# BANK FOR INTERNATIONAL SETTLEMENTS

## FIFTY-FIRST ANNUAL REPORT

1st APRIL 1980 – 31st MARCH 1981

BASLE

15th June 1981

# TABLE OF CONTENTS

* * *

Balance Sheet and Profit and Loss Account at 31st March 1981.

# LIST OF TABLES AND GRAPHS

(Graphs are indicated by an asterisk)

Page

## International Trade and Payments



## The International Credit and Capital Markets



## The International Monetary Scene

Page

## Activities of the Bank

# FIFTY-FIRST ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 15th June 1981

Ladies and Gentlemen,

I have the honour to submit herewith the fifty-first Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1980 and ended on 31st March 1981.

The net profit for the year amounted to 67,004,609 gold francs, after transfer of 1,057,331 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit for the preceding year of 50,977,378 gold francs, including net proceeds of 2,630,695 gold francs from the sale of the Bank's old premises.

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 17,004,609 gold francs in payment of a dividend of 135 Swiss francs per share.

The Board further recommends that 20,000,000 gold francs be transferred to the General Reserve Fund, 2,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 28,000,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1980–81 will be payable to shareholders on 1st July 1981.

# I. THE AFTERMATH OF THE SECOND OIL SHOCK.

For more than two years now the world economy has been struggling to correct the renewed imbalances forced on it by the second oil shock: the acceleration of inflation and the stagnation of output on the domestic front, and large balance-of-payments disequilibria at the international level. As time goes by, the contrasts with developments after the first oil price rise are tending to become sharper, and the similarities to weaken. Remedies now being more firmly applied to old problems are raising new ones. The results so far have been mixed, and it would be exaggerated to claim that developments in the last year or so have on balance been tending in the right direction. But it would also be a mistake not to recognise that in two key areas at least – those of inflation and oil conservation – a number of countries in the developed industrial world are reacting more positively to the second oil shock than they did to the first. In these respects, history is not repeating itself. As in 1974–75, financing the payments imbalances has so far proved less difficult than had been feared, although the balance-of-payments pattern that has until now facilitated the recycling process has also created problems in other respects, namely by causing sharp exchange rate movements and by leading, in some countries, to excessively high real interest rates.

Three facts seem to lie behind these developments. All three are in contrast to what happened six years ago and therefore deserve to be mentioned at the very beginning of this Report.

First and foremost, a significant shift has occurred in policy attitudes regarding inflation. The fight against inflation has, it is true, figured among the authorities' policy objectives for a long time, but in many cases declarations of intent were not followed up by action. Moreover, after the first oil shock a number of countries deliberately opted for expenditure-stimulating policies, in the belief that there *was* a trade-off between inflation and unemployment. It is now widely recognised that, except in the relatively short run, no decline in the rate of unemployment can be secured at the price of higher inflation. On the contrary, in the longer run, sustained growth in output, and hence in employment, will take place only if the process of inflation is brought under control. The fight against inflation has therefore tended to become a declared policy target of first priority; and anti-inflationary policies have in fact been adopted in many countries, with the main burden falling on monetary policy.

This shift in policy stances, the heavy reliance placed on monetary policy and the experimentation with new monetary control techniques that has inevitably accompanied the more stringent use of monetary policy have created problems of their own, which are discussed in some detail in the Conclusion. But they have also given initially some modest, positive results. The price-raising impact of the higher cost of oil has not spread through the economy to the same extent as it did six years ago; and, more importantly, both money and real wages have been rising more moderately than they did at that time, with the result that there are a number of

countries in which both corporate profits and fixed capital formation, though distinctly weaker, have held up better than in the aftermath of the first oil shock. These developments are unfortunately not universal, and where they are observable they may turn out to be short-lived. However, they do provide a glimmer of hope that an anti-inflationary policy can work in ways other than by pushing up the external value of the country's currency – a policy route which can clearly not be followed by all industrial countries at the same time.

The second significant fact is that household and corporate oil consumers as well as the governments of oil-importing countries have now come round to the conviction that the higher real price of energy, and of oil in particular, is here to stay. Despite some recent easing of supply conditions, some even fear further real price increases or supply disruptions, which was hardly the general case two years after the first oil shock. It is not too difficult to see the reasons for this change in expectations. The recent oil price increase was the second, and not the first; it started from a much higher level; while it has so far been similar to the first in absolute real size, its time pattern has been different in that it has taken place more gradually; furthermore, it has affected the final consumers more directly, since it has passed more swiftly through the system. Last but not least, events in Iran and the subsequent war between Iran and Iraq have drawn attention to the vulnerability of oil supplies.

Just as the more conservative turn taken by monetary policies creates new problems as it begins to solve old ones, the recognition that high – and, a fortiori, rising – oil prices may well be a lasting phenomenon is hardly a piece of good news. Should the phenomenon indeed turn out to be permanent, the adjustment problems will prove formidable both domestically and internationally, and there are quite legitimate grounds for fearing that they might exert a long-lasting, severely depressive effect on economic activity. But these pessimistic expectations at least have the advantage of provoking action. Governments have introduced positive, real, adjustment policies by promoting domestic oil production or the substitution of other sources of energy for oil. Corporations are actively seeking both global energy conservation and specific oil savings; and households are following suit. The result is that the decline in oil consumption per unit of gross national product has speeded up. Here again, progress is not universal and is still not fast enough; moreover, it is questionable how far it will go. But it is at least under way.

The third fact that deserves to be pointed out is one that was already mentioned in last year's Report. This is the fact that an unexpectedly large part of the huge global oil deficit has so far been concentrated in the group of relatively wealthy industrial countries and, among these, in the less inflationary economies. Setting aside the intriguing analytical question of why this should be the case, this balance-of-payments pattern has clearly facilitated the recycling of the oil surplus, since most of the countries concerned could borrow relatively easily in the international markets, and some of them had ample external reserves on which to draw.

At the same time, this new constellation of external balances, coupled with the more conservative US monetary policy stance and the Federal Reserve's adoption of

a new operating technique, has created a host of new problems. It has led to wide exchange rate movements completely opposed to the "vicious" and "virtuous" circle developments that created so many problems in the late 1970s: it has been the turn of the less inflationary countries' currencies to depreciate, while those of the more inflationary ones have become stronger.

In one sense, of course, this has been a welcome development: nobody should wish to see a repetition of the diverging inflation and exchange rate trends that divided the western industrial countries into two so sharply contrasting groups after the first oil shock. It would also seem possible to argue that part of the recent exchange rate movements has simply tended to correct under or over-valuations which have come about precisely as a result of the "overshooting" of exchange rates that took place during the late 1970s. But there is the other side of the coin, too. On the one hand, exchange rates outside the European Monetary System have become far too volatile. On the other, some of the exchange rate movements – most notably, the depreciation of the effective exchange rate of the Deutsche Mark – were clearly becoming excessive during the early months of 1981, and as a result some of the less inflationary countries have been forced to accept abnormally high real interest rates. This has happened because their own interest rate policy had to be geared to the need to contain exchange rate depreciation and maintain global balance in their external payments at a time when, for reasons of domestic balance, the more inflationary countries – first and foremost the United States – were pursuing a monetary policy also leading to high interest rates. Thus all major countries had their own reasons for maintaining high interest rates – some of them because their fight against inflation inevitably implied high interest rates, some because they wished to avoid inflation being rekindled as a result of the depreciation of their currencies, and others simply because they needed to finance their external deficits. The problem was compounded by the interest rate volatility that resulted from the new monetary control techniques introduced by the United States in October 1979.

**Outline of the Report.**

Chapter II examines the revival of inflation in 1979–80 and its relation to the second oil shock. It compares this scenario with inflationary experiences in 1974–75 and attempts to answer two questions.

The first concerns the respective importance of external (i.e. terms-of-trade-induced) and internal influences in the acceleration of price increases following the two oil crises. The answer is fairly clear: whereas in 1974–75 domestically generated inflation played an overwhelming rôle everywhere, its contribution to inflation has now decreased in many countries, and in some of them quite sharply, both in relation to the current impact of deteriorating terms of trade and compared with the domestic inflationary influences observed in 1974–75. It is in Japan that the change has been most spectacular, while the performances of the United States, Canada and Italy have remained relatively disappointing.

The second involves looking behind the "veil" of global price indices to try to find out the degree and nature of domestic adjustment to the recent oil price

increase, i.e. the changes that have been taking place in the distribution of income between households and corporations. It appears that, at least until recently, wage-earners fairly generally have been accepting a greater share of the burden imposed by deteriorating terms of trade than they did in 1974–75. Thus profits have not suffered the same setback, except in the United Kingdom, and the corporate sector is therefore now in a better position than it was at that time to sustain its investment activity.

Chapter III focuses on the reactions of the real economy to the second oil shock in terms of output, expenditure, employment and oil savings, and concludes with an analysis of the constraint which the energy situation still places on the prospects for renewed expansion and a higher degree of employment. The picture that emerges is a mixed one. On the one hand, both the corporate and the household sectors have in most countries displayed a more stable behaviour than during 1974–75: fixed investment has remained relatively strong, and savings ratios have not risen dramatically. Correspondingly, the recession has so far been milder – the United Kingdom being, again, the exception. At the same time, relative domestic demand adjustments have been less disparate than those made after the first oil shock, with the result that the pattern of external imbalance among the industrial countries has not been as unsustainable as at that time.

On the other hand, despite the emergence of a healthy trend towards greater energy efficiency and, more particularly, oil savings, this very important "real" adjustment has done little more than halt the rapid rise in the industrial countries' dependence on imported oil. Thus their vulnerability to external shocks – price increases or supply shortfalls – remains very great; and, as long as the low-absorbing OPEC countries remain unable to re-spend their expanded income on imports, the global oil deficit is likely to remain high. In this situation, the prospects for a rapid resumption of faster growth and a spontaneous decline in the rate of unemployment are dim.

Dealing with monetary policy and domestic financial markets, Chapter IV highlights several major developments. Firstly, the general, and in some cases even dominant, reliance on monetary policy in the fight against inflation. This has resulted in historically high nominal interest rates and, in strong contrast to what happened in 1974–75, the emergence of positive real interest rates. Under the impact of the new pattern of external imbalances, real interest rates have reached very high levels in Germany and the Benelux countries. While positive real interest rates should clearly be regarded as an essential ingredient of an anti-inflationary policy stance, their high level may also signal the wrong kind of policy mix, i.e. an excessive burden on monetary policy in the presence of persistent, in some cases very high, public-sector deficits.

The second major development is to be found in the significant changes that have occurred in monetary control techniques, especially in the United States, but also, to a lesser extent, in some other countries. This experimentation with new techniques has led in the US market to wide interest rate fluctuations (and short-term volatility), which have spread to the rest of the industrial world, though the United Kingdom and Japan have been shielded from these developments thanks to the strength of their currencies.

Thirdly, interest rate patterns have been characterised in many countries by unusually long-lasting inverse yield curves. Whatever explanation can be found for these term/yield patterns – forecasts of moderating inflation rates or unexpectedly persistent liquidity restraint – they are apt to create severe problems for financial intermediaries whose normal business is to engage in maturity transformation.

Chapter V, on international trade and payments, follows the example of the earlier chapters in comparing recent developments with those of 1974–75. It sees the first major difference between these two experiences in the fact that the Group of Ten countries' current account has been much worse affected by the second oil shock than by the first, and detects a second striking contrast in an entirely different distribution of the external deficits within the Group of Ten countries and Switzerland, with a much greater burden falling on the less inflationary countries.

The chapter points out that, despite the high global oil imbalance, the payments shortfall of the oil-importing countries has so far on the whole been financed without great difficulty. The reasons given are the regional distribution of the oil imbalance referred to above, the fact that the size of the non-oil LDCs' external deficit (expressed as a percentage of the group's export earnings) was smaller than in 1974–75, and, last but not least, the continuation of a relatively high degree of liquidity in the international banking market.

Chapter VI contains the usual analysis of the international credit markets. The traditional concern about international banking in general, and the Euro-currency markets in particular, namely that their development may fuel international inflation or lead to an excessively fast growth of international liquidity, that they may serve as a vehicle for currency speculation, or that they may disturb the orderly conduct of domestic monetary policy, has this time been overshadowed by the vital rôle played by the international banking system in financing the large payments imbalances created by the second oil price increase. This chapter presents some hitherto unpublished statistics on the banks' part in the recycling of the oil surplus and assesses the problems raised by the continued participation of banks in large-scale balance-of-payments financing.

The central topics discussed in Chapter VII, which reviews the international monetary scene, are the striking exchange rate developments that have taken place over the last couple of years. There have been sharp fluctuations in the prices of the US dollar, the yen and the Deutsche Mark, and sterling has registered a substantial appreciation. Only the European Monetary System has provided some measure of stability for its members' currencies (at any rate until the devaluation of the lira in late March 1981), but even in this case relatively large fluctuations in their trade-weighted effective rates could not be avoided.

These exchange rate developments raise several intriguing questions which the chapter attempts to answer. Is it true that exchange rates have, in many instances, moved out of line with domestic cost and price developments? How have competitive positions been affected by these movements? What lessons can be learned from these experiences to gain a better understanding of the relative importance of the various factors determining exchange rate movements? Are there signs that exchange rates have again "overshot" – although this time in the opposite direction?

# II. INFLATION AND DOMESTIC ADJUSTMENT.

Over the past two years the world economy has been in the grip of a new inflationary surge. Once again, as in 1973–75, a steep upward adjustment in the price of oil, combined with a demand-induced rise in the prices of non-oil commodities, has provided a strong impulse to an acceleration in inflation in all the industrial countries. However, as the pattern of exchange rate movements has been different from that of the earlier 1970s, the impact of the external price shock has been differently distributed in this new round of inflation. Moreover, while the economic severity of the energy price rise since early 1979 has been comparable to that of the 1973–74 oil shock, the rise in the price of oil and non-oil commodities has been more gradual and the policy reactions to it have been more determinedly anti-inflationary. In consequence, the movement of prices has been less divergent internationally than it was in the course of the first oil shock. Recently, it would appear that a slowing-down of price inflation has been under way in a number of countries, the decline having been quite dramatic in the United Kingdom. However, the rate of inflation is still unacceptably high almost everywhere.

This chapter examines the implications of these developments by comparing the whole of the two years 1979–80 with 1974–75. Broadly speaking, it focuses on two questions. One has to do with the relative importance of external and domestic sources of inflation and the linkages between them. In other words, how big was the external shock and how successful were countries in containing its effects together with other sources of domestic inflation? The second question seeks to look behind the veil of overall price adjustments. To what extent have individual countries been able during the second oil shock period to achieve a better absorption of the implied loss of real income? In other words, has it been possible to achieve a better pass-through of the price impulses from abroad, while at the same time avoiding a sharp set-back in profitability, investment and hence in prospects for future growth and employment?

## Recent price developments.

The acceleration of consumer price inflation in the late 1970s went hand in hand with the renewed upswing in business activity. In the United States and Canada, where recovery took hold at an early stage, the rise in prices began to speed up in early 1977. In other countries price inflation continued on average to subside until the early part of 1978, though in some of them prices had started to rise in the second half of 1977 as economic activity strengthened. Thereafter, with commodity prices increasing and oil prices being ratcheted up in sharp, irregular steps, inflation advanced strongly in all countries in 1979 and early 1980. By the second half of 1980 and in the early months of 1981 there were signs of a deceleration in a number of countries. In others, however, there was little indication of an easing in the high rate of inflation.

In the spring of 1981 the dispersion of national inflation rates continued to be quite great, though less than it had been five years earlier (see table). The lowest rates, ranging between 5.5 and 7.5 per cent., were recorded for Japan, the Federal Republic of Germany and economies closely linked to the latter country by finance and trade, viz. the Benelux countries, Austria and Switzerland. Inflation rates of between 10.0 and 14.5 per cent. were recorded by the United States, Canada, the United Kingdom, the Scandinavian countries and Spain. Finally, inflation in Italy continued to hover near 20 per cent., while in Greece the rate of inflation has been running at over 25 per cent.

Changes in consumer prices.

| Countries | Changes over twelve months ending | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1973 Dec. | 1974 Dec. | 1975 Dec. | 1976 Dec. | 1977 Dec. | 1978 Dec. | 1979 Dec. | 1980 June | 1980 Dec. | 1981 latest month |
| | in percentages | | | | | | | | | |
| United States | 8.8 | 12.2 | 7.0 | 4.8 | 6.8 | 9.0 | 13.3 | 14.3 | 12.4 | 10.0[2] |
| Japan | 19.0 | 22.0 | 7.7 | 10.4 | 4.8 | 3.5 | 5.8 | 8.4 | 7.1 | 6.2[1] |
| United Kingdom | 10.6 | 19.2 | 24.9 | 15.1 | 12.1 | 8.4 | 17.2 | 21.0 | 15.1 | 12.0[2] |
| Italy | 12.3 | 25.3 | 11.1 | 21.8 | 14.9 | 11.9 | 19.8 | 20.7 | 21.1 | 19.9[2] |
| Canada | 9.1 | 12.5 | 9.5 | 5.8 | 9.5 | 8.4 | 9.8 | 10.1 | 11.2 | 12.6[2] |
| France | 8.5 | 15.2 | 9.6 | 9.9 | 9.0 | 9.7 | 11.8 | 13.5 | 13.6 | 12.5[1] |
| Sweden | 7.5 | 11.6 | 8.9 | 9.6 | 12.7 | 7.4 | 9.8 | 13.1 | 14.1 | 12.9[2] |
| Germany | 7.8 | 5.8 | 5.4 | 3.7 | 3.5 | 2.5 | 5.4 | 6.0 | 5.5 | 5.6[2] |
| Switzerland | 11.9 | 7.6 | 3.4 | 1.3 | 1.1 | 0.7 | 5.1 | 3.3 | 4.4 | 5.6[2] |
| Belgium | 7.3 | 15.7 | 11.0 | 7.6 | 6.3 | 3.9 | 5.1 | 6.2 | 7.5 | 7.4[2] |
| Netherlands | 8.2 | 10.9 | 9.1 | 8.5 | 5.2 | 3.9 | 4.8 | 6.6 | 6.7 | 6.2[2] |
| Austria | 7.8 | 9.7 | 6.7 | 7.2 | 4.2 | 3.7 | 4.7 | 7.1 | 6.7 | 7.4[2] |
| Denmark | 12.6 | 15.5 | 4.3 | 13.1 | 12.2 | 7.1 | 11.8 | 13.3 | 10.9 | 11.3[1] |
| Finland | 14.1 | 16.9 | 18.1 | 12.3 | 11.9 | 6.5 | 8.6 | 11.2 | 13.8 | 13.1[1] |
| Greece | 30.7 | 13.5 | 15.7 | 11.7 | 12.8 | 11.5 | 24.8 | 26.2 | 26.2 | 24.3[2] |
| Norway | 7.6 | 10.5 | 11.0 | 8.0 | 9.1 | 8.1 | 4.7 | 10.8 | 13.7 | 14.6[2] |
| Ireland | 12.6 | 20.0 | 16.8 | 20.6 | 10.8 | 7.9 | 16.0 | 20.2 | 18.2 | 21.0[3] |
| Spain | 14.3 | 17.9 | 14.1 | 19.8 | 26.4 | 16.6 | 15.5 | 15.9 | 15.1 | 13.8[3] |

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

Judged purely in terms of the performance of overall consumer prices, inflation in 1979 and 1980 was somewhat less than in the two years following the first oil shock. Consumer prices in the Group of Ten countries and Switzerland rose on an unweighted basis by a total of about 24 per cent. during the first period, as against about 20.5 per cent. during the second. The pattern of price rise also differed. In the first period prices skyrocketed during the twelve months or so following the shock, whereas in 1979–80 the acceleration was smoother and more protracted.

Although the second external price shock was broadly similar in nature to the first, developments in individual countries differed in many respects. Several broad country groupings may be distinguished here. In the first group (the United States, Canada, France, Norway and Sweden) inflation rates around the start of each shock (late 1973 and late 1978 respectively) were more or less the same, i.e. 7.5–9.5 per

cent. However, whereas two years after the first shock inflation rates were back not far from their starting-point (7.0–11.0 per cent.), they rose during the comparable period of the second shock to appreciably higher levels (11.0–14.0 per cent.). A second group (the United Kingdom, Italy and Spain) also entered the two shock periods at roughly the same inflation rate each time, though at levels higher than the first group. But while in the United Kingdom inflation increased notably less in the second period than in the first, Italy's experience was just the contrary.

Many countries started the second oil shock period at sharply lower inflation rates than the first. In one group (Japan, Germany, the Benelux countries, Austria and Switzerland) strong anti-inflationary policies approximately halved the rates of inflation between 1973 (7.0–19.0 per cent.) and 1975 (3.5–11.0 per cent.). But during the second shock the range of inflation rates for these countries increased, from 0.5–4.0 per cent. in 1978 to 4.5–7.5 per cent. at the end of 1980. In the other group (Denmark, Finland, Greece and Ireland) the same general acceleration was observed between the two periods, though from a base that was markedly higher on average than in the previous group.

These differences in performance patterns, both between countries and between external price shock periods, were influenced by a number of factors which are discussed later in this chapter, namely differences in the time profile of the shocks, in relative exchange rate behaviour and in the stance of anti-inflationary policies. However, some factors which had a more direct impact on price behaviour may already be noted here. One of these is that the rise in prices appears to have been allowed to feed through more quickly in the second oil crisis than in the first. After the first shock many countries had followed policies that attempted to repress or postpone some of its inflationary consequences. During the second episode most countries allowed prices to increase so as to curb energy dependence. In the United States the new Administration abolished the remaining price controls on domestically produced oil, in Belgium special energy-use taxes were applied, and in France and Italy sharply higher public utility charges were introduced. In Canada, on the other hand, regional income-distribution considerations have led to a continuation of price controls on domestic energy output.

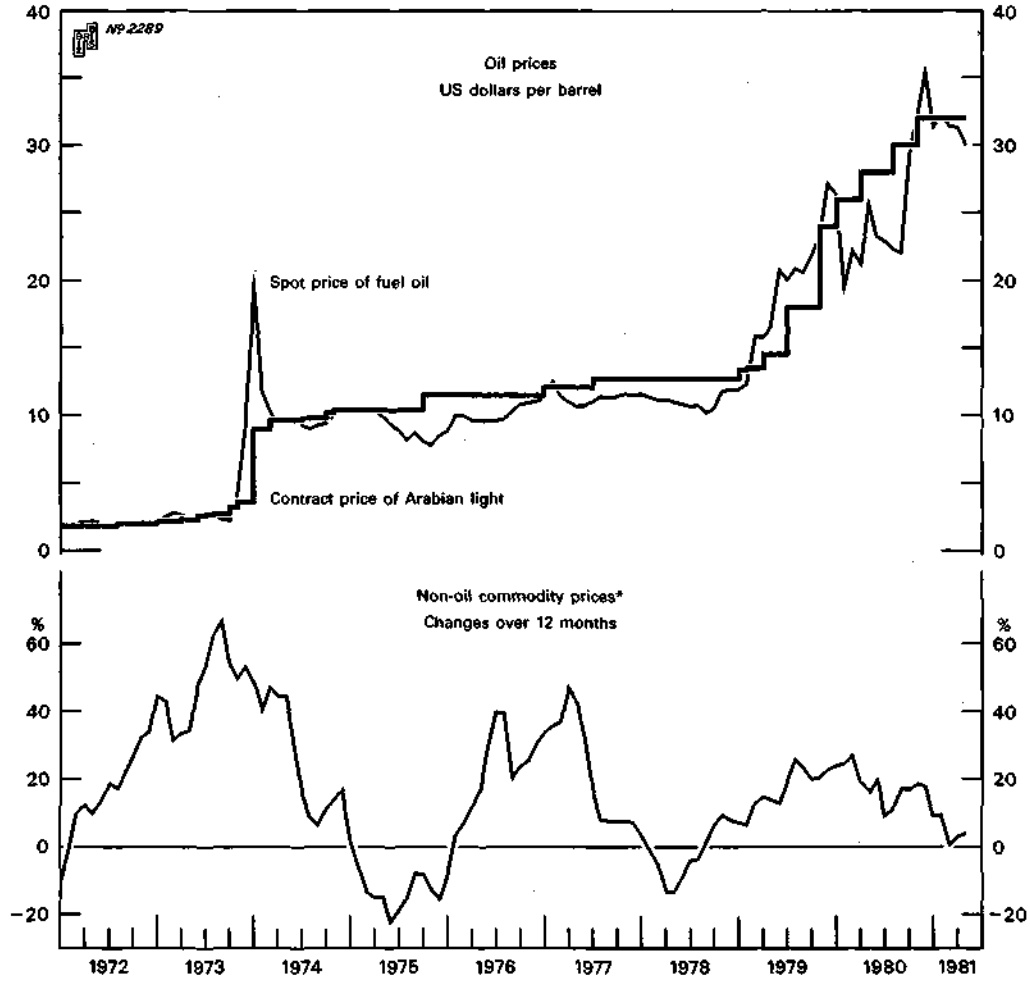
Alterations to administered prices and value added taxes have also significantly influenced consumer price indices in some countries. In the United Kingdom, for example, an increase in VAT in June 1979 was estimated to have added some 3 percentage points to the consumer price index, and a further rise in indirect taxes in the March 1980 Budget implied another 2 percentage point rise. In Sweden, too, a large increase in value added taxes was introduced during the past year. With regard to administered prices, concern over the finances of public-sector corporations and municipalities in the United Kingdom led to large upward adjustments in public-sector charges. Rents for local-authority housing, which constitutes a large part of the United Kingdom's rented housing stock, have risen substantially during the past two years. In Italy strict controls on rent had been phased out and replaced with an indexation scheme that led to sharp increases during the second oil shock. In the United States financial deregulation contributed to large increases in mortgage rates, these increases being estimated to have added 1½ percentage points to the consumer price index in both 1979 and 1980.

Apart from energy prices and rents, other components of consumer prices — food, services and non-energy commodities — appear in most countries to have risen more moderately in 1979–80 than they did after the first oil shock. In part, this reflects the relatively weaker state of international commodity markets and domestic labour markets in the second period.

**International prices: Commodities and oil.**

The aggravation of inflation at the turn of the decade was in large measure closely linked to the behaviour of prices on the world commodity markets. Commodity prices surged upwards between late 1978 and early 1980 as global demand strengthened. Although overshadowed by the more than twofold increase in oil prices, the prices of non-oil industrial commodities and foodstuffs (as measured by the "Economist" indicator, expressed in SDRs) rose by 44 per cent. between July

World-market commodity prices: Oil and non-oil.




* The "Economist" indicator, expressed in SDRs.

1978 and February 1980. Subsequently, as US economic activity dipped sharply and recession got under way in a number of countries, industrial commodity prices for both metals and fibres declined, but then firmed up again as from the end of the summer. Meanwhile, food prices contributed to a rise in the overall commodity price indicator for the year as a whole as poor harvests in various countries caused stocks to decline. It is noteworthy, however, that the rise in food prices largely reflected a very steep increase in sugar prices. Altogether, the overall indicator peaked in November 1980 and thereafter dropped back, its decline amounting to about 7 per cent. by April 1981.

Tensions in world oil markets also eased in late 1980 as industrialised countries' oil consumption declined. Partly reflecting a deliberate adjustment in supplies, production in the Organisation of Petroleum Exporting Countries (OPEC) cartel has recently been running at a ten-year low. The possibility of further such adjustments, together with political uncertainties in some of the oil-exporting countries and the continuing Iran-Iraq conflict, raises questions about the future adequacy and continuity of world oil supplies.

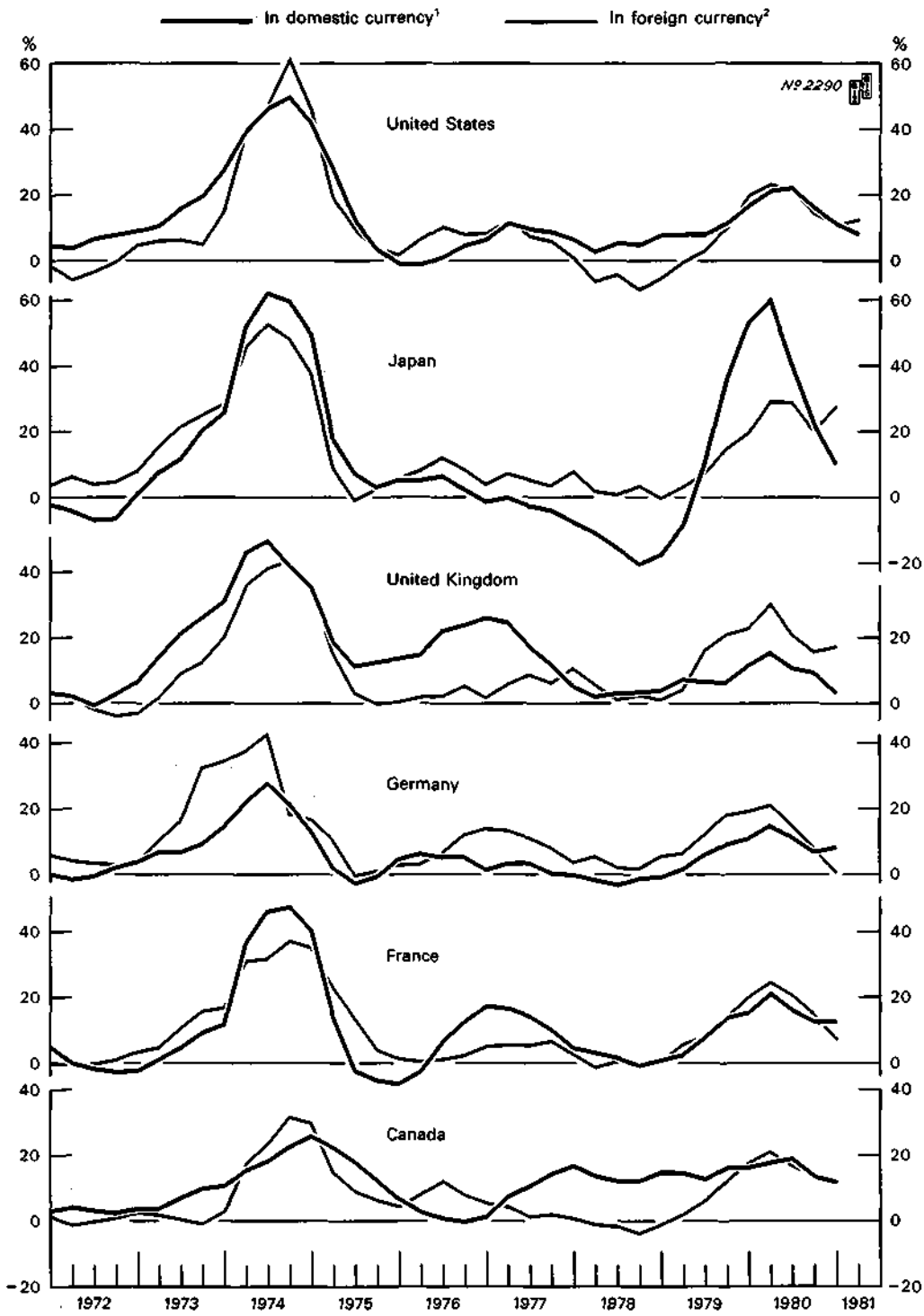
There are many similarities between the 1973–74 and 1978–79 eruptions of world commodity prices. The first episode saw a fivefold increase in the price of crude oil, albeit from a very low base. Even before the oil crisis, non-oil commodity prices had almost doubled as a result of strong global demand pressures in the years 1972–73. Unusually high levels of capacity utilisation, production bottlenecks and widespread raw-material shortages — all of which reflected the strains of an overheated world economy — created a speculative environment which fanned commodity price inflation. At the same time, a series of widespread crop shortages caused food prices to explode.

In these respects the second eruption of commodity prices was not very different from the first. Again, the main source of disturbance was a sharp upward adjustment in the price of oil beginning in early 1979, while around the middle of 1978 industrial commodity prices had already started to rise in response to a gradual strengthening of world economic activity. There were also elements of speculative buying as well as agricultural supply problems. All in all, however, the increase in non-oil commodity prices did not approach the severity of the first shock, in large measure because business activity was in better balance internationally and capacity pressures were less intense. While in percentage terms the most recent oil shock appears less severe than the one which occurred in 1973–74, the comparison is misleading because of the low levels from which oil prices started their rise in 1973. In economic terms, the increase in the oil import bill relative to the domestic incomes of the Group of Ten countries and Switzerland was roughly equal in both periods.

**Exchange rates and external price impulses.**

How inflation in the world commodity markets is transmitted to domestic economies depends in part on the movement of international exchange rates. This rôle of foreign exchange rates is illustrated for selected countries in the

Import prices.
Changes over four quarters, in percentages.




[1] Implicit import price deflator. [2] Import price deflator adjusted by the effective exchange rate.

accompanying graph. The heavy line shows the annual rate of change in import prices in domestic currency terms, as measured by the change in the import price deflator over four quarters. The thin line is the same measure in foreign currency terms, i.e. adjusted by the four-quarter rate of change in the effective exchange rate. As is to be expected, the weighted change in import prices in foreign currency terms follows a roughly similar pattern for each country, reflecting commonly felt developments emanating from the international commodity markets. Differences among countries in the behaviour of this measure are thus due largely to differences in the composition of imports and in the degree of dependence on oil and other primary commodities.

In the 1970s, as the graph shows, import prices rose sharply for all countries, but particularly for Japan and the United States. How these rises in import prices were transmitted to domestic price/wage mechanisms depended, of course, on the contemporaneous movements in effective exchange rates. In late 1973 and in 1974 the actual import price increases in Japan, the United Kingdom and France were substantially magnified by the depreciation in these countries' effective exchange rates. In contrast, in the United States, Germany and Canada the rise in import prices was mitigated to some extent by the appreciation of the dollar currencies and the Deutsche Mark.

The importance of exchange rates is readily apparent in the period after the initial shock and before the commodity price increases in 1978. While there was not a generalised price shock during this period, commodity prices tended to rise as economic activity recovered. During this interval, in terms of the differential impact of import prices for individual countries, the relative movement of exchange rates appears to have dominated developments in the commodity markets. In terms of price change, the fall of the dollar from late 1977 onwards, the protracted appreciation of the yen from 1976 to 1978, the sterling crisis in 1975–76, the appreciation of the Deutsche Mark from 1976 to 1979, the depreciation of the French franc accompanying France's withdrawal from the "snake" arrangement in 1976 and the decline in the Canadian dollar in 1977–78 were all important in contributing to the notable differences in the way that external price developments affected the various countries.

The second surge in international commodity prices began around the middle of 1978. The rôle of exchange rates in conditioning the magnitude of these price disturbances varied dramatically from the 1973–75 episode. In Japan the depreciation of the yen in 1979 greatly increased the domestic impact of the commodity price rise, making the second oil rise as great as, if not greater than, the earlier shock. In the United Kingdom, on the other hand, the sharp appreciation of sterling moderated the impact of international price rises. Germany and France benefited for a time from appreciating effective exchange rates, but this gain was thereafter reversed as a result of the strengthening of the dollar against European currencies.

**"Imported" and "home-made" inflation.**

Part of the worsening of inflation in the 1970s has been of international origin, reflecting the recurring commodity price shocks and, at least for some countries, the

behaviour of exchange rates. Conceptually, a useful distinction can be made between "imported" and "domestically produced" inflation, though it is by no means exact and unambiguous. First, much of an inflation shock which appears to be exogenous to any individual country may only be an indirect reflection of developments in the large industrialised countries as a group. Moreover, inflation is a dynamic process with complex interactions and feedbacks of actual costs, prices and expectations. In a prolonged bout of inflation these differing aspects may become so intermingled that it is virtually impossible to distinguish between them.

With these caveats in mind, the "imported" and "domestically generated" components of inflation for the Group of Ten countries and Switzerland during the two import price shocks are distinguished in the following table. The "imported inflation" element is measured by the annual changes in the terms of trade,

Contributions of "imported" and "domestically generated" inflation to overall inflation.[1]

| Countries | Imported inflation | | | Domestically generated inflation | | | Overall inflation | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1973 *1978* | 1974 *1979* | 1975 *1980* | 1973 *1978* | 1974 *1979* | 1975 *1980* | 1973 *1978* | 1974 *1979* | 1975 *1980* |
| | fourth-quarter to fourth-quarter changes, in percentages | | | | | | | | |
| Canada | – 2.1 | – 0.1 | – 0.1 | 11.6 | 15.1 | 10.2 | 9.5 | 15.0 | 10.1 |
| | *1.3* | *– 1.0* | *– 0.2* | *6.6* | *11.9* | *9.9* | *7.9* | *10.9* | *9.7* |
| France | 0.0 | 3.2 | – 1.3 | 8.0 | 12.2 | 10.3 | 8.0 | 15.4 | 9.0 |
| | *– 1.5* | *0.1* | *1.7* | *9.8* | *9.8* | *10.7* | *8.3* | *9.9* | *12.4* |
| Germany | 1.1 | – 0.9 | 0.9 | 6.7 | 8.6 | 3.8 | 7.8 | 7.7 | 4.7 |
| | *– 0.5* | *1.3* | *0.5* | *3.8* | *4.0* | *5.4* | *3.3* | *5.3* | *5.9* |
| Italy[2] | 3.0 | 2.3 | – 1.4 | 13.1 | 23.8 | 13.0 | 16.1 | 26.1 | 11.6 |
| | *– 0.3* | *1.9* | *3.5* | *14.1* | *16.3* | *20.3* | *13.8* | *18.2* | *23.8* |
| Japan | 1.0 | 3.1 | 1.2 | 15.7 | 18.4 | 5.1 | 16.7 | 21.5 | 6.3 |
| | *– 1.9* | *4.4* | *2.2* | *3.3* | *1.0* | *4.5* | *1.4* | *5.4* | *6.7* |
| United Kingdom | 3.8 | 2.7 | – 1.9 | 8.1 | 19.6 | 24.8 | 11.9 | 22.3 | 22.9 |
| | *– 1.0* | *– 1.5* | *– 1.3* | *10.5* | *18.2* | *16.8* | *9.5* | *16.7* | *15.5* |
| United States | 0.1 | 1.0 | – 0.5 | 7.5 | 11.0 | 7.5 | 7.6 | 12.0 | 7.0 |
| | *– 0.3* | *1.6* | *– 0.2* | *8.2* | *6.9* | *9.8* | *7.9* | *8.5* | *9.6* |
| | year-to-year changes, in percentages | | | | | | | | |
| Belgium | – 0.7 | 1.4 | 0.7 | 6.9 | 12.2 | 12.6 | 6.2 | 13.6 | 13.3 |
| | *0.1* | *– 0.3* | *1.5* | *4.2* | *4.2* | *5.0* | *4.3* | *3.9* | *6.5* |
| Netherlands | 0.3 | 2.6 | – 0.2 | 8.4 | 9.3 | 11.2 | 8.7 | 11.9 | 11.0 |
| | *– 0.3* | *1.5* | *1.2* | *5.1* | *3.9* | *5.9* | *4.8* | *5.4* | *7.1* |
| Sweden | 0.8 | 2.2 | – 3.2 | 7.1 | 8.7 | 14.7 | 7.9 | 10.9 | 11.5 |
| | *1.4* | *1.1* | *1.4* | *9.8* | *7.1* | *12.3* | *11.4* | *8.2* | *13.7* |
| Switzerland | 0.7 | 2.0 | – 2.6 | 8.1 | 6.9 | 7.1 | 8.8 | 8.9 | 4.5 |
| | *– 2.7* | *1.7* | *2.2* | *3.6* | *2.0* | *2.0* | *0.9* | *3.7* | *4.2* |

[1] Percentage point contributions of imported inflation (changes in terms of trade) and domestically generated inflation (GNP/GDP deflator) to overall inflation (domestic demand deflator). [2] Data for 1980 estimated.

calculated on the basis of the export and import price deflators and weighted by the size of the external goods and services sector. The measure of "domestically generated" inflation is the GNP/GDP price deflator, which does not include the increase in import prices. Implicitly, it is assumed that domestic factor prices are not directly affected by movements in the prices of imported goods. Together the two elements add up to "overall" inflation as measured by the domestic demand deflator. Prior to the onset of the second oil shock, the rate of domestically generated inflation in 1978 was actually much lower in some countries than it had been in 1973 before the first oil shock. This was particularly true of the Common Market countries bound together by fixed exchange rates (Germany, Belgium and the Netherlands) and of Japan, Canada and Switzerland. On the other hand, a number of countries entered the second oil shock at substantially higher rates of inflation than they had experienced in 1973. These included France, Italy, Sweden, the United Kingdom and the United States.

In the years 1979–80 the imported inflation factor was stronger, on balance, in a number of countries than it had been in 1974–75. This was especially true of Switzerland, Japan, Italy and Sweden, but the difference was also significant in the case of Germany and the United States. In Belgium and France the external impulse, though smaller in the second period than in the first, was still appreciable, while in the Netherlands it was about the same size in both periods.

Despite these external shocks, in 1979–80 the increase of domestically generated inflation was markedly smaller in most countries than it had been in 1974–75. Indeed, in Japan domestically generated inflation actually slowed despite unusually large external price shocks. On the other hand, in Italy and the United States domestically generated inflation rose in 1979–80 as much as in 1974–75, in part owing to the fact that the price impulse emanating from abroad was relatively larger in the second period than in the first.

These results point to several tentative conclusions. First, the link between external price shocks and the domestic inflationary process seems not to be as close as is sometimes supposed. During the second oil shock practically all countries acted in an early, determined way to avoid its secondary repercussions. In general, they were more successful than in the 1974–75 period in interrupting, or damping down, the transmission process, especially in the initial phase. Secondly, while the external/domestic link is not a very rigid one, relative movements in effective exchange rates nevertheless do play an important rôle in distributing the impact of external price disturbances. Some countries, the United Kingdom and Switzerland being at opposite extremes, found themselves in a quite different position in the second oil shock than the first because of exchange rate developments. Thirdly, and this follows from the first two points, the concerted, timely efforts made to contain domestically generated inflation appear to have met with a certain degree of success. Viewed in terms of the overall inflation rate, reflected in the domestic demand deflator, inflation was higher in 1980 than in 1975 in Germany, Italy, Sweden and the United States, while it was substantially lower in other countries, namely in Belgium, the Netherlands and the United Kingdom. Developments in the latter country emphasise the need not to over-extend the distinction between the "external" and "internal" aspects of inflation. The increased competitiveness of

imported goods in the United Kingdom due to the marked strengthening of sterling has, by squeezing profit margins, sharply reduced the rise in the price of domestic goods.

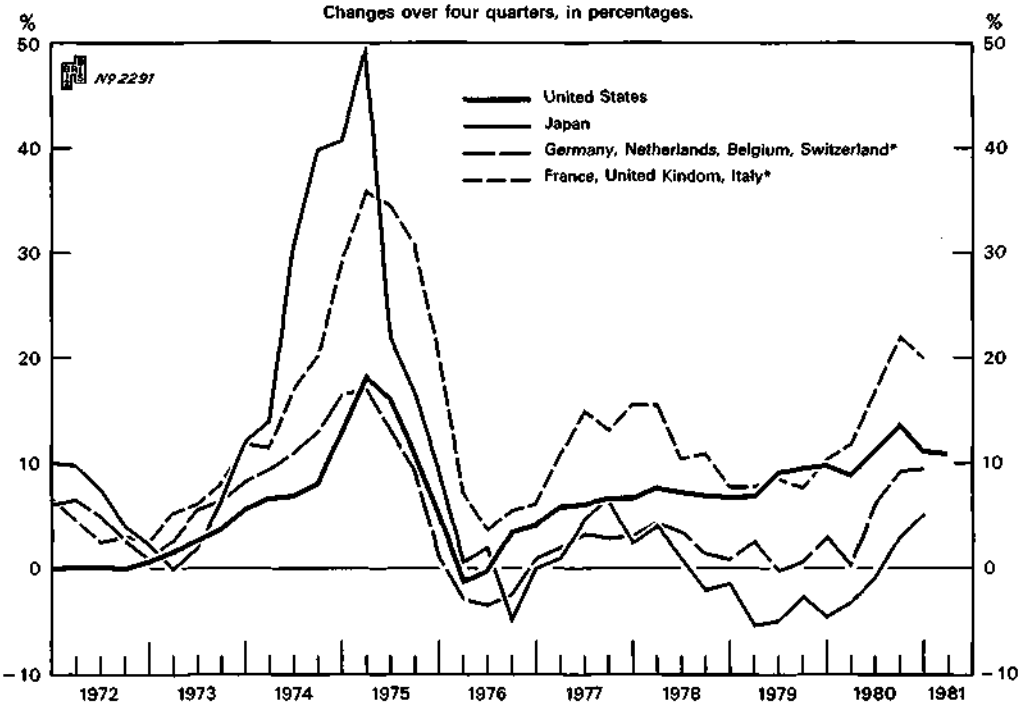
**The domestic inflationary process.**

Viewed in terms of the final price of goods, the worsening of inflation during 1979–80 was strikingly reminiscent of that which occurred in the wake of the first oil shock. From an income distribution standpoint, however, the underlying adjustment of price/cost relationships appears for most countries to have been very much better in the second oil shock period, at least up to now, than in the first. In part this reflects the relatively weaker state of the labour markets. Also, it would appear that the "learning process" helped, in that the social partners in the current episode were more willing to accept the adverse real-income implications of the fresh deterioration in the terms of trade.

By its nature, an international price shock implies a terms-of-trade loss of real income for most industrial countries. The extent of this loss obviously varies with a country's dependence on oil and commodity imports and its ability to recoup the loss partly by higher export prices. To the extent that the transfer of real purchasing power from importing countries to exporting countries is not offset by productivity growth, real incomes must decline. From the domestic standpoint, the income adjustment should preferably be borne by the household sector. This form of

Unit labour costs.

Changes over four quarters, in percentages.




* Weighted arithmetic averages based on gross national products for the year 1978.

adjustment helps to preserve or even to improve price/cost relationships. Otherwise, the burden may fall heavily on company profitability, adversely affecting investment and the future growth of real income.

Seen from the costs side, the improved performance of the industrial countries in the second oil shock period is reflected in the behaviour of unit labour costs (as shown in the graph on page 17). In contrast to the years 1974–75, when unit labour costs climbed substantially in all countries, the rises remained fairly moderate in 1979–80. The moderate increase occurred in the face of large increases in non-wage labour costs, most notably employers' contributions for social security insurance, which rose in most countries. This improved performance of unit labour costs was partly a reflection of a milder recession and in some cases better sustained

Hourly earnings and productivity in manufacturing.

| Countries | Nominal earnings[1] | | Real earnings[2] | | Productivity[3] | |
|---|---|---|---|---|---|---|
| | 1973 *1978* | 1974–75 *1979–80* | 1973 *1978* | 1974–75 *1979–80* | 1973 *1978* | 1974–75 *1979–80* |
| | annual rate of change, in percentages[4] | | | | | |
| United States | 6.6 | 7.4 | – 0.8 | – 1.5 | – 1.6 | 2.9 |
| | *9.2* | *8.4* | *1.5* | *– 1.2* | *0.8* | *0.8* |
| Canada | 9.5 | 15.0 | 0.4 | 3.7 | 2.9 | 2.7 |
| | *6.7* | *10.2* | *– 0.9* | *0.1* | *6.1* | *– 1.7* |
| Japan | 19.1 | 20.1 | 5.4 | 4.4 | 9.0 | 2.3 |
| | *5.0* | *6.5* | *– 0.4* | *1.3* | *10.2* | *9.2* |
| Austria | 9.8 | 13.4 | 2.9 | 4.1 | – 3.1 | 7.7 |
| | *6.7* | *7.4* | *1.4* | *2.1* | *13.7* | *8.0* |
| Belgium | 16.1 | 20.8 | 9.6 | 7.5 | 9.7 | 7.8 |
| | *6.6* | *9.0* | *2.3* | *3.4* | *13.2* | *3.0* |
| France | 15.9 | 17.6 | 7.6 | 4.9 | 0.3 | 3.7 |
| | *12.6* | *14.6* | *2.7* | *3.6* | *10.3* | *4.4* |
| Germany | 11.1 | 10.2 | 3.2 | 3.6 | 3.6 | 3.5 |
| | *5.7* | *6.1* | *3.1* | *1.0* | *3.8* | *0.2* |
| Italy | 25.4 | 22.2 | 10.5 | 5.6 | 11.1 | 1.5 |
| | *16.1* | *22.1* | *3.2* | *2.5* | *12.2* | *5.7* |
| Netherlands | 13.6 | 15.1 | 3.9 | 4.3 | 4.9 | 4.6 |
| | *5.0* | *4.2* | *0.7* | *– 1.4* | *11.7* | *– 0.3* |
| Sweden | 8.6 | 16.2 | 1.1 | 5.3 | 3.3 | 0.1 |
| | *6.1* | *10.2* | *– 4.6* | *1.5* | *14.3* | *3.2* |
| Switzerland | 9.2 | 9.7 | 0.2 | 1.3 | 5.4 | 4.4 |
| | *3.7* | *4.5* | *3.1* | *0.2* | *3.7* | *1.2* |
| United Kingdom | 13.0 | 24.4 | 3.0 | 2.3 | 2.6 | 0.7 |
| | *13.4* | *19.5* | *4.7* | *4.0* | *1.3* | *0.3* |
| Unweighted average | 13.1 | 16.0 | 3.9 | 3.8 | 4.0 | 3.5 |
| | *8.0* | *10.2* | *1.4* | *1.4* | *8.4* | *2.8* |

Note: The data for 1980 are partly estimated.

