5
Non-oil developing countries	− 3	−19	−16	−10	8	− 2	−14

[1] Based on customs data. [2] Petroleum and petroleum products (SITC 33). [3] For country classification, see table on page 94.

and the resulting growth of OPEC countries' merchandise imports. Countries' and groups' net imports of crude oil and petroleum products and their exports to OPEC are combined into a "net trade balance vis-à-vis OPEC". This approach is adopted because in 1973 and 1978 OPEC was the only significant net exporter of oil, so that as a group oil-importing countries were able to offset larger payments for oil only by increased exports to OPEC countries. The residual changes in trade balances shown in the table indicate shifts in total trade balances which result from changes in trade transactions among oil-importing countries.

The table shows that in 1978 the combined foreign trade surplus of the Group of Ten countries and Switzerland was substantially higher in current dollar terms than it had been in 1973, as were the combined trade deficits of both the other main oil-importing areas. While in all three groups of oil-importing countries the net trade balance vis-à-vis OPEC was worse in 1978 than five years earlier, by far the greater part of the changes in the combined overall trade balances of these countries over this period originated in the residual trade balance, i.e. in trade transactions among the oil-importing countries themselves.

In the Group of Ten countries and Switzerland the evolution of individual countries' net trade balances vis-à-vis OPEC showed markedly differing trends during 1974–78. Three countries — the United Kingdom, Germany and Switzerland — achieved notable improvements, the United Kingdom through a 64 per cent. reduction in net oil imports as production from the North Sea oil fields came on stream, and Germany and Switzerland mainly through the strong growth of their exports to OPEC countries. Three other countries — the United States, Japan and France — recorded deteriorations in their net trade balance vis-à-vis OPEC countries over this period. Easily the biggest deterioration, amounting to nearly $18 billion, was in the United States, the volume of whose net oil imports was 34 per cent. higher in 1978 than five years earlier. In France a 13 per cent. decline in the volume of oil imports was accompanied by a relatively small increase in exports to OPEC countries, while in Japan, where the volume of net oil imports was 3½ per cent. lower in 1978 than in 1973, a substantial expansion of more than $11 billion in exports to the OPEC market did not suffice to make up for the adverse effect on Japan's oil bill of higher prices. Other Group of Ten countries showed almost no change in net trade balances vis-à-vis OPEC on a comparison of 1978 and 1973; however, Canada became a net importer of oil while some of the other countries reduced the volume of their net oil imports over this period by sizable amounts.

Two observations can be made about the post-1974 adjustment to the first oil price shock. On the one hand, the fact that by 1978 the combined current-account surplus of the OPEC countries had vanished shows that in the oil-importing countries taken as a whole the balance-of-payments effects of the 1973 oil price increases had been largely digested. On the other hand, the large disequilibria in the current payments balances of certain Group of Ten countries in 1978 were partly a reflection of the fact that different countries had responded differently to the 1973 oil price shock. The current payments deficit of the United States in 1978 was the result partly of the increase in the volume of that country's net oil imports between 1973 and 1978, as well as of the pursuit by the US authorities of strongly expansionary domestic policies from 1975 onwards. Equally, on the side of the surplus countries, the size of both the German and Japanese current-account surpluses in 1978 was in part the result of these countries having followed more cautious demand policies both in the immediate aftermath of the 1973 oil price increase and in the following years.

Looking at the prospects for an adjustment to the 1979 oil price shock, the shift by most Group of Ten countries and Switzerland to policies of greater demand restraint is likely to contain their demand for OPEC oil. While this should by itself tend to reduce somewhat the current-account surplus of OPEC countries, it would also produce some slowdown in the major industrial countries' demand for imports from the non-oil developing countries. As a result, the share of the counterpart to the OPEC surplus borne by the non-oil developing countries could become larger. But it remains uncertain when and to what extent these developments might exert a significant effect on the structure of global current-account balances. The most important lesson offered by the post-1974 adjustment process, however, is that a return to a better balanced world payments structure will be heavily dependent on a resumption of growth in the volume of OPEC countries' imports. If no such resumption occurs, there is little hope for a rapid adjustment process unless the terms of trade are significantly reversed in favour of the oil-importing world and/or the dependence on OPEC oil for energy supplies is substantially reduced.

Balance-of-payments developments in industrial countries in 1979.

Apart from the effects of the oil price rise, the most important balance-of-payments developments in 1979 were the very large changes that occurred in the balances of payments of the three largest industrial countries, eliminating or reversing earlier imbalances on current account. These adjustments, which were superimposed on the effects of the oil price rise, were the result partly of earlier exchange rate movements and partly of shifts in the relative strength of demand in different countries.* The experiences of these countries, together with those of Switzerland, where there was also a substantial adjustment, are discussed in the first part of this section. There was a second identifiable group of industrial countries which had not had sizable payments imbalances before 1979, but in which major deteriorations, not wholly explicable by the oil price rise, took place last year. In a third group of

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* In some cases where it has seemed useful and where the necessary statistics have been available, an attempt has been made to estimate the relative quantitative impact of these separate influences on the development of the current account of the balance of payments. Briefly, the method used is as follows. Firstly, the balances on investment income and unilateral transfers are subtracted from the current account, because these items do not respond to economic developments in the same way as the balance on trade in goods and other services. Secondly, the changes in the balances on goods and other services are split into two parts, representing the contributions of movements in volumes and in prices. Finally, an attempt is made to divide the volume contribution into changes arising from cyclical developments (in the country concerned and in other countries), from exchange rate movements and from other sources. The cyclical component is estimated from a statistical analysis of the effects of past cyclical changes on the volume balance. Unless there are any other evident influences, that part of the volume change which cannot thus be ascribed to cyclical influences is put down to exchange rate changes. Price contributions, too, have in some cases been apportioned among oil price, exchange rate and other effects.

countries changes in current-account balances in 1979 were relatively moderate despite higher oil prices.

Countries where there was a substantial degree of adjustment in 1979. In 1979 the three largest industrial countries — the United States, Japan and Germany — eliminated or reversed the previous imbalances on the current accounts of their balances of payments. There was also a reduction in the Swiss current-account surplus. In addition, these countries experienced major changes in their capital accounts which in general amplified the current-account changes. Summary statistics describing the three largest economies' current-account adjustments are shown in the table on this page; figures relating to the balance of payments as a whole are shown in the table on page 98.

Components of major current-account adjustments in 1979.

Countries	Current-account balances		Changes between 1978 and 1979					
			Goods and services[1]			Net investment income	Net transfers	Total
	1978	1979	Volume[2]	Price[2]	Value			
	in billions of US dollars							
United States	−13.5	− 0.3	12.0	− 9.0	3.0	10.7	− 0.5	13.2
Japan	16.5	− 8.6	−12.0	−13.5	−25.8	1.1	− 0.4	−25.1
Germany	8.9	− 5.8	− 6.0	− 6.0	−12.1	0.0	− 2.6	−14.7

[1] Other than investment income. [2] Estimates, rounded to the nearest $0.5 billion.

In 1979 the largest changes in any country's balance of payments occurred in the *United States.* The deficit in the current account, which had been around $14 billion in each of the two preceding years, was all but eliminated. Moreover, although identified capital flows showed a deficit in 1979, the positive balancing item of $28.7 billion was so large as to make it clear that in total there were net capital inflows, which partly reversed the heavy outflows of 1977 and 1978. As a result, the overall balance, defined as the increase in the reserve assets of the United States net of the increase in US liabilities to foreign official institutions, as shown in the table on page 98, was in surplus by $14.4 billion in 1979. This was the first annual surplus since 1969, and it followed deficits exceeding $30 billion in each of the two preceding years.

The US current-account deficits in 1977 and 1978 had not been large in relation to the size of the domestic economy, amounting to less than three-quarters of one per cent. of gross national product. But the fact that they had been accompanied by substantial net outflows of capital from the United States had been the main cause of the decline in the dollar's exchange rate during these two years and of the unsettled conditions in the exchange market which were associated with it. Last year's major improvement in the US balance of payments, therefore, provided the basis not only for a strengthening of the dollar but also for the better conditions that prevailed in the exchange markets more generally.

The improvement in the current account in 1979 was assisted by cyclical developments — the acceleration in demand in other industrial countries and the reduced rate of growth of the US economy — and by the depreciation of the dollar in 1977 and 1978, the effects of which became evident last year. The influence of the exchange rate was most apparent in the rise of $10.7 billion in net investment income to $32.3 billion. The principal reason for the increase of $22.4 billion in gross investment income receipts was that the depreciation of the dollar and the rise in oil prices meant, in effect, large increases in the dollar prices of goods and services produced by US foreign investments — for example, the unit value index of world exports calculated in dollar terms went up by 19½ per cent. in 1979, compared with 11 per cent. in 1978. On the other side of the account, outward payments of investment income to non-residents also increased sharply because of higher US interest rates.

The deficit on goods and services other than investment income narrowed from $30 billion in 1978 to $27 billion in 1979, despite an increase of $17.3 billion in oil imports. The improvement came through volume effects which by themselves contributed some $12 billion, and in which both cyclical and exchange rate factors played a part. However, a deterioration in the terms of trade, which stemmed both from the earlier depreciation of the dollar and from the rise in the price of oil, offset most of the volume improvement.

As regards the balance of identified capital movements in 1979, two features stand out: the reduction in total net outflows to $14 billion, about half the 1978 figure, that resulted from the strengthening of confidence in the dollar; and the marked variations in the balance of inward and outward capital movements that occurred during the course of the year, to a considerable extent as a consequence of the discontinuous path of the dollar's recovery. For the year as a whole, the biggest change on capital account was the shift in the net movements of funds reported by banks in the United States from an outflow of $16 billion in 1978 to a $6.6 billion inflow in 1979. This was partly offset by an increase in net outflows of direct investment from $10.4 billion in 1978 to $17.1 billion in 1979, mainly reflecting the reinvestment of higher foreign earnings by US corporations. The reduction in total identified net capital outflows was greatly reinforced by the very large increase in the favourable balancing item from $10.7 to 28.7 billion, a change which must have resulted largely from unidentified capital inflows.

The variations in net capital movements that occurred during the course of 1979 showed up particularly in the banking sector. During the first five months of the year, when the dollar was strengthening on the exchange market, there were net banking inflows of some $20 billion. In the following four months, when the dollar weakened again, there were net banking outflows, but these gave way to net inflows of about $7 billion in October and November, after US monetary policy had been tightened. Finally, there was a net outflow of about $14 billion through the banks in December, part of which was seasonal.

Statistics for the first quarter of 1980 point to some deterioration in the current account. The merchandise trade deficit was some $12.2 billion, seasonally adjusted, compared with a quarterly average of $7.4 billion in 1979; this clearly indicates that the current account was in deficit. The worsening was accounted for by rising energy imports. There were, however, very large capital inflows and an overall surplus of some $10 billion.

In *Japan*, too, there was a major balance-of-payments adjustment in 1979. The current-account surplus of $16.5 billion recorded in 1978 gave way to a deficit of $8.6 billion, a turn-round equivalent to 2½ per cent. of gross national product. In addition, net long-term capital outflows, at $13 billion, were rather higher than in 1978, so that the basic balance of payments shifted from a surplus of $4.1 billion to a very substantial deficit of $21.6 billion, equal to 2 per cent. of gross national product. A significant part of the basic payments deficit was covered by net short-term capital inflows (including the balancing item) of $8.9 billion, and the official reserves, excluding valuation changes, were drawn down by $12.7 billion.

The remarkable shift in the balance of payments was the result of several coincident developments, some of which were reactions to the large external surpluses of 1977 and 1978. As regards the current account, the pressure of demand in the Japanese economy increased as a result of expansionary fiscal policy, thus stimulating import volume and holding back export volume — indeed, for the first time for very many years there was a slight fall in the volume of Japanese merchandise exports. It is true that the pressure of demand in the rest of the OECD area taken as a whole increased too, but this can have offset only a small part of the effect of the domestic upturn. In total, the volume contribution to the change in the current balance was about $12 billion, most of which may reasonably be attributed to the change in cyclical conditions; the appreciation of the yen that took place in the two preceding years appears to have exerted its main influence in 1978.

On top of this volume change, the terms of trade began to deteriorate late in 1978 as the yen depreciated very sharply from the high levels it had reached in October. Although it has been normal in the past for the yen to appreciate as long as a current-account surplus persisted, the opening-up of the Tokyo capital market meant that a big deficit emerged in the basic balance of payments during the fourth quarter of 1978, while there was still a current-account surplus. The depreciation immediately had an adverse effect on the terms of trade, but the favourable effects on import and export volumes did not appear in 1979. The terms of trade were, of course, also adversely affected by the rise in oil prices, which added nearly $9 billion to Japan's import bill last year.

On capital account, net long-term outflows continued last year at the much higher rate which had been established in 1978, amounting to $13 billion, of which $9.6 billion represented portfolio capital, including loans. Outflows of long-term capital were not evenly spread over time, and they broadly coincided with exchange rate movements. Thus, in the first five months of the year there were net long-term outflows of $6.6 billion, while the yen was continuously weak against the dollar. From June to September the exchange market was quieter, and the outflow of long-term capital fell to $2.3 billion. The yen came under pressure again in October and November, when the net outflow was $3.3 billion, but conditions in December were calmer and the outflow was $0.8 billion. In the short-term capital account there were net inflows of $6.3 billion during 1979, including an increase of $4 billion in the net external short-term liabilities of the banks. Much of this probably reflected extra credit taken up to cover oil imports. In addition, there was a favourable balancing item of $2.6 billion.

In the first quarter of 1980 the current-account deficit widened further to $6 billion. However, there was an inflow of long-term capital amounting to $1.2 billion, and short-term capital movements and the balancing item taken together were also favourable. The overall result was that net official monetary assets fell by $1.6 billion, excluding valuation adjustments.

Like Japan, *Germany* had a current-account deficit last year — the first since 1965. Its current account swung from a surplus of $8.9 billion in 1978 to a deficit of $5.8 billion in 1979, a change equivalent to about 2 per cent. of Germany's gross national product. There was a capital-account surplus of $5.6 billion in 1979, but an adverse balancing item meant that net official monetary assets (before valuation changes) fell by $2.4 billion over the year.

As the table on page 89 shows, the volume and price components of the German current-account adjustment were of comparable size. The volume deterioration, which amounted to about $6 billion, was the result of the cyclical upswing in Germany, partly offset by the upswing elsewhere in the industrial world, of the appreciation of the Deutsche Mark, and of the build-up of stocks of crude oil. It seems plausible, on the basis of statistical analysis of the sort described in the footnote on page 88, that the cyclical and exchange rate developments contributed to the volume change in roughly equal amounts. Superimposed on the volume contribution was an adverse price effect of $6 billion, much of which may be attributed to higher oil prices.

The deterioration in the current account in 1979 was particularly marked in three areas. Firstly, the deficit on trade in oil and oil products widened by $9.8 to 24.5 billion. This reflected not only the rise in oil prices, but also an increase of 3½ per cent. in the volume of imports of crude oil and petroleum products. There was a big change in the travel account, where the customary deficit widened by $2.7 to 12.2 billion. Finally, the deficit on unilateral transfers widened by $2.6 billion to reach $11.3 billion.

On the capital account of the balance of payments, total net inflows increased between 1978 and 1979 from $3.2 to 5.6 billion, despite the much smaller appreciation of the Deutsche Mark against the dollar in 1979. Moreover, as in the United States, there were marked fluctuations in the balance of capital movements during the course of the year, to a large extent reflecting changes in exchange-market conditions. These developments are summarised in the table on page 93. Net long-term inflows amounted to $5.8 billion, compared with net outflows of $1.4 billion in 1978. The principal element in this change was the inflow of long-term credits and loans amounting to $8.8 billion last year, arising mainly from new borrowing by banks in Germany in response to tight domestic credit conditions. The turn-round in long-term capital flows was more than enough to offset the change in the short-term capital account from a net inflow of $4.6 billion to a small net outflow. As regards the timing of capital movements, in the first five months of the year, as the dollar recovered, there were large outflows from Germany. The dollar began to weaken

Germany: Identified net capital flows, 1979–80.*

Identified net capital flows	1979 January to May	1979 June to August	1979 September	1979 October-November	1979 December	1979 Year	1980 January to March
	in billions of US dollars						
Short-term	− 8.7	2.6	5.5	− 3.8	4.2	− 0.2	− 0.1
Long-term	0.0	4.9	1.6	− 1.3	0.6	5.8	− 2.8
Total	− 8.7	7.5	7.1	− 5.1	4.8	5.6	− 2.9

* Banking and non-banking transactions.

in June, and funds flowed back to Germany in June, July and August. There were large inflows in September in advance of the revaluation of the Deutsche Mark within the European Monetary System. The revaluation took place on 24th September, so the figures shown in the table almost certainly understate the size of the inflow to Germany in anticipation of the realignment. The subsequent unwinding of positions, as well as the more restrictive monetary policy stance of the US authorities, led to outflows in October and November, but there were renewed inflows in December reflecting seasonal influences.

In the first quarter of 1980 the overall deficit was as much as $7.9 billion — more than three times as much as in the whole of 1979. The current-account deficit widened to $3 billion and, despite the relaxation of controls on inflows of capital into Germany, there were autonomous net capital outflows of $2.9 billion, reflecting the very high level of US interest rates. As well, there was an adverse balancing item of $2 billion. The deficit was financed mainly by a reduction of $6.3 billion in the reserves, but also by official borrowing of about DM 3 billion from the Saudi Arabian Monetary Agency.

The persistent current-account surplus of *Switzerland*, which in 1978 had been $4.4 billion, or 5 per cent. of gross national product, was reduced to $2.5 billion last year. To the reduction in the current-account surplus was added a much larger shift in the capital account (including unidentified items) from a surplus of $2.3 billion to a deficit of $7.5 billion last year. Official financing of $5 billion, excluding dollar swaps with the commercial banks, was thus required. This financing included an increase of $1.2 billion in foreign official holdings of Swiss francs.

Real demand grew by 2.5 per cent. in Switzerland last year. This was a little less than in 1978, but there was nevertheless a further volume increase of about $1.1 billion in net imports of goods and services, some of which may be attributed to the Swiss franc's high external value. In particular, net tourist income fell by 21 per cent. to $0.8 billion, and the volume of non-energy merchandise imports went up by 10 per cent. There was also an unfavourable terms-of-trade effect of about $1.4 billion resulting from higher oil prices. The only area of the current account to show a significant improvement was net investment income, which went up from $3.5 to 4.1 billion. In the capital account, net outflows through the banks increased to $9.8 billion last year from $3.5 billion in 1978 and net portfolio investment abroad went up by $1.3 to 7.1 billion, perhaps as a result of the combination

International current-account transactions.[1]

Countries and areas	Trade balance (f.o.b.)			Services and transfers			Current balance		
	1977	1978	1979	1977	1978	1979	1977	1978	1979
	in billions of US dollars								
BLEU*	− 1.4[2]	− 1.2[2]	− 3.3[2]	0.7	0.3	− 0.5	− 0.7	− 0.9	− 3.8
Canada*	2.5	3.0	3.4	− 6.6	− 7.6	− 7.7	− 4.1	− 4.6	− 4.3
France	− 2.4	1.5	− 1.3	− 0.6	2.2	2.8	− 3.0	3.7	1.5
Germany	19.8	25.6	17.3	−15.5	−16.7	−23.1	4.3	8.9	− 5.8
Italy*	− 0.1	2.9	− 1.0	2.6	3.3	6.1	2.5	6.2	5.1
Japan*	17.3	24.6	2.0	− 6.4	− 8.1	−10.6	10.9	16.5	− 8.6
Netherlands*	− 0.1	− 0.9	− 1.2	0.7	− 0.5	− 1.1	0.6	− 1.4	− 2.3
Sweden	0.3	2.6	0.9	− 2.4	− 2.9	− 3.4	− 2.1	− 0.3	− 2.5
Switzerland*	− 0.1	0.2	− 2.2	3.5	4.2	4.7	3.4	4.4	2.5
United Kingdom	− 3.9	− 2.9	− 6.9	3.6	4.7	1.9	− 0.3	1.8	− 5.0
United States	−30.9	−33.8	−29.5	16.8	20.3	29.2	−14.1	−13.5	− 0.3
Group of Ten and Switzerland	*1.0*	*21.6*	*−21.8*	*− 3.6*	*− 0.8*	*− 1.7*	*− 2.6*	*20.8*	*−23.5*
Australia	1.0	0.1	2.5	− 3.6	− 3.9	− 4.6	− 2.6	− 3.8	− 2.1
Austria*	− 3.9	− 3.1	− 3.9	0.9	1.6	2.0	− 3.0	− 1.5	− 1.9
Denmark*	− 2.7	− 2.4	− 3.4	1.0	0.9	0.4	− 1.7	− 1.5	− 3.0
Finland	0.5	1.2	0.6	− 0.7	− 0.6	− 0.9	− 0.2	0.6	− 0.3
Greece*	− 3.2	− 3.5	− 5.2	1.9	2.2	2.9	− 1.3	− 1.3	− 2.3
Ireland*	− 0.8	− 1.0	− 2.2	0.5	0.7	0.6	− 0.3	− 0.3	− 1.6
Israel	− 2.2	− 2.8	− 3.0	1.7	1.8	1.8	− 0.5	− 1.0	− 1.2
New Zealand*	0.2	0.6	0.7	− 0.8	− 1.0	− 1.2	− 0.6	− 0.4	− 0.5
Norway	− 4.0	− 0.5	0.1	− 1.0	− 1.6	− 1.3	− 5.0	− 2.1	− 1.2
Portugal	− 2.5	− 2.4	− 2.4	1.0	1.6	2.6	− 1.5	− 0.8	0.2
South Africa*	2.5	3.8	6.2	− 2.0	− 2.3	− 2.5	0.5	1.5	3.7
Spain*	− 6.2	− 4.0	− 5.5	4.0	5.6	6.5	− 2.2	1.6	1.0
Turkey	− 3.5	− 1.9	− 2.3	0.1	0.4	0.9	− 3.4	− 1.5	− 1.4
Yugoslavia*	− 3.6	− 3.5	− 5.3	2.0	2.2	1.9	− 1.6	− 1.3	− 3.4
Other developed countries	*−28.4*	*−19.4*	*−23.1*	*5.0*	*7.6*	*9.1*	*−23.4*	*−11.8*	*−14.0*
Total developed countries	*−27.4*	*2.2*	*−44.9*	*1.4*	*6.8*	*7.4*	*−26.0*	*9.0*	*−37.5*
Oil-exporting countries[3]	62	42	112	−36	−42	−49	26	0	63
Other developing countries	−10	−20	−33	− 1	− 5	− 5	−11	−25	−38
Total developing countries	*52*	*22*	*79*	*−37*	*−47*	*−54*	*15*	*−25*	*25*
Centrally planned economies[4]	− 1	− 6	0	.	.	.	.	.	.

* Services and transfers account figures for these countries exclude undistributed income from direct investment.
[1] On a transactions basis, except for Greece and New Zealand. [2] Imports and exports partly c.i.f. [3] OPEC countries, plus Bahrain and Oman. [4] Eastern European countries, the Soviet Union and China; partly estimated; based on customs data.

of low interest rates and the growing feeling that the Swiss franc was unlikely to appreciate very sharply. On the other hand, there were unidentified inflows, presumably mainly of capital, totalling $9.4 billion in 1979.

In the first quarter of 1980 the merchandise trade deficit was $2 billion, according to customs statistics, compared with $2.8 billion for the whole of 1979. Moreover, net official monetary assets, excluding dollar swaps with the commercial banks, declined by $2.3 billion.

Countries where the balance-of-payments situation deteriorated in 1979. The countries covered in this part are the United Kingdom, the Belgium-Luxembourg Economic Union and Sweden. In the BLEU and Sweden the current account deteriorated substantially last year, while in the United Kingdom, although the reserves increased and the pound appreciated strongly, the structure of the balance of payments deteriorated, both on current and capital account.

Of those countries whose current-account balances of payments had not been in major disequilibrium in 1978, the *United Kingdom* experienced by far the largest deterioration during 1979. Despite a large increase in North Sea oil and gas production, the current account swung from a $1.8 billion surplus in 1978 to a $5 billion deficit in 1979. On top of that deficit, long-term autonomous capital outflows during the year totalled $3.4 billion. The fact that the United Kingdom's official reserves nevertheless increased by $1.8 billion (excluding valuation changes and the SDR allocation), that the external indebtedness of the public sector was reduced by a similar amount and that the exchange rate of the pound sterling appreciated by 9.8 per cent. in effective terms is attributable to net inflows of short-term funds, including liabilities to foreign monetary authorities, totalling no less than $10.8 billion.

On current account, the contribution of sales of North Sea oil and gas in 1979, net of operating costs paid abroad, was as much as $8.9 billion — up $5.2 billion on the net 1978 figure. The deterioration in the rest of the current account, therefore, was no less than $12 billion — despite a favourable change in the terms of trade arising mainly from the appreciation of the pound. Thus, the merchandise trade deficit, excluding North Sea effects, increased from $8.7 to 19.8 billion; the surplus from investment income declined from $2 to 0.4 billion, largely because of increased remittances by foreign corporations of their profits from North Sea operations; and the deficit on unilateral transfers widened by $1.4 to 5.1 billion.

The main problem facing the United Kingdom on the current account of its balance of payments is that the revenue from the sale of exhaustible oil and gas resources has so far been consumed rather than invested, either abroad, through a current-account surplus, or domestically; the share of gross domestic product devoted to public and private consumption was no smaller in 1979 than in 1977, despite the increased share of North Sea energy production in total output. Excluding North Sea operations, the volume contribution to the deterioration in the current account in 1979 was of the order of 3½ per cent. of gross domestic product.

Much of this volume deterioration was the result of a spending boom in the United Kingdom last year: private and public consumption together went up by nearly 3 per cent. of gross domestic product, and stockbuilding was about 2 per cent. In addition, production was held back by strikes at times during the year. However, the balance-of-payments effects of these factors were greatly reinforced by the combination of the rise in the effective exchange rate of the pound, which amounted to 9.1 per cent. between the averages for 1977 and 1979, with the United Kingdom's above-average rate of inflation. Unit labour costs in the United Kingdom rose by 23.6 per cent. between 1977 and 1979 in relation to an average of similar costs in other countries, expressed in a common currency, and other indices of competitiveness show a similar picture. There may therefore be some truth in the complaint that North Sea oil is "crowding out" the rest of the UK economy.

As already indicated, the main feature of the capital account was that large autonomous long-term outflows were accompanied by even larger short-term inflows. On long-term capital account, where net outflows totalled $3.4 billion, there were two main features. The first was that the abolition of exchange controls, which had been in force with varying degrees of severity since 1939, led to outflows estimated at $4 billion, mainly in the form of repayments of foreign currency loans. Secondly, and partly offsetting this, there were net sales of $2.1 billion of gilt-edged stock to non-residents, which were made possible by the high yields offered, and by the fact that the United Kingdom, by virtue of North Sea oil, stood to lose relatively little from the turmoil in the oil market. These factors were also responsible for a large part of the inflow of short-term capital, which totalled $10.8 billion. Of that amount, some $7.1 billion took the form of increases in sterling balances. It was mainly private sterling balances that were built up; official balances went up by only $1.6 billion. As well, there was an increase of $3.1 billion in the net external liabilities of the banks in foreign currencies.

In the first quarter of 1980 the current-account deficit was $1.6 billion on a seasonally adjusted basis. This was the same as in the fourth quarter of 1979; however, there was a volume improvement between the two quarters which was offset by an adverse movement in the terms of trade. Autonomous capital inflows continued, and the reserves increased by $1.1 billion, excluding valuation changes and the SDR allocation.

In the *Belgium-Luxembourg Economic Union* too the current-account balance deteriorated significantly last year, the deficit rising from $0.9 to 3.8 billion, or 3.4 per cent. of gross national product. As well as this, net autonomous capital flows were adverse for much of the year, and the Belgian franc came under pressure in the European Monetary System from time to time. However, for a time after the exchange rate realignment in September capital flowed back to the BLEU, and over the year as a whole there was a net autonomous inflow of $0.5 billion.

Much of last year's worsening in the current account can be attributed to the strength of domestic demand, which rose by 3.7 per cent., including a large increase in stocks, and to the rise in oil prices. Some observers have suggested that a further reason for the poor external position is that the BLEU's cost and price competitiveness in international trade is weak, partly as a result of the effective appreciation of the Belgian franc since 1972, when it joined the "snake" arrangement. However, the available indices suggest that competitiveness improved both in 1978 and last year. Although it is possible that earlier adverse developments in competitiveness continued to exert an influence even after they had been reversed, it seems unlikely that this could account for a very large part of the worsening in the current account last year, which amounted to 2.5 per cent. of gross national product. It is more probable that the structure of Belgian industry has exerted an adverse influence on the current account of the balance of payments.

The result of the deficit on the combined current and autonomous capital accounts, together with the adverse balancing item, was that official financing of $3.7 billion was needed. Most of this was provided by official foreign currency borrowing of $2.5 billion, net of repayments, including $1.2 billion borrowed from the domestic banking system. In addition there was a fall of $1.1 billion in the reserves, excluding the SDR allocation.

Sweden's current-account deficit, which had been all but eliminated in 1978, widened sharply in 1979 to some $2.5 billion, or 2.5 per cent. of gross domestic product, and a large amount of official financing was needed. The deterioration in the current account stemmed almost entirely from an increase of $2.2 billion in net imports of mineral fuels. About $1.6 billion of this increase was the result of higher oil prices, while at the same time the volume of imports of refined petroleum recovered sharply from its abnormally low level of 1978. As well as the current-account deficit, there was an adverse balancing item of $0.4 billion, which more than offset net identified capital inflows, and the total to be financed was $2.9 billion. Of this, $2.2 billion was covered by long-term loans raised abroad by the Government. The rest was reflected in a fall in the reserves.

Balance-of-payments developments in the other countries of the Group of Ten in 1979. The current-account deficit in *Canada* fell slightly to $4.3 billion in 1979, but it was around 2 per cent. of gross national product for the fourth consecutive year. It has been traditional for Canada's current-account deficit to be financed by autonomous long-term capital inflows, but in 1978 and 1979 such inflows were not large enough to prevent the emergence of deficits in the basic balance, excluding official compensatory borrowing, of $4 and 2.9 billion respectively. Last year, however, there were very large autonomous short-term capital inflows, partly offset by an adverse balancing item.

Since 1975, when the first large deficit in the recent succession emerged, net payments of investment income abroad have grown steadily. In 1979 they amounted to $4.4 billion, or 2 per cent. of gross national product. The rest of the current account has improved gradually since 1976 and last year was in surplus by $0.2 billion. However, the improvement has evidently not been fast enough for the current-account deficit as a whole to be adjusted, in spite of the depreciation of the Canadian dollar by 20.3 per cent. in effective terms between 1976 and 1979 and the relatively modest rate of growth of the Canadian economy since 1976. It may be that the main hindrance to adjustment has been that many industries producing exports and import substitutes have reached their capacity limits. If this

Developed countries: Balances of payments, 1978–79.

Countries	Years	Net external transactions				of which, changes in:	
		Current account	Capital account[1]	Balancing item	Total	official reserves[2]	liabilities to official monetary authorities[3]
		in billions of US dollars					
Austria*	1978	− 1.5	1.6	1.1	1.2	1.2	—
	1979	− 1.9	0.0	0.6	− 1.3	− 1.3	—
Belgium-Luxembourg*	1978	− 0.9	0.2	0.4	− 0.3	− 0.1	− 0.2
	1979	− 3.8	3.0	− 0.4	− 1.2	− 1.1	− 0.1
Canada*	1978	− 4.6	6.0	− 1.6	− 0.2	− 0.2	—
	1979	− 4.3	7.1	− 3.7	− 0.9	− 0.9	—
Denmark*	1978	− 1.5	3.1	− 0.1	1.5	1.5	0.0
	1979	− 3.0	3.2	− 0.3	− 0.1	− 0.1	0.0
Finland	1978	0.6	− 0.1	0.1	0.6	0.6	0.0
	1979	− 0.3	− 0.1	0.1	− 0.3	− 0.4	0.1
France	1978	3.7	− 3.9	3.0	2.8	3.1	− 0.3
	1979	1.5	− 1.5	2.1	2.1	1.8	0.3
Germany	1978	8.9	3.2	− 1.7	10.4	12.9	− 2.5
	1979	− 5.8	5.6	− 2.2	− 2.4	− 3.8	1.4
Greece*	1978	− 1.3	1.7	− 0.3	0.1	0.1	− 0.0
	1979[4]	− 2.3	2.6	− 0.3	− 0.0	− 0.1	0.1
Ireland*	1978	− 0.3	0.3	0.1	0.1	0.1	—
	1979	− 1.6	0.9	0.1	− 0.6	− 0.6	—
Italy*	1978	6.2	0.3	0.5	7.0	3.4	3.6
	1979	5.1	− 1.7	0.1	3.5	2.0	1.5
Japan	1978	16.5	− 8.6	0.3	8.2	10.2	− 2.0
	1979	− 8.6	− 6.6	2.6	−12.6	−12.7	0.1
Netherlands*	1978	− 1.4	0.6	− 0.1	− 0.9	− 0.7	− 0.2
	1979	− 2.3	2.0	− 0.2	− 0.5	− 0.9	0.4
Norway*	1978	− 2.1	2.7	0.5	1.1	0.7	0.4
	1979	− 1.2	1.8	0.7	1.3	1.3	0.0
Portugal	1978	− 0.8	0.6	0.2	− 0.0	0.2	− 0.2
	1979	0.2	− 0.2	0.4	0.4	0.1	0.3
Spain*	1978	1.6	2.1	0.3	4.0	4.1	− 0.1
	1979	1.0	4.2	− 2.0	3.2	2.7	0.5
Sweden	1978	− 0.3	1.4	− 0.4	0.7	0.7	− 0.0
	1979	− 2.5	2.2	− 0.4	− 0.7	− 0.7	0.0
Switzerland*	1978	4.4	− 9.3	11.6	6.7	7.2	− 0.5
	1979	2.5	−16.9	9.4	− 5.0	− 4.2	− 0.8
Turkey	1978	− 1.5	2.0	− 0.5	− 0.0	0.2	− 0.2
	1979	− 1.4	0.6	0.7	− 0.1	− 0.1	− 0.0
United Kingdom	1978	1.8	− 6.2	2.2	− 2.2	− 4.5	2.3
	1979	− 5.0	5.2	1.2	1.4	1.8	− 0.4
United States	1978	−13.5	−28.9	10.7	−31.7	− 0.7	−31.0
	1979	− 0.3	−14.0	28.7	14.4	− 0.0	14.4
Yugoslavia*	1978	− 1.3	1.7	− 0.1	0.3	0.2	0.1
	1979	− 3.4	1.6	0.3	− 1.5	− 1.2	− 0.3

* Current and capital-account figures for these countries exclude undistributed income from direct investment and the corresponding reinvestment of such income. For Japan, only the reinvestment, but not the income, is *included*.

[1] Includes commercial banks' transactions and, in some cases, compensatory borrowing abroad to finance balance-of-payments deficits; excludes liabilities to official monetary authorities. [2] Excludes valuation adjustments, where possible, and SDR allocations. [3] Includes liabilities to the IMF and to the EMCF; excludes valuation adjustments. [4] Partly estimated.

is so, an improvement in the trade balance will have to await the completion of new investment programmes; prospective profits may not have offered a sufficient incentive for investment in the past. This explanation is supported by the fact that the ratio of unfilled orders in export-based manufacturing industries to total manufactured exports increased by around 60 per cent. between 1977 and 1979.

In contrast to 1978, when the current-account deficit was financed mainly by official borrowing abroad, there were very large autonomous capital inflows last year totalling \$8.1 billion, of which \$6.8 billion was in short-term form. These flows may have been partly motivated by Canada's favourable energy position and by the feeling that the exchange-market depreciation of the Canadian dollar had come to an end. In addition, the authorities raised a further \$1.4 billion in foreign currencies through loans and bond issues in 1979, but they also repaid \$2.4 billion of drawings under stand-by arrangements with Canadian and foreign banks. There was an adverse balancing item of \$3.7 billion, and the reserves fell by \$0.9 billion, excluding the SDR allocation.

The current-account surplus of *France* fell to \$1.5 billion last year from \$3.7 billion in 1978; on a seasonally adjusted basis, the surplus almost disappeared in the second half of 1979. In the year as a whole, the deficit in petroleum and petroleum products, including transport costs, widened by \$5.1 billion, to \$17.5 billion, but more than half of this deterioration was offset by improvements elsewhere in the current account. The largest improvements in the merchandise trade balance were in trade in agricultural and food products and in industrial equipment; in the invisibles account the balances on investment income and government services each improved by \$0.5 billion. The decline in France's current payments surplus last year was roughly offset by a reduction, from \$3.9 to 1.5 billion, in the capital-account deficit. The principal change between the two years was a shift in movements of short-term banking funds, from net outflows of \$3.2 billion in 1978 to a net inflow of \$0.5 billion last year. This was partly offset by an increase in net long-term capital outflows from \$1.9 to 3.9 billion. There was a favourable balancing item of \$2.1 billion, and net official monetary assets went up by \$2.1 billion, excluding the SDR allocation.

In the first quarter of this year the seasonally adjusted merchandise trade deficit was \$3.5 billion on a customs basis. Compared with \$1.3 billion in the fourth quarter of 1979 and with a quarterly average of \$0.7 billion for the whole of last year, this suggests that a significant deficit has emerged in France's current external account. However, there were inflows of capital and France's foreign exchange reserves continued to increase.

The current-account surplus of *Italy* was \$5.1 billion in 1979, which was \$1.1 billion less than in 1978 and equal to about 1.6 per cent. of gross domestic product. The surplus on services and transfers went up from \$3.3 to 6.1 billion, but this improvement was more than offset in the merchandise trade account; in particular the oil deficit (including transport costs) went up by \$3.2 to 11.9 billion. There was a deficit of \$1.7 billion in the capital account last year. Net trade credit totalling \$3.6 billion was extended by Italy in 1979, but there were net capital imports through the banks, excluding trade credit, of \$1.3 billion. The net official monetary position improved by $3.5 billion, disregarding valuation adjustments. Of this, $2 billion was used to augment the reserves.

Customs figures indicate that Italy's merchandise trade deficit was $4.3 billion in the first quarter of 1980 on a seasonally adjusted basis, compared with a quarterly average of $1.4 billion in 1979. Large-scale financing through the banks has been needed this year.

The current-account position of the *Netherlands* worsened for the third successive year in 1979, when the deficit widened to $2.3 billion, or 1.5 per cent. of gross national product, from $1.4 billion in 1978. In spite of the increase in oil prices, the merchandise trade deficit increased by only $0.3 billion; the deterioration was more pronounced in the invisibles account, where the deficit on travel widened by $0.6 to 2.7 billion. Last year's deterioration in the current account was more than offset by an increase in the capital-account surplus from $0.6 to 2 billion. The main elements in this change were the emergence of a surplus of $0.5 billion on private long-term flows — the first surplus since 1971 — after a deficit of $0.8 billion in 1978, and an inflow through the banks of $2.1 billion, or $0.9 billion more than in the preceding year. These capital-account developments were encouraged by the high level of Dutch interest rates and by the removal of some restrictions on capital inflows. Taking the balancing item into account, net official monetary assets fell by $0.5 billion before adjustments for valuation changes and the SDR allocation.

Financing of global current payments imbalances.

The rise in the price of oil and the resulting shifts in the global pattern of current-account balances of payments described earlier in this chapter greatly increased the volume of external financing in 1979. This section deals first with the surplus side, examining the external placement of funds by the oil-exporting countries, both in 1979 and during 1974–78. It then reviews the financing of the aggregate current-account deficits of oil-importing countries, concentrating particularly on countries outside the Group of Ten and Switzerland and tracing their principal sources of external financing since the first oil price shock.

The deployment of the investible surpluses of oil-exporting countries. The available information on the investment of the oil-exporting countries' current-account payments surpluses since 1974 is set out in the following table. After four years in which these countries' long-term external assets had been increasing more rapidly than their short-term investments, in 1979 the bulk of the identified counterpart to their $63 billion surplus took the form, as in 1974, of increases in bank deposits and money-market investments. In fact, three-quarters of the identified increase during 1979 in the oil-exporting countries' external assets was in short-term assets, as compared with 55 per cent. in the first year after the 1973 oil price increases. The high proportion of last year's surplus invested at short term may be attributed to two main factors: firstly, the sharp increase in the surplus itself and the difficulty of immediately arranging for an enlarged volume of long-term external investment; and, secondly, the sharp rise during 1979 in short-term interest rates in the main financial centres. Thus, not only was the increase in the oil-exporting countries'

Oil-exporting countries: Estimated deployment of investible surpluses, 1974–79.

Items	1974	1975	1976	1977	1978	1979	1974–78
	in billions of US dollars						
Bank deposits and money-market placements:							
Dollar deposits in the United States	1.9	1.1	1.8	0.4	0.8	4.9	6.0
Sterling deposits in the United Kingdom	1.7	0.2	− 1.4	0.3	0.2	1.4	1.0
Deposits in foreign currency markets	22.8	9.1	12.1	10.6	3.0	31.2	57.6
Treasury bills in the United States and the United Kingdom	4.8	0.6	− 1.0	− 1.1	− 0.8	3.4	2.5
Total	31.2	11.0	11.5	10.2	3.2	40.9	67.1
Long-term investments:							
Special bilateral arrangements and other investments	11.8	12.4	12.2	12.7	8.7	11.8	57.8
Loans to international agencies	3.5	4.0	2.0	0.3	0.1	− 0.4	9.9
Government securities in the United States and the United Kingdom	1.1	2.2	4.1	4.5	− 1.8	− 0.9	10.1
Other[1]	8.7	6.1	8.5	5.8	3.3	2.4	32.4
Total[2]	25.1	24.7	26.8	23.3	10.3	12.9	110.2
Total new investments	56.3	35.7	38.3	33.5	13.5	53.8	177.3

[1] Including equity and property investments in the United States and the United Kingdom, and foreign currency lending. [2] The totals in this table are not the same as the total OPEC current-account figures given in the table on page 85; the differences between the two sets of figures essentially reflect trade credits and external borrowing by OPEC countries.

Source: Bank of England.

external assets heavily concentrated on deposits with commercial banks, but in addition investments in longer-term government securities in the United States and the United Kingdom actually declined a little, by \$0.9 billion. Other identified long-term investments increased on balance by \$13.8 billion. Loans to international institutions were reduced by \$0.4 billion as a consequence of repayments by oil-importing countries of drawings made in 1974 and 1975 on the IMF's oil facility. Other long-term lending — which includes both direct and portfolio investments, except for holdings of US and UK Government securities, as well as concessional credit flows to developing countries — rose appreciably to \$11.8 billion. At that level it was about equal to the 1974–78 average.

The financing of current-account deficits of groups of oil-importing countries. For the second time in recent history the Group of Ten countries and Switzerland were faced with a sizable aggregate current-account deficit in 1979. The first large deficit emerged in 1974, but for the period 1974–78 as a whole a cumulative surplus of \$20 billion was registered. While the group's traditional rôle as net supplier of capital to other countries was suspended in 1979, its rôle as financial intermediary between OPEC countries and other oil-importing countries became more important. As was indicated in the previous section, the financing of current-account deficits differed significantly between individual countries in the Group of Ten and

Switzerland, but financing itself did not present any problem. The group's combined current-account deficit was \$23.5 billion, but this included some surpluses and the total of current-account deficits (excluding the small US deficit) amounted to \$32.3 billion. After taking movements on capital account into consideration, the total of the overall deficits of these countries was \$16.9 billion. Most of this was covered by drawing down reserves, especially in Japan. In addition, two countries — Belgium and Sweden — had quite substantial recourse to official external borrowing.

For the rest of the oil-importing countries, the table below brings together, both for 1979 and for the period 1974–78, their current payments deficits, their identifiable external financing and the estimated changes in their external financial assets. However, data on some relatively minor financing flows, such as borrowing from banks outside the BIS reporting system and from non-banks, as well as borrowing from official monetary sources other than the IMF, are not available. Foreign claims are therefore likely to have risen by somewhat more than is suggested in the table.

The \$14 billion combined current payments deficit of developed countries outside the Group of Ten and Switzerland in 1979 was more than covered by capital inflows, so that these countries' combined monetary reserves (with gold valued at constant prices) increased by \$2 billion and their non-official claims on

Oil-importing countries:
Estimates of current-account financing, 1974-78 and 1979.

Items	Developed countries outside the Group of Ten and Switzerland		Non-oil developing countries: total		Non-oil developing countries: four major countries[1]	
	1974–78[2]	1979	1974–78[2]	1979	1974–78[2]	1979
	in billions of US dollars					
Current-account balance[3]	− 99	− 14	−109	− 38	− 58	− 21
Identifiable external financing	118	26	172	58	74	22
Net direct investment	11	3	23	6	11	3
Borrowing:						
from BIS reporting banks[4]	63	15	85	36	50	17
through foreign and international bonds[5]	33	7	8	2	6	1
from the IMF[6]	4	− 1	4	0	1	0
from other official sources[7]	7	2	52	14	6	1
Acquisition of foreign claims[8] (— = increase)	− 19	− 12	− 63	− 20	− 16	− 1
of which:						
Official reserves[9]	− 8	− 2	− 38	− 9	− 9	2
Other	− 11	− 10	− 25	− 11	− 7	− 3
Memorandum item: *Change in deposits with BIS reporting banks[4]*	*26*	*10*	*48*	*13*	*12*	*0*

[1] Brazil, Mexico, Korea, the Philippines. [2] Cumulative amounts. [3] Including official transfers. [4] Banks in Group of Ten countries and Switzerland and the foreign branches of US banks in the Caribbean area and the Far East. [5] Gross of redemption. [6] Net of repayment. [7] Official development assistance and official export credits (net). [8] Current-account balance minus identifiable external financing. [9] 1979 figures include SDR allocations.

commercial banks in the BIS reporting area by $10 billion. The main sources of finance were $15 billion of borrowing from commercial banks and $7 billion of new foreign and international bond issues.

In the group of non-oil developing countries, total capital inflows during 1979 exceeded the $38 billion current-account deficit by an even greater margin, so that these countries' external assets increased by $20 billion, almost half of which represented additions to official reserves. Total identified capital flows amounted to $58 billion, of which two-thirds came from market sources, nearly all of it in the form of $36 billion of new credits taken up from commercial banks in the BIS reporting area. Of the remaining $20 billion, over two-thirds took the form of borrowing from official sources other than the IMF.

Capital inflows during 1979 into oil-importing countries other than the Group of Ten and Switzerland followed the same kind of pattern as in 1974–78. During those five years the developed countries outside the Group of Ten and Switzerland relied heavily on borrowing from financial markets, which, at $96 billion, covered virtually the whole of their current-account deficit and accounted for 90 per cent. of their total external borrowing. Two-thirds of their external borrowing from financial markets during these five years came from banks in the BIS reporting area and the remainder from bond issues. It may be added that the modest $8 billion increase in these countries' total official reserves during 1974–78 meant a sharp fall in their reserve/imports ratio, from about 45 per cent. at the end of 1973 to under 30 per cent. five years later.

In the non-oil developing countries taken as a group, borrowing in the international markets covered about 85 per cent. of the cumulative current-account payments deficit during 1974–78, a proportion not much lower than that recorded for the developed countries outside the Group of Ten and Switzerland. As a proportion of total external borrowing, however, funds raised from market sources, at 62 per cent., played a much less important rôle — although they were easily the largest single source of financing.

Within this group of countries, moreover, there was a marked contrast between the pattern of capital inflows into four major non-oil developing countries — Brazil, Mexico, Korea and the Philippines – and the rest of the group. Thus, for these four countries market borrowing covered almost the whole of the 1974–78 current payments deficit and at the same time accounted for about 75 per cent. of total external financing. In the rest of the non-oil developed world taken together, official borrowing, at $49 billion, covered nearly all of the current-account deficit and was one-third as much again as the total of $37 billion borrowed on the international financial markets.

Perhaps the most striking feature, however, of the figures relating to external financing received by non-oil developing countries during 1974–78 was the extent to which it exceeded these countries' combined current-account payments deficits, allowing a $38 billion increase in their official reserves over these five years, as well as an estimated $25 billion build-up of non-official claims on the rest of the world. Additions to non-oil developing countries' reserves averaged $12 billion a year during 1976–78, so that, in contrast to the situation of developed countries outside the Group of Ten and Switzerland, their overall reserve/imports ratio of about 35 per cent. at the end of 1978 was roughly the same as it had been five years earlier.

Looking to the prospects for financing oil-importing countries' payments deficits in 1980 and beyond, it seems unlikely that the Group of Ten countries and Switzerland will run into financing problems — at any rate for as long as their domestic policies are generally aimed, as at present, at reducing inflation rates, and as long as a large share of their aggregate current payments deficit is concentrated on Germany, Japan and, as appears likely from the first-quarter 1980 figures, the United States. Furthermore, the large majority of developed countries outside the Group of Ten are unlikely to encounter financing difficulties in the near future — particularly in view of the relatively small increase in their combined current-account deficit last year.

In 1979, however, more than half of the counterpart to the OPEC surplus was constituted by the deficit of the non-oil developing countries. Moreover, the slower economic growth that is now in prospect in the developed areas of the world, although it may bring about some reduction in the overall OPEC surplus, will tend to shift a larger share of the counterpart deficits onto the non-oil developing countries.

While the poorest of these countries essentially rely on official sources of external finance, the table on page 102 shows the extent to which the non-oil developing countries as a group borrowed from the international financial markets during 1974–78, both to cover their external deficits and, after 1976, to build up their monetary reserves. As a result, the proportion of their medium-term public and publicly-guaranteed external debt that is owed to private creditors has risen from one-third in 1973 to about one-half in 1978. If non-guaranteed private long-term debt and short-term external borrowing were included, the relative importance of debt to private creditors would be even greater.

Does this build-up of market debt mean that non-oil developing countries as a group will in future find it harder to raise external financing from these sources? Certainly there is at present no shortage of liquid funds available to the international banking system and it seems likely that a significant part of future OPEC surpluses will be placed with the banks. But the banks may be less keen than formerly to expand their loans to some countries in which their exposure has increased very rapidly since 1974, particularly if they are able to find sizable opportunities for financing lower-risk countries in the industrial world with balance-of-payments deficits. In addition, the banks' assessment of country risk will no doubt have been affected by the political tensions that developed in late 1979. More generally, there is the question of the limits that their existing capital base may set to the future growth of banks' international lending.

The non-oil developing countries' access to additional bank finance may, therefore, become somewhat less easy, although this will depend to an important extent on whether it is always the same countries that borrow from the banks or whether the deficits shift over time between countries. In any case, there are at present sizable unused credit facilities at the International Monetary Fund, much of the available credit carrying little or no conditionality, as well as the prospect that the 50 per cent. increase in Fund quotas decided on in 1978 will come into effect later this year.

All in all, the financing needs of oil-importing countries in 1980 appear manageable. Looking further ahead, the longer the OPEC surplus lasts at present levels the more likely it is that difficult financing problems will arise. These problems may call for imaginative responses on the part of the authorities to facilitate the movement of funds, through both private and official channels, from surplus to deficit countries.

VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

The year 1979 witnessed a period of intense activity and rapid growth in the international financial markets. The international banking sector played a key rôle in the recycling of the re-emerging large OPEC surplus and the growth of its lending to both developing and industrial countries accelerated. In addition to OPEC moneys, there were also large inflows of new funds to the Euro-market from most groups of oil-importing countries. Euro-currency interest rates mirrored the strong rise of interest rates in national financial markets, but there was no shortage of liquidity and, interest rates apart, lending conditions were, during most of 1979, even more favourable to borrowers than in 1978. Towards the end of the year, however, the further increase in oil prices, as well as political developments in Iran and Afghanistan, produced a change in market climate. The banks became more hesitant about increasing their exposure vis-à-vis certain groups of countries. At the same time, the unprecedented rise of US and Euro-dollar interest rates, as well as the stronger dollar, tended to discourage borrowers. Consequently, in early 1980 the growth of international bank lending began to show signs of slowing down.

As well as describing the sequence of developments, this chapter considers the future rôle of the international banking sector in recycling OPEC surpluses and the discussions of international banking problems by the central banks of the Group of Ten countries and Switzerland that have taken place over the past year.

Main facts.

The external claims of banks in Group of Ten countries and Switzerland, Austria, Denmark and Ireland and of the branches of US banks in the offshore centres of the Caribbean and Far East expanded by $218 billion, or 24 per cent., during 1979 to reach a total of $1,111 billion. Liabilities showed an even stronger increase of $264 billion, or 31 per cent. The resultant $46 billion shift of the reporting banks from an overall external net creditor position of $36 billion to $10 billion of net liabilities reflected heavy capital inflows via the banking sector in a number of industrial countries, including the United States, Germany and the United Kingdom.

As usual, the expansion of the banks' gross external positions was substantially inflated by the redepositing of funds between the reporting banks themselves. Excluding the resultant double-counting, the volume of new funds channelled through the international banking sector last year may be estimated at around $130 billion, compared with $110 billion in 1978. However, these figures understate the acceleration in growth that occurred; whereas in 1978 valuation changes resulting from the depreciation of the dollar had added about $20 billion to the expansion in the dollar value of the banks' positions in other currencies, such exchange rate effects accounted for only about $6 billion of the 1979 increase.

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

Lenders	Changes 1977	Changes 1978	Changes 1979	Amounts outstanding 1979
	in billions of US dollars			
Banks in European reporting countries[1]	+ 80.6	+145.2	+164.8	776.2
of which in foreign currency (Euro-currency market)	*+ 68.5*	*+117.2*	*+137.9*	*639.9*
Banks in Canada and Japan	+ 0.9	+ 16.2	+ 15.0	71.0
Banks in the United States	+ 11.5	+ 37.8	+ 17.1	136.0
Branches of US banks in offshore centres[2]	+ 16.2	+ 15.4	+ 21.2	127.7
Total	+109.1	+214.6	+218.1	1,110.9
minus: double-counting due to redepositing among the reporting banks	34.1	104.6	88.1	445.9
A = Net new international bank lending[3]	75.0	110.0	130.0	665.0
Euro-bond and foreign bond issues	36.1	37.3	37.1	.
minus: redemptions and repurchases	5.1[4]	8.3[4]	9.6[4]	.
B = Net new international bond financing	31.0	29.0	27.5	.
A+B = Total new bank and bond financing	106.0	139.0	157.5	.
minus: double-counting[5]	4.0	6.0	7.5	.
Total net new bank and bond financing	102.0	133.0	150.0	.

[1] Belgium, Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland, the United Kingdom and, as from 1978, Austria, Denmark and Ireland. [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.

On the basis of the gross figures, over 75 per cent. of the recorded growth in external claims last year was accounted for by banks in the reporting European countries, whose assets increased at a rate of 27 per cent. Moreover, particularly strong growth was shown by banks in Japan, whose external claims rose by 35 per cent. On the other hand, banks in the United States and US banks' branches in offshore centres accounted for only 17.5 per cent. of the 1979 expansion, considerably less than in previous years. This was due to a slowdown in the growth of the external assets of banks in the United States from 41 per cent. in 1978 to 14 per cent. The expansion in the claims of the foreign branches of US banks in offshore centres accelerated from 17 to 20 per cent., but still remained well below the growth rate recorded for the reporting European banks.

The figure of $218 billion quoted above for the total expansion in external assets last year somewhat understates the expansion of international banking activity since it includes neither the offshore activities of banks in Bahrain nor the business done by non-US banks in the offshore centres of the Caribbean and Far East. If these sectors of international banking activity are included, the overall growth in banks' external assets may be estimated at around $240 billion, bringing the total amount outstanding to about $1,200 billion. However, because of the lack of adequate geographical and currency details for these more comprehensive data, the figures used in the remainder of this chapter relate only to the narrower reference area.

Total international bond issues, including foreign issues in national markets, amounted to $37 billion last year, about the same as in 1978. However, allowing for redemptions and bonds taken up by banks, the direct flow of new non-bank funds into this market was about $3 billion smaller than in 1978. Taking bank lending and net new issuing activity together, but excluding double-counting, the total amount of new credit intermediated by the international financial markets may be estimated at $150 billion, about 13 per cent. more than in 1978.

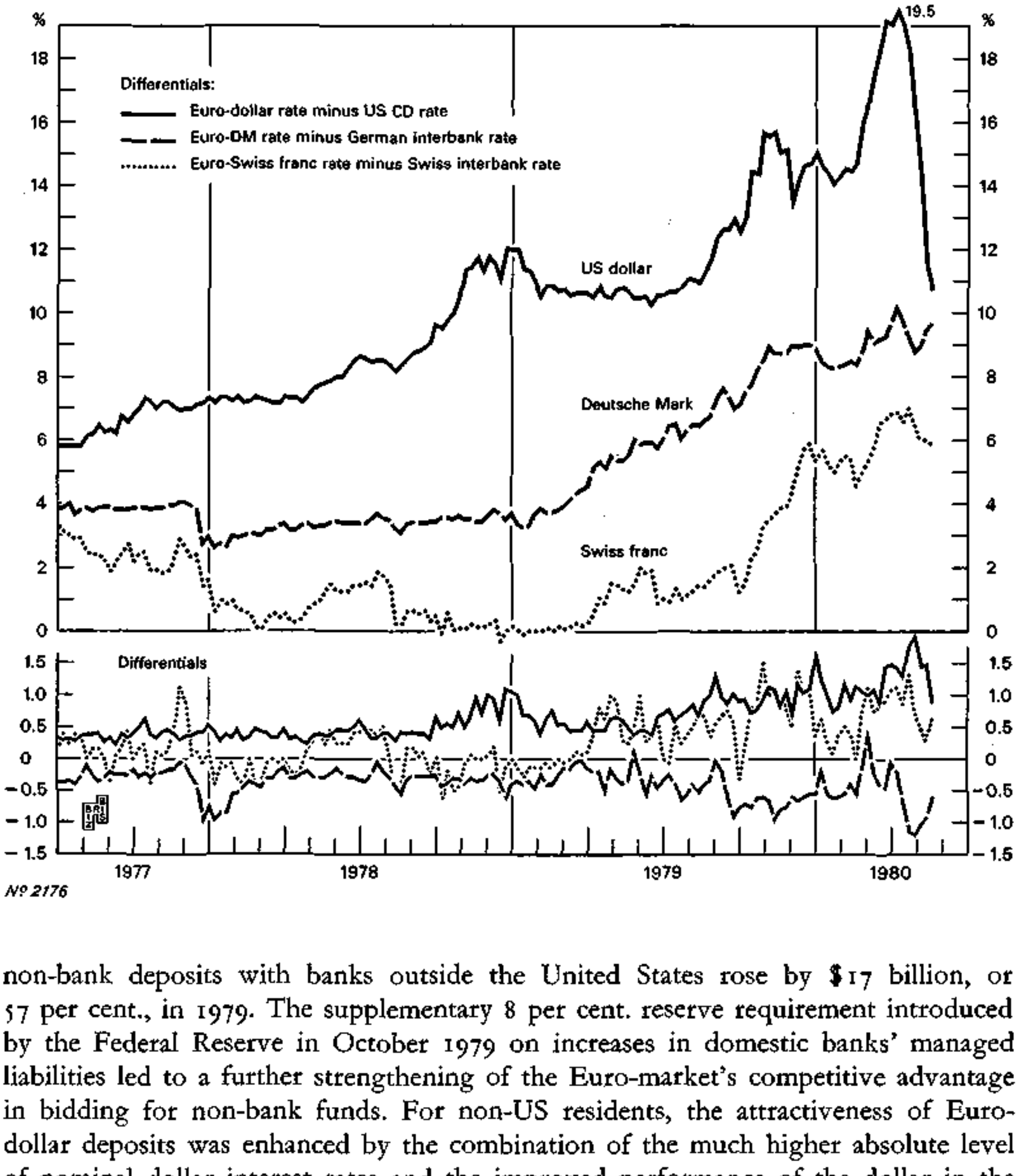
Main influences.

Despite much higher levels of interest rates and a further strong expansion in market volume, credit conditions in the international banking sector remained easy for most of 1979. There was continued strong competition between banks for new borrowers, further downward pressure on lending margins and a lengthening of maturities. All this suggests that the banks continued to be flush with funds and that the expansionary impetus came not only from the demand side but also in large measure from the sources side of the international credit markets. What were the main supply factors that helped to maintain such a heavy flow of new funds to the international banking sector at a time when interest rates were rising sharply in the principal national financial markets?

The most significant development was the re-emergence of a large OPEC surplus and the fact that a major part of this surplus found its way to the banks in the international markets. As a result, identified new deposits by oil-exporting countries with the international banking sector, which in 1978 had amounted to a mere $6 billion, jumped to $38 billion in 1979.

A second influence was that throughout most of 1979 the rise in interest rates in national markets mainly reflected an acceleration in inflation rather than a real shortage of liquidity and credit. As a result, there were continued large flows of bank and non-bank funds from industrial countries to the international banking sector. In fact, the higher level of nominal interest rates magnified the real cost impact of domestic reserve requirements in national financial markets, thereby strengthening the competitive advantage of the Euro-market, which is free from such reserve requirements. This was particularly true of the dollar sector, where US reserve requirements on large domestic dollar CDs with original maturities of less than six months had been raised from 6 to 8 per cent. in November 1978. The increased premium which the banks could thus offer on Euro-dollar deposits over US domestic deposits acted as a magnet for funds from US residents, so that US

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



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non-bank deposits with banks outside the United States rose by $17 billion, or 57 per cent., in 1979. The supplementary 8 per cent. reserve requirement introduced by the Federal Reserve in October 1979 on increases in domestic banks' managed liabilities led to a further strengthening of the Euro-market's competitive advantage in bidding for non-bank funds. For non-US residents, the attractiveness of Euro-dollar deposits was enhanced by the combination of the much higher absolute level of nominal dollar interest rates and the improved performance of the dollar in the exchange markets.

Another influence that became important especially in the second half of the year was the negative impact on the long-term capital markets of accelerating inflation, as well as the very substantial premium of short-term interest rates over long-term bond yields. These developments tended to divert funds from the national and international bond markets to the international banking sector.

A further expansionary factor on the supply side of the market for international bank funds was that a considerable number of oil-importing countries continued to show reserve gains in 1979, a substantial part of which was deposited in the Euro-currency market. Altogether, identified official deposits with banks outside the United States advanced by \$35 billion last year, which was nearly three times as much as in 1978, with the main source of this very large increase coming, of course, from the OPEC surplus.