[1] Wage rates for Italy, France and the Netherlands. [2] Nominal earnings deflated by prices of personal consumption. [3] Adjusted for working time. [4] December to December for earnings data and fourth quarter to fourth quarter for productivity, *where available.*

productivity in the second period, but these results were themselves a function of a more moderate outcome with respect to nominal and real wages.

A comparison of changes in nominal earnings, real earnings and productivity is shown for the two oil shock periods in the accompanying table. A striking feature of the years 1979–80 is the more moderate increase in nominal earnings compared with 1974–75. Only in the United States were the annual increases in earnings in the second adjustment period higher than in the first. In all other countries the rise in earnings was smaller than in 1974–75 — in some cases, such as Japan, Germany, the Benelux countries, Austria and Switzerland, substantially so. However, in many of these countries there was a considerable acceleration in the growth of earnings in the course of the second adjustment period.

The picture of a better wage adjustment is confirmed by a comparison of changes in real earnings with those in productivity gains. In most countries real earnings rose relatively little, or even declined, during the second oil shock, while productivity performance was on average nearly as good as it had been in 1974–75. One exception was the United States, where in 1979–80 there was a decline in real wages but at the same time only a modest increase in productivity. Another was Germany, where both real earnings growth and productivity growth were much lower than they had been in 1974–75.

The most remarkable example of domestic adjustment to the second inflationary shock was without doubt Japan. Despite a severe external price shock, prompt application of restrictive monetary policy was able to dampen the price pressures emanating from the international economy, so that there was very little impetus to inflation from domestic sources. At the same time the severity of the 1974–75 recession, during which real output fell precipitously, affected wage bargaining attitudes. The painful experience of the first shock created a keen awareness of the close link between domestic wage costs, employment and real income. The unique relationship that exists between business and labour in Japan also helped. In addition to life-time employment guarantees, wage bonuses — which account for about one-quarter of labour income — are varied with business profitability. In this setting the central bank's determination to contain the external inflationary shock was heeded by the social partners, and a resurgence of excessive wage demands was avoided.

In the United Kingdom, by way of contrast, little progress was made during most of the 1970s in bringing down the high underlying rate of inflation. In the past two years the Government has pursued a severely restrictive demand-management policy aimed at bringing about a basic change in inflationary expectations, particularly in respect of the wage bargaining process. In 1979, however, earnings rose sharply, in part as a result of a large adjustment in public-sector wages in response to the Clegg Commission's proposals, which aimed to put public-sector pay back on a comparable footing with private-sector wages. The large size of this adjustment, however warranted in its own right, contributed to a further leap-frogging of wage demands. More recently, the Government has abandoned the comparability approach and has sought to bring public-sector pay under better control. In the private sector, following a painful further worsening of labour-

market conditions, recent wage settlements have been appreciably lower than those concluded a year earlier.

In the United States, unlike the improved results achieved in Japan and most European countries, recent wage performance has not compared favourably with the 1974–75 period. At least part of the worsening labour cost pressures must be ascribed to the gradual relaxation of the existing wage and price restraint programme. The complete dismantling of these controls at the start of 1981 promised to aggravate underlying inflationary pressures.

Uncertainties over the rate of inflation and the desire to protect against the ravages of inflation have led to the spread of indexation practices, of a formal or a de facto nature. Provided such arrangements are suitably conceived, they can make a positive contribution towards the lessening of social conflict over the distribution of income. On the other hand, if no allowance is made for warranted reductions in real income, indexation can reinforce the transmission of external cost shocks and add to inflationary pressures. Moreover, if strong demands for real-income gains come on top of the increases ensured by indexation, there is a major danger of inflaming the inflationary process. In Switzerland, for example, where strong public concern about inflation goes hand in hand with moderate expectations concerning real wage gains, widespread de facto indexation has not generally tended to exacerbate inflation. In a country such as Italy, on the other hand, the existence of indexation combined at times with large real wage increases appears to have reinforced the self-perpetuating wage/price spiral.

### Are monetary and fiscal policies enough?

With the intensification of inflation during the past two years, national authorities have had little choice but to pursue restrictive demand-management policies. The setting in which heavy reliance was to be placed on such policies was scarcely an auspicious one. Unemployment already stood at high levels in many countries, and the legacy of past inflation had become embedded in expectations and the wage bargaining process, making wages and prices increasingly unresponsive to changes in demand. In these circumstances experience suggested that the costs of curbing inflation were likely to be high in terms of employment as well as of political and social stability. With a view to minimising these costs, national authorities generally sought to influence expectations directly by pointing in advance to the broader implications of their policies. In this way, it was hoped, moderation in wage/price behaviour could be achieved spontaneously and the adjustment process foreshortened without heavy costs.

In a few countries, notably the United Kingdom and the United States, the reliance placed on restrictive demand-management policies marked a departure from the emphasis given during lengthy periods in the past to "incomes policies". In principle, incomes policies, consisting of more or less formal arrangements for directly influencing wage and price behaviour, have long been considered by many as a relatively low-cost way to contain the wage/price spiral. However, the feasibility, and even relevance, of such policies depends on the institutional structure

and social cohesion of each country. As a practical matter, incomes policies are difficult to formulate and administer. Some countries have preferred to shun them altogether, at least in their narrower conception, while others have found them to yield disappointing, even counter-productive, results over the long term. In certain countries, on the other hand, price and pay policies are still in favour and have on balance been found helpful. Moreover, viewed more broadly as an entire range of economic and social policies, incomes policies can extend well beyond pay and price controls as such. They may be seen to include the indirect announcement effects of monetary targets, tax and subsidy measures, exchange rate commitments, public-sector pay policy, and also improvements in the performance of labour and product markets.

In the United States price and pay guidelines were reintroduced in the late 1970s and appear to have enjoyed a moderate degree of success. However, their effectiveness had been eroded by the time the new Administration assumed office in 1981, and the guidelines have since been abandoned.

In the United Kingdom, which has a long and unencouraging history of efforts to apply incomes policies, much of the 1970s was devoted to trying to implement a sort of permanent incomes policy. Indexation was dropped in 1975, but incomes policy initiatives continued to be taken on an annual basis until 1978. During the second oil shock period pay policies were eschewed altogether, with the Price Commission being abolished in July 1979.

In France, although there has been no full-blown incomes policy, some elements of such a policy, for example price controls and efforts to influence wages via public-sector pay determination, were adopted in the 1970s. Under the Barre plan, industrial prices were decontrolled as a stimulus to competition, and this was followed at the beginning of 1980 by the removal of most controls on retail prices. Pay policy has generally been aimed at keeping the growth in average wages approximately in line with the increase in prices, while permitting some upward adjustment in the real minimum wage.

The greater reliance now being placed on monetary policy and monetary targets in the above-mentioned three countries does not imply that incomes policies are everywhere becoming obsolete. In Austria, thanks to a long-standing "social partnership", reductions in nominal wage claims have been consciously accepted as a contribution towards absorbing the real-income loss associated with higher oil prices, and helping to improve investment and international competitiveness. In a different form a restrictive incomes policy has also been applied in the Netherlands. After a two-month wage freeze in early 1980, limits were imposed on further rises in wages, cost-of-living adjustments were curtailed, and price controls were maintained. To ease part of the burden of the adjustment, there were concessionary cuts in income taxes. In February 1981 the Belgian Government was able to induce a voluntary two-year pay restraint settlement that limited the rise in wages to increases in the consumer price index.

In the Scandinavian countries there has been a long history of centralised collective bargaining, with governments relatively far removed from the negotiations. In Sweden, following a breakdown of the centralised incomes

negotiations in March 1980, the Government introduced a general price freeze until May to pave the way for wage and salary bargaining. Following strike action, the new settlement limited the annual increase in average labour costs to about 10 per cent., after taking wage drift into account. In Norway the expiration of the existing pay/price programme at the close of 1979 sharply aggravated inflationary pressures. In Denmark the energy component has been excluded from the wage-regulating price index so as to reduce pressures on profit margins and to weaken the link between external and domestic costs.

In the broadest sense, incomes policies may also be conceived as encompassing the expectational benefits associated with policy announcements. In many countries the monetary authorities make use of publicly announced targets to affect public expectations concerning wages and prices. For example, in Germany, while the Bundesbank plays no direct rôle in wage/price discussions, its monetary targets provide a framework — a set of assumptions about the economic environment and the conduct of policy — that can help the social partners in the wage bargaining process. Monetary targets are now used in a large number of countries, but the degree to which these targets are expected to influence wage bargaining differs substantially according to institutional circumstances. At all events, there is a danger of overestimating the impact of announcement effects on price expectations. Uncertainties over the resolve or ability of the monetary authorities can quickly undermine the intended effects.

In the inflation/unemployment environment of recent years, national authorities have also turned to a broad array of essentially structural policies. These have included policies for energy conservation and substitution, manpower training, education and other programmes that might raise productivity and increase the growth of supply. At the same time a proliferation of governmental regulations has in some countries tended to impose onerous burdens on private enterprise. A reduction of these burdens where they seem excessive should enhance firms' ability to expand and respond to changes in relative prices. Among the more dramatic demonstrations of the effectiveness of such policies is the decontrol of the airlines in the United States.

The effectiveness with which incomes and structural policies have functioned in the past dictates to an important extent their relative rôle in the current mix of policies. Incomes policies can certainly pose potential dangers. By temporarily quelling the inflation upsurge, controls may reduce the urgency of pursuing restrictive policies. Moreover, there is the awkward problem, particularly where indexation is a feature, of accommodating the flexibility of relative wages and prices required by a dynamic economy.

Some of the dangers of an ineffective incomes policy are eloquently illustrated by past experience in both the United States and western Europe. By the same token, the costs of severe demand restraint in the absence of such policies are also apparent in many countries, and especially so in the United Kingdom. The recurrence of external price shocks over the past decade together with the stubbornness of wage cost pressures suggest that the character of the macro-economic problem has undergone a fundamental change. A policy of constantly

pressing down aggregate demand in response to these repeated price and cost shocks poses many risks — political, social and economic. In economic terms, the greatest risks are of creating high levels of unemployment and low rates of industrial utilisation which reduce current levels of activity and ultimately undermine profitability and the incentive to invest. It would seem undeniable, in principle, that some more direct form of anti-inflation policy — be it known as concerted action, social compact or incomes policy — can contribute to the maintenance of real-income growth. Yet, in practice, despite their persistent efforts over many years, the authorities in various countries have not yet succeeded in creating the market structure and social cohesion needed as the basis for such a policy.

**Inflation and growth: New focus on the public sector.**

In the current effort to combat the flare-up of inflation, real growth has faltered in most countries and outright recession has taken hold in others. In the past, this situation has triggered stimulative policies — most usually discretionary fiscal measures — to renew expansion and reduce unemployment. But this time there are striking differences in attitudes. Instead of concern over bolstering aggregate demand, a sense of urgency about the growing imbalance between the market and non-market sectors, or, more broadly, between the private and public sectors, is almost universally observed. This imbalance is widely viewed as a serious impediment to productive investment and the maintenance of adequate growth potential. To a large extent these views are consonant with the concept of "supply-side" economics. While considerable doubt has been expressed about the incentive effects of tax reductions per se, there is widespread agreement about the need in many countries to curb the growth of the public sector and to provide more scope for fixed capital investment and the growth of productivity and private employment. By the same token, there has been little support for fiscal measures designed purely to stimulate output by expanding aggregate demand.

The enormous expansion of public-sector spending is obvious in every country (as shown in the table on page 24, which gives data for selected years beginning in 1961). Broadly speaking, the most rapid increase in outlays has occurred since the outbreak of the first oil crisis in late 1973, but there were also substantial increases in both transfer payments and public-sector consumption during the preceding years.

As a long-term trend, it is natural to expect that public expenditure will gradually rise as a proportion of gross domestic product. In other words that, as real national income grows, a larger share will be allocated to providing public-sector services and to ensuring a more equitable distribution of social benefits and burdens. However, the dramatic scale on which public spending has expanded during the past two decades, combined with a low rate of investment and slow growth in the 1970s, has become a source of acute policy concern. From 1961 to 1980, for instance, public expenditure as a proportion of gross domestic product rose from 31.0 to 63.2 per cent. in Sweden, while in the Netherlands it jumped from 35.0 to 60.4 per cent. Even in countries such as Japan and Switzerland, where the ratio of public expenditure to gross domestic product remains relatively low, appreciable increases have occurred since the early 1960s.

General government: Expenditure and revenue.

| Countries | Years | Expenditure | | | Revenue | | | Surplus or deficit (–) |
|---|---|---|---|---|---|---|---|---|
| | | Public consumption | Transfer payments | Total* | Taxes | Transfer receipts | Total | |
| | | in percentages of gross domestic product | | | | | | |
| Belgium | 1961 | 12.2 | 15.5 | 29.8 | 19.9 | 7.4 | 28.4 | – 1.4 |
| | 1967 | 13.8 | 17.6 | 34.5 | 22.8 | 9.5 | 33.2 | – 1.3 |
| | 1973 | 14.8 | 21.0 | 39.1 | 24.9 | 11.4 | 36.4 | – 2.7 |
| | 1979 | 18.2 | 28.0 | 49.9 | 30.5 | 12.7 | 43.2 | – 6.7 |
| | 1980 | 18.3 | 29.5 | 51.8 | 30.0 | 12.9 | 43.0 | – 8.8 |
| Canada | 1961 | 15.4 | 10.7 | 30.0 | 22.7 | 3.4 | 26.6 | – 3.4 |
| | 1967 | 16.5 | 12.8 | 32.1 | 25.5 | 5.0 | 31.0 | – 1.1 |
| | 1973 | 18.5 | 14.0 | 36.0 | 28.6 | 6.3 | 35.6 | – 0.4 |
| | 1979 | 19.7 | 17.2 | 38.6 | 26.9 | 9.9 | 36.8 | – 1.8 |
| | 1980 | 19.9 | 18.5 | 40.1 | 27.5 | 10.2 | 37.8 | – 2.3 |
| France | 1961 | 13.1 | 18.7 | 35.7 | 22.5 | 13.3 | 36.2 | 0.5 |
| | 1967 | 13.0 | 21.1 | 39.0 | 22.6 | 15.3 | 38.2 | – 0.8 |
| | 1973 | 13.2 | 21.6 | 38.5 | 21.8 | 16.6 | 38.6 | 0.1 |
| | 1979 | 14.9 | 27.4 | 45.4 | 22.5 | 20.2 | 44.8 | – 0.6 |
| | 1980 | 15.3 | 27.9 | 46.3 | 23.3 | 21.3 | 46.6 | 0.3 |
| Germany | 1961 | 13.9 | 14.3 | 33.4 | 24.1 | 10.1 | 35.9 | 2.5 |
| | 1967 | 16.3 | 16.8 | 38.2 | 23.7 | 10.9 | 36.3 | – 1.9 |
| | 1973 | 18.2 | 17.0 | 40.5 | 25.5 | 14.2 | 41.2 | 0.7 |
| | 1979 | 19.9 | 20.8 | 45.6 | 25.4 | 16.2 | 42.7 | – 2.9 |
| | 1980 | 20.3 | 20.7 | 46.1 | 25.2 | 17.3 | 42.6 | – 3.5 |
| Italy | 1961 | 12.7 | 14.0 | 30.5 | 17.0 | 11.1 | 28.1 | – 2.4 |
| | 1967 | 14.4 | 17.1 | 35.0 | 17.9 | 13.0 | 31.0 | – 4.0 |
| | 1973 | 15.5 | 20.5 | 39.1 | 15.8 | 14.5 | 30.4 | – 8.7 |
| | 1979 | 16.1 | 25.5 | 45.9 | 19.3 | 17.2 | 36.5 | – 9.4 |
| | 1980 | 16.3 | 25.6 | 45.6 | 21.0 | 16.7 | 37.7 | – 7.9 |
| Japan | 1961 | . | . | . | . | . | . | . |
| | 1967 | 7.7 | 6.0 | 18.3 | 14.2 | 4.3 | 19.2 | 0.9 |
| | 1973 | 8.3 | 6.7 | 25.4 | 16.5 | 4.8 | 22.4 | – 3.0 |
| | 1979 | 9.8 | 14.3 | 31.3 | 17.4 | 9.2 | 26.6 | – 4.7 |
| | 1980 | 10.0 | 14.7 | 31.6 | 18.2 | 9.4 | 27.6 | – 4.0 |
| Netherlands | 1961 | 14.0 | 15.4 | 35.0 | 23.6 | 9.2 | 35.0 | 0.0 |
| | 1967 | 16.2 | 20.7 | 42.0 | 24.9 | 13.8 | 40.7 | – 1.3 |
| | 1973 | 16.3 | 27.4 | 48.1 | 27.2 | 19.5 | 49.2 | 1.1 |
| | 1979 | 18.9 | 36.2 | 58.8 | 28.8 | 21.8 | 55.8 | – 3.0 |
| | 1980 | 18.7 | 37.0 | 60.4 | 29.4 | 21.8 | 57.1 | – 3.3 |
| Sweden | 1961 | 15.9 | 11.0 | 31.0 | 26.3 | 6.1 | 33.6 | 2.6 |
| | 1967 | 19.6 | 13.7 | 39.7 | 31.0 | 10.2 | 42.3 | 2.6 |
| | 1973 | 23.3 | 18.0 | 46.1 | 34.1 | 13.6 | 49.0 | 2.9 |
| | 1979 | 29.1 | 29.2 | 62.7 | 36.5 | 19.5 | 59.9 | – 2.8 |
| | 1980 | 29.7 | 29.6 | 63.2 | 36.7 | 20.0 | 59.7 | – 3.5 |
| Switzerland | 1961 | 9.7 | 8.4 | 18.0 | 15.7 | 5.8 | 22.2 | 4.2 |
| | 1967 | 10.3 | 10.1 | 20.4 | 16.8 | 6.1 | 23.5 | 3.1 |
| | 1973 | 11.2 | 12.9 | 24.2 | 19.0 | 8.9 | 28.9 | 4.7 |
| | 1979 | 13.1 | 17.5 | 30.6 | 21.0 | 15.9 | 38.0 | 7.4 |
| | 1980 | 13.1 | 17.8 | 30.9 | 22.0 | 16.1 | 39.5 | 8.6 |
| United Kingdom | 1961 | 16.7 | 13.7 | 33.3 | 24.6 | 6.0 | 31.4 | – 1.9 |
| | 1967 | 18.0 | 15.2 | 38.6 | 28.2 | 7.3 | 36.5 | – 2.1 |
| | 1973 | 18.4 | 16.0 | 41.1 | 27.3 | 8.4 | 36.5 | – 4.6 |
| | 1979 | 20.1 | 19.1 | 42.4 | 29.1 | 10.0 | 39.1 | – 3.3 |
| | 1980 | 21.6 | 19.6 | 44.3 | 30.4 | 10.2 | 40.6 | – 3.7 |
| United States | 1961 | 18.0 | 8.8 | 29.7 | 22.5 | 4.7 | 27.9 | – 1.8 |
| | 1967 | 19.3 | 9.3 | 31.8 | 22.1 | 6.2 | 28.9 | – 2.9 |
| | 1973 | 17.9 | 12.1 | 32.0 | 23.2 | 7.9 | 31.7 | – 0.3 |
| | 1979 | 17.3 | 11.6 | 31.2 | 23.9 | 7.8 | 31.7 | 0.5 |
| | 1980 | 17.9 | 12.7 | 33.1 | 24.1 | 7.8 | 31.9 | – 1.2 |

Note: The data for 1980 are partly estimated.

* Except for Switzerland, total expenditure includes public investment and capital transfers; for Belgium, total expenditure excludes capital transfers.

The reasons for the rapid growth of public-sector expenditure vary from country to country. One common factor in recent years has been the tendency for the authorities to base expenditure plans on over-optimistic estimates of real growth and revenue and, in some cases, to couch expenditure plans in real terms. Relatively rapid increases in public-sector pay have also contributed in some countries to fast expenditure growth. With regard to transfer payments, benefits are in many instances inflation-indexed and sometimes provide for gradual improvement in real terms. Combined with these developments, a factor contributing on the revenue side to large deficits is the tendency in various countries to adjust tax rates, systematically or on a discretionary basis, to allow for the effects of inflation.

In view of the substantial size of public-sector expenditure, it is small wonder that the possible negative effects of this development — high inflation, the crowding-out of investment and the threat of continued slow growth — should cause increasing disquiet. In one country after another the authorities have announced policies, or are formulating them, with a view to curbing public spending (a more detailed examination of these developments is provided in Chapter III). In the United Kingdom planned expenditure reductions have been a key element of the policies pursued during the past two years. The new US Administration, while putting heavy emphasis on the incentive effects of tax reductions, has announced sharp across-the-board cuts in public-sector expenditure. It might be noted that while the ratio of public expenditure to gross domestic product is comparatively low in the United States, the conviction is widely held that expenditure has long been "out of control" and that deficits have contributed through high interest rates to serious financing problems for industry. In many continental European economies — particularly Germany, Italy, the Benelux countries and the Scandinavian ones — the goal of curbing the growth of public spending now also appears to be receiving high priority.

It is no accident that the growth of government should have gone hand in hand with a long-term worsening in inflation. The commitment to full employment and the emergence of the modern welfare state have changed attitudes and imparted an inflationary bias to economies. In the labour markets the increased cover provided by unemployment insurance, higher levels of unemployment benefits and ever-rising levels of minimum wages have tended to ratchet up labour costs. These inflationary pressures have been further aggravated by the higher payroll taxes needed to finance the growing social welfare system.

An even more general problem posed by the increased size of the public sector and the heavy weight of transfer payments is the associated rise in taxes — on both individuals and businesses. The burden of taxation has further eroded incentives to work and invest, and has encouraged what has been termed the tax/wage spiral.

Heavy public-sector expenditure and large deficits often occur together, but, as the table suggests, the relationship is a very loose one. Indeed, in Japan, where the ratio of public expenditure to gross domestic product is comparatively low, the overall deficit is one of the largest. As far as public-sector deficits are concerned, a major turning-point was the first oil crisis, which led in 1974–75 to a sharp decline in final demand. At that time national authorities tended in most cases to accept the need for larger deficits as a necessary means to stabilise their economies and avoid

excessively deep recession. Some went even further by introducing discretionary fiscal measures designed to provide a further buffer against the fall in activity. Whatever the response, the relative size of the deficit appears to have grown after the initial shock. In the current environment these larger deficits may create expectations of higher inflation despite the efforts of monetary authorities to hit monetary targets.

Higher taxes and the uncertainty engendered by inflation have taken a heavy toll on investment. While it is difficult to disentangle the impact of cyclical elements, the rate of growth in productive investment in the major industrialised countries in the past decade has been less than half that recorded in the preceding twenty-five years. This fall-off in capital spending is all the more worrisome in the face of the enormity of the industrial restructuring that is necessary in order to adjust to the higher price of energy. Despite the need to foster capital spending in order to re-establish economies' growth potential, supply-oriented tax cuts do present the short-run risk of exacerbating inflation. An increased level of investment will tend to raise productivity, but this improvement will occur only with a lag, while the expansion of spending will affect demand immediately. As a result, the application of supply-oriented policies requires some caution so that the progress made in slowing inflation is not lost or eroded.

Withdrawal from inflation's addictive grip will not be easy or painless. The bulwark of any attack on inflation must remain the traditional tools of demand management, namely monetary and fiscal policy. But lessening the obstacles to success against inflation may also require other tools — policies relating to incomes, energy conservation and substitution, as well as to regulation. The bold shift in the focus of government's rôle should help, but, in the final analysis, it is only through a broad recognition of the costs of inflation that public support for a return to price stability can be achieved. At the present time, it has widely been accepted that, by undermining productivity growth, inflation has eroded economies' ability to satisfy competing social claims. The primary question of the 1980s is whether this support for anti-inflationary policies will be sustained.

# III. OUTPUT, EMPLOYMENT AND THE ENERGY CONSTRAINT.

The sharp rise in the price of oil and other commodities since the end of 1978 contributed to renewed recession in the western industrial economies last year. In most countries industrial production turned downwards at some point during the year, and on average unemployment rose. Even so, the recession has generally been milder than that which occurred in 1974–75.

As a background to this, demand-management policies have been relatively and appropriately restrictive, and remain so, though the burden of restraint has fallen heavily on monetary policy. However, in terms of the promptitude and resolve of the policy response, this avenue of short-term adjustment to the new external price shock has been better utilised than it was in 1974–75. As Chapter II has demonstrated, it has also had a significant measure of success. This chapter examines other reactions to the two oil shocks and attempts to determine whether and to what extent they have also been in the right direction, in particular as far as the longer-term requirements of economic health are concerned.

After reviewing output and labour-market developments the chapter goes on to a comparative examination of the reactions and adjustments seen in the industrial economies in the context of the second oil shock. Fiscal policy responses are considered first and then the rather better performance of profits and investment in the private economy as compared with 1974–75. Finally, after a brief review of the relative strength of domestic demand reactions from country to country, the chapter concludes with an analysis of the serious constraint which the energy situation still places on the prospects for further growth and lower unemployment.

## Output.

In the industrial countries as a whole the growth of output slowed down markedly last year under the combined influence of the new external price impulses and a fairly uniform restrictive response from demand-management policies. Total output probably rose by a little over 1 per cent., compared with 3.3 per cent. in 1979 and 3.9 per cent. in 1978. So far, though, the reaction to the second oil shock has been less severe than that of 1974–75, when output rose by only 0.6 per cent. in the first year and actually fell by 0.5 per cent. in the second. In particular, there has not been the violent reaction seen last time round in terms of private fixed investment and, more importantly, stockbuilding. There is also evidence of more stable behaviour on the part of consumers: the table on page 42 shows, for example, how saving ratios, though remaining at high levels in most countries, have not moved up abruptly as they did after 1973.

Judging by the movements in industrial production, the onset of the recession was remarkably synchronous across the industrial world, and can be dated to around the end of the first quarter of last year. The pattern has, however, differed quite

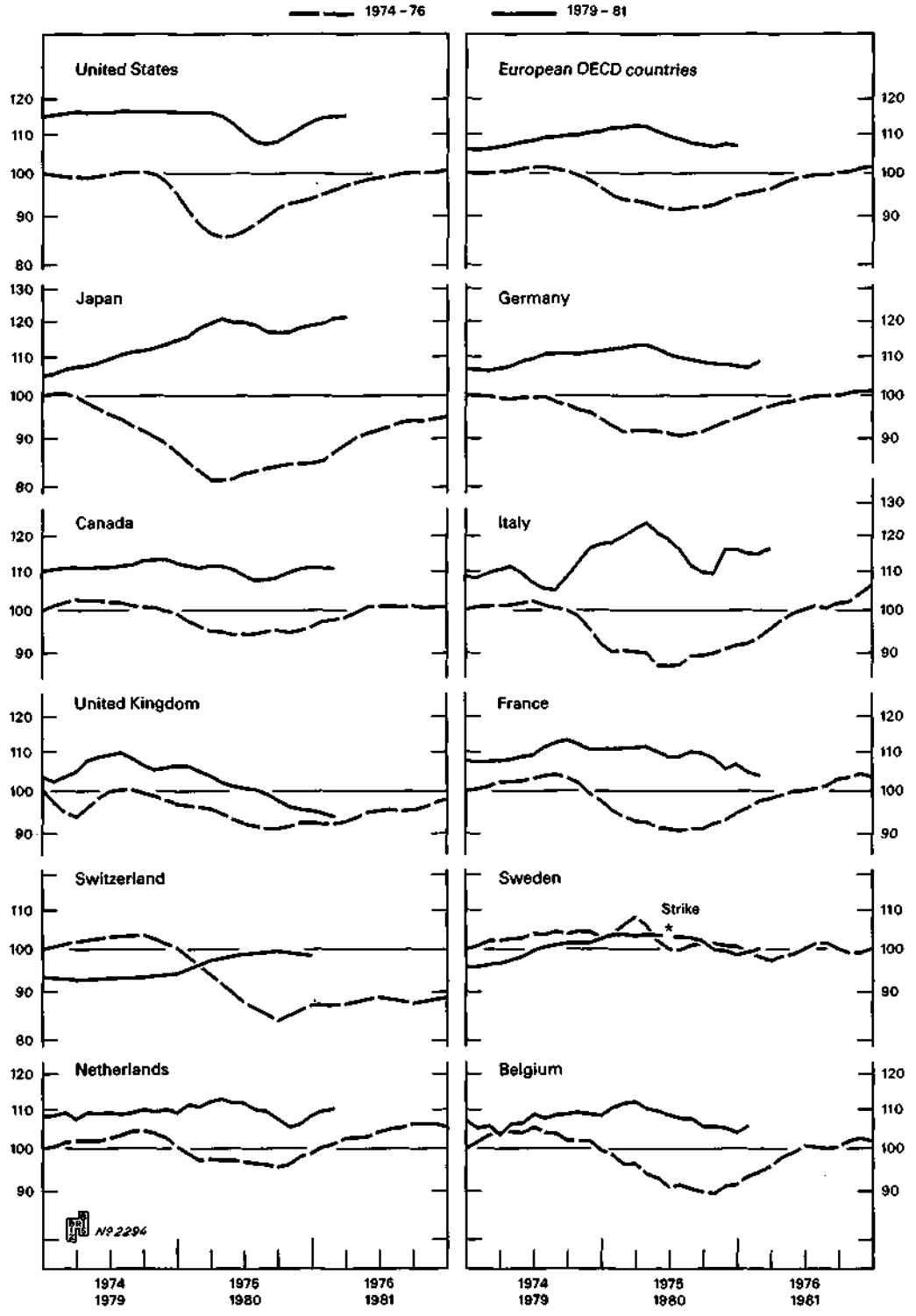
dramatically in the United States and the rest of the world. In the United States the whole of the fall in output was concentrated in the second quarter, when gross national product fell at an annual rate of nearly 10 per cent. In retrospect it seems fairly clear that the credit control policies introduced in March, when the economy was already weakening because of unusually high interest rates, must have been a major cause of this precipitous decline. In the April–June period the volume of consumer durable spending fell by 13 per cent. (at a quarterly rate) and the volume of housing investment by no less than 20 per cent. With an equally precipitous decline in short-term interest rates, economic activity began to rise with unexpected buoyancy in the second half of the year.

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* |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | private | public | private non-residential | private residential | public | | | |
| | | annual volume changes, in percentages | | | | | | | | |
| United States .... | 1977 | 5.5 | 4.9 | 3.2 | 11.9 | 18.4 | – 6.5 | 2.8 | 7.8 | 0.9 |
| | 1978 | 4.8 | 4.7 | 1.5 | 9.1 | 3.0 | 6.2 | 12.6 | 12.8 | 1.0 |
| | 1979 | 3.2 | 2.9 | 2.4 | 6.5 | – 5.3 | – 5.6 | 15.2 | 6.0 | 0.7 |
| | 1980 | – 0.2 | 0.4 | 3.1 | – 3.0 | –18.6 | 1.3 | 9.7 | – 0.1 | – 0.2 |
| | 1980 IV | – 0.3 | 0.5 | 2.0 | – 4.3 | –12.9 | – 1.6 | 1.7 | – 3.3 | – 0.5 |
| Japan ..... | 1977 | 5.3 | 3.8 | 3.9 | 2.5 | 1.7 | 11.6 | 11.4 | 4.1 | 0.7 |
| | 1978 | 5.1 | 4.7 | 5.1 | 6.6 | 6.6 | 16.1 | 0.2 | 6.5 | 0.6 |
| | 1979 | 5.6 | 6.2 | 4.0 | 12.5 | – 1.0 | 3.0 | 6.6 | 14.7 | 1.2 |
| | 1980 | 4.2 | 1.3 | 2.0 | 6.4 | – 9.1 | – 4.5 | 19.2 | – 3.9 | 0.8 |
| | 1980 IV | 3.5 | 1.2 | 2.8 | 5.7 | –10.5 | – 2.2 | 14.5 | – 7.7 | 0.1 |
| Germany ..... | 1977 | 2.8 | 3.5 | 0.5 | 7.1 | 2.8 | – 4.8 | 4.3 | 4.7 | 1.2 |
| | 1978 | 3.6 | 4.0 | 4.2 | 5.5 | 4.0 | 5.0 | 4.1 | 5.2 | 0.8 |
| | 1979 | 4.5 | 3.3 | 3.3 | 10.0 | 6.3 | 6.1 | 5.4 | 11.2 | 2.3 |
| | 1980 | 1.8 | 1.5 | 2.4 | 4.0 | 3.1 | 3.7 | 5.5 | 5.9 | 1.9 |
| | 1980 IV | – 0.5 | 1.1 | 0.8 | | – 0.7 | | 2.0 | 1.3 | 1.5 |
| France ..... | 1977 | 3.0 | 3.2 | 1.4 | 1.6 | – 2.9 | – 6.3 | 8.5 | 2.2 | 1.0 |
| | 1978 | 3.7 | 4.7 | 4.3 | 3.7 | – 1.7 | – 3.0 | 6.6 | 6.1 | 0.7 |
| | 1979 | 3.5 | 3.5 | 1.6 | 6.0 | – 0.5 | 1.7 | 6.7 | 11.3 | 1.7 |
| | 1980 | 1.2 | 2.1 | 2.5 | 3.4 | – 1.0 | 1.4 | 3.4 | 8.4 | 1.8 |
| | 1980 IV | – 0.4 | 1.8 | 2.9 | – 1.5 | | – 2.7 | 1.7 | 5.2 | 1.6 |
| United Kingdom . | 1977 | 1.0 | – 0.6 | – 1.2 | 8.1 | – 6.5 | –13.1 | 6.7 | 1.2 | 1.2 |
| | 1978 | 3.6 | 6.0 | 2.1 | 10.3 | 14.3 | – 8.6 | 1.8 | 3.9 | 0.8 |
| | 1979 | 1.1 | 4.7 | 2.0 | 2.7 | –13.6 | – 4.0 | 2.1 | 11.1 | 1.4 |
| | 1980 | – 1.4 | 0.6 | 2.1 | 1.8 | –14.2 | – 5.6 | 0.4 | – 3.5 | – 1.6 |
| | 1980 IV | – 2.9 | – 0.2 | 2.7 | – 2.2 | –32.8 | –10.0 | – 3.9 | –11.7 | – 3.3 |
| Italy ..... | 1977 | 1.9 | 2.3 | 2.3 | – 0.9 | 1.2 | – 0.7 | 6.6 | – 0.2 | 1.2 |
| | 1978 | 2.7 | 3.0 | 2.3 | – 0.1 | 1.2 | – 2.0 | 10.1 | 8.1 | 0.9 |
| | 1979 | 4.9 | 5.3 | 1.6 | 7.9 | 3.0 | 3.0 | 9.1 | 13.8 | 1.7 |
| | 1980 | 4.0 | 4.4 | 2.0 | 13.4 | 3.8 | 7.1 | – 4.3 | 7.9 | 3.6 |
| | 1980 IV | 0.5 | 1.6 | | | 5.7 | | – 9.5 | – 2.4 | . |
| Canada ..... | 1977 | 2.2 | 2.8 | 3.4 | 1.1 | – 5.1 | 0.0 | 6.9 | 2.1 | 0.1 |
| | 1978 | 3.4 | 3.0 | 0.9 | 2.2 | – 3.8 | – 2.1 | 9.9 | 4.4 | 0.1 |
| | 1979 | 2.7 | 1.9 | – 1.0 | 9.4 | – 7.5 | – 0.8 | 2.3 | 5.9 | 1.6 |
| | 1980 | 0.1 | 0.6 | 0.6 | 8.6 | – 9.8 | 1.3 | 1.0 | – 2.8 | – 0.6 |
| | 1980 IV | 0.7 | 2.3 | 2.1 | 7.1 | – 8.7 | 1.0 | 4.5 | 1.7 | – 1.6 |

* As a percentage of previous year's gross national product.

**Industrial production in two periods of external price shock.***




* Uncentred three-month moving averages of seasonally adjusted data. Fourth quarter *1973 = 100.*

By contrast, in other countries the recession developed more gradually. In addition, it had in several cases been immediately preceded by fairly firm growth. For example, Japanese industrial production had been growing and even accelerating as the peak approached. And even after the peak this time there has been no major absolute decline in activity. As the graph shows, this is in very marked contrast to the large peak-to-trough decline of nearly 20 per cent. which occurred in 1974–75. By March of this year industrial production was up marginally on an annual basis. Indeed, with the inflation record being so much better this time, the Japanese

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 | public | private non-residential | private residential | public | | |
| | | annual volume changes, in percentages | | | | | | | | |
| Austria | 1977 | 4.4 | 4.3 | 6.8 | 3.7 | | 4.7 | | 5.2 | 8.8 |
| | 1978 | 1.0 | 0.9 | − 2.2 | 3.5 | | − 4.7 | | 6.1 | − 1.4 |
| | 1979 | 5.1 | 3.6 | 4.7 | 3.0 | | 4.2 | | 9.1 | 11.1 |
| | 1980 | 3.6 | 3.1 | 1.6 | 2.0 | | 4.4 | | 9.3 | 7.9 |
| Belgium | 1977 | 0.7 | 0.7 | 2.0 | 3.3 | − 1.8 | 1.8 | 0.4 | 13.2 | 15.3 |
| | 1978 | 3.0 | 3.1 | 2.7 | 6.5 | 1.0 | 6.4 | − 4.0 | 4.3 | 4.4 |
| | 1979 | 2.1 | 1.8 | 4.6 | 2.7 | 3.9 | −12.5 | 13.4 | 10.4 | 13.9 |
| | 1980 | 1.7 | 1.3 | 1.6 | 1.0 | 10.8 | − 0.9 | 11.7 | 8.5 | 8.4 |
| Denmark | 1977 | 1.8 | 2.0 | 0.3 | 2.3 | 2.7 | −13.3 | .[2] | 4.7 | − 1.1 |
| | 1978 | 1.3 | 1.6 | − 0.7 | 5.5 | 0.0 | 3.6 | .[2] | 3.8 | 1.6 |
| | 1979 | 3.5 | 3.3 | 3.0 | 5.4 | − 2.5 | − 4.2 | .[2] | 9.3 | 6.0 |
| | 1980 | − 1.0 | 0.2 | − 4.0 | 5.5 | −12.5 | −25.0 | .[2] | 6.0 | 7.5 |
| Finland | 1977 | 0.4 | 1.8 | − 1.4 | 4.1 | −10.6 | 5.0 | − 0.1 | 9.4 | − 6.2 |
| | 1978 | 2.3 | 2.7 | 2.6 | 3.8 | −14.1 | − 1.7 | 0.8 | 8.1 | − 3.1 |
| | 1979 | 7.2 | 2.1 | 5.0 | 3.3 | 9.8 | − 3.5 | 0.8 | 8.6 | 16.4 |
| | 1980 | 4.9 | 7.1 | 2.6 | 3.5 | 17.9 | 3.1 | 3.8 | 9.0 | 11.6 |
| Netherlands | 1977 | 2.4 | 3.0 | 4.4 | 3.2 | 18.4 | 15.9 | −11.6 | − 1.8 | 2.9 |
| | 1978 | 2.5 | 2.1 | 3.9 | 3.6 | 6.2 | 2.7 | − 2.5 | 3.1 | 6.4 |
| | 1979 | 2.2 | 2.8 | 2.2 | 2.9 | 3.8 | − 5.2 | − 5.7 | 7.7 | 5.8 |
| | 1980 | − 0.3 | 0.0 | 0.0 | 1.0 | − 1.5 | 3.3 | − 1.3 | − 0.5 | − 0.3 |
| Norway | 1977 | 3.6 | 5.7 | 6.9 | 4.6 | −10.1 | 2.9 | 31.2[3] | 3.6 | 3.4 |
| | 1978 | 4.5 | 6.7 | − 1.6 | 5.7 | −23.0 | 9.1 | − 3.5[3] | 8.4 | −13.5 |
| | 1979 | 4.5 | 1.7 | 2.3 | 3.9 | − 8.6 | 3.0 | − 6.0[3] | 2.5 | − 0.7 |
| | 1980 | 3.8 | 1.2 | 1.7 | 4.2 | 3.8 | 1.1 | − 0.3[3] | 1.4 | 4.0 |
| Spain | 1977 | 2.6 | 3.6 | 1.9 | 3.7 | | − 1.2 | | 14.4 | 10.3 |
| | 1978 | 2.7 | 4.0 | 1.5 | 5.5 | | − 4.0 | | 10.6 | − 1.1 |
| | 1979 | 0.8 | 1.0 | 2.1 | 3.8 | | − 0.4 | | 5.7 | 11.7 |
| | 1980 | 1.3 | 1.2 | 0.8 | 2.5 | | 1.0 | | 3.4 | 3.5 |
| Sweden | 1977 | − 2.4 | 1.0 | − 0.9 | 2.9 | − 7.3 | − 2.1 | − 0.3 | 2.1 | − 3.2 |
| | 1978 | 1.4 | 2.7 | − 0.8 | 3.1 | −22.9 | 15.4 | 0.0 | 8.3 | − 5.3 |
| | 1979 | 3.7 | 1.8 | 2.7 | 4.3 | 10.7 | 3.1 | 0.7 | 5.8 | 13.0 |
| | 1980 | 2.2 | 0.6 | 0.3 | 2.9 | 3.6 | − 8.0 | 4.6 | − 0.7 | 1.3 |
| Switzerland | 1977 | 2.8 | 3.0 | 3.0 | 0.5 | 0.3 | 7.5 | .[2] | 9.3 | 8.5 |
| | 1978 | 0.3 | 0.0 | 2.2 | 1.0 | 4.3 | 13.7 | .[2] | 4.1 | 11.4 |
| | 1979 | 2.5 | 0.7 | 1.1 | 1.3 | 3.5 | 12.0 | .[2] | 3.8 | 6.9 |
| | 1980 | 2.8 | 3.3 | 2.2 | 1.0 | 11.5[e] | 8.5[e] | .[2] | 5.0 | 7.0 |

[e] = estimate.

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

authorities have even begun to implement some stimulative measures in an attempt to turn the output trend upwards — but they are so far virtually alone in such a policy initiative.

In Germany a period of fairly strong growth also preceded the spring peak, but with the balance of payments in large deficit the German authorities precluded monetary measures to counteract the recession. The Netherlands and Belgium have also been seriously constrained by the state of both their external and public-sector finances. The Italian economy, which was remarkably, if erratically, buoyant throughout the autumn and winter of 1979–80, has managed so far to maintain output levels rather more successfully than in 1974–75. But with pressure on the exchange rate in early 1981, the Government has more recently been obliged to introduce a number of restrictive measures. The Swiss economy alone in the industrial world experienced no deceleration of growth last year, with GNP growth at around 2¾ per cent., marginally higher than the 2½ per cent. achieved in 1979.

The case of the United Kingdom is rather unique. Although the economy has been more or less immune from the direct effects of the new oil price shock by virtue of oil self-sufficiency, the recession is proving considerably more severe than elsewhere. It also started earlier: the graph shows the near-two-year decline in industrial production. This index, however, includes rising oil output from the North Sea. For manufacturing industry alone the recession has been even more severe. By February manufacturing output was showing a fall of around 15 per cent. over the year and a total decline from the previous peak of some 20 per cent. In terms of gross national product the fall of 1½ per cent. last year, and of 3 per cent. between fourth quarters, was the sharpest setback seen since the Second World War.

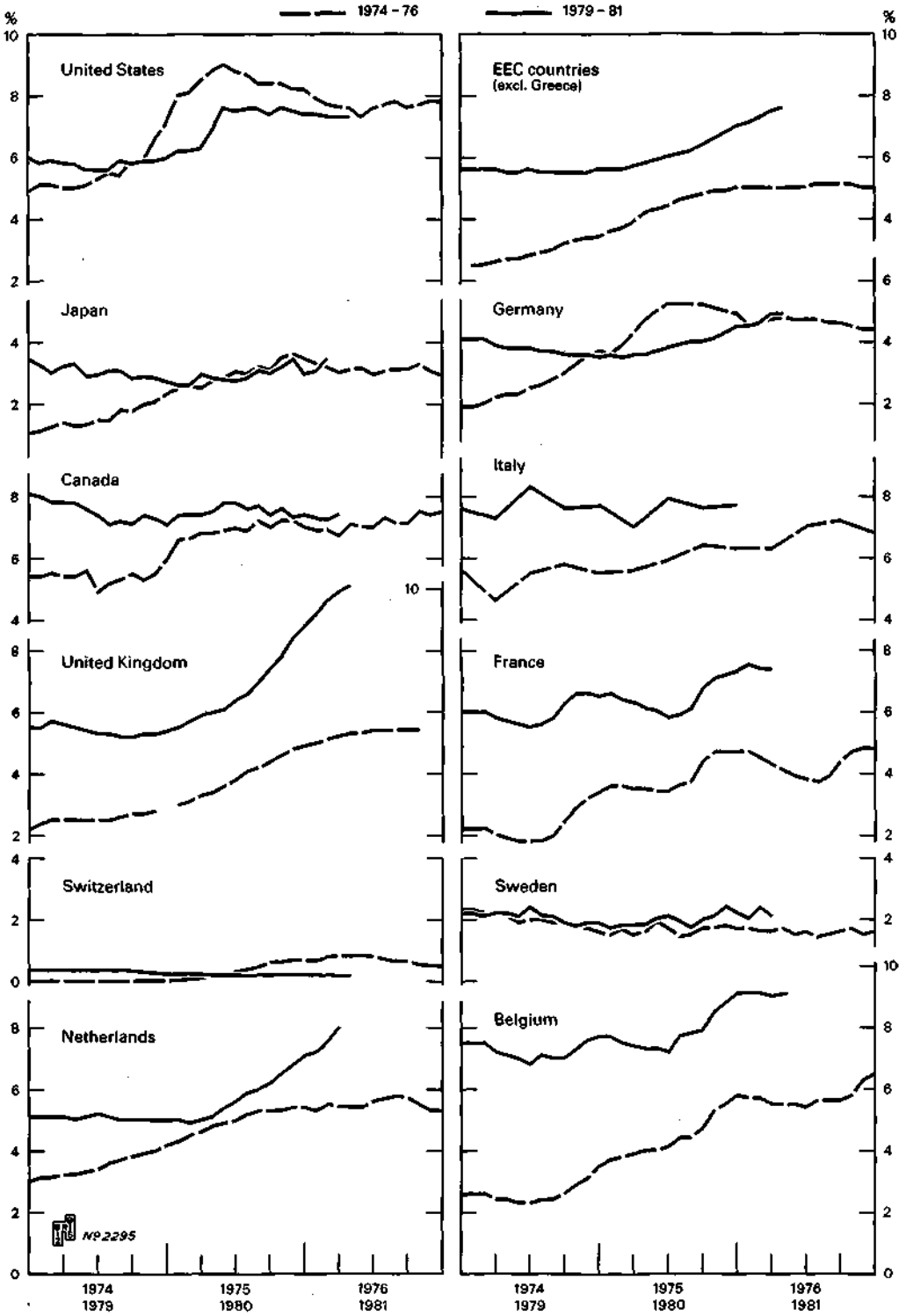
**Labour-market developments.**

During 1980 unemployment began to rise fairly generally. The growth of employment slackened, but only in a few cases such as Belgium, the Netherlands and the United Kingdom was the average level for the year down on 1979. By the same token, however, productivity growth slowed down, largely for cyclical reasons, with especially poor results in North America and the United Kingdom.

In the United States unemployment rose sharply in the second quarter but thereafter declined gradually — at no time reaching the high level recorded in 1974–75. In Canada, which began the second oil crisis at a much higher jobless rate than the first, unemployment has declined on balance over the past two years. And in Japan the continued growth of output throughout 1979 and early 1980 found its reflection in some improvement in the ratio of labour supply to labour demand (this measure is a better labour-market indicator than the Japanese unemployment statistics), though some deterioration set in around mid-year following the change in the trend of output.

In Europe, however, the picture is somewhat different in that unemployment had continued to rise on average between the two oil shock periods. For the countries of the EEC, for example, the average unemployment rate was some 3

Unemployment rates in two periods of external price shock.*




* For Japan the ratio of unemployment to job offers is shown.

percentage points higher in early 1979 than it had been at the end of 1973. This longer-term increase has been especially marked in Belgium, France and Denmark. And in these countries, as well as in the United Kingdom, a new upturn in unemployment set in during the course of last year.

In Germany, on the other hand, unemployment has not yet risen to the levels of the first oil crisis. Indeed, throughout 1979 and into the early months of 1980 unemployment was declining slightly. Part of the reason is that Germany's indigenous labour force has grown very little over the past decade, while many foreign workers returned home during the first oil crisis. By the middle of last year, however, a rising trend set in, which has now taken the rate to around 5 per cent., compared with a low point of 3.5 per cent. in February 1980. In Switzerland, too, the labour force has been contracting, and here the departure of foreign workers was relatively more important, especially in 1974–75. But the economy was also buoyant last year and by the year's end the labour market showed signs of tightness. Sweden is another country in which unemployment has remained comparatively low, though for different reasons. During the first oil shock economic activity was deliberately maintained at quite a high level and there has since been considerable government intervention to keep down the unemployment rate by means of training schemes, job subsidies and other assistance to industry. In varying degree, in European countries as well as in Canada, governments have continued, and in some cases stepped up, direct programmes to combat unemployment, often aimed at alleviating the position of young people.