Finally, and despite the strengthening of domestic borrowing demands, the supply of international bank credit continued to be influenced by the eagerness of the major banks in the industrial countries to expand their international business, particularly through their affiliates in the principal Euro-market centres. This was particularly true of Japanese and European-owned banks, whereas US banks' share in international lending declined. Because of its wholesale character, low unit costs and privileged regulatory status, the banks still found Euro-business quite attractive, notwithstanding the thinness of lending margins in the syndicated loan market. In addition, front-end fees and the payment of rates below LIBOR to non-bank depositors certainly made for higher margins than might appear from published figures. Moreover, their relatively good loan-loss experience in recent years may have led to a lowering of the banks' perception of the risks involved in their international lending business.

On the uses side of the international market for bank credit, two developments stood out in 1979: the very large balance-of-payments financing requirements of most groups of oil-importing countries, resulting both from the renewed emergence of a huge OPEC surplus and the elimination of the US current-account deficit; and the large-scale recourse of US banks to the Euro-dollar market. The combined current-account position of the Group of Ten countries other than the United States but including Switzerland shifted from a \$34 billion surplus in 1978 to a \$23 billion deficit last year; the current-account deficit of non-oil developing countries widened by \$13 billion to about \$38 billion and that of developed countries outside the Group of Ten by \$2 billion to approximately \$14 billion. A substantial proportion of these deficits was financed through Euro-market borrowing. In the case of the industrial countries, most of this current-account financing did not go through the official sector but took the form of borrowing by the private bank and non-bank sectors. One incentive for such private borrowing was the tightening of monetary policies, rendered possible or even advisable by the sharp deterioration in most industrial countries' external accounts.

In the United States, the only major industrial country to record a strong improvement in its current-account balance of payments in 1979, the Euro-market continued to offer advantages to borrowers. For most of the time the premium of Euro-deposit rates over comparable US domestic rates did not fully reflect the Euro-market's cost advantage resulting from its freedom from reserve requirements, and it was therefore cheaper for banks in the United States to raise funds in the Euro-market than through domestic CD issues. As a result of this interest rate constellation, banks in the United States were themselves heavy takers of Euro-currency funds in 1979, with their liabilities to banks abroad showing an increase of over \$30 billion. In this way the funds placed abroad by the US non-bank sector returned to the country largely in the form of interbank flows. In addition, non-bank firms in the United States raised about $5.5 billion of new funds from the reporting banks abroad and, especially during the fourth quarter of the year, there may have been a substantial amount of unidentified Euro-market borrowing by US non-bank firms via their foreign affiliates.

A third factor that helped to sustain the demand for international bank credit in 1979 was the relative strength of the world economy, which meant that, particularly in value terms, investment and international trade, as well as the related financing requirements, continued to expand quite strongly. For example, on a fourth-quarter to fourth-quarter basis and in current dollars, world exports rose by 30 per cent. last year.

Finally, and partly through the banks' continuing efforts to expand their international credits, a number of countries again borrowed for the purpose of adding to their official reserves. The high level of dollar interest rates did not serve as a major deterrent to such borrowing since, to the extent that the proceeds were redeposited in the Euro-currency market, the cost of financing the reserve build-up was essentially limited to the banks' lending margins.

As regards the relative importance of supply and demand factors in last year's expansion of the banks' international business, there were a number of factors that pointed to the existence of an ex ante excess of supply over demand and a further intensification of the borrowers' market that had existed in 1977 and 1978. In the syndicated loan market maturities tended to lengthen, while average spreads continued to shrink. Margins charged to borrowers from OECD countries declined from an average of about 0.7 per cent. in the last quarter of 1978 to 0.5 per cent. in the late autumn of 1979, and those charged to borrowers from other western countries dropped from 1.05 per cent. to 0.75 per cent. In the latter part of 1979 some public-sector entities were even able to obtain credits at margins as low as 0.375 per cent. It is not easy to say why this happened. One possibility is that the factors affecting the supply of new funds to the market were, to a greater extent than those affecting new borrowing from the banks, accounted for by developments external to the banking market itself, with banks in industrial countries acting as residual takers of funds. At the same time, the large-scale inflows from the market to a number of industrial countries were, in part at any rate, the result of developments in those countries, including balance-of-payments financing requirements and tighter domestic monetary conditions.

Both the pace at which international business was expanding and the rather optimistic terms on which it was conducted gave rise to increasing concern about the banks' international risk exposure and some of the macro-economic consequences. In October the Japanese authorities virtually halted the participation of Japanese banks and their foreign branches in the syndicated loan markets, and the authorities of other Group of Ten countries had by then also begun to consider ways of introducing a larger element of caution and reserve into the banks' international lending policies.

However, in the last two months of 1979 and in early 1980 world economic and political developments themselves began to produce such an adjustment in lenders' attitudes. The unexpectedly high oil price increases and their likely balance-of-payments implications gave rise to increasing concern about the future ability of certain groups of countries to maintain their external solvency. Moreover, events in Iran, the US financial counter-moves and developments in Afghanistan underlined the significance of political imponderables and added to the general uncertainties.

As a result, banks became more hesitant about lending to certain groups of countries. For such borrowers the loan maturities granted began to shorten, while at the same time margins charged to them gradually started widening. In addition, smaller banks began to steer clear of involvement in new loans to these countries and the broad sharing-out of syndicated loan participations became increasingly difficult. This gave rise to new lending techniques, such as "club loans" in which small groups of large banks themselves take up an entire loan and which involve a narrowing of the market's lending base.

At the same time, banks continued to be very liquid and, reflecting the uncertainties with respect to interest rates, inflation and the international political situation, were flooded with short-term deposits. Non-US banks in particular were offered large amounts of funds from oil-exporting countries, for which, in view of their increasing dependence on this group of depositors, they became more and more reluctant to pay rates close to LIBOR. This persistence of ample availability of new funds, together with hesitation about lending to certain groups of countries, strengthened the incentives for the banks to seek new business in the industrial countries and produced a kind of two-tier market. Despite the worsening outlook for the world economy, borrowers in the latter countries therefore had no difficulty in continuing to obtain financial accommodation in the international banking sector on very favourable terms.

The situation was, moreover, complicated by monetary developments in the United States, where the Federal Reserve's October 1979 package in some respects marked a turning-point in the US approach to monetary policy. Dollar interest rates began substantially to exceed US inflation rates and, particularly after their renewed explosion in February, really started to bite. This emergence of a very real and substantial interest cost entailed a much greater degree of selectivity by borrowers. Countries borrowing for balance-of-payments purposes, unlike private borrowers in national markets, have no tax liabilities from which they can deduct their interest payments. Moreover, the stronger exchange-market performance of the dollar increased the potential cost of borrowing in that currency. The resulting tendency for borrowers temporarily to stay away from the market and to wait for better conditions may help to explain why the widening of the margins charged by banks to certain groups of borrowing countries proceeded only slowly and hesitantly despite the pronounced change in risk assessment. On the other hand, the combination of very high dollar interest rates and the strength of the dollar tended to boost borrowing in other Euro-currencies, a trend which had already manifested itself at times during 1979.

In the course of April 1980, however, the very sharp turn-round of dollar interest rates — three-month Euro-deposit rates dropped from over 19½ per cent. in early April to below 10 per cent. in the second half of May — introduced a new element in the market situation. It is likely that this return of dollar interest rates to relatively moderate levels and the concomitant weakening of the dollar in the exchange markets will strengthen borrowers' interest in the medium and long-term Euro-credit market. However, with the market considerably less receptive than in 1979, it remains to be seen whether all groups of borrowers will be able to obtain large-scale financial accommodation without accepting a significant stiffening in loan conditions.

The rôle of the international banking sector in recycling the OPEC surplus.

As already mentioned, the re-emergence of the OPEC payments surplus in 1979 led to a renewal of large-scale recycling operations by the international banking sector. While towards the end of last year the banks began to show hesitancy about lending to certain groups of countries, it is nevertheless quite likely that the financing of the oil-price-induced balance-of-payments deficit will not give rise to acute problems for some time to come. For one thing, a considerable number of non-oil developing countries have, largely with the help of international bank credit, been able to strongly improve their gross reserve positions in recent years and could use some of these assets to meet their current payments needs. Moreover, non-oil developing countries have been building up very substantial unused credit facilities with the international banking sector on which they could draw. And, finally, not having had much recourse to IMF credit in recent years, these countries could potentially obtain a considerable amount of finance from that institution.

At the same time, these sources of finance can provide only temporary relief, particularly since for some countries their reserves, and to a certain extent also their unused borrowing facilities in the Fund, serve as a kind of collateral for their borrowing in the international credit markets, which could not be drawn down heavily without endangering the countries' credit standing. Moreover, countries outside the Group of Ten hold a large proportion of their reserves with banks in the Euro-market. The withdrawal of these reserves would tend both to reduce the deposit base of the Euro-banks themselves and to increase the net debtor position of these countries vis-à-vis the international banking sector.

Looking further ahead, there are several reasons for thinking that recycling through the international banking sector might prove more difficult than it was after the 1973 oil price increases. There is once more bound to be considerable mismatching, both geographically and as regards maturities, between the placing of surplus OPEC funds and the financing needs of oil-importing countries. The flow of OPEC funds is likely to be concentrated to a large extent on a relatively small number of industrial countries with well developed financial markets, whereas the deficits will be shared by a much broader group of countries, including many developing ones. Moreover, in view of the uncertainties with regard to inflation and the general world economic and political outlook, the oil-exporting countries may wish to keep a large proportion of their investments in relatively liquid and short-term form, whereas the financing requirements of oil-importing countries will basically be of a long-term nature.

The most important reason why this time the banks may be less well placed to cope with this dual transformation problem relates to the possible durability of the OPEC surplus. Whereas after the 1974 oil shock the OPEC surplus was already down to half its initial size a year later and was thereby reduced to fairly manageable proportions, the surplus seems likely this time to remain at a high level for a longer period. From the point of view of sound banking principles financing a persistent payments deficit is a different proposition from financing a temporary one, particularly when the larger amounts that are borrowed are not translated into a higher level of domestic investment and economic growth in the borrowing countries. The clouded outlook for the world economy in general, together with increased political uncertainties in the wake of developments in Iran and Afghanistan, may also make the banks more cautious in their future lending policies.

A second reason why recycling might be more difficult this time is that by contrast with 1974 banks are not starting out with relatively clean sheets but are already heavily burdened with third-world risks. They may therefore have less scope than before to expand their international risk exposure more rapidly than their balance-sheet totals. Conversely, the debt burdens of certain groups of countries vis-à-vis the international financial markets have increased substantially since 1974, which has certainly not helped their risk ratings.

Thirdly, high domestic inflation rates, weak equity markets and the rapid expansion of their international business have tended to lead to a further stretching of the gearing ratios of some banks. As a result, from the point of view of their own capital endowment, these banks may be more vulnerable, and have less room for manoeuvre, than in 1974. An additional constraint which, after the rapid growth of OPEC deposits in the second half of last year and in early 1980, already seems to be making its influence felt may be the reluctance of banks to become too dependent on a single group of depositors for their funding needs.

Central-bank discussions of international banking problems.

The rapid growth during recent years of their banks' international business, and in particular of their Euro-currency business, led the central banks of the Group of Ten countries and Switzerland in the summer of 1979 to consider whether these developments were giving rise to problems which called for corrective action, either by individual countries or on an internationally co-ordinated basis. The discussions concentrated on three main points: the worldwide macro-economic effects of the growth of international banking; its effects on the ability of national authorities to control liquidity in their own economies; and the prudential questions raised by the growth of banks' international operations, including those carried out by their foreign branches and subsidiaries.

As regards the first of these points, the principal issue is whether the growth of international banking has materially contributed to the worldwide problem of inflation. There are a number of aspects to this question. Firstly, the rate of growth of banks' international lending, which has been much more rapid during recent years than the growth of banks' domestic lending in the main industrial countries. Secondly, the growth of the Euro-currency deposits of non-banks, which are not included in national monetary aggregates and therefore escape direct control by national monetary authorities. Thirdly, the substantial scale on which banks have given credits both to cover the external financing needs of countries in balance-of-payments deficit and, in a number of cases, to enable such countries to increase their foreign exchange reserves. Have these credits enabled countries to postpone the introduction of necessary adjustment policies, including appropriate anti-inflationary measures, with a consequent spill-over of inflation into countries with more stability-oriented policies, and have they also contributed to an excessive expansion of global foreign exchange reserves?

In assessing the possible overall inflationary effect of these developments there are a number of other considerations that need to be taken into account. In the first place, the present volume of non-bank deposits in the Euro-currency market, although it has grown rapidly, is still very small in relation to the total stock of world liquid assets. Furthermore, the question of whether banks' international credits have exerted a general inflationary influence on the world economy can only be decided in the light of the uses to which such credits are put and of the general economic situation at the time, rather than simply in the light of their growth rate in itself. There is no dispute that in the years immediately after the 1973 oil price increases the international banking system played an essential part in recycling the surplus funds of OPEC countries. Moreover, from 1976 onwards, when bank credits served also to increase the exchange reserves of a number of oil-importing countries, including countries that were still running current payments deficits, they did so at a time when these countries' reserves were standing at levels which, in relation to their import bills, were much lower than they had been in the early 1970s. No general state of reserve ease has existed in the oil-importing world in recent years.

Another question about the worldwide macro-economic effects of international banking relates to the rôle it played in the switching of funds out of dollars into other currencies, particularly during the dollar crises of 1977 and 1978, and in enabling countries to hold substantial exchange reserves in currencies other than the dollar. Clearly, the Euro-currency market is an efficient mechanism both for such switching of funds and for holding balances in Deutsche Mark, Swiss francs and other non-dollar currencies. However, there is no strong statistical evidence that the Euro-market played a large part in the switching of funds between currencies; nor is the basic cause of exchange rate instability and diversification of exchange reserves out of dollars to be found in the existence of the Euro-currency market.

It may be said that no general verdict on the macro-economic effects of international banking is likely to be of much validity, owing to the changing circumstances in which the banks have to operate. A striking example of this is provided by the changes in the international economic situation — most notably the re-emergence of vast OPEC payments surpluses, the virtual disappearance of the US current payments deficit and the appearance of large current payments deficits in Germany and Japan — that occurred while the central banks' discussions of these problems were taking place.

As regards the relation between the international banking system and the effectiveness of domestic monetary control in individual countries, the Euro-currency market has, by facilitating international movements of funds, tended to reduce the autonomy of domestic monetary policies. A number of countries feel able to limit the obstacles which the market puts in the way of their freedom of manoeuvre in this area either by placing restrictions on movements of funds between their countries and the rest of the world or by the use of a flexible exchange-rate policy. However, the situation is rather different in those countries where no restrictions on capital movements exist, whose currencies are used on a large scale in the Euro-market and where the use of non-interest-bearing reserve requirements against bank deposits as a monetary policy instrument puts the domestic banking system at a cost disadvantage vis-à-vis the Euro-currency market. In such countries residents may, through using the Euro-markets in their own currencies, be able partly to circumvent domestic monetary control at times when policy is restrictive without running any exchange risk. At present, this problem is liable to arise mainly for Germany and the United States, although some other countries too could be faced with it in future.

As regards the third of the points covered in the discussions, there is general agreement that the rapid growth of the banks' international business has thrown up a number of prudential problems. These include: the problem of exercising effective prudential control over banks' foreign subsidiaries, particularly where parent authorities do not supervise their banks on the basis of fully consolidated accounts and where supervisory arrangements in the countries in which the subsidiaries operate are inadequate; the growth of banks' risk exposure vis-à-vis foreign countries, especially certain developing countries with substantial external indebtedness; and the borrowers' market for international bank credits that existed from 1976 to late 1979 which, with the concomitant squeeze on banks' lending margins and the lengthening of the average maturity of their credits, weakened the capital base of some banks and led to an increase in the degree of maturity transformation. Furthermore, as a result of the relatively good loss record of the international banking system in recent years some banks may have come to underestimate the risks involved in this part of their business, at any rate until last year's events in Iran.

The results of these discussions were summarised in the press communiqué issued by the central-bank Governors of the Group of Ten countries and Switzerland in April this year. Recognising the importance of maintaining the soundness of the international banking system and of preventing its future operations from having undesirable effects, either on the world economy as a whole or on individual countries, the Governors reached three main conclusions. Firstly, they decided to strengthen their arrangements for regular monitoring of the economic effects of international banking developments, both worldwide and on individual countries. These new arrangements will enable the central banks to assess the significance of the banks' international operations in the light of changing circumstances and will provide a framework for considering any co-operative action on domestic monetary policies that might be appropriate in the light of such assessments.

Secondly, the Governors have given high priority to bringing into full effect certain initiatives already taken to improve the supervision of banks' international operations. These concern particularly the use of consolidated accounts as the basis for supervising banks, the supervision of banks' country risk assessment procedures and the monitoring of their maturity transformation. The importance which the

Governors attach to the prudential aspects of international banking reflects two considerations: the further increase in the volume of international bank credit which is bound to result from the recycling of the new OPEC surpluses; and the belief that the risks which this will entail cannot necessarily be judged on the basis of the banks' loss record to date in their international credit business.

Lastly, the Governors recognised that one reason why their banks' international business has been expanding more rapidly than their domestic business is to be found in the existence of various biases in official regulations and policies that have favoured the growth of banks' international lending. The Governors have agreed to continue their efforts to reduce such biases. For example, the extension of the practice of supervising banks on the basis of fully consolidated accounts should help to avoid unduly rapid expansion of the business of those bank subsidiaries that operate in centres with relatively liberal supervisory régimes.

At the same time, some of the differences in national official regulations and policies that favour the growth of international banking are firmly rooted in national banking and monetary policy traditions. Proposals to change them — for example, the proposal to introduce reserve requirements on all Euro-currency deposits held with the banking systems of the Group of Ten countries, including their foreign branches and subsidiaries — therefore raise, inter alia, questions about the harmonisation of countries' basic instruments of monetary control. For this reason the Governors recognised the difficulty, in some cases, of combining a reduction of official biases that favour the growth of international banking with the maintenance of countries' traditional ways of controlling their banks' liquidity.

Total international banking flows: Sources and uses.

The expansion in the banks' external assets and liabilities last year was, as usual, accounted for in large measure by cross-border flows within the reporting area (including offshore centres). Thus, intra-area assets and liabilities rose by $153 and 195 billion respectively, whereas claims and liabilities vis-à-vis countries outside the reporting area expanded only by about $65 and 70 billion. The figures for cross-border positions within the reporting area are, however, considerably inflated by double-counting resulting from the redepositing of funds among the reporting banks themselves. Excluding this double-counting, the amount of new funds absorbed within the reporting area may be estimated at around $65 billion, while supplies of new funds from the inside area may be put at around $60 billion.

Within the reporting area the largest takers of new funds were the United States, Germany and Japan; the borrowers were mainly banks, which used the funds largely for financing domestic lending and investments or for foreign trade finance. Gross claims on the United States of banks in the other reporting countries rose by $33.7 billion in the first nine months of 1979, before the reimposition of an 8 per cent. marginal reserve requirement on US banks' foreign borrowing seems to have contributed to a $4.8 billion decline during the fourth quarter. Claims on Germany and Japan rose by over $10 billion each. Very large increases in claims occurred vis-à-vis the United Kingdom, Belgium-Luxembourg, France and the offshore centres, but this largely reflected the rôle of these countries as market-places. At the same time, there was a substantial amount of Euro-currency lending to non-banks in Belgium and the United Kingdom. In Belgium the public sector itself was the largest borrower, raising about $2.5 billion of new Euro-currency funds both directly from banks abroad and via banks in Belgium-Luxembourg. In the case of the United Kingdom, non-bank borrowing was particularly pronounced following the removal of exchange controls, with Euro-sterling lending to the UK non-bank sector advancing by $1.1 billion, or by over 150 per cent., during the fourth quarter. Other important borrowers of new Euro-currency funds within the reporting area were the Italian, Danish and Irish non-bank sectors.

On the liabilities side of the market, the two largest sources of new funds inside the reporting area were Switzerland and the United States. Liabilities vis-à-vis Switzerland rose by $28.7 billion, with over half of this amount representing trustee funds placed in the market by Swiss banks on behalf, but at the risk, of their customers; a substantial proportion of these funds, of course, originates from outside Switzerland. Direct liabilities to the Swiss non-bank sector rose by "only" about $3.5 billion. Liabilities vis-à-vis the United States advanced by nearly $22 billion, about $17 billion of which represented US non-bank funds.

Turning to countries outside the reporting area, the main features last year were the further acceleration in lending to the non-oil developing world and the very large inflows of new funds from oil exporters. Following increases of $11.1 and 24.7 billion in 1977 and 1978 respectively, the reporting banks' claims on non-oil developing countries soared by $37.1 billion, or over 30 per cent. This change in pace, which resulted largely from the deterioration in these countries' current-account balances, was even more pronounced in terms of net flows. Whereas in 1977 developing countries had on balance been net depositors of new funds to the tune of about $1 billion and in 1978 their borrowing had exceeded their new deposits by only $8.7 billion, last year they were net takers to the extent of nearly $24 billion.

As usual, Latin America accounted for by far the largest share of non-oil LDC borrowing, with the reporting banks' claims on this group of countries rising by $23.6 billion. Mexico (about $7.5 billion), Argentina (about $6.5 billion) and Brazil (nearly $5.5 billion) were by far the heaviest borrowers, but substantial amounts of new funds were also raised by Chile and Colombia. Countries in "Other Asia" were the second largest group of borrowers; they obtained $8.8 billion in new funds, with South Korea, the Philippines and China respectively accounting for $3.4, 1.4 and 1.2 billion of this amount. New deposits of developing countries with reporting banks amounted to $13.2 billion last year. This was about $3 billion less than in 1978 and compares with a $7.6 billion increase in their foreign exchange reserves. The largest depositors were Argentina ($3 billion), Mexico ($1.8 billion) and Malaysia ($1.2 billion), while Brazil withdrew $2.6 billion.

The second outstanding feature of developments in 1979 was the re-emergence of the oil-exporting countries as one of the main sources of international banking funds. Following an increase of only $6 billion in 1978, their deposits with the reporting banks rose by $37.8 billion, or 46 per cent., last year. Since at the same

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

	1977 Dec.	1978 Dec. I	1978 Dec. II	1979 March	1979 June	1979 Sept.	1979 Dec.
	In billions of US dollars						
Banks' claims on:							
Group of Ten countries and Switzerland, Austria, Denmark and Ireland	349.9	472.7	466.9	457.2	490.3	546.7	587.9
of which: Reporting European area	*268.6*	*362.8*	*359.9*	*339.7*	*363.1*	*394.2*	*437.5*
United States	*39.8*	*53.0*	*53.0*	*62.0*	*70.9*	*86.7*	*81.9*
Canada	*11.9*	*17.9*	*15.9*	*16.6*	*16.8*	*18.0*	*19.2*
Japan	*29.6*	*39.0*	*38.1*	*38.9*	*39.5*	*47.8*	*49.3*
Offshore banking centres[2]	98.9	123.8	123.5	121.6	132.9	147.7	155.6
Other countries in western Europe	40.8	50.7	50.4	49.6	52.4	56.1	58.7
Australia, New Zealand and South Africa	14.7	13.8	13.5	13.0	13.8	13.9	13.7
Eastern Europe	38.3	47.6	47.5	47.0	49.5	52.8	55.9
Oil-exporting countries	39.1	57.2	56.4	55.5	57.7	62.5	64.1
Non-oil developing countries	98.7	123.4	121.7	127.1	136.6	146.6	158.8
of which: Latin America[3]	*65.9*	*80.8*	*79.9*	*82.8*	*88.4*	*94.7*	*103.5*
Middle East	*5.2*	*6.6*	*6.5*	*6.4*	*7.3*	*7.4*	*8.2*
Other Asia	*20.5*	*24.8*	*24.3*	*26.5*	*29.3*	*31.7*	*33.1*
Other Africa	*7.1*	*11.2*	*11.0*	*11.4*	*11.6*	*12.8*	*14.0*
Unallocated[4]	9.3	15.1	12.9	12.4	13.2	15.2	16.2
Total	689.7	904.3	892.8	883.4	946.4	1,041.5	1,110.9
Banks' liabilities to:							
Group of Ten countries and Switzerland, Austria, Denmark, and Ireland	408.5	539.1	533.5	527.5	576.6	635.8	685.9
of which: Reporting European area	*314.5*	*409.6*	*404.4*	*395.4*	*436.0*	*473.4*	*528.3*
United States	*74.1*	*101.9*	*101.9*	*100.9*	*110.1*	*126.0*	*123.8*
Canada	*12.6*	*15.8*	*15.7*	*17.0*	*17.2*	*17.8*	*17.8*
Japan	*7.3*	*11.8*	*11.5*	*14.2*	*13.3*	*18.6*	*16.0*
Offshore banking centres[2]	71.5	97.2	96.9	104.0	115.5	131.1	139.2
Other countries in western Europe	25.7	35.8	35.4	34.9	37.8	41.4	42.5
Australia, New Zealand and South Africa	2.4	2.7	2.7	3.2	3.6	3.6	3.6
Eastern Europe	8.4	10.7	10.6	9.4	9.9	12.6	15.4
Oil-exporting countries	77.9	83.9	82.5	84.4	87.3	106.9	120.3
Non-oil developing countries	62.0	78.0	77.1	79.9	83.9	87.3	90.3
of which: Latin America[3]	*25.2*	*33.9*	*33.2*	*34.1*	*35.4*	*36.7*	*38.4*
Middle East	*10.0*	*13.8*	*13.8*	*14.0*	*15.2*	*15.3*	*16.0*
Other Asia	*20.1*	*22.9*	*22.7*	*24.5*	*25.6*	*26.7*	*26.6*
Other Africa	*6.7*	*7.4*	*7.4*	*7.3*	*7.7*	*8.6*	*9.3*
Unallocated[4]	15.6	18.4	17.7	18.5	18.9	17.1	23.2
Total	672.0	865.8	856.4	861.8	933.5	1,035.8	1,120.4

Note: The figures in this table are partly based on estimates.
As from December II 1978 the figures for banks in the United States exclude all custody items except negotiable US bank certificates of deposit held on behalf of non-residents. Previously the only custody items excluded were non-resident holdings of Treasury bills and certificates.

[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] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore and other British West Indies. [3] Including those countries in the Caribbean area which cannot be considered as offshore banking centres. [4] Including international institutions other than the BIS.

time new borrowing by these countries slowed down from $18.1 to 7.7 billion, they moved from $12 billion of net borrowing in 1978 to $30 billion of net deposits. This $42 billion shift, which was the equivalent of two-thirds of the 1979 expansion in the oil-exporting countries' current-account surplus, dramatically underlines the recycling rôle of the international banking sector. But even these figures are likely to understate the supply of new funds from oil-exporting countries, since they do not, for example, include funds that might have been channelled into the market via trustee accounts in Switzerland.

About 13 per cent. of the identified increase in oil-exporting countries' deposits with reporting banks was in the United States; 5 per cent. represented deposits with banks in other national markets, while Euro-currency deposits made up the remaining 82 per cent. As regards currency composition, 70 per cent. of the total was denominated in dollars. Of the $11 billion of non-dollar deposits, about $5 billion may be estimated to have been in Deutsche Mark and about $3 billion in sterling.

Not too surprisingly, about three-quarters of the new oil funds came from Middle Eastern countries. Excluding funds placed with banks in Switzerland, the United States and the branches of US banks in offshore centres, for which no breakdown by individual oil-exporting countries is available, the largest depositors were Iraq ($7.2 billion), Kuwait ($4 billion) and Saudi Arabia ($3.3 billion). On the same basis, deposits by Iran rose by $2.4 billion in the first nine months of 1979, before declining by $0.6 billion during the fourth quarter, whereas claims on that country decreased by $1.3 billion in the course of the year.

Eastern European countries reduced their recourse to international bank credit from $9.3 billion in 1978 to $8.4 billion last year. Since at the same time the flow of deposits accelerated, net recourse to international banking funds by these countries dropped off sharply from $7 billion in 1978 to $3.6 billion. This pattern was, however, set in large measure by the Soviet Union, which reduced its net indebtedness by $2.6 billion last year, whereas that of other eastern European countries rose by $6.2 billion. On a gross basis the heaviest borrowers were Poland ($3.3 billion), the German Democratic Republic ($1.5 billion) and Rumania ($1.4 billion).

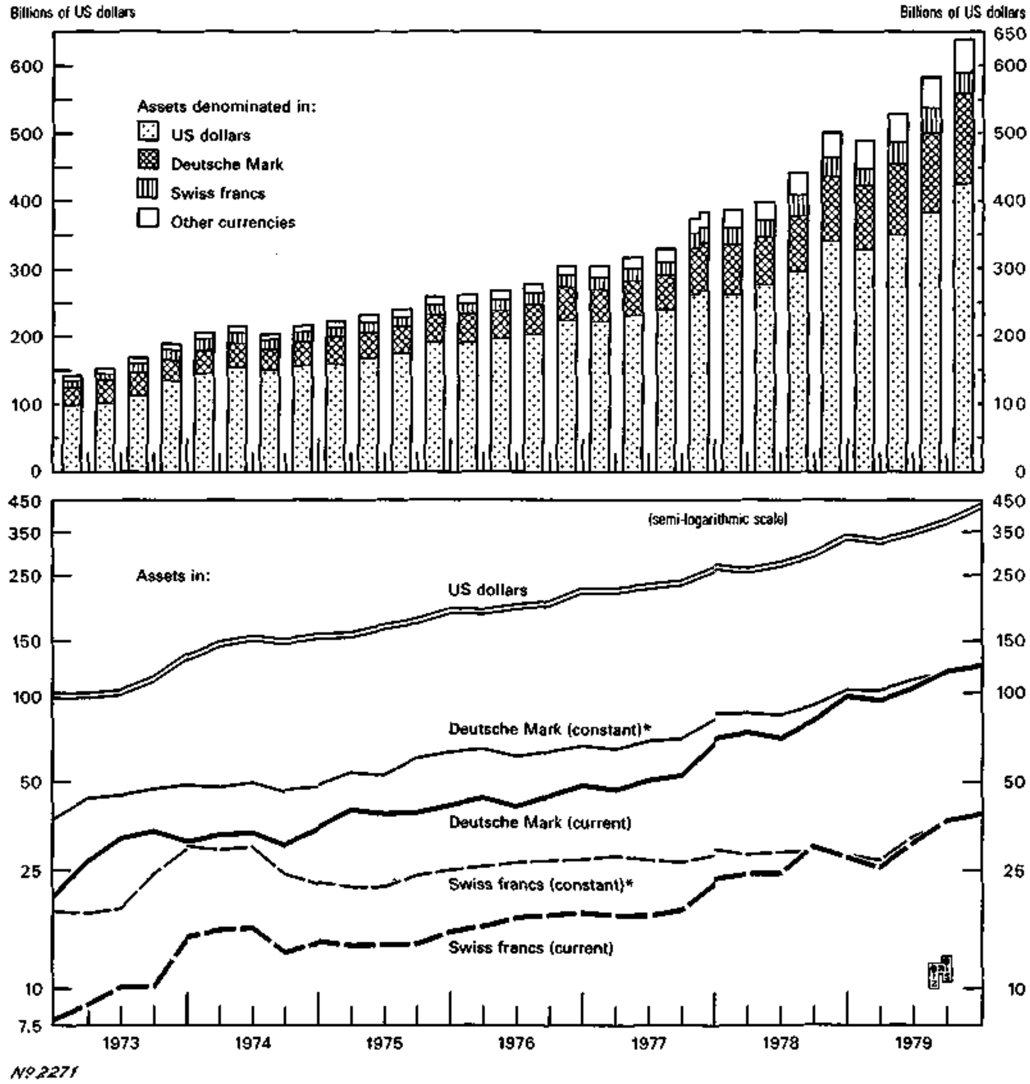
Developed countries outside the reporting area obtained $8.5 billion of new funds last year, but also built up their deposits by $8 billion. Spain alone accounted for $2.8 billion of the increase in borrowing and for $4.4 billion of new deposits. Other major borrowers were Yugoslavia, Norway and Portugal.

Developments in European market centres.

Currency composition. The international business of banks in the reporting European countries continued to expand at a very rapid pace in 1979, with their external claims and liabilities rising by 27 and 31 per cent. respectively. The growth rate of assets was a few percentage points lower than in 1978, but in absolute terms the increases on both sides of the balance sheet were considerably larger, and they were much less inflated by valuation effects.

As usual, the bulk of the growth was made up of Euro-currency business, with the share of conventional domestic currency assets and liabilities amounting to less than 20 per cent. A substantial part of the banks' foreign positions in

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



* At constant end-December 1979 exchange rates.

domestic currency tends to be related to foreign trade finance; however, in the case of countries such as Germany and Switzerland whose currencies are among the principal Euro-currency denominations, external assets and liabilities in domestic currency to a large extent reflect the domestic links with the Euro-market.

As regards external positions in foreign currencies, the reporting banks' dollar assets and liabilities expanded by 26 and 25 per cent. respectively, or at virtually the same rates as in 1978. The salient feature last year, however, was the very strong 41 per cent. growth in the reporting banks' external liabilities in foreign currencies other than dollars. Of the total $155.2 billion expansion in foreign currency liabilities,

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				
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[1]	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[2]	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 Dec. I .	262,430	64,660	111,370	31,040	67,510	22,560	4,420	4,210	3,270
Dec. II[3]	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
1979 March .	327,200	85,570	162,340	42,870	94,860	26,000	8,260	7,690	6,420
June .	351,050	90,780	177,700	44,130	104,850	31,480	8,290	7,390	6,750
Sept. .	384,190	96,710	199,160	49,370	116,870	37,250	9,420	8,080	6,810
Dec.. .	427,980	104,330	211,960	52,410	124,430	38,650	11,370	8,470	7,820
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[3]	*92,330*	*29,370*	*34,790*	*9,730*	.	.	.	.	.
1978 Dec.. .	*105,000*	*31,170*	*48,370*	*12,330*	.	.	.	.	.
1979 March .	*107,340*	*34,750*	*50,780*	*14,140*	.	.	.	.	.
June. .	*110,540*	*35,700*	*59,320*	*17,610*	.	.	.	.	.
Sept.. .	*116,070*	*34,560*	*65,980*	*18,990*	.	.	.	.	.
Dec.. .	*126,570*	*34,860*	*69,610*	*20,250*	.	.	.	.	.
					Liabilities				
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[1]	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[2]	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 Dec. I .	272,880	34,200	110,560	12,050	64,970	20,870	5,920	4,900	4,400
Dec. II[3]	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
1979 March .	336,550	47,810	165,890	18,770	93,250	26,840	11,990	8,110	8,180
June .	359,930	51,820	185,430	18,780	104,630	32,270	13,060	7,650	8,900
Sept. .	392,420	58,640	212,040	21,570	117,790	38,280	14,550	8,370	9,620
Dec.. .	436,620	64,180	229,420	22,700	127,940	40,710	15,390	6,610	11,370
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[3]	*75,310*	*12,280*	*30,400*	*5,460*	.	.	.	.	.
1978 Dec.. .	*87,690*	*14,690*	*45,060*	*7,440*	.	.	.	.	.
1979 March .	*85,360*	*14,210*	*45,120*	*7,220*	.	.	.	.	.
June. .	*90,680*	*16,390*	*50,060*	*8,140*	.	.	.	.	.
Sept.. .	*96,400*	*16,580*	*57,590*	*8,830*	.	.	.	.	.
Dec.. .	*108,940*	*17,170*	*63,940*	*9,280*	.	.	.	.	.

[1] 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. [2] 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. [3] From December II 1977 onwards includes the positions of banks in Austria, Denmark and Ireland.

\$67.2 billion was in non-dollar form, which meant that the non-dollar component of the European reporting banks' external foreign currency liabilities rose from 31.8 per cent. at the end of 1978 to 34.4 per cent. The Deutsche Mark and the Swiss franc accounted as usual for the greater part of this expansion, but in terms of growth rates the sharpest increases were shown by the yen, the French franc and sterling. Excluding exchange rate effects, the increase in non-dollar deposits amounted to \$61 billion, compared with \$26 billion in 1978. On the assets side, positions in currencies other than the dollar showed a substantially smaller increase, so that the reporting banks shifted from a small net creditor position of \$0.2 billion in these currencies to a net debtor position of \$17.5 billion.

There are several factors which may help to explain the very strong expansion in gross liabilities in currencies other than the dollar and the large shift in the banks' net position. One important influence was the less buoyant exchange-market outlook for currencies such as the Deutsche Mark, the Swiss franc and the yen. The resultant unwinding of exchange-market positions by their customers confronted the banks with an excess offer of these currencies in the forward market. The banks in turn covered their forward purchases of these currencies from their customers by borrowing the same currencies spot and selling them against dollars or domestic currency. Moreover, reporting banks' outright borrowing of non-dollar foreign currency funds for domestic use was encouraged by the lower interest cost of these currencies. The same factors — much lower interest rates than on dollar funds and less likelihood of appreciation than in 1978 — may also help to explain from the point of view of borrowers why the banks' external lending in currencies other than the dollar, notably in Swiss francs, picked up strongly from \$27 billion in 1978 to \$43 billion (adjusted for exchange rate effects) last year. Finally, one reason for the particularly rapid growth in non-dollar liabilities was the sharp widening of the oil-exporting countries' surplus, a substantial part of which traditionally tends to be invested in non-dollar form.

The rôle of individual market centres. The growth of Euro-currency business last year was particularly marked in Luxembourg and the United Kingdom, where the banks' external assets expanded by 36 and 33 per cent. respectively, compared with a 27.5 per cent. average for all the reporting European countries. At the other end of the spectrum, claims in foreign currencies of banks in Germany and Switzerland expanded only marginally. However, these two countries supplied a substantial volume of new funds in domestic currency to the Euro-markets. This was particularly true of banks in Switzerland, which recorded an increase of 41 per cent. in their external claims in domestic currency.

The rapid growth of international banking activity in Luxembourg was somewhat less concentrated than in previous years on business in Deutsche Mark, while, on the other hand, external assets and liabilities in Swiss francs rose by over 80 per cent.

The strong expansion of Euro-currency business in London meant that the UK market share, after some decline in previous years, widened from 40 to 42 per cent. in 1979. This buoyancy was due above all to the affiliates of Japanese banks, which recorded an increase of about 60 per cent. in their external assets.

External assets and liabilities of banks in individual reporting countries and of certain offshore branches of US banks.

			1977 Dec.	1978 Dec.	1979 March	1979 June	1979 Sept.	1979 Dec.
			in millions of US dollars					
Austria	Assets	Domestic currency . . .	1,950	2,930	3,090	3,350	3,910	4,160
		US dollars	3,870	4,460	5,010	5,910	5,890	6,610
		Other foreign currencies	3,570	5,120	4,550	5,880	6,770	7,130
	Liabilities	Domestic currency . . .	540	830	820	850	1,010	1,090
		US dollars	4,320	5,300	5,190	5,830	5,940	6,870
		Other foreign currencies	5,380	7,490	7,080	8,710	9,640	11,040
Belgium	Assets	Domestic currency . . .	2,470	2,800	2,870	2,970	3,230	3,330
		US dollars	14,260	18,550	19,490	20,100	22,860	23,310
		Other foreign currencies	8,650	13,230	13,790	14,340	15,630	16,380
	Liabilities	Domestic currency . . .	3,790	4,730	5,720	5,280	5,590	6,590
		US dollars	13,080	18,040	18,900	19,450	21,620	22,200
		Other foreign currencies	10,450	15,500	16,570	18,060	20,390	21,350
Luxembourg	Assets	Domestic currency . . .	710	1,050	990	1,090	1,420	1,400
		US dollars	18,820	22,040	23,010	24,450	25,460	29,300
		Other foreign currencies	25,220	36,300	38,100	42,030	46,660	50,100
	Liabilities	Domestic currency . . .	570	730	860	790	910	1,030
		US dollars	18,680	24,400	25,450	28,590	28,760	32,950
		Other foreign currencies	23,260	30,080	31,560	33,910	39,350	42,680
Denmark	Assets	Domestic currency . . .	90	90	140	190	290	150
		US dollars	1,420	1,640	1,590	1,620	1,650	1,860
		Other foreign currencies	640	1,200	1,230	1,420	1,650	1,960
	Liabilities	Domestic currency . . .	260	390	380	370	390	410
		US dollars	840	1,500	1,530	1,280	1,230	1,900
		Other foreign currencies	530	860	890	1,110	1,310	1,420
France	Assets	Domestic currency . . .	11,450	18,200	18,100	19,280	21,410	23,180
		US dollars	45,160	60,210	53,230	57,730	61,080	71,740
		Other foreign currencies	17,050	20,570	21,110	22,750	26,180	28,700
	Liabilities	Domestic currency . . .	4,220	5,700	5,760	5,820	6,060	6,610
		US dollars	44,430	53,160	46,190	49,220	52,010	61,100
		Other foreign currencies	18,540	25,630	26,650	29,490	34,600	38,500
Germany	Assets	Domestic currency . . .	31,450	40,340	40,190	42,630	43,490	47,620
		US dollars	12,710	14,720	13,360	13,790	14,100	14,360
		Other foreign currencies	4,570	6,050	6,150	6,310	7,160	7,350
	Liabilities	Domestic currency . . .	24,330	40,220	37,250	41,320	45,830	54,330
		US dollars	12,380	14,510	13,350	13,690	14,760	16,430
		Other foreign currencies	2,850	4,370	4,180	4,370	6,860	7,000
Ireland	Assets	Domestic currency . . .	.	.	.	.	.	.
		US dollars	710	400	330	390	380	380
		Other foreign currencies	830	1,110	660	670	820	1,280
	Liabilities	Domestic currency . . .	.	.	.	.	.	.
		US dollars	800	550	540	480	640	740
		Other foreign currencies	890	1,260	910	860	1,030	1,470
Italy	Assets	Domestic currency . . .	300	590	610	600	770	1,320
		US dollars	11,480	17,380	10,440	11,740	11,480	21,190
		Other foreign currencies	3,300	4,780	4,550	5,680	6,400	7,130
	Liabilities	Domestic currency . . .	1,540	2,010	2,010	2,420	2,730	2,900
		US dollars	17,010	21,840	15,700	17,010	15,640	25,400
		Other foreign currencies	4,510	5,960	6,200	8,260	8,800	9,850
Netherlands	Assets	Domestic currency . . .	5,240	8,490	9,210	9,640	10,460	11,390
		US dollars	15,150	19,470	18,210	20,460	20,380	23,010
		Other foreign currencies	12,030	17,090	16,690	18,110	20,170	21,470
	Liabilities	Domestic currency . . .	5,100	7,930	8,700	8,650	9,070	10,860
		US dollars	15,460	20,710	18,820	19,920	20,980	23,320
		Other foreign currencies	10,010	14,840	15,330	18,050	19,640	21,270

Table continued on page 125.

			1977 Dec.	1978 Dec.	1979 March	1979 June	1979 Sept.	1979 Dec.
			in millions of US dollars					
Sweden	Assets	Domestic currency . . .	930	860	1,060	1,210	1,100	1,030
		US dollars	1,970	2,160	2,260	2,380	2,570	2,950
		Other foreign currencies	1,210	1,230	1,410	1,530	1,570	1,830
	Liabilities	Domestic currency . . .	580	700	730	860	950	900
		US dollars	2,120	2,790	3,470	3,740	4,130	4,620
		Other foreign currencies	1,290	1,730	2,200	2,600	2,740	3,190
Switzerland	Assets	Domestic currency . . .	14,500	19,290	21,430	24,430	27,720	27,170
		US dollars	17,070	21,580	20,660	20,860	21,840	21,510
		Other foreign currencies	5,940	9,830	9,810	9,140	10,140	10,390
	Liabilities	Domestic currency . . .	5,650	6,820	6,390	6,830	7,290	7,440
		US dollars	13,130	18,540	17,040	18,440	18,980	21,110
		Other foreign currencies	4,880	8,330	8,030	7,900	9,100	9,670
United Kingdom	Assets	Domestic currency . . .	12,230	14,740	14,870	15,140	15,480	15,490
		US dollars	125,810	156,910	159,610	171,620	196,500	211,760
		Other foreign currencies	33,400	45,940	44,290	49,840	56,010	58,240
	Liabilities	Domestic currency . . .	11,100	11,950	13,280	14,680	16,040	19,230
		US dollars	136,590	167,250	170,370	182,280	207,730	219,980
		Other foreign currencies	34,770	46,170	46,290	52,110	58,580	61,980
Total for European reporting countries	Assets	Domestic currency . . .	81,320	109,380	112,560	120,530	129,280	136,240
		US dollars	268,430	339,520	327,200	351,050	384,190	427,980
		Other foreign currencies	116,410	162,450	162,340	177,700	199,160	211,960
	Liabilities	Domestic currency . . .	57,680	82,010	81,900	87,870	95,870	111,390
		US dollars	278,840	348,590	336,550	359,930	392,420	436,620
		Other foreign currencies	117,360	162,220	165,890	185,430	212,040	229,420
Canada	Assets	Domestic currency . . .	430	480	500	580	570	580
		US dollars	16,480	20,430	20,760	21,450	22,820	22,990
		Other foreign currencies	1,240	1,460	1,380	1,830	2,000	2,030
	Liabilities	Domestic currency . . .	2,180	2,620	2,640	2,860	3,000	3,080
		US dollars	15,860	21,340	23,260	25,380	26,270	28,170
		Other foreign currencies	840	1,010	910	1,400	1,550	1,560
Japan	Assets	Domestic currency . . .	3,550	7,970	8,720	9,490	10,260	11,350
		US dollars	15,930	22,520	24,950	24,120	31,290	30,350
		Other foreign currencies	2,220	3,200	2,960	3,460	3,460	3,730
	Liabilities	Domestic currency . . .	4,110	8,690	7,170	5,380	5,130	3,820
		US dollars	23,360	28,490	30,900	31,980	41,910	43,900
		Other foreign currencies	1,110	1,830	1,730	2,340	3,400	2,770
United States[1]	Assets	Domestic currency . . .	90,210	115,370	108,350	115,070	127,250	133,590
		Foreign currencies . . .	2,350	3,500	2,590	2,520	2,610	2,440
	Liabilities	Domestic currency . . .	77,940	89,910	96,820	110,690	122,980	128,540
		Foreign currencies . . .	920	2,240	1,780	1,960	2,320	2,320
Offshore branches of US banks[2]	Assets	Foreign currencies[3]. . .	91,090	106,520	111,130	118,570	128,590	127,670
	Liabilities	Foreign currencies[3]. . .	91,660	107,480	112,260	118,300	128,960	128,820

[1] As from December 1978 the figures for banks in the United States exclude all custody items except negotiable US bank certificates of deposit held on behalf of non-residents. Previously the only custody items excluded were non-resident holdings of Treasury bills and certificates. On the old basis the figures for December 1978 were: domestic currency assets, $126,540 million; foreign currency assets, $3,870 million; liabilities, $99,000 million and $2,490 million respectively. [2] Offshore branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [3] Including negligible amounts in domestic currencies.

On the other hand, at 26 per cent., the growth of the external assets of the affiliates of US banks remained well below the London average. In this context it may be noted that the London affiliates of US banks financed nearly 60 per cent. of last year's expansion in their external lending through CD liabilities, the outstanding volume of which soared by nearly 70 per cent. Their other external liabilities rose by 16 per cent. up to mid-October, before declining by 4.4 per cent. in the following two months, probably in connection with developments in Iran and the US counter-moves.

One significant feature last year was that the banks in nearly all reporting European countries were substantial net importers of foreign currency funds, particularly banks in Switzerland and Germany. However, whereas in the case of Switzerland a drop in the banks' net external creditor position in foreign currencies was far outweighed by an increase in their net external creditor position in Swiss francs, in Germany there were substantial inflows of funds in both foreign and domestic currency. As a result, the German banks' overall net external position shifted from $2 billion of assets to $8.4 billion of liabilities last year. This $10.4 billion net inflow, which was nearly twice the size of the 1979 German current-account deficit, resulted from domestic banks' foreign sales of borrowers' notes and other deposits with maturities of four years or over, which are exempt from both reserve requirements and the coupon tax.

In the United Kingdom, too, the tightening of monetary policy and the strength of sterling were reflected in large inflows of funds through the banking sector, mainly in the form of sterling. As a result, the overall net external debtor position of banks in the United Kingdom doubled from $7.8 to 15.7 billion.

Net size of the Euro-currency market. The figures of $138 billion and $155 billion for the 1979 growth of the reporting European banks' foreign currency assets and liabilities are considerably inflated by double-counting due to interbank deposits. Excluding this double-counting, but making allowance for the banks' use of foreign currency funds for domestic lending, the volume of new funds intermediated by the banks in the narrowly defined Euro-currency market may be estimated at $98 billion, raising the total of credit outstanding at the end of 1979 to $475 billion. Valuation effects resulting from exchange rate changes accounted for only about $3 billion of the increase, compared with as much as $15 billion of the $75 billion expansion recorded in 1978.

On the sources side, two developments in particular accounted for the market's stronger expansion in 1979. Firstly, after showing hardly any increase in 1978, deposits by oil-exporting countries rose by $26.3 billion, or 48 per cent., last year. Secondly, the supply of new non-bank funds from within the reporting European area accelerated from $14.1 billion in 1978 to $22.9 billion. About 70 per cent. of these funds came from Switzerland, largely through trustee accounts. Relatively strong increases were also recorded in the reporting European banks' liabilities vis-à-vis the United States (36 per cent.), primarily the US non-bank sector, and vis-à-vis eastern Europe, notably the Soviet Union. On the other hand, the growth in deposits received from non-oil developing countries and "Other developed countries" slowed down last year.

On the uses side of the market, there was a sharp acceleration in new lending to the United States, largely in the form of interbank flows, and substantial inward switching of foreign currency funds for domestic use by the reporting European banks themselves. New lending to non-oil developing countries accelerated from

Estimated sources and uses of Euro-currency funds.

End of month	Reporting European area: Total[1]	Reporting European area: of which non-bank[2]	United States	Canada and Japan	Other developed countries	Eastern Europe[3]	Offshore banking centres[4]	Oil-exporting countries[5]	Developing countries	Unallocated[6]	Total
	in billions of US dollars										
	Uses										
1977 December	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	348.0
December I	136.0	92.0	24.6	24.6	34.7	31.4	55.0	24.3	40.1	4.3	375.0
December II	139.5	94.5	24.6	24.6	34.7	31.4	55.0	24.3	40.1	2.8	377.0
1979 March	141.8	96.2	25.6	26.3	34.0	30.9	53.2	24.2	44.5	3.5	384.0
June	147.5	100.9	29.1	27.5	36.1	32.6	58.6	26.3	48.7	3.6	410.0
September	160.0	105.2	34.0	32.4	38.2	34.5	66.1	29.4	51.1	4.3	450.0
December	171.3	111.3	36.7	33.0	40.5	36.0	67.5	30.4	55.1	4.5	475.0
	Sources										
1977 December	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	348.0
December I	142.5	70.1	37.0	13.0	26.2	8.8	45.4	54.7	39.8	7.6	375.0
December II	144.5	70.1	37.0	13.0	26.2	8.8	45.4	54.7	39.8	7.6	377.0
1979 March	150.5	73.1	36.4	13.3	26.0	7.7	43.7	56.3	42.4	7.7	384.0
June	163.0	81.4	41.0	13.9	28.1	7.8	45.5	58.6	44.6	7.5	410.0
September	167.5	87.0	50.0	15.2	30.9	10.4	49.0	73.2	46.3	7.5	450.0
December	174.0	93.0	50.5	15.2	31.7	13.0	52.8	81.0	47.8	9.0	475.0

Note: *As from June 1979 a change has been made in estimating procedures, insofar as the partial netting-out* of interbank assets and liabilities, previously limited to the growth of the reporting European banks' positions within their own area, has been extended to cover their positions vis-à-vis the United States, Canada, Japan and the offshore centres. This change has become necessary as a result of the very rapid growth of such positions, which suggests that the figures have been inflated to a substantial extent by circular flows of interbank funds between the reporting European area and these other market centres.

[1] Includes: (a) under "Uses", the banks' conversions from foreign currency into domestic currency and foreign currency funds supplied by the reporting banks to the commercial banks of the country of issue of the currency in question (such as DM funds deposited with German banks); (b) under "Sources", deposits by official monetary institutions of the reporting area, the banks' conversions from domestic into foreign currency and foreign currency funds obtained by the reporting banks from the banks in the country of issue of the currency in question (such as funds received in DM from German banks). [2] On the sources side including trustee funds to the extent that they are transmitted by the Swiss banks to the other banks within the reporting area and to the extent that they are not reported by the Swiss banks themselves as liabilities vis-à-vis non-banks outside the reporting area. [3] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [4] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, other British West Indies. [5] Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates, Venezuela. [6] Including positions vis-à-vis international institutions other than the BIS.

$9.8 billion in 1978 to $15 billion, with the reporting banks' net creditor position vis-à-vis these countries widening from only $0.3 billion at the end of 1978 to $7.3 billion. Some acceleration in new lending also occurred vis-à-vis "Other developed countries", whereas the growth in credits to oil-exporting countries and eastern Europe slowed down.

Developments in centres outside Europe.

With the calming-down of the exchange markets and the gradual tightening of US domestic credit conditions, the strong build-up in the net external assets of *banks in the United States* that had occurred in the last quarter of 1977 and in

1978 was reversed last year. As a result of both an acceleration in external borrowing and a slowdown in their external lending, the net external creditor position of banks in the United States contracted sharply from $26.7 billion at the end of 1978 to $5.2 billion.

The external liabilities of US banks soared by 42 per cent., or $38.7 billion. The bulk of these funds was raised in the Euro-markets, with interbank liabilities, mainly to the banks' own foreign affiliates or parents, accounting for $30.7 billion of the increase. Liabilities to foreign official institutions contributed another $4.7 billion, whereas deposits from non-banks rose by only $2.6 billion. This borrowing pattern was also reflected in the geographical composition of the increase. Liabilities to the reporting area (including offshore centres) rose by $32.3 billion, while liabilities to oil-exporting countries and developing countries went up by $5 billion and $2.2 billion respectively.

The external claims of banks in the United States rose by $17.2 billion last year. The bulk of this expansion was accounted for by the US affiliates of foreign banks, whereas, owing to the recall of funds from foreign affiliates, the external claims of US-owned banks on balance showed very little increase. In sharp contrast to the pattern on the liabilities side, the major part of new lending was to non-banks, with claims on foreign public borrowers and other non-banks expanding by $5.1 and 7.3 billion respectively. In geographical terms, new lending to non-oil developing countries and eastern European countries amounted to $10.8 billion and $0.6 billion respectively, while claims on oil-exporting countries recorded a slight decline following several years of strong growth.

To a large extent the *branches of US banks in the offshore centres* of the Caribbean and Far East served as a channel for funds from the rest of the world, and notably the Euro-markets, to the US domestic banking sector last year. Of the total $21.2 billion increase in reported branch assets, $10.2 billion represented claims on the United States and $6.8 billion consisted of claims between offshore centres. Outside the reporting area, claims on developing countries expanded by $4.5 billion.

On the sources side of their balance sheets, the offshore branches substantially reduced their liabilities to head offices and other banks in the United States, but these repayments were largely offset by an increase in deposits obtained from the US non-bank sector, and overall liabilities vis-à-vis the United States showed only a slight decline. The bulk of new funds was raised in the Euro-market, with branch liabilities to the rest of the reporting area (including offshore centres) showing a $17.8 billion increase.

Although for the year as a whole *Japanese banks* recorded one of the highest growth rates in external claims, the tightening of official guidelines governing Euro-currency lending showed its impact in the quarterly figures. Following an increase of one-third in the first nine months of the year — which came on top of a 55 per cent. jump in 1978 — the external lending of banks in Japan came to a halt in the last quarter when the Ministry of Finance suspended Japanese banks' participation in the syndicated medium-term loan market. External liabilities in foreign currency rose by 54 per cent., whereas, owing to the weakening of the yen, the large-scale inflows of domestic currency funds that had occurred in 1978 were sharply reversed, and in dollar terms banks' external liabilities in yen dropped from $8.7 to 3.8 billion.

The international bond markets.

In the international bond markets 1979 and the early months of 1980 were a period of strong disturbances and rapidly changing market situations. Rising interest rates in the principal financial centres, reversed yield curves and exchange rate uncertainties at times created a rather unfavourable environment for the placement and pricing of new issues. Nevertheless, owing to the markets' flexibility, activity was on balance well maintained and it was only in early 1980 that the soaring of US interest rates to unprecedented levels resulted in really low issue volumes.

Total new issues of Euro-bonds and foreign bonds amounted to $37.1 billion last year, only $0.2 billion less than in 1978. The turbulences were, however, reflected in the pattern of new issues. Foreign bond issues, which felt the tightening of national markets most directly, declined by $2.2 billion to $19.2 billion. Thus, foreign issues in the US market decreased by $1.8 to 4.6 billion as a result of a decline in the amount raised by both Canadian and European borrowers. Foreign yen issues in Japan, which suffered not only from rising interest rates but also from a weakening of the yen and heavy government borrowing programmes, contracted from $4.7 to 3.1 billion. On the other hand, foreign issues in Switzerland reached the remarkable level of $9 billion, up by $1.5 billion on 1978. Foreign borrowers were attracted to this market by the relatively low level of interest rates and the less strong exchange-market performance of the Swiss franc. The very same considerations, of course, dampened investor interest. Despite ample domestic liquidity and the removal in January 1979 of restrictions on non-resident purchases of Swiss franc paper, the market went through occasional periods of congestion and foreign issue activity had to be temporarily curtailed.

The Euro-bond market was rather more buoyant than the foreign bond market. After declining from $19.5 billion in 1977 to $15.9 billion in 1978, the new issue volume recovered to $17.9 billion last year. The reasons for this pick-up were the improved exchange-market performance of the US dollar and the increased use of floating interest rates and similar formulae which helped the market to cope with some of the worst uncertainties associated with the sombre prospects for inflation. The impact of these two factors was seen mainly in the dollar sector, where the issue volume recovered from $7.7 billion in 1978 to $10.5 billion, while at the same time the proportion in the form of floating rate notes expanded from about 30 to 35 per cent. These notes are not very widely bought by the general public, but are taken up largely by the banks themselves and are therefore in some respects closer to the Euro-credit market than to the issues market.

In contrast to the dollar sector, Euro-Deutsche Mark issues contracted from $6.5 billion in 1978 to $4.9 billion. In view of the changed situation of the Deutsche Mark in the exchange market, Euro-DM yields apparently no longer looked quite so attractive to investors as in 1978. Moreover, in order to limit the international

International bond issues.[1]

Borrowing countries or areas	Years	Euro-bond issues				Foreign issues			
			of which				of which		
		Total	US dollars	Deutsche Mark	Private place-ments	Total	in United States	in Switzer-land	Private place-ments
		In millions of US dollars							
Western Europe .	1977	9,010	5,740	2,780	1,860	5,060	1,280	2,650	2,910
	1978	5,410	2,440	2,240	1,310	6,090	1,640	2,590	1,840
	1979	7,120	3,730	2,030	1,280	5,660	970	4,030	2,440
	1980/I	1,980	900	760	110	1,260	30	890	590
Canada	1977	1,950	990	410	70	3,430	2,980	360	1,830
	1978	830	470	360	380	3,930	3,270	230	990
	1979	1,400	830	30	30	2,720	2,060	510	560
	1980/I	—	—	—	—	580	490	10	40
United States . .	1977	1,300	1,190	10	430	220	—	20	200
	1978	1,290	970	230	200	370	—	220	150
	1979	2,570	2,480	60	130	160	—	60	—
	1980/I	350	240	110	110	1,260	—	90	90
Other developed countries[2] . . .	1977	2,080	1,450	590	320	1,450	670	660	510
	1978	2,550	920	1,590	400	2,940	410	1,870	2,080
	1979	1,730	730	960	250	3,620	80	3,180	2,880
	1980/I	210	200	10	10	710	—	460	440
Rest of the world[3]	1977	2,660	990	1,190	500	1,610	820	400	440
	1978	2,990	1,080	1,290	750	2,200	440	540	830
	1979	1,830	1,300	410	210	1,410	370	280	330
	1980/I	20	20	—	—	50	30	20	30
International institutions . .	1977	2,480	1,980	240	880	4,840	1,920	870	1,810
	1978	2,870	1,810	820	1,230	5,850	600	2,000	3,070
	1979	3,250	1,460	1,370	1,280	5,610	1,110	900	2,860
	1980/I	140	40	50	60	710	250	220	110
Total issues placed	1977	19,480	12,340	5,220	4,060	16,610	7,670	4,960	7,700
	1978	15,940	7,690	6,530	4,270	21,380	6,360	7,450	8,960
	1979	17,900	10,530	4,860	3,180	19,180	4,590	8,960	9,070
	1980/I	2,700	1,400	930	290	4,570	800	1,690	1,300

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

rôle of the Deutsche Mark, the Bundesbank urged the banks not to apply the floating interest rate formula to DM issues. Euro-bond issues in other currencies or in units of account remained of secondary importance, with Euro-dollar and Euro-Deutsche Mark issues combined accounting for 86 per cent. of the total market volume.

As regards groups of borrowers, one significant development last year was the increased difficulties developing countries had in obtaining direct access to the international issue markets. This was especially the case in the fourth quarter, when the sharp deterioration in market conditions affected the less-than-prime borrowers most strongly. As a result, direct takings by developing countries declined from

$5.2 billion in 1978 to $3.2 billion; however, issues by international development institutions (excluding the European ones) came to $5 billion, only slightly less than their 1978 volume.

OECD countries' recourse to the issue markets widened from $22.8 billion in 1978 to $24.6 billion. US corporations, taking advantage of the relatively more favourable conditions prevailing in the international than in the domestic market, boosted their offerings from $1.7 to 2.7 billion. Japanese borrowers stepped up their takings from $2.8 to 3.8 billion. In view of the relatively low interest rates, they were attracted primarily to the Swiss franc and Deutsche Mark sectors. However, investors' interest in Japanese issues, which were largely in the form of convertible bonds, was dampened in the latter part of the year as a result of the weak performance of the Tokyo share market. Other countries whose residents increased their recourse to international bond finance were Sweden, France and the Netherlands. On the other hand, Canada, by far the largest borrower in 1978, reduced its gross new takings from $4.8 to 4.1 billion, as the balance-of-payments deficit was largely financed by short-term capital inflows via the banking sector.