But, in contrast to a fairly widespread willingness to support employment directly — albeit on a limited scale — most governments are clearly not willing to do so by more general use of fiscal and monetary policies. At least, they are not prepared to do so by setting these policies in a traditionally stimulatory mode. On

*Employment, unemployment and the labour force, 1970–80.*

| Countries | 1970–75 | | | 1975–80 | | | 1970–80 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Employ-ment | Unemploy-ment | Labour force | Employ-ment | Unemploy-ment | Labour force | Employ-ment | Unemploy-ment | Labour force |
| | changes, in percentages* | | | | | | | | |
| United States ... | + 7.8 | + 3.6 | +12.0 | +14.7 | − 1.4 | +13.1 | +23.7 | + 2.2 | +26.6 |
| Japan ..... | + 2.5 | + 0.7 | + 3.3 | + 6.0 | + 0.1 | + 6.1 | + 8.7 | + 0.8 | + 9.6 |
| Germany ..... | − 5.2 | + 4.0 | − 1.7 | + 1.6 | − 0.9 | + 0.8 | − 3.8 | + 3.1 | − 0.9 |
| France ..... | + 1.7 | + 1.5 | + 3.5 | + 2.3 | + 2.6 | + 4.8 | + 4.1 | + 4.1 | + 8.5 |
| United Kingdom . | + 0.9 | + 1.3 | + 2.1 | − 0.9 | + 2.9 | + 2.3 | + 0.1 | + 4.2 | + 4.5 |
| Italy ..... | + 2.4 | + 0.5 | + 2.5 | + 5.0 | + 1.7 | + 7.3 | + 7.5 | + 2.2 | +10.0 |
| Canada ..... | +17.2 | + 1.1 | +18.8 | +14.8 | + 0.5 | +15.5 | +34.6 | + 1.6 | +37.3 |
| Belgium ..... | + 2.2 | + 2.4 | + 4.9 | + 1.2 | + 4.2 | + 4.7 | + 3.5 | + 6.6 | + 9.8 |
| Netherlands .... | − 0.7 | + 4.1 | + 2.5 | + 2.2 | + 0.6 | + 3.0 | + 1.4 | + 4.7 | + 5.6 |
| Sweden ..... | + 5.4 | + 0.1 | + 5.5 | + 4.2 | + 0.4 | + 4.6 | + 9.8 | + 0.5 | +10.4 |
| Switzerland .... | − 3.4 | + 0.3 | − 3.1 | − 0.4 | − 0.1 | − 0.4 | − 3.8 | + 0.2 | − 3.5 |

* For employment and the labour force, percentage changes over the period. In the case of unemployment, absolute changes in the unemployment rate.

the contrary, many, if not most, governments now appear to believe that restrictive demand management offers the main — and perhaps even the only — hope, via the conquest of inflation, of a gradual return to more satisfactory levels of unemployment.

Whatever the means chosen, in many countries any attempt to deal with unemployment potentially runs into the problem of past or prospective increases in the labour force (see table above). The last decade has witnessed a very large rise in the labour force in the United States and an even more spectacular increase in Canada. In both cases rising numbers of school-leavers and a strong secular rise in the propensity of married women to enter the labour force have been the important factors. The capacity of the North American economy to provide jobs has thus been remarkable over the past ten years. Even in Europe there are a number of countries where, despite the difficulties of the past decade, the economy has been able to provide an increasing number of jobs. The table shows a particularly good job position in Sweden, Italy and France. And in Japan employment rose by nearly 9 per cent. between 1970 and 1980. It is important to keep such facts in mind when attempting to assess economies' overall performance as far as unemployment is concerned.

Labour force developments may also have had some effects on recent trends in overall productivity (see table below), though they are obviously not the whole story. It is nevertheless striking that a particularly bad productivity performance has been seen recently in the United States and Canada. By the same token, however, the prospective slowdown in the growth of the labour force in these two countries, together with the gradual acquisition of skills and experience on the part of recent new entrants, offers hope of an improvement in underlying productivity growth as time goes on.

Trends in overall productivity.*

| Countries | 1960–73 | 1973–76 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|
| | average annual changes, in percentages | | | | | |
| United States | 2.1 | 0.0 | 1.9 | 0.1 | 0.5 | – 0.4 |
| Japan | 9.1 | 2.4 | 3.9 | 3.8 | 4.2 | 3.1 |
| Germany | 4.5 | 4.8 | 3.0 | 3.0 | 3.2 | 1.1 |
| France | 4.7 | 3.1 | 1.3 | 3.3 | 3.4 | 1.0 |
| United Kingdom | 3.0 | 1.0 | 0.7 | 2.0 | – 0.2 | – 0.3 |
| Italy | 5.7 | 0.7 | 0.8 | 2.2 | 3.7 | 2.6 |
| Canada | 2.5 | 0.8 | 0.4 | 0.0 | – 1.2 | – 2.6 |
| Belgium | 4.3 | 2.8 | 0.9 | 3.0 | 1.0 | 0.6 |
| Netherlands | 4.0 | 2.8 | 2.2 | 2.1 | 1.3 | – 1.0 |
| Sweden | 3.3 | 0.9 | – 2.7 | 1.0 | 2.1 | 1.0 |
| Switzerland | 2.9 | 0.6 | 2.6 | – 0.3 | 1.8 | 1.3 |

* Real gross national (or domestic) product in relation to civilian employment.

Elsewhere, as output growth slowed down last year so did overall productivity growth. In Japan and Italy, where output was fairly strong — at least in the earlier part of the year — productivity increased by 3.1 and 2.6 per cent. respectively, though these apparently good rates were still respectively only a third and a half the norms of the 1960s and early 1970s. At the other end of the spectrum, and despite increasing oil output and a large drop in employment of nearly 2 per cent. last year, the severity of the developing recession in the United Kingdom was sufficient to produce an absolute fall in gross domestic product per person employed. In manufacturing industry, however, the profit squeeze was potentially so severe as to result in a marked decline in average hours worked. Thus, in terms of output per man-hour 1980 saw only a small decline in productivity.

The outlook for productivity is mixed. On the one hand, a cyclical recovery in output, even if slow and moderate, should bring a definite improvement in most countries. On the other hand, the generally lower rates of fixed industrial investment over the last decade have no doubt reduced the supply potential of many economies and threaten to create a worrying imbalance between the supply of labour and the supply of capital. Various European countries face the added problem that some further rise in the proportion of young people in the work-force will tend to compound the effects on productivity of secularly weak investment growth, high energy prices and inevitably slow growth overall. Against this background, new attention is being given in many countries to problems of the public sector and ways in which fiscal policy can help increase the scope and incentives for private investment.

**Fiscal policy.**

In a world of stagflation, with inflation rates high and economic activity fluctuating around a low-growth trend, an assessment of the stance of fiscal policy becomes unusually difficult. At certain times, for instance in the context of the two oil shocks, the decline in private-sector activity may be such as to warrant a cushioning increase, at least for a time, in public-sector deficit spending. This was clearly the case after the first oil shock, when the depth of the decline justified a sharp deterioration in government budget positions. Paradoxically, with the important exception of the United States, this deterioration has not generally been reversed, and in some countries, notably Sweden, Denmark, the Netherlands, Belgium and Japan, the budget deficit of general government has grown further as a percentage of national income. Thus there has been concern that these continuing deficits may have been fuelling the continuing inflation, and/or that they may hold further price rises in store. At the same time some observers have suggested that large and prolonged fiscal deficits may be "crowding out" some private-sector activity, despite the generally high levels of unemployment and economic slack. Finally, in the wake of the latest oil price rise, many countries have been concerned to limit its adverse balance-of-payments consequences — the necessary counterpart of the renewed OPEC surplus.

In the face of persistent and sizable public-sector deficits it becomes less and less clear precisely what the stance of fiscal policy really is. For example, to what

extent do the deficits merely compensate for inflation's erosion of the real value of private-sector financial assets? And to what extent should such a "compensation" depend upon the private sector's efforts to preserve real wealth by increasing its rate of financial saving? And how much adjustment should be made for the cycle? This question subdivides into two others. What rate of unemployment is it now reasonable to assume in calculating full-employment budget balances? And, after more than half a decade of large deficits, can it be assumed that cyclical effects are still operative as opposed to some change in long-term trends? In short, it is difficult, after all this time, to say to what extent budget deficits merely compensate for high private-sector savings and "warranted" oil-related balance-of-payments deficits and how much they have themselves come to be the cause of the very factors they were supposed to counterbalance. Add to this the fact that high nominal deficits undoubtedly complicate the conduct of monetary policy, especially through their disturbing effects on financial markets and interest rates, and it is not surprising that budget deficits have come to be viewed with even more than the traditional suspicion.

In view of these problems, other, longer-term considerations have recently come to play a much greater rôle in fiscal policy plans, the proposals of the new US Administration being a notable case in point. The "new conservatism", of course, continues to be concerned with the budget deficit, but now more attention is also directed to the absolute size of the two sides of the budget. To some extent, this is not new. For example, there has been debate in the Netherlands and elsewhere over a number of years about the level of the total tax burden. This debate has been particularly concerned with the effect of taxation on the wage-bargaining process, and with the possible existence of "tax-push" cost pressures. Now, however, the

General-government net borrowing.[1]

| Countries | 1970–73 | 1974–76 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|
| | annual averages, as percentages of gross national product | | | | | |
| United States | 0.2 | – 1.5 | – 1.0 | – 0.0 | 0.5 | – 1.2 |
| Japan | 1.0 | – 2.0 | – 3.8 | – 5.5 | – 4.7 | – 4.0 |
| Germany | 0.2 | – 3.6 | – 2.4 | – 2.7 | – 2.9 | – 3.5 |
| France | 0.8 | – 0.7 | – 0.8 | – 1.8 | – 0.6 | 0.3 |
| United Kingdom | – 0.3 | – 4.6 | – 3.4 | – 4.3 | – 3.3 | – 3.7 |
| Italy | – 7.4 | – 9.6 | – 7.9 | – 9.7 | – 9.4 | – 7.9 |
| Canada | 0.5 | – 0.8 | – 2.6 | – 3.1 | – 1.8 | – 2.3 |
| Belgium | – 2.2 | – 4.2 | – 5.7 | – 6.2 | – 6.7 | – 8.8 |
| Netherlands | – 0.1 | – 1.7 | – 1.5 | – 2.1 | – 3.0 | – 3.3 |
| Sweden[2] | 4.9 | 3.0 | 2.0 | – 0.1 | – 2.8 | – 3.5 |
| Denmark | 3.7 | 0.7 | – 1.7 | – 2.2 | – 3.3 | – 3.3 |
| Norway | 4.4 | 3.9 | 1.7 | 0.6 | 1.7 | 5.1 |

[1] A negative figure indicates net borrowing, i.e. a deficit. General government includes central, regional and local government, including social security funds, but excluding nationalised enterprises. Net borrowing excludes the purely financial transactions of the public sector and in some countries is much lower than the (gross) public-sector borrowing requirement. [2] Includes National Pension Fund.

focus has widened and encompasses the broader effects of taxation on incentives to work, save and invest. And on the expenditure side high spending on social programmes, and big government generally, are thought to have been carried to counter-productive lengths.

On the face of it, the change of policy in the United Kingdom in 1979 and the more recent proposals in the United States seem to have much in common in this respect. However, both the emphasis and the circumstances are somewhat different. In the British case the attempt to cut back the size of the budget was linked to supposedly rigid control over such nominal aggregates as the money supply and the public-sector borrowing requirement. If the virulent British inflation did not subside rapidly as a result of a combination of expectational and "supply-side" forces, then it would have to be reduced by a decline in activity. In the American case there appears to be more faith in the anti-inflationary effects of a "supply-side stimulus" and a consequently greater commitment to cutting taxes per se. Especially if the accompanying expenditure reductions prove difficult to achieve, one might say that whereas in the British case risks were taken on the downward, or deflationary, side, in the American case the risks may be in the opposite direction. If so, the weight to be placed on monetary policy might be increased further.

In its original Unified Budget proposals for the *United States* the previous Administration put the deficit for the fiscal year 1980 (October 1979 to September 1980) at $29 billion. This figure implied, on a constant-employment basis, a reduction of some $15 billion compared with the previous fiscal year. In the event, however, the actual deficit was $59 billion. And as the overrun, which was principally on the outlays side, was only partly due to a weaker-than-expected economy, fiscal policy turned out to be stimulative last year.

In the current fiscal year, which began in October 1980, there are again likely to be overruns beyond the original budget intentions. The Unified Budget deficit for the year is currently estimated at $55 billion and once more reflects the workings of the automatic stabilisers during a period of weaker activity. But it also reflects overruns related to higher-than-expected outlays in respect of debt interest payments and to the fact that social security payments are linked to a consumer price index which includes mortgage interest rates. In addition, it may be noted that defence spending has been rising substantially, to some extent in excess of original plans. However, in August, following the sharp drop in output in the second quarter, President Carter proposed a significant stimulative package of measures to take effect this year. Even so, on a constant-employment basis the budget surplus was still expected to increase, both in fiscal 1981 and in fiscal 1982. The fiscal stance which the new Administration inherited was, on the usual criteria, still one of some restraint in terms of the phase of the cycle. In particular, a large increase in social security tax took effect at the beginning of 1981.

The new Administration of President Reagan moved quickly to make major changes to this fiscal picture. However, in proposing large cuts on both the revenue and expenditure sides of the budget ($54 billion and over $41 billion respectively in fiscal 1982) the President did at least reject the more extreme forms of "supply-side economics". Nevertheless, in projecting a Unified Budget deficit of $45 billion for

the fiscal year 1982, the calculations appear to assume some specific supply response in addition to an increase in demand. The programme envisages further large expenditure and tax cuts in later years combined with growth at between 4 and 5 per cent. per annum, further declines in inflation and a balanced budget by the fiscal year 1984.

Critics have suggested that the new Administration is placing too much faith in an untried area of policy. However, it is perhaps more important to recognise that the American programme is further evidence of a move away from undue reliance on traditional demand-management policies. Chapter II has already indicated the growing cost of dealing with inflation solely by this means, and this chapter will later suggest that the same is true with respect to the energy problem. In this sense the Reagan programme is to be welcomed for its long-term orientation with respect to investment, productivity and incentives. A major dilemma will present itself, however, should the legislature respond more favourably on the tax than on the expenditure side. If so, the decision will have to be taken whether to risk a larger budget deficit or rescind some or all of the tax cut proposals which are one of the cutting edges of the supply-side approach.

Turning now to *Japan*, the tight fiscal stance adopted in the face of the second oil shock was partially relaxed last year. With the economy both slackening and adjusting more successfully than it had done to the first oil crisis, the Government introduced a package of measures in September including a large temporary boost to public works expenditure that had previously been deferred. Assistance was also given to certain forms of investment, particularly those related to energy conservation. Nevertheless, the overall policy stance remained deflationary and for the fiscal year 1981–82 (April to March) the original budget proposals foresaw a further and more marked decline in the budget deficit as a percentage of gross national product. However, this stance was relaxed again in March this year in an attempt to ensure that the 5.3 per cent. growth target is met. In addition to a further cut in the official discount rate, spending on public works was speeded up with provision for 70 per cent. of this fiscal year's contracts to be awarded in the first six months of the year which began on 1st April. Housing construction was further encouraged, as was the development of electrical power generation. While Japan appears to be the only major country currently seeking to reach a quantified growth target by means of a discretionary fiscal stimulus, it is noteworthy that the emphasis has been on investment.

In *Germany*, however, policy turned out to be roughly neutral last year instead of slightly restrictive as had been planned. The budget deficit ratio has increased since 1978 at the same time as unemployment has fallen slightly. This creates a presumption that, so far during the current oil shock, German fiscal policy has been mildly expansionary, in contrast to the stance adopted in most other countries. Part of the reason is, of course, the expansionary measures already adopted following the Bonn Summit of 1978, and before the second oil shock occurred. It should be added that public expenditure also exceeded budget plans last year. In addition, in July Parliament agreed to a tax relief programme originally proposed in December 1979. However, the effects of this have subsequently been

offset by expenditure cuts and increases in indirect taxes on oil and alcohol, so that, as in most other countries, the current stance of German fiscal policy can also be described as restrictive.

In *France* the Government has clearly adopted a tight fiscal policy in response to the latest oil price rise. The financial balance of the general-government sector has improved by 1 per cent. of gross national product while unemployment has risen. However, 1980 saw some relaxation as the year progressed. In September a special temporary increase in certain social security benefits was introduced together with tax reliefs for investment. And the special 1 per cent. increase in social security contributions was revoked, as foreseen, in February this year. The budget for the current year aims to reduce the budget deficit and stabilise the tax burden. More recently, however, the French and German Governments have announced their intention jointly to borrow money from abroad for the purpose of energy-related investments. And the French Government may authorise some expenditure from a cyclical fund. Together, these actions amount to some minor relaxation as compared with earlier fiscal plans, though the advent of a new administration in France may now change this picture.

Among the other larger countries, *Canada* and *Italy* show a considerably more restrictive fiscal stance over the past two years in comparison with the 1974–75 experience. In the former case further tightening is implied for this year as a result of the combined effects of the October budget and the National Energy Programme. In Italy, against a background of exchange rate pressures, a broad range of restrictive measures was introduced in March this year. Among the smaller industrial countries fiscal policy has generally been moving in a restrictive direction, particularly in the Netherlands and Belgium, spurred by deteriorating external and public-sector accounts. In the Dutch case an emergency package of additional measures was introduced on 25th March this year with the aim of cutting the budget deficit by the equivalent of ¾ per cent. of gross national product. And in Belgium a similarly restrictive package ran into considerable political opposition which resulted in the fall of the Government. Sweden and Denmark have also both introduced restrictive measures recently.

Finally, the case of the *United Kingdom* is again an interesting one. It will be recalled that the budget of early 1980 promulgated a financial strategy for the medium-term reduction of inflation, the centre-piece of which was the progressive reduction of the rate of growth of the broad money supply. Fiscal policy was to play an important auxiliary rôle in the achievement of this goal and, accordingly, the public-sector borrowing requirement (PSBR) was to be reduced to 3¾ per cent. of gross domestic product in 1980–81 and 1½ per cent. of gross domestic product by 1983–84.

In the event, however, both the broad money supply and the PSBR overshot their targets by very large margins. The money supply rose by 20 per cent. and the PSBR amounted to £12½ billion, or 5½ per cent. of gross domestic product. Even so, the recession has been without precedent since the 1930s.

A major explanation of this contradiction between a seemingly lax policy stance and the sharp contraction in activity lies in the evolving policy mix, the sharp

appreciation of sterling and the downward inflexibility of wages. As far as budget policy is concerned, the PSBR, largely because of expenditure overruns, was some £4 billion more than expected, of which perhaps something like half was recession-induced. Partly for this reason interest rates were higher than they would otherwise have been and contributed, with other factors, to the appreciation of sterling. As a consequence, strong crowding-out effects were unleashed on the company sector, though export volumes continued to hold up well. Rather, as wages still rose rapidly, the strain was taken by profitability and company finances. In reaction to this, manufacturing companies sharply cut back stocks and employment, and increasingly also fixed investment, while at the same time contributing to the unusual rise in $M_3$ by concentrating their borrowing on the banking system. The slow growth of the narrowly defined money supply ($M_1$) and the strength of sterling were perhaps more symptomatic of the severity of the policy squeeze.

With little question, the Government's policy has resulted in a marked fall in the rate of inflation, though with the brunt of the squeeze being concentrated on the company sector. From a peak of over 20 per cent., the rate over one year is currently down to 12½ per cent. and is still falling. Even so, in response to the budget overruns, and in spite of the recession, the Government introduced further large tax increases and some expenditure cuts were made, first in November and then again in March of this year. These measures were required by the medium-term financial strategy which seemed likely to continue to be seriously overshot.

The failure to cut back public expenditure sufficiently over the past two years has thus meant that much of the supply-side approach to the United Kingdom's problems has been abandoned for a time in the face of the overriding need to get back within the money supply and borrowing targets. In turn, undue strains have been placed on the private sector. The latest budget, with its increased emphasis on expenditure planning in cash terms, will, it is to be hoped, assist the Government in its determined efforts to put the UK economy back on a stable path leading to an early resumption of growth.

**The second oil shock: Reactions and adjustments.**

By the beginning of this year the price of crude oil had ratcheted up by 175 per cent. or thereabouts compared with the end of 1978. Coming as it did on top of a base price which had been quintupled by the first oil shock in 1973–74, the latest rise imposed on the industrial world a terms-of-trade and real income loss of the same order of magnitude as before. For the importation of some 10 per cent. less oil in 1980 as compared with 1978, the OECD countries paid an extra $150 billion, a sum equivalent to about 2 per cent. of total national income. However, the bulk of this initial income transfer from the industrial countries to the oil exporters (over two-thirds of it) again took the form of an accumulation of financial claims rather than a transfer of real resources in the form of an equivalent rise in exports of goods and services by the oil-importing countries. The current-account surplus of the OPEC countries vis-à-vis the whole of the rest of the world has consequently risen by about $110 billion. This figure gives some indication of the first-round deflationary shock — that is the initial net effect on world demand — resulting from the oil price rise.

In the aftermath of the first oil price rise there was considerable discussion of the need to counter this loss of demand by offsetting policy measures involving increased budget and external deficits. It soon became apparent, however, that this form of short-run adjustment brought serious inflationary problems. Accordingly, on this occasion, the proper short-term response has been seen as one which attempted both to limit the overall inflationary impact and encourage appropriate cost/price relationships. In turn — and not altogether fortuitously — the private sector's spending response has not been as precautionary, and hence deflationary, as it was previously. Nevertheless, it has also become clearer during the second oil shock that the only fundamental adjustment to the energy problem is a reduction by the industrialised countries in their dependence on imported oil through a combination of energy saving and substitution by alternative domestic sources of energy supply. The rôle of investment is clearly crucial to this process and in this sense the success of the short-term adjustment process can be a complement to that required in the longer term. The discussion of the adjustment process therefore begins with a comparative examination of developments in the private sector.

## The private sector.

As compared with the first oil crisis period two broad developments now stand out as far as the private economy is concerned. Firstly, the distribution of income does not seem to have moved so markedly against corporate profits, and consequently, the volume of business fixed investment spending has held up better. Secondly, the private sector as a whole has not reacted as defensively as it did last time, with the result that total private spending has to some degree cushioned economies from the full deflationary impact of the second oil price rise, whereas in the earlier crisis the full burden — and more — of offsetting the oil-price-induced

Labour's share in total domestic factor income.

| Countries | 1960–64 | 1965–69 | 1970–73 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|---|---|
| | in percentages | | | | | | | | | |
| United States | 72.5 | 73.2 | 77.3 | 79.3 | 78.7 | 78.4 | 78.0 | 78.0 | 79.1 | 79.6 |
| Japan | 52.2 | 53.4 | 56.6 | 63.0 | 65.9 | 66.8 | 67.9 | 66.7 | 65.3 | · |
| Germany | 62.9 | 65.5 | 69.2 | 72.4 | 72.3 | 71.4 | 71.5 | 71.0 | 70.8 | 71.8 |
| France | 60.4 | 62.0 | 63.9 | 67.5 | 70.1 | 71.5 | 71.3 | 71.3 | 71.1 | 73.0 |
| United Kingdom | 74.7 | 75.7 | 76.0 | 80.9 | 82.6 | 80.7 | 78.3 | 78.0 | 79.8 | 81.4 |
| Italy | 55.0 | 56.8 | 61.1 | 64.1 | 68.2 | 67.2 | 68.5 | 68.0 | 66.0 | 65.6 |
| Canada | 68.5 | 70.5 | 72.6 | 70.6 | 72.1 | 72.7 | 73.5 | 72.1 | 69.5 | 68.8 |
| Belgium | 58.7 | 62.2 | 64.6 | 67.8 | 70.0 | 70.1 | 71.7 | 71.9 | 71.7 | · |
| Netherlands | 61.9 | 67.2 | 70.7 | 72.3 | 74.7 | 72.1 | 72.8 | 73.2 | 73.8 | · |
| Sweden | 69.6 | 74.8 | 77.4 | 76.7 | 77.9 | 80.8 | 85.0 | 83.5 | 80.9 | · |
| Switzerland | 63.8 | 65.6 | 68.4 | 70.7 | 72.5 | 71.7 | 72.0 | 72.8 | 73.2 | · |

deflation of demand was thrown onto public-sector budgets. Indeed in six of the seven major countries (the exception is Japan) the general-government budget deficit ratio was noticeably lower in 1980 (see page 36 above) than it was in the peak year of 1975. This generalisation is not, however, true for all the smaller countries: serious further worsening of public-sector balances has been seen in Belgium, the Netherlands, Sweden and Denmark.

The important point about real incomes is that the share of profits in total value added does not appear to have fallen as sharply as it did in 1974–75. Data in this area are unfortunately incomplete. However, the examination of price and cost movements in Chapter II suggested the same conclusion. The table above shows the sharp increase in labour's (pre-tax) share of national income which occurred in 1974–75. In contrast, the share seems to have remained more stable in 1979–80, the major exception being the United Kingdom.

There are probably several reasons for this more satisfactory outcome, and the most obvious one — namely that nominal wages did not explode in the same way — was no doubt very important. In addition, however, it may also be that enterprises were more able and willing to pass wage and non-wage cost increases through more rapidly into final prices. In part this may have been because the cost increases were themselves less, in the case of both wages and non-oil commodities. But firms may also have been more alive to the threat to profits following their earlier experience. Finally, overall demand and output in the industrial countries did not suffer the nose-dive that occurred previously. It should also be noted, as the table shows, that the 1974–75 gain in labour's share of income was not generally reversed after the first oil shock. Thus, although the long-term upward trend may have been broken for the time being, labour shares are almost universally still much higher than they were ten or fifteen years ago.

As far as the personal sector is concerned, the outstanding feature is the fairly general absence of a marked rise in the propensity to save (see table below). In most countries this was also reflected in the behaviour of purely financial saving (i.e. total sectoral saving less own capital expenditure), the private sector's equivalent of the budget surplus or deficit. In 1974–75 large rises in nominal wage incomes no doubt

Ratios of personal saving to disposable income.

| Countries | 1970–71 | 1972–73 | 1974–75 | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|
| | in percentages | | | | | | | |
| United States ... | 8.1 | 7.6 | 8.6 | 6.9 | 5.6 | 5.2 | 5.3 | 5.6 |
| Canada ..... | 5.6 | 8.3 | 10.4 | 10.0 | 9.8 | 10.3 | 10.5 | 10.2 |
| Japan ..... | 17.8 | 19.3 | 23.1 | 22.4 | 21.1 | 20.1 | 19.6 | 19.5 |
| France ..... | 16.7 | 17.1 | 18.0 | 16.4 | 16.6 | 17.5 | 15.9 | 14.1 |
| Germany ..... | 14.4 | 15.2 | 16.2 | 14.7 | 13.6 | 13.7 | 14.4 | 14.6 |
| Italy ..... | 22.0 | 23.1 | 23.1 | 24.7 | 25.2 | 27.2 | 25.6 | 23.3 |
| United Kingdom . | 8.5 | 10.7 | 13.1 | 11.9 | 10.8 | 12.7 | 14.1 | 15.3 |

**Private-sector financial saving: Reactions to the two oil shocks.**

| Countries/Sectors | | 1973 | 1974 | 1975 | 1976 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|
| | | as a percentage of gross national product | | | | | | |
| United States | Households | 4.0 | 4.2 | 5.1 | 3.7 | 1.9 | 2.1 | 3.5 |
| | Corporations | − 4.4 | − 4.3 | 0.5 | − 0.9 | − 2.4 | − 2.6 | − 1.5 |
| | Total | − 0.4 | − 0.1 | 5.6 | 2.8 | − 0.5 | − 0.5 | 2.0 |
| Japan | Households | 8.8 | 10.3 | 10.5 | 11.5 | 11.1 | 9.2 | 8.4 |
| | Corporations | − 7.6 | − 8.5 | − 4.1 | − 4.0 | − 1.0 | − 3.1 | − 3.5 |
| | Total | 1.2 | 1.8 | 6.4 | 7.5 | 10.1 | 6.1 | 4.9 |
| Germany | Households | 3.4 | 6.0 | 7.0 | 5.3 | 3.2 | 3.1 | 3.4 |
| | Corporations | − 3.8 | − 2.9 | − 1.2 | − 1.8 | 0.0 | − 2.1 | − 2.9 |
| | Total | − 0.4 | 3.1 | 5.8 | 3.5 | 3.2 | 1.0 | 0.5 |
| France | Households | 3.5 | 3.7 | 5.7 | 3.8 | 5.5 | 4.3 | 3.6 |
| | Corporations | − 5.1 | − 6.9 | − 3.7 | − 4.9 | − 3.6 | − 4.0 | − 4.6 |
| | Total | − 1.6 | − 3.2 | 2.0 | − 1.1 | 1.9 | 0.3 | − 1.0 |
| United Kingdom | Households | 3.6 | 6.7 | 6.0 | 5.1 | 5.7 | 6.3 | 8.7 |
| | Corporations | − 2.5 | − 5.3 | 0.1 | − 0.2 | − 0.3 | − 2.4 | − 1.0 |
| | Total | 1.1 | 1.4 | 6.1 | 4.9 | 5.4 | 3.9 | 7.7 |
| Italy | Households | 16.0 | 12.7 | 16.7 | 14.2 | 16.2 | 16.0 | 12.9 |
| | Corporations | − 7.8 | − 7.9 | − 7.8 | − 7.3 | − 3.2 | − 2.1 | − 7.0 |
| | Total | 8.2 | 4.8 | 8.9 | 6.9 | 13.0 | 13.9 | 5.9 |
| Canada | Households | 4.9 | 6.3 | 6.2 | 4.7 | 5.4 | 5.1 | 5.5 |
| | Corporations | − 6.1 | − 8.6 | − 6.0 | − 5.7 | − 5.2 | − 5.3 | − 4.2 |
| | Total | − 1.2 | − 2.3 | 0.2 | − 1.0 | 0.2 | − 0.2 | 1.3 |

led to some unplanned increase in saving. In addition, the higher inflation rate was then causing greater real value losses on the existing stock of financial assets, to which the personal sector responded in an attempt to maintain the real value of its stock of financial wealth. Finally, the shock effect of the first oil crisis was probably greater than that of the second.

The upshot was thus a tendency for the personal sector to cut back its net spending between 1973 and 1975. But this threw a greater deflationary burden onto the company sector — at least initially — in addition to that resulting directly from the oil price shock itself. Bearing in mind that the first shock hit at the top of a boom, when companies are usually extending themselves financially in order to increase capital spending, it is not surprising that they reacted violently, sharply cutting back expenditure on both stocks and fixed investment.

The second oil shock period has thus so far seen, in several countries, a movement in private net spending behaviour in the opposite direction from that

which occurred in the first. An important corollary of this has been that the automatic stabilisers of the budget have not been called upon further to support demand and activity to anything like the same extent as in 1975.

Despite the fact, then, that fiscal and monetary policies have been somewhat tighter on this occasion, the overall deceleration of demand and output growth has so far been less severe than in 1974–75. Some might see in this relative strength of aggregate demand an absence of part of the required adjustment to the higher oil price and to the external imbalance. In terms of resource allocation, however, the adjustment process appears broadly to have been moving along the right lines. In 1979–80 public consumption and, in most cases, public investment were less expansive than in 1974–75, and by 1980, except in Italy, private consumption was rising much more slowly than in the comparable year 1975.

Thus, as far as the composition of demand is concerned, and given the development of income shares already noted, business fixed investment held up relatively well in 1979–80. The table shows this to be especially true of Japan, France, Germany and Italy. Better investment performance has also been recorded among the smaller countries, especially Switzerland, Belgium and Finland. Bearing in mind, however, that profits are still at a low level in historical terms, it may be that other factors have also played a rôle. In particular, it is possible that a good deal of the investment is aimed at energy saving and reflects a lagged response to the change in relative energy prices during the 1970s. There is growing evidence to suggest that the trend in this direction may already be quite strong. Secondly, the most recent oil shock came at a different point in the cycle, not at the top of a synchronised boom.

Consumption and investment, 1974–75 and 1979–80.

| Countries | Private consumption | | Public consumption | | Private non-residential investment | | Public investment | |
|---|---|---|---|---|---|---|---|---|
| | 1974<br>*1979* | 1975<br>*1980* | 1974<br>*1979* | 1975<br>*1980* | 1974<br>*1979* | 1975<br>*1980* | 1974<br>*1979* | 1975<br>*1980* |
| | annual percentage changes at constant prices | | | | | | | |
| United States | – 0.6<br>*2.9* | 2.2<br>*0.4* | 3.3<br>*2.4* | 3.3<br>*3.1* | – 1.7<br>*6.5* | –12.1<br>*– 3.0* | 1.7<br>*– 5.6* | – 5.4<br>*1.3* |
| Japan | 0.9<br>*6.2* | 4.3<br>*1.3* | 3.3<br>*4.0* | 6.3<br>*2.0* | – 6.1<br>*12.5* | – 6.9<br>*6.4* | –13.8<br>*3.0* | 5.2<br>*– 4.5* |
| Germany | 0.3<br>*3.3* | 3.1<br>*1.5* | 4.3<br>*3.3* | 4.5<br>*2.4* | –10.9<br>*10.0* | – 1.5<br>*4.0* | 7.5<br>*6.1* | – 2.7<br>*3.7* |
| France | 3.2<br>*3.5* | 3.2<br>*2.1* | 1.3<br>*1.6* | 4.6<br>*2.5* | – 1.1<br>*6.0* | – 6.8<br>*3.4* | 1.4<br>*1.7* | 9.7<br>*1.4* |
| United Kingdom | – 2.2<br>*4.7* | – 0.7<br>*0.6* | 1.4<br>*2.0* | 6.0<br>*2.1* | – 1.8<br>*2.7* | – 3.0<br>*1.8* | 0.5<br>*– 4.0* | – 1.0<br>*– 5.6* |
| Italy | 2.7<br>*5.3* | – 1.4<br>*4.4* | 2.9<br>*1.6* | 2.9<br>*2.0* | 2.9<br>*7.9* | –19.9<br>*13.4* | 7.1<br>*3.0* | 17.9<br>*7.1* |
| Canada | 5.1<br>*1.9* | 5.2<br>*0.6* | 4.0<br>*– 1.0* | 4.0<br>*0.6* | 7.7<br>*9.4* | 7.8<br>*8.6* | 5.5<br>*– 0.8* | 4.3<br>*1.3* |

To sum up private-sector reactions so far, the two facts which are probably most significant are that total demand growth was less seriously affected in 1979 and 1980 than in 1974–75. And within this total, private business investment performed quite strongly in many countries. To what extent this constitutes fundamental adjustment it is not possible to say precisely. But higher fixed investment, even if not specifically linked with energy adaptations as a first priority, will nevertheless have included more recent and more appropriate energy-related techniques. At the same time, better maintenance of the capital stock means that the future prospects for output and employment have not been as severely compromised as might have been the case.

**Relative domestic demand changes following the two oil shocks.**

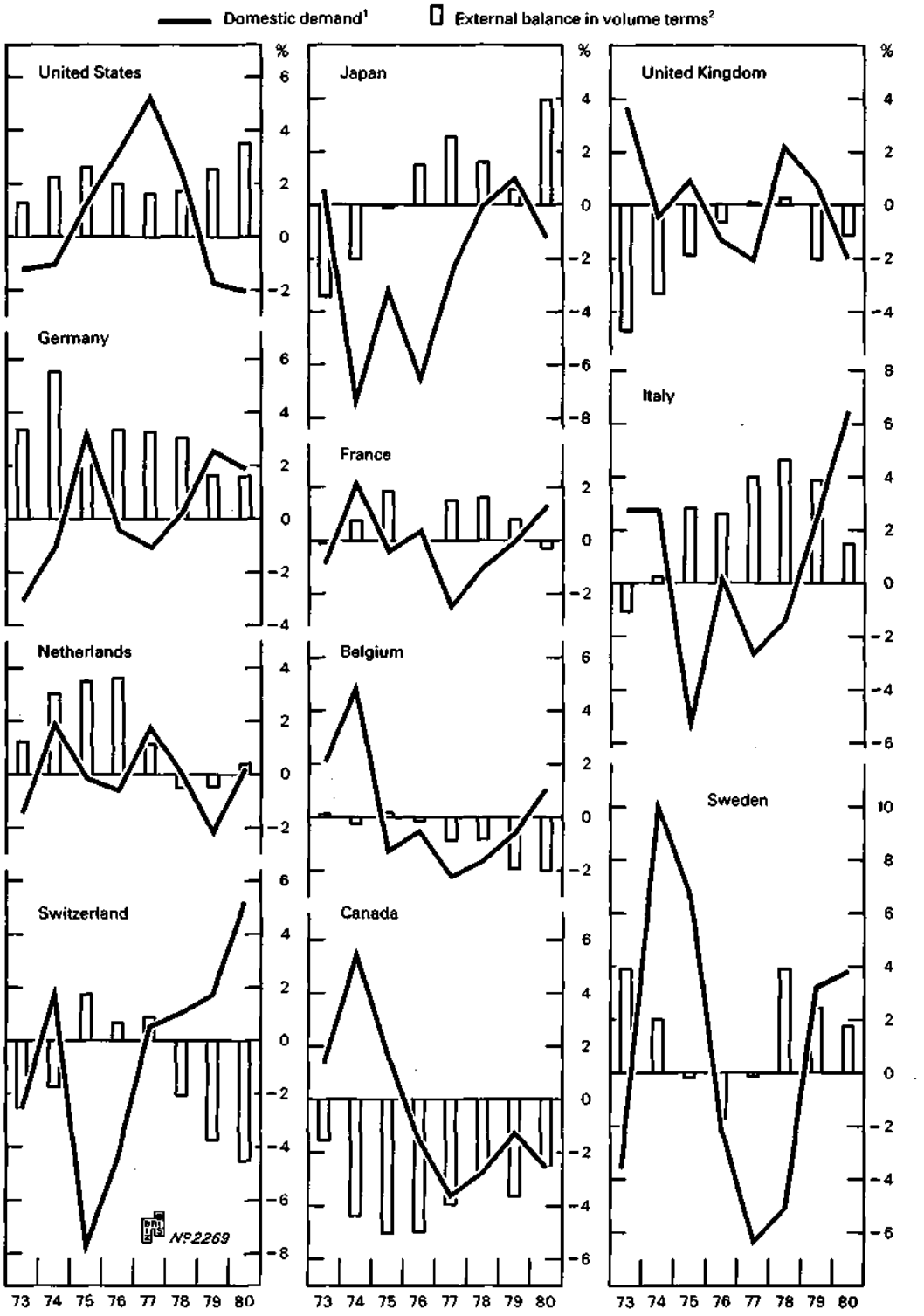
One widespread concern following the first oil shock was that recovery for some countries was being obstructed by an inappropriate constellation of external-account positions among the industrial countries themselves. In particular, countries such as Germany, Switzerland and, later, Japan, which are heavily dependent on imported oil, all ran sizable surpluses on external current account. With the United States also in surplus up to 1977 the burden of bearing the "oil deficit" thus fell disproportionately heavily on some weaker countries, notably Italy and the United Kingdom, and on some of the smaller European countries such as Spain, Greece, Finland and Sweden.

One remedy for this situation was an adjustment in exchange rates, which did take place as time went on. But another remedy which was urged on the stronger countries was to increase differentially the growth of domestic demand, thereby reducing their net exports of goods and services while permitting others to do the opposite. And at the Bonn Summit meeting in 1978 Germany and Japan responded by agreeing to give some stimulus to their economies.

The resulting contrasts in the pattern of demand adjustment in the two oil shock periods can be seen from the graph. For each country a ten-year moving average growth rate of domestic demand was calculated and the same was done for all other OECD countries combined. The country's relative demand growth for any given year was then calculated as the difference of its actual demand growth from the moving average compared with the same difference for all other countries. These differential growth rate patterns have been plotted over the year-by-year levels of the volume of net exports. The graph confirms the notion of very different relative demand movements this time. Germany has moved noticeably ahead of the average, while in Switzerland the large decline in demand experienced in 1975 did not recur. Italy, too, perhaps to some degree in the wake of its important German trading partner, recorded demand growth above the average. In Japan domestic demand was stronger than in 1974–75. In Sweden, Belgium and the Netherlands, however, relatively more restraint has been needed over the past two years, largely because, in contrast to the situation in 1973, all three countries entered the second oil shock with already weak external accounts. The same was true of Canada.

Thus the pattern of relative demand growth on this occasion is to some extent the consequence of pre-shock policy changes as well as a result of policy responses

Changes in relative domestic demand pressures and real foreign balances.




[1] See text on page 45 for explanation. [2] As a percentage of gross national product.

to the new oil price rise as such. Indeed in the case of Germany the reversal of position has gone too far, with a large and troublesome current-account deficit. But the other half of the story is that the Bonn Summit "game plan" was overtaken by events. The lessening of external constraints which was expected from the German and Japanese efforts was counteracted in many countries by the new oil price shock. Indeed in some, especially the United Kingdom, policies had to be turned firmly in the opposite direction. Thus, whereas a gently rising tide was supposed gradually to lift all the ships, including, eventually, those that were stranded on the beach, the new oil price storm caused some to decide that the beach might after all be a safer place. Nevertheless, taking the overall picture, relative demand adjustments have been less disparate than they were in the mid-1970s, with the result that the pattern of external imbalance among the industrial countries has been less unsustainable than it then was.

**The energy sector.**

1980 brought further and accelerated progress in savings in the use of energy in the industrial countries. Unfortunately, however, these successes were largely offset, as far as the oil market was concerned, by further evidence of instability in the supply of oil from the Gulf.

Among the industrial countries total energy consumption seems to have dropped quite sharply last year, by some 3½ per cent., and oil demand alone probably fell by more than twice that amount — though this was partly due to a decline from the high rate of precautionary stockbuilding in 1979. In relation to gross national product the falls were rather greater — 4½ per cent. and 8½ per cent. respectively. These changes brought the overall decline in energy use per unit of gross national product since 1973 to some 11–12 per cent., with a fall of 16–17 per cent. for the oil component alone. Oil saving has been particularly marked in France, while in the United States, after a hesitant start, oil conservation has been more marked in the last two years.

There can be little doubt that the change in the relative price of energy since 1973 has been the prime cause of the trend towards greater energy efficiency. The OECD has estimated that the real, or relative, price of energy to final users rose by some 25 per cent. in the wake of the first oil crisis. This time the rise may ultimately be even larger despite the similarity in the size of the real crude oil price change. Firms seem more alive to the necessity of passing on the rise in energy costs more completely and more promptly. And governments too are, on the whole, now more willing to add to the price incentives to conservation by action on the taxation side.

The change in the relative price of energy since 1973 seems hitherto to have had a considerably greater effect in terms of curbing consumption than it has in encouraging energy production. It is estimated that between 1973 and 1979 indigenous energy production in the industrial countries rose by only 5 per cent. For oil alone, the combined net rise in production in the five major non-OPEC producers — the United States, Mexico, Canada, the United Kingdom and Norway — amounted to only 2¾ million barrels per day between 1973 and 1980. Over the

same period OPEC production fell by 4 million barrels per day. And, although there is now evidence, for example, that drilling activity has picked up substantially in the United States following the second oil shock, it may be some time before this results in a significant contribution to output. In Europe, too, the Commission of the European Communities has estimated that the proportion of output devoted to investment in the energy sector, at rather less than 1½ per cent. of Community gross national product, has not risen at all from the pre-1973 level. One obvious reason for this is the way in which, for example, the nuclear energy programme has been held up in Germany because of popular fears about safety and the environment. By contrast, however, the Government in France has been able to push ahead with a major nuclear programme since the first oil crisis. As a result, oil consumption in France has been reduced by about 30 per cent. as a proportion of gross national product, about twice the saving achieved for energy as a whole. Consequently, despite national output growth of 22 per cent. since 1973 net imports of oil last year were over 15 per cent. lower in absolute terms. In contrast there was no change in Italy over the same period, and in Germany the fall was only 7 per cent.

Oil dependence in the OECD.

| Items | 1960 | 1965 | 1973 | 1980* |
|---|---|---|---|---|
| | in percentages | | | |
| Oil consumption as a proportion of total energy consumption ..... | 38.6 | 44.6 | 53.1 | 50.2 |
| Net oil imports as a proportion of total oil consumption ..... | 45.2 | 55.8 | 66.3 | 64.0 |
| Net oil imports as a proportion of total energy consumption ..... | 17.4 | 24.9 | 35.2 | 32.0 |

* Estimates.

It is clear, therefore, that substitution by domestic sources of energy, both oil and non-oil, has not yet gone very far in most industrial countries, though a large adjustment has come through conservation. The OECD countries as a whole used something like 13 per cent. less energy last year than they would have done had energy consumption continued to grow in line with gross national product since 1973. This saving was equivalent to some 10 million barrels of oil per day, and in fact it is quite likely that, as oil is the marginal fuel, the overall saving can nearly all be thought of as oil conservation.

In addition, however, some adjustment must also have come through lower growth than might otherwise have been the case. How much is impossible to say with any precision because it depends on what growth rate would have proved possible in the absence of the two oil shocks.

Nevertheless, it is clear that, from a combination of conservation, slower growth and substitution, there has been a very large adjustment in total consumption of energy. The problem is, however, as the accompanying table shows, that this adjustment has done little more than halt the rapid rise in the industrial countries' dependence on imported oil. While oil was cheap the proportion of total needs met from imported oil rose rapidly, and, for the OECD area as a whole, the

proportion of total energy consumption met in this way doubled between 1960 and 1973. All the adjustment that has occurred since 1973 has thus reduced the imported oil/total energy ratio by only 3 percentage points. Last year the industrial countries were still dependent on imported oil for nearly one-third of their overall energy requirements, and they still imported some 24 million barrels per day, compared with 27 million in 1973.

The constraint which this situation places on the scope for better economic performance in the oil-consuming countries can be examined under two headings. Firstly, dependence on external supplies for a significant proportion of such a vital resource clearly increases vulnerability to shock events beyond the control of the consuming countries. The fragile security of supply became quite clear in the wake of the Iranian revolution in 1979. The market pressures which led to the large rise in price came mainly from a precautionary scramble to build up stocks in an uncertain situation. Consumption of oil in the industrial world was virtually unchanged between 1978 and 1979. And, despite the Iranian cutback, OPEC oil production actually rose by 2½ per cent.

The second aspect of the situation concerns the inability and/or reluctance of the OPEC countries as a group to re-spend the whole of their increased revenues on imports from the oil-buying world. This has, of course, resulted in the re-emergence of a large current-account surplus which, as is discussed later in this Report, is a major international financial problem in its own right. Here it is more important to note that, because of the re-spending question, OPEC countries are understandably reluctant to supply oil at whatever rate is demanded.

An early and satisfactory resolution of this situation is difficult to foresee. It may well be that there are more, lagged, conservation effects to come in the industrial countries themselves as a result of the rise in real energy prices which has already occurred. Indeed, the OECD has calculated that the full response to price changes may take as long as six years. Even so, six years is a long time to wait, while it is likely that the more conservation already achieved, the more difficult further progress on this front will be. As far as substitution is concerned, there is some evidence of the beginnings of a significant response, but progress has been slow and the new investment will take several years to bear fruit in terms of any appreciable increase in non-OPEC energy supplies. The conclusion must therefore be that any early attempt to return quickly to a more satisfactory employment and growth situation in the industrial world would be almost certain to require increased production of oil by the OPEC countries with all the attendant risks in terms of prices and supplies.

**Prospects for improvement.**

This chapter and the previous one have shown the industrial world to be firmly held in the double-lock grip of the interlinked inflation and energy constraints. In the context of inflation Chapter II asked whether monetary and fiscal policies were enough. The question is also pertinent in the energy context. The move towards greater concern with supply-side policies in several countries and away from exclusive reliance on traditional demand management is a welcome recognition that

the latter may not be enough in the situation with which the world economy is now faced. However, it may be that the focus of these new policy approaches needs to be broadened to include the prices at which labour and output are supplied domestically and the international supply of energy.

To put the point another way, in a perfect world one might envisage a significant addition to anti-inflation policies coming from a more effective consensus between what Europeans often call the social partners. And in the energy field, one might likewise envisage sufficient co-operation and agreement between oil suppliers and consumers for a reliable increase in oil supplies to be temporarily provided to allow some renewed growth while further conservation and, particularly, substitution policies are implemented and intensified.

In the world as it is, success in such politically sensitive areas is likely to be difficult to achieve. In that case, the restrictive fiscal and monetary policies which have been appropriately applied in the short term will remain appropriate for a longer period.

# IV. MONETARY POLICY AND THE FINANCIAL MARKETS.

During the past year conditions in the financial markets were particularly turbulent. Interest rates fluctuated over a wide range, reaching unprecedented peaks, and for extended periods short-term rates stood at unusual levels in relation to long-term yields. Higher rates of inflation in the wake of the second oil crisis, and countries' efforts to avoid accommodating them, contributed to interest rate pressures. Policies designed to slow down the pace of monetary expansion were kept in place, and resolute monetary action was taken in many countries to limit the depreciation of their currencies so as to avoid a possible worsening of the domestic cost/price spiral.

Lower rates of monetary expansion in nominal and real terms, high real interest rates and slackness in the economy testify to distinctly restrictive monetary conditions in many countries. However, in some cases, not least that of the United States, buoyant inflationary expectations may, at least for a time, have blunted the edge of policy.

Corporate financial positions and public-sector finances came under further pressure last year, largely for cyclical reasons. The financial position of business, strong only in Japan, has in a number of cases become more fragile, with heavy dependence on external financing, often at short term. Monetary financing of the public sector has so far been moderate, but government borrowing requirements may have contributed to external problems in some countries, as well as to the high level of real interest rates.