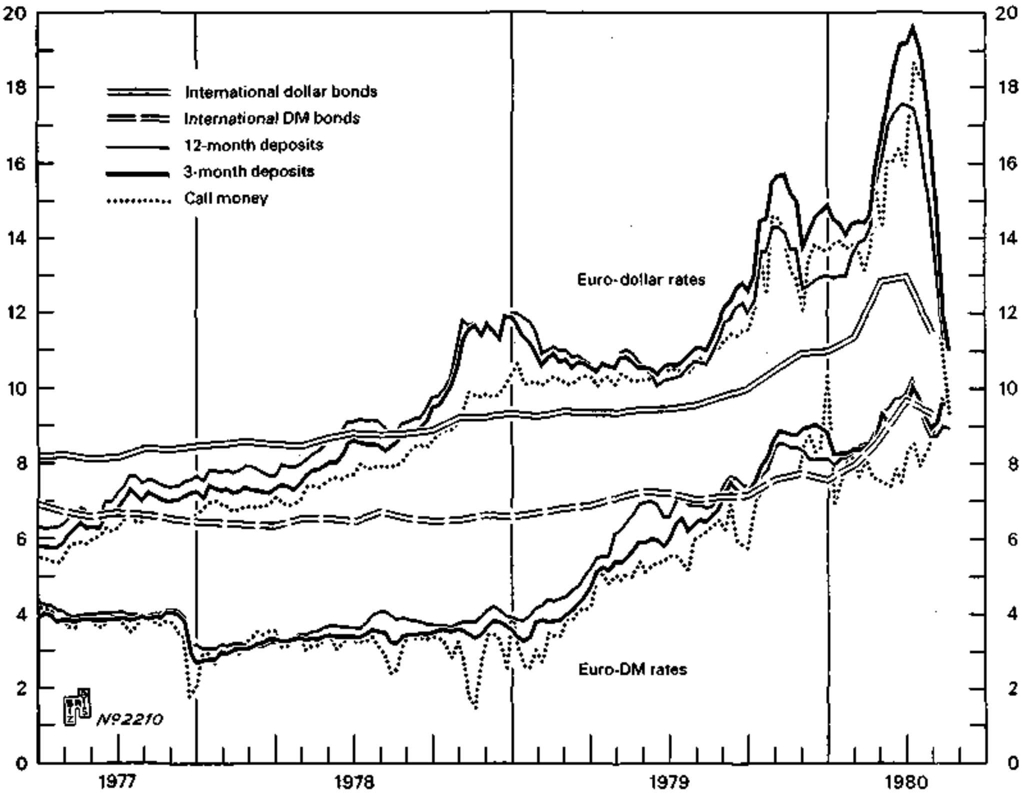
During the course of 1979 the markets went through different phases, with frequent and sudden shifts of sentiment that reflected the pronounced uncertainties about inflation, the business cycle and the economic consequences of the renewed oil price increases. The year began quite favourably, with an improved exchange-market outlook for the dollar and expectations of a peaking-out of long-term dollar interest rates contributing to a strong come-back of Euro-dollar issues, from only $1 billion in the final quarter of 1978 to $2.7 and 3.7 billion in the first and second quarters of 1979 respectively. This remarkable expansion was achieved despite an inverted yield curve and a rather jittery market where the borrowers' rush to benefit from favourable market conditions, combined with investors' hesitancy, resulted in recurrent periods of congestion.

In the summer months the renewed exchange-market troubles of the dollar and the steepening of the uptrend in US interest rates once again reversed the fortunes of the Euro-dollar bond sector. Especially from September onwards, the spiralling of US interest rates sent dollar bond prices to record lows and caused most new fixed rate dollar issues to be postponed or withdrawn. As a result, issue activity dropped to about 69 per cent. of the volume recorded in the second quarter, while yields rose from about 9½ per cent. in July to nearly 11 per cent. in November.

After a relatively sluggish second quarter, the demand for Swiss franc and Deutsche Mark paper was boosted in the summer of 1979 by the renewed weakening of the dollar, and international issue activity in both these market sectors picked up strongly. In the fourth quarter, however, the much more restrictive stance of US domestic monetary policy and its calming impact on the exchange markets permitted some further tightening of monetary conditions in Germany and Switzerland, where the authorities were concerned about a resumption of domestic inflationary pressures. The impact of these factors was particularly felt in the Swiss franc sector, where foreign issues dropped to 55 per cent. of their — albeit very high — third-quarter level.

Euro-currency deposit rates and yields of US dollar and DM bonds on international markets.*

Weekly averages and end-of-month rates.



* The bond yields are calculated to average maturity.

With the intensification of inflationary expectations in the United States and the effects this had on dollar interest rates and the US issues markets, conditions in the Euro-bond market worsened further in the first quarter of 1980. While Euro-dollar bond yields experienced an unprecedentedly sharp rise from about 11 per cent. at the end of 1979 to 13 per cent. three months later, the volume of new dollar issues dropped to $1.4 billion, or to little more than half its 1979 quarterly average, despite the remarkable strengthening of the dollar in the exchange markets. The international repercussions of soaring US interest rates and the strong dollar also affected conditions for Euro-Deutsche Mark and foreign Swiss franc issues, with Euro-Deutsche Mark bond yields advancing by over 200 basis points to around 9½ per cent. at the end of the quarter, and in March issue calendars for the two markets had to be scaled down sharply.

However, in the course of April the bond markets reacted very promptly to the sudden easing of US domestic monetary conditions and the sharp drop in short-term dollar interest rates. Despite earlier pessimistic forecasts, issue activity began to pick up quite strongly and by the end of the month Euro-dollar bond yields had come down by 1½ percentage points from their March peak.

VII. THE INTERNATIONAL MONETARY SCENE.

The present chapter reviews the principal international monetary developments of the past year and a half. The first section deals with exchange rate developments, the main features of which were the further recovery of the dollar in 1979, the accompanying greater stability of the exchange rates of other major currencies, except the yen and the pound sterling, the sharp fluctuations of the dollar against most European currencies in March–April 1980 and the first year of operation of the exchange rate mechanism of the European Monetary System. A second section considers the main factors that contributed to the greater stability of most major currencies' exchange rates during most of the period under review, as well as the outlook for currency stability. The third section deals with gold production and gold-market developments, notably the unprecedented rise in the market price of gold during 1979 and the early weeks of 1980, and its subsequent sharp decline. The fourth section describes developments in global reserves, the main features of which were the slowdown in the growth of foreign exchange reserves, to a considerable extent as a result of the very large swing into surplus of the US balance of payments, the effects on gold reserves of the rise in the market price of gold and the introduction of the European currency unit as a reserve asset held by the monetary authorities of the countries participating in the European Monetary System. The chapter concludes with a short review of the current situation of, and outlook for, global reserves.

Exchange rate developments.

Three main features distinguished exchange rate developments during the period under review. The first of these was the recovery of the US dollar, whose weakness had been the basic cause of the exchange-market turbulence in 1977–78. By early April 1980 the dollar had recovered three-quarters of the 18 per cent. loss in its trade-weighted index recorded between July 1977 and October 1978. However, the recovery was not a continuous one, and there were times from mid-June 1979 onwards when the dollar came under quite heavy pressure. Furthermore, in March and April 1980 the dollar fluctuated sharply against a number of other major currencies. The second feature was the very large movements that occurred in the exchange rates of the yen and the pound sterling. In early April 1980 the trade-weighted exchange rate of the yen was about 23 per cent. below its end-1978 level, and this decline was followed by an 11 per cent. appreciation in the one and a half months to late May 1980. The pound sterling, on the other hand, appreciated by nearly 16 per cent. on the trade-weighted basis during the period under review. The third feature was the relative stability of the exchange rates of other major currencies. The trade-weighted exchange rate of the Swiss franc, which between September 1977 and September 1978 had risen by over 40 per cent., moved within a range of 11¾ per cent. during the period under review, and that of the Deutsche Mark, which between end-1976 and October 1978 had risen by 15 per cent., remained within one of 7¼ per cent. Against the dollar, too, these two currencies, except during March–April 1980, fluctuated less widely than before. Elsewhere in Europe the area of exchange rate stability was enlarged by the inclusion of the French franc, the Italian lira and the Irish pound in the exchange rate mechanism of the European Monetary System, while the Canadian dollar stabilised after its sharp fall in 1977–78.

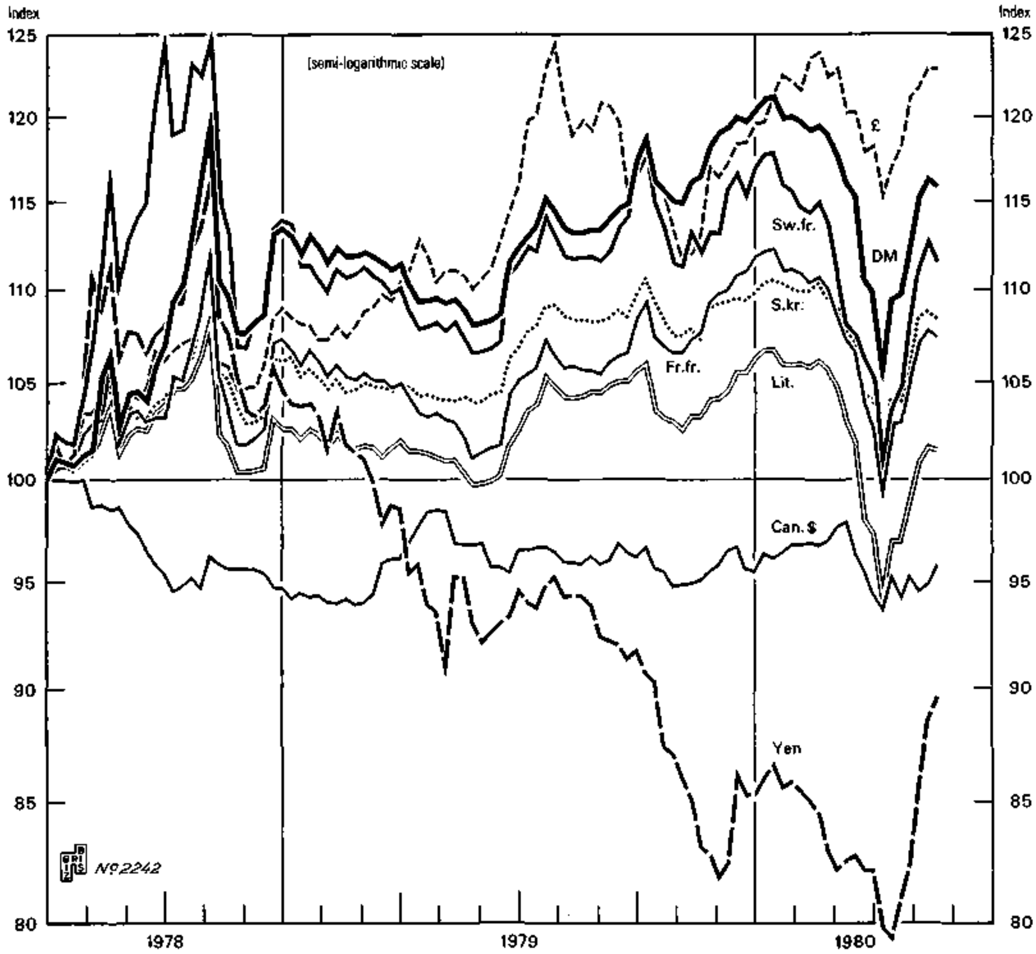
The strengthening of the dollar not only contributed to exchange rate movements that were quite different from those of 1977–78, it also improved the general condition of the exchange markets. During most of the period under review, although substantial official intervention was needed from time to time, markets were free of the exaggerated movements that had been seen in the two preceding years. In March and April 1980, however, the dollar first rose and then declined by about 10 per cent. against a number of other major currencies, with exchange rate movements of nearly 5 per cent. being recorded in the space of a single day.

Following support operations by the US authorities totalling $6.7 billion during the last two months of 1978, together with substantial purchases of dollars by the German, Japanese and Swiss authorities, the *US dollar* began to firm on its own from January 1979 onwards, as confidence strengthened and the large interest rate differentials in favour of the dollar began to dominate the exchange markets. By the end of April the US authorities had repaid all of their foreign currency indebtedness to other central banks; and by early June the dollar had recovered by about 10 per cent. from its 1978 low point on the trade-weighted basis, while against the yen, the Swiss franc and the Deutsche Mark it had risen by 25¾, 16½ and 10¾ per cent. respectively.

In mid-June, by which time the favourable interest rate differentials had narrowed considerably, the dollar came under downward pressure again and the US authorities sold the net equivalent of $4.7 billion in foreign currencies, mainly Deutsche Mark, during June and July. After stabilising in late July, the dollar weakened again in mid-September as US price inflation accelerated and the monetary aggregates kept growing faster than the target rate. The US authorities sold the DM equivalent of $4.2 billion in the market between early August and early October, while in September the Federal Reserve discount rate was raised to 11 per cent. During September the dollar lost 4¾ and 6½ per cent. respectively against the Deutsche Mark and the Swiss franc to stand at DM 1.74¼ and Sw.fr. 1.55¼ respectively at the end of the month. On the trade-weighted basis, however, the decline was little more than 1 per cent., mainly because the dollar was appreciating against the yen.

On 5th October the Federal Reserve announced a wide-ranging set of measures to tighten monetary control, described in Chapter IV, and the dollar began to appreciate against all major currencies. By early November the effective exchange rate had risen by 4¼ per cent. from its late-September level, surpassing its level in early June. After mid-November, however, political and economic events, including the seizure of the US Embassy in Tehran, the Soviet military intervention in Afghanistan, the further increase in oil prices and a surge in the prices of precious

Nominal exchange rates:
Indices of spot quotations for selected currencies vis-à-vis the US dollar.
Wednesday figures, end-June 1978 = 100.



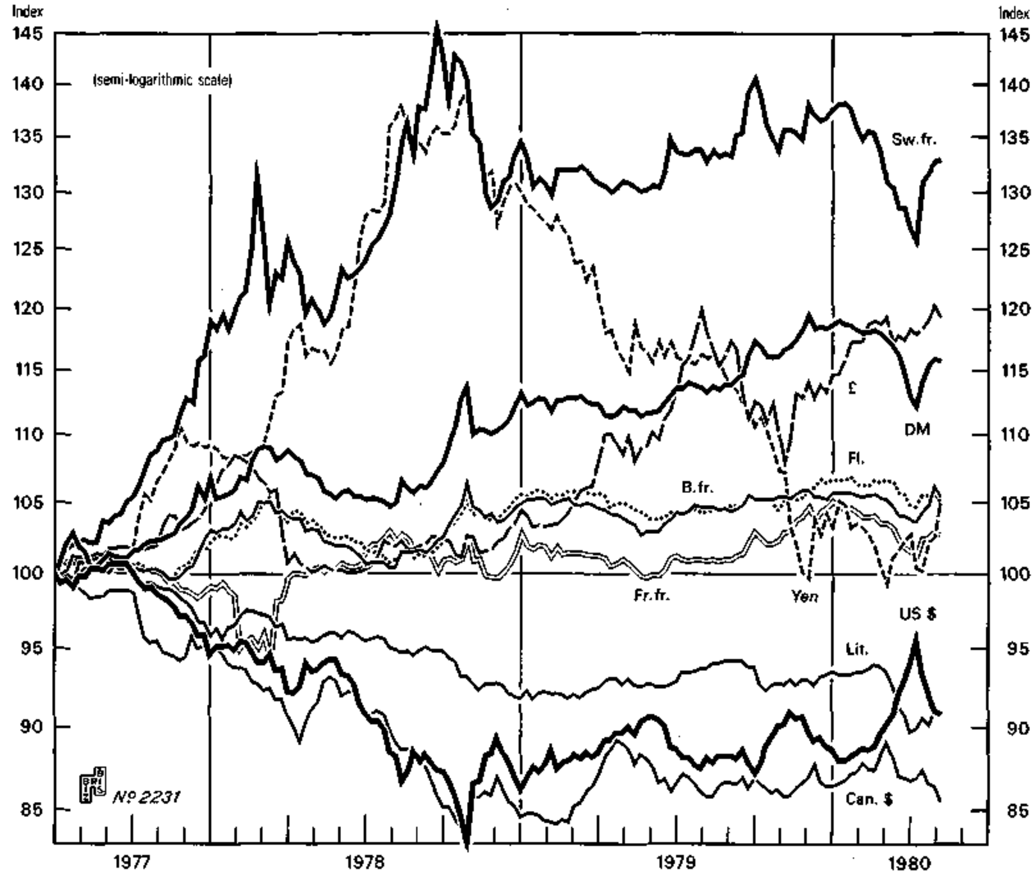
metals and some other commodities, gave rise to renewed pressure. By early January 1980 the effective exchange rate of the dollar stood about 3 per cent. below its early-June and early-November 1979 levels. Against the Deutsche Mark the dollar reached a record low point, around DM 1.70.

In mid-January 1980 market sentiment turned in favour of the dollar. Traders began re-assessing the vulnerability of other countries to the events cited above. Moreover, the current-account balance of payments of the United States had improved considerably in 1979, while those of Germany and Japan in particular had deteriorated. Following the announcement of the anti-inflationary monetary and fiscal package described in Chapter IV on page 69 and the further sharp rise in US interest rates, the dollar rose rapidly between 12th March and 1st April, gaining about 9¾ and 8½ per cent. respectively against the Deutsche Mark and the Swiss franc. This movement was quickly reversed when dollar interest rates began to decline in early April, narrowing the favourable differential vis-à-vis the Deutsche

Mark from about 10 percentage points to only about 1 point in mid-May. By late May the dollar had fallen against the Deutsche Mark by 9½ per cent., to DM 1.79, and against the Swiss franc by 11¼ per cent., to Sw.fr. 1.66.

Effective exchange rates.

Friday figures, indices: end-June 1977 = 100.



Source: Bank of England.

Between early January and late May 1979 the *Deutsche Mark* declined against the dollar from DM 1.80¾ to DM 1.92¼. During this period the Bundesbank intervened substantially to moderate the movement of the exchange rate, so that there was a $6.6 billion underlying reserve loss. In addition the US authorities purchased a net $4.5 billion worth of Deutsche Mark in the first half of the year. From mid-June onwards, with the Bundesbank's monetary policy increasingly geared towards containing inflationary pressures, the Deutsche Mark, which had for some weeks been strengthening against the other currencies participating in the EMS exchange rate mechanism, began to appreciate against the dollar too. Both the Bundesbank and the Federal Reserve intervened on a fairly large scale, and the pressure subsided after the Deutsche Mark had risen to DM 1.80¼ against the dollar in mid-July. At that point the effective exchange rate of the Deutsche Mark had gained 2¼ per cent. since mid-May and stood ¾ per cent. higher than its end-1978 level. However, from mid-September onwards, when the dollar came under renewed pressure, more funds were attracted into the Deutsche Mark than into other EMS currencies. The Bundesbank intervened strongly in the market, as reflected in the $2.4 billion underlying reserve gain in that month, and some other EMS participants sold large amounts of Deutsche Mark to support their currencies. Just prior to the EMS parity realignment on 24th September, the Deutsche Mark stood at DM 1.77¼ against the dollar, while its trade-weighted exchange rate had risen by 2 per cent. since mid-July. The Deutsche Mark was then revalued by 5 per cent. against the Danish krone and by 2 per cent. against other currencies participating in the EMS exchange rate mechanism.

Tensions within the EMS then subsided and after reaching DM 1.73¾ in early October the Deutsche Mark started to decline against the dollar too, its exchange rate reaching DM 1.81¼ later in the month. Further upward pressure on the Deutsche Mark developed in November, however, and in early December the rate against the dollar stood at just over DM 1.70. During the first quarter of 1980 the Deutsche Mark declined substantially against the dollar. By end-February the dollar rate had reached DM 1.77¼ and the decline accelerated in March as the differential between interest rates on short-term investments in the two currencies jumped to almost 10 percentage points. Early in April, when the dollar rate reached DM 1.97¾, the decline in the Deutsche Mark since early December worked out at 13½ per cent. against the dollar and at 5¼ per cent. on the trade-weighted basis. The subsequent rapid recovery brought the dollar rate back to DM 1.79 in late May, when the trade-weighted exchange rate of the Deutsche Mark stood 3 per cent. above its early-April level.

During the first five months of 1979 the exchange rate of the *Swiss franc* declined by 2¾ per cent. on the trade-weighted basis and by 7 and 2¼ per cent. respectively against the dollar and the Deutsche Mark. There were a number of factors behind this: the recovery of confidence in the dollar, a differential of 10 percentage points between short-term dollar and Swiss franc interest rates, the policy initiated in October 1978 of setting a ceiling on the exchange rate against the Deutsche Mark and the authorities' decision not to set a monetary growth target for 1979. Despite support operations totalling $7.5 billion by the Swiss authorities during March–May 1979, by late May the decline of the franc from its September 1978 peak amounted to 10¾ per cent. on the trade-weighted basis, while against the dollar and the Deutsche Mark, the exchange rates for which currencies had recovered to Sw.fr. 1.74 and 0.90½ respectively, it was about 16 per cent. On 31st May, the Swiss authorities revoked some of the restrictions on inflows of funds from abroad. These included the system of mandatory approval for foreign borrowing by the non-banking sector in excess of Sw.fr. 50,000; the requirement that banks' total foreign currency liabilities be covered by the total of their foreign currency assets at the end of each day; and the power — never invoked — of the Swiss National Bank to sterilise the Swiss franc proceeds of exchange-market interventions.

From mid-June onwards, as the dollar weakened, the franc began to appreciate again. By mid-July the dollar rate had fallen to Sw.fr. 1.62½ and by early October to Sw.fr. 1.54¼. At that point the trade-weighted exchange rate of the franc had risen by about 6 per cent. since end-May, although vis-à-vis the Deutsche Mark the exchange rate remained very stable at about Sw.fr. 0.90. Following the US measures on 6th October the franc rapidly lost the ground gained earlier and stood at around Sw.fr. 1.68 against the dollar in late October. It also declined against the Deutsche Mark to Sw.fr. 0.92¾. In early November the official discount and lombard rates were raised by one percentage point to 2 and 3 per cent. respectively, while by December the 10 per cent. per quarter negative interest charge on non-residents' Swiss franc deposits had also been lifted. By late December the franc had stabilised at around Sw.fr. 1.60 against the dollar.

During the first three months of 1980 the franc depreciated more than any other major currency, both against the dollar and on the trade-weighted basis. Against the dollar the decline amounted to 16 per cent., from Sw.fr. 1.57¼ to Sw.fr. 1.87¼, between 3rd January and 1st April. On the trade-weighted basis the decline amounted to 9 per cent. During this period the Swiss authorities took various measures aimed at checking the fall of the franc. On 21st February payment of interest was resumed on non-resident savings and deposit accounts at Swiss banks, as well as on foreign central banks' time deposits at the Swiss National Bank with maturities of six months or longer. A week later the Swiss National Bank raised its discount and lombard rates to 3 and 4 per cent. respectively, and in early March restrictions on forward sales of Swiss francs to non-residents were lifted. By mid-March, however, the differential between short-term dollar and franc rates was 13 percentage points. On 28th March the Swiss authorities announced their intention to prevent any further depreciation of the exchange rate against the Deutsche Mark, which by then had fallen to Sw.fr. 0.95, 20 per cent. below its late-September 1978 level. In the subsequent reversal the franc appreciated more than any other currency except the Japanese yen. By late May it had recovered by about 5½ per cent. on the trade-weighted basis and by 12¾ per cent., to Sw.fr. 1.66, against the dollar.

The decline in the external value of the *Japanese yen* between late 1978 and April 1980 was almost as dramatic as its earlier rise. Between the end of 1976 and the end of October 1978 the yen rose against the dollar from Yen 293 to Yen 176, subsequently declining to a low point of Yen 260 in early April 1980. During the course of these two periods the effective exchange rate first rose by 54 per cent. and then declined by 28 per cent. Although the basic causes of the yen's decline were a large turn-round in Japan's basic balance of payments and a rapidly worsening wholesale price inflation, both its pace and its magnitude suggest that confidence factors, too, played an important part. The change in the yen's position also shows up clearly in the published reserve figures: after increasing by $15.2 billion in the fifteen months to end-1978, the reserves declined by $14.5 billion in the subsequent fifteen months.

In the early months of 1979 the yen declined faster against the dollar than any other major currency. In view of this, the Japanese authorities abolished the marginal reserve requirement on non-resident free yen deposits, as well as the restrictions on non-resident purchases of Japanese securities. The Bank of Japan intervened heavily in the market, to the extent of about $6.4 billion during March and April, and raised its discount rate from 3½ to 4¼ per cent. on 17th April. Nevertheless, the yen declined against the dollar from Yen 196¾ at the beginning of the year to nearly Yen 225 in early May, before recovering to about Yen 212¾ in mid-May. At its low point the yen was about 21½ per cent. below its late-October 1978 peak against the dollar, while on the trade-weighted basis the decline amounted to 17¾ per cent.

The yen then stayed at around its mid-May level throughout the summer, both against the dollar and on the trade-weighted basis. After mid-October, however, a further rapid decline took place, as Japan's current-account balance of payments had moved into deficit and wholesale price rises had begun accelerating rapidly. Despite large-scale intervention by the Bank of Japan, whose reserves recorded a $5.2 billion underlying loss in October and November, and an increase in its discount rate from 5¼ to 6¼ per cent. on 2nd November, the yen declined by 15½ per cent. from its mid-May level to Yen 251½ against the dollar in late November. The decline in the trade-weighted exchange rate, at 16 per cent., was slightly larger. On 27th November further measures to stimulate capital inflows were taken. These included an increase in the ceiling on the amount of foreign currencies convertible into yen by banks operating in Japan and a more flexible attitude towards foreign borrowing by Japanese firms. The exchange rate then started to rise, jumping to Yen 231 against the dollar on 10th December.

The strengthening of the dollar during the first quarter of 1980, however, brought a further substantial decline in the yen's exchange rate despite the taking of a variety of measures to encourage capital inflows. These included the abolition in March 1980 of the ceiling on the amount of Euro-yen deposits Japanese banks could transfer to domestic offices, a liberalisation of interest rates on free yen deposits and the abolition of restrictions on Japanese banks' medium and long-term foreign currency lending to domestic firms. The discount rate of the Bank of Japan was increased, by 2¾ percentage points in two steps, to 9 per cent. by 19th March. In addition, the authorities continued to intervene forcefully in the market, and in April stand-by swap agreements totalling Yen 200 billion (about Sw.fr. 1½ billion) and DM 2½ billion respectively were concluded with the Swiss National Bank and the Deutsche Bundesbank. In early April the exchange rate against the dollar fell to Yen 260¾, its lowest point for thirty months. Subsequently, as the unfavourable interest rate differential against the dollar almost disappeared, the yen recovered rapidly to Yen 224 by late May.

Despite the major deterioration in the United Kingdom's current-account balance of payments, the *pound sterling* was the only major currency that recorded substantial gains both against the US dollar and on the trade-weighted basis during the period under review. This was the result partly of high domestic interest rates and partly of the view that the United Kingdom was among the least vulnerable of the industrialised countries to oil price increases. In February 1979 sterling began to advance against the dollar, which was itself appreciating against most other major currencies. By mid-April 1979 the effective exchange rate had gained 5½ per cent. since the beginning of the year, while against the dollar the rate had risen from $2.03½ to about $2.10. Sterling began appreciating strongly again in mid-June, as traders reacted favourably to the fiscal and monetary measures announced by the new Government (see Chapter II). With the Bank of England allowing the exchange rate to move more freely, by late July it had gained about 9 per cent. on the trade-weighted basis from its mid-April level and stood at a four-year peak of around \$2.33 to the dollar.

From August onwards, as inflation accelerated and favourable interest rate differentials narrowed considerably, sterling began to decline both against the dollar and on the trade-weighted basis. The decline accelerated in late October following the tightening of US monetary policy and the removal of all exchange controls in the United Kingdom. By early November sterling had fallen to \$2.06¼ against the dollar, and was 10 per cent. below its late-July peak on the trade-weighted basis. Funds began to flow back into sterling in mid-November, when the Bank of England raised its minimum lending rate by 3 percentage points to a record 17 per cent. The effect of this measure on the exchange rate was reinforced by events in Iran and by the announcement of large oil price increases. By mid-February 1980 sterling had been bid up again to over \$2.30, while the effective exchange rate had risen by 10¼ per cent. from its early-November level. Subsequently, as the earlier favourable differential between sterling and dollar interest rates was reversed, sterling started to decline against the dollar in March, reaching about \$2.14 in early April. A recovery then followed to \$2.32 in late May, when the effective exchange rate stood just above the earlier peak reached in July 1979.

On the trade-weighted basis the movements of the *French franc,* within a range of some 5½ per cent., were somewhat larger during the period under review than in 1978 (excluding the period around the parliamentary elections of March 1978), despite France's participation in the exchange rate mechanism of the European Monetary System. The movements of the bilateral exchange rates of the franc, however, were significantly less than in the earlier period. The relative stability of the franc during the period under review resulted from various factors: the continuing surplus on France's current-account balance of payments, the monetary policy pursued by the French authorities and the stronger performance of the dollar in the exchange markets.

During the first five months of 1979 the franc depreciated against the dollar by 7 per cent., from Fr.fr. 4.14¼ to Fr.fr. 4.45½, subsequently strengthening to about Fr.fr. 4.26 in late August. In the EMS exchange rate mechanism downward pressure on the franc developed during September as a result of large-scale capital flows into the Deutsche Mark. Official intervention by the Bank of France kept the franc from reaching its bilateral limit against the Deutsche Mark, while its dollar rate advanced to Fr.fr. 4.10 at end-September. After the 24th September realignment of the EMS central rates, funds started to flow back into the franc, which began to appreciate vis-à-vis other currencies in the EMS exchange rate mechanism, reaching the top of the band in mid-November. Against the US dollar the exchange rate, after declining to Fr.fr. 4.23¾ in late October, had risen to Fr.fr. 4.02 at the end of 1979. During the first four months of 1980 the franc's movements against the US dollar were similar to those of most other European currencies. By the beginning of April it had declined to Fr.fr. 4.55½ against the dollar, 11¾ per cent. below its end-1979 level, subsequently recovering to Fr.fr. 4.16 by late May.

After a depreciation of about 4¼ per cent. on the trade-weighted basis in 1978, the *Italian lira* lost a further 1¼ per cent. on balance during the period under review. Its trade-weighted fluctuations since end-1978, within a range of 5 per cent., have been about the same as those of the French franc. As with the franc, this stability was due to the combination of a strong current-account balance of payments and a relatively tight monetary policy. In fact, the lira was continuously the strongest currency in the EMS exchange rate mechanism from its start on 13th March 1979 up to the first parity realignment in September. Because of this, the lira was more stable against the dollar in the first eight months of 1979 than some other major currencies, with a 5½ per cent. fluctuation range between Lit. 811¾ and Lit. 857½.

When strains developed in mid-September within the EMS exchange rate mechanism, the lira lost some ground against other currencies in the system, but was never under any serious pressure, and its dollar rate advanced from Lit. 817 at end-August to Lit. 801 in early October. Thereafter, the lira tended to weaken both against the dollar and against other participants in the EMS exchange rate mechanism until the Bank of Italy's discount rate was raised by 3 percentage points, to 15 per cent., on 6th December. Its dollar rate stood at Lit. 804 at the end of the year. The subsequent strengthening of the dollar brought the lira to a four-year low point of Lit. 912 in early April 1980. From mid-April onwards the lira was the weakest of the currencies participating in the EMS exchange rate mechanism, but against the dollar it had strengthened by late May to Lit. 840.

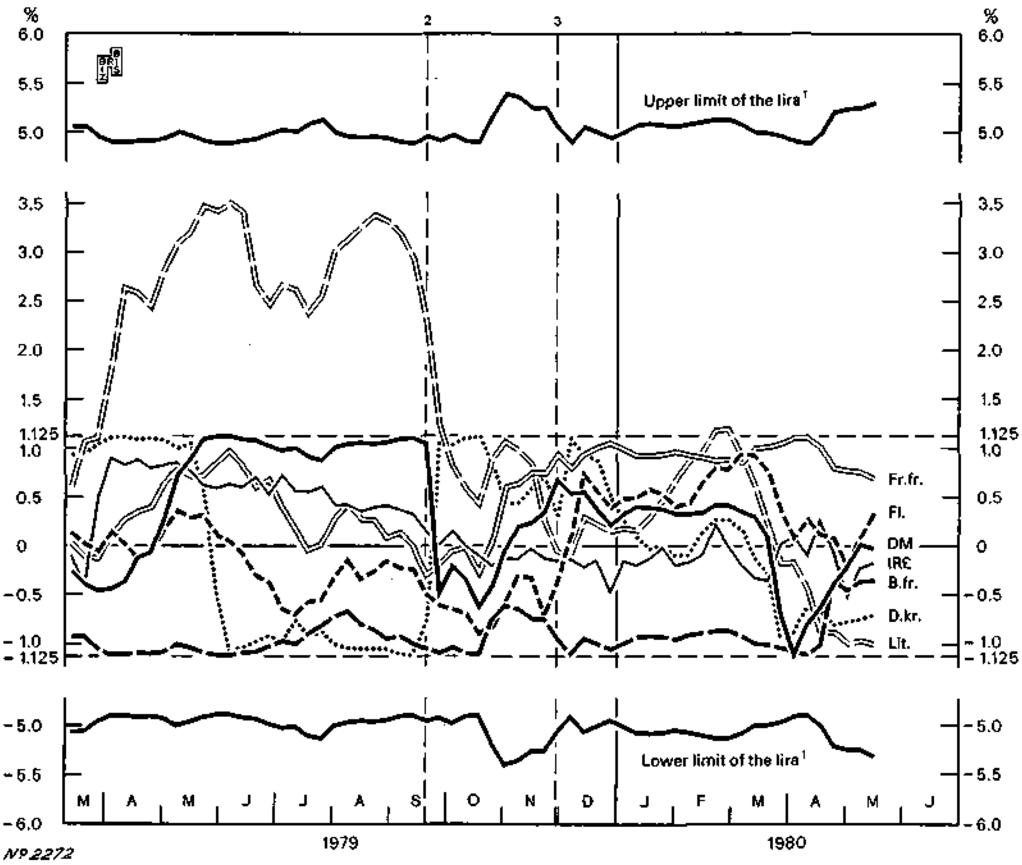
After two successive years in which its effective exchange rate had depreciated by about 10 per cent., the *Canadian dollar* recorded a moderate gain of about 3 per cent. during the period under review. Against the US dollar, the level of US$ 0.83¼ recorded in early February 1979 proved to be the low point. Later that month the Canadian dollar started to strengthen against the US currency, which itself was appreciating against most major European currencies and the yen. By end-April the Canadian dollar had risen to US$ 0.87¾ and its trade-weighted index was about 5½ per cent. higher than at the end of 1978. After losing some of its earlier gains in May the dollar stabilised at between US$ 0.84¼ and US$ 0.86½ during the rest of 1979. Its fluctuation on the trade-weighted basis was also confined to a range of 2¼ per cent. During the first two months of 1980 the Canadian dollar gradually strengthened further, to over US$ 0.87 in late February. Following the sharp rise in US interest rates in mid-March, however, it declined to below US$ 0.84 in early April, although its effective exchange rate was still 2¾ per cent. above its end-1978 level. On 2nd April the discount rate of the Bank of Canada, which had been set since 13th March at ¼ percentage point above the weekly Treasury bill tender rate, reached 16.2 per cent., so that the unfavourable interest rate differentials vis-à-vis the US dollar were narrowed considerably. By late May the Canadian dollar had recovered to US$ 0.86¼, partly reflecting the general weakening of the US dollar since mid-April.

The exchange rate mechanism of the *European Monetary System,* which came into operation on 13th March 1979, enlarged the area of fixed but adjustable exchange rates among European currencies to include the French franc, the Italian lira and the Irish pound. This greater stability can be seen from the fact that since the mechanism came into effect market movements in the exchange rate of the Deutsche Mark against the French franc have been limited to about 2¾ per cent., as compared with movements of 8½ per cent. in 1978, excluding the February–March 1978 election period in France. The lira, too, although its permitted margins of fluctuation against other participating currencies are 6 per cent. on either side of bilateral central rates, has been more stable than before against the Deutsche Mark. Since the inception of the EMS the lira's range of movement against the Deutsche Mark has been about 6½ per cent., as against 12 per cent. in 1978.

The operation of the system has been helped by the relatively stronger performance of the dollar in the exchange markets, and the relatively weaker performance of the Deutsche Mark — as is shown by the fact that the only period of real strain so far was in September 1979, when the weakness of the dollar led to strong upward pressure on the Deutsche Mark. The very rapid appreciation of the dollar during the first part of 1980, on the other hand, did not affect the stability

Spot exchange rates in the EMS exchange rate mechanism.

Weekly averages, in percentages, of participants' currencies in relation to their intervention point.



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¹ The lira's position is shown by its percentage deviation from the weakest and the strongest currency within the 2¼ per cent. band; its maximum and minimum permissible position is indicated by the top and the bottom line in the graph. ² The realignment on 24th September 1979 (the Deutsche Mark was revalued by 5 per cent. vis-à-vis the Danish krone and by 2 per cent. vis-à-vis all other currencies). ³ On 30th November 1979 the Danish krone was devalued by 4.76 per cent. vis-à-vis all other participating currencies.

of the system. At the same time divergences in member countries' economic performances, including their rates of price increase, have necessitated two moderate realignments of exchange rates since March 1979, and the longer-term success of the system will certainly depend on a reduction of these divergences.

In the opening months of the mechanism's existence, the Belgian franc was consistently at the bottom of the band, requiring support from time to time at its bilateral margins and crossing its "divergence threshold" against other participating currencies on 3rd May 1979. The National Bank of Belgium raised its discount rate in three steps from 6 to 9 per cent. in May and June, and the franc subsequently rose above the divergence threshold, although remaining near the bottom of the band. In early June the franc was joined at the bottom by the Danish krone, which also reached its divergence threshold. The National Bank of Denmark raised its discount rate from 8 to 9 per cent. on 15th June, and the krone then rose above the threshold without large-scale interventions.

In September 1979, when the weakness of the dollar caused strong upward pressure on the Deutsche Mark, the Belgian and Danish central banks sold large amounts of Deutsche Mark at or near the margins, and the Bank of France also sold sizable amounts of Deutsche Mark, although the French franc was well within its margins. The Bundesbank, too, intervened on a large scale, both against dollars and against other EMS currencies. Before any currency had reached its divergence threshold, the Deutsche Mark was revalued on 24th September by 5 per cent. against the Danish krone and by 2 per cent. against all other participating currencies.

Since then the system has again been free from major strains. There was no market turmoil before or after the second realignment on 30th November, when the Danish krone was devalued by 4.76 per cent. against all other participating currencies. The French franc has been the strongest currency in the system most of the time since mid-November 1979, while until very recently the Belgian franc continued to be at the bottom of the band. By late February 1980 the National Bank of Belgium had, despite Belgium's relatively low inflation rate, raised its discount rate to 12 per cent., while by April 1980 its cumulative reserve loss since the system's inception came to $2.5 billion. Since mid-April, however, the Belgian franc has left the bottom of the band, and the Italian lira has become the weakest currency for the first time since the system came into operation.

Assessment of post-November 1978 currency developments.

The stronger performance of the dollar and the greater stability of other major currencies (with the exceptions of the yen and the pound sterling) which have been described in the preceding section were the outcome of two major factors. One was the reversal of the current-account balances of payments of a number of countries in 1979, in particular the virtual elimination of the US deficit and the large shifts from surplus to deficit in Germany and Japan. The other factor was the increased commitment to exchange rate stability of a number of major countries. The most important development in this area has been the change since November 1978 in the attitude of the US authorities towards the exchange rate of the dollar, as manifested in both their exchange-market interventions and their monetary policy. In addition, there has been the commitment of the Swiss authorities to greater exchange rate stability since October 1978 and the coming into operation of the European Monetary System in March 1979, with the enlargement of the intra-European system of fixed but adjustable exchange rates to include the French franc, the Italian lira and the Irish pound.

Both these factors were necessary to obtaining the greater degree of exchange rate stability that prevailed in 1979, and the improvement in confidence which went with it. Some of last year's changes in current-account balances of payments, and in particular a decline in the US deficit, were already beginning to be apparent before November 1978. However, the markets ignored this development so long as the US authorities were not committed to strong and direct action, through intervention and interest rate policies, to support the dollar. Equally, the decline of the yen during 1979 shows that an active intervention policy cannot offset the effects of basic weakness in the balance of payments, while the cost of supporting the Belgian franc during a period of substantial deficit on current external account has included heavy reserve losses and a very high level of real interest rates. It may be added that the strengthening of the dollar, because of that currency's leading position in the monetary system, has in itself been a cause of the generally greater stability of other major currencies.

Looking to the future, while the change in the pattern of balance-of-payments disequilibria among major industrialised countries has removed an important factor that had contributed to earlier exchange rate instability, there is a possibility that the present pattern may reverse itself in the medium run, putting renewed pressure on exchange rates. An important consideration in this context is the continued existence of large inflation differentials between countries. While most of the changes in real exchange rates since November 1978 have been in the right direction from the point of view of current-account balance-of-payments developments, it may be doubted whether these changes would be sustainable with a different pattern of current-account balances of payments among the major countries. Some of last year's exchange rate movements were adjustments to earlier "overshooting"; however, countries in which the price level increases persistently faster than in their main trading partners cannot, over the longer run, avoid depreciation of their currencies. If, therefore, last year's greater exchange rate stability is to be consolidated it will be necessary to achieve more convergence of inflation rates, and to do so at an average level significantly lower than exists at present.

Another problem concerns the sharp fluctuations of exchange rates which have again been seen in recent months. This problem has two aspects. One is the less than symmetrical reactions of central banks to depreciation and appreciation of their currencies. Outside the European Monetary System and, earlier, the joint European float against the dollar, countries whose currencies were rising in value have sometimes seen less cause to intervene in the exchange market than those whose currencies were depreciating. Among the reasons for this difference of approach has been, of course, the desire of weak-currency countries to avoid "vicious circles" and the acceptance by strong-currency countries of "virtuous circles". The recent fluctuations of the dollar against European currencies suggest that there is scope for more symmetrical intervention policies in helping to eliminate exchange rate movements that are unrelated to fundamental factors.

The other aspect of this problem is that the sharp rise in the dollar's exchange rate in March 1980 was set off by exceptionally high interest rates in the United States. The recent acceptance in some countries of wide swings in interest rates over short periods may make it harder to co-ordinate policies to minimise exchange rate instability. These wide swings in interest rates are a consequence of high inflation rates and inflation differentials, without a reduction of which exchange rate instability is likely to recur from time to time.

Gold production and the gold market.

In 1979 world gold production (excluding that of the USSR and other eastern European countries, China and North Korea) fell back from above 950 to 935 metric tons. The decline chiefly reflected reduced output in North America, Spain and Papua-New Guinea.

Production in South Africa, at 705 tons, remained at virtually the same level as in 1978. The total of ore milled increased by a further 6.9 per cent. (following a rise of 4.9 per cent. in 1978), while the average gold content of the ore, which had fallen by 4 per cent. in 1978, went down by a further 7.5 per cent. Last year's very steep rise in the price of gold meant that as well as continuing the policy of extracting lower-grade ore the South African mining companies were also able to accommodate a further 11.2 per cent. increase in production costs while recording a 77 per cent. rise in average profits from gold mining.

World gold production.

Countries	1929	1940	1946	1953	1970	1976	1977	1978	1979
	in metric tons								
South Africa	323.9	436.9	371.0	371.4	1,000.4	713.4	699.9	706.4[1]	705.4[1]
Canada	60.0	165.9	88.5	126.1	74.9	52.6	53.9	54.0	49.1
United States	64.0	151.4	49.0	60.9	54.2	32.6	34.2	31.1	27.6
Papua-New Guinea	.	.	.	.	0.7	20.8	23.0	24.1	20.9
Australia	13.3	51.1	25.6	33.4	19.3	15.7	19.4	20.0	18.2
Philippines	5.1	34.9	—	14.9	18.7	15.6	17.4	18.2	16.7
Ghana	6.4	27.6	18.2	22.7	22.0	16.6	15.0	12.3	13.2
Zimbabwe	17.4	25.7	16.9	15.6	15.6	11.2	11.7	10.8	11.8
Colombia	4.3	19.7	13.6	13.6	6.3	9.3	8.2	8.0	8.3
Mexico	20.4	27.4	13.1	15.0	6.2	5.1	6.6	6.2	6.4
Brazil	3.3	4.7	4.4	3.6	5.3	4.9	4.9	5.4	5.4
Spain	.	.	.	.	.	9.4	9.8	8.6	5.1
Japan	9.3	12.6	1.3	7.1	7.9	4.3	4.6	4.6	4.6
Total listed	527.4	957.9	601.6	684.3	1,231.5	911.5	908.6	909.7	892.7
Other countries	43.1	207.1	64.9	69.9	36.0	49.6	44.2	43.3	43.7
Estimated world total[2]	570.5	1,165.0	666.5	754.2	1,267.5	961.1	952.8	953.0	936.4

[1] Including gold production of Bophuthatswana. [2] Excluding the USSR, eastern Europe, China and North Korea.

In addition to the drop in total western production there was an estimated decline of some 160 tons — from 450 to 290 tons — in market sales of gold by communist countries in 1979. The reduction in supplies from these two sources was, however, more than offset by an increase from 320 to 605 tons in net sales of gold out of western gold reserves. The total supply from US Treasury gold auctions came to 412 tons, compared with 79 tons the previous year. IMF auctions provided another 170 tons — slightly down from the figure of 184 tons in 1978 — while other net sales from western gold reserves declined from 57 tons in 1978 to 23 tons in 1979. Thus, for the third year in succession total net supplies of gold to the market increased significantly, to an estimated figure of 1,830 tons. At that level they were 105 tons higher than in 1978 and 365 tons, or about 25 per cent., higher than in 1976, the year when the IMF auction programme started.

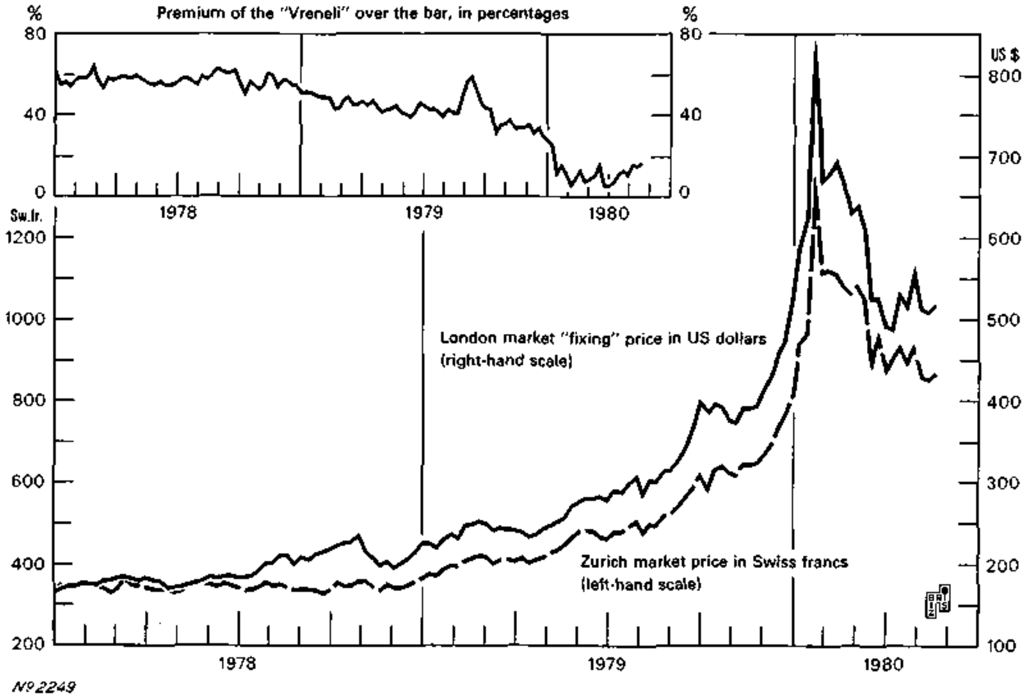
Estimated sources and uses of gold.

Items	1976	1977	1978	1979
	in metric tons			
Production	960	955	955	935
Estimated sales by communist countries	350	450	450	290
Decline in western official gold stocks (net)	155[1]	195[1]	320[2]	605
Total (= estimated non-monetary absorption)	1,465	1,600	1,725	1,830

[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.

The further increase in supplies was overshadowed by the dramatic rise in demand for gold which, in the space of little over a year, caused the London market price to increase more than fourfold to a peak of $850 per ounce in January 1980. In addition to its sheer magnitude, last year's gold price rise had three other remarkable features: firstly, it took place against all major currencies, including those whose value had increased most during the 1970s. As the graph on page 147 shows, the Swiss franc price of gold went up by virtually as much in percentage terms as the dollar price. Secondly, it took place at a time of generally rising interest rates in the industrialised world, one effect of which was to increase the cost of holding gold. Thirdly, it took place at a time when, by and large, the dollar was strengthening in the exchange markets. The deficit on the current balance of payments of the United States was virtually eliminated last year, while the capital account benefited from the widening of the gap in favour of US dollar interest rates. In short, last year's gold fever had three main causes: the accelerating rates of price increase recorded in most of the industrialised world, which led to a weakening of confidence in all major currencies; the effect of this inflation on OPEC investment preferences in a year when OPEC countries moved back into very large payments surplus; and, in late 1979 and early 1980, the effects of political events in Iran and Soviet military intervention in Afghanistan.

Market prices of gold bars in US dollars and Swiss francs, 1978–80.
Friday figures, per fine ounce.



At the beginning of 1979 the gold price continued the rise which had started from a low point of \$193.4 per ounce on 30th November 1978 and which by 8th February had raised quotations on the London market to \$254, an increase of 31 per cent. in slightly more than two months. A downward reaction then ensued and on 17th April the price stood at \$231.75. Soon, however, the price began to rise again. On 18th April the US Treasury announced a halving of the quantity of gold to be sold at its monthly auctions and in addition there was increasing concern about the oil situation in the light of the events in Iran and OPEC's pricing policy. In July the absence of short-term measures from the US Administration's new energy policy accentuated the movement and on 26th July the quotation at the London morning fixing reached an intermediate peak of \$307.

After a short-lived fall in the price to slightly above \$280 in early August renewed buying interest developed, encouraged by the continuing uncertainties concerning oil supplies and exchange rate movements as well as by the increasing inflationary pressures. News that at the US Treasury auction on 21st August one German bank had bid for nearly the entire amount auctioned reinforced the movement and on 6th September, in increasingly unsettled trading conditions, the gold price rose above \$340. On 17th September it went above \$350 and the next day to \$370. After passing \$400 on 1st October, the price reached a peak of \$437 the next morning at the London market fixing.

A sharp reaction then occurred, bringing prices down by \$70 in just three days; and after a recovery to \$413 on 10th October the price fell back again below

$400 two days later. Trading conditions became calmer and there was no apparent reaction to the announcement on 16th October by the US Treasury that its future gold auctions would be subject to variations in amounts and dates of offering. When on 25th October the Treasury announced an auction to be held a week later for an amount two-thirds higher than that of the previous sale, the downward movement was resumed. On 2nd November — the day following the Treasury auction — a low of $372.8 was reached and the gold price fluctuated between $378 and $397 in the following three weeks.

In the last few days of November 1979 large-scale buying developed again and the price of gold, which had roughly doubled since November 1978, more than doubled again within the space of two months, to $850 on 21st January. The new elements which brought about this unprecedented development were fears of war, in the light of events in Iran and Afghanistan, and a further large increase in oil prices. Thus, in the last week of November the taking of hostages in the US Embassy in Tehran and the attack on the Grand Mosque at Mecca helped to raise quotations above $400 again. On 13th December, just before the OPEC meeting in Caracas, they reached $450, while on 19th December, when it emerged that oil price increases in 1980 would be higher than anticipated, they topped $494. By the end of the year, following the Soviet intervention in Afghanistan, the price had reached $525. Then began the final three weeks of hectic trading, which culminated in a $200 rise between 14th and 21st January to an all-time peak of $850.

The fall in the price of gold that then immediately followed was even sharper than the preceding rise. In the space of two days the London market price declined by $200, to $650 on 23rd January. Several subsequent rallies above $700 were short-lived and by early March quotations were below $600. In the meantime, US interest rates were breaking all records, making investments in US short-term paper particularly attractive, and shortly after the prime rate climbed to 18 per cent. the price of gold fell to $474. A prompt recovery brought quotations above $500 and in late May the market price was around $510.

In the gold coin market the rise in prices during 1979 was less sharp than for gold bullion. For example, the premium of the Swiss Vreneli over the value of its gold content declined over the year from 52 to 28 per cent. When the bullion price reached its peak on 21st January 1980 the premium of the Vreneli was less than 10 per cent. and in the following two months the prices of coins fell even more sharply than the bullion price, until the Vreneli premium had come down to about 5 per cent. near the end of March. Subsequently, it rose to around 19 per cent. in late May.

International liquidity.

International liquidity developments during the period under review were, in a number of respects, markedly different from those observed during 1977 and 1978, and they led to considerable changes in the asset structure of global reserves. Four main developments stand out from the summary figures in the table on page 149. Firstly, total foreign exchange reserves, after having risen by $102 billion during 1977–78, showed a slight decline of $6.5 billion. If the $16 billion of dollar reserves swapped against European currency units (ECUs) by participants in the European Monetary System are counted as still being part of exchange reserves, then the latter would have shown a slight increase, of $9.5 billion. Secondly, the most important reason for the different evolution of total exchange reserves in 1979 was the contractionary effect exerted by the improvement in the US balance of payments. This effect was twofold: the virtual elimination of the US current-account deficit brought to an end the provision of net dollar reserves to the rest of the world; and, in addition, there were large net inflows of capital to the United States in 1979, following the large net outflows in the two preceding years. The combined effect of these two factors was that the total of dollar reserves held in the United States, which had risen by $64.3 billion in 1977–78, showed a $13.1 billion decline in 1979.

Thirdly, there was a considerable expansion of net reserves held in forms other than foreign exchange assets. Gold reserves were boosted, despite a 9 per cent. decline in their volume, by the very large increase in the market price of gold and there was a further allocation of special drawing rights to virtually all members of the International Monetary Fund in the amount of SDR 4 billion, or $5.3 billion.

Fourthly, a new reserve asset, the European currency unit, was introduced into the monetary system through swaps against gold and dollars from the reserves of member countries of the European Monetary System. Since the gold swapped against ECUs is valued at market-related prices, the creation of ECUs through gold swaps has made explicit (to the extent that countries had not already revalued their gold reserves at market-related prices) the impact of the gold price increase on this part of EMS countries' gold reserves. In addition to this "optical" effect, the gold/ECU swaps also produced some increase in the liquidity of this part of EMS countries' reserves, since ECUs are transferable between EMS monetary authorities.

As regards the details of the changes during 1979 in the asset composition of global reserves, the total of countries' gold reserves (excluding gold swapped

Changes in the asset composition of global reserves, 1977–79.

Items	1977–78	1979
	in billions of US dollars	
Foreign exchange reserves	102.0	− 6.5
Gold reserves		
at $ 42.22 per ounce	0.4	− 3.9
at market prices	94.4	255.2
Special drawing rights	0.5	5.9
IMF reserve positions	− 1.3	− 3.9
European currency units		41.9
Memorandum items:		
US current-account balance of payments	*− 27.6*	*− 0.3*
Changes in dollar reserves held in the United States	*64.3*	*− 13.1*

by EMS participants against ECUs, which is counted as reserves held in the form of ECUs) declined in volume by about 9 per cent., or 92.1 million ounces. Over 90 per cent. of this decline, or 85.3 million ounces, was accounted for by the swaps of gold against ECUs mentioned above.

In sharp contrast to the decline in the volume of official gold reserves (excluding the gold swapped against ECUs) there was a $255 billion increase in their market value during 1979 as a result of the rise in the market price of gold from about $225 to $525 per ounce in the course of the year. The bulk of this increase in the market valuation of gold reserves, or $199 billion, accrued to the Group of Ten countries and Switzerland, a further $27 billion to the rest of the developed world and $18 and 11 billion respectively to the non-oil developing countries and the oil-exporting countries.

These valuation changes on the basis of market prices cannot, of course, be taken as representing the actual increase in the effective value of gold reserves, since the gains resulting from the rise in the market price of gold can be fully realised only by market sales of the metal. Nevertheless, last year's rise in the market price of gold certainly produced substantial, if unquantifiable, reserve gains for countries with significant official gold holdings. For one thing, a part of these notional gains can in fact be realised by sales of gold to the market. Secondly, gold reserves can be used as collateral for borrowing, either on the international financial markets or from other monetary authorities, at market-related prices. Thirdly, the rise in the market value of their gold reserves may enlarge the scope for countries in balance-of-payments deficit to use their other reserve assets.

Official reserves other than those held in the form of gold, including the ECU holdings of EMS member countries, increased during 1979 by $37.4 billion, or nearly 12 per cent. This compared with increases of $58.5 billion in 1977 and $42.7 billion in 1978. More than the whole of last year's increase in non-gold reserves, or $41.9 billion, took the form of ECUs. At the end of 1979 $16 billion worth of ECUs were outstanding under swaps against dollars from EMS participants' exchange reserves and the remaining $25.9 billion under gold swaps. While the ECU/dollar swaps represented an exchange of conventional liquid foreign exchange reserves for assets usable between EMS monetary authorities, the creation of ECUs through swaps against gold resulted in an increase in EMS member countries' total reserves in the sense explained on page 149.

Total SDR reserves increased by $5.9 billion in 1979. Of this amount, $5.3 billion came from new allocations at the beginning of the year, $0.4 billion from transfers of SDRs from the General Account of the IMF to Fund member countries, and $0.2 billion from the effect on the dollar value of countries' SDR holdings of the slight appreciation of the SDR basket against the US dollar which took place during the course of the year.

Countries' total reserve positions at the IMF showed a further $3.9 billion decline during 1979. This was the result of two separate developments. Firstly, member countries further reduced their net recourse to the Fund's resources by SDR 2.4 billion in 1979, with a substantial part of these repayments being made by countries which had drawn earlier on the credit tranches of their Fund quotas.

Changes in global reserves, 1977–79.

Areas and periods	Gold		Foreign exchange	IMF reserve positions	SDRs	ECUs	Non-gold total
	in millions of ounces	in billions of US dollars*					
Group of Ten + Switzerland							
1977	7.5	26.4	34.2	1.1	− 0.2		35.1
1978	3.2	51.5	35.6	− 2.6	− 0.1		32.9
1979	− 95.0	199.3	− 30.4	− 2.3	3.7	41.2	12.2
Amounts outstanding at end-1979	*740.7*	*388.1*	*109.7*	*9.0*	*11.2*	*41.2*	*171.1*
Other developed countries							
1977	− 5.4	2.0	1.7	—	− 0.1		1.6
1978	− 1.3	5.3	9.9	0.3	0.3		10.5
1979	0.5	27.1	0.9	− 0.1	0.2	0.7	1.7
Amounts outstanding at end-1979	*90.7*	*47.5*	*33.0*	*1.3*	*1.2*	0.7	*36.2*
Developing countries other than oil-exporting countries							
1977	2.4	2.0	10.8	0.1	—		10.9
1978	2.9	3.9	13.7	0.4	0.3		14.4
1979	2.1	17.7	7.6	0.3	1.2		9.1
Amounts outstanding at end-1979	*57.8*	*30.3*	*68.0*	*1.2*	*2.6*		*71.8*
Total oil-importing countries							
1977	4.5	30.4	46.7	1.2	− 0.3		47.6
1978	4.8	60.7	59.2	− 1.9	0.5		57.8
1979	− 92.4	244.1	− 21.9	− 2.1	5.1	41.9	23.0
Amounts outstanding at end-1979	*889.2*	*465.9*	*210.7*	*11.5*	*15.0*	*41.9*	*279.1*
Oil-exporting countries							
1977	− 2.6	0.7	10.6	0.2	0.1		10.9
1978	1.9	2.6	− 14.5	− 0.8	0.2		− 15.1
1979	0.3	11.1	15.4	− 1.8	0.8		14.4
Amounts outstanding at end-1979	*37.2*	*19.5*	*70.5*	*4.0*	*1.4*		*75.9*
All countries							
1977	1.9	31.1	57.3	1.4	− 0.2		58.5
1978	6.7	63.3	44.7	− 2.7	0.7		42.7
1979	− 92.1	255.2	− 6.5	− 3.9	5.9	41.9	37.4
Amounts outstanding at end-1979	*926.4*	*485.4*	*281.2*	*15.5*	*16.4*	*41.9*	*355.0*

* Gold reserves valued at market prices.

Such repayments of credit-tranche drawings produce a decline in the Fund reserve positions of the countries whose currencies are used for repayment, but without giving rise to any reconstitution of Fund reserve positions in the countries which make the repayments. Secondly, out of a total of gross new drawings on the Fund last year of SDR 1.8 billion, SDR 1.3 billion was drawn in SDRs and only SDR 0.5 billion in currencies. As drawings in SDRs, unlike those in currencies, do not give rise to an increase in any member country's Fund reserve position, such drawings made by countries which themselves had Fund reserve positions resulted in a decline in total Fund reserve positions.

Finally, there was a dramatic change in the evolution of total foreign exchange reserves in 1979. After having risen by $102 billion during 1977–78, they showed a slight decline of $6.5 billion in 1979. Most of this remarkable shift occurred in the Group of Ten countries and Switzerland. Their total foreign exchange reserves, which had increased by about $35 billion in each of the two preceding years — to a large extent as a result of the balance-of-payments deficit of the United States — declined in 1979 by $30.4 billion, about half of which was accounted for by EMS member countries' swaps of dollar reserves against ECUs. The total exchange reserves of the rest of the world, on the other hand, showed a further increase of $23.9 billion, after gains of $23.1 billion in 1977 and $9.1 billion in 1978.

This shift in the distribution of total exchange reserves away from the Group of Ten and Switzerland to other countries had consequences for both the location and the currency composition of official foreign exchange holdings. Group of Ten countries other than the United States hold their exchange reserves mainly in the United States and in the form of US dollars, whereas other countries invest a greater part of their exchange reserves with banks outside the United States and in currencies other than the dollar. These differences in exchange reserve policies were reflected last year in a $13.1 billion decline in dollar reserves held in the United States, accompanied by a $35.1 billion increase in identified official foreign exchange holdings with banks outside the United States, of which $14 billion was in currencies other than the dollar.

Turning to the country distribution of last year's changes in global reserves, mention has already been made of the fact that the main beneficiaries of the increase in the market price of gold were the Group of Ten countries and Switzerland, which together hold 80 per cent. of countries' total gold reserves. Leaving this development on one side, the salient features of last year's changes in the country distribution of non-gold reserves (including ECUs) were the sharp slowdown in reserve growth of the oil-importing countries and accelerated reserve growth in the group of oil-exporting countries.