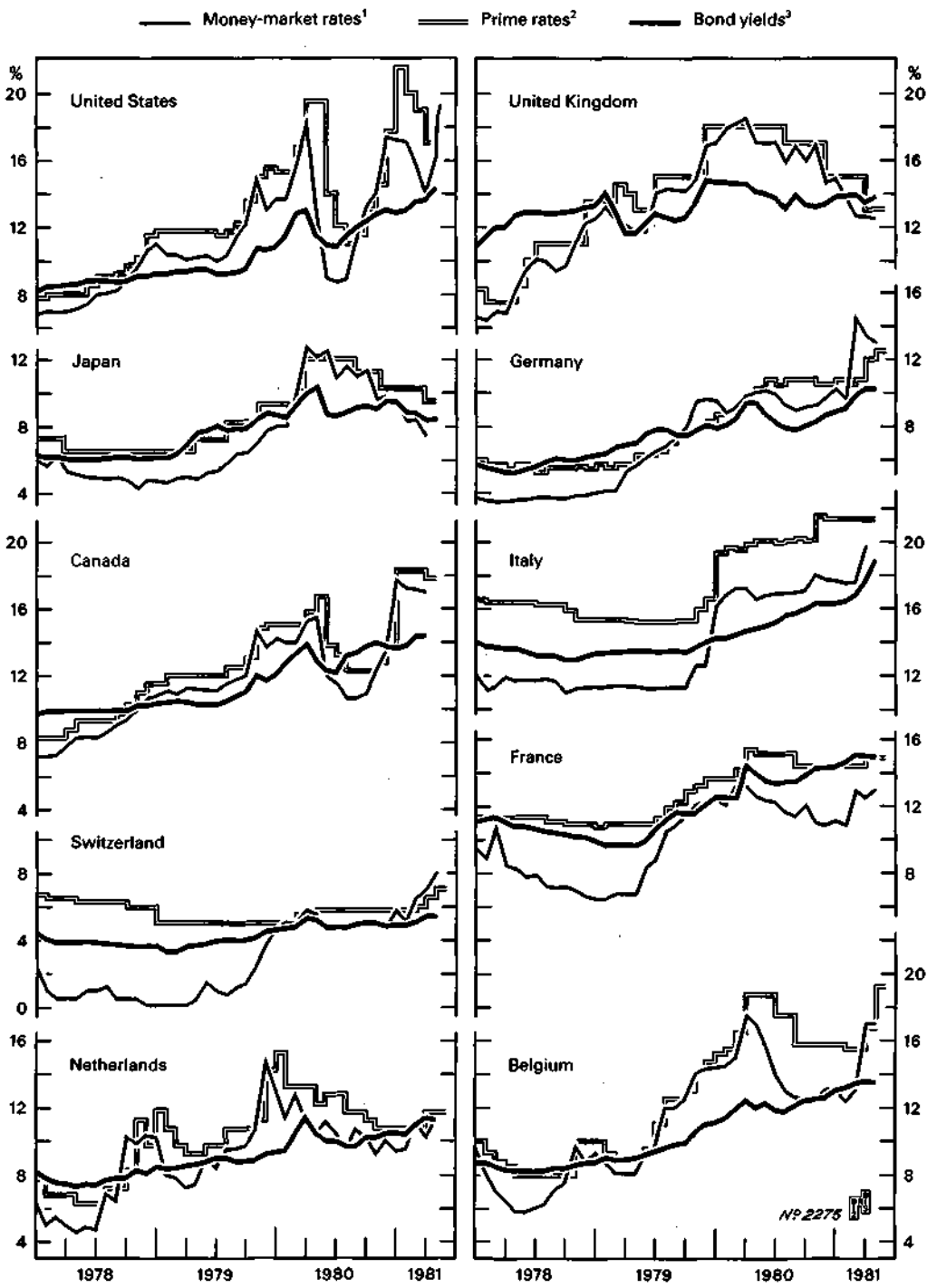
Significant changes in monetary control procedures have been made in the United States and in other key countries over the past year or two. The issues these raise primarily concern the efficacy of differing money-stock control procedures, the appropriate time horizons for achieving intermediate targets, and the implications for interest rates and exchange rates. Countering inflation may indeed be primarily the responsibility of monetary policy, and the improvement of control procedures is important. But equally at issue are the risks which may be associated with an inappropriate policy mix. Interest rate levels may be higher than necessary if monetary restraint is not supported by appropriate fiscal policies and, where possible, also by incomes policies.

## Interest rates.

Developments in interest rates strikingly illustrate the changing pressures to which financial markets were subject during the year.

In the United States both short and long-term interest rates recorded unprecedentedly large swings. After a steep but irregular ascent which began in the summer of 1979, money-market rates reached high levels in the spring of 1980. Even

Short and long-term interest rates.




[1] Representative rates. (For Italy, interbank sight deposits; for France, one-month interbank deposits; for Belgium, four-month certificates; for other countries, three-month money-market instruments.) [2] Minimum rates charged by commercial banks for cash credits to first-class borrowers. (For Germany, lower end of range for large current-account credits.) [3] Representative rates. (For the United States, all corporate bonds; for the United Kingdom and the Netherlands, government bonds; for Canada, industrial bonds; for other countries, various other public-sector bonds.)

more startling was their subsequent plunge, which in the space of three months brought the Federal funds rate down from 20 to 8½ per cent. and the rate on ninety-day commercial paper from 18 to 8 per cent. A reversal soon occurred, however, and by mid-December the Federal funds rate, at over 20 per cent., and the commercial paper rate, at almost the same level, had reached new peaks even higher than those of the previous spring. A decline of about 7 percentage points in these rates in early 1981 was followed by a new upsurge in April–May. Banks' posted prime lending rates, which had reached 20 per cent. in April 1980, fell to 11 per cent. in August, rose to 21½ per cent. in December and, after slipping to 17 per cent. in early April 1981, recovered to 20 per cent. by mid-May. Bond yields, which in the United States had traditionally been slow to respond even to substantial movements in short-term rates, also recorded large swings last year and, on balance, a substantial rise.

In most other industrial countries interest rates at both short and long term had moved up broadly in line with US rates in late 1979 and early 1980 to reach levels which were generally high by previous standards. In Germany a weak external position made interest rates unusually sensitive last year to developments in dollar rates. Some of the brunt was borne by movements in the DM/dollar exchange rate, but both long and short-term rates remained at levels which, though considerably lower than those of dollar rates, were the highest recorded in Germany since 1973–74. Moreover, interest rates surged up further in early 1981 when the Deutsche Mark suffered a new bout of weakness. Interest rates in Switzerland followed a broadly similar course. In France and the Netherlands, whose currencies were relatively strong within the European Monetary System for much of 1980, short-term interest rates moved down gradually from the high peaks reached early in the year. In Belgium money-market rates followed a similar pattern in 1980, but rose steeply in March 1981 when measures were taken to support the Belgian franc. In France there was a substantial rise in money-market rates in early May. In Italy short-term interest rates had been raised sharply around the end of 1979 and went up further between the autumn of 1980 and the spring of 1981 as monetary policy was tightened progressively. Bond yields rose during the year in varying degrees in the Netherlands, France, Belgium and Italy.

Interest rates in the United Kingdom were largely shielded from developments in financial markets abroad by sterling's oil-related strength. They were kept at high levels, however, since the authorities were seeking to brake the fast advance of sterling $M_3$. In late 1980 and early 1981, with competitiveness threatened by the level of sterling, steps were taken to encourage a decline at the short end of the market.

In Japan a marked fall in money-market rates was fostered by the Bank of Japan from the spring of 1980 onwards as the yen strengthened. Policies to restrain monetary expansion had helped in containing the domestic inflationary impact of the second oil crisis, and faster real adjustment the second time around was increasingly reflected in Japan's external current-account position. Bond yields also moved down slightly.

The recent interest rate constellation has been characterised by unusually marked and, in many cases, persistently inverse term/yield structures. In the United

States the ninety-day commercial paper rate stood more than 5 percentage points above the prime corporate bond yield at each of the rate peaks in 1980 and early 1981. These developments reflected fluctuations in economic activity as well as the volatility of short-term rates consequent upon the policy shift towards control of bank reserves. Short-term rates also moved well above long-term rates at times in Japan and in most western European countries. Within the past two years money-market rates have stood above government or public-sector bond yields for unprecedented periods of some eighteen months or more in Germany, the United Kingdom, Belgium and the Netherlands. Interest rate relationships such as these may imply that rates of inflation are expected to moderate in time. However, they also seem to be indicative of severe liquidity restraint protracted well beyond anything many market participants had expected.

Interest rate peaks.[1]

| Interest rates | Years | United States | Japan | Germany | France | United Kingdom | Italy | Belgium | Nether-lands | Switzer-land |
|---|---|---|---|---|---|---|---|---|---|---|
| | | peak-month rate, in percentages per annum | | | | | | | | |
| Short-term | 1973–75 | 11.9 | 16.9 | 14.8 | 14.8 | 16.3 | 18.0 | 12.0 | 14.0 | 6.0 |
| | 1976–78 | 11.0 | 7.7 | 5.1 | 11.0 | 15.4 | 20.5 | 13.8 | 14.8 | 3.5 |
| | 1979–81[2] | 18.2 | 12.7 | 14.5 | 13.3 | 18.6 | 19.7 | 17.5 | 14.8 | 8.0 |
| Long-term | 1973–75 | 9.3 | 10.9 | 10.7 | 11.5 | 17.4 | 12.7[3] | 9.3[3] | 10.5 | 7.9 |
| | 1980–81[2] | 14.3 | 10.3 | 10.3 | 15.0 | 14.7 | 18.9 | 13.6 | 11.5 | 5.5 |

[1] Representative rates (see graph on page 52; for Japan, industrial bonds). Based on monthly average data for the long-term rates of Germany, Japan, the Netherlands and the United States and end-month data for other series. [2] Based on data up to April. [3] Higher peaks were reached in 1976–77 (14.9 per cent. for Italy and 9.4 per cent. for Belgium).

While developments differed slightly from country to country, interest rates everywhere stood for most of last year at levels close to and in some cases above the highest peaks previously recorded. In the United States, Germany and Japan the only previous comparable period was that which included the first oil shock and the preceding commodity boom. In the United Kingdom, Italy, Belgium, the Netherlands and, to a lesser extent, France, interest rates had reached high levels in 1976 in conjunction with efforts to counteract the external weakness of the currencies concerned. Following the first oil shock, differences between the amount of attention countries gave to their external flank had resulted in widely divergent rates of inflation. Reflecting the lessons of this experience, the high interest rates that prevailed in almost all countries last year appear to have been strongly influenced by external circumstances. Fairly generally, one underlying consideration was the impact that excessive currency depreciation might have on the domestic wage/price spiral.

**Indicators of the stance of monetary policy.**

Developments in interest rates suggest that monetary conditions in the industrial countries became quite restrictive last year. In an inflationary environment, it is true, the impression given by nominal interest rates may be

deceptive, and it is often quite difficult precisely to ascertain the thrust of policy. To consider a range of indicators can be helpful, however.

*Rates of monetary expansion.* Analysis of developments in monetary policy is often based mainly on developments in monetary aggregates. To a degree, consideration of the movement of aggregates permits policies to be measured against the authorities' own criteria, given the central rôle that official objectives for the aggregates have come to play in many countries.

Rates of monetary expansion.

| Money stock | Years | United States | | Japan | Germany | France | United Kingdom | Italy | Canada |
|---|---|---|---|---|---|---|---|---|---|
| | | A | B | | | | | | |
| | | fourth quarter to fourth quarter, in percentages | | | | | | | |
| Broad[1] | 1971–75 average | 9.6 | 10.9 | 17.1 | 10.3 | 16.8 | 17.7 | 19.7 | 17.3 |
| | 1976–80 average | 9.7 | 10.9 | 10.3 | 8.3 | 12.4 | 13.0 | 18.9 | 14.7 |
| | 1975 ..... | 12.3 | 9.4 | 14.5 | 9.1 | 17.7 | 8.6 | 22.3 | 17.5 |
| | 1980 ..... | 9.8 | 9.9 | 7.7 | 5.9 | 10.4 | 18.5 | 11.4 | 10.9 |
| Narrow[2] | 1971–75 average | 5.9 | 6.0 | 16.2 | 10.2 | 12.4 | 12.2 | 15.7 | 13.4 |
| | 1976–80 average | 6.3 | 7.8 | 5.4 | 8.1 | 10.2 | 12.2 | 20.5 | 8.8 |
| | 1975 ..... | 4.8 | 5.0 | 10.9 | 15.4 | 15.3 | 22.0 | 10.3 | 21.1 |
| | 1980 ..... | 5.0 | 7.3 | −1.8 | 4.5 | 8.7 | 4.0 | 11.9 | 9.5 |

[1] For the United States, $M_2$ (column A) and $M_3$ (column B); for Japan, $M_2$+CDs; for Germany, $M_3$; for France, Italy and Canada, $M_2$; for the United Kingdom, sterling $M_3$. [2] For the United States, $M_{1A}$ (column A) and $M_{1B}$ (column B); for other countries, $M_1$.

As the table shows, the pace of monetary expansion in most countries has been slower on average during the past few years than it was in the years preceding and immediately following the first oil shock. Monetary growth rates have also been more stable in the recent period than in the first half of the 1970s, when there was first a monetary explosion and then a steep cyclical reduction. A notable exception, however, is the case of the United States, where the narrow aggregates and $M_2$ have expanded as rapidly in recent years as before. Last year the rate of expansion of both broad and narrow aggregates was generally lower than the average during the last four years — markedly so in most countries other than the United States. In the United Kingdom sterling $M_3$ expanded very rapidly but $M_1$ recorded a slowdown comparable with that experienced in many other countries.

The fact that the prevailing interest rate relationships were conducive to economising on low-yielding transactions balances and savings deposits helped to slow down the growth of the narrow aggregates and in many cases of the broad ones, too. In the United Kingdom, on the other hand, the average return on sterling $M_3$ placements had risen quite steeply in relation to yields on potential alternatives such as bonds. In Italy the slowdown in the growth of $M_2$ in recent years has been associated with a large increase in the public's holdings of Treasury bills. The expansion of $M_3$, which includes such bills, came to 17 per cent. in 1980.

*Domestic credit expansion.* In a context of large external payments imbalances such as those which followed both oil shocks, the growth of the money stock may

prove an unreliable indicator of policy stance in individual countries. Particularly in situations where a large balance-of-payments deficit is draining off liquidity on a considerable scale, the expansion of bank lending or of total domestic credit must be taken into account in assessing monetary impulses at work in open economies.

**Bank credit and the net foreign position of the banking system.**[1]
Changes over twelve months ending in December.

| Countries | Total domestic credit[2] | | | | | Net foreign assets[3] | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1973 | 1974 | 1975 | 1979 | 1980 | 1973 | 1974 | 1975 | 1979 | 1980 |
| | in percentages[4] | | | | | contribution to growth of the money stock[5] | | | | |
| Japan | 17.1 | 15.1 | 16.7 | 8.4 | 8.4 | −3.7 | −2.1 | −0.8 | −2.3 | −1.0 |
| Germany | 11.0 | 7.7 | 10.5 | 11.5 | 9.3 | 5.4 | 0.7 | 4.5 | −3.8 | −1.5 |
| France | 15.5 | 20.1 | 15.2 | 15.2 | 11.1 | −1.5 | −0.4 | 1.9 | 0.6 | 2.0 |
| United Kingdom | 31.1 | 20.7 | 12.9 | 19.7 | 21.7 | −3.5 | −9.3 | −3.7 | −5.4 | −5.7 |
| Italy | 22.6 | 22.6 | 22.6 | 20.0 | 21.2 | −3.8 | −5.6 | −0.8 | 1.7 | −2.2 |
| Belgium | 17.1 | 10.1 | 13.6 | 15.8 | 12.1 | 0.4 | −2.2 | 2.8 | −7.8 | −1.2 |
| Netherlands | 18.7 | 15.3 | 14.1 | 16.7 | 10.5 | 3.6 | 5.7 | 4.3 | −3.6 | −3.6 |
| Sweden | 10.8 | 13.5 | 13.3 | 19.2 | 19.7 | 4.4 | −1.2 | 2.6 | −4.3 | −2.7 |
| Denmark | 12.6 | 13.4 | 26.8 | 14.3 | 16.7 | 2.4 | −1.4 | −2.4 | −2.8 | −6.5 |
| Canada | 19.5 | 19.6 | 13.2 | 18.4 | 11.1 | . | . | . | . | . |
| Switzerland | 10.0 | 7.0 | 6.8 | 15.5 | 14.2 | . | . | . | . | . |
| Spain | 24.9 | 24.8 | 22.5 | 17.2 | 20.3 | 1.7 | −3.4 | −2.6 | 0.5 | −3.1 |

[1] Based mainly on national sources; for Switzerland, IMF International Financial Statistics. [2] For the United Kingdom, includes public-sector borrowing abroad. [3] For France, Bank of France only; for the United Kingdom, includes public-sector borrowing abroad (−). [4] For the United Kingdom and Denmark, increase as a percentage of the broad money stock at the beginning of the period. [5] Increase as a percentage of the broad money stock at the beginning of the period. (For Germany and Sweden, $M_3$; for the United Kingdom, sterling $M_3$; for other countries, $M_2$.)

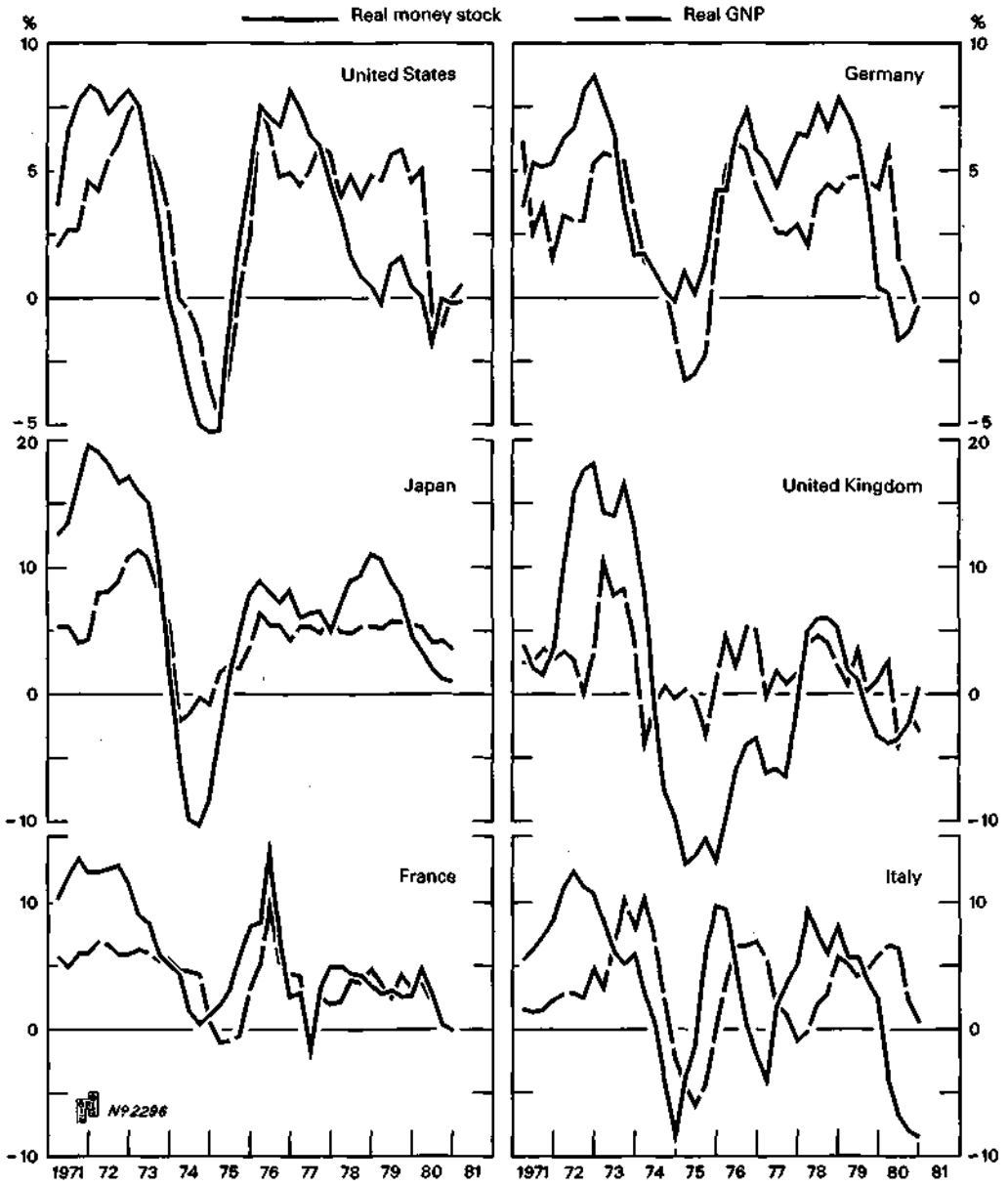
Reflecting, in most cases, growth in the banks' domestic non-monetary liabilities as well as a deterioration in the external position of the banking system, bank credit to the domestic economy expanded faster than the broad money supply last year in Germany, France, Belgium and the Netherlands. However, as can be seen from the table, bank credit expansion in most of these countries was fairly moderate and generally slower than in the period following the first sharp increase in oil prices. A slowdown in recent years is particularly apparent in Japan. In all these countries bank lending to the private sector has tended to slow down, and credit to the public sector — though remaining an important element in total bank credit expansion in Belgium and the Netherlands — has not surged upwards as it did in the previous recession when private credit demand weakened. In considering the broader credit picture it must be recalled that the Belgian and German Governments borrowed abroad on a large scale last year and that in Germany the enterprise sector also had substantial recourse to short-term credit from abroad. Such transactions are not reflected in the increase in bank credit as shown in the table but instead help to limit the deterioration in the external position of the banking system.

Domestic bank credit expansion was substantial both in relation to the increase in the broad money stock and in absolute terms last year in the United Kingdom, Italy, Sweden, Denmark and Switzerland. Moreover, to finance the rise, banks in most of these countries had recourse on a considerable scale to net foreign borrowing or to foreign currency funds which were not included in the money supply. Bank lending to the private sector expanded strongly in Switzerland and

Italy in a context of relatively buoyant economic activity, and in the United Kingdom under rather different circumstances. However, credit to the government or public sector constituted a large part of total bank credit expansion in Italy and the United Kingdom, and in Sweden and Denmark it accounted for the lion's share.

*The real money stock.* Efforts to slow down rates of monetary expansion in the major countries have, of course, been based on the view that they would result, sooner or later, in more moderate rates of inflation. Hopes that the adoption of

The real money stock and real gross national product.
Changes over four quarters, in percentages.*




* Based on quarterly averages. Changes in the broad money stock have been deflated by changes in price indices for gross domestic expenditure. Double scale for the United States and Germany.

determined restraint policies and the announcement of a commitment to them on the part of the authorities might lead to a prompt downward revision in inflationary expectations and in wage settlements often proved illusory. By last year the policies had been in place for some time. However, in a context of disruptive shocks in the price sphere, an adverse impact on output and employment had to be reckoned with even under gradualist policies which remained largely unchanged.

To the extent that rates of inflation and rates of monetary expansion diverge, large swings in the growth of real money balances may occur. While the significance of short-run changes in real money balances is often open to question, they do in practice seem to be related to cycles in output in many countries. This can be seen in the graph on page 57, which compares the rates of expansion, calculated over four quarters, of gross national product and the broad money stock in real terms. Changes in the money stock have been deflated by concurrent movements in price indices for gross domestic expenditure.

In most countries there is a tendency for movements in the real money stock to precede movements in gross national product. Such a pattern of development persisted throughout the 1970s in the United States, Germany and France and also prevailed during much of the period in Japan and Italy. In some countries — including the United Kingdom — such a relationship to gross national product can also be found in the case of narrow monetary aggregates.

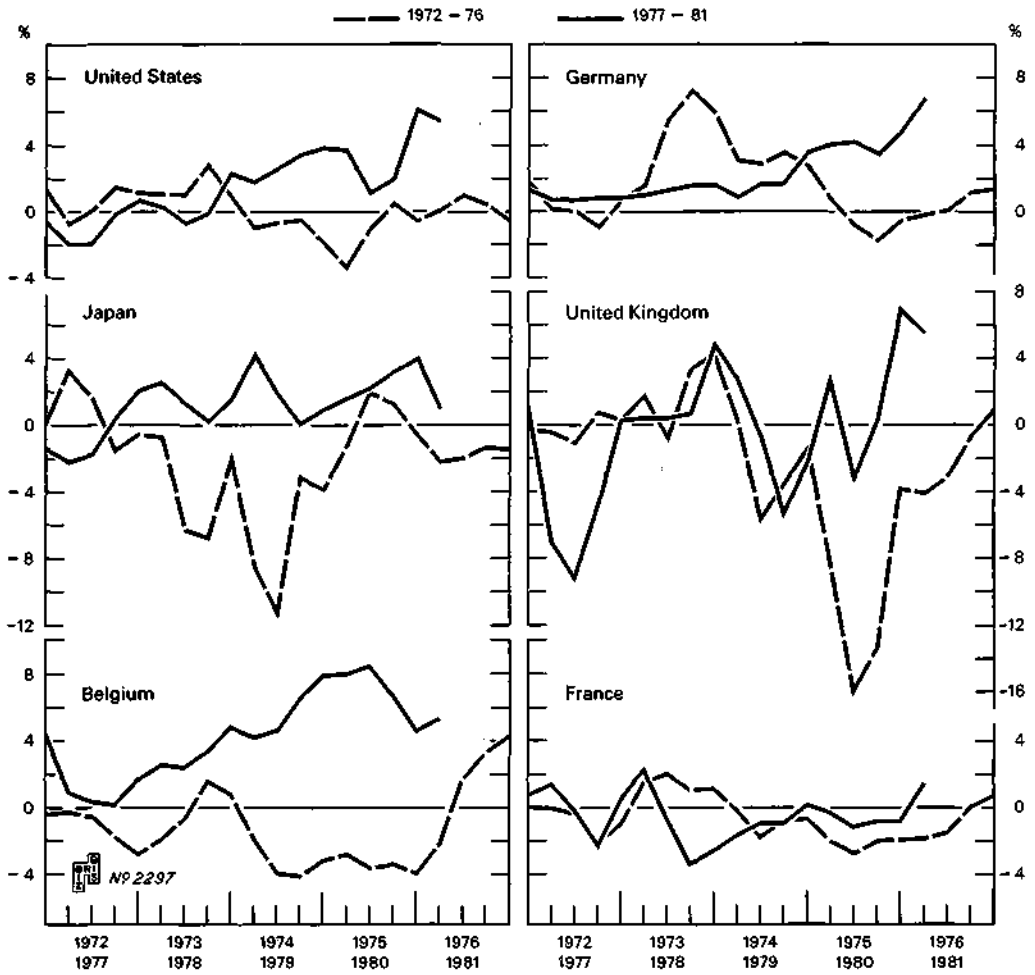
In real terms, the growth rates of the broad monetary aggregates have slackened markedly during the past two years in nearly all the major countries, and they appear to have become negative in several of them. In Germany recent rates of growth of the real broad money stock also seem to have been lower than in 1974. The same is true of real growth rates for $M_1$ — but not those for broad aggregates — in Japan and the United Kingdom. In the United States, on the other hand, the rates of increase over four quarters in both $M_1$ and $M_2$ in real terms (when calculated on the basis of gross domestic expenditure prices) were consistently higher, even in 1980, than those recorded in late 1974 and early 1975.

*Real interest rates.* Because of the difficulties in interpreting what are often divergent short-run movements in the various monetary aggregates, the view has gained ground that interest rates adjusted for expected rates of inflation can also be a useful indicator of financial conditions. Real interest rates seem to exert a direct influence on many borrowing and investment decisions, and they play an important rôle in some views of the policy transmission mechanism.

Direct measures of price expectations are available for a few countries only. Over fairly long periods, however, actual price developments should broadly reflect developments in expectations. The graph shows real short-term interest rates calculated using movements over the current and preceding quarters in the consumer price index (the gross domestic expenditure deflator for the United States).

In the two years following the first oil shock real money-market rates appear to have become negative in varying degrees in all the countries shown as the pace of inflation quickened. But in the United States, Japan, Germany and Belgium these real rates seem to have become positive in 1978–80. In France and the United Kingdom real money-market rates were generally higher in 1979–80 than in the

Real short-term interest rates.*




* Representative money-market rates (for Belgium, four-month certificates; for France, one-month interbank deposits; for other countries, three-month instruments) deflated by the annualised average change in consumer prices (for the United States, gross domestic expenditure prices) in the current and preceding quarters.

1974–75 period, and were distinctly positive by the end of last year. In the United States, Japan, France, the United Kingdom and Belgium bond yields had been clearly below current rates of inflation in 1974–75 but stood well above them by late 1980. In these terms "real" bond yields in Germany seem to have remained positive throughout the whole of the 1970s and to have moved up further in early 1981. Very striking were the high levels which rates reached in relation to rates of inflation in Belgium, where monetary policy was largely geared to stabilising the exchange rate of the Belgian franc in a context of budgetary imbalance and a large external current-account deficit. "Real" bond yields also seem to be relatively high in Denmark and, to a lesser extent, in France.

Calculations of this sort can be indicative only. Where rates of inflation are high, variable and dispersed rises in interest rates may lose some of their power to discourage spending. There also appears to have been a decline over the years in

money illusion. If this is the case, both borrowers and lenders may increasingly have come to base investment and portfolio decisions on real rates of return, and to accept that high nominal rates need not be out of line with the yields on real assets. In practice, too, after-tax costs and rates of return would seem to be relevant in financial decisions. In the United States, for example, some corporate borrowers and personal-sector lenders may deduct for tax purposes about half of the nominal interest rate before applying an inflation adjustment. However, in situations where enterprises' taxable incomes are severely depressed and firms are forced to borrow simply to stave off liquidation, no such adjustment may be appropriate. And sheer uncertainty about the outlook for the price level or relative prices may make potential borrowers unwilling to incur financial commitments at high nominal interest rates.

*Credit shortages and rationing.* Developments in the money supply and interest rates may not fully capture the impact of monetary policy in situations where credit is subject to rationing. In recent years reliance by the authorities on quantitative credit control devices has decreased in the United States and the United Kingdom, while in many countries the removal of interest rate controls and increased interest rate competition in the financial system have tended to undermine rationing mechanisms applied by the banks. In the United States the impact of interest rate ceilings has gradually diminished. The credit control programme was a form of direct intervention in the markets, but its effects, though substantial, were of limited duration. In the United Kingdom the "corset" controls were removed in June 1980 and bank credit subsequently expanded strongly. However, this may be indicative less of pressures that built up previously under the controls than of reintermediation and a deterioration in corporate financial positions.

Credit norms or ceilings are still in effect in Japan, France, Italy, the Netherlands and a number of the smaller industrial countries. The Bank of Japan's "window guidance" was eased progressively during the year and no longer operates restrictively. However, in France and Italy controls were tightened and a strong rise in foreign-trade-related credit seems to indicate that the limits on other credits were biting. In the Netherlands and France banks were free to expand credit financed by non-monetary resources outside the ceiling limitations. This may have mitigated the availability effects of credit restraint, but it seems to have contributed to interest rate pressures in the capital markets.

High and more or less unpredictable rates of inflation have virtually paralysed the markets for long-term fixed-interest finance in some countries. Short-term or variable rate instruments may be a partial substitute, but some borrowing to finance long-term productive investment or housing may have been discouraged. In the United States the supply of bond and mortgage finance was squeezed each time interest rates were at their peaks, but it is quite possible that only the timing of commitments was affected.

*Exchange rates* have come to be regarded as intermediate targets or indicators of monetary policy in many countries, and their movements are sometimes indicative of changing judgements about the relative effectiveness of policies geared mainly to controlling the money stock. However, exchange markets also respond to many non-monetary forces, and the relationships between exchange rates and

monetary conditions are extremely complex. Last year markets seem to have anticipated that the authorities would intervene to limit exchange rate movements, so that more weight than usual was attached to differences in interest rates in purely nominal terms. In these circumstances monetary conditions had to be made relatively more restrictive than before in some countries with comparatively low rates of inflation. Another problem is that while the influence that exchange rate depreciation can exert on countries' rates of inflation may be felt almost immediately, the effects of appreciation take time to work through fully. The strength of sterling helped to slow down inflation in the United Kingdom, though partly at the expense of severe pressures on the profitability of export industries.

*Evidence from the economy.* The monetary policies applied in recent years have been designed largely to counter inflation, but as usual they had substantial repercussions on output. The impact of monetary policy on interest-sensitive components of aggregate expenditure could be seen last year in some countries in the behaviour of stocks and housebuilding. Fixed investment generally proved fairly resilient, perhaps because of long-term inflationary expectations but also because of the shift to energy-saving outlays. The fact that recovery got under way quickly in late 1980 in the United States, while output suffered a prolonged and serious setback elsewhere, broadly bears out the impression conveyed by the indicators of financial conditions.

In some countries developments in prices and output suggest that monetary conditions may have become more restrictive than the behaviour of the intermediate variables indicated last year. In the United Kingdom, in particular, the expansion of the broad money supply was not in fact kept within the authorities' targets, but the economy moved into the worst recession since the Second World War, mainly as the result of a combination of wage and exchange rate pressures on corporate financial positions. Though their impact has so far been less severe, pressures on private financial positions have also built up in other countries. In Japan, in particular, enterprises seem well placed to withstand such pressures, but in many countries developments in recent years have left the business sector very dependent on external financing.

The question arises, when economic difficulties unexpectedly emerge, whether some departure from a published monetary target course or from an exchange rate objective is warranted and whether the norms should be modified to some extent. Where published monetary targets are viewed as a cornerstone of strategies for controlling inflation, there is a risk that failure to adhere closely to them may weaken the credibility of the authorities' resolve. Yet money-demand relationships and the exchange markets are often unstable, and in many countries norms have been fixed on the basis of fairly simple considerations which may prove to be *inappropriate. It is now generally recognised* that the effect of supply-side shocks cannot simply be offset by expansionary credit policies, and fine-tuning has few advocates. While this suggests a need for more emphasis on a medium-range stabilisation strategy, confidence in such an approach is not always quick to materialise. Thus, in situations where the legacy of past policies is not encouraging the authorities may find that they have little room for manoeuvre with respect to declared short-term objectives.

**Private-sector financial positions and credit markets.**

The impact of monetary policy on the economy cannot be assessed simply by looking at developments in the monetary aggregates. To obtain a complete view of the interaction between the financial and real sides of the economy it is necessary to consider sectoral financial positions in broader terms.

*The business sector.* Financial positions in the business sector deteriorated cyclically last year in many of the industrial countries. In general the impact of the current recession has so far been less marked than the previous one, but in many cases the intervening recovery was incomplete and did not permit a full restoration of earlier balance-sheet strengths. The situation differs considerably from country to country, however, as can be seen, for instance, in the ratio of internal funds to gross investment. In the United States the internal financing ratio of non-financial corporations, which had fallen sharply in 1979, rose somewhat last year as firms trimmed their expenditure on fixed capital and stocks. In neither year was it as low as it had been in 1974, but on average corporations have been much more reliant on external financing in recent years than they were in the 1960s. In the United Kingdom the incipient deterioration last year in the internal financing capacity of companies in the non-oil sector of the economy was comparable to that experienced in 1974, but having apparently learnt from the earlier experience, companies rapidly cut back their investment expenditure. In Japan and Germany, on the other hand, enterprises' self-financing ratio had improved markedly in 1975–79, thanks partly to

Internal resources and balance-sheet ratios for non-financial companies.[1]

| Financial ratios | | Average 1960–69[2] | Average 1970–79[3] | 1973 | 1974 | 1975 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|---|
| | | in percentages | | | | | | | |
| United States | Internal financing ratio | 89 | 83 | 74 | 61 | 109 | 84 | 83 | 87 |
| | Liquid assets/short-term debt | 92 | 54 | 55 | 46 | 58 | 50 | 46 | 48 |
| | Long-term debt/total debt[4] | 69 | 65 | 65 | 62 | 66 | 64 | 62 | 61 |
| | Equity[5]/total debt[4] | 296 | 167 | 173 | 107 | 135 | 124 | 124 | 145 |
| Japan | Financial deficit/investment[6] | 31 | 27 | 38 | 41 | 25 | 7 | 19 | 21 |
| | Liquid assets/borrowing | 44 | 48 | 48 | 46 | 46 | 49 | 49 | 47 |
| Germany | Internal financing ratio | 77 | 80 | 71 | 75 | 88 | 100 | 85 | 80 |
| | Liquid assets/short-term debt | 92 | 113 | 107 | 97 | 113 | 136 | 124 | 114 |
| | Long-term debt/total debt[4] | 61 | 66 | 64 | 64 | 67 | 68 | 66 | 65 |
| | Equity[5]/total debt[4] | 85 | 49 | 47 | 43 | 50 | 47 | 41 | 39 |
| France | Internal financing ratio | . | 61 | 59 | 47 | 62 | 67 | 67 | 56 |
| | Liquid assets/total credit | . | 26 | 24 | 24 | 27 | 28 | 30 | 29 |
| United Kingdom | Internal financing ratio | 99 | 97 | 99 | 52 | 112 | 101 | 71 | 75 |
| | Liquid assets/bank borrowing | 94 | 64 | 64 | 50 | 61 | 67 | 59 | 58 |
| Belgium | Internal financing ratio | . | 69 | 75 | 52 | 55 | 83 | 73 | 66 |

[1] BIS estimates based on national data for amounts outstanding at end of period (except in the case of internal financing and financial deficit ratios). Data cover non-financial corporations for the United States, France and Belgium, corporate business sector for Japan, industrial and commercial companies for the United Kingdom, enterprise sector (excluding housing) for Germany. The internal financing ratio is normally that of gross saving and capital transfers received (net) to gross investment. (For the United Kingdom and the United States both saving and investment are calculated net of stock appreciation.) Liquid assets consist mainly of bank deposits but include government and certain other securities in some cases. [2] For the United Kingdom, 1963–69. [3] For Belgium, 1972–79. [4] Credit-market debt. [5] At market values. [6] Approximate indicator. Denominator excludes gross investment of public-sector corporations.

rationalisation efforts and relatively modest wage increases but partly also to slower rates of investment growth than in earlier years. In both countries the renewed cyclical deterioration has so far been limited. In France, Italy and Belgium enterprises' internal financing capacity had increased in 1976–79. It fell last year, though less steeply than in 1974.

A related development in many countries has been a fall in business liquidity and an increase in firms' reliance on short-term borrowing. In the United Kingdom the ratio of liquid assets to bank borrowing for industrial and commercial companies had by June 1980 fallen to a level seen previously only in 1974. In the case of non-financial corporate business in the United States the ratios of liquid assets to current liabilities and long-term debt to total debt have declined progressively since the mid-1960s, and last year reached record low points. Corporations substantially increased their recourse to bond financing in the spring and summer of 1980, but the renewed upsurge in interest rates soon brought this restructuring process to an end. Business liquidity positions deteriorated somewhat last year in Japan and Germany, but this followed a substantial improvement which had extended over a period of several years. In Germany and apparently also in Japan the availability of long-term bank credit has enabled enterprises to reduce their reliance on short-term financing during the past decade. In the United States relatively favourable conditions on share markets permitted a considerable increase in equity issues last year. The equity/debt ratio rose considerably without, however, reaching the levels characteristic of the 1960s. Measured at market values, equity/debt ratios have fallen steeply in recent years in most of the industrial countries.

Faced with shortages of internal resources, a lack of outside risk capital and interest rate uncertainty in the bond market, enterprises in many countries have come to rely very heavily on bank credit granted at variable interest rates and on short-term market instruments, such as bills, acceptances or commercial paper. In

**United States:**
**Funds raised in credit markets by domestic non-financial sectors.**

| Items | 1973 | 1974 | 1975 | 1978 | 1979 | 1980 | | | | 1981 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 1st quarter | 2nd quarter | 2nd half | year | 1st quarter |
| | as a percentage of gross national product | | | | | | | | | |
| Non-financial business .... | 7.2 | 6.9 | 3.2 | 6.0 | 6.5 | 6.6 | 3.2 | 5.1 | 5.0 | 5.0 |
| *Equities* ..... | *0.6* | *0.3* | *0.7* | *0.1* | *0.2* | *0.4* | *0.2* | *0.6* | *0.4* | *0.5* |
| *Bonds* ..... | *0.8* | *1.5* | *1.9* | *1.1* | *1.0* | *1.0* | *1.8* | *0.9* | *1.2* | *1.0* |
| *Open-market paper* ..... | *0.1* | *0.4* | *– 0.2* | *0.2* | *0.4* | *1.2* | *0.8* | *– 0.6* | *0.2* | *0.4* |
| *Bank loans and other* ... | *5.7* | *4.7* | *0.8* | *4.6* | *4.9* | *4.0* | *0.4* | *4.2* | *3.2* | *3.1* |
| Households ..... | 6.0 | 3.6 | 3.3 | 7.5 | 6.8 | 5.3 | 1.6 | 4.2 | 3.8 | 4.5 |
| *Mortgages* ..... | *3.6* | *2.6* | *2.6* | *4.9* | *4.6* | *4.0* | *2.2* | *3.3* | *3.2* | *2.8* |
| *Consumer credit* ..... | *2.0* | *0.7* | *0.6* | *2.3* | *1.8* | *0.9* | *– 1.3* | *0.4* | *0.1* | *1.0* |
| *Bank loans and other* ... | *0.4* | *0.3* | *0.1* | *0.3* | *0.4* | *0.4* | *0.7* | *0.6* | *0.6* | *0.7* |
| Government* ..... | 1.7 | 2.3 | 6.3 | 3.4 | 2.2 | 3.5 | 3.6 | 4.6 | 4.1 | 4.1 |
| Total* ..... | 14.9 | 12.8 | 12.8 | 16.9 | 15.5 | 15.4 | 8.4 | 13.9 | 12.9 | 13.6 |

* Net of changes in US Government cash balances.

part, this reflects the efforts of business to economise on cash balances and to adapt fund-raising techniques to changing cost relationships, but in part it also reflects circumstances beyond the control of companies, such as tax constraints and inflation. It has, in addition, made firms more vulnerable to adverse economic and financial conditions.

*The personal sector.* Households restructured their financial positions quite flexibly last year in response to changes in the economic outlook and the changing pattern of yields. Housing and consumer credit had expanded strongly in many countries in 1979, and in the United States household instalment loan indebtedness, considered in relation to disposable income, had reached unprecedentedly high levels. Fairly generally, the pace of household borrowing slowed down last year and the accumulation of financial assets increased, albeit less dramatically than might have been anticipated on the basis of experience in 1974.

In the United States consumer borrowing contracted sharply in the period following the announcement of the credit control programme in March 1980. Household instalment indebtedness declined considerably in relation to disposable income and did not hinder a renewed upsurge in consumer spending. Difficulties encountered by the savings institutions in keeping abreast of the rise in interest rates reduced the flow of mortgage credit, though to a much lesser extent than in earlier credit restraint periods thanks to regulatory changes which had authorised the issue of more attractive savings instruments. Fairly generally, fixed-interest mortgage borrowing was discouraged by interest rate levels which were considered too high to last. By the end of the year hopes of an early decline in interest rates were fading and borrowers were attaching more importance to the prospect of continuing large increases in construction costs and real estate prices. In the United States new mortgage instruments providing for variable interest rates and in some cases permitting lenders to benefit from the appreciation in property prices were used more widely. Thus, mortgage lending was able to expand quite strongly even when interest rates were moving up. By early 1981, however, house prices had begun to show signs of weakening.

The accumulation of financial assets by households proceeded at a fairly modest pace in most countries last year. A shift in the composition of household placements away from sight and savings deposits towards time deposits was quite generalised, and in many cases much more pronounced than in the previous period of high interest rates. Acquisitions by households of longer-term financial assets, including bonds, were substantial in some countries, but purchases were heavily concentrated in relatively brief periods when interest rates were clearly in retreat. In the United Kingdom, by contrast with most other countries, the financial surplus of the personal sector increased sharply, contributing to a fast expansion of the broad money stock. In addition to interest rate differentials, the limited range of attractive alternatives to bank deposits as a store of household wealth may have played a rôle here, and new types of government securities for households have since been designed.

*Bank credit to the private sector.* Against a background of growing financial pressures and changing interest rate relationships, bank credit to the private sector developed in ways that differed — often strikingly — from country to country. In

United States: Changes in the pattern of bank lending.[1]

| Items | 1974 | 1975 | 1976 | 1979 | 1980 | | | | Amount outstanding Dec. 1980[2] |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter | |
| | in percentages | | | | | | | | |
| Treasury securities ..... | – 8.5 | 52.9 | 22.5 | 0.4 | 3.0 | 10.6 | 39.6 | 11.3 | 109.6 |
| Other loans and investments ..... | 12.0 | 0.3 | 6.1 | 12.6 | 12.2 | – 5.7 | 11.2 | 14.7 | 1,127.3 |
| Business loans[3] ..... | 19.3 | – 3.8 | 1.3 | 17.5 | 16.7 | – 9.6 | 14.4 | 22.3 | 325.3 |
| *Memorandum item:* *Short-term business credit*[4] ..... | *23.6* | *– 4.0* | *4.5* | *20.0* | *22.0* | *0.6* | *8.0* | *16.5* | *476.3* |

[1] Annual or quarter-to-quarter changes at annual rates based on last month of period. [2] In billions of US dollars. [3] Commercial and industrial loans. [4] Commercial and industrial loans by commercial banks plus non-financial commercial paper, finance company loans to businesses and bankers' acceptances outstanding outside banks.

the United States bank lending had expanded strongly in early 1980 just prior to the introduction of credit controls. It contracted briefly in the second quarter — less sharply than it had in 1974 — and rebounded soon afterwards, with the pace of the advance quickening in the fourth quarter. This pattern was common to business and consumer loans, but the fluctuations were accentuated in the case of business loans by shifts in the structure of corporate financing induced by changing relationships between banks' prime lending rates and the cost of issuing short-term market paper. By early 1981 banks were adapting to competitive pressures by increasing the proportion of their lending contracted at interest rates other than their posted prime charge.

Bank lending to the economy expanded only moderately last year in Japan, where corporate positions remained fairly sound, but slowed down progressively until late in the year in many continental European countries, apparently reflecting a precautionary reaction on the part of both enterprises and households to the weakening of economic activity. There was a renewed acceleration in some of these countries in late 1980 and early 1981, however. Much as in the United States, the slow adjustment of base lending rates to changes in financial conditions may have influenced the pattern in some countries. In Germany enterprises borrowed heavily at short term on the Euro-markets between May and September. In some countries,

Bank credit to enterprises and individuals.*
Changes over twelve months ending in December.

| Years | Japan | Germany | France | United Kingdom | Italy | Canada | Belgium | Nether-lands | Sweden | Denmark |
|---|---|---|---|---|---|---|---|---|---|---|
| | in percentages | | | | | | | | | |
| 1973 | 18.4 | 10.9 | 19.6 | 33.9 | 17.6 | 23.4 | 15.5 | 27.8 | 12.1 | 15.4 |
| 1974 | 12.5 | 6.4 | 18.1 | 16.3 | 20.3 | 20.8 | 13.0 | 20.5 | 11.8 | 7.0 |
| 1975 | 12.0 | 5.2 | 12.1 | – 5.0 | 15.0 | 16.2 | 14.3 | 12.2 | 12.4 | 16.3 |
| 1979 | 7.9 | 12.1 | 15.3 | 23.2 | 20.6 | 20.6 | 13.7 | 15.9 | 13.4 | 3.9 |
| 1980 | 8.3 | 9.8 | 14.3 | 21.2 | 17.7 | 12.5 | 8.7 | 10.2 | 11.6 | 7.1 |

* Based on national sources. For France, Canada and Denmark, includes credit to public authorities other than central government.

however, additional borrowing may have been the unavoidable outcome of the struggle to contend with weakening cash flows. Last year's massive expansion of bank credit to the private sector in the United Kingdom was largely attributable to the plight of companies, although the reintermediation of bill financing which had grown up around the "corset" was also an influence.

## Government finance.

Partly reflecting the fiscal policy developments discussed in Chapter III, the increase in central-government and public-sector borrowing requirements seems generally to have been kept to fairly modest proportions so far in the present adjustment phase. In relation to gross national product these requirements were, as a rule, higher last year than in 1979 but, except in Belgium and the Netherlands, lower than earlier peaks recorded in 1975 and 1978.

In seeking to finance their deficits, many governments have experienced difficulties in procuring a stable flow of non-monetary resources. In the United Kingdom substantial volumes of gilts were sold to the non-bank private sector at times during the year, being offered at nominal yields which seemed increasingly high in real terms as the outlook for inflation improved. In France the Treasury also proved resolute in its determination to finance most of its deficit by bond issues.