In the oil-importing world taken as a whole, non-gold reserves increased by $23 billion, or 9 per cent., as against a rise of $58 billion, or 29 per cent., in 1978. The oil-exporting countries' reported non-gold reserves, on the other hand, increased by $14.4 billion, after having declined by $15.1 billion in 1978. Last year's reported increase in OPEC reserves, it should be added, considerably understates the build-up of these countries' external liquid assets. Banks in the Group of Ten countries, Switzerland, Austria, Denmark and Ireland, together with the branches of US banks located in the principal offshore banking centres, received new deposits from OPEC countries totalling $37.8 billion in 1979. While a significant proportion of these balances may belong to non-official OPEC holders, it is likely that the build-up of liquid external assets by official OPEC holders last year was larger than is indicated by the figures in the table on page 151.

In the oil-importing world, the non-gold reserves (including ECUs) of the Group of Ten countries and Switzerland rose by $12.2 billion. US non-gold reserves registered a small gain of $0.8 billion, with a $1.2 billion SDR allocation and a $0.2 billion increase in the IMF reserve position partly offset by a $0.6 billion decline in official holdings of foreign exchange. Non-gold reserves of Group of Ten countries that are participants in the European Monetary System increased during 1979 by $27.2 billion, a very large part of which was accounted for by the effects of the swaps of part of these countries' gold reserves against ECUs at market-related prices. France's non-gold reserves went up by $8.3 billion, and those of Italy, Germany and the United Kingdom by $7.1, 4.1 and 3.8 billion respectively. The non-gold reserves of other Group of Ten countries declined by $15.8 billion in 1979. Japan's reserves fell from $32.4 to 19.5 billion as a consequence of large-scale intervention to support the yen in the exchange market. In addition, Switzerland's non-gold reserves showed a decline of $1.3 billion.

The non-gold reserves of developed countries outside the Group of Ten increased by only $1.7 billion in 1979, after a gain of $10.5 billion in 1978. Spain and Norway added $3.1 and 1.4 billion respectively to their reserves, while Yugoslavia and Austria experienced declines of $1.1 and 1 billion.

Despite the increase in their combined current-account payments deficit, non-oil developing countries showed a further $9.1 billion expansion in their non-gold reserves in 1979. In Latin America, Argentina's reserves went up by $4.4 billion, and those of Colombia, Peru and Chile by $1.5, 1.1 and 0.8 billion respectively. Brazil's non-gold reserves, on the other hand, declined by $2.9 billion. Elsewhere in the non-oil developing world, there were reserve gains of $1 billion, $0.7 billion and $0.5 billion in India, Malaysia and the Philippines.

The $14.4 billion reported increase in the non-gold reserves of oil-exporting countries represented little more than one-fifth of these countries' combined current-account payments surplus for 1979. The largest reported reserve gains were in Nigeria ($3.7 billion), Iran ($3.2 billion), Libya ($2.2 billion), Indonesia ($1.4 billion) and Venezuela ($1.2 billion). Saudi Arabia's reported non-gold reserves were virtually unchanged.

Reserve developments in the first quarter of 1980 were in several respects quite similar to those during 1979. A further overall surplus in the US balance of payments caused by inflows of private funds into the United States gave rise to a decline in official foreign exchange reserves held in the United States, while at the same time holdings of SDRs, as well as foreign exchange reserves held in the form of Euro-currency deposits, showed increases. As in 1979, the decline in conventional dollar reserves was concentrated on the Group of Ten countries and Switzerland. Official non-gold reserves of Group of Ten countries excluding the United States declined by $8.1 billion, while US non-gold reserves increased by $2.5 billion.

In view of the deterioration in their current-account balances, the reserve holdings of oil-importing countries outside the Group of Ten are unlikely to have shown any increase during the first quarter of 1980, and the combined non-gold reserves of all oil-importing countries taken together probably declined. In addition, the market value of their gold reserves decreased somewhat, since the market price of gold at the end of March 1980 was below the end-1979 level. Liquid official assets of OPEC countries, largely in the form of Euro-currency deposits, seem to have shown a further large increase during the first quarter of 1980.

The present situation and outlook for global reserves and their asset composition.

As described earlier in this chapter, three main developments influenced the evolution of global reserves during the period under review: the elimination of the current external deficit of the United States, combined with the re-emergence of a large OPEC surplus; the increase in the market price of gold; and the introduction, as a reserve asset, of the European currency unit. The combined effects of these developments can be summed up in three main conclusions. Firstly, reserve ease in the OPEC area has clearly increased. Secondly, the overall situation of oil-importing countries with little or no gold in their reserves, i.e. most of the oil-importing world, is clearly deteriorating. Thirdly, the increase in the market price of gold, together with the creation of ECUs through gold swaps at market-related prices, has benefited the reserve positions of the main gold-holding countries, although to an extent which is only partly quantifiable and which varies with the size of individual countries' gold reserves and with movements in the gold price itself.

Looking to the future, so long as the OPEC countries continue to run a large current payments surplus the overall reserve situation of the oil-importing world seems bound to deteriorate progressively. The reappearance of current payments deficits in the United States, together with allocations of SDRs, may provide two sources of net reserve growth, but their effects are likely to be more than offset by oil-importing countries' use of existing reserves and of international credit facilities to finance the counterpart of the OPEC payments surplus.

The changes that have occurred in the international liquidity situation since the end of 1978 have also had implications for the diversification of exchange reserves out of dollars into other currencies. The following table shows identifiable developments in this area since the end of 1976. Between that date and the end of 1978 total exchange reserves went up by \$102 billion, from \$186 to 288 billion; of that increase the table shows rises in non-dollar exchange reserves to have accounted for \$18.5 billion. On that understated basis — the table includes only those non-dollar exchange reserves which are held in the form of deposits with commercial banks in the countries listed in footnote 1 — the share in total exchange reserves of currencies other than the dollar increased during 1977–78 from 10 to 13 per cent.

In 1979 diversification out of dollars into other currencies increased further, with non-dollar official currency deposits shown in the table rising to nearly 16 per cent. of total exchange reserves, including those swapped by EMS participants against ECUs. This does not mean, however, that individual countries' reserve policies moved any further in the direction of holding currencies other than the dollar in their exchange reserves. As already mentioned on page 152, it was a result of the fact that the exchange reserves of the Group of Ten countries (other than the United States), which hold the bulk of their exchange reserves in dollars, were reduced, while the official currency holdings of other countries, which hold a larger proportion in other currencies, increased. In fact, there were clear signs during 1979 that the dollar was coming back into favour as a reserve asset outside the Group of Ten area, thanks to the recovery of its exchange rate and the growing

Identified official deposits with commercial banks outside the United States.

Items	End-1976		End-1977		End-1978		Mid-1979		End-1979	
	amounts outstanding, in billions of US dollars									
A. Deposits with banks in European countries,[1] Canada and Japan										
I. In national markets . . .		5.0		7.6		9.3		8.3		8.8
Deutsche Mark	1.0		2.2		3.1		3.2		3.4	
Swiss francs	1.5		1.3		0.6		0.5		0.6	
Yen	0.2		0.9		2.7		1.4		0.9	
Pounds sterling	1.2		1.6		1.2		1.5		1.9	
Other currencies	1.1		1.6		1.7		1.7		2.0	
II. In Euro-markets		60.4		71.0		80.1		90.6		115.0
Dollars	47.2		53.0		52.8		61.5		73.3	
Deutsche Mark	8.3		12.0		16.8		18.2		24.1	
Swiss francs	2.6		3.2		4.6		4.6		6.0	
Yen	0.5[2]		0.9[3]		2.2[3]		2.6[3]		4.2[3]	
Pounds sterling	0.3		0.3		0.7		1.1		1.5	
Other currencies	1.5		1.6		3.0		2.6		5.9	
Total I + II		65.4		78.6		89.4		98.9		123.8
of which in non-dollar currencies		*18.2*		*25.6*		*36.6*		*37.4*		*50.5*
B. Deposits with offshore branches of US banks . . .		4.5		4.4		5.7		6.2		6.4
Total A + B		69.9		83.0		95.1		105.1		130.2
Memorandum items:										
Private and official OPEC deposits with banks in European countries[1] and with offshore branches of US banks.		*55.1*		*68.2*		*73.4*		*77.8*		*106.2*
US liabilities to foreign official institutions.		*92.0*		*126.1*		*156.5*		*138.1*		*143.1*
Total foreign exchange reserves (including dollars swapped against European currency units)		*185.7*		*243.0*		*287.7*		*300.7*		*323.1*

Note: The figures in the table include changes in the dollar value of reserves held in other currencies arising out of movements in the exchange rates of the dollar against these other currencies.

[1] Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom; since 1977 also including Austria, Denmark and Ireland. [2] Estimate. [3] Excluding deposits with banks in Switzerland.

attractions of dollar interest rates. Thus, whereas in 1978 the whole of the increase in official deposits with European, Canadian and Japanese commercial banks shown in the table had been in currencies other than the dollar, in 1979 the non-dollar share was about 40 per cent.

As far as the scope for future diversification is concerned, the emergence of large current-account deficits in Germany and Japan and the reduction of Switzerland's surplus may provide the monetary authorities of the OPEC surplus countries with increased opportunities for building up assets in these currencies and for doing so without destabilising effects on exchange rates or on domestic money supplies in the countries which are supplying their currencies as reserve assets.

Another form of diversification which has been under discussion over the past year is the proposal for the creation of a substitution account at the IMF in which Fund members would be able to deposit excess dollar reserves and, in exchange, would receive for them SDR-denominated claims on the Fund. When this idea was first put forward the dollar was depreciating against other major currencies and the OPEC surplus had been reduced to modest proportions. What part might a substitution account play in the situation that has been created by the re-emergence of a large OPEC payments surplus? Firstly, its use would probably be limited mainly to OPEC countries. Secondly, as already mentioned, the emergence of large current payments deficits in Germany and Japan means that there may now be more scope for orderly diversification into these countries' currencies. Thirdly, the attractions of SDR-denominated assets will depend on the relative returns available on them and on currency reserves, as well as on the degree of stability maintained in the bilateral exchange rates of the currencies contained in the SDR basket. In that connection, a large-scale substitution of SDR-denominated assets for OPEC-owned dollars, by in effect recycling OPEC dollars to the United States in excess of any payments deficit in that country, might cause other oil-importing countries to try to shift part of their current payments deficits onto the United States and/or to borrow on a large scale from the United States, with possibly unfavourable effects on the exchange rate of the dollar. Whatever the uses and consequences of a substitution account might be, it does not seem likely to be introduced into the monetary system for some time yet. For the near future, therefore, concerns about international liquidity seem likely to focus on ways of financing the oil-importing world's payments deficit and of assuring the OPEC countries of a reasonable return on reserves held in the conventional form of foreign exchange assets.

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. Following various exchanges of views between the Governors of the central banks of the Group of Ten countries and Switzerland on the evolution during recent years, and the future prospects, of the international banking system in general, and the Euro-currency market in particular, a press communiqué was issued on 15th April 1980.

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.

The Bank also continued to provide the Secretariat for the Committee of Governors of the Central Banks of the Member States of the European Economic Community and for the Board of Governors of the European Monetary Co-operation Fund — EEC organs which were established in May 1964 and April 1973 respectively — as well as for their sub-committees and groups of experts. The latter include in particular the Committee of Governors' Alternates, which systematically prepares the groundwork for the meetings of the Governors; a group specialising in matters relating to foreign exchange markets and intervention policies on these markets (since the beginning of 1976 the composition of this group has varied according to the subject matter under discussion, having on occasion been confined to representatives from the EEC countries and at other times extended to include participants from other industrialised countries, generally members of the Group of Ten); a group commissioned to examine at periodic intervals the monetary situation in member states and the problems raised by the Community-wide co-ordination of national monetary policies; and a group entrusted with the task of promoting the harmonisation of the monetary policy instruments applied by member states (this group is responsible to both the Monetary Committee of the EEC and the Committee of Governors).

As in previous years, these committees and groups held a large number of regular or ad hoc meetings in 1979–80, mostly in Basle and generally in preparation for discussions among the Governors. On the basis of their work the Committee of Governors itself and the Board of Governors of the European Monetary Co-operation Fund, each within the framework of its competence and functions, which are closely related and complementary, are able to take various decisions relating to the monetary arrangements between central banks or to prepare reports and opinions, on a regular or ad hoc basis, for the Commission of the European Communities or, more usually, for the Ministers of Finance of the EEC countries. In the 1979–80 financial year this activity centred on the new European Monetary System established on 13th March 1979. The principal tasks were to ensure that the arrangements governing the system were properly applied, to strengthen the co-ordination of the exchange rate and domestic monetary policies pursued by the EEC central banks as a prerequisite for the smooth operation of the EMS, and, at the end of the first six months' experience, to review certain arrangements. The Committee of Governors also commenced discussions on the possible evolution of the EMS towards a more institutionalised, more definitive phase.

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 experts pursued their analysis of funds transfers, concentrating almost exclusively on updating, expanding upon and supplementing the information they had compiled the previous year on the payment systems in use in the Group of Ten countries and Switzerland, with the intention of drawing up a detailed, and coherent, record of the status quo. In March 1980 their work culminated in the publication of a descriptive study entitled "Payment Systems in Eleven Developed Countries". The Group also followed the activities of a number of organisations in related areas; these included the transmission of banking messages, a field in which the work of the International Standards Organisation was observed with particular interest.

Under the aegis of the Group of Experts on Monetary and Economic Data-Bank Questions, for which the BIS also performs secretariat functions, a data base of macro-economic time series has been further developed and is on the point of being transferred from the outside computer facility to the Bank's own premises. The data bank will permit the rapid exchange of important economic data in a timely fashion among the BIS and the central banks of the Group of Ten countries and Switzerland. BIS economists and statisticians will work with the data-bank contents using a personal computing system which is now complete in its initial form.

2. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1980, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.

Since June 1979, in accordance with the decision announced at last year's Annual General Meeting, the basis adopted for converting assets and liabilities in currencies into gold francs has been US$ 208 per ounce of fine gold (the average market price during the Bank's financial year 1978–79), compared with US$ 42.22... per fine ounce previously. According to Article 4 of the Statutes, the gold franc is the equivalent of 0.290 322 58... grammes fine gold. Assets and liabilities in US dollars are thus converted on the basis of 1 gold franc = US$ 1.941 49.... All other items in currencies are converted at market rates against the US dollar.

With the introduction of this new rate of conversion there has been a substantial reduction in terms of gold francs in the currency items in the Bank's Balance Sheet, although the Bank's capital, which is entirely represented by gold holdings, and the part of the reserves represented by gold have not been affected by the change.

As a consequence, the ratio of the Bank's own funds (viz. its paid-up capital and reserves) to the balance-sheet total has improved.

The Bank has been publishing its monthly statements of account on the basis of the new method of conversion since June 1979; for ease of comparison, however, figures were also given on the old basis until the end of the financial year 1979–80. For the same reason, the Balance Sheet and the Profit and Loss Account for the financial year ended 31st March 1980 are accompanied by pro forma accounts drawn up for the last time on the old basis. In the sections of this chapter devoted to the activities of the Bank, all gold franc figures are based on the new method of conversion except where otherwise stated.

* * *

It may be recalled that, on the basis of the former method of conversion, at 31st March 1979 the balance-sheet total stood at 70,408,614,197 gold francs.*

On the basis of the new method of conversion, the total at 31st March 1980 stood at	F 24,409,416,167
against, on 31st March 1979,	F 19,101,218,925
The increase thus amounted to	F 5,308,197,242

or 27.8 per cent., a quite substantially higher percentage increase than that of 18.7 per cent. recorded the previous financial year.

* In this chapter the term "francs" (abbreviated to F) signifies *gold* francs unless otherwise specified.

The changes in the middle rates of currencies other than the US dollar between the ends of the last two financial years resulted in most cases in a slight decline in their gold franc value; it should, however, be noted that the movements recorded in this section of the Annual Report do not reflect the sharp appreciation of the currencies in the European Monetary System — in particular the Deutsche Mark — registered in June 1979 when central rates were replaced by market rates, which were appreciably higher; the reason for this is that, as mentioned above, the value of all currencies at the beginning of the financial year has also been recalculated using the new method, in other words on the basis of market rates.

The total of the monthly statement of account recorded an immediate, very marked increase in April 1979; subsequent fluctuations in both directions — in some cases fairly wide — resulted in a further net expansion, which was, however, smaller than that registered at the beginning of the financial year.

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
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
1979*	19,101	—	—
1980*	24,409	+ 5,308	+ 28

* On the basis of the new method of conversion.

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 or Trustee) 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 1,034 million francs on 31st March 1980, against 1,020 million on 31st March 1979.

LIABILITIES (COMPOSITION OF RESOURCES).

BIS: Development of the composition of resources over the past ten financial years.[1]

Financial years ended 31st March	Paid-up capital and reserves	Borrowed funds	Sundry liabilities	Balance-sheet total
	in millions of francs			
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
1979[2]	859	17,991	251	19,101
1980[2]	887	23,239	283	24,409

[1] From 1972 onwards, after allocation of the net profit for the year as proposed to the Annual General Meeting.
[2] On the basis of the new method of conversion.

A. Capital, reserves and miscellaneous liabilities.

(a) Paid-up capital F 295,703,125

This compares with 300.7 million francs on 31st March 1979, representing a decrease of 5 million; in fact, the number of shares issued — paid up to the extent of 25 per cent. — was reduced from 481,125 to 473,125 with the cancellation of 8,000 shares of the Danzig issue in June 1979 pursuant to the decision taken by the Extraordinary General Meeting held on 11th June 1979; the nominal value of the issued capital accordingly fell from 1,202.8 million to 1,182.8 million francs. These movements are summarised in the table at the end of this Annual Report, under Item I. The authorised capital, however, remained unchanged at 1,500 million francs.

(b) Reserves

The movements in the various reserve funds commented upon below are shown in the above-mentioned table, under Item II.

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

The total of this Fund, which is entirely represented by gold, showed no change; it has in fact remained unchanged since 1971, when it reached 10 per cent. of the then paid-up capital, this being the proportion laid down in Article 51(1) of the Statutes.

(2) *General Reserve Fund*

after allocation of the net profit for 1979–80 F 397,152,793

On the basis of the former method of converting currencies, this Fund stood at 576.2 million at the beginning of the financial year; being represented only partly by gold, it decreased to 384 million in June 1979 when the new system of conversion was introduced; to this will be added the sum of 13.2 million which it is proposed to transfer from the net profit; the envisaged 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 1979–80 F 17,530,055

On the basis of the former method of conversion, this Fund stood at 83.2 million on 31st March 1979; being entirely represented by currencies, it declined to 16.5 million when the conversion system was changed; it is proposed that this amount should now be raised by 1 million, by transfer from the net profit, so that the total of this Reserve Fund remains slightly higher than the gold franc equivalent of a dividend of 110 Swiss francs per share (see item (d) below).

(4) *Free Reserve Fund*

after allocation of the net profit for 1979–80 F 146,730,236

For the same reason as that given under item (3) above, the amount of this Fund declined from 643.7 million to 127.9 million; it is proposed that a sum of 18.8 million be transferred to it from the net profit.

The Bank's overall reserves after allocation of the net profit for 1979–80 thus stand at F 591,483,397

On the basis of the old method of conversion, these reserves amounted to 1,333.2 million on 31st March 1979, equivalent to 558.5 million on the present basis; they thus increased by 33 million. By way of comparison, the increase during the previous financial year would have worked out at 28.6 million using the new conversion method.

(c) The item "Miscellaneous" stood at F 265,170,988

This item amounted to 728.1 million at the beginning of the financial year on the basis of the old system of conversion, equivalent to 235 million using the new conversion method.

(d) Profit and Loss Account, *before* allocation F 50,977,378

This figure represents the net profit for the financial year 1979–80 and it incorporates the net proceeds of the sale of the Bank's old premises, viz. approximately 2.6 million; for purposes of comparison, the figure for the financial year 1978–79, recalculated on the basis of the new method of conversion, was about 44.8 million; details of its proposed allocation, in accordance with the provisions of Article 51 of the Statutes, are given in Section 3 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 17,977,378 francs to be set aside in respect of the dividend to be paid on 1st July 1980; the total dividend includes an amount of 110 Swiss francs per share — the same as in the previous financial year — plus an exceptional dividend of 25 Swiss francs per share to mark the occasion of the Bank's fiftieth anniversary.

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 1979	1980	Movement
	in millions of francs		
Deposits of central banks	17,515	22,486	+ 4,971
Deposits of other depositors.	476	753	+ 277
Total	17,991	23,239	+ 5,248

"Deposits of central banks" increased even more markedly than during the preceding financial year, by 28.4 per cent. against 16.7 per cent. (the increases in the two years are not comparable in absolute terms because of the change in the conversion system); the expansion was again chiefly in US dollars, a proportion of which — albeit small — was indexed to the special drawing right, with some central banks having added to their deposits in this form and others having made deposits of this type for the first time; it may be noted that there was some growth in deposits in Deutsche Mark and Swiss francs, despite the aforementioned slight depreciation of these currencies, whereas the movements in the other currencies were generally downwards and in all cases small.

The increase in "Deposits of other depositors", while very substantial, was much less marked than in the preceding financial year, with the balance outstanding increasing by 58.2 per cent. after almost tripling previously; this increase mainly reflected the receipt of new deposits in US dollars, indexed to the special drawing right.

The preponderance of "Deposits of central banks" in the total of borrowed funds continued to diminish very slightly; their share — recalculated using the new conversion method — fell from 97.4 to 96.8 per cent., while that of "Deposits of other depositors" increased correspondingly.

As may be seen from the table below, expressed as a proportion of total borrowed resources, deposits in currencies rose from 77.8 to 80.7 per cent. during the financial year and deposits in gold declined from 22.2 to 19.3 per cent.

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

Term	Deposits in gold			Deposits in currencies			Total		
	Financial years ended 31st March		Move-ment	Financial years ended 31st March		Move-ment	Financial years ended 31st March		Move-ment
	1979	1980		1979	1980		1979	1980	
	in millions of francs								
Sight	3,941	4,432	+ 491	188	366	+ 178	4,129	4,798	+ 669
Not exceeding 3 months . . .	49	46	— 3	10,688	15,992	+ 5,304	10,737	16,038	+ 5,301
Over 3 months .	9	9	—	3,116	2,394	— 722	3,125	2,403	— 722
Total . .	3,999	4,487	+ 488	13,992	18,752	+ 4,760	17,991	23,239	+ 5,248

In terms of maturity, the share of the total accounted for by time deposits rose from 77 to 79.4 per cent., whereas that of sight deposits declined from 23 to 20.6 per cent.

(a) Deposits in gold F 4,486,882,681

This figure compares with that of 3,999 million francs at the beginning of the financial year; the increase of 488 million, or 12.2 per cent., is significantly higher than that of 41 million recorded during the previous financial year; it corresponds almost exactly to the increase in sight deposits, due partly to the receipt of net new deposits from several central banks and partly to the reduction in the amount involved in swaps, the gold concerned having been left on sight deposit with the Bank upon maturity of the swaps; despite fluctuations during the financial year, the volume of time deposits in gold remained virtually unchanged, with only those with not more than three months to run showing a very slight decline.

(b) Deposits in currencies F 18,752,198,598

Having stood at 13,992 million on 31st March 1979, this item, which now accounts for a little over three-quarters of total liabilities, showed a particularly sharp increase of 4,760 million, or 34 per cent. (+ 20.3 per cent. for the previous financial year); by far the greater part of the increase was in funds not exceeding three months, which rose by one-half, though the volume of sight deposits almost doubled; by contrast, funds with more than three months to maturity declined by almost one-quarter. This shows that the average term of all the deposits received in currencies by the Bank shortened appreciably during the financial year.

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	
	1979		1980			
	in millions of francs					
Sight assets						
Gold	4,987		5,313		+ 326	
Currencies	20	5,007	15	5,328	− 5	+ 321
Treasury bills						
Currencies		260		156		− 104
Time deposits and advances						
Currencies		12,952		14,487		+ 1,535
Securities at term						
Currencies		867		4,268		+ 3,401
Total						
Gold	4,987		5,313		+ 326	
Currencies	14,099	19,086	18,926	24,239	+ 4,827	+ 5,153

(a) Gold F 5,313,151,938

This item, which had amounted to 4,987 million francs at the beginning of the financial year, rose by 326 million or 6.5 per cent., whereas during the previous financial year the balance outstanding had declined slightly; the increase recorded reflected net gold deposits from various central banks and, to a lesser degree, the maturing of swaps of gold (sold spot) against US dollars that had been concluded with the market.

(b) Cash on hand and on sight account with banks F 15,504,444

This figure compares with 20 million at 31st March 1979; it should be noted that this item was slightly inflated at the end of the previous financial year, when the Bank had received funds at short notice which it had been obliged to keep in cash.

(c) Treasury bills F 156,032,236

This compares with a figure of 260 million at 31st March 1979 and represents a decline of 104 million, or 40 per cent., which amounts to about one-half of the increase recorded in the previous financial year; this decline, which was in US dollars, corresponds to the difference between maturities of Treasury bills payable to bearer issued by a foreign government and purchases of US Treasury bills.

(d) Time deposits and advances F 14,486,946,979

This figure compares with one of 12,952 million at 31st March 1979; this item, consisting entirely of currencies and by far the most important on the assets side, increased by 1,535 million, or by 11.9 per cent., a slightly lower rate than that recorded in the previous financial year; the increase was accounted for by deposits on a fairly large number of markets, mainly in US dollars and Deutsche Mark, in comparable amounts, and on a much smaller scale in Swiss francs and various other currencies; it should be noted that, compared with the distribution of borrowed resources, the proportion of assets in currencies other than the US dollar and the Swiss franc is much larger; the reason for this is that, on receiving deposits in US dollars indexed to the special drawing right, the Bank covers itself — generally by spot purchases against US dollars — and at the same time invests the various currencies that it has purchased.

(e) Securities at term F 4,267,952,816

From a figure of 867 million at 31st March 1979 this item increased virtually fivefold, having already increased by almost three-quarters during the previous financial year; the expansion of 3,401 million was in US dollars; it corresponds primarily to various US Treasury securities that the Bank acquired under repurchase agreements; in addition, there were purchases of bank certificates of deposit issued on the US market, but these were largely offset by maturities of various notes bearing a government guarantee.

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 1979	1980	Movement
	in millions of francs		
Not exceeding 3 months	8,068	14,652	+ 6,584
Over 3 months	5,751	4,103	— 1,648
Total	13,819	18,755	+ 4,936

Reflecting the movement, already described, of deposits received in currencies, the table above shows a fairly substantial shortening of the average term of these investments; assets not exceeding three months increased by about four-fifths, while those with more than three months to maturity declined by over one-quarter.

(f) Miscellaneous F 169,827,753

This figure compares with 15 million at 31st March 1979; the increase of 155 million broadly corresponds to adjustments due to the fact that, as a result of the rise in the market price of gold during the financial year, the weights of gold involved in swaps of gold (purchased spot at market-related prices) against currencies concluded with central banks were appreciably reduced when these swaps were renewed; consequently, from a book-keeping point of view, the value of the gold in question fell considerably below that of the currencies made available by the Bank.

Forward gold operations.

These operations, the volume of which is indicated in Note 2 to the Balance Sheet, resulted in a negative balance of F 164,204,075 compared with a negative balance of 326 million at the beginning of the financial year; the contraction — of 162 million — in the amount of gold payable forward was due principally to the reduction (mentioned in connection with the previous item) in the weights of gold involved in swaps transacted with central banks; this reduction was, however, partially offset by maturities of swaps of gold (sold spot) against US dollars which had been concluded with the market.

* * *

The Bank's operations, which had expanded at a moderate rate in 1978–79, increased at an appreciably faster pace during the financial year under review to reach a record level.

3. Net profits and their distribution.

The accounts for the fiftieth financial year ended 31st March 1980 show a total surplus of 54,966,432 francs, compared with some 45,123,000 francs for the preceding financial year and about 41,507,000 francs for the financial year 1977–78. The main reasons for the further increase recorded in the year under review are the greater volume of funds handled by the Bank during this period, the higher levels of interest rates obtained on various markets from the employment of the growing volume of the Bank's own funds held in currencies, and the inclusion of net proceeds of 2,630,695 francs from the sale of the Bank's old premises.

The Board of Directors has decided to transfer 3,989,054 francs to the Provision for Exceptional Costs of Administration. As a result of this transfer the net profit amounts to 50,977,378 francs, against some 44,775,000 francs for the previous financial year and about 38,781,000 francs for the financial year 1977–78. The allocation of this amount is governed by Article 51 of the Statutes.

On the basis of this Article, the Board of Directors recommends that the net profit of 50,977,378 francs be applied by the General Meeting in the following manner:

(i) in respect of the dividend, on 473,125 shares, provided for under clause (2) of Article 51 of the Statutes:

  (a) a sum of 14,648,234 francs in payment of an amount of 110 Swiss francs per share in respect of the financial year ended 31st March 1980, together with

  (b) a further sum of 3,329,144 francs in payment of an amount of 25 Swiss francs per share, representing a special non-recurring dividend to mark the fiftieth anniversary of the Bank;

(ii) an amount of 13,200,000 francs to be transferred to the General Reserve Fund;

(iii) an amount of 1,000,000 francs to be transferred to the Special Dividend Reserve Fund; and finally

(iv) an amount of 18,800,000 francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose which is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on 1st July 1980 to the shareholders whose names are contained in the Bank's share register on 20th June 1980.

The Balance Sheet, the Profit and Loss Account and a summary statement showing the movements during the financial year in the Bank's paid-up capital and reserves 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 1980 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.

In addition, a pro forma Balance Sheet and Profit and Loss Account drawn up on the old basis of conversion will be found, for the purpose of comparison, at the end of this Report.

4. 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 1979–80 for the Young Loan ended on 1st June 1980, on which date all the outstanding conversion bonds fell due and were redeemed. The interest in respect of the financial year 1979–80 was duly paid to the Bank and distributed by the latter among the Paying Agents. As the funding bonds had already been called in for final redemption on 1st December 1972, all the bonds of the Young Loan issued in accordance with the London Agreement have now been redeemed. However, as is explained below, holders of bonds and coupons may be entitled to supplementary payments under the exchange guarantee clause attached to the Young Loan.

The following table shows the position with regard to the Young Loan.

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		Bonds redeemed on final maturity date (1st June 1980)
			1958–59 to 1978–79	1979–80	
American . . .	$	90,139,000	33,197,000	766,000	56,176,000
Belgian	B.fr.	202,894,000	71,524,000	37,001,000	94,369,000
British	£	39,055,000	13,675,000	2,522,000	22,858,000
Dutch	Fl.	52,581,000	18,190,000	6,770,000	27,621,000
French	Fr.fr.	633,074,000	224,447,000	25,261,000	383,366,000
German . . .	DM	14,509,000	4,917,000	96,000	9,496,000
Swedish . . .	S.kr.	126,666,000	45,134,000	6,830,000	74,702,000
Swiss	Sw.fr.	58,393,000	20,152,000	948,000	37,293,000

* On the basis of values established by the German Federal Debt Administration for the 1st December 1979 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 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 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.

As mentioned in the forty-ninth Annual Report of the BIS, 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. On the occasion of the maturities for the Loan of 1st June and 1st December 1979, the Belgian franc was still considered by the German Federal Debt Administration to be the "least depreciated currency"; the calculation made on this basis by the Federal Debt Administration gave rise to a slight downward adjustment in the amounts due to bondholders of the American and British issues on 1st June 1979, whereas the amounts payable in respect of the 1st December 1979 maturity date remained unchanged for all issues.