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 | 0.8 | 6.6 | 14.6 | 7.0 | 4.8 | 10.1 | 6.7 |
| | 1978 | 8.1 | 1.8 | 3.1 | 15.0 | 10.7 | 4.0 | 5.1 | 2.7 |
| | 1979 | 9.4 | 0.8 | 3.4 | 11.6 | 10.2 | 5.1 | 6.6 | 2.0 |
| | 1980 | 12.1 | 0.8 | 3.8 | 10.6 | 9.8 | 6.8 | 5.6 | 3.6 |
| Central government[3] .. | 1975 | 5.6 | 3.0 | 6.2 | 11.3 | 2.7 | 3.0 | 8.0 | 5.9 |
| | 1978 | 6.3 | 1.3 | 3.3 | 14.4 | 5.7 | 3.3 | 5.1 | 2.7 |
| | 1979 | 7.4 | 1.2 | 3.1 | 11.1 | 5.2 | 4.4 | 5.5 | 1.9 |
| | 1980 | 9.0 | 1.3 | 3.7 | 10.3 | 5.6 | 4.8 | 5.1 | 3.6 |
| *met by:* | | | | | | | | | |
| Banking system ..... | 1975 | 0.7 | 2.2 | 4.9 | 8.1 | 2.1 | 0.9 | 2.3 | 2.3 |
| | 1978 | 2.8 | – 0.3 | 2.7 | 7.7 | 4.0 | 0.7 | – 0.3 | – 0.1 |
| | 1979 | 3.6 | 0.2 | 2.3 | 2.6 | 3.6 | 1.8 | 0.1 | 0.4 |
| | 1980 | 3.3 | – 0.5 | 1.8 | 3.8 | 2.8 | 0.5 | 0.1 | 1.0 |
| Other domestic sources ..... | 1975 | 4.9 | | 1.0 | 3.2 | | 2.1 | 5.5 | 3.1 |
| | 1978 | 2.6 | | 0.5 | 6.6 | | 2.6 | 4.5 | 1.4 |
| | 1979 | 2.2 | 0.8 | 0.6 | 8.3 | 0.6 | 2.6 | 5.5 | 2.1 |
| | 1980 | 1.3 | 1.6 | 0.4 | 6.3 | 1.7 | 4.3 | 4.5 | 2.4 |
| Foreign sources[4] ..... | 1975 | 0.0 | 1.0 | 0.3 | 0.0 | 1.6 | – | 0.2 | 0.5 |
| | 1978 | 0.9 | 1.8 | 0.1 | 0.1 | 2.8 | – | 0.9 | 1.4 |
| | 1979 | 1.6 | | 0.2 | 0.2 | | – | – 0.1 | – 0.5 |
| | 1980 | 4.4 | | 1.5 | 0.2 | | – | 0.5 | 0.2 |

[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 France, net lending(–)). 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); 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. [4] For the United Kingdom and the United States, includes increases (–) in official foreign exchange assets.

Expectations of rising interest rates and the inverse yield structures which prevailed throughout much of the period were not conducive to large-scale purchasing of long-term fixed-interest bonds by non-banks, so that, in seeking to raise funds from the latter, many Treasuries relied very heavily on issues of short-term paper, such as Treasury bills in the United States and Italy, or on medium-term bonds, as in Japan. Securities with variable interest rates or price-index linkages were issued in the United Kingdom and Italy, and new kinds of instruments of this type were announced in the United Kingdom in early 1981.

The banking system took up a fairly large volume of government securities in the United States and Japan, while in Germany the public authorities had recourse to direct bank loans on a considerable scale. Monetary financing in various forms was also substantial in Belgium and the Netherlands.

Novel, on the external side, was the extensive use by the German authorities of foreign funds coming directly or via banking channels from oil producers and the industrial countries. The Belgian Treasury also had substantial recourse to foreign funds. Where the specific aim is to mitigate short-term pressures on domestic interest rates and the exchange rate, borrowing abroad to finance public spending can be a helpful interim policy option. However, it may in some cases give an unwelcome indirect boost to domestic liquidity creation when the proceeds are converted into domestic currency.

Increases in government borrowing requirements are now in prospect in many countries. In many cases the financing difficulties they pose are aggravated by the impact on wealth positions and market expectations of an accumulation of large deficits in recent years. Some of the problems can be illustrated by looking at broad developments in the public debt in relation to movements in prices and output.

Generally reflecting a consistently higher level of yearly deficits since the first oil crisis, the debt of the central government and of the public sector grew much more rapidly in 1974–79 than in 1969–74 in all the countries shown in the table on page 68. Economic growth slowed down between the two periods and the rise in the debt, which was not far out of line with the expansion of real gross national product in some countries in the 1969–74 period as a whole, far outpaced the rise in output in all countries in 1974–79. In relation to gross national product the public debt fell considerably in many countries in 1969–74 but rose in 1974–79 in nearly all cases, the United Kingdom being a notable exception. The measures differ conceptually from country to country and cannot give a precise indication of the relative levels of debt ratios. It is clear, however, that large financing requirements in relation to gross national product have often been associated with substantial increases in debt ratios. The rise was, for instance, particularly marked in the case of Japan and quite modest in that of France. At the same time, high rates of inflation, by eroding the real value of the existing debt, tended to reduce the debt ratio, particularly in countries such as the United Kingdom and Italy, where the public debt was already high in relation to gross national product in the early 1970s.

Once a premium reflecting the risk of continuing high rates of inflation came to be reflected in interest rates, interest charges began to swell the public-sector current budget deficit. By this time new government borrowing, typically large in

The public debt, output and prices.[1]

| Debt of | Years or periods | United States | Germany | Japan | France | United Kingdom | Italy | Belgium | Nether-lands |
|---|---|---|---|---|---|---|---|---|---|
| | | as a percentage of gross national product | | | | | | | |
| Public authorities[2] ..... | 1969 | 42 | 20 | 22 | · | 105 | 47 | 78 | 56 |
| | 1974 | 35 | 19 | 29 | · | 71 | 57 | 68 | 39 |
| | 1979 | 36 | 30 | 55 | · | 65 | 68 | 76[3] | 43 |
| Central government .... | 1969 | 31 | 8 | 5 | 23 | 80 | 38 | 52 | 29 |
| | 1974 | 25 | 7 | 7 | 16 | 52 | 45 | 39 | 18 |
| | 1979 | 27 | 15 | 24 | 17 | 51 | 63 | 50 | 27 |
| | | total increase during period, in percentages | | | | | | | |
| Public authorities ..... | 1969–74 | 26 | 63 | 188 | · | 26 | 159 | 58 | 31 |
| | 1974–79 | 73 | 115 | 212 | · | 103 | 189 | 63[4] | 73 |
| Central government .... | 1969–74 | 26 | 59 | 233 | 26 | 22 | 157 | 37 | 16 |
| | 1974–79 | 82 | 181 | 447 | 91 | 118 | 236 | 100 | 135 |
| Real output[5] ..... | 1969–74 | 13 | 20 | 41 | 28 | 14 | 23 | 29 | 26 |
| | 1974–79 | 18 | 15 | 28 | 16 | 9 | 12 | 10 | 12 |
| Price level[6] ..... | 1969–74 | 33 | 38 | 56 | 42 | 56 | 61 | 41 | 49 |
| | 1974–79 | 42 | 23 | 28 | 64 | 110 | 117 | 41 | 41 |

[1] BIS estimates, based on national data which differ conceptually from country to country. Public debt as recorded at end-March for the United Kingdom and at end-year for other countries. For Germany, gross debt; for Japan, central-government domestic bonds plus, in the case of the public authorities, local-government and public corporation bonds and borrowing; for most other countries, outstanding debt net of liquid asset holdings and of intra-sector holdings of debt. [2] Central government, local authorities and the social security system. For Germany, all public authorities other than the social security institutions; for Japan and the United Kingdom, includes debt of public corporations; for Italy, enlarged public sector, including some public corporations. [3] 1978. [4] 1974–78. [5] Gross domestic product. [6] Based on GDP price deflators.

relation to outstanding debt under inflationary conditions, could be arranged at long term on a fixed-interest basis only on conditions likely to prove very expensive in real terms should rates of inflation come down. Applicable also to private-sector borrowing, the inflation premium helped to drive non-financial enterprises out of the bond market in some countries. Of course, even countries which have been experiencing fairly moderate rates of inflation have to take account of the risk that additional borrowing will increase pressures on interest rates and will crowd out private borrowers.

It is not easy to establish close ex post statistical relationships between government borrowing requirements and rates of monetary expansion or interest rates. Large borrowing requirements accompanying major wars have in many countries been associated with high rates of monetary expansion and inflation, but large budget imbalances have in many cases been reflected mainly in external payments deficits which have drained off liquidity. Rates of expansion of the monetary aggregates are in many countries closely related to cycles in credit-granting to the private sector and in economic activity. Interest rates respond to external developments — directly or as a result of the authorities' actions — and the largest movements reflect changes in inflationary expectations which may be positively correlated with rates of monetary expansion. At the present time, however, the credit and capital markets in many countries are dominated by public-sector borrowing. To a degree, no doubt, this simply compensates for the cyclical weakness of private credit demand, but it may not be unreasonable to associate the current high levels of real interest rates in many countries — at least in some measure

— with the fact that governments' financing requirements are already large and are likely to rise further.

**Problems of monetary policy.**

Monetary policy and in particular efforts to stabilise the aggregates have come to form the core of macro-economic policy in many countries. Not surprisingly, therefore, much attention has been paid to efforts to improve monetary control. In the process central banks have come to accept and even to encourage greater flexibility in interest rates. This is fully consonant with their view that interest rates are an important element not only in monetary control mechanisms but also in the process by which the money supply influences the economy.

*Targets for intermediate variables and the actual outturn.* Except in Italy, Belgium and Sweden, published objectives or norms for the monetary aggregates are used to guide monetary policy in all of the Group of Ten countries and Switzerland. In Italy the authorities have a published target limit for the expansion of total domestic credit. They also attach importance to restraining the growth of the monetary base but do not publish a norm for this aggregate. In Belgium the exchange rate is in effect a major intermediate objective of monetary policy. This is also true in varying degrees in Denmark, the Netherlands, France and Germany. Indeed, the EMS arrangements are tantamount to published target ranges for the exchange rate as an intermediate policy variable, though discrete changes in the currency relationships are, of course, possible, and the proportion of total external transactions covered by the system varies from country to country. Though in many cases both types of policy may be complementary, monetary authorities may, in difficult circumstances, be unable simultaneously to meet targets for the monetary aggregates and to avoid unwelcome developments in the exchange rate. In the United States the authorities are prepared to intervene in the exchange market to limit short-term fluctuations but normally give clear priority to their efforts to control rates of monetary expansion.

Intended as they are to help moderate inflationary expectations, the published targets for monetary expansion have normally been lowered from time to time. Adjustments of this type were announced in late 1980 or early 1981 in France, Germany, Canada and – in respect of $M_{1A}$ and $M_{1B}$ — the United States. In Japan the norms, which are in the nature of forecasts for growth rates over four-quarter periods, have been brought down progressively. In the United Kingdom the Chancellor confirmed in March 1981 that in respect of the period beginning in February the target range for sterling $M_3$ would indeed be lowered as provided for in the medium-term plan published a year earlier. In the United States the Federal Reserve System has expressed approval of the new President's proposal for bringing monetary growth down over a five-year period to half the present rate.

In relation to the targets the results for last year as a whole — considered solely in terms of rates of expansion of particular aggregates — were in most countries quite good. The growth rate of the target aggregate fell somewhat below the corresponding norm or target range in Japan, Germany, France and Switzerland

Monetary and credit aggregates: Objectives and rates of expansion.

| Countries | Monetary or credit aggregate | Objective for 1980 | Monetary or credit expansion in 1980[1] | Objective for 1981[1] | Monetary or credit expansion, quarterly averages at annual rates[2] | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 1980 | | | | 1981 |
| | | | | | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter | 1st quarter |
| | | in percentages | | | | | | | |
| United States .... | $M_{1A}$ | 3.5–6.0 | 6.25 | 3.0–5.5 | 5.0 | – 4.7 | 12.0 | 8.3 | –17.4 |
| | $M_{1B}$ | 4.0–6.5 | 6.75 | 3.5–6.0 | 6.8 | – 2.8 | 14.7 | 11.3 | 6.7 |
| | $M_2$ | 6.0–9.0 | 9.8 | 6.0–9.0 | 8.2 | 5.5 | 16.7 | 8.4 | 8.6 |
| | $M_3$ | 6.5–9.5 | 9.9 | 6.5–9.5 | 8.4 | 6.1 | 13.7 | 10.7 | 12.5 |
| | Total bank credit | 6.0–9.0[3] | 7.9 | 6.0–9.0[3] | 9.8 | – 0.5 | 7.0 | 15.8 | 12.6 |
| Japan ..... | $M_2$ + CDs | 8.0[4] | 7.8 | >7.0[4] | 9.6 | 8.1 | 6.0 | 7.0 | 8.2 |
| Germany ..... | Central-bank money | 5.0–8.0 | 4.9 | 4.0–7.0 | 6.1 | 4.3 | 3.8 | 5.8 | 5.9 |
| France ..... | $M_2$ | 11.0 | 9.8 | 10.0 | 13.0 | 9.8 | 9.3 | 9.6 | . |
| United Kingdom .. | Sterling $M_3$ | 7.0–11.0 | 19.4 | 6.0–10.0 | 7.4 | 10.7 | 39.0 | 20.7 | 10.2 |
| Canada ..... | $M_1$ | 5.0–9.0[5] | 6.5[5] | 4.0–8.0[5] | 9.0 | – 1.8 | 13.6 | 18.1 | – 2.4 |
| Switzerland ..... | Monetary base | 4.0 | 2.2 | 4.0 | – 8.9 | 0.9 | – 0.2 | – 0.5 | . |
| Italy ..... | Total credit | 17.5[6] | 18.0[6] | 16.0[6] | 18.3 | 18.4 | 16.8 | 17.6 | . |

[1] For the United States and Germany, fourth quarter to fourth quarter; for Japan, fourth quarter to fourth quarter for 1980 and second quarter to second quarter for 1981; for France and Italy, December to December; for the United Kingdom, periods beginning in February 1980 and February 1981; for Switzerland, November 1979–November 1980 and annual average for 1981; for Canada, periods beginning with the second quarter of 1979 and August–October 1980. For the United States, the growth of $M_{1A}$ and $M_{1B}$ in 1980 is adjusted to take account of estimated transfers of funds into non-interest-bearing cheque accounts. After adjustment for this factor the target ranges for 1981 are 0–3 per cent. for $M_{1A}$ and 5–7½ per cent. for $M_{1B}$. [2] For Switzerland and Italy, changes over four quarters in unadjusted end-month data. [3] Estimate designed to be consistent with the targets for the monetary aggregates. [4] Projection announced two to three months before the end of the period to which it relates. [5] Annual rate. [6] Upper limit expressed in terms of amounts: Lit. 59,000 billion in 1980 and Lit. 64,500 billion in 1981.

and was within the target range in Canada. In Germany the shortfall was negligible, especially considering that the authorities were deliberately aiming at the lower end of the target range. In the Netherlands liquidity creation from domestic sources in 1980 was broadly in line with the authorities' norm. In the United States the rise in both $M_{1A}$ and $M_{1B}$, after adjustment to take account of an unexpectedly large increase in the use of automatic transfer facilities, was close to the top of the target ranges. In Italy the expansion of total credit was larger than the authorities intended, though the modest scale of the overrun does not reveal the extent to which the components diverged from the projected course. A marked difference between objectives and outcome was apparent only in the United Kingdom. Although the authorities had realised that the abolition of the "corset" would make it difficult to keep monetary expansion within the target limits, the target set did not allow for the complexity of the situation which actually developed.

Rather different, however, is the picture which emerges when changes over periods shorter than a year are considered. In the United States $M_{1A}$ and $M_{1B}$ expanded moderately in the first quarter of 1980, then actually fell in the second quarter, before going on to expand very rapidly in the remainder of the year. Extensive changes in the regulatory framework began to take effect during the year following the passage of the Depository Institutions Deregulation and Monetary Control Act in March 1980. Banks were permitted to offer customers automatic transfer services (ATS) for moving deposits from savings to demand accounts, and

negotiable order of withdrawal (NOW) accounts were authorised nationwide as from the beginning of 1981. Regulation Q ceilings on deposit interest rates are to be gradually phased out. The inclusion of NOW accounts in $M_{1B}$ but not $M_{1A}$ largely explains the divergent behaviour of these aggregates in early 1981. Swings in interest rates and changes in interest rate expectations must also have contributed to the large shifts in the demand for transactions balances which took place. Especially in a situation of this kind short-run changes in money-growth rates need not have any impact on developments in the real economy. Other provisions of the Monetary Control Act should ultimately make it easier for the Federal Reserve to control the aggregates. The Act envisaged a sweeping revision of reserve requirements and the extension of both reserve requirements and access to the discount window, formerly confined to 5,400 Federal Reserve member banks, to 35,000 banks and thrift institutions.

However, large quarter-to-quarter fluctuations in rates of monetary expansion were also experienced, under different systems of monetary control, in countries where there were no major institutional changes. In many of them the authorities do not seek to meet monetary targets over periods of less than a year. Even with improved procedures it may in practice be impossible for the central bank to smooth out short-run fluctuations in rates of monetary expansion. To attempt to do so may place unnecessary pressure on interest rates and exchange rates. Short-run swings in monetary growth rates need not be regarded as disturbing and the authorities themselves generally try to take a longer view. In time, it is to be hoped, market participants will appreciate this and adjust their behaviour accordingly.

*New techniques of monetary policy.* One control problem for the authorities is to distinguish temporary disturbances in the development of intermediate variables from more permanent shifts to which some response would be appropriate. Another is to ensure that a timely and adequate response is forthcoming when it is needed.

It has frequently been argued that greater stability in rates of monetary expansion and in the economy could be achieved by policies geared to steering the monetary base than by reliance on interest rate mechanisms. In the United States short-run monetary control procedures based largely on influencing non-borrowed bank reserves were established in October 1979. However, interest rates have remained an important element in the process by which banks and the public adapt their portfolios to the authorities' actions. The issues have also been considered by monetary authorities in other countries including the United Kingdom, where monetary control arrangements were changed significantly last year. So far policies using the monetary base as an indicator or control variable have been followed only in Italy, Switzerland and Spain, and in none of these countries do the authorities seek to control the base closely in the very short run. However, in managing the money market and bank reserve positions, a number of monetary authorities have recently moved some way towards employing more quantitatively oriented approaches which permit money-market interest rates and even official rates to be influenced by market forces. One question involved is the implications that procedures of this kind may have for interest rates and exchange rates.

In the *United States* rates of monetary expansion, interest rates and the exchange rate have all been more volatile since October 1979 than they were before.

A few critics of the new policy argue that instability in rates of monetary expansion has continued to contribute to unduly wide fluctuations in interest rates. There is little evidence, however, that in the present institutional setting a monetary base target would increase the precision of monetary control or could do so without destabilising interest rates further. Another view is that the new procedures led to an increase in the volatility of money-market rates in the very short run — though by less than a fully-fledged system of monetary base control might have done — but were not themselves the cause of the wide swings in interest rates that took place from quarter to quarter, and which in relative terms may not have been out of line with previous cyclical experience.

Quarter-to-quarter changes in rates of growth of gross national product in the United States were very large last year. Anticipation of direct credit restraints, the imposition of the credit control programme and its subsequent abandonment had a marked impact on the pattern of credit demand. The outlook for inflation was highly uncertain and market expectations seem to have responded to distorted signals emitted by the consumer price index. However, in conjunction with the change in procedures, the authorities' tolerance bands for fluctuations in the Federal funds rate were widened from 50–100 basis points just before October 1979 to some 400–600 basis points. As a result substantial movements in interest rates up or down could occur without the explicit approval of the Federal Reserve Board. Moreover, the attitude which underlay the change in procedures, namely dissatisfaction with the results of earlier attempts at gradualism, seems to have made the authorities more willing to accept large movements in interest rates.

Compared with the swings in market interest rates, changes in the discount rate were modest last year, though a surcharge of 2 or 3 percentage points was in effect between March and May and from November onwards. In May 1981, when the discount rate was raised from 13 to 14 per cent., the surcharge was increased to 4 percentage points. At present under review, in the light of experience, are further changes in Federal Reserve techniques, such as more frequent adjustment of the discount rate, more forceful adjustments in the path for non-borrowed reserves when the money stock is off course and a return to contemporaneous reserve accounting. In each case the possible advantage of closer control over non-borrowed reserves and the money supply has to be set against the risk of aggravating interest rate instability unnecessarily.

In the *United Kingdom* a Green Paper on monetary control published by the authorities in March 1980 had considered various alternatives to existing procedures for controlling sterling $M_3$ by adapting budgetary policy, gilt-edged funding and interest rates. Subsequent events illustrated some of the problems which can be encountered under a system of this kind, without, however, clearly establishing that extensive changes would be feasible or appropriate. With the banks bridging large imbalances in company and personal-sector finances, and with the public-sector borrowing requirement fluctuating unusually erratically, bank liquidity came under considerable strain at times. The authorities took steps to relieve pressures in the money market — introducing a new type of repurchase facility in the process — rather than run the risk of intensifying upward pressures on interest rates and the exchange rate.

In a notice on methods of monetary control published in November 1980 the authorities concluded that present arrangements did not permit a categorical judgement about how effective monetary control would be under a system based either on compulsorily or voluntarily held bank reserve deposits. However, to leave both options open, it was decided to permit market forces to play a greater rôle in the determination of short-term interest rates. More emphasis was placed on official open-market operations in bills and less on discount window (last resort) lending, and the practice of over-issuing Treasury bills at the tender so as to create shortages of money which the Bank of England subsequently acted to relieve was abandoned. The new operational aim was to keep very short-term interest rates within an unpublished band determined with a view to achieving the monetary objectives. The minimum lending rate was to remain above comparable market interest rates but within the band. The Bank of England also ceased quoting buying prices for bills with over one month to maturity and instead responded to offers.

The November notice heralded the abandonment of the practice of announcing a minimum lending rate and also the phasing-out of the liquid asset ratio once suitable alternative prudential arrangements for bank liquidity were in place. In January and February 1981 the liquid asset ratio was lowered. The replacement of the 1½ per cent. cash ratio observed by the London clearing banks by a minimum requirement applying uniformly to all banks and deposit-taking institutions was announced in a subsequent paper "*Monetary control: next steps*" published in March. Also proposed were an extension of the list of eligible acceptors and arrangements providing for a minimum deposit to be held by accepting institutions with the discount houses, the aim being to ensure that the bill market would retain sufficient size and depth to accommodate the authorities' operations when the reserve asset ratio was phased out. The intention was that the bulk of the authorities' bill operations should continue to be conducted with the discount houses and that discount window facilities should remain confined to these institutions.

With sterling $M_3$ increasingly controversial as a monetary indicator, new measures of the monetary base and of retail deposits, to be called $M_2$, were foreshadowed in the Chancellor's budget speech in March 1981. However, it was still considered that a broad aggregate with close links to spending and borrowing was the most appropriate for expressing the authorities' strategies.

In *Germany* the Deutsche Bundesbank continues to regard central-bank money as an indicator of the results of monetary policy and to consider banks' free liquidity alone — rather than some concept of the total monetary base — as an instrument variable. Last year, in a context of large outflows of funds, decreases in minimum reserve requirements and regular increases in rediscount quotas were used to provide bank reserves on a permanent basis. However, these traditional instruments, which have often been found to have unwelcome signal effects, were complemented by newer reversible fine-tuning instruments, such as currency swaps and repurchase agreements for commercial bills and securities, which permit the authorities to exercise more initiative in accommodating the banks' liquidity needs. Moreover, confronted in February 1981 with a further weakening of the Deutsche Mark, the Bundesbank temporarily withdrew altogether the ordinary lombard facilities — hitherto available at 9 per cent. — and announced that, as and when

appropriate, it would instead offer special lombard facilities at an interest rate which might be varied from day to day in response to changing circumstances. Money-market rates soon stabilised at a new, higher level, underpinned by the offer of special lombard credit at an interest rate of 12 per cent.

In *Japan,* also, the introduction of a new refinancing facility providing for secured credit to be granted at interest rates which could readily be adjusted at the discretion of the central bank was proposed in March. Japan's external position was strong at the time, and the announcement was accompanied by a lowering of reserve requirements and a cut — the third since August 1980 — in the discount rate. It was, however, felt advisable to have an instrument which could be adapted more easily than the discount rate to cope with volatile capital flows, should they become a problem. In Japan interest rate determination in the money markets had become much more competitive in recent years with the liberalisation of controls and with the rapid growth of the security, bill repurchase and CD markets. As in Germany, however, interest rates on many lending contracts are still linked in various ways to the official discount rate.

More flexibility in the determination of central-bank lending rates has been introduced in recent years in a number of other countries. In *Canada* the official discount rate has been changed since March 1980 in line with the three-month Treasury bill tender rate. In *France* refinancing arrangements were modified in March 1980 in ways which permitted them to be more readily adapted to changes in circumstances and in market interest rates. These changes were supplemented in November, however, by a traditional measure in the form of a rise in reserve requirements. In *Italy,* too, the authorities have made innovations in control techniques, notably in Treasury bill operations and in the use of repurchase agreements with flexible conditions, but have also been willing to use traditional instruments forcefully when necessary. In March 1981 the discount rate was raised from 16½ to 19 per cent., marginal reserve requirements on the growth of bank deposits were increased and ceilings were placed on the issue of acceptances. Prompt and sizable adjustments in the terms of central-bank lending, particularly at the margin, are no novelty, of course, in *Belgium* and the *Netherlands,* and in Belgium arrangements for moving the National Bank's rate for advances in line with money-market rates were announced in March.

To a degree greater flexibility in the determination of official interest rates is a response to greater flexibility in the market-place. In seeking to stabilise exchange rates or to avoid excessive recourse to official financing facilities, monetary authorities have often had to find ways of adapting their lending conditions more speedily than traditional procedures and institutional arrangements permit. In some countries, however, the changes deliberately permit short-term yields in the money market more freedom from direct official influence.

*Is there a better policy mix?* At present, high levels of interest rates reflect high rates of price increase, but they also reflect a policy mix in which monetary policy has to be tighter than might be the case if other elements of policy were better adapted. High interest rates, in turn, make the financial positions of non-financial enterprises in particular more vulnerable and increase the risks to which they and their creditors are exposed in recession.

Faced with severe pressures on their cash flow or liquidity, enterprises may cut back on investment and their labour force, as companies in the United Kingdom, in particular, seem to have done last year, and as firms in other countries may be doing now. Should corporations be unable to improve their viability in time, even more severe recessionary forces could be unleashed. Steep rises in the incidence of company failures were recorded last year in the United Kingdom, France, Germany and the United States. Similar rises must also have occurred in other countries. In Germany and the United Kingdom rates of company insolvencies in late 1980 remained below those recorded in the period following the first oil shock, but in the United States commercial and industrial failures were running above previous peak levels. Most of the larger key companies have so far managed to weather the storm, but a number have had to be restructured with government assistance.

In some countries pressures on the profits or balance-sheet positions of certain financial institutions which traditionally engage in maturity transformation and lend at fixed interest rates have also begun to emerge. In the United States thrift institutions, which were locked into fixed low interest rate mortgages but have had to pay money-market-related rates to attract depositors' balances, have been going through a difficult time. Commercial banks in most countries lend mainly at short term or at interest rates which can be varied or renegotiated, and have been well able to cope with the situation. In cases where such instruments have not traditionally been employed, the use of them seems to be spreading. An endowment of low-cost transactions balances or savings deposits even permitted some banks to increase their gross interest rate margins as market yields went up. The favourable position of banks in this respect seems to have been eroded, however — quite rapidly in some countries — since high interest rates also provide depositors with a strong incentive to manage their placements more actively.

Severe monetary restraint, if not supported by appropriate policies in other areas, may actually tend to impair an economy's supply potential. It may, for instance, encourage capital inflows, currency appreciation and a weakening of the current account. High interest rates and weak overall demand, continuing for a protracted period, may result in a serious loss of productive investment. The new capacity and skills required to support a recovery in output may not be acquired, and firms may even close existing capacity or withdraw permanently from traditional markets. At present the struggle to reduce rates of inflation or to keep them within bounds is of critical importance and monetary policy must continue to bear a large share of the burden. However, in the real world the costs of relying on monetary restraint alone and the hazards involved can run high. These costs may be justifiable, even unavoidable, if supporting measures to combat inflation have for various reasons to be ruled out. Nonetheless, they can often be reduced significantly by recourse to a more eclectic policy approach, particularly one which ensures that budgets are adapted to giving as much support to monetary policy as the cyclical situation will permit.

# V. INTERNATIONAL TRADE AND PAYMENTS.

The present chapter reviews world trade and balance-of-payments developments in 1980, which were dominated by the effects of the major oil price increases that began at the end of 1978. The first section deals with world trade, the volume of which for 1980 as a whole was very little higher than in 1979, with some actual decline being recorded in the second half of the year, owing to a sharp cutback in oil imports and the slowdown of economic activity in the developed countries. The second section summarises world balance-of-payments developments last year. On current account, the principal features were the further widening of the imbalance between the OPEC countries and the rest of the world, together with the redistribution in the second half of the year of the non-OPEC countries' aggregate deficit away from the Group of Ten countries and Switzerland. The financing of current payments deficits did not, on the whole, present major difficulties in 1980, partly because of the extent to which the deficits were concentrated in financially strong countries in the developed world, and partly also because the international banking sector further expanded its recycling operations. The section also compares the evolution of the Group of Ten countries' current-account balances of payments following the first and second round of major oil price increases and examines the reasons for the very large deterioration in the group's aggregate current-account position between 1974–75 and 1979–80. The third section looks in more detail at balance-of-payments performances of the developed countries, particularly those in the Group of Ten, last year. The narrowing of the Group of Ten's aggregate current-account deficit between the first and second halves of 1980 resulted essentially from shifts in the US and UK balances from deficit into surplus, and from the virtual disappearance of Japan's deficit. The fourth and fifth sections look briefly at balance-of-payments developments in the non-oil developing countries and the OPEC countries, with particular reference to the financing of the non-oil developing countries' deficit and the investment of the OPEC surplus.

## World trade.

The volume of world trade grew by only 1½ per cent. in 1980, after a 7 per cent. increase in 1979. The rise in average world trade prices, however, accelerated between the two years from 18 to 20 per cent., so that the dollar value of world trade, at about $2,000 billion, was 21 per cent. higher than in 1979. Except for 1975, when the volume of world trade fell by 5 per cent., last year's growth rate was the slowest for two decades. Moreover, the volume of world trade declined by about 3 per cent. between the first and second halves of 1980.

The biggest single influence on world trade last year was the series of 1979–80 increases in the price of oil, both directly, through their demand-deflationary and cost-inflationary effects on the world economy, and indirectly, as a result of the

restrictive policies adopted by many countries in an attempt to limit the inflationary consequences of oil price increases. Not surprisingly, the most marked change in world trade volumes was in the oil sector, where there was a shift from a 3½ per cent. increase in 1979 to a 10 per cent. decline last year. Trade in manufactures grew by 3 per cent., as against 5½ per cent. in 1979, while the growth of trade in agricultural products is estimated to have slowed down between the two years from 7 to 4 per cent.

World trade, 1979–80.[1]

| Countries | Exports (f.o.b.) | | | | Imports (c.i.f.) | | | |
|---|---|---|---|---|---|---|---|---|
| | 1979 | 1980[2] | | | 1979 | 1980[2] | | |
| | | year | 1st half | 2nd half | | year | 1st half | 2nd half |
| | in billions of US dollars *(volume index 1978 = 100)* | | | | | | | |
| Group of Ten countries and Switzerland | 953 *(106.6)* | 1,119 *(111.0)* | 557 *(112.5)* | 562 *(109.5)* | 1,020 *(108.4)* | 1,219 *(107.5)* | 619 *(111.2)* | 600 *(103.8)* |
| Other developed countries[3] | 143 *(109.0)* | 176 *(114.2)* | 87 *(115.1)* | 89 *(113.3)* | 173 *(108.2)* | 218 *(110.1)* | 106 *(109.9)* | 112 *(110.3)* |
| Total developed countries | 1,096 *(106.9)* | 1,295 *(111.4)* | 644 *(112.8)* | 651 *(110.0)* | 1,193 *(108.4)* | 1,437 *(107.9)* | 725 *(111.0)* | 712 *(104.8)* |
| Oil-exporting countries[4] | 212 *(103.0)* | 298 *(89.4)* | 150 *(93.9)* | 148 *(84.9)* | 104 *(88.2)* | 134 *(102.3)* | 65 *(99.8)* | 69 *(104.8)* |
| Other developing countries | 175 *(109.1)* | 216 *(118.5)* | 105 *(117.9)* | 111 *(119.1)* | 223 *(111.8)* | 286 *(118.4)* | 137 *(115.1)* | 149 *(121.6)* |
| Total developing countries | 387 *(105.7)* | 514 *(101.6)* | 255 *(103.8)* | 259 *(99.5)* | 327 *(104.3)* | 420 *(113.3)* | 202 *(110.2)* | 218 *(116.3)* |
| Centrally planned economies[5] | 150 | 174 | 84 | 90 | 156 | 178 | 84 | 94 |
| Grand total[6] | 1,633 *(106.6)* | 1,983 *(108.6)* | 983 *(110.2)* | 1,000 *(107.0)* | 1,676 *(107.5)* | 2,035 *(109.1)* | 1,011 *(110.8)* | 1,024 *(107.5)* |

[1] Based on customs data. [2] Partly estimated. [3] OECD countries, except the Group of Ten countries and Switzerland, plus Israel, South Africa and Yugoslavia. [4] OPEC countries (Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela) plus Oman. [5] Bulgaria, China, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania and the USSR. [6] Volume index excludes centrally planned economies.

By groups of countries, on the export side the OPEC countries were most affected by the slowdown. In fact, as the decline in world oil consumption coincided with a further increase in non-OPEC countries' share in total oil production, the decrease of 14 per cent. in the volume of OPEC oil exports in 1980 was considerably bigger than the decline in total world oil trade. In the developed countries export gains, in volume terms, were about 3 per cent. lower than in 1979, while the non-oil developing countries' real exports grew at almost the same rate as in the preceding year.

On the import side, the decline in volumes was most pronounced in the Group of Ten countries, where the 8 per cent. growth recorded in 1979 gave way to a fall of 1 per cent. last year. Import growth slowed down from 8 to 2 per cent. in the case of the other developed countries and from 12 to 6 per cent. in that of the non-oil developing countries. On the other hand, the volume of OPEC imports, after a 12 per cent. fall in 1979, went up last year by 16 per cent.

The main features of last year's movements in relative trade prices were a worsening of the non-OPEC countries' terms of trade and further large gains by OPEC. In the developed world the terms of trade deteriorated by about 6 per cent., twice as much as in 1979. For the non-oil developing countries, whose terms of trade had remained constant in 1979, last year's deterioration was of the order of 6 per cent. The OPEC countries' terms of trade recorded an improvement of 46 per cent., following one of 25 per cent. in 1979.

The decline in the volume of world trade during the second half of 1980 was reflected in a reduction of export volumes for all groups with the exception of the non-oil developing countries. The strongest contractionary influence came from the Group of Ten countries, whose imports fell by 6½ per cent. in volume terms between the first and second halves of the year. In parallel with the decline in volumes, the rate of increase of world trade prices slowed down between the two halves of 1980, from 12 to 4 per cent., to a considerable extent as a result of the levelling-off of oil prices.

The combined effect of the volume and price changes described above was to increase the OPEC countries' trade surplus (on the basis of the trade figures shown in the table on page 77) by $56 billion, to $164 billion, and to increase the trade deficits of most other groups of countries. In absolute terms the biggest rise was that of $33 billion in the aggregate deficit of the Group of Ten countries and Switzerland, but in relation to the size of their economies the increases of $22 and 12 billion respectively in the trade deficits of the non-oil developing countries and the smaller developed countries were larger. Only the centrally planned economies, which as a group are small net exporters of oil, maintained a more or less balanced trade account. In line with the slowdown of their economies, the aggregate trade deficit of the Group of Ten countries declined considerably, from $62 to 38 billion, between the first and second halves of the year, while there were increases in the deficits of the other developed countries and of the non-oil developing countries, as well as a reduction of the OPEC surplus.

**World balance-of-payments developments.**

The growing imbalances in world trade were, of course, reflected in the overall pattern of current-account balances of payments. The current-account surplus of the OPEC countries is estimated to have increased between 1979 and 1980 from $65 to 108 billion, while the aggregate current-account deficit of the Group of Ten countries more than doubled, from $22 to 53 billion. The aggregate deficits of the other developed countries and of the non-oil developing countries, at $24 and 61 billion respectively, were more than half as large again, in current dollar terms, as in 1979.

Once again, the financing of current-account payments deficits did not, in general, present any major problems. For this there appear to have been three main reasons. First, there was the degree to which deficits were concentrated in the Group of Ten countries and Switzerland, some of which were the direct recipients of capital inflows from OPEC while others were well placed to finance their deficits

International current-account balances, 1978–80.[1]

| Countries and areas | Trade balance (f.o.b.) | | | Invisibles balance | | | Current balance | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1978 | 1979 | 1980 | 1978 | 1979 | 1980 | 1978 | 1979 | 1980 |
| | in billions of US dollars | | | | | | | | |
| BLEU* | − 3.0[2] | − 5.0[2] | − 6.3[2] | 2.0 | 1.7 | 0.4 | − 1.0 | − 3.3 | − 5.9 |
| Canada* | 3.2 | 3.4 | 6.8 | − 7.6 | − 7.7 | − 8.1 | − 4.4 | − 4.3 | − 1.3 |
| France | 0.7 | − 2.0 | −12.0 | 3.1 | 3.1 | 4.6 | 3.8 | 1.1 | − 7.4 |
| Germany | 23.9 | 16.0 | 8.1 | −14.6 | −21.3 | −24.2 | 9.3 | − 5.3 | −16.1 |
| Italy* | 2.9 | − 1.1 | −15.9 | 3.3 | 6.2 | 6.0 | 6.2 | 5.1 | − 9.9 |
| Japan* | 24.6 | 1.8 | 2.1 | − 8.1 | −10.6 | −12.9 | 16.5 | − 8.8 | −10.8 |
| Netherlands* | − 1.5 | − 1.5 | − 1.3 | 0.1 | − 0.8 | − 1.5 | − 1.4 | − 2.3 | − 2.8 |
| Sweden | 2.6 | 0.8 | − 0.3 | − 2.9 | − 3.5 | − 4.9 | − 0.3 | − 2.7 | − 5.2 |
| Switzerland* | 0.1 | − 2.3 | − 6.9 | 4.3 | 4.7 | 6.7 | 4.4 | 2.4 | − 0.2 |
| United Kingdom | − 3.0 | − 7.3 | 2.9 | 4.4 | 4.0 | 3.7 | 1.4 | − 3.3 | 6.6 |
| United States | −33.8 | −29.4 | −27.4 | 19.5 | 28.7 | 27.5 | −14.3 | − 0.7 | 0.1 |
| *Group of Ten countries and Switzerland* | *16.7* | *−26.6* | *−50.2* | *3.5* | *4.5* | *− 2.7* | *20.2* | *−22.1* | *−52.9* |
| Australia | 0.1 | 2.4 | 1.6 | − 4.0 | − 4.4 | − 5.3 | − 3.9 | − 2.0 | − 3.7 |
| Austria* | − 3.3 | − 4.2 | − 6.2 | 1.8 | 2.3 | 2.6 | − 1.5 | − 1.9 | − 3.6 |
| Denmark* | − 2.4 | − 3.1 | − 2.0 | 0.9 | 0.2 | − 0.5 | − 1.5 | − 2.9 | − 2.5 |
| Finland | 1.1 | 0.4 | − 0.6 | − 0.5 | − 0.6 | − 0.8 | 0.6 | − 0.2 | − 1.4 |
| Greece* | − 3.5 | − 5.0 | − 5.5 | 2.5 | 3.1 | 3.4 | − 1.0 | − 1.9 | − 2.1 |
| Ireland* | − 1.1 | − 2.3 | − 2.2 | 0.7 | 0.8 | 0.6 | − 0.4 | − 1.5 | − 1.6 |
| Israel | − 2.8 | − 3.3 | − 3.3 | 1.9 | 1.8 | 1.3 | − 0.9 | − 1.5 | − 2.0 |
| New Zealand* | 0.6 | 0.8 | 0.9 | − 1.0 | − 1.3 | − 1.5 | − 0.4 | − 0.5 | − 0.6 |
| Norway | − 0.5 | 0.3 | 2.1 | − 1.6 | − 1.3 | − 1.1 | − 2.1 | − 1.0 | 1.0 |
| Portugal | − 2.4 | − 2.6 | − 4.1 | 1.6 | 2.6 | 3.0 | − 0.8 | − 0.0 | − 1.1 |
| South Africa* | 3.8 | 6.1 | 7.1 | − 2.3 | − 2.5 | − 3.6 | 1.5 | 3.6 | 3.5 |
| Spain* | − 4.0 | − 5.7 | −11.9 | 5.6 | 6.8 | 6.8 | 1.6 | 1.1 | − 5.1 |
| Turkey | − 1.9 | − 2.3 | − 3.6 | 0.7 | 1.1 | 0.9 | − 1.2 | − 1.2 | − 2.7 |
| Yugoslavia* | − 3.5 | − 6.1 | − 4.8 | 2.2 | 2.4 | 2.6 | − 1.3 | − 3.7 | − 2.2 |
| *Other developed countries* | *−19.8* | *−24.6* | *−32.5* | *8.5* | *11.0* | *8.4* | *−11.3* | *−13.6* | *−24.1* |
| *Total developed countries* | *− 3.1* | *−51.2* | *−82.7* | *12.0* | *15.5* | *5.7* | *8.9* | *−35.7* | *−77.0* |
| Oil-exporting countries[3] | 41.6 | 112.9 | 163.5 | −43.8 | −48.4 | −55.5 | − 2.2 | 64.5 | 108.0 |
| Other developing countries | −20.8 | −32.9 | −48.1 | − 2.5 | − 5.7 | −13.1 | −23.3 | −38.6 | −61.2 |
| *Total developing countries* | *20.8* | *80.0* | *115.4* | *−46.3* | *−54.1* | *−68.6* | *−25.5* | *25.9* | *46.8* |
| Centrally planned economies[3,4] | − 2.7 | 3.6 | 5.8 | . | . | . | . | . | . |

* Invisibles balances 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] For country composition see table on page 77. [4] Partly estimated; based on customs data; includes estimated gold exports of the USSR.

in other ways. Moreover, one-half of last year's aggregate current external deficit in the Group of Ten area was borne by Germany and Japan, two of the financially strongest countries. Secondly, the current payments deficits of other groups of oil-importing countries, taken as a whole, were smaller in relation to export earnings

than after the 1973 oil price rises, despite the large increases both in the size of their external indebtedness and in the cost of servicing it. In the case of the non-oil developing countries the aggregate current-account deficit declined slightly — from 28 to 27 per cent. of export earnings — between 1974–75 and 1979–80, while in that of the smaller developed countries the decline was much more pronounced, from 27 to 12 per cent. Thirdly, the international banking sector further expanded its recycling operations last year. Net flows of funds from banks in the BIS reporting area to non-oil developing countries and lending to developed countries outside the reporting area increased by about $12 and 9½ billion respectively.

A comparison of the evolution of the world balance-of-payments pattern after the first and second rounds of major oil price increases shows a striking contrast in the country distribution of the deficits which formed the counterpart to the OPEC surpluses. In particular, the Group of Ten countries and Switzerland, whose current-account external position had been roughly in balance during 1974–75, recorded a cumulative aggregate deficit of $75 billion in 1979–80, equal to nearly half of the OPEC surplus.

For the most part this change reflected an increase from $21 to 85 billion between the two periods in the Group of Ten countries' trade deficit (on a customs basis) with the OPEC countries. Oil prices rose by $18 per barrel between 1978 and 1980, as against an increase of $7.8 per barrel between 1973 and 1975. Consequently, the impact of higher prices on the Group of Ten countries' oil import bill with the OPEC countries was about $135 billion between 1978 and 1980, as compared with $65 billion between 1973 and 1975. Only about one-quarter of this greater price effect was offset by larger savings on the volume of oil imports. In addition, the Group of Ten countries were much less successful in 1979–80 than in the earlier period in offsetting a part of their higher oil import bill through an expansion of exports to OPEC countries. During 1974–75 the buoyancy of OPEC import demand had allowed the Group of Ten countries to raise their export earnings from those countries by nearly $30 billion, most of which represented a volume increase. During 1979–80, on the other hand, exports to OPEC countries declined slightly in volume terms and the gain in export receipts amounted to only $18 billion.

As well as the much larger deterioration in their trade balance with OPEC countries, the Group of Ten countries experienced practically no change in their aggregate trade surplus with the rest of the world in 1979–80, as compared with an increase of $25 billion in 1974–75. For this there were two reasons. First, the fact that 1979 and the first half of 1980 was a period of continued, if declining, economic growth in most Group of Ten countries, whereas 1974 and the first half of 1975 had been a period of recession. Secondly, the non-oil terms of trade of the Group of Ten countries deteriorated during 1979–80, whereas they had improved during 1974–75.

**Balances of payments in the developed countries.**

In the Group of Ten countries and Switzerland, the increase between 1979 and 1980 in the aggregate current-account balance-of-payments deficit from $22 to 53

billion was fairly widely spread. On a year-on-year comparison only three countries improved their current-account positions: the United Kingdom, with a large turn-round from deficit into surplus, the United States, where the small deficit recorded in 1979 was eliminated, and Canada, where the deficit narrowed substantially. Elsewhere, there were large increases in the current-account deficits of Germany, Belgium and Sweden and major swings from surplus to deficit in France and Italy. In Japan and the Netherlands the deficits widened moderately and in Switzerland the current account moved from surplus to a small deficit. The decline between the first and second halves of 1980 in the Group of Ten's aggregate current-account deficit, from $39 to 14 billion, essentially reflected the improvements in the positions of the United States and the United Kingdom, from deficit to surplus, and the major reduction in Japan's deficit during the course of the year.

While most Group of Ten countries were in deficit on current external account last year, only Germany experienced a major loss of monetary reserves. Elsewhere current-account deficits were financed through inflows of capital, and four of the countries with deficits — France, Italy, Japan and the Netherlands — actually added to their gross reserves. As regards the types of capital inflows that contributed to the financing of deficits last year, Belgium, Germany and Sweden had large-scale recourse to external borrowing by the public sector, while in the other deficit countries capital inflows took place mainly through the private sector, to a large extent via the banking systems.

The balance of payments of the *United States* showed big changes in 1980, on both current and capital account. For the year as a whole there was a very large improvement in the non-oil trade balance, so that, despite a $18 billion increase in the net oil import bill, the current-account balance strengthened slightly, to a surplus of $0.1 billion. Moreover, a substantial improvement in the overall trade balance during the course of 1980 shifted the current account from a seasonally adjusted deficit of $5 billion in the first half of the year to a surplus of similar magnitude in the second half. On capital account (including unidentified transactions) there was a very large turn-round between 1979 and 1980 in the total balance, from a net inflow of $14.3 billion to a net outflow of $7.9 billion, essentially as a result of large net banking outflows from the second quarter onwards.

For the year as a whole the overall trade deficit declined by $2 billion, to $27.4 billion. Excluding net oil imports, the improvement on trade account amounted to $20 billion. As the terms of trade worsened by 7 per cent., the real trade balance improved by about $21 billion, of which oil accounted for $12 billion. The volume of exports was 8 per cent. higher than in 1979, while that of imports was 3 per cent. lower, with oil imports down by 20 per cent. and other imports by 1 per cent. The improvement in the non-oil trade balance resulted from the combination of slower economic growth at home and the effects of the dollar's depreciation in 1977–78.

By far the largest improvements in the trade balance were recorded in transactions with the EEC countries and the non-oil developing countries, where the shifts were $8.4 and 5.2 billion respectively between 1979 and 1980. By categories of

merchandise, there were increases of $9.7 billion in net exports of capital goods, $6.2 billion in those of non-oil industrial supplies and raw materials, and $5.8 billion in net agricultural exports.

The turn-round in the current-account position between the two halves of 1980 was almost fully reflected in a reduction of the seasonally adjusted trade deficit from $18.4 to 9 billion. This improvement must be ascribed essentially to the fact that the deterioration in the terms of trade, which amounted to 10 per cent. in the first half, compared with the second half of 1979, was followed by a small rise of 1 per cent. in the remainder of 1980. Volume trends derived from customs data indicate that the real trade balance strengthened throughout the year. The volume of exports, which had expanded rather sharply in the first six months, shrank during the second half of 1980 in line with the weakening of economic activity in the other industrial countries. At the same time, however, the decline in the volume of imports which had begun in the first half accelerated as the US gross national product stagnated during the last six months, so that real imports fell more sharply than real exports.

The invisibles surplus declined slightly in 1980, falling by $1.2 billion to $27.5 billion. This was entirely the result of larger net payments on US Government account, in respect of both military services and transfers. The balance on other net invisibles transactions showed hardly any change. In particular, net investment income, which had risen by $11.6 billion in 1979 to $32.5 billion, remained at the same level in 1980. A decline in net undistributed earnings from direct investment was exactly offset by an increase in other net investment income.

On capital account, there was an almost fivefold increase in identified net outflows between 1979 and 1980, from $9.5 to 43.5 billion. If account is taken of the $11.8 billion increase in net inflows from unidentified transactions, which is likely to have primarily reflected unrecorded private capital inflows, the change in the capital-account balance was $22.2 billion, from net inflows of $14.3 billion to net outflows of $7.9 billion.

As can be seen from the following table, capital outflows were concentrated in the banking sector, where the change in the net balance between the two years amounted to $42.7 billion, from net inflows of $6.8 billion to net outflows of $35.9 billion. This change was essentially due to US banks' operations in dollars with commercial banks in the rest of the world, and in particular their foreign branches in the Caribbean area, while net bank lending in dollars to non-resident non-banks, at $11.1 billion, was about the same as in 1979. The radical shift in net flows of funds between US banks and banks in the rest of the world took place in the second quarter of 1980, when there were net outflows of $20.2 billion. Coming after net inflows of $9.4 billion in the first quarter of the year, this shift reflected the decline that occurred in US banks' domestic lending during the second quarter, partly as a result of the monetary restraint and credit control programme introduced by the US authorities in March 1980. Not only did the sharp fall in domestic credit demand set funds free for lending abroad, but the credit control programme also provided an incentive for the US banks' domestic customers to borrow from banks abroad. Some of this borrowing may have been financed by outflows from banks in the United

States to banks elsewhere, and the large net outflows from US banks during the second quarter of 1980 were in fact accompanied by large net unidentified inflows into the United States. It may be added that in the second half of 1980, despite the termination of the credit control programme and despite a renewed rise in US short-term interest rates to levels even higher than those reached in the first quarter, net outflows of funds through the US banking system continued, although on a much lesser scale than in the second quarter. Gross external claims of US banks increased by over $12 billion in both the third and fourth quarters of 1980.

United States: External capital flows, 1979–80.[1]

| Items | 1979 | 1980 | 1980[2] 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|---|---|
| | in billions of US dollars | | | | | |
| Non-banking flows (net) | −16.3 | − 7.6 | − 1.0 | − 0.1 | − 1.9 | − 4.6 |
| Banking flows (net) | 6.8 | −35.9 | 6.1 | −25.2 | −12.1 | − 4.7 |
| *of which:* | | | | | | |
| *Changes in banks' net foreign assets in dollars vis-à-vis banks abroad*[3] | *24.9* | *−19.5* | *9.4* | *−20.2* | *− 7.1* | *− 1.6* |
| *Changes in banks' net dollar claims on non-banks* | *−10.5* | *−11.1* | *− 0.8* | *− 2.6* | *− 5.1* | *− 2.6* |
| *Other transactions*[4] | *− 7.6* | *− 5.3* | *− 2.5* | *− 2.4* | *0.1* | *− 0.5* |
| Balancing item | 23.8 | 35.6 | 7.0 | 20.2 | 2.9 | 5.5 |
| Total | 14.3 | − 7.9 | 12.1 | − 5.1 | −11.1 | − 3.8 |

[1] Excludes transactions in US official reserve assets and in foreign official assets in the United States. [2] Seasonally adjusted. [3] Includes foreign-owned banks in the United States. [4] Includes transactions in dollars, both on account of domestic customers and custody liabilities, and changes in banks' assets and liabilities in foreign currencies.

Partly offsetting the banking outflows, there was a decline of $8.7 billion in 1980, to $7.6 billion, in identified non-bank net capital outflows. Net outflows on direct investment were $2.2 billion smaller than in 1979, purchases of long-term foreign securities by US residents declined by $1.5 billion and purchases of US long-term securities, other than Treasury securities, by non-residents went up from $2.9 to 7.4 billion. On the other hand, non-residents' purchases of long-term US Treasury securities were $2.5 billion less than in 1979.

With the current external account almost in balance, the total net capital outflow was reflected in a $7.8 billion deterioration in the net official monetary position of the United States, excluding the SDR allocation of $1.2 billion. The foreign exchange reserves went up by $7 billion, mostly as a result of official intervention in the exchange market, while total liabilities to foreign official institutions increased by $14.8 billion, $13 billion of which represented liabilities to OPEC countries.

During the first quarter of 1981 the seasonally adjusted trade deficit of $3.7 billion was considerably below the deficit of $6.2 billion recorded in the preceding three months, which meant that the current account continued to be in surplus. However, the deterioration of about $2 billion in the net official monetary position (excluding the SDR allocation) implied a continuation of net capital outflows from the United States.

The *United Kingdom* was the only Group of Ten country to record a substantial surplus, amounting to $6.6 billion, on its current-account balance of payments in 1980. The surplus contrasted with a deficit of $3.3 billion in 1979 and it was entirely concentrated in the second half of the year. The current-account surplus was more than offset by autonomous long-term capital outflows totalling $10.8 billion and by net repayments of long-term external debt of the public sector amounting to $2.2 billion. However, short-term transactions and the balancing item together accounted for net inflows totalling $7 billion, including additions of $8.8 billion to non-residents' sterling balances, so that the net official monetary position (excluding official sterling balances) improved by $0.5 billion, represented by a reduction of $0.3 billion in liabilities to the IMF and an increase of $0.2 billion in reserve assets (excluding valuation changes and the SDR allocation).

The current account improved rapidly during 1980, moving into balance on a seasonally adjusted basis in the first half of the year, from a deficit of $1.6 billion in the previous six months, and then registering a surplus of $6.6 billion in the second half. The improvement over the year, which was confined to merchandise trade, resulted from two main factors: the sharp fall in domestic economic activity; and the increased output of North Sea oil. The volume of imports declined by 5 per cent. over the year as a whole, and by 10 per cent. between the first and second halves. Here, the main influence was the stock recession. The total volume of exports rose by 2 per cent. over 1980, although between the first and second halves of the year it declined by 3 per cent. This relatively good performance, in the light of the upward movement of the exchange rate, may have been related to the weakness of domestic sales induced by the recession. In addition to these developments in trade volumes, a further positive contribution to the trade balance was made last year by a 3½ per cent. improvement in the non-oil terms of trade, which chiefly reflected the appreciation of sterling by 10 per cent. in effective terms.

During the year the balance on oil trade, assisted by a fall in domestic fuel consumption, moved into surplus for the first time and accounted for just under a quarter of the $10.2 billion improvement in the overall trade balance. The broader impact of North Sea operations, including gas production, on the current-account balance of payments may be estimated by taking the total revenue from oil and gas sales and deducting related goods imports, operating costs and interest and profits transferred abroad. On that basis the contribution of oil and gas production in 1980 amounted to $15½ billion, $6½ billion more than in 1979.

The surplus on invisibles and transfers contracted by $0.3 billion, to $3.7 billion. The balance on investment income deteriorated by a further $1.6 billion to a $0.2 billion deficit — the first in the post-war period and attributable mainly to increased outpayments to foreign oil companies operating in the North Sea and higher interest payments on non-residents' sterling assets. Net travel receipts declined by $0.8 billion under the influence of the high exchange rate, with UK residents' foreign travel expenditure rising four times as much as spending by foreign visitors in the United Kingdom. On the other hand, the rest of the invisibles account improved by $2.1 billion, of which $0.7 billion was on transportation account.

On long-term capital account, a large part of the $10.8 billion autonomous net outflow appears to have reflected the continued effects of exchange control abolition

in late 1979. Net portfolio investment turned round from a surplus of $0.8 billion to a deficit of $4.6 billion, as UK financial institutions increased their acquisitions of overseas securities. Direct investment by the non-oil sector gave rise to a sizable net outflow of $3.5 billion, a little higher than in the previous year. Other long-term autonomous outflows, amounting to a net $2.7 billion, were less than half as large as in 1979 and included sharply lower investment abroad by UK oil companies. The short-term capital account, too, showed the effects of the abolition of exchange controls, with net sterling lending of $5.8 billion by UK banks, contrasting with net inflows of $0.5 billion to them in 1979. Much of this lending, particularly in the earlier part of the year, appears to have been to the Euro-sterling market. A portion may also have contributed to the $8.8 billion rise in non-residents' liquid sterling holdings, of which $6 billion accrued on private balances. The increase of $2.8 billion in official sterling holdings — included under "liabilities to foreign monetary authorities" in the table on page 90 — restored them (in sterling terms) to their end-1974 level. Other identified short-term capital transactions gave rise to a net inflow of $4.3 billion, primarily reflecting net foreign currency borrowing by UK banks.

Available data for the first two months of 1981 show a seasonally adjusted trade surplus of $2.5 billion, compared with a surplus of $1.8 billion in the preceding two months. The oil balance improved by $0.8 billion, but the surplus on non-oil trade fell by $0.1 billion, primarily as a result of unfavourable volume movements in manufactures trade, where exports (excluding erratic items) declined by 5 per cent., compared with a 2 per cent. drop in imports. After allowing for estimated net receipts on invisibles trade, the current-account surplus for the two months may be put at $3.9 billion. Excluding the SDR allocation and valuation changes, official reserve assets showed no variation, indicating that there were further large net outflows on capital account.

For 1980 as a whole, *Japan's* current-account deficit, at $10.8 billion, was $2 billion higher than in 1979. By the end of the year, however, the deficit had all but disappeared. Up to mid-year, it had been running at a seasonally adjusted annual rate of nearly $18 billion, double the figure for the whole of 1979; in the third quarter it fell, on the same basis, to about $7 billion and in the fourth quarter to under $1 billion. On long-term capital account net inflows of $2.4 billion stood in marked contrast to the net outflow of $12.6 billion recorded in 1979, while on short-term capital account, including the balancing item, there were net inflows of $13.1 billion. Net capital inflows thus not only covered the current external deficit but also permitted an addition to net official reserves (excluding valuation changes and the SDR allocation) of nearly $5 billion.

The contrast between the size of the current-account deficit for 1980 as a whole and its progressive elimination during the course of the year was largely the result of a dramatic change between the first and second halves of the year in the evolution of Japan's terms of trade. For the year as a whole the terms of trade deteriorated by 20 per cent., export unit values rising in yen terms by 12 per cent. and import unit values by 40 per cent., with the rise in oil prices adding $25 billion to Japan's crude oil bill between 1979 and 1980. The year-on-year worsening of the terms of trade was more than offset by an improvement in the real trade balance, so that the trade surplus increased slightly in 1980, to $2.1 billion. The volume of

exports went up by 16½ per cent. last year, owing partly to the depreciation of the yen between late 1978 and early 1980, while that of imports, which had risen by 11 per cent. in 1979, fell by 6 per cent. Between the first and second halves of 1980, however, strong volume gains on trade account were reinforced by a favourable swing in the terms of trade, producing a very substantial improvement in the trade balance, from a seasonally adjusted annual-rate deficit of about $5 billion to a surplus of over $9 billion. Real export growth accelerated from 4½ to 12½ per cent. between the two half-years in spite of the falling volume of world trade, while the decline in Japan's import volume slowed from 5½ to 2½ per cent.; but the decisive factor in the re-emergence of the trade surplus was the terms of trade, which, having worsened by 15 per cent. in the first half, improved by 3½ per cent. in the second, as the rise in oil prices tapered off and the exchange rate of the yen appreciated strongly.

The net inflow of $2.4 billion on long-term capital account in 1980 was in marked contrast to the preceding two years, in each of which there had been net outflows in excess of $12 billion. On portfolio investment account the previous year's net outflow of $1.2 billion gave way to a net inflow of $9.4 billion as inward investment almost tripled to $13.2 billion. To a considerable extent this reflected investments by oil-exporting countries. In addition, there was a sharp reduction in private-sector lending abroad, other than trade credit, from $8.1 to 2.6 billion, principally as a result of restrictive official guidelines for banks' international lending. As well as the shift in long-term flows, there was a very large increase in the net inflow of short-term capital, from $6.4 to 16.2 billion. The bulk of the short-term inflow was concentrated in the first half of the year, following various steps taken in November 1979 and March 1980, including the raising of interest rates and the easing of administrative controls on inflows of funds, to facilitate the financing of the current external deficit. One of the measures taken in March 1980 permitted banks to pay market interest rates on non-residents' yen accounts with Japanese commercial banks, and over the year as a whole, total non-resident yen balances with these banks, adjusted to exclude the effects of exchange rate movements, went up by $7.8 billion, of which additions to official balances accounted for $3.6 billion.

In the first quarter of 1981 the seasonally adjusted current-account position moved from near balance in the previous quarter to a $1 billion deficit, entirely as a result of higher net payments for invisibles. On capital account, there was a net long-term inflow of $2.8 billion, and short-term transactions and the balancing item taken together were also favourable. Net official monetary assets rose by $2.2 billion, excluding the SDR allocation and valuation adjustments.

*Germany's* balance-of-payments developments in 1980, on both current and capital account, were in sharp contrast to those of Japan. On current external account, not only was the $16.1 billion deficit about three times as large as it had been in 1979, but it widened steadily during the year to a seasonally adjusted annual rate of $18.5 billion in the fourth quarter. On capital account, including errors and omissions, the modest 1979 surplus virtually disappeared last year, which meant that the current-account deficit had to be financed by drawing down net official monetary assets (before valuation changes) by $15.1 billion.

Taking the two years 1979 and 1980 together, Germany's cumulative current-account deficit amounted to over $21 billion, as compared with the surplus of over $14 billion achieved in 1974–75. At the same time, the traditional deficit on invisibles account widened by nearly $10 billion. As was true of other industrial countries, the reduction of Germany's trade surplus from $23.9 billion in 1978 to $8.1 billion in 1980 was predominantly attributable to unfavourable price movements, reflected in terms-of-trade losses of over 6 per cent. in both 1979 and 1980. While these relative price movements were caused largely by the surge in oil prices, the non-oil terms of trade deteriorated by about 2 per cent. in each of the last two years. In 1979 relative volume trends aggravated the terms-of-trade loss — the real growth of imports having exceeded that of exports by 2 percentage points — but there was some improvement in the real trade balance in 1980, when real exports and imports expanded by 4 and 2 per cent. respectively. However, the smallness of last year's rise in the volume of imports was more than accounted for by a 10 per cent. cutback in oil imports. Non-oil imports grew in real terms by around 5 per cent. As a consequence of the unfavourable price and volume trends, the 46 per cent. increase in the value of non-oil imports between 1978 and 1980 considerably exceeded the 35 per cent. growth in the value of total exports. While the rise in the oil bill from $15.8 to 34.6 billion was larger than the total $15.8 billion deterioration in the trade balance during 1979–80, the rather modest $3 billion improvement in the non-oil trade balance during these two years contrasts with an improvement of $41.8 billion in the United States and with a rise last year of $18.2 billion in Japan's non-oil trade surplus. This contrast would seem to point to the existence of other causes for the recent weakness of Germany's foreign trade balance.

What these other causes may have been is suggested by a comparison of Germany's foreign trade performance in the first and second halves of the 1970s. During 1970–74 economic growth in Germany's main export markets, measured by the export-share-weighted average growth of real gross national product in the major developed countries, which take up roughly two-thirds of Germany's exports, consistently exceeded the growth of Germany's gross national product. At the same time the volume of German exports increased at a compound annual rate of 9 per cent., or nearly 5 percentage points per annum faster than that of imports. During the five-year period 1976–80, however, when Germany's economic growth consistently surpassed that of the countries which form its principal export markets, the volume of German exports increased at a compound annual rate of 5 per cent., whereas that of German imports rose by 5½ per cent. a year. Moreover, while during 1970–74 Germany's import propensity followed the same growth trend as that of the group of the seven largest industrial countries, after 1975 the ratio of real imports of goods and services to real gross national product began to rise much more rapidly in Germany than in the group as a whole. This increased propensity to import — which was particularly pronounced during 1979–80 — was related to the cumulative appreciation of the Deutsche Mark's effective exchange rate, which amounted to 60 per cent. between the end of 1972 and the end of 1979, and which impaired the ability of domestic producers to compete with imported goods. The effects of exchange rate movements were particularly evident in 1980, when the value of imports from the United States and Japan — countries against whose

currencies the Deutsche Mark had risen by 14 and 41 per cent. respectively between the third quarter of 1978 and the last quarter of 1979 — expanded by 26½ and 32 per cent., compared with a 14½ per cent. increase in the value of total non-oil imports. In this connection it may be added that whereas the effective exchange rate of the yen depreciated sharply between late 1978 and early 1980, the depreciation of the Deutsche Mark was a more recent development, which began at around the end of 1979.

The cyclical and exchange rate effects which accentuated the oil price impact on the foreign trade balance are likely also to have contributed to the rapid rise in net tourist expenditure, which accounted for nearly one-half of the deterioration — from $14.6 billion to $24.2 billion — recorded in Germany's net payments on invisibles account between 1978 and 1980. The other half of the widening in the deficit came largely from increased transfer payments, which rose by $5.2 billion in the last two years, mainly on account of official transfers to the EEC and, in 1980, also because of cancellations of official claims of $0.8 billion on developing countries.

Capital-account transactions, including errors and omissions, resulted in net inflows of $1 billion in 1980, compared with a surplus of $2.9 billion in 1979. In fact, a large deficit on capital account was avoided only by substantial public-sector borrowing abroad. Total net inflows through the public sector amounted to $11.3 billion and they included the sale of nearly $13 billion of government securities to non-residents. About one-half of that amount consisted of sales of promissory notes through the banking system, mainly to OPEC countries, while the other half reflected direct borrowing by the Federal Government, primarily from Saudi Arabia, as well as purchases of German Government securities by the US authorities.

Private capital movements produced a net outflow of $10.3 billion in 1980, most of which was on long-term capital account, after net inflows of $3.5 billion in

Germany: Private external capital flows, 1979–80.

| Items | 1979 | 1980 | 1980 | | | |
|---|---|---|---|---|---|---|
| | | | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
| | in billions of US dollars | | | | | |
| Long-term capital (net) | 6.7 | – 8.0 | – 2.9 | – 1.2 | – 0.9 | – 3.0 |
| *Direct investment* | *– 3.6* | *– 3.4* | *– 1.2* | *– 0.7* | *– 0.4* | *– 1.1* |
| *Portfolio investment* | *1.6* | *– 3.7* | *– 1.9* | *– 0.3* | *– 0.3* | *– 1.2* |
| *Other long-term capital* | *8.6* | *– 0.9* | *0.2* | *– 0.2* | *– 0.1* | *– 0.8* |
| Short-term capital (net) | – 0.4 | – 0.1 | – 2.5 | 0.2 | 5.6 | – 3.5 |
| *Banking sector* | *2.4* | *– 5.2* | *– 5.6* | *0.5* | *2.0* | *– 2.1* |
| *Non-banking sector* | *– 2.7* | *5.1* | *3.1* | *– 0.2* | *3.6* | *– 1.4* |
| Errors and omissions | – 2.9 | – 2.2 | – 0.9 | – 0.0 | – 0.1 | – 1.2 |
| Total private capital (net) | 3.5 | –10.3 | – 6.3 | – 1.0 | 4.6 | – 7.7 |
| US dollar/DM interest rate differential* (percentage) | 5.0 | 7.4 | 10.0 | –0.4 | 4.8 | 7.4 |

Note: Components may not add up to totals owing both to rounding-up and to strong movements in the quarterly exchange rate between the US dollar and the Deutsche Mark.

* Uncovered three-month interest rate differential between Euro-dollar and German interbank rate at the end of the period.

1979. The most important reason for this turn-round was the emergence of large interest rate differentials between Germany and a number of other countries, and in particular the very big rise in dollar interest rates. The effects on capital flows of these interest rate differentials were reinforced by the weakening of confidence in the Deutsche Mark as a result of Germany's current-account deficit. As the table on the opposite page shows, the influence of these factors on private capital movements was strongest in the first and fourth quarters of the year, when the interest rate differentials were at their widest and when the Deutsche Mark was under strong pressure in the exchange market.

On long-term capital account, the balance of net movements changed between 1979 and 1980 from inflows of $6.7 billion to outflows of $8 billion. On portfolio investment account, the change in the net balance from inflows of $1.6 billion to outflows of $3.7 billion included a rise of $2.6 billion in residents' purchases of foreign fixed-interest securities and a decline of $2.7 billion in non-residents' purchases of German fixed-interest paper. The other main change between the two years on long-term capital account was in net banking transactions (included in "Other long-term capital" in the table), from inflows of $9.5 billion in 1979 to outflows of $0.5 billion last year. German banks' long-term lending to non-residents was $2.2 billion higher, and the growth of non-residents' long-term claims on German banks $7.7 billion less, than in 1979.

Net outflows on short-term capital account, at $0.1 billion, were roughly the same as in 1979. Within this small net total, however, there were banking outflows of $5.2 billion and non-bank inflows of $5.1 billion, reversing the 1979 pattern. The non-bank inflows consisted mainly of Euro-Deutsche Mark credits taken up with banks abroad, some of which may have been financed through outflows from the German banking system. The banking outflows — which were concentrated in the first and fourth quarters of the year — were influenced by the same factors which affected long-term capital movements. Of the total net outflow of $5.2 billion through the banks, $3.9 billion were additions to the banks' external claims.

In the first quarter of 1981 the deficit on current account, at $4.4 billion, was considerably higher than the $2.9 billion deficit recorded in the corresponding period of 1980. However, owing to net long-term public-sector borrowing abroad and large-scale net short-term inflows, the net external monetary position (excluding the SDR allocation) improved by $1 billion.

*Italy's* current-account balance of payments worsened between 1979 and 1980 from a surplus of $5.1 billion to a deficit of $9.9 billion. The deterioration, equivalent to 3.7 per cent. of gross national product, was the largest experienced by any developed country. Moreover, the current-account balance worsened between the two halves of 1980, with the deficit increasing from an annual rate of $8.8 billion to one of $11 billion. On capital account, there were total net inflows (including the balancing item) of $10.8 billion during 1980, largely through the banking system, so that there was a small overall balance-of-payments surplus for the year.

The worsening of the current-account balance was due almost entirely to merchandise trade transactions, the deficit on which increased from $1.1 to 15.9 billion. While more than half of this change resulted from higher payments for net

## Developed countries: Balances of payments, 1979–80.

| Countries | Years | Net external transactions | | | | | |
|---|---|---|---|---|---|---|---|
| | | Current account | Capital account[1] | Balancing item | Total | *of which, changes in:* official reserves[2] | *of which, changes in:* liabilities to foreign monetary authorities[3] |
| | | in billions of US dollars | | | | | |
| Austria* | 1979 | – 1.9 | 0.1 | 0.6 | – 1.2 | – 1.0 | – 0.2 |
| | 1980 | – 3.6 | 3.3 | 2.0 | 1.7 | 1.4 | 0.3 |
| Belgium-Luxembourg* | 1979 | – 3.3 | 2.4 | – 0.3 | – 1.2 | – 1.2 | – 0.0 |
| | 1980 | – 5.9 | 5.8 | 0.5 | 0.4 | – 0.5 | 0.9 |
| Canada* | 1979 | – 4.3 | 6.7 | – 3.3 | – 0.9 | – 0.9 | – |
| | 1980 | – 1.3 | 2.8 | – 2.2 | – 0.7 | – 0.7 | – |
| Denmark* | 1979 | – 2.9 | 3.2 | – 0.4 | – 0.1 | – 0.1 | – 0.0 |
| | 1980 | – 2.5 | 3.0 | – 0.4 | 0.1 | 0.1 | – 0.0 |
| Finland | 1979 | – 0.2 | 0.2 | – 0.0 | – 0.0 | – 0.1 | 0.1 |
| | 1980 | – 1.4 | 1.6 | – 0.0 | 0.2 | 0.2 | 0.0 |
| France | 1979 | 1.1 | – 1.5 | 2.3 | 1.9 | 1.7 | 0.2 |
| | 1980 | – 7.4 | 8.4 | 5.6 | 6.6 | 8.0 | – 1.4 |
| Germany | 1979 | – 5.3 | 5.7 | – 2.8 | – 2.4 | – 3.4 | 1.0 |
| | 1980 | –16.1 | 3.2 | – 2.2 | –15.1 | –10.2 | – 4.9 |
| Greece* | 1979 | – 1.9 | 1.3 | 0.5 | – 0.1 | – 0.1 | 0.0 |
| | 1980 | – 2.1 | 2.2 | 0.1 | 0.2 | 0.1 | 0.1 |
| Ireland* | 1979 | – 1.5 | 0.9 | 0.0 | – 0.6 | – 0.6 | – |
| | 1980 | – 1.6 | 2.3 | – 0.0 | 0.7 | 0.7 | – |
| Italy* | 1979 | 5.1 | – 1.8 | 0.1 | 3.4 | 1.9 | 1.5 |
| | 1980 | – 9.9 | 12.9 | – 2.1 | 0.9 | 1.0 | – 0.1 |
| Japan | 1979 | – 8.8 | – 6.2 | 2.3 | –12.7 | –13.9 | 1.2 |
| | 1980 | –10.8 | 18.6 | – 3.1 | 4.7 | 5.5 | – 0.8 |
| Netherlands* | 1979 | – 2.3 | 2.0 | – 0.2 | – 0.5 | – 0.7 | 0.2 |
| | 1980 | – 2.8 | 5.3 | – 1.5 | 1.0 | 1.7 | – 0.7 |
| Norway* | 1979 | – 1.0 | 1.7 | 0.6 | 1.3 | 1.3 | – 0.0 |
| | 1980 | 1.0 | – 0.0 | 0.9 | 1.9 | 2.0 | – 0.1 |
| Portugal | 1979 | – 0.0 | – 0.2 | 0.6 | 0.4 | 0.1 | 0.3 |
| | 1980 | – 1.1 | 0.2 | 1.3 | 0.4 | – 0.0 | 0.4 |
| Spain* | 1979 | 1.1 | 4.3 | – 2.0 | 3.4 | 2.9 | 0.5 |
| | 1980 | – 5.1 | 5.0 | – 0.6 | – 0.7 | – 0.7 | – |
| Sweden | 1979 | – 2.7 | 2.0 | 0.0 | – 0.7 | 0.1 | – 0.8 |
| | 1980 | – 5.2 | 5.9 | – 0.8 | – 0.1 | 0.0 | – 0.1 |
| Switzerland* | 1979 | 2.4 | –13.1 | 8.6 | – 2.1 | – 1.3 | – 0.8 |
| | 1980 | – 0.2 | – 7.1 | 6.7 | – 0.6 | – 0.8 | 0.2 |
| Turkey | 1979 | – 1.2 | 0.5 | 0.6 | – 0.1 | – 0.1 | – 0.0 |
| | 1980 | – 2.7 | 2.8[4] | . | 0.1 | 0.5 | – 0.4 |
| United Kingdom | 1979 | – 3.3 | – 0.2 | 4.9 | 1.4 | 1.8 | – 0.4 |
| | 1980 | 6.6 | – 8.6 | – 0.3 | – 2.3 | 0.2 | – 2.5 |
| United States | 1979 | – 0.7 | – 9.5 | 23.8 | 13.6 | – 0.0 | 13.6 |
| | 1980 | 0.1 | –43.5 | 35.6 | – 7.8 | 7.0 | –14.8 |
| Yugoslavia* | 1979 | – 3.7 | 2.3 | 0.0 | – 1.4 | – 1.2 | – 0.2 |
| | 1980 | – 2.2 | 2.0[4] | . | – 0.2 | 0.1 | – 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 foreign 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] Including balancing item.

imports of oil, there was also an adverse movement in the real trade balance. In particular, the volume of exports was 8 per cent. lower than in 1979 according to customs figures, its first fall for thirty years. As well as a sharp drop in the number of motor vehicles exported, there were declines in the quantities of metals, textiles and clothing sold abroad. The weakness of Italy's exports last year partly reflected a loss of international competitiveness resulting from the relatively high rate of domestic price increases. In addition, the buoyancy of the domestic economy — total domestic demand rose by 6½ per cent. — may have diverted some sales from foreign markets to the home market. On the other side of the trade balance, total imports rose by 2 per cent. in volume and non-oil imports by 4 per cent. The adverse changes in the real trade balance were reinforced by a 7 per cent. deterioration in the terms of trade, the largest single element in which was the rise in oil prices.

Total identified capital movements produced net inflows of $12.9 billion in 1980. Two-thirds of these inflows took place through the banks, whose net foreign indebtedness rose by $8.5 billion. In the non-bank sector net official borrowing amounted to $3.5 billion, a substantial proportion of which was raised in the Euro-market. Partly offsetting the identified net capital inflows there was a negative balancing item of $2.1 billion, so that the overall balance of payments showed a surplus of $0.9 billion, virtually all of which was reflected in additions to official reserves.

In the first quarter of 1981 a further large current payments deficit, combined with net capital outflows, led to exchange rate pressures and the lira was devalued on 23rd March by 6 per cent. within the European Monetary System. Provisional estimates put the current-account deficit at around $3 billion, net outflows through the banks totalled $1.2 billion and the net official monetary position deteriorated by $4.6 billion.

In *France* the deterioration of $8.5 billion in the current-account balance of payments in 1980 was not much smaller than that observed in Germany, although the deficit, at $7.4 billion, was still considerably lower than the German one, both in absolute terms and in relation to gross national product. On capital account, moreover, developments in the two countries were quite different. France recorded total net inflows (including the balancing item) of $14 billion, so that its net official reserves, excluding the SDR allocation, rose by $6.6 billion.

The worsening of the current-account balance was entirely attributable to a sixfold increase in the merchandise trade deficit, to $12 billion. The traditional surplus on invisibles, on the other hand, increased by $1.5 billion to $4.6 billion. On the basis of customs data (imports c.i.f.), which provide details of merchandise transactions, the trade deficit went up by $13.8 billion between 1979 and 1980, from $9.7 to 23.5 billion. Most of this deterioration can be accounted for by an increase of $11.5 billion in the deficit on transactions in energy products, with an 11 per cent. cutback in the tonnage of crude oil imports being more than offset by higher energy import prices and a larger quantity of other energy imports. In the rest of the trade balance, net exports of food and agricultural products quadrupled between the two years, to $2.8 billion, while the surplus on transactions in all other products

declined by $4.4 billion. France's total exports rose by 2 per cent. in volume last year, while non-energy imports were 15 per cent. higher. The growth of non-energy imports was particularly strong in metal and metal products and in industrial investment goods and consumer durables, where the volume increases were around 20 per cent. Imports from the United States and Japan expanded by about one-third in 1980, or by more than twice as much as imports from EEC countries, perhaps as a result of the depreciation of these two countries' currencies against the French franc in 1979.

On capital account, net long-term outflows amounted to $1.5 billion. On short-term capital account there were net inflows through the banks of $7.1 billion and an increase of $2.9 billion in the net indebtedness of the private non-bank sector. A sizable portion of the inflows through the banks took the form of additions to non-resident French franc deposits. The quarterly pattern of identified capital movements in the course of the year was to some extent the mirror image of that of Germany. The largest net inflows, totalling $6.7 billion, occurred in the first and last quarters of 1980, when Germany experienced sizable net private capital outflows. For the year as a whole, total net identified capital inflows amounted to $8.4 billion and in addition there was a large favourable balancing item of $5.6 billion.

Provisional data for the first quarter of 1981 show a current payments deficit of $2.4 billion, compared with a deficit of $3.3 billion in the corresponding period of 1980. On capital account, there was a surplus of $4.1 billion, resulting almost entirely from large net inflows through the banks, and net official assets, excluding the SDR allocation and valuation adjustments, rose by $1.7 billion.

In the *Netherlands* the deficit on the current account of the balance of payments increased from $2.3 to 2.8 billion in 1980. On capital account, including the balancing item, net inflows of $3.8 billion were recorded, so that the net official reserves (excluding valuation changes and the SDR allocation) went up by $1 billion. The deterioration in the current-account balance had its origin in the invisibles account, where higher net service and transfer payments produced a $0.7 billion increase in the deficit. The trade deficit, on the other hand, declined from $1.5 to 1.3 billion, with a slackening of domestic economic activity leading to a $0.8 billion improvement, on a customs basis, in the balance on trade in merchandise other than petroleum and gas. The energy balance deteriorated slightly, mainly because natural gas prices were adjusted only partially and with a time-lag to the increased price of oil.

Identified net capital inflows more than doubled between 1979 and 1980, from $2 billion in 1979 to $5.3 billion. Net long-term outflows, which had amounted to $1.4 billion in 1979, virtually disappeared last year, mainly because of larger net inflows from portfolio investment and smaller net outflows on other private long-term capital. The rise in identified net short-term capital inflows from $3.5 billion in 1979 to $5.3 billion in 1980 was basically accounted for by an increase of $1.8 billion, to $5.5 billion, in net inflows through the banks, which led to a position of net foreign currency indebtedness. As in France, net capital inflows were most pronounced in the first and fourth quarters of the year, when there were sizable net outflows from Germany.

In the *Belgium-Luxembourg Economic Union* the current-account deficit increased between 1979 and 1980 from $3.3 to 5.9 billion, at which level it was equivalent to 5 per cent. of gross national product. The deficit was mainly covered by net capital inflows through the official sector amounting to $5.1 billion. Compensatory borrowing accounted for $4.2 billion of this total, partly in the form of government foreign currency borrowing from the domestic banking system and partly through credits taken up abroad by public-sector institutions. In addition, there were net private capital inflows (including errors and omissions) of $1.2 billion, with net inflows through the banks totalling $1 billion, so that the net official monetary position (excluding the SDR allocation) improved by $0.4 billion during 1980.

The merchandise trade deficit increased last year from $5 to 6.3 billion, and the surplus on services and transfers shrank by $1.3 billion, to $0.4 billion. On trade account, customs data indicate that the balance on transactions in oil worsened by $1.5 billion, implying a marginal improvement in the non-oil trade balance. The three main features of the sharp fall in the invisibles surplus were lower net receipts for trade-related services, a shift from net receipts to net payments on investment income account, associated with higher interest payments on external debt, and a rise in the official transfers deficit.

In *Sweden*, as in the BLEU, there was a substantial deterioration in the current-account balance of payments between 1979 and 1980, from a deficit of $2.7 billion in 1979 to one of $5.2 billion last year, equal to 4.2 per cent. of gross national product. As in Belgium, the deficit was principally financed by long-term government borrowing abroad, which totalled $5 billion. Other capital transactions, including the balancing item, produced a net inflow of $0.1 billion, and the net official monetary position (excluding valuation changes and the SDR allocation) deteriorated by $0.1 billion.

On merchandise trade account, there was a shift from a surplus of $0.8 billion to a deficit of $0.3 billion. Net imports of petroleum rose by $1.2 billion, as higher oil prices were partly offset by a reduction in import volume. The non-oil trade balance showed little change. A terms-of-trade gain, associated with the appreciation of the Swedish krona, was cancelled out by a worsened net volume position. Trade was badly affected by prolonged labour disputes in the second quarter, which are estimated to have reduced industrial production by about 2 per cent. The deficit on services and transfers widened by $1.4 billion to $4.9 billion. Half of the deterioration was on investment income account, mostly reflecting the higher cost of servicing foreign debt.

In *Switzerland* the current-account balance of payments deteriorated between 1979 and 1980 from a surplus of $2.4 billion to a small deficit of $0.2 billion. At the same time there was an even larger offsetting movement on capital account, with total net outflows (including unidentified transactions) falling from $4.5 to 0.4 billion. Last year's decline of $0.6 billion in net official assets (including dollar swaps with the commercial banks) was therefore considerably smaller than the decline of $2.1 billion recorded in 1979.

The deterioration on current account in 1980 occurred despite a $2 billion increase in the invisibles surplus to $6.7 billion, brought about by higher net

receipts from tourism, investment income and other services. The merchandise trade deficit went up sharply, from $2.3 to 6.9 billion, to a considerable extent as a result of the strength of domestic demand. Non-oil imports (excluding certain erratic items) were 9 per cent. higher in volume than in 1979, while the volume of oil imports fell by only 2 per cent., a smaller decline than in most other industrial countries. Export volume, also net of certain erratic items, rose by 5 per cent., a strong performance given the sluggishness of world trade, and one which was no doubt related to gains in competitiveness achieved since late 1978.

On capital account, identified net outflows declined between 1979 and 1980 from $13.1 to 7.1 billion. This was principally the result of the fact that the net external assets of the Swiss banking system, after having risen by $7 billion in 1979, showed very little change last year. The banks' gross external assets increased by $3.5 billion less than in 1979, no doubt partly because of the vigorous expansion of domestic credit, while their external liabilities went up by $3.4 billion more than the year before, to some extent as a result of the abolition of restrictions on the payment of interest on non-resident Swiss franc balances. Outside the banking sector, net identified capital outflows increased between 1979 and 1980 from $6.1 to 7.1 billion, reflecting a rise in outward investment in long-term bonds and notes. Partly offsetting the decline in net identified capital outflows, the favourable balance on unidentified transactions declined from $8.6 to 6.7 billion.

For the second successive year the size of net outflows through the banks, and therefore of the movement of official reserves, was substantially affected by increased swaps of dollars by the commercial banks with the Swiss National Bank. In 1980 these swap balances went up $3.2 billion, after a $2.9 billion rise in 1979. At the end of 1980 dollars held by the Swiss National Bank under swaps with the commercial banks amounted to a total of $7.6 billion, equal to one-half of all official foreign exchange reserves.

There was a major improvement in *Canada's* current-account balance of payments in 1980, with the deficit narrowing from $4.3 to 1.3 billion. Total net identified capital inflows, however, declined even more, from $6.7 to 2.8 billion, to a considerable extent because of the high level of interest rates in the United States, and in addition there were net unidentified outflows of $2.2 billion. Canada's overall balance of payments therefore showed a small deficit of $0.7 billion.

The improvement in the current-account balance to the lowest deficit for six years was more than accounted for by a doubling of the foreign trade surplus from $3.4 to 6.8 billion. The only major sector in which the balance of trade worsened last year was that of crude oil and natural gas, where the surplus of $0.9 billion recorded in 1979 was eliminated, higher sales of natural gas being more than offset by increased payments for crude oil. The value of wheat exports, on the other hand, rose by $1.4 billion as a result of favourable volume and price developments, and the deficit on trade with the United States in automotive products narrowed by $0.8 billion, reflecting lower imports into Canada from the United States. In the rest of the trade balance there was a marked increase in the surplus, from $3.2 to 5.3 billion. This reflected the improvement in Canada's international competitive position following the depreciation of the Canadian dollar in 1977 and 1978, as well

as the slowdown in domestic economic growth. The volume growth of imports, other than US automotive products and oil, decelerated between 1979 and 1980 from 11 to 3 per cent., and while the growth of exports — excluding automotive products to the United States, wheat, oil and gas — was also lower than in 1979, it still amounted to 6 per cent. in volume. The deficit on non-merchandise current-account transactions, at $8.1 billion, was a little higher than in 1980, reflecting a $0.2 billion increase in net interest and dividend payments to a total of $4.8 billion.

On capital account, the principal development in 1980 was a decline in net short-term inflows from $4.3 to 1.6 billion, which resulted from the fact that short-term interest rates rose less in Canada during 1980 than they did in the United States. At times, indeed, the interest rates available on some short-term investments in Canada were lower than those on comparable US dollar securities. In the absence of Federal Government borrowing on international capital markets, where $1.4 billion had been raised in 1979, net long-term inflows fell from $2.4 to 1.2 billion. An increase of $1.5 billion in non-residents' net purchases of Canadian long-term securities was offset by a rise in net outflows from direct investment and other long-term transactions. Excluding the SDR allocation and additions to the foreign exchange reserves (totalling $0.7 billion) arising from the proceeds of gold sales by the Government, the net official asset position deteriorated by $0.7 billion.

The aggregate current-account deficit of the *developed countries other than the Group of Ten and Switzerland* rose by $10.5 billion in 1980, to $24.1 billion. The group's trade deficit went up from $24.6 to 32.5 billion and at the same time its surplus on invisibles transactions fell from $11 to 8.4 billion. By far the largest deterioration on current account occurred in Spain, from a $1.1 billion surplus to a $5.1 billion deficit. With no fall in the volume of oil imports, most of the swing in Spain's current account was attributable to a $5 billion rise in the oil bill. In addition, the current-account deficits of Australia and Austria widened from $2 and 1.9 billion to $3.7 and 3.6 billion respectively, while those of Finland and Turkey went up from $0.2 and 1.2 billion to $1.4 and 2.7 billion respectively. On the other hand, higher oil prices contributed to a $2 billion improvement in Norway's current account, while Denmark and Yugoslavia recorded smaller deficits than in 1979.

As in 1979, aggregate inflows of capital to these countries more than covered the current-account deficit, so that the group's total reserves (excluding gold) went up by $4.3 billion. Moreover, the increase in capital inflows last year was greater than the rise in the current-account deficit, so that total reserve gains were $2.1 billion higher than in 1979. The additional inflows of capital came to a large extent from these countries' greater recourse to the international banking system. Their total net borrowings in 1980 from commercial banks in the Group of Ten countries and Switzerland, and from the branches of US banks in the offshore centres of the Caribbean and the Far East, amounted to $11 billion, double the 1979 figure. The total of new funds raised through international bond sales, at $7 billion, was $1 billion less than in 1979. As regards transactions with the International Monetary Fund, large net drawings by Turkey ($0.5 billion) and Yugoslavia ($0.4 billion) were offset by repayments from Australia, New Zealand, South Africa, Greece and Portugal, so that the group as a whole had no net recourse to IMF credit in 1980.

**Balance-of-payments developments in the non-oil developing countries.**

The aggregate trade deficit of the non-oil developing countries is estimated to have increased last year by about $15 billion, to a total of $48 billion. In volume terms the trade balance improved last year, as total exports rose by 8½ per cent., almost as rapidly as in 1979, while the growth of imports slowed down from 12 to 6 per cent. Total export receipts were also raised by an increase of 14 per cent. in unit values, but with import unit values rising by 21 per cent., the terms of trade deteriorated by 6 per cent., more than offsetting the favourable development of the real trade balance. In addition to the widening of the shortfall on trade account, the group's deficit on invisibles account went up from $6 to 13 billion. This was the consequence of the further increase in these countries' external indebtedness last year, coupled with the steep rise in interest rates on international financial markets. On long-term external indebtedness alone, the non-oil developing countries' interest payments are estimated to have increased by about $14 billion between 1978 and 1980, which was rather more than the growth of their total deficit on invisibles transactions over these two years.

Identified capital inflows into the non-oil developing countries went up by much less in 1980 than the current-account deficit, from $53 to 65 billion, so that these countries' total monetary reserves (excluding gold), which had risen by $9.5 billion in 1979, showed a small decline of nearly $1 billion last year. Net inflows from direct investment last year may have totalled about $6 billion, as they had done in 1979, but external borrowing rose markedly. The amount of new funds taken up from official creditors, including international institutions, is estimated to have increased between 1979 and 1980 by $7 billion, to a total of $18 billion. Net recourse to the IMF (including Trust Fund loans) last year totalled $3.4 billion, compared with $1.1 billion in 1979. Gross borrowings from commercial banks in the Group of Ten countries and Switzerland, as well as from the branches of US banks in the offshore centres of the Caribbean and the Far East, amounted to $37.6 billion, as against $35 billion a year earlier, with a larger proportion than before in the form of short-term borrowing rather than syndicated bank credits.

**The balance of payments of the OPEC countries and the investment of the OPEC surplus.**

The current-account surplus of the OPEC countries is estimated to have increased from $65 to 108 billion in 1980, despite a marked drop in the volume of oil exports and a rise in the volume of OPEC imports. In volume terms the biggest change was on the import side, where a fall of 12 per cent. in 1979, mainly caused by the interruption of sales to Iran, contrasted with a rise of 16 per cent. last year. On the export side, last year's decline of 13 per cent. compared with a small increase in 1979. The figures in the world trade table on page 77 show a reduction in the OPEC trade surplus between the first and second halves of last year, from $85 to 79 billion, and this would no doubt have been more pronounced had it not been for the war between Iraq and Iran, which slowed down the growth of total OPEC imports, while on the export side the lower level of oil supplies from these two countries was to a large extent made up through increased output in other OPEC countries.

Estimated deployment of OPEC countries' investible surplus, 1974–75 and 1979–80.[1]

| Items | 1974 | 1975 | 1979 | 1980 |
|---|---|---|---|---|
| | in billions of US dollars | | | |
| Identified investible surplus | 53.2 | 35.2 | 60.6 | 87.0 |
| Short-term investments | 36.6 | 9.5 | 43.2 | 42.5 |
| *of which:* | | | | |
| In the United States[2] | *9.4* | *1.1* | *8.3* | *0.2* |
| in the United Kingdom[2] | *18.2* | *3.4* | *16.2* | *16.1* |
| *(of which:* Euro-currency deposits) | *(13.8)* | *(4.1)* | *(14.8)* | *(14.8)* |
| in other industrial countries[3] | *9.0* | *5.0* | *18.7* | *26.2* |
| Long-term investments | 16.6 | 25.7 | 17.4 | 44.5 |
| *of which:* | | | | |
| in the United States | *2.3* | *8.5* | *– 1.5* | *14.3* |
| in the United Kingdom | *2.8* | *0.9* | *1.0* | *2.0* |
| in other industrial countries | *3.1* | *5.8* | *8.7* | *16.7* |
| with international institutions[4] | *3.5* | *4.0* | *– 0.4* | *4.9* |
| in developing countries | *4.9* | *6.5* | *9.6* | *6.6* |

Source: Bank of England.

[1] The difference between the current-account position and identified foreign investment reflects, apart from recording errors, borrowing (net of repayments) by OPEC countries, direct investment inflows, trade credits and other unidentified capital flows. [2] Includes bank deposits and money-market placements. [3] Bank deposits only. [4] IBRD and IMF.

Available data show an increase in the identified external investments of the OPEC countries of $87 billion during 1980, divided about equally between short-term investments in bank deposits and money-market investments and longer-term placements of surplus funds. The pattern of identified additions to OPEC countries' external assets last year showed two contrasts with 1979. Firstly, the proportion of new long-term investments, amounting to over 50 per cent., was nearly twice as high as the year before. Secondly, there were notable shifts in the regional distribution of short and long-term investments among the industrial countries. While the amount of new short-term investments in the United Kingdom was the same in 1980 as in 1979, there were hardly any short-term placements in the United States in 1980 but a large increase was recorded in the acquisition of short-term assets in other industrial countries. As a result, the share of "other industrial countries" in total short-term investments of OPEC funds rose from 43 per cent. in 1979 to 62 per cent. in 1980. Identified long-term investment of OPEC funds increased from $17.4 billion in 1979 to $44.5 billion in 1980. With $2 billion being invested in the United Kingdom, the bulk of new long-term investments accrued to the United States, where long-term assets held by OPEC countries had declined slightly in 1979, and to other industrial countries, where the inflows, at $16.7 billion, were nearly twice as large as in 1979.

Taking short and long-term placements together, the amount invested in industrial countries other than the United States and the United Kingdom went up from $27.4 billion in 1979 to $42.9 billion in 1980. The greater use of the financial markets of these other countries, all of which had current payments deficits, meant that a larger share of the OPEC countries' investible surplus was recycled directly to deficit countries. However, this was not true of the deficit countries in the developing world. Identified long-term investment in these countries in fact

decreased last year. Even if account is taken of investments with international institutions, most of which are likely to have been onlent to developing countries, there was only a very modest rise in the flow of OPEC funds to the developing countries.

Comparing briefly the pattern of identified placements of OPEC surplus funds in 1974–75 and 1979–80, two tendencies can be observed. Firstly, the share of the industrial countries in total OPEC investments rose from 79 per cent. in the earlier period to 86 per cent. in 1979–80. Secondly, there was a clear trend towards a greater regional diversification of investment in the industrial countries. The shares of assets acquired in the United States and the United Kingdom fell between the two periods from 24 to 14 per cent. and from 29 to 24 per cent. respectively, while OPEC countries' investments in the other industrial countries increased from 26 to 48 per cent. of the total investible surplus.

# VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

1980 was a year of strong growth in the international financial markets. Against the background of unusually high and volatile dollar interest rates, unrest in the exchange markets and pronounced economic and political uncertainties, the international banking sector continued to act as a principal outlet for the OPEC surpluses and as a major source of credit both for the industrial countries and, after some hesitancy in the earlier part of the year, for the developing world. Although some individual borrowers found the markets less receptive, overall lending conditions remained very easy, there was no shortage of funds and there were few signs of a general slowdown in the growth of the markets. As well as describing these developments, this chapter reviews the major recycling rôle of the international banks since 1974 and assesses the outlook for its continuation.

## The overall picture.

Expressed in current dollars, the external claims of banks in the Group of Ten countries, Switzerland, Austria, Denmark and Ireland, and of the branches of US banks in the offshore centres of the Caribbean and Far East, increased by $212 billion, or just under 20 per cent., last year to reach a total of $1,323 billion. The comparable growth figures for 1979 were $218 billion and 24 per cent. However, the 1980 expansion was understated by the effect of the dollar's appreciation on the current dollar value of the banks' assets in currencies such as the Deutsche Mark and the Swiss franc, whereas in 1979 exchange rate movements had exaggerated the increase. In addition, the aggregates were somewhat less inflated in 1980 than in 1979 by the double-counting that results from the redepositing of funds between the reporting banks themselves. After exclusion of these influences, the underlying growth of international bank lending in 1980 may be estimated at around $165 billion, or 26 per cent., which was more than the $125 billion, or 24 per cent., estimate for 1979.

The volume of new issues in the international bond market increased by $4.7 to 22.5 billion. Foreign issues in national markets, on the other hand, seem to have been adversely affected by inverted yield curves, interest rate volatility and exchange rate uncertainties, so that their volume declined by $4.2 to 15.8 billion. As a result, the total volume of international issues was more or less unchanged. Excluding redemptions of earlier issues, as well as double-counting resulting from bond issues or bond holdings by the banks themselves, the international bond markets may be estimated to have added $21 billion to the amount of finance obtained in the form of bank credit last year, bringing the total growth of international credit in 1980 to about $186 billion.

In the banking sector, the external assets of banks in Japan, Canada and the United States showed particularly strong growth last year, increasing by 45, 39 and 30 per cent. respectively. In the European reporting countries the rate of expansion

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

| Lenders | Changes 1978 | 1979 | 1980 | Amounts outstanding 1980 |
|---|---|---|---|---|
| | in billions of US dollars | | | |
| Banks in European reporting countries[1] | +145.2 | +164.6 | +126.9 | 902.9 |
| *of which in foreign currency (Euro-currency market)* | *+117.2* | *+137.7* | *+111.5* | *751.2* |
| Banks in Canada and Japan | + 16.2 | + 15.1 | + 30.1 | 101.2 |
| Banks in the United States | + 38.2 | + 16.8 | + 40.9 | 176.9 |
| Branches of US banks in offshore centres[2] | + 15.4 | + 21.1 | + 14.5 | 142.1 |
| Total | +215.0 | +217.6 | +212.4 | 1,323.1 |
| minus: double-counting due to redepositing among the reporting banks | 105.0 | 87.6 | 67.4 | 513.1 |
| minus: exchange rate effects | 20.0 | 5.0 | − 20.0 | . |
| A = Net new international bank lending[3] | 90.0 | 125.0 | 165.0 | 810.0 |
| Euro-bond and foreign bond issues | 37.5 | 37.8 | 38.3 | . |
| minus: redemptions and repurchases[4] | 8.5 | 9.3 | 9.3 | . |
| B = Net new international bond financing | 29.0 | 28.5 | 29.0 | . |
| A+B = Total new bank and bond financing | 119.0 | 153.5 | 194.0 | . |
| minus: double-counting[5] | 6.0 | 7.5 | 8.0 | . |
| Total net new bank and bond financing | 113.0 | 146.0 | 186.0 | . |

[1] Austria, Belgium-Luxembourg, Denmark, France, Germany, Ireland, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. [2] Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [3] Computed at constant end-of-period exchange rates; 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.

of the banks' assets slowed down from 27 per cent. in 1979 to 16 per cent., and their share in total new external assets shrank from 76 to 60 per cent., this decline being, however, exaggerated by exchange rate effects. Relatively slow asset growth, of 11 per cent., was recorded by the branches of US banks in the offshore centres of the Caribbean and the Far East, but the external assets of other banks in offshore centres and of banks in offshore centres not covered by the BIS statistics seem to have continued to expand at a rapid pace, and in round figures may be estimated to have added about $40 billion to the $212 billion asset growth registered by the reporting banks.