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 Federal Debt Administration has been informed by the Trustee that the reservations it had expressed in connection with the legal dispute concerning the 1961 and 1969 revaluations of the Deutsche Mark, with a view to preserving the rights of holders regarding application of the exchange guarantee clause of the Young Loan, extended equally to the question of floating exchange rates. The fact that coupons and bonds that have matured since 1st June 1961, and in particular on the final maturity date of 1st June 1980, have already been presented for redemption has no bearing on the reservations expressed by the Trustee.

The question whether the exchange guarantee was applicable in the case of the revaluations of the Deutsche Mark in 1961 and 1969 was submitted to the Arbitral Tribunal referred to in Article 28 of the London Agreement by the American, Belgian, British, French and Swiss Governments, in their capacity as applicant governments, and by the Government of the German Federal Republic, in its capacity as defendant government, in May 1971. The Arbitral Tribunal issued its award in favour of the defendant government, by a majority of four votes to three, on 16th May 1980. The Trustee hopes that this decision will pave the way for a 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.

All the assented bonds of the American and Anglo-Dutch issues were redeemed in 1978 and 1979 respectively; those of the Swiss issue still outstanding will be called in for final redemption on 1st July 1980, on which date the Austrian Government International Loan 1930 will have been redeemed in full.

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

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 1980	Rates of interest %	Year of final maturity or redemption
1st	1954	United States	US Government	$	100,000,000	—	3⅞	1979
2nd	1955	Belgium	Caisse Générale d'Epargne et de Retraite, Brussels	B.fr.	200,000,000	34,800,000	3½	1982
3rd	1955	*Germany*	Westdeutsche Landesbank Girozentrale, Düsseldorf[1]	DM	50,000,000	1,274,400	3¾	1981
4th	1955	Luxembourg	Caisse d'Epargne de l'Etat, Luxembourg	B.fr.	20,000,000	3,480,000	3⅜	1982
				L.fr.	5,000,000	—	3⅜	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	1957	United States	Public issue	$	25,000,000	—	5½	1975
8th	1957	United States	Public issue	$	7,000,000	—	5	1962
9th	1957	United States	Bank loans	$	3,000,000	—	5	1962
10th	1957	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	21,793,586	5⅝	1982
11th	1958	United States	Public issue	$	35,000,000	—	5	1978
12th	1958	United States	Public issue	$	15,000,000	—	4½	1963
13th	1960	United States	Public issue	$	25,000,000	1,900,000	5⅝	1980
14th	1960	United States	Public issue	$	3,300,000	—	4¾	1963
				$	3,300,000	—	4⅞	1964
				$	3,400,000	—	5	1965
15th	1961	Luxembourg	Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg	L.fr.	100,000,000	40,142,654	5¼	1986
16th	1961	Netherlands	Public issue	Fl.	50,000,000	6,450,000	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.

The above 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 1979-80 the amounts received by the Bank for the service of the secured loans came to the equivalent of about 0.5 million francs in respect of interest and about 6 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 5 million francs.

6. 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.

As the Fund's Agent, the Bank performs two main sets of functions: on the one hand, those connected with the operation of the European Monetary System; and, on the other, those relating to the execution of financial operations in connection with Community borrowing and lending.

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

(a) It records in European currency units (ECUs) in the Fund's books:

- the debts and claims vis-à-vis the Fund of the EEC central banks participating in the EMS exchange rate mechanism which arise from interventions carried out by those central banks in other member countries' currencies and reported to the Agent;
- the immediate or periodic settlement of these very short-term debts and claims.

(b) The Bank carries out operations associated with the creation, utilisation and remuneration of ECUs, namely:

- concluding, in the name and for the account of the Fund, swap operations with each of the EEC central banks 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 gold holdings and 20 per cent. of their gross US dollar reserves. These swap operations are renewed every three months, when the necessary adjustments are made, firstly, to ensure that each central bank's contribution to the Fund continues to represent at least 20 per cent. of its gold and dollar reserve holdings at the end of the month preceding the renewal date and, secondly, in order to take account of changes in the price of gold and in dollar rates vis-à-vis the ECU;

- 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.

(c) The Bank enters in the Fund's books the operations carried out in the context of the short-term monetary support arrangements.

During the first year of operation of the EMS those interventions carried out by the central banks participating in the exchange rate mechanism that gave rise to book-keeping entries in ECUs in the books of the EMCF amounted to approximately ECU 4 billion in all.

At 31st March 1980 the Fund had issued a total of almost ECU 33 billion, equivalent to about US$ 43 billion at the exchange rate prevailing on that date. These ECUs were created as the counterpart of the compulsory contributions of reserve assets by the EEC central banks participating in the EMS exchange rate mechanism as well as the voluntary contribution made by the Bank of England a few months after the implementation of the system. A portion of these ECU assets was used by several EEC central banks mainly to settle, in full or in part, their debts resulting from the interventions mentioned above.

The short-term monetary support facility was last used in 1974 by the Bank of Italy and has not been activated since.

(2) 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 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 final recipients of the payments;

- recording these financial operations in the Fund's books;

- 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.

During the financial year 1979–80 the Bank in its capacity as Agent for the Fund effected the payment of interest and commission and the repayment of a loan of $500 million which had been placed by the European Economic Community in 1976. At 31st March 1980 it was administering, after this repayment, a total of six loan operations, amounting to US$ 1.1 billion and DM 0.5 billion, approximately 85 per cent. 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 (initially over five years on average), the currency of issue and the date of conclusion of the contract.

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

The mandate of Dr. Jelle Zijlstra as Chairman of the Board and President of the Bank being due to expire on 30th June 1979, he was re-elected to these offices under Article 38 of the Statutes at the meeting of the Board held on 11th June 1979 for a period of three years ending on 30th June 1982.

In October 1979 Dr. Carlo Azeglio Ciampi succeeded Prof. Paolo Baffi as Governor of the Bank of Italy and became an ex officio member of the Board in place of Prof. Baffi. At the meeting of the Board held on 13th November 1979 the Chairman expressed the sincere gratitude of all members of the Board for Prof. Baffi's remarkable services to the Bank during a period of office of more than nineteen years, first as an Alternate, then as an appointed Director and finally as an ex officio member of the Board.

Mr. Carl-Henrik Nordlander relinquished his post as Governor of the Bank of Sweden in November 1979 and at the same time gave up his seat on the Board of Directors of the BIS. At the Board meeting held on 13th November 1979 the Chairman thanked Mr. Nordlander for the very valuable services he had rendered to the Bank during a three-year term of office.

In November 1979 M. Bernard Clappier resigned as Governor of the Bank of France and was succeeded by M. Renaud de la Genière, who thereby became an ex officio member of the Board. At the Board meeting held on 11th December 1979 the Chairman announced that, in accordance with Article 27(2) of the Statutes, M. de la Genière had appointed M. Clappier as a member of the Board for a period of three years ending on 27th November 1982. The Chairman also expressed the Board's pleasure that M. Clappier, who had been an ex officio Director since July 1974, should continue to be one of its members.

At the meeting of the Board held on 11th December 1979 the new Governor of the Bank of Sweden, Mr. Lars Wohlin, was elected in accordance with Articles

27(3) and 28 of the Statutes to be a member of the Board for a period of office expiring on 31st March 1981.

On 1st January 1980 Herr Karl Otto Pöhl succeeded Dr. Otmar Emminger as President of the Deutsche Bundesbank and became an ex officio Director of the BIS in place of Dr. Emminger. At the meeting of the Board held on 11th December 1979 the Chairman expressed to Dr. Emminger the deep gratitude of all the members of the Board for his outstanding contribution to the work of the Bank and to central-bank co-operation during a period of office of more than ten years, first as an Alternate and then as an ex officio Board member.

Dr. Antonino Occhiuto relinquished his directorship on 11th February 1980. At the Board meeting held on 8th January 1980 the Chairman paid tribute to him for the very valuable services he had rendered to the Bank over a period of four and a half years.

At the meeting held on 12th February 1980 the Chairman announced that Dr. Ciampi, Governor of the Bank of Italy, had appointed Prof. Paolo Baffi as a member of the Board to fill the vacancy caused by the resignation of Dr. Occhiuto. This appointment was made under Articles 27(2) and 28 of the Statutes for the unexpired period of Dr. Occhiuto's term of office ending on 7th November 1981. The Chairman said how pleased the Board was that Prof. Baffi should again be able to participate in its deliberations.

At the same meeting the Chairman informed the Board that Herr Pöhl, President of the Deutsche Bundesbank, had appointed Dr. Leonhard Gleske as his Alternate.

The mandate of Dr. Fritz Leutwiler as a member of the Board being due to expire on 31st March 1980, he was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 11th March 1980 for a further period of three years ending on 31st March 1983.

The Chairman informed the Board at the same meeting that Mr. Gordon Richardson, Governor of the Bank of England, had appointed Mr. A.D. Loehnis to act as his Alternate in place of Mr. C.W. McMahon. The Chairman expressed the Bank's gratitude to Mr. McMahon for his valuable services during a period of more than seven years.

The Chairman announced at the Board meeting held on 11th March 1980 that the Bank had decided to promote M. Jean Vallet to the rank of Assistant Manager as from 1st April 1980.

* * *

It was with deep regret that the Bank learned of the death of Dr. Milton Gilbert on 28th September 1979. Dr. Gilbert had been the Bank's Economic Adviser and the Head of its Monetary and Economic Department from November 1960 until his retirement at the end of December 1975.

CONCLUSION.

Two contrasting impressions emerge from the main chapters of this Report. The first is that prospects for 1980 are less gloomy than a simplistic analogy between the second oil shock and that of 1973–74 would suggest. The other, however, is that while the current year can be viewed with a certain amount of equanimity, clouds seem to be gathering on the horizon to darken the outlook from next year onwards. Policy-makers are well aware of the ambivalence, and this Report does not contradict what has now become the conventional wisdom. Nevertheless, it is possible to draw different policy conclusions from a similar analysis — and it is the purpose of these concluding pages to call attention to the long-run implications of the policy choices that are likely to present themselves as time goes by.

Concern about the more distant horizon stems from a cumulation of pessimistic assumptions or forecasts. At the starting-point is the fear that cyclical developments, reinforced by the generally — and on occasion even competitively — restrictive stance of monetary policies, will push the western industrial world into an outright recession. It is assumed that such a recession will shift the burden of the current-account deficits from the stronger industrial countries to the weaker ones and, in particular, to the non-oil LDCs; and that this will be all the more disquieting since, despite the recession, the global oil imbalance is going to be more durable this time than it was six years ago. In the western industrial countries themselves the recession will aggravate unemployment and increase already high public-sector deficits; at the same time it is feared that while the inflationary excesses will have lessened, the decline of inflation rates will come to an early halt. The persistently high "underlying" inflation rate, combined with large public-sector deficits and a stubborn global oil imbalance, will make a concerted policy of re-expansion difficult to implement, and perhaps impossible to sustain. The western industrial world will thus find itself back on the road to stagflation — but with even more inflation, less growth and wider external imbalances than after the first oil shock.

What can be done to prevent such a pessimistic scenario from materialising? The answer is that in the short run it will not be possible to avoid all these evils at the same time. A choice will have to be made; and this choice will have to be based on an analysis of the courses that are effectively open for policy action.

A broad guideline can be suggested in the search for the right choice. Experience tells us that it would be better to base policies on an assessment of the current realities taken in conjunction with what seem to be the more permanent or long-lasting features of the world economy rather than on reactions to every twist and turn in short-term developments. There are two reasons for making this suggestion. Firstly, short-term cyclical forecasts have proved notoriously unreliable — an unreliability the destabilising effects of which have been enhanced by lags in policy decisions and in their implementation. Such mistakes in timing assume particular importance in the context of international co-operation, since, as we saw in the 1970s, they can produce synchronised international cycles or, at the other extreme, large external imbalances and exchange-market disturbances. Secondly, such an approach would have the additional advantage of revealing long-term constraints which effectively limit the freedom of choice that would seem to be open on the basis of short-term forecasts.

What can be said in this perspective?

Firstly, that inflation is both an incontrovertible fact and a long-run problem. Inflation rates are high and in some cases still rising. Admittedly, as this Report has argued, our chances of bursting the current inflationary bubble can be rated reasonably high — provided restrictive policies are effectively pursued. But several facts have to be kept in mind when taking a longer-term view. Inflation has enjoyed a long run in almost all western industrial countries, so that the simple principle of inertia is likely to carry it well into the future, though at less spectacular rates. This is just another way of saying that the "underlying" rate of inflation may still be high, and quite sticky. After all, the recent upsurge began from a historically high average rate of 7 per cent. in the Group of Ten countries. Another fact is that those countries which in the past have achieved marked success in their fight against inflation did so with the help of appreciating currencies. All these countries are now running a current-account deficit, which makes it less likely that they will be able to use exchange rate appreciation as an effective anti-inflationary weapon. But even more important, the generalised recognition that currency depreciation is a great handicap in an inflationary world environment will make it increasingly difficult for any large country — even one with a strong balance of payments — to benefit from the anti-inflationary effect of appreciation to the extent to which Germany and Switzerland did in the past. Inflation, being a common malady, will have to be fought by means that do not bear the taint of competitive currency appreciation.

Secondly, recent history has taught us that the experience of inflation in industrial countries ultimately weakens investment activity and therefore growth. This is not only because there is no other way of stopping inflation than by restrictive policies which naturally restrain investment too. Inflation also inevitably generates a climate of uncertainty — inflation rates are never stable, nor are interest rates in an inflationary environment — which in itself is detrimental to investment activity.

Thirdly, there are lessons to be drawn from the experiences of the commodity booms in 1973–74 and 1979. In both instances, sharp increases in the prices of industrial raw materials played an important part in the acceleration of wholesale price rises in the main industrial countries. Neither of these commodity price booms can be regarded as a predominantly "external" shock produced by a supply breakdown or price agreements — although, of course, such external elements were visible in the case of some particular products. On the contrary, there is strong evidence to suggest that both commodity booms were triggered by the overall strength of demand in the main industrial countries and hence that they were endogenous to the world economy. There was also some evidence of speculative stockpiling, made possible by relatively accommodating monetary policies.

These experiences point to two conclusions. One is that, given the present state of productive capacity and market organisation, world commodity markets limit the rate at which industrial production can grow in the western world without triggering a process of inflation. The other is that an excessive acceleration in the growth of industrial production can be the outcome of concerted expansionary policies — not by design, but because of policy mishaps or short-term forecasting deficiencies. The problem in 1979 was not that growth accelerated in the Federal Republic of Germany and Japan, but that aggregate demand did not slacken in the United States in line with forecasts. Episodes of this kind cast serious doubt on the effectiveness and therefore on the desirability of international fine tuning.

Finally, but most importantly, lessons will have to be drawn from the recurrence of an oil shock. What has just been said about commodities in general applies with even greater force to the oil market in particular. Booms in the prices of industrial raw materials tend to fade out, oil price increases do not seem to: the peaks of 1973–74 and 1979 were followed, at least for a time, by a downturn in most industrial commodity prices, while the real price of oil declined only relatively little in the second half of the 1970s and does not appear to be falling at all at present. For this reason alone the inflation-generating impact of the oil shock is much less transient. At the same time, the oil price increase also tends to have a more general, sharper and longer-lasting impact on external balances than even a fairly widespread rise in commodity prices. It is more general because all countries use oil; it is sharper because the world is quite neatly divided between a small group of oil-exporting and a large group of oil-importing countries, whereas there are many more commodity-exporting countries, mainly the LDCs but also some industrial ones; and the impact tends to last longer because of the substantial weight of a handful of low-absorbing oil producers.

Can part of the blame for the oil price increase be attributed, as in the case of industrial commodity prices, to worldwide excess demand? Two arguments can be cited against such an assertion. Firstly, the oil supply disruption caused by the Iranian revolution has played a direct causal rôle and, secondly, the OPEC possesses monopolistic price-fixing power. On the other hand, it can be argued that the shortfall in the supply from Iran could have been absorbed more rapidly by the world markets had there been a reasonable safety margin not only in terms of stocks but also in terms of the relationship between productive capacity and final demand. Such a safety margin would also have limited the price-raising power of OPEC, which is not a monopoly but at best an oligopoly; and it is well known that the organisational coherence of an oligopolistic group of producers is greatly enhanced by the existence of a sellers' market.

This set of considerations points towards several broad policy recommendations.

The first concerns the duration and nature of anti-inflationary policies. The authorities of the western industrial countries have made it clear, individually as well as collectively, that their first priority is to fight inflation. Unfortunately this is not enough. They should also make it clear that they will persist in using all the available anti-inflationary policy tools until rates of inflation have fallen significantly below the level that, before the oil price explosion, was considered to be the "underlying" inflation rate in the various individual countries. Unless such a commitment is made quite explicit, the present policy stance will not be credible, and therefore current tight-money policies will fail to achieve a lasting victory over inflation.

In a longer-term perspective there is no alternative to the course of action recommended, for the longer inflation persists, the more painful will be the cure. Demand stimulation may be effective in the short run, but there is no long-run trade-off between growth and inflation. What is clear from the 1970s is that efforts to break out of the stagflation trap by "going for growth" tended ultimately to exacerbate both inflation and unemployment. Nor can it be said at this stage that a radical policy stance of this nature will necessarily entail intolerable losses of output or employment. It is argued in this Report that, with very few exceptions, money and real wage increases were significantly lower in 1979 than in the first half of the 1970s, thus preparing the ground for potentially rapid success in the fight against inflation.

In urging the use of "all the available anti-inflationary policy tools", some clarification is necessary. The implication is that, in varying degrees in different countries, monetary policy will have to be complemented not only by fiscal policy but also by some form of incomes policy appropriate to the country's institutions and circumstances. True, the process of inflation is a monetary phenomenon insofar as price increases cannot continue unless they are validated by money creation. This clearly implies that they cannot be stopped either unless monetary policy ceases to be accommodating. In those countries where inflation has become a way of life, however, exclusive reliance on monetary policy may well lead to a very severe and protracted decline in real output before it eventually has a lasting effect on the rate of price increase. Incomes policy may therefore prove helpful in such cases as a means of seeking a consensus needed to minimise the deflationary impact of monetary policy on output and employment.

A second policy recommendation concerns the process of adjustment to the disturbances created by the second oil shock. Forecasts in 1973–74 of a persisting, large OPEC payments surplus were very wide of the mark, principally because the capacity and willingness of oil exporters to import goods and services were underestimated. It is impossible to predict to what extent the process of absorption, together with some reversal of the initial terms-of-trade gain registered by the oil exporters, will follow the earlier pattern. There would obviously be very great dangers for the world economy if neither of these corrective processes were to occur; and there would be even greater dangers if the real price of oil were to ratchet further upwards. This uncertainty points to an acute need for other methods of adjustment. Clearly, the only rational one is oil saving, either through energy conservation or through the substitution of other sources of energy for oil. Progress along this road has already been made, but it is of cardinal importance to the world economy that it should be speeded up by using all possible incentives, including higher user prices, to encourage both of these forms of oil saving.

Even on the most optimistic assumptions, however, the achievement of substantial oil savings is a long-term business, and this raises the question of what can be done in the meantime. It has been suggested that the oil exporters could be offered financial assets which would induce them to maintain, or possibly even expand, their rate of production. These ideas should be explored, although the creation of special investment outlets for a specific category of investors is likely to raise problems of principle as well as many technical difficulties. The more likely outcome is that during these years of transition the western industrial world will have to accept a rate of growth modest enough to ensure a reasonable balance between the supply of and the demand for oil. The disappointing conclusion is that a world beset with political uncertainties, and hence faced with the possibility of further supply shocks, badly needs a safety margin.

In short, both the state of the oil and commodity markets and the need for an unequivocal commitment to reducing the rate of inflation — even below the "underlying" level that prevailed at the start of 1979 — foreshadow an extended period of painfully slow growth for the western industrial world. This scenario, admittedly, would raise critical problems in other areas.

At the head of the list would be the problem of high, and possibly rising, unemployment. Since in many industrial countries unemployment is already too high, it is legitimate to wonder whether the advantages of a radical attack on inflation and of containing the oil surplus within manageable proportions outweigh the social and human costs that may have to be paid. In the short-term context they probably do not, but in a longer-term perspective there is simply no freedom of choice in this regard. As mentioned above, toleration of a higher rate of inflation will not, in the long run, ensure a higher rate of growth. However, the acceptance of a lower rate of growth will make it easier to fight inflation and, ultimately, to bring about renewed expansion. During the intermediate period it will be up to the individual industrial countries to find ways and means compatible with their traditions and social structures to solve the problems arising out of unemployment.

The second crucial question in western industrial countries concerns investment. Capacity-expanding investment would obviously not be stimulated by slower growth, nor would it be needed. A high level of investment activity would, however, be necessary in all the energy-saving areas and in the development of new sources of energy. Investment would also be needed in order to facilitate the process of industrial redeployment and thus prepare the ground for the next stage of renewed expansion. Here again, solutions will have to be found to ensure that slower growth does not deter investment of this kind. One source of hope is the fact that technological progress has continued at a high rate, and a return to a less inflationary and hence less uncertain climate would foster an increase in autonomous investment. Another can be derived from the seemingly permanent increase in the price of energy in relation to that of both capital and labour. These shifts in relative prices should themselves stimulate energy-saving and perhaps even labour-using investment.

The main international problem area would be in the financing of the sizable current-account deficits of the less wealthy, smaller industrial countries and of the non-oil LDCs. For obvious reasons, these countries cannot afford, as a group, to follow the example of the large, high-income industrial countries along the path of substantially slower growth. Thus they will have to shoulder a greater share of the global oil deficit, which may be substantial and persistent even in this scenario, though, it is to be hoped, smaller than in 1980.

It would be of mutual benefit to these and to the large industrial countries if a fresh look could be taken at ways of increasing capital flows for the purpose of developing supplies of primary commodities and energy in the smaller countries and the LDCs.

There is no doubt, however, that the international banking system will have to play an important part in the financing of external deficits. For reasons explained in the body of this Report, the continued, orderly participation of banks in the process of recycling the new OPEC surplus may be more of a problem than after the first oil shock.

One prerequisite for assuring this participation is that within the two aforementioned groups of countries there should be shifts among individual countries from deficit to equilibrium, and vice versa. Global adjustment is clearly impossible; "rolling readjustments" are not. Such shifts would demonstrate the capacity for effective adjustment by specific debtor countries, and could thus be of great help in the maintenance of confidence. A global confidence crisis is more likely to arise from sticky, prolonged financing requirements of individual debtors than from the large global financing needs of a group of countries. This is certainly the lesson taught by domestic banking experience.

Another, more important, prerequisite is that funds from official sources take up a larger share of balance-of-payments financing. There is clearly scope for a much greater rôle to be played by the IMF, which during the last few years has been "crowded out" by the borrowers' market for international bank loans. However, while the present liquidity position of the IMF is quite satisfactory, it is doubtful whether it will remain so in the years ahead. The order of magnitude of the likely LDC deficit is quite considerable. The time may therefore soon be ripe to explore the conditions under which the IMF could substantially increase its resources by borrowing directly from surplus countries or in the markets. There is reasonable hope that both these prerequisites could be met.

The broad conclusion is that the most difficult problems now facing the world economy are those deriving from the imbalance in the international energy and commodity markets and from the "underlying" momentum of inflation. The solution of these problems will require, first and foremost, both real and financial adjustments in the western industrial economies. To the extent that effective action is taken to deal with these problems, the difficulties that may have to be confronted on the international monetary and financial scene are likely to prove less troublesome.

René Larre

General Manager

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1980

BALANCE SHEET

ASSETS

(Before and after

		Gold francs
Gold		5,313,151,939
Cash on hand and on sight account with banks		15,504,444
Treasury bills		156,032,236
Time deposits and advances		
Not exceeding 3 months	11,017,468,563	
Over 3 months	3,469,478,416	
		14,486,946,979
Securities at term		
Not exceeding 3 months	3,634,229,829	
Over 3 months	633,722,987	
		4,267,952,816
Miscellaneous		169,827,753
Land, buildings and equipment		1
		24,409,416,167

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 at US$ 208 per fine ounce of gold (equivalent to 1 gold franc = US$ 1.941 49...), and all other items in currencies on the basis of market rates against the US dollar.

Note 2: At 31st March 1980, gold payable against currencies on forward contracts amounted to 164,204,075 gold francs.

AT 31st MARCH 1980

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: 473,125 shares ...	1,182,812,500		
of which 25% paid up ...		295,703,125	*295,703,125*
Reserves			
Legal Reserve Fund ...	30,070,313		*30,070,313*
General Reserve Fund ...	383,952,793		*397,152,793*
Special Dividend Reserve Fund ...	16,530,055		*17,530,055*
Free Reserve Fund ...	127,930,236		*146,730,236*
		558,483,397	*591,483,397*
Deposits (gold)			
Central banks			
Sight ...	4,398,619,874		
Not exceeding 3 months ...	46,569,012		
Over 3 months ...	8,611,110		
Other depositors			
Sight ...	33,082,685		
		4,486,882,681	*4,486,882,681*
Deposits (currencies)			
Central banks			
Sight ...	353,147,840		
Not exceeding 3 months ...	15,665,746,736		
Over 3 months ...	2,013,061,158		
Other depositors			
Sight ...	13,144,928		
Not exceeding 3 months ...	325,889,418		
Over 3 months ...	381,208,518		
		18,752,198,598	*18,752,198,598*
Miscellaneous ...		265,170,988	*265,170,988*
Profit and Loss Account ...		50,977,378	–
Dividends payable on 1st July 1980 ...		–	*17,977,378*
		24,409,416,167	*24,409,416,167*

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 1980 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, 28th April 1980

PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1980

		Gold francs
Net interest and other income ...		69,358,154
Less: Costs of administration:		
Board of Directors ...	170,421	
Management and Staff ...	11,683,415	
Office and other expenses ...	5,168,581	17,022,417
Net operating surplus ...		52,335,737
Add: Net proceeds from sale of old premises ...		2,630,695
Total surplus ...		54,966,432
Less: Amount transferred to Provision for Exceptional Costs of Administration ...		3,989,054
Net Profit for the financial year ended 31st March 1980 ...		50,977,378
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:		
Dividends payable on 473,125 shares:		
110 Swiss francs per share in respect of the annual dividend ...	14,648,234	
25 Swiss francs per share in respect of the special fiftieth anniversary bonus ...	3,329,144	17,977,378
		33,000,000
Transfer to General Reserve Fund ...		13,200,000
		19,800,000
Transfer to Special Dividend Reserve Fund ...		1,000,000
		18,800,000
Transfer to Free Reserve Fund ...		18,800,000
		—

MOVEMENTS IN THE BANK'S PAID-UP CAPITAL AND RESERVES
during the financial year ended 31st March 1980

in gold francs

I. Reduction in Paid-up Capital resulting from the cancellation of the 8,000 shares of the Danzig issue pursuant to the decision of the Extraordinary General Meeting held on 11th June 1979

Balance at 1st April 1979: 481,125 shares, each of 2,500 gold francs, of which 25% paid up	300,703,125
Less: 8,000 shares, cancelled pursuant to the decision of the Extraordinary General Meeting held on 11th June 1979	5,000,000
Balance at 31st March 1980 (473,125 shares)	295,703,125

II. Adjustments to the Reserve Funds resulting from the change in the gold price used for converting currencies into gold francs from US$ 42.22... to US$ 208 per fine ounce, and allocations thereto for the financial year 1979–80

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1979, after allocation of Net Profit for the financial year 1978–79	30,070,313	576,247,193	83,175,781	643,718,200
Less: Valuation loss incurred upon adoption in June 1979 of new basis for conversion of currencies into gold francs	–	192,294,400	66,645,726	515,787,964
Balances at 30th June 1979	30,070,313	383,952,793	16,530,055	127,930,236
Add: Allocations in respect of the financial year 1979–80	–	13,200,000	1,000,000	18,800,000
Balances at 31st March 1980 as per Balance Sheet ...	30,070,313	397,152,793	17,530,055	146,730,236

III. Paid-up Capital and Reserve Funds at 31st March 1980 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold	295,703,125	356,362,057	652,065,182
Currencies	–	225,121,340	225,121,340
	295,703,125	581,483,397	877,186,522

FOR THE PURPOSE OF COMPARISON

PRO FORMA
BALANCE SHEET AND PROFIT AND LOSS ACCOUNT
AT 31st MARCH 1980

(OLD BASIS OF CONVERSION - AS APPLIED UP TO THE END OF THE FINANCIAL YEAR 1978-79)

PRO
BALANCE SHEET

ASSETS (old basis of conversion — before allocation of the year's

		Gold francs
Gold		5,313,151,938
Cash on hand and on sight account with banks		76,411,634
Treasury bills		769,445,112
Time deposits and advances		
Not exceeding 3 months	54,308,352,275	
Over 3 months	17,103,213,650	
		71,411,565,925
Securities at term		
Not exceeding 3 months	17,922,279,096	
Over 3 months	3,125,004,033	
		21,047,283,129
Miscellaneous		1,482,656,306
Land, buildings and equipment		1
		100,100,514,045

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 at US$ 42.22... per fine ounce of gold (equivalent to 1 gold franc = US$ 0.394 1...), and all other items in currencies on the basis of market rates against the US dollar.

FORMA
AT 31st MARCH 1980

total surplus — given for the purpose of statistical comparison only)

LIABILITIES

		Gold francs
Capital		
Authorised: 600,000 shares, each of 2,500 gold francs	1,500,000,000	
Issued: 473,125 shares	1,182,812,500	
of which 25% paid up		295,703,125
Reserves		
Legal Reserve Fund	30,070,313	
General Reserve Fund	576,247,193	
Special Dividend Reserve Fund	83,175,781	
Free Reserve Fund	643,718,200	
		1,333,211,487
Deposits (gold)		
Central banks		
Sight	4,398,619,874	
Not exceeding 3 months	46,569,012	
Over 3 months	8,611,110	
Other depositors		
Sight	33,082,685	
		4,486,882,681
Deposits (currencies)		
Central banks		
Sight	1,741,480,390	
Not exceeding 3 months	77,232,986,713	
Over 3 months	9,925,781,346	
Other depositors		
Sight	64,777,528	
Not exceeding 3 months	1,605,936,618	
Over 3 months	1,879,843,393	
		92,450,805,988
Miscellaneous		1,263,278,198
Profit and Loss Account (total surplus)		270,632,566
		100,100,514,045

Note 2: At 31st March 1980, gold payable against currencies on forward contracts amounted to 164,204,076 gold francs.

PRO FORMA
PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1980
(old basis of conversion)

		Gold francs
Net interest and other income ...		341,529,129
Less: Costs of administration:		
Board of Directors ...	839,543	
Management and Staff ...	57,554,722	
Office and other expenses ...	25,461,751	83,856,016
Net operating surplus ...		257,673,113
Add: Net proceeds from sale of old premises ...		12,959,453
Total surplus ...		270,632,566

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
Dr. Carlo Azeglio Ciampi, Rome
Bernard Clappier, Paris
Renaud de la Genière, Paris
Dr. Fritz Leutwiler, Zurich
Karl Otto Pöhl, Frankfurt a/M.
The Rt. Hon. Gordon Richardson, London
Dr. Johann Schöllhorn, Kiel
Cecil de Strycker, Brussels
Lars Wohlin, Stockholm

Alternates

Dr. Leonhard Gleske, Frankfurt a/M.
Georges Janson, Brussels
A.D. Loehnis, London, or
M.J. Balfour, London
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
Jean Vallet	Assistant Manager