**Main influences.**

The rapid growth in the volume of international bank credit last year once again occurred without a general tightening of market conditions. The very high short-term dollar interest rates that prevailed during parts of 1980 mainly reflected monetary developments in the United States and were not symptomatic of tightness in the international banking sector. Although some borrowers that were confronted with a sharp deterioration in their international payments position found the markets less receptive, banks actively continued their search for prime customers, and spreads charged to such borrowers remained at the low levels observed in the course of 1979, or even showed some further decline. There was no shortage of funds available for new lending, and the expansionary influences appear to have been at least as strong on the sources side of the international financial markets as they were on the uses side.

Looking first at the supply side, the most important expansionary factor was once again the large OPEC surplus, which showed a further increase of approximately $45 billion to an estimated $110 billion. Excluding the effects of movements in exchange rates, identified new deposits by OPEC countries with the reporting banks totalled $41.5 billion, $4.5 billion more than in 1979. The fact that this increase was very much smaller than the expansion in the OPEC surplus may have reflected not only a shift in the OPEC countries' own investment policies towards longer-term placements, but also concern on the part of the banks about excessive dependence on this source of funding.

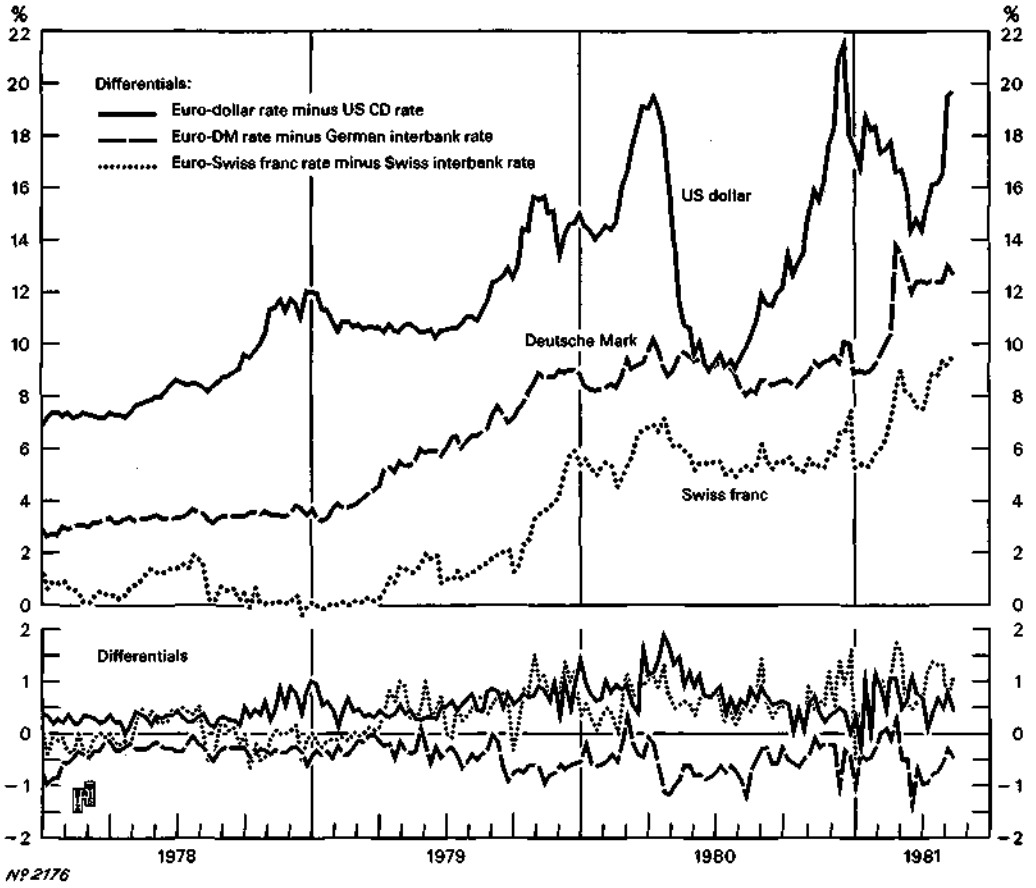
A second very important source of supply was banks in the United States, the growth of whose external assets accelerated from about $17 to 41 billion. Moreover, this increase coincided with a sharp slowdown in the growth of their external liabilities, so that banks in the United States, which had taken up a net total of $21 billion of external funds in 1979, were net capital exporters to the tune of $33 billion in 1980. There can be little doubt that this $54 billion turn-round, which was even larger than the increase in the OPEC surplus, was one of the principal reasons for the continued ease of the international financial markets last year and for the general absence of external financing problems in the rest of the non-OPEC world.

Thirdly, the high level of Euro-deposit rates, a further steepening of the inverted yield curves and the related uncertainties in the bond markets helped to maintain a large flow of non-bank funds to the international banking market.

Finally, the rapid growth of lending observed last year was made possible by the continued efforts of the large commercial banks to expand the international side of their business. The cyclical weakening of domestic credit demand and, in some countries, administrative restraints on the banks' domestic credit growth did act as incentives in this direction. But one important longer-term structural influence, already perceptible in preceding years, was the continued weak borrowing demand from their prime domestic corporate customers with which the large commercial banks of some of the major industrial countries were confronted in their home markets. A further expansionary influence in this context was the increasing presence in the international banking circuit of Arab banks with fresh capital resources.

**Interbank rates on three-month Euro-currency deposits and differentials over domestic rates.**

Wednesday figures, in percentages.




It is, of course, true that the developments surrounding the Iranian crisis, certain political events and the possible international financial implications of the 1979 oil price increases led at the beginning of 1980 to enhanced risk awareness on the part of the banks, particularly in the field of country risk exposure. But this resulted in increased selectivity rather than general retrenchment. Where it became more difficult to spread credit participations among a large number of smaller banks, the major banks had recourse to so-called "club loans" or to bilateral lending. And as regards the major banks themselves, reservations about further increases in their risk exposure vis-à-vis certain countries were balanced by the importance they attached to the business relationships built up with those customers. As regards official attitudes to the risks involved in further growth of the banks' international business, whereas supervisory authorities were concerned about the maintenance, or strengthening, of standards in the field of country risk exposure and gearing ratios, governments on some occasions solicited the participation of commercial banks in project or trade-related financing in the developing world.

On the uses side of the international financial markets, the OPEC payments surplus was the main factor in boosting demand for international bank credit,

through its effects on the balance-of-payments financing needs of the rest of the world. Over half of last year's overall current-account payments deficit of non-OPEC countries was concentrated on developed countries other than the United States. These countries, to the extent that they were not direct recipients of OPEC surplus funds, had, with few exceptions, very little difficulty in obtaining accommodation in the international financial markets. Moreover, a substantial fraction of total demand for international credit on the part of the private non-bank sectors in these countries was motivated by cost, availability and exchange rate considerations rather than being in any way related to balance-of-payments needs. Tighter domestic monetary policy stances and the volatility of interest rates provided borrowers in these countries with increased opportunities for arbitraging between the domestic and international credit sectors.

Non-oil developing countries, too, experienced a substantial increase in their balance-of-payments financing needs last year, and the statistics once again showed an acceleration in the reporting banks' new lending to these countries both for 1980 as a whole and during the course of the year. However, new credits were concentrated on a limited number of economically relatively advanced countries, with Mexico alone, which is by now a net oil exporter, accounting for 27 per cent. of the total. Moreover, in order to obtain financial accommodation, a number of developing countries had to accept credits on less favourable conditions, including higher spreads and shorter maturities, than in 1979. Furthermore, although total bank lending to non-oil developing countries was higher in 1980, there was a slowdown in the growth of publicised syndicated bank credits granted to them. This suggests that these countries had to have increased recourse to short-term financing and to bilateral and unpublicised borrowing, for which it was perhaps less difficult for them to agree to conditions more favourable to the lending banks. Moreover, whereas in 1979 borrowing from the international banking sector had allowed the non-OPEC developing countries to add $8 billion to their aggregate exchange reserves, several borrowing countries had to fall back on their reserves in 1980, and the developing countries' aggregate exchange reserves showed a $2 billion decline. Finally, whereas the published loan figures for 1979 had been substantially inflated by debt refinancing ahead of maturity on terms more favourable to the borrowers, this kind of market activity came to an end in 1980.

One factor that tended to keep down the effective demand, but not the need, for international bank credit last year was the exogenously determined high level of dollar interest rates. Unlike US corporations, sovereign borrowers have no taxable income from which to deduct their interest payments. Moreover, high interest rates are particularly painful when they begin to exceed the rate of increase in a country's own export prices and when, as was the case with the dollar last year, they go hand in hand with an appreciation of the currency in which the debt is denominated. There is strong evidence that the unusually sharp rise of dollar interest rates exerted a major contractive impact on international borrowing demand in the early months of 1980. By the fourth quarter of the year, however, when US interest rates once again reached record levels, international borrowers had probably started to feel that the period of low or, in some instances, negative real interest rates had come to an end and, with few alternatives available, they decided to bite on the bullet.

**Total international banking flows: Sources and uses.***

1980 was a year of heavy international bank lending to borrowers both inside and outside the reporting area. Of the total $212 billion increase in the banks' external assets, approximately $140 billion represented cross-border claims within the reporting area itself, with these being, as usual, strongly inflated by interbank deposits. Excluding the resultant double-counting, new lending within the reporting area may be estimated at around $80 billion in current dollar terms, or at $90 billion if exchange rate effects are excluded.

Roughly $40 billion of this adjusted total represented the banks' own use of external funds for domestic lending in local currency, while their direct credits to non-banks totalled about $50 billion. The largest non-bank borrowers of external funds within the reporting area were the German non-bank sector, which obtained $12 billion (after valuation adjustments) in the first nine months of the year before repaying $1.5 billion during the fourth quarter, Italian non-bank entities, which raised nearly $10 billion, and the non-bank sectors of Belgium, France, Japan, Sweden and the United States, which took between $4 and 5 billion each.

At $106 billion (excluding both exchange rate effects and double-counting), the reporting area's contribution to the growth of the international banking aggregates was even larger on the sources side of the market. Direct deposits by non-bank entities (including new funds flowing into the market via trustee accounts in Switzerland) amounted to about $45 billion, while the balance of over $60 billion was mainly accounted for by external lending in domestic currency by the reporting banks themselves. The largest component of such lending was a $40 billion increase in the external claims of banks in the United States. The United States was also the largest source of non-bank funds, US residents' deposits with reporting banks abroad having expanded by approximately $10 billion last year. This was considerably less than the $17 billion increase recorded in 1979 and, in contrast to that year, the bulk of these deposits was booked with the branches of US banks in the Caribbean.

Turning to the rest of the world, credits granted by the reporting banks to non-OPEC countries outside their own area (excluding the unallocated item) rose by approximately $55 billion last year, or by $62 billion if exchange rate effects are excluded. At $37.9 billion, or $40.5 billion on a valuation adjusted basis, new credits to developing countries reached their highest level yet. Since new deposits received by the banks from developing countries were sharply lower than in 1979, the net recourse of non-oil developing countries to the reporting banks, at $35 billion (excluding exchange rate effects), was nearly 50 per cent. higher than in 1979. Latin American countries alone borrowed $26.7 billion, or over two-thirds of total new credit to non-oil LDCs, while at the same time they reduced their deposits with the reporting banks by $2.1 billion. As regards individual borrowing countries, the largest takers of new funds were Mexico ($10.4 billion), Brazil ($6.5 billion) and Argentina ($5.8 billion). Mexico added $1.2 billion to its deposits with the

---

* In this section, unless otherwise specified, figures are not adjusted to exclude the valuation effects of movements in the exchange rates of the US dollar against other currencies.

**Geographical distribution of external positions of banks in the reporting area and of certain offshore branches of US banks.[1]**

| | 1978 | 1979 | | 1980 | | | |
|---|---|---|---|---|---|---|---|
| | Dec. | June | Dec. | March | June[2] | Sept. | Dec. |
| | in billions of US dollars | | | | | | |
| **Banks' claims on:** | | | | | | | |
| Group of Ten countries and Switzerland, Austria, Denmark and Ireland | 466.9 | 490.2 | 587.7 | 599.1 | 644.1 | 658.2 | 704.0 |
| *of which: Reporting European area* | *359.9* | *363.1* | *437.3* | *434.0* | *474.6* | *481.8* | *522.3* |
| *United States* | *53.0* | *70.8* | *81.9* | *89.9* | *87.0* | *88.9* | *89.1* |
| *Canada* | *15.9* | *16.8* | *19.2* | *19.6* | *21.8* | *22.6* | *23.5* |
| *Japan* | *38.1* | *39.5* | *49.3* | *55.6* | *60.7* | *64.9* | *69.1* |
| Offshore banking centres[3] | 123.5 | 132.9 | 155.6 | 157.4 | 168.8 | 179.2 | 187.5 |
| Other countries in western Europe | 50.4 | 52.4 | 58.7 | 59.0 | 65.2 | 67.1 | 70.1 |
| Australia, New Zealand and South Africa | 13.5 | 13.8 | 13.7 | 12.8 | 14.5 | 14.7 | 15.5 |
| Eastern Europe | 47.5 | 49.5 | 55.9 | 53.3 | 57.6 | 58.1 | 59.8 |
| OPEC countries[4] | 56.4 | 57.7 | 64.1 | 59.9 | 63.2 | 66.0 | 70.0 |
| Other developing countries | 120.8 | 135.8 | 157.1 | 158.1 | 172.3 | 183.6 | 195.0 |
| *of which: Latin America[5]* | *79.9* | *88.4* | *103.5* | *105.5* | *114.1* | *122.3* | *130.2* |
| *Middle East* | *6.5* | *7.3* | *8.2* | *7.4* | *8.3* | *8.7* | *9.8* |
| *Other Asia* | *23.1* | *28.2* | *31.1* | *30.9* | *34.7* | *36.7* | *38.9* |
| *Other Africa* | *11.3* | *11.9* | *14.3* | *14.3* | *15.2* | *15.9* | *16.1* |
| Unallocated[6] | 14.1 | 14.2 | 17.9 | 17.8 | 20.3 | 21.0 | 21.2 |
| Total | 893.1 | 946.5 | 1,110.7 | 1,117.4 | 1,206.0 | 1,247.9 | 1,323.1 |
| **Banks' liabilities to:** | | | | | | | |
| Group of Ten countries and Switzerland, Austria, Denmark and Ireland | 533.5 | 576.6 | 685.7 | 694.0 | 760.1 | 763.7 | 823.7 |
| *of which: Reporting European area* | *404.4* | *436.0* | *528.1* | *524.7* | *565.9* | *569.0* | *613.5* |
| *United States* | *101.9* | *110.1* | *123.8* | *128.0* | *144.1* | *148.0* | *160.1* |
| *Canada* | *15.7* | *17.2* | *17.8* | *21.0* | *20.8* | *23.3* | *23.1* |
| *Japan* | *11.5* | *13.3* | *16.0* | *20.3* | *19.3* | *23.4* | *27.0* |
| Offshore banking centres[3] | 96.9 | 115.4 | 139.2 | 143.4 | 145.5 | 155.0 | 164.6 |
| Other countries in western Europe | 35.4 | 37.8 | 42.5 | 39.2 | 42.8 | 45.0 | 46.3 |
| Australia, New Zealand and South Africa | 2.7 | 3.6 | 3.6 | 3.7 | 3.7 | 4.3 | 3.8 |
| Eastern Europe | 10.6 | 9.9 | 15.4 | 12.7 | 12.6 | 13.5 | 15.6 |
| OPEC countries[4] | 82.5 | 87.3 | 120.3 | 129.6 | 145.7 | 155.8 | 159.7 |
| Other developing countries | 76.6 | 83.4 | 89.6 | 87.2 | 92.3 | 92.9 | 92.7 |
| *of which: Latin America[5]* | *33.2* | *35.4* | *38.4* | *36.2* | *35.6* | *35.4* | *36.3* |
| *Middle East* | *13.8* | *15.2* | *15.9* | *16.2* | *18.2* | *18.1* | *18.9* |
| *Other Asia* | *22.2* | *25.1* | *26.0* | *25.3* | *28.0* | *29.3* | *27.5* |
| *Other Africa* | *7.4* | *7.7* | *9.3* | *9.5* | *10.5* | *10.1* | *10.0* |
| Unallocated[6] | 18.1 | 19.5 | 23.0 | 26.7 | 30.6 | 29.6 | 28.2 |
| Total | 856.3 | 933.5 | 1,119.3 | 1,136.5 | 1,223.3 | 1,259.8 | 1,334.6 |

Note: The figures in this table are partly based on estimates. 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.

[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] Including for the first time the external positions in domestic currency of banks in Ireland. At the end of June 1980 these amounted to $0.1 billion on the claims side and $1.8 billion on the liabilities side. The bulk of these positions were vis-à-vis the other reporting European countries. [3] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, Panama, Singapore, Vanuaatu (formerly New Hebrides) and other British West Indies. [4] Includes, in addition, Bahrain, Brunei, Oman, Trinidad and Tobago. [5] Including those countries in the Caribbean area which cannot be considered as offshore banking centres. [6] Including international institutions other than the BIS.

reporting banks, while Brazil and Argentina drew down their deposits by $3.3 billion and $1.1 billion respectively. Assets and liabilities vis-à-vis developing countries outside Latin America rose by $11.2 and 5.2 billion respectively, which means that considered as a group such countries were relatively modest net takers of

new funds. Countries in the Far East alone accounted for 70 per cent. of the gross borrowings and their net indebtedness increased by $6.3 billion. Non-OPEC countries in the Middle East, by contrast, were net depositors, and countries in "Other Africa" borrowed only $1.8 billion gross or $1.1 billion on a net basis.

Developed countries outside the reporting area stepped up their new recourse to international bank credit by $4.7 to 13.2 billion. Excluding exchange rate effects, new borrowings were twice as large as in 1979, and, whereas in that year these countries' new deposits had equalled their new borrowings, in 1980 this group became net takers of new funds to the extent of nearly $10 billion. The largest individual borrowers were Spain ($2.6 billion), Yugoslavia ($2.1 billion), Greece ($1.9 billion), Australia and Portugal ($1.3 billion each). Greece and, to a lesser extent, Yugoslavia also added substantially to their deposits with the reporting banks.

Eastern European countries obtained $3.9 billion in new credits from the reporting banks in 1980, or $6.5 billion if exchange rate effects are excluded. This was less than in 1979, but since they sharply scaled down their new deposits with the reporting banks, their net takings, at $5.5 billion on a valuation adjusted basis, were much larger than in the preceding year. The largest borrowers, both gross and net, were the German Democratic Republic and Rumania. Poland seems to have added only moderately to its gross indebtedness, but at the same time drew down its deposits with the reporting banks from $1.1 to 0.6 billion.

Turning finally to the OPEC countries, the growth of their deposits with the reporting banks accelerated further, from $37.8 billion in 1979 to $39.4 billion, or from $37 to 41.5 billion if exchange rate effects are excluded. At the same time their recourse to international bank credit slowed down somewhat. This meant that the net supply of new funds by OPEC countries to the reporting banks on a valuation adjusted basis was $6 billion larger in 1980 than in 1979, though this was considerably less than the increase in the banks' net new lending to the rest of the world outside the reporting area. Moreover, the OPEC countries' rôle as net suppliers of new funds to the reporting banks diminished considerably in the course of the year. Excluding exchange rate effects, in the first quarter of 1980 new deposits by OPEC countries amounted to $12.4 billion, whereas by the fourth quarter they were down to $6.4 billion. At the same time, while the OPEC countries reduced their gross indebtedness to the reporting banks by $2.8 billion in the first quarter, in the fourth quarter they were borrowers, for a total of $5 billion. In other words, after having been the principal source of new funds during the early months of 1980, the oil-exporting countries played only a very insignificant rôle as net depositors in the fourth quarter.

Although the bulk of OPEC funds, viz. $30 billion (excluding, as all figures in this paragraph, exchange rate effects), was once again deposited in the narrowly defined Euro-currency market, its geographical deployment was in some ways quite different from that witnessed in 1979. For one thing, whereas in 1979 identified OPEC deposits with banks in the United States and their branches in offshore centres had increased by $6.5 billion, in 1980 they declined by $1.3 billion. Secondly, OPEC deposits with banks in national markets outside the United States

increased by more than three times as much as in 1979, by $7.5 billion. This development largely reflected the lowering of barriers against capital inflows in Japan, Germany and Switzerland. The 1980 deployment pattern of OPEC deposits also had certain implications for their currency denomination. Although within the narrowly defined Euro-market the dollar portion of new OPEC deposits increased, the dollar's share in total new OPEC deposits declined from 72 per cent. in 1979 to 69 per cent. last year, despite the dollar's strength in the exchange market. There was, however, a substantial flow of OPEC funds into Japanese yen and sterling, two currencies which appreciated against the dollar in the course of 1980. Moreover, the currency composition of OPEC deposits changed considerably in the course of the year, and in the fourth quarter, when the dollar was particularly strong, virtually all new OPEC deposits were dollar-denominated.

**The rôle of the international banking sector in the recycling process: Retrospective and forward analysis.**

The table on the next page presents a longer-range view, covering the years 1974–80, of the rôle of the reporting banks as a deposit outlet and a source of credit for the principal groups of countries outside their own area. The flow figures in the table cannot be directly derived from the stock figures in the table on page 105 because they have been adjusted to exclude the effects of movements in exchange rates. It may be added that the figures in the table understate the rôle of the reporting banks as recipients of OPEC funds, since they do not include OPEC balances, both official and private, that have flowed into the market via trustee accounts at Swiss banks, or via non-reporting banks in offshore centres outside the Middle East.

As regards the rôle of the banks in recycling OPEC surpluses, in 1974, the year immediately following the first oil price explosion, new identified OPEC deposits with the reporting banks amounted to 40 per cent. of the combined OPEC current-account surplus, but in the following two years this share declined to about 24 per cent. Since this decline coincided with a sharp contraction in the OPEC surplus itself, OPEC countries very quickly lost their dominant position as suppliers of new funds to the reporting banks. If account is taken of their borrowing from the banks, the decline in the importance of OPEC countries as a source of new funds from 1975 onwards is even more pronounced. Whereas in 1974 the net supply of funds from OPEC countries to the reporting banks covered the whole of the banks' net lending to other countries outside the reporting area, in 1975–76 it financed only 13 per cent. of it. And in 1978, when their aggregate current-account surplus was temporarily wiped out, the OPEC countries were the largest net takers of funds from the banks.

Their place as the principal net suppliers of funds to the reporting banks was, from 1975 onwards, taken by the main industrial countries. This can be seen from the net deposit totals given at the bottom of the table, which, with the signs reversed, show the position of the reporting countries themselves with the rest of the world. Thus, in the period following the first oil price increase, only in 1974 were the reporting countries, via the international banking sector, net takers of funds

**Estimated flows between the BIS reporting banks[1] and groups of countries outside the reporting area, 1974–80.**

| Items | Stocks at end-1973 | Flows[2] | | | | | | | Stocks at end-1980 |
|---|---|---|---|---|---|---|---|---|---|
| | | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | |
| | in billions of US dollars at constant end-of-period exchange rates | | | | | | | | |
| OPEC countries[3] | | | | | | | | | |
| Gross deposits | 16.0 | 26.5 | 7.5 | 12.5 | 12.5 | 3.5 | 37.0 | 41.5 | 159.7 |
| Gross borrowings | 6.5 | 2.5 | 5.0 | 9.5 | 11.0 | 17.5 | 7.5 | 6.0 | 70.0 |
| Net deposits[4] | 9.5 | 24.0 | 2.5 | 3.0 | 1.5 | −14.0 | 29.5 | 35.5 | 89.7 |
| *Memorandum items:* | | | | | | | | | |
| *Foreign exchange reserves[5]* | *12.6* | *31.1* | *7.3* | *8.0* | *10.6* | *−14.5* | *15.4* | *19.8* | *90.3* |
| *Current-account balances* | . | *66.0* | *31.0* | *37.0* | *27.0* | *− 2.0* | *66.0* | *110.0* | . |
| Other LDCs[6] | | | | | | | | | |
| Gross deposits | 27.5 | 4.0 | 4.0 | 11.5 | 12.0 | 14.0 | 12.0 | 5.5 | 92.7 |
| Gross borrowings | 32.0 | 15.0 | 15.0 | 16.5 | 10.5 | 22.5 | 35.5 | 40.5 | 195.0 |
| Net deposits[4] | − 4.5 | −11.0 | −11.0 | − 5.0 | 1.5 | − 8.5 | −23.5 | −35.0 | −102.3 |
| *Memorandum items:* | | | | | | | | | |
| *Foreign exchange reserves[5]* | *21.2* | *0.6* | *− 1.3* | *10.6* | *10.0* | *11.9* | *7.8* | *− 1.9* | *58.9* |
| *Current-account balances* | . | *−24.0* | *−31.0* | *−20.0* | *−13.0* | *−24.0* | *−40.0* | *−61.0* | . |
| Developed countries[7] | | | | | | | | | |
| Gross deposits | 27.0 | 0.5 | 5.5 | 1.5 | 4.5 | 8.5 | 7.5 | 5.5 | 50.1 |
| Gross borrowings | 23.0 | 7.5 | 10.0 | 12.5 | 12.5 | 5.5 | 7.5 | 15.0 | 85.6 |
| Net deposits[4] | 4.0 | − 7.0 | − 4.5 | −11.0 | − 8.0 | 3.0 | − | − 9.5 | − 35.5 |
| *Memorandum items:* | | | | | | | | | |
| *Foreign exchange reserves[5]* | *23.5* | *− 2.1* | *− 1.4* | *0.4* | *1.7* | *6.4* | *3.1* | *1.5* | *26.7* |
| *Current-account balances* | . | *−17.0* | *−19.0* | *−21.0* | *−22.0* | *− 7.0* | *− 6.0* | *−14.0* | . |
| Eastern Europe | | | | | | | | | |
| Gross deposits | 4.5 | 1.5 | 0.5 | 1.0 | − | 2.0 | 4.5 | 1.0 | 15.6 |
| Gross borrowings | 9.5 | 3.5 | 8.5 | 6.5 | 2.0 | 5.5 | 7.0 | 6.5 | 59.8 |
| Net deposits[4] | − 5.0 | − 2.0 | − 8.0 | − 5.5 | − 2.0 | − 3.5 | − 2.5 | − 5.5 | − 44.2 |
| *Memorandum item:* | | | | | | | | | |
| *Trade balances[8]* | . | *− 2.0* | *− 9.0* | *− 7.0* | *− 1.0* | *− 4.0* | *3.0* | *5.0* | . |
| Unallocated[9] | | | | | | | | | |
| Gross deposits | 7.5 | 2.5 | 4.5 | 3.0 | 5.5 | 5.0 | 7.5 | 5.0 | 40.0 |
| Gross borrowings | 4.5 | 1.5 | 4.0 | 1.5 | 3.0 | 7.0 | 6.0 | 5.0 | 33.0 |
| Net deposits[4] | 3.0 | 1.0 | 0.5 | 1.5 | 2.5 | − 2.0 | 1.5 | − | 7.0 |
| Total | | | | | | | | | |
| Gross deposits | 82.5 | 35.0 | 22.0 | 29.5 | 34.5 | 33.0 | 68.5 | 58.5 | 358.1 |
| Gross borrowings | 75.5 | 30.0 | 42.5 | 46.5 | 39.0 | 58.0 | 63.5 | 73.0 | 443.4 |
| Net deposits[4] | 7.0 | 5.0 | −20.5 | −17.0 | − 4.5 | −25.0 | 5.0 | −14.5 | − 85.3 |

[1] Up to 1977 the BIS reporting banks covered Belgium-Luxembourg, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and the branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. Thereafter they also covered Austria, Denmark and Ireland, as well as certain trade-related items in domestic currency for banks in France and the United Kingdom not included before. [2] The total of the flow figures shown for each of the years under consideration may not necessarily be equal to the difference between the amounts outstanding at the beginning and the end of the whole period, as a result both of breaks in the series and of the method used for the calculation of flow figures. [3] Includes, in addition, Bahrain, Brunei, Oman and Trinidad and Tobago. [4] A minus sign (−) equals net borrowing. [5] At current exchange rates. [6] Excludes offshore centres. [7] Including up to 1977 Austria, Denmark and Ireland, which are thereafter considered as part of the reporting area. [8] Exports and imports f.o.b. [9] Includes non-reporting offshore centres (Barbados, Bermuda, other British West Indies, Lebanon, Liberia, Netherlands Antilles and Vanuatu (formerly New Hebrides) and international institutions other than the BIS.

from the rest of the world. By the following year they had resumed their rôle as net lenders for an amount of $20.5 billion, which was eight times the net supply of funds to the reporting banks from the OPEC countries.

Coming to the more recent period of renewed major increases in oil prices, and bearing in mind that this time the price increases were spread over a longer period

than in 1973, developments have been in several respects similar to those immediately after 1973. In 1979 identified OPEC deposits with the reporting banks amounted to 56 per cent. of the OPEC surplus and, as in 1974, the net supply of new OPEC funds to these banks more than covered their net new lending to other groups of countries outside the reporting area. In 1980 the proportion of the OPEC surplus deposited with the banks was down to 38 per cent. Moreover, as already explained on page 106 above, the growth of OPEC deposits slowed down in the course of the year, while their new borrowing from the banks increased, so that by the fourth quarter of 1980 the reporting countries had again replaced the OPEC members as the main net source of new funds to the banks. The fourth-quarter figures may, to some extent, be a statistical quirk and present an exaggerated picture. Nevertheless, particularly if the real price of oil and the OPEC surplus should show a significant decline in 1981, it is quite possible that the reporting area will continue to act as the main net source of funds for lending to non-OPEC countries outside the reporting area.

At the same time, some of the major reporting countries have remained large-scale recipients of OPEC funds through non-banking channels. By acting as net exporters of funds from these countries to the rest of the oil-importing world, the banks therefore still perform a kind of indirect recycling of OPEC funds. Such indirect recycling, in which the sources side of the banks' balance sheets is made up of deposits from residents of their own countries rather than from OPEC members, may imply less of a funding and liquidity risk, but the country risk exposure which the banks undertake is, of course, the same as when they recycle OPEC funds directly.

On the uses side of the reporting banks' balance sheets, the table on page 108 shows that after the first wave of oil price increases the borrowing needs of the oil-importing countries proved to be more protracted than the OPEC surpluses. While the overall OPEC surplus shrank from $66 billion in 1974 to an average of $34 billion in the following two years, the banks' lending to non-OPEC countries outside the reporting area (including the unallocated item) accelerated further from $27.5 to 37 billion, before slowing down to $28 billion in 1977. One reason for this development was that these countries' balances of payments were adversely affected not only by the higher cost of their oil imports but also by economic slack in the major countries of the industrial world. Many of the developing and smaller developed countries tried to ride out the recession in the large industrial countries by maintaining a relatively high level of domestic demand and financing their resultant payments deficits in the international financial markets. However, when the economic trough in the industrial countries proved to be deeper and more persistent than expected, and financing problems started to loom on the horizon, non-OPEC countries outside the reporting area began to adopt restrictive domestic policies, in many cases with considerable success. As a result, the combined current-account deficit of the non-OPEC developing countries shrank from about $31 billion in 1975 to $13 billion in 1977. The payments deficits of the developed countries outside the reporting area proved to be more stubborn, but a decisive improvement occurred in 1978. A second reason for the continued high level of borrowing by non-OPEC countries from the reporting banks was that, as their external deficits

declined, they took advantage of the borrowers' market for international banking funds which emerged in 1976 to build up their official reserves, the real value of which had been depleted after the 1973 oil price increases. In 1977 non-oil developing countries, and in 1978 the group of developed countries outside the reporting area, temporarily became net suppliers of new funds to the reporting banks.

Before the results of the various adjustment efforts, the inflation of dollar prices and economic growth could go very far towards reducing the real debt burdens accumulated in the aftermath of the first oil price explosion, the renewed upsurge in oil prices in the course of 1979 and 1980 led to another sharp increase in oil-importing countries' indebtedness vis-à-vis the international banking sector. Outside the reporting area the increase in external financing requirements was this time particularly heavily concentrated on the non-OPEC developing countries. Once again, the increase in these countries' indebtedness to banks abroad by far outpaced the growth in their domestic economies and in the lending banks' own balance sheets. Thus, in the two years up to the end of 1980 the banking indebtedness of these countries rose by 64 per cent. and, allowing for their deposit build-up with the reporting banks, their net debtor position, which had already jumped from $5 to 32 billion in the three years after the first oil price surge, soared from $44 billion at the end of 1978 to $102 billion two years later. Moreover, the impact of this sharp expansion in net indebtedness on countries' debt service burdens was compounded by the dramatic rise in interest rate levels that has occurred over the past three years.

Over the whole period from 1974 to 1980 inclusive, the cumulative effect of the net flows of funds through the reporting banks to the rest of the world may be summarised as follows: the non-oil developing countries' net indebtedness to the banks increased by $92.5 billion, an amount equal to just under half their cumulative current-account deficit of some $210 billion during this period, while their gross borrowing totalled $155 billion; the developed countries outside the reporting area borrowed, on a net basis, $37 billion, and, on a gross basis, $70 billion, which compared with their cumulative current-account deficit of some $105 billion; and the eastern European countries' net borrowings from the banks totalled $29 billion, which was nearly twice their cumulative trade deficit over the period. The reporting banks' total net lending to these three groups of countries amounted to $158.5 billion, of which $82 billion came from the OPEC countries.

The demand for international credit is likely to remain strong in the years to come, not only so long as the present phase of large OPEC payments surpluses persists but also, if past experience is any guide, beyond it. There seems little likelihood that international flows of non-bank capital could in future take over the leading rôle hitherto played by the banks, although every effort should certainly be made to increase flows through other channels, especially direct investment. Clearly, therefore, a considerable further increase in the reporting banks' lending to non-OPEC countries outside the reporting area will be needed.

Equally clearly, the conditions for a further large increase in international bank lending, particularly to non-oil developing countries, are now less favourable than

they were in 1974, and the attendant risks for the banks are greater. The banks' exposure vis-à-vis some individual countries has reached levels that are high in relation to their own funds; in many instances their capital base is weaker than it was in the mid-1970s; and certain measures now being taken by the banking regulatory authorities, notably the spread of banking supervision on the basis of worldwide consolidated accounts, may somewhat limit the scope for further growth of international bank lending. Furthermore, it cannot be assumed that the OPEC payments surplus will, in the years to come, be reduced as rapidly as it was after 1974 or, therefore, that resumed economic growth in the main industrial countries will enable the non-oil developing countries to achieve a rate of export growth commensurate with their import and debt service needs. In this situation, appropriate action is called for by the international financial community as a whole, by certain deficit countries and by the banks themselves in order to assure a continuation of adequate recycling through the international banking system.

So far as the rôle of the international financial community is concerned, the most important need is to maintain and develop the enlarged rôle which the International Monetary Fund began to play last year, after a period in which member countries' net recourse to its facilities had been declining, in official international financing and in the balance-of-payments adjustment process. On the financing side, the borrowing arrangements recently concluded by the Fund with Saudi Arabia and with the central banks of thirteen developed countries are an encouraging development, which will need to be followed up in due course by a further general increase in Fund quotas. On the adjustment side, the Fund has already recognised the need for new kinds of conditionality, designed to place more emphasis on bringing about structural changes in member countries' economies. These new policies, however, will by no means dispense with the need for the Fund to apply its traditional macro-economic conditionality.

The Fund's traditional policies of conditionality will indeed be an important element in the second type of action that will be called for if the banks are to make an optimum contribution to future balance-of-payments financing, namely the avoidance by individual deficit countries of unduly protracted situations of external disequilibrium. It is essential, in a situation where the demands made on the banks for balance-of-payments financing are, in any case, likely to continue to be very substantial, that countries in receipt of external financing should, where this is necessary, adopt appropriate adjustment policies so that the banks' international risk exposure is, over time, spread as widely as possible.

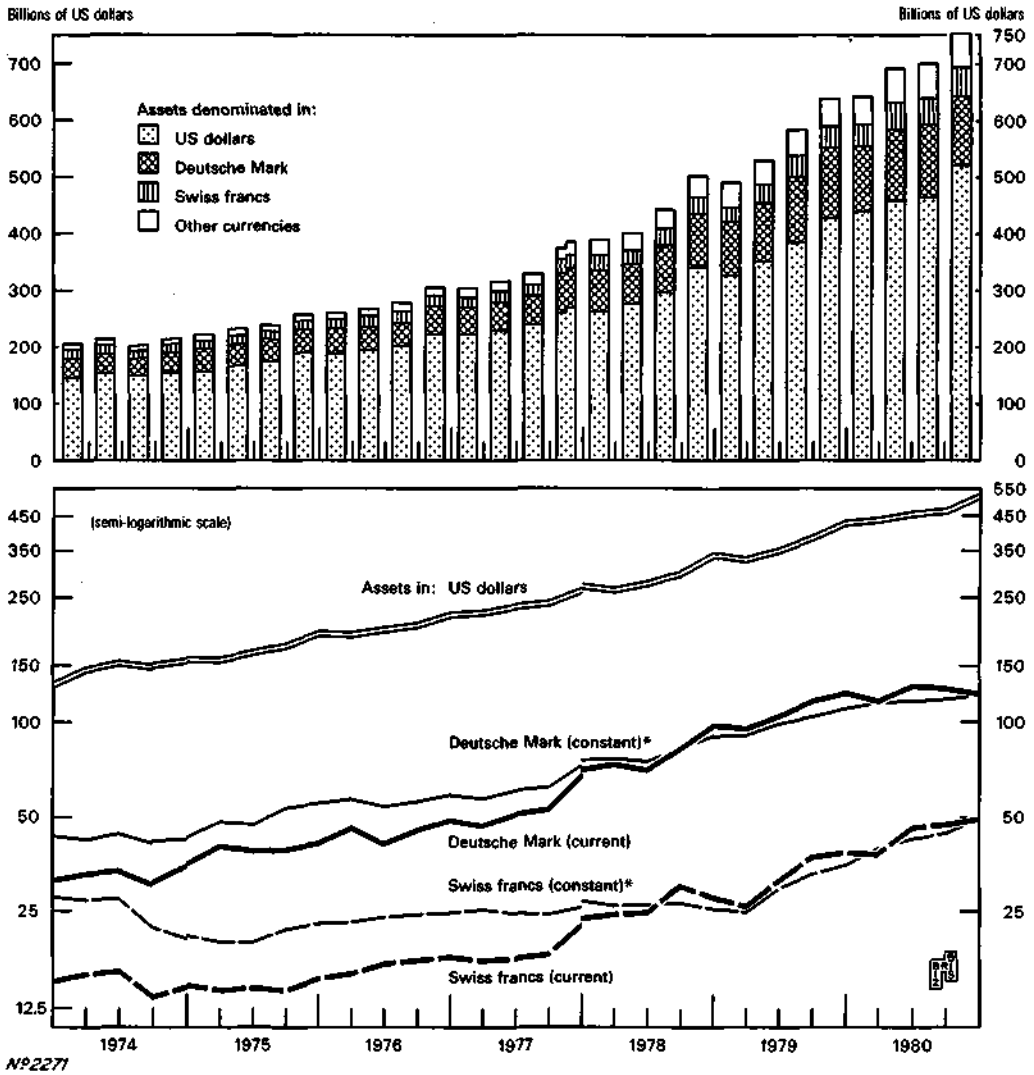
Lastly, the banks themselves will need to avoid lending policies that aggravate payments imbalances. It is, of course, not the banks' business to make conditional loans of the kind which the IMF exists to provide. But instances have occurred in the past where the banks clearly overlent to certain countries whose payments deficits were obviously unsustainable.

Given action along the lines outlined above, there is reason to believe that the banks can continue to play a major rôle in international lending without problems arising that would undermine the functioning of the adjustment process and the soundness of international financial markets.

**Developments in European market centres.**

In 1980 the dollar value of the total external assets of banks in the reporting European countries rose by $127 billion, or 16 per cent., to a total of $903 billion. This was considerably less than the $165 billion increase recorded in 1979. However, the 1980 figure was reduced to the extent of $32 billion by the impact of the dollar's appreciation on the dollar value of the banks' assets in currencies such as the Deutsche Mark and the Swiss franc, whereas in 1979 exchange rate effects had amplified the growth figures by $12 billion. Moreover, much of the slowdown in the unadjusted figures was due to the less rapid growth of interbank positions within the reporting area itself.

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




* At constant end-December 1980 exchange rates.

## Currency breakdown of foreign currency positions of reporting European banks.

| End of month | Dollars | | Other foreign currencies | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | *of which vis-à-vis non-banks* | Total | *of which* | | | | | |
| | | | | *vis-à-vis non-banks* | Deutsche Mark | Swiss francs | Pounds sterling | Dutch guilders | French francs |
| | in millions of US dollars | | | | | | | | |
| **Assets** | | | | | | | | | |
| 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* | 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 | 86,570 | 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. | 427,960 | 104,320 | 211,770 | 52,140 | 124,430 | 38,660 | 11,140 | 8,470 | 7,820 |
| 1980 March | 438,960 | 108,630 | 204,220 | 54,230 | 115,710 | 38,010 | 11,590 | 7,810 | 8,500 |
| June | 456,730 | 118,310 | 234,750 | 62,950 | 129,830 | 46,240 | 13,650 | 8,680 | 9,140 |
| Sept. | 465,620 | 122,540 | 234,710 | 67,020 | 127,430 | 47,230 | 13,440 | 8,040 | 10,450 |
| Dec. | 518,730 | 129,080 | 232,510 | 64,420 | 122,930 | 49,620 | 12,970 | 7,430 | 11,550 |
| *Memorandum item* | | | | | | | | | |
| *Positions vis-à-vis residents* | | | | | | | | | |
| *1976 Dec.* | *74,740* | *21,330* | *26,920* | *7,560* | . | . | . | . | . |
| *1977 Dec. I* | *92,810* | *30,240* | *34,220* | *9,850* | . | . | . | . | . |
| *Dec. II** | *93,510* | *30,560* | *35,710* | *10,640* | . | . | . | . | . |
| *1978 Dec.* | *106,530* | *32,690* | *49,550* | *13,500* | . | . | . | . | . |
| *1979 Dec.* | *126,570* | *34,850* | *69,610* | *20,270* | . | . | . | . | . |
| *1980 March* | *137,280* | *36,780* | *73,120* | *22,710* | . | . | . | . | . |
| *June* | *148,680* | *40,610* | *81,990* | *27,780* | . | . | . | . | . |
| *Sept.* | *156,010* | *41,570* | *81,830* | *27,690* | . | . | . | . | . |
| *Dec.* | *169,560* | *42,200* | *85,400* | *29,860* | . | . | . | . | . |
| **Liabilities** | | | | | | | | | |
| 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* | 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 | 93,060 | 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. | 436,630 | 64,190 | 229,200 | 22,480 | 127,940 | 40,710 | 15,180 | 8,810 | 11,370 |
| 1980 March | 450,050 | 68,680 | 225,990 | 23,500 | 118,250 | 41,680 | 19,350 | 8,210 | 11,450 |
| June | 474,000 | 71,380 | 254,490 | 26,860 | 133,000 | 49,240 | 22,930 | 9,440 | 12,610 |
| Sept. | 486,110 | 74,410 | 255,760 | 26,410 | 130,470 | 51,690 | 23,070 | 8,860 | 13,430 |
| Dec. | 548,360 | 83,900 | 252,140 | 27,480 | 125,260 | 51,620 | 23,820 | 8,300 | 14,470 |
| *Memorandum item* | | | | | | | | | |
| *Positions vis-à-vis residents* | | | | | | | | | |
| *1976 Dec.* | *64,060* | *10,660* | *23,710* | *4,290* | . | . | . | . | . |
| *1977 Dec. I* | *74,620* | *12,080* | *29,590* | *5,330* | . | . | . | . | . |
| *Dec. II** | *75,310* | *12,280* | *30,400* | *5,460* | . | . | . | . | . |
| *1978 Dec.* | *87,690* | *14,690* | *45,060* | *7,440* | . | . | . | . | . |
| *1979 Dec.* | *108,910* | *17,180* | *63,940* | *9,280* | . | . | . | . | . |
| *1980 March* | *117,850* | *18,000* | *61,580* | *9,860* | . | . | . | . | . |
| *June* | *124,710* | *19,290* | *68,680* | *10,980* | . | . | . | . | . |
| *Sept.* | *132,650* | *18,990* | *66,120* | *10,960* | . | . | . | . | . |
| *Dec.* | *148,100* | *20,480* | *66,570* | *10,240* | . | . | . | . | . |

* From December II 1977 onwards includes the positions of banks in Austria, Denmark and Ireland.

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

| | | | 1978 Dec. | 1979 Dec. | 1980 March | 1980 June | 1980 Sept. | 1980 Dec. |
|---|---|---|---|---|---|---|---|---|
| | | | in millions of US dollars | | | | | |
| Austria | Assets | Domestic currency | 2,930 | 4,160 | 4,040 | 4,690 | 4,880 | 4,840 |
| | | US dollars | 4,460 | 6,610 | 7,030 | 6,850 | 7,290 | 7,220 |
| | | Other foreign currencies | 5,120 | 7,130 | 6,690 | 7,650 | 7,680 | 7,790 |
| | Liabilities | Domestic currency | 830 | 1,090 | 980 | 1,280 | 1,310 | 1,360 |
| | | US dollars | 5,300 | 6,870 | 6,820 | 7,150 | 8,010 | 8,010 |
| | | Other foreign currencies | 7,490 | 11,040 | 10,820 | 12,760 | 13,430 | 14,040 |
| Belgium | Assets | Domestic currency | 2,800 | 3,330 | 3,290 | 3,830 | 3,360 | 3,280 |
| | | US dollars | 18,550 | 23,310 | 25,220 | 28,860 | 30,700 | 33,430 |
| | | Other foreign currencies | 13,230 | 16,380 | 16,710 | 20,030 | 19,520 | 18,930 |
| | Liabilities | Domestic currency | 4,730 | 6,590 | 5,880 | 8,190 | 8,280 | 8,000 |
| | | US dollars | 18,040 | 22,200 | 23,450 | 26,970 | 29,500 | 32,940 |
| | | Other foreign currencies | 15,500 | 21,350 | 22,430 | 26,160 | 26,200 | 24,990 |
| Luxembourg | Assets | Domestic currency | 1,050 | 1,400 | 1,550 | 1,540 | 1,540 | 1,330 |
| | | US dollars | 22,040 | 29,300 | 28,550 | 31,460 | 32,710 | 33,620 |
| | | Other foreign currencies | 36,300 | 50,100 | 48,890 | 56,290 | 56,250 | 53,690 |
| | Liabilities | Domestic currency | 730 | 1,030 | 980 | 1,200 | 1,210 | 1,130 |
| | | US dollars | 24,400 | 32,950 | 33,380 | 36,310 | 36,900 | 38,000 |
| | | Other foreign currencies | 30,080 | 42,680 | 41,710 | 48,720 | 48,950 | 45,500 |
| Denmark | Assets | Domestic currency | 90 | 150 | 180 | 200 | 170 | 220 |
| | | US dollars | 1,640 | 1,860 | 1,800 | 1,860 | 1,970 | 2,140 |
| | | Other foreign currencies | 1,200 | 1,960 | 1,750 | 1,660 | 1,500 | 1,500 |
| | Liabilities | Domestic currency | 390 | 410 | 360 | 390 | 420 | 510 |
| | | US dollars | 1,500 | 1,900 | 1,640 | 1,580 | 1,640 | 1,960 |
| | | Other foreign currencies | 860 | 1,420 | 1,360 | 1,540 | 1,480 | 1,360 |
| France | Assets | Domestic currency | 18,200 | 23,180 | 21,460 | 25,060 | 25,350 | 24,430 |
| | | US dollars | 60,210 | 71,740 | 70,180 | 71,660 | 73,080 | 87,690 |
| | | Other foreign currencies | 20,570 | 28,700 | 25,500 | 29,300 | 30,600 | 31,080 |
| | Liabilities | Domestic currency | 5,700 | 6,610 | 7,340 | 8,690 | 9,420 | 8,610 |
| | | US dollars | 53,160 | 61,100 | 58,460 | 62,530 | 66,250 | 81,450 |
| | | Other foreign currencies | 25,630 | 38,500 | 36,350 | 39,640 | 39,570 | 40,250 |
| Germany | Assets | Domestic currency | 40,340 | 47,620 | 45,630 | 51,490 | 49,820 | 51,820 |
| | | US dollars | 14,720 | 14,360 | 12,920 | 14,110 | 14,020 | 14,190 |
| | | Other foreign currencies | 6,050 | 7,350 | 6,930 | 7,850 | 7,630 | 7,320 |
| | Liabilities | Domestic currency | 40,220 | 54,330 | 46,500 | 53,530 | 52,190 | 50,690 |
| | | US dollars | 14,510 | 16,430 | 14,070 | 15,350 | 17,140 | 16,790 |
| | | Other foreign currencies | 4,370 | 7,000 | 7,740 | 8,150 | 7,680 | 6,710 |
| Ireland | Assets | Domestic currency | . | . | . | 100 | 130 | 140 |
| | | US dollars | 400 | 360 | 280 | 380 | 390 | 540 |
| | | Other foreign currencies | 1,110 | 1,090 | 1,090 | 1,580 | 1,590 | 1,440 |
| | Liabilities | Domestic currency | . | . | . | 1,800 | 1,900 | 1,940 |
| | | US dollars | 550 | 740 | 620 | 660 | 690 | 740 |
| | | Other foreign currencies | 1,260 | 1,260 | 1,400 | 2,390 | 2,430 | 2,450 |
| Italy | Assets | Domestic currency | 590 | 1,320 | 900 | 740 | 1,170 | 1,000 |
| | | US dollars | 17,380 | 21,190 | 14,890 | 14,550 | 13,000 | 23,250 |
| | | Other foreign currencies | 4,780 | 7,130 | 6,150 | 6,900 | 6,190 | 6,440 |
| | Liabilities | Domestic currency | 2,010 | 2,900 | 2,610 | 2,760 | 2,730 | 2,900 |
| | | US dollars | 21,840 | 25,400 | 20,160 | 20,000 | 19,460 | 31,740 |
| | | Other foreign currencies | 5,960 | 9,850 | 10,010 | 10,900 | 10,480 | 11,880 |
| Netherlands | Assets | Domestic currency | 8,490 | 11,390 | 10,220 | 11,540 | 10,950 | 11,310 |
| | | US dollars | 19,470 | 23,010 | 24,650 | 25,710 | 25,810 | 27,960 |
| | | Other foreign currencies | 17,090 | 21,470 | 21,150 | 23,780 | 23,950 | 22,850 |
| | Liabilities | Domestic currency | 7,930 | 10,860 | 10,870 | 12,860 | 12,690 | 12,190 |
| | | US dollars | 20,710 | 23,320 | 24,420 | 25,890 | 25,940 | 28,980 |
| | | Other foreign currencies | 14,840 | 21,260 | 21,460 | 23,360 | 23,790 | 23,420 |

Table continued on page 115.

| | | | 1978 Dec. | 1979 Dec. | 1980 March | 1980 June | 1980 Sept. | 1980 Dec. |
|---|---|---|---|---|---|---|---|---|
| | | | in millions of US dollars | | | | | |
| Sweden | Assets | Domestic currency | 860 | 1,030 | 1,010 | 1,070 | 1,250 | 1,200 |
| | | US dollars | 2,160 | 2,950 | 3,030 | 3,610 | 3,830 | 4,330 |
| | | Other foreign currencies | 1,230 | 1,830 | 2,020 | 2,420 | 2,340 | 2,120 |
| | Liabilities | Domestic currency | 700 | 900 | 880 | 960 | 1,000 | 1,000 |
| | | US dollars | 2,790 | 4,620 | 5,270 | 5,820 | 6,020 | 6,850 |
| | | Other foreign currencies | 1,730 | 3,190 | 3,430 | 4,030 | 4,040 | 3,910 |
| Switzerland | Assets | Domestic currency | 19,290 | 27,170 | 27,830 | 29,910 | 30,460 | 29,480 |
| | | US dollars | 21,580 | 21,510 | 22,130 | 20,600 | 21,810 | 21,570 |
| | | Other foreign currencies | 9,830 | 10,390 | 9,250 | 10,250 | 9,130 | 8,500 |
| | Liabilities | Domestic currency | 6,820 | 7,440 | 7,450 | 9,740 | 11,570 | 11,950 |
| | | US dollars | 18,540 | 21,110 | 22,540 | 20,930 | 21,300 | 23,890 |
| | | Other foreign currencies | 8,330 | 9,670 | 8,840 | 9,520 | 8,550 | 7,900 |
| United Kingdom | Assets | Domestic currency | 14,740 | 15,490 | 15,930 | 18,530 | 20,480 | 22,670 |
| | | US dollars | 156,910 | 211,760 | 228,280 | 237,080 | 241,010 | 262,790 |
| | | Other foreign currencies | 45,940 | 58,240 | 58,090 | 67,040 | 68,330 | 70,850 |
| | Liabilities | Domestic currency | 11,950 | 19,230 | 19,760 | 24,180 | 26,360 | 27,630 |
| | | US dollars | 167,250 | 219,990 | 239,220 | 250,810 | 253,260 | 276,990 |
| | | Other foreign currencies | 46,170 | 61,980 | 60,440 | 67,320 | 69,160 | 69,730 |
| Total for European reporting countries | Assets | Domestic currency | 109,380 | 136,240 | 132,040 | 148,700[1] | 149,560 | 151,720 |
| | | US dollars | 339,520 | 427,960 | 438,960 | 456,730 | 465,620 | 518,730 |
| | | Other foreign currencies | 162,450 | 211,770 | 204,220 | 234,750 | 234,710 | 232,510 |
| | Liabilities | Domestic currency | 82,010 | 111,390 | 103,610 | 125,580[1] | 129,080 | 127,910 |
| | | US dollars | 348,590 | 436,630 | 450,050 | 474,000 | 486,110 | 548,360 |
| | | Other foreign currencies | 162,220 | 229,200 | 225,990 | 254,490 | 255,760 | 252,140 |
| Canada | Assets | Domestic currency | 480 | 580 | 550 | 640 | 570 | 640 |
| | | US dollars | 20,430 | 22,990 | 26,120 | 27,280 | 29,220 | 31,820 |
| | | Other foreign currencies | 1,460 | 2,030 | 2,280 | 2,580 | 3,130 | 3,020 |
| | Liabilities | Domestic currency | 2,620 | 3,080 | 2,940 | 3,080 | 3,070 | 2,990 |
| | | US dollars | 21,340 | 28,170 | 30,600 | 31,900 | 33,830 | 38,250 |
| | | Other foreign currencies | 1,010 | 1,560 | 1,860 | 2,190 | 2,500 | 2,360 |
| Japan | Assets | Domestic currency | 7,970 | 11,350 | 11,510 | 14,040 | 14,960 | 16,960 |
| | | US dollars | 22,520 | 30,350 | 34,790 | 33,590 | 40,960 | 43,980 |
| | | Other foreign currencies | 3,200 | 3,730 | 3,460 | 3,700 | 4,190 | 4,730 |
| | Liabilities | Domestic currency | 8,690 | 3,820 | 4,320 | 11,400 | 12,170 | 12,340 |
| | | US dollars | 28,490 | 43,900 | 49,730 | 51,100 | 56,470 | 60,440 |
| | | Other foreign currencies | 1,830 | 2,770 | 3,720 | 5,210 | 6,510 | 7,440 |
| United States[2] | Assets | Domestic currency | 115,660 | 133,580 | 130,780 | 149,440 | 161,520 | 172,700 |
| | | Foreign currencies | 3,510 | 2,440 | 2,810 | 3,000 | 3,110 | 4,210 |
| | Liabilities | Domestic currency | 89,700 | 128,120 | 130,360 | 128,580 | 129,370 | 135,530 |
| | | Foreign currencies | 2,350 | 1,870 | 1,820 | 2,240 | 2,580 | 2,670 |
| Offshore branches of US banks[3] | Assets | Foreign currencies[4] | 106,520 | 127,640 | 129,890 | 131,510 | 140,370 | 142,120 |
| | Liabilities | Foreign currencies[4] | 107,480 | 128,840 | 131,510 | 133,530 | 142,320 | 144,140 |

[1] Including for the first time the external positions of banks in Ireland. [2] 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. [3] Offshore branches of US banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore. [4] Including negligible amounts in domestic currencies.

External liabilities showed a stronger increase than assets, going up by $151 billion to a total of $928 billion. This meant that the reporting European banks' net external position, which had already been reversed from $19 billion of assets to $1 billion of liabilities in the course of 1979, shifted further, to net liabilities of $25 billion at the end of 1980. This $44 billion turn-round from a net creditor to a net

debtor position within the space of only two years was related in large measure to the banks' rôle in financing the reporting European countries' oil-induced balance-of-payments deficits.

The dollar's recovery in the exchange markets in 1980 helped to underpin its leading rôle in international banking business. Excluding exchange rate effects, the reporting European banks' external assets in other currencies grew at about the same rate as their dollar assets, viz. by somewhat over 21 per cent., but at current exchange rates their dollar value expanded only by about half as much. On the liabilities side of the banks' balance sheets, dollar positions showed an expansion of 26 per cent., and the banks' net external liabilities in that currency widened from $8.7 billion at the end of 1979 to $29.6 billion. This would suggest that the banks' Euro-currency activities helped to moderate the strength of the dollar in the spot exchange market and therefore tended to reduce exchange rate instability, although the banks' short spot positions in dollars were undoubtedly covered in large measure by forward dollar purchases.

Euro-Deutsche Mark assets and liabilities grew relatively slowly last year, and their dollar value actually declined, so that their share of total outstanding Euro-currency assets contracted from 19.5 to 16.4 per cent. On the other hand, Euro-Swiss franc assets and liabilities expanded by over 40 per cent. (excluding exchange rate effects), largely as a result of the relaxation of the various Swiss controls on capital inflows, which helped to re-establish the links with the domestic Swiss franc markets. Similarly, the Euro-sterling market benefited from the earlier abolition of UK exchange controls. Euro-sterling liabilities (still excluding exchange rate effects) increased by $7.5 to 23.8 billion last year, with the major part of the funds concerned coming from the United Kingdom, including $1.6 billion from non-bank entities.

A notable feature on the liabilities side of the reporting European banks' balance sheets was that new deposits received from official monetary institutions slowed down sharply from $32 billion in 1979 to $11.4 billion (excluding exchange rate effects), and this notwithstanding the heavy inflow of new funds from OPEC countries. Here again, there is no evidence that Euro-currency facilities served as a vehicle for exchange rate speculation, as the slowdown also encompassed those currencies, notably the dollar, which appreciated in the exchange markets, while deposits in Deutsche Mark and Swiss francs continued to show sizable increases.

Looking at developments in individual markets, banks in the United Kingdom alone accounted for 53 per cent. of the total increase (valuation adjusted) in the European reporting banks' external foreign currency assets and their market share increased from 42.2 to 44.4 per cent. In terms of growth rates, the most rapid expansion, of 36 per cent., was achieved by banks in Belgium, whereas banks in Germany showed hardly any increase in their external assets in foreign currency, and those in Switzerland recorded a certain decline. However, in view of the strong foreign demand for Deutsche Mark and Swiss franc credits, banks in Germany and Switzerland added nearly $10 and 5 billion respectively (excluding valuation effects) to their external assets in domestic currency. As a result of the abolition of exchange controls in the United Kingdom, the UK banks' external claims in domestic

currency also expanded very rapidly, by over $6 billion, or 37 per cent. Another consequence of the abolition of UK exchange controls was an increase of nearly $3 billion, or 25 per cent., in the London banks' foreign currency liabilities vis-à-vis UK non-bank entities.

As regards the rôle of the European banks as a channel for balance-of-payments finance, the largest increase in a net external debtor position in foreign currency was shown by banks in Italy, with a rise of $6.6 to 13.9 billion, the proceeds being used for foreign currency lending to residents. A very substantial volume of net external borrowing in foreign currency was also contracted by banks in France and Austria, although at the same time they built up their net external creditor positions in domestic currency to some extent. Following the relaxation of the measures to prevent capital inflows, the banks in Switzerland saw their external liabilities in Swiss francs jump by nearly 80 per cent. last year, although the bulk of these funds was re-exported. The Swiss banks, however, were substantial net takers of foreign currency funds, and in sharp contrast to the usual pattern their total net external creditor position declined by $2.9 billion, which undoubtedly helped to moderate the downward pressure on the Swiss franc in the exchange markets. The operations of banks in Germany, on the other hand, seem to have added to the country's balance-of-payments problems last year. Whereas in 1979 the banks had imported a net total of $10.5 billion of foreign funds, last year they exported $6.9 billion. Against this background, in December the Bundesbank reached a gentleman's agreement with the German banks, temporarily limiting their long-term external lending in Deutsche Mark.

Turning finally to the so-called "net size" concept of the narrowly defined Euro-currency market (i.e. excluding double-counting but including the banks' use of foreign currency funds for domestic lending), the volume of foreign currency credits intermediated by banks in the reporting European countries may be estimated to have expanded by $100 billion to a total of $575 billion last year. At constant end-1980 exchange rates, the increase amounted to about $115 billion, or some $20 billion more than in 1979.

Overall, the geographical pattern of this new lending was not very different from that of the total international banking flows described on pages 104–107 above. The banks used approximately $55 billion of Euro-currency funds for lending within the reporting area (excluding, as in the case of all the other figures quoted in the rest of this section, exchange rate effects). Claims on Japan, the United States and Canada together expanded by $16 billion, and about $6.5 billion was lent via the offshore centres. Outside this broader reporting area, the largest single item was a $16.5 billion expansion in credits to non-oil developing countries. Since liabilities to such countries showed little increase, the reporting European banks' net creditor position in foreign currency vis-à-vis the developing world, which at the end of 1978 had been close to zero, widened to $24.4 billion. "Other developed countries" and eastern Europe received $12.5 and 4 billion respectively of new Euro-credits last year.

On the sources side of the market, the reporting European area's contribution amounted to roughly $45 billion, or $10 billion less than on the uses side. In

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] | OPEC countries[5] | Other 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 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 |
| 1980 March ..... | 179.7 | 119.0 | 39.9 | 35.5 | 42.4 | 34.4 | 69.5 | 29.6 | 57.6 | 4.4 | 493.0 |
| June ..... | 204.6 | 138.1 | 40.6 | 38.7 | 46.4 | 36.8 | 71.1 | 30.8 | 63.0 | 5.0 | 537.0 |
| September .. | 210.3 | 142.8 | 39.5 | 41.6 | 48.9 | 37.3 | 70.7 | 31.8 | 65.9 | 5.0 | 551.0 |
| December .. | 216.4 | 143.7 | 39.7 | 45.1 | 52.1 | 38.9 | 73.0 | 33.8 | 71.0 | 5.0 | 575.0 |
| **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 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 |
| 1980 March ..... | 183.0 | 101.0 | 51.0 | 17.8 | 29.4 | 10.4 | 54.2 | 89.7 | 46.0 | 11.5 | 493.0 |
| June ..... | 202.0 | 113.3 | 57.0 | 18.3 | 30.9 | 10.4 | 59.9 | 96.2 | 48.7 | 13.6 | 537.0 |
| September .. | 200.5 | 112.4 | 54.5 | 20.1 | 33.4 | 11.0 | 64.0 | 106.0 | 47.7 | 13.8 | 551.0 |
| December .. | 211.0 | 124.3 | 59.7 | 22.1 | 33.5 | 12.8 | 68.0 | 109.8 | 46.6 | 11.5 | 575.0 |

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 as liabilities vis-à-vis non-banks outside the reporting area by the Swiss banks themselves. [3] Excluding positions of banks located in the Federal Republic of Germany vis-à-vis the German Democratic Republic. [4] Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, Panama, Singapore, Vanuatu (formerly New Hebrides) and other British West Indies. [5] Includes, in addition, Bahrain, Brunei, Oman, Trinidad and Tobago. [6] Including positions vis-à-vis international institutions other than the BIS.

addition, $9 billion of new funds flowed into the market from the United States and the bulk of the $16 billion of new funds obtained via offshore centres was also probably of US origin. However, the largest item outside the reporting European area was an increase of $30.5 billion in new deposits received from OPEC countries, as a result of which the banks' net liability position vis-à-vis these countries rose to $76 billion, or to nearly 250 per cent. of its end-1978 level.

**Developments elsewhere.**

External assets of banks in the United States expanded by $41 billion last year, more than twice as much as in 1979, whereas external liabilities showed only a comparatively modest increase. The bulk of asset growth occurred in the spring and

early summer when US monetary conditions were relatively easy, but surprisingly enough there were also substantial outflows during the final months of the year when US interest rates reached new records and the dollar was very strong.

As regards the geographical distribution of this new foreign lending, the outstanding feature was the sharp expansion of $12.3 billion, or 34 per cent., in claims on non-oil developing countries; a substantial part of the $17.6 billion of new lending that showed up as claims on the offshore centres also seems to have gone to these countries. At the same time, the flow of new deposits received from developing countries came nearly to a standstill. Claims on oil-exporting countries, after a slight decline in 1979, showed a modest $1.4 billion increase, but, more significantly, OPEC countries drew down their deposits with banks in the United States by $0.7 billion, whereas in 1979 they had made new deposits of $5 billion.

The branches of US banks in the offshore centres acted mainly as a channel for funds from the United States last year, their liabilities vis-à-vis that country going up by $22 billion, or over 50 per cent. A substantial part of these funds, however, was used not for new foreign lending but to replace other sources of finance. One-third of the increase in the branches' liabilities to the United States represented deposits received from US non-bank entities. New claims amounted to $14.5 billion, of which $5.1 billion was on non-oil developing countries and $7.5 billion vis-à-vis the United Kingdom.

Of all reporting institutions, banks in Japan showed the strongest growth in external positions last year. External assets, at constant exchange rates, expanded by $18.5 to 65.7 billion, while liabilities showed an even larger expansion of $29.3 billion, or nearly 60 per cent. The resultant $10.8 billion increase in the banks' net external debtor position, which occurred solely in the first half of the year, was the combined result of official restrictions on the banks' participation in the international loan market and the March 1980 yen support package, which included, inter alia, relaxations of restrictions on Japanese banks' bringing-in of Euro-deposits from their overseas branches and the exemption of foreign monetary authorities from interest rate ceilings on free yen deposits. The latter move contributed to large inflows of oil funds and in the second quarter free yen deposits increased by $6.4 billion, or 130 per cent. In the second half of the year the decline of domestic short-term interest rates in relation to long-term yields caused a sharp slowdown in the build-up of non-residents' free yen deposits, while the restrictions on Japanese banks' external loan activities were eased and banks in Japan became net exporters of funds.

**The international bond markets.**

Volatile and, at times, steeply rising dollar interest rates, unstable yield curves and exchange rate uncertainties meant that conditions in the bond markets were rather unsettled during much of 1980 and early 1981. The main victim of these developments was foreign bond issues in national markets, which declined by $4.2 to 15.8 billion, whereas the volume of Euro-bond issues rose by $4.7 to 22.5 billion. As a result, the total value, in current dollars, of international bond issues, at $38.3

billion, was slightly larger than in 1979, though after allowing for inflation there was some contraction.

The relatively strong showing of the Euro-bond market, and especially its dollar sector, was due to its superior flexibility and ability to adapt to rapidly changing circumstances. The market's innovative character and the wide range of techniques and options available also helped to enhance its attractiveness. Floating rate notes, accounting for 30 per cent. of total dollar issues, were generally well received, as could be expected at a time of marked uncertainties about future interest rates. Convertible issues, which accounted for another 15 per cent. of the dollar total, were supported by the strength of the US and Japanese share markets, as the bulk of such securities is issued by companies from these two countries. Finally, the market benefited from the increased participation of institutional investors and from keen competition between issuing houses, which helped to keep charges down.

**International bond issues.**[1]

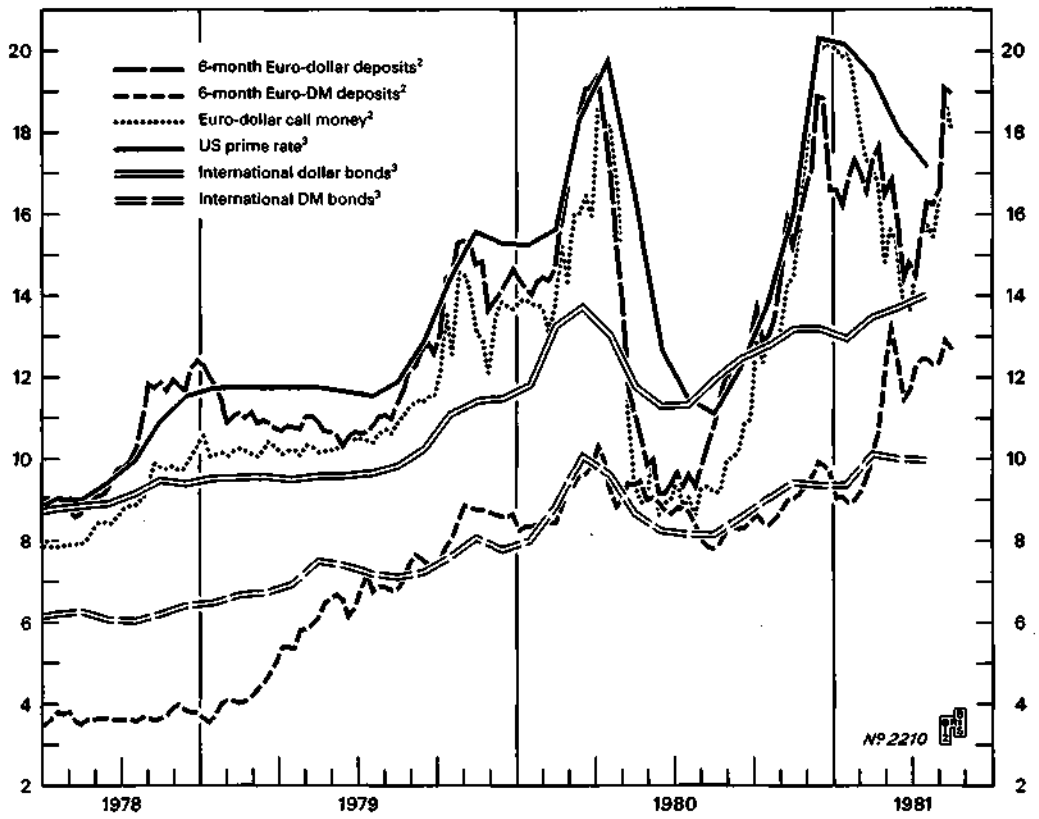
| Borrowing countries or areas | Years | Euro-bond issues | | | | Foreign issues | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Total | *of which* | | | Total | *of which* | | |
| | | | US dollars | Deutsche Mark | Private placements | | in United States | in Switzerland | Private placements |
| | | in millions of US dollars | | | | | | | |
| Western Europe ... | 1978 | 5,410 | 2,440 | 2,240 | 1,310 | 6,260 | 1,640 | 2,690 | 1,980 |
| | 1979 | 7,160 | 3,740 | 2,030 | 1,340 | 5,780 | 960 | 4,160 | 2,560 |
| | 1980 | 9,900 | 4,640 | 2,430 | 1,580 | 5,020 | 490 | 3,330 | 1,540 |
| | 1981/I | 1,540 | 760 | – | . | 1,440 | 100 | 960 | . |
| Canada ..... | 1978 | 830 | 470 | 360 | 380 | 3,930 | 3,270 | 230 | 990 |
| | 1979 | 1,410 | 830 | 30 | 30 | 2,720 | 2,070 | 510 | 570 |
| | 1980 | 1,380 | 1,050 | 60 | – | 1,460 | 1,220 | 160 | 320 |
| | 1981/I | 740 | 660 | – | . | 690 | 500 | 180 | . |
| United States ..... | 1978 | 1,290 | 970 | 230 | 200 | 370 | – | 220 | 150 |
| | 1979 | 2,570 | 2,470 | 50 | 130 | 160 | – | 60 | – |
| | 1980 | 4,310 | 3,900 | 120 | 260 | 200 | – | 200 | 120 |
| | 1981/I | 1,290 | 1,190 | – | . | 220 | – | 220 | . |
| Other developed countries[2] ..... | 1978 | 2,550 | 920 | 1,590 | 400 | 2,930 | 410 | 1,870 | 2,080 |
| | 1979 | 1,780 | 780 | 960 | 330 | 3,940 | 80 | 3,500 | 3,200 |
| | 1980 | 2,410 | 1,220 | 950 | 350 | 2,470 | – | 2,230 | 1,830 |
| | 1981/I | 330 | 300 | – | . | 770 | – | 640 | . |
| Rest of the world[3] . | 1978 | 2,990 | 1,080 | 1,290 | 750 | 2,200 | 440 | 540 | 830 |
| | 1979 | 1,830 | 1,320 | 410 | 210 | 1,410 | 240 | 300 | 330 |
| | 1980 | 1,290 | 780 | 390 | – | 750 | 380 | 140 | 100 |
| | 1981/I | 310 | 270 | – | . | 240 | 140 | – | . |
| International institutions ..... | 1978 | 2,870 | 1,810 | 820 | 1,230 | 5,850 | 600 | 2,000 | 3,070 |
| | 1979 | 3,050 | 1,470 | 1,170 | 1,230 | 5,960 | 1,250 | 990 | 3,060 |
| | 1980 | 3,220 | 2,070 | 300 | 1,050 | 5,850 | 550 | 1,380 | 2,830 |
| | 1981/I | 380 | 240 | – | . | 740 | – | 190 | . |
| Total issues placed ..... | 1978 | 15,940 | 7,690 | 6,530 | 4,270 | 21,540 | 6,360 | 7,550 | 9,100 |
| | 1979 | 17,800 | 10,610 | 4,650 | 3,270 | 19,970 | 4,600 | 9,520 | 9,720 |
| | 1980 | 22,510 | 13,660 | 4,250 | 3,240 | 15,750 | 2,640 | 7,440 | 6,740 |
| | 1981/I | 4,590 | 3,420 | – | 210 | 4,100 | 740 | 2,190 | 1,340 |

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

Dollar bond issues were, moreover, underpinned by the currency's strength in the exchange markets and well maintained their share in total issues at around 60 per cent. Exchange rate considerations and attractive interest rates were supportive influences in some of the smaller currency compartments of the Euro-bond market, as, for example, in the case of sterling, French franc and Dutch guilder issues, the combined market share of which soared from 6 per cent. in 1979 to 14 per cent. On the other hand, the share of the Deutsche Mark fell quite sharply, from 26 to 19 per cent.

The buoyancy of the Euro-dollar bond sector even extended to straight fixed rate issues, which increased by $2.5 billion to about $7.5 billion. However, over 60 per cent. of this total was issued during the second quarter alone, when a normal upward-sloping yield curve was temporarily restored, while at some other times new issuing activity ground virtually to a halt. This was the case in February-March and November-December, when the differential between Euro-dollar bond yields and six-month Euro-dollar deposit rates moved to over 6 per cent., despite relatively strong rises in the bond yields themselves. Thus, dollar bond yields opened the year at close to 11.5 per cent., rose to 14 per cent. in March, and, after easing to a low of

Euro-currency deposit rates, US prime rate and yields on international markets for US dollar and DM bonds.[1]




[1] The bond yields are calculated to average maturity. [2] Weekly averages of daily quotations. [3] Monthly averages.

10.5 per cent. at around mid-year, went up steadily in the second half of the year to reach about 12.5 per cent. at the end of December.

Substantially lower yields than on dollar bonds, combined with the weaker exchange-market outlook for the Deutsche Mark, tended to dampen investors' interest in DM bonds, and, at $4.3 billion, the volume of Euro-DM issues was the lowest for four years. Despite the differences in domestic economic situations, yield movements paralleled quite closely those for dollar bonds and issuing activity was greatest in the months around mid-year when the Deutsche Mark was relatively strong in the exchange market and the yield curve was temporarily positive.

The currency distribution of foreign bond issues was quite different from that in the Euro-bond market. The only major sector to show an increase was DM issues in Germany, whereas foreign issues in Switzerland, the United States and Japan all recorded a substantial contraction. Foreign issues in Switzerland declined by $2.1 billion, to the still very high level of $7.4 billion, with relatively low interest yields and the weaker exchange-market outlook for the Swiss franc being the main reasons for a slackening in investors' interest. A much sharper relative contraction, from $4.6 billion in 1979 to $2.6 billion last year, took place in foreign issues in the United States, where the factors mentioned above were not operative. Here it was rather the disarray of the domestic market and competition from the Euro-dollar bond market, where borrowing costs were at times significantly lower, which may help to explain the lower level of total issues. Foreign yen issues in Japan declined from $3.1 to 1.6 billion. The volume of DM issues in Germany, which increased from $1.8 billion to $3.5 billion, was sustained by large borrowing by international institutions.

Even more than in preceding years, the international bond market in 1980 was primarily a market for borrowers from industrial countries. The share of developed countries in total issues rose from 68 per cent. to 71 per cent., and including European-based international organisations the industrial world accounted for over 80 per cent. of the total offtake. The share of non-oil developing countries declined from 7.3 to 4.7 per cent., but, at 14 per cent., the share of international development institutions was slightly higher than the year before. Within the industrial countries, US corporations were by far the largest group of borrowers, obtaining $4.5 billion, or $1.8 billion more than in 1979. Sweden, Austria, Italy and the United Kingdom also considerably stepped up their recourse to international bond finance. On the other hand, Japanese and Canadian entities, which had been by far the largest issuers in 1979, reduced their borrowings to $3.7 and 2.8 billion respectively.

In the early months of 1981 the situation in the international bond markets remained very much the same as in 1980: high and unstable short-term interest rates and pronounced exchange rate uncertainties. Fixed rate dollar issues at times came virtually to a halt. Moreover, following a decision taken by the German Capital Markets Sub-Committee in December 1980, the Deutsche Mark sector was practically closed to all foreign borrowers other than international institutions until mid-April. As a result, in the first quarter the total international issue volume, at $8.7 billion, was somewhat lower than the quarterly average for 1980.

# VII. THE INTERNATIONAL MONETARY SCENE.

The present chapter reviews international monetary developments during 1980 and the early months of 1981. The first section of the chapter looks at exchange rate developments, the main features of which were the strength of the dollar, the yen and the pound sterling, the weakness of continental European currencies, notably the Deutsche Mark, and a very marked increase in exchange rate volatility. Except in the case of the yen, the movements of major countries' exchange rates were unrelated to inflation differentials, with currencies of high-inflation countries appreciating and those of relatively low-inflation countries depreciating. The second section of the chapter examines the reasons for these developments and assesses the changes in international competitive positions that they have brought about. The third section deals with developments in gold, notably the major fall in non-monetary absorption and the very wide movements in its market price. The fourth section describes developments in reserves and international liquidity during 1980, when a further rise in global reserves was accompanied by a widespread decline of reserve ease in the oil-importing areas of the world.

## Exchange rate developments.

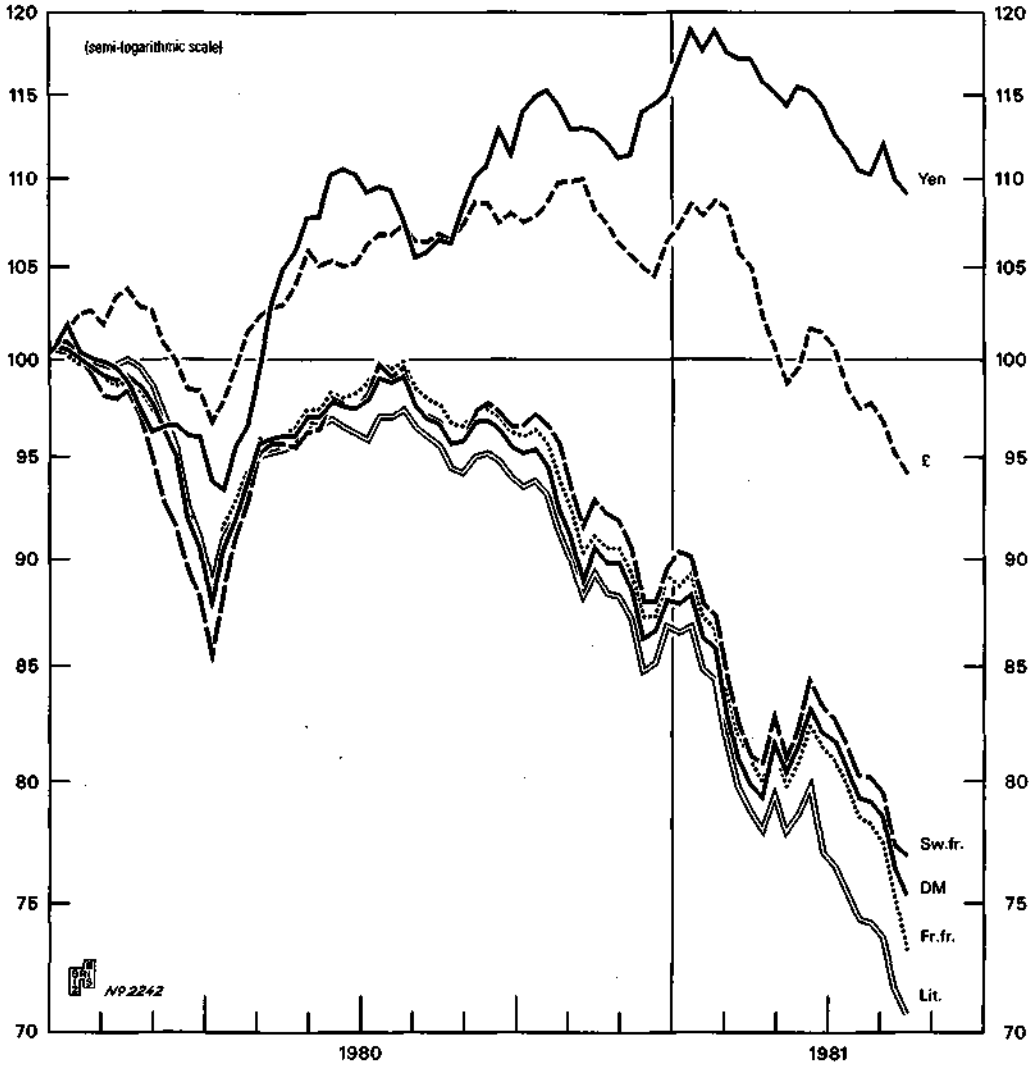
The period under review saw important changes both in the situation, and in the market's assessment, of a number of major currencies, together with unusual volatility of market exchange rates. The dollar, the yen and the pound sterling appreciated considerably, whilst continental European currencies experienced recurrent bouts of weakness. To a large extent these developments were associated with a reshuffling of current-account imbalances in favour of countries with high inflation rates and to the detriment of those with relatively low inflation rates. The exchange-market effects of these shifts in balances of payments were reinforced by the workings of US monetary policy, which led at times to the emergence of double-digit short-term interest rate differentials in favour of the dollar, as well as to unprecedented volatility of dollar interest rates. In these circumstances, large-scale official intervention was powerless to prevent major fluctuations in bilateral exchange rates. The only exception was in the EMS fixed rate system, where the stability of exchange rates during 1980 owed much to the weakness of the Deutsche Mark. However, the renewed strengthening of the Deutsche Mark in the system, after mid-February 1981, was soon followed by a downward adjustment of the lira's central rate, as well as by increased pressure on the Belgian franc, while the French franc weakened sharply following the presidential elections in May.

Exchange-market developments during the first quarter of 1980 were dominated by the upward movement of the US dollar, particularly after mid-March, when the announcement by the US authorities of a wide range of restrictive monetary and credit measures was followed by a sharp rise in dollar interest rates. By early April 1980 the dollar's effective exchange rate stood 10½ per cent. above its

level three months earlier. The strengthening of the dollar was most pronounced vis-à-vis continental European currencies. With three-month interest rate differentials in favour of the dollar reaching 9½ per cent. against the Deutsche Mark and nearly 13 per cent. against the Swiss franc in early April, the cumulative appreciation of the dollar since early January came to 16 per cent. vis-à-vis the Deutsche Mark, from DM 1.71 to DM 1.98, whilst against the franc it amounted to 19 per cent.

**Bilateral exchange rates:**
**Indices of spot quotations for selected currencies vis-à-vis the US dollar, 1980–81.**

Weekly averages, end-December 1979 = 100.




Although important, changes in international interest rate differentials were not the only cause of the dollar's rise. The new method of operating monetary policy adopted by the US monetary authorities in October 1979 strengthened the

exchange market's belief in their determination to control inflation and contributed to a reassessment of the outlook for the dollar. This was illustrated by the behaviour of the yen, which declined by over 10 per cent. against the dollar during the first quarter of 1980 despite some narrowing of the short-term interest rate differentials in favour of the dollar.

Sterling had shown considerable strength during the last month and a half of 1979, and it continued to appreciate in the first seven weeks of 1980. Although subsequently affected by the upward movement of the US dollar, it rose further against other European currencies. In early April 1980, at the time of the dollar's peak, sterling stood about 4 per cent. below its early-January exchange rate level vis-à-vis the dollar, but 10½ per cent. higher against the Deutsche Mark.

In an attempt to moderate the rapid movements of exchange rates that began in mid-February 1980, the monetary authorities of those countries whose currencies came under downward pressure intervened heavily in the exchange markets and had recourse to a variety of measures aimed at tightening domestic credit conditions or at influencing international payments flows directly. In a number of countries the official discount rate was raised. Moreover, steps were taken to remove administrative restrictions on capital inflows, especially by those countries, such as Germany, Japan and Switzerland, which had earlier introduced such measures in an attempt to counter the growing international demand for their currencies and which now found their former current external surpluses converted into deficits, or at least much reduced.

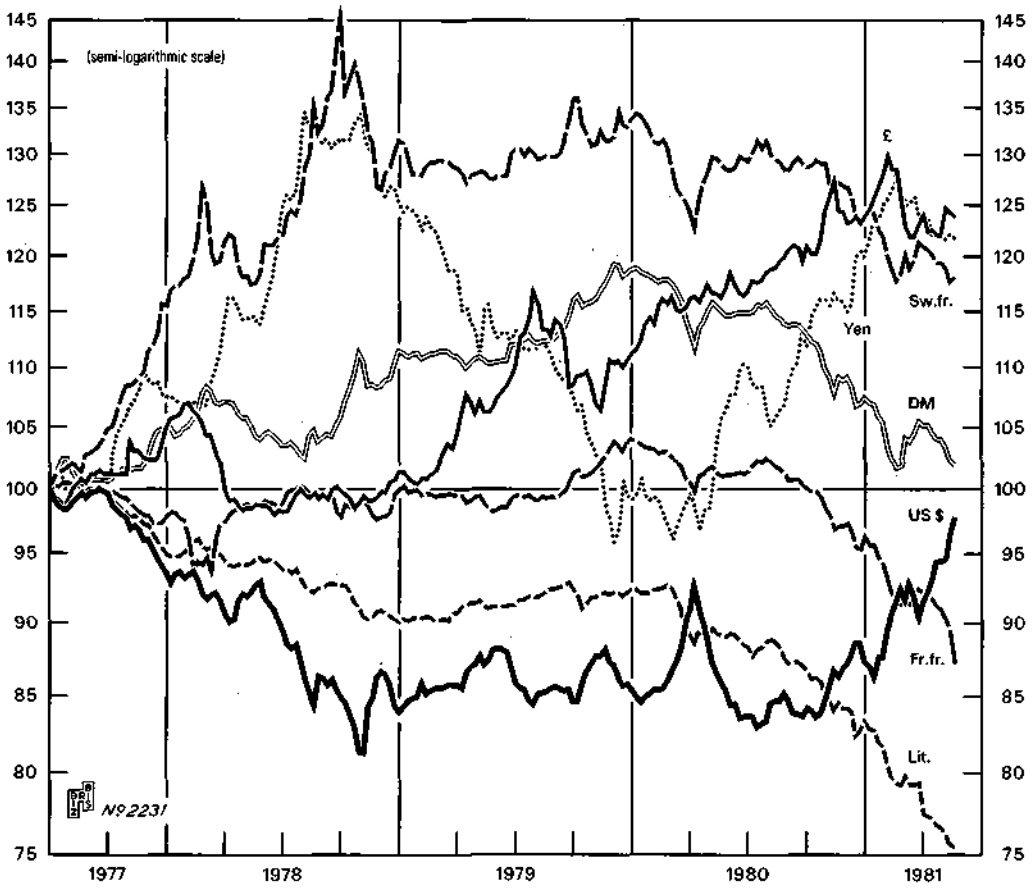
The pronounced strength of the US dollar was suddenly reversed in April, when US interest rates began to decline even more steeply than they had earlier risen. As a result, short-term interest rates on dollar investments came down to the level of those on DM investments; indeed, between late May and mid-July 1980 the differentials were on occasion in favour of DM rates. By late May the effective exchange rate of the dollar stood 10 per cent. below its April peak.

The extent of the recovery of other currencies was not uniform. In early July the Deutsche Mark was quoted at DM 1.73 against the dollar, marginally below its early-January level. The pattern was similar for the other EMS currencies (except the lira) and for the Swiss franc. The pound sterling and the yen, on the other hand, more than made up the ground lost earlier. The yen in particular appreciated by no less than 21 per cent. between early April and mid-June, when its dollar exchange rate, at Yen 215.5, stood 11 per cent. above its end-1979 level. Against the European currencies the yen's appreciation between January and mid-June 1980 was somewhat greater, amounting to 13 and 14½ per cent. vis-à-vis the Deutsche Mark and the Swiss franc respectively. The recovery of the pound was less dramatic; in early July it stood at $2.38, about 7 per cent. above its end-1979 level against the dollar.

A number of factors worked in favour of the yen and sterling. In the case of the yen, these included a relatively low domestic inflation rate, the first signs of a reduction of the current-account payments deficit, the easing of restrictions on capital inflows and the tighter stance of monetary policy. In contrast to Japan, the inflation rate in the United Kingdom remained high despite a sharp cutback in economic activity; but in the eyes of the international investor sterling was attractive

Effective exchange rates, 1977–81.

Weekly averages, end-June 1977 = 100.




as a hedge against further oil price increases, and its interest rate advantage once more became very large as a result of the second-quarter drop in dollar interest rates.

With the bottoming-out of US interest rates, the dollar's exchange rate stabilised in the course of July. Towards the end of that month, indeed, it began to rise once more against the continental European currencies. By the second week of October the dollar stood nearly 5½ per cent. above its mid-July low against the Deutsche Mark, although on the weighted basis it was scarcely higher than it had been three months earlier. After mid-October the pace of the dollar's appreciation accelerated sharply, despite substantial exchange-market intervention by the US authorities. As short-term dollar interest rates rose to new record levels, differentials in favour of the dollar reached 11½ per cent. vis-à-vis the Deutsche Mark and nearly 15 per cent. against the Swiss franc in mid-December. On 11th December the dollar was quoted at DM 2.025, about 19 per cent. above its level at the beginning of the year and 2½ per cent. above the April 1980 high point. On the weighted basis, the dollar had risen by nearly 8 per cent. since early July, but was still 4½ per cent. below its April peak.

The yen, after a downward movement in reaction to its steep rise during the spring quarter, began to strengthen again in August 1980. In early October, thanks to the improvement of the current-account balance of payments and to large-scale inflows of funds, it stood at Yen 207 to the dollar, 10 per cent. up on its early-August level. Subsequently, the steep upward movement of US interest rates, as well as fears about the consequences for the Japanese economy of the war between Iran and Iraq, did have some impact on the yen. However, the exchange rate resumed its upward trend at the beginning of December, several days before US interest rates reached their new peak. By the end of the year the yen had more than regained its early-October level, and in early January 1981 its rate against the dollar stood at around Yen 200, some 17 per cent. above its level of a year earlier. Against the Deutsche Mark the yen's appreciation over the same period amounted to 35 per cent., while on the weighted basis it came to 23 per cent.

Sterling steered a middle course between the yen and the continental European currencies. During the second half of the year it appreciated by a further 6 per cent. on the weighted basis but against the dollar it showed, on balance, no further rise. Even this was in a way a remarkable performance, since the very large interest rate advantage over the US dollar that sterling had enjoyed in the second quarter of the year was later eroded and eventually, in November 1980, reversed. Between late June and early November the pound appreciated against the dollar, from about $2.34 to $2.45. It then fell back to $2.30 around the middle of December before recovering to above $2.40 in January 1981.

The easing of US interest rates after mid-December 1980 brought only a temporary halt in the upward trend of the dollar. From mid-January 1981 onwards it once more appreciated strongly, despite heavy intervention by the US and European monetary authorities. The dollar's strength was again particularly pronounced vis-à-vis the Deutsche Mark, with the spot rate appreciating by 16½ per cent. to DM 2.25 between early January and mid-February despite some narrowing of the interest rate differential in favour of the dollar. Market sentiment appears to have been influenced by the strong anti-inflationary stance of the new Administration in the United States and by the uncertainties surrounding the situation in Poland. Against the Swiss franc the dollar appreciated even more rapidly between early January and mid-February, climbing by 17½ per cent. to nearly Sw.fr. 2.06, while on the effective basis the dollar rose by about 10 per cent.

In the second half of February declining dollar interest rates, together with a sharp tightening of monetary policy in Germany and the lifting of the remaining restrictions on non-resident purchases of German bonds, produced a temporary reversal in exchange-market trends and the DM price of the dollar eased to a low of DM 2.05 on 19th March. However, in early April US interest rates began to rise again rather sharply and the dollar resumed its upward trend. In early May its DM rate went above the previous mid-February peak, and with its rise steepening in the aftermath of the French presidential elections the dollar was quoted at DM 2.31 on 14th May, up by 18 per cent. on its end-1980 level. This was the third major movement of the dollar against the Deutsche Mark (and other continental currencies) since the beginning of 1981. On the weighted basis, the appreciation of the dollar during the first four and a half months of 1981 amounted to 13½ per

cent., and the depreciation of the Deutsche Mark to 5 per cent., bringing to about 15 per cent. the cumulative decline of the Deutsche Mark since the peak it had reached near the end of 1979.

In early 1981 the weakness of continental European currencies vis-à-vis the dollar was in large measure shared by sterling. Paradoxically, this happened at a time when there was increasing evidence that UK domestic economic policies had finally succeeded in bringing about a significant drop in the domestic inflation rate. However, there was mounting awareness of the consequences for the British economy of sterling's high exchange rate, and in March the Bank of England's minimum lending rate was reduced from 14 to 12 per cent. Sterling began to weaken quite sharply against the dollar at the end of January 1981, and by early March it had lost all the ground gained in the course of 1980, being quoted at about $2.18. It recovered towards mid-March but by mid-May it had eased further, to about $2.07, or 7 per cent. below its end-1979 level. On the weighted basis, however, sterling was still about 9 per cent. above its end-1979 level in mid-May 1981, owing to its appreciation over that period against other European currencies.

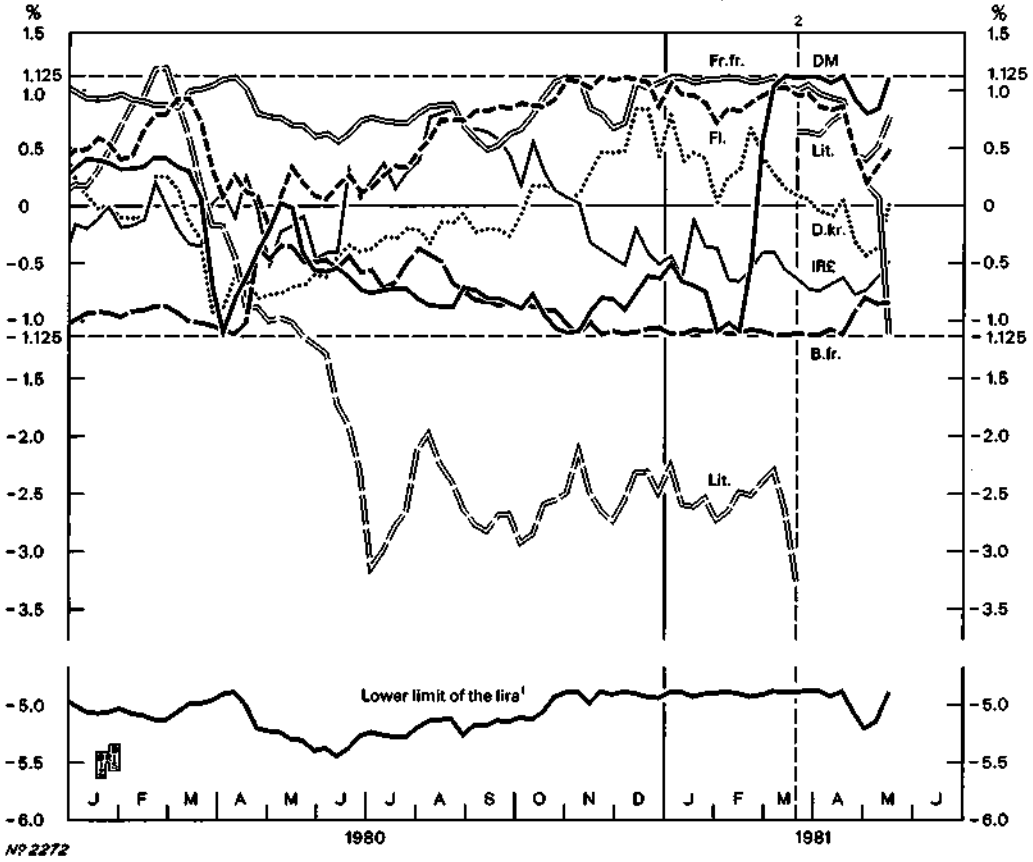
The yen, on the other hand, remained relatively firm against the dollar during the early part of 1981, with the spot rate weakening between early January and mid-February by only 4 per cent., to about Yen 207.5. The continued easing of domestic interest rates in March, including the official discount rate cut, had little immediate impact on the exchange rate, partly because it coincided with the decline in US interest rates. However, the renewed upturn of US interest rates from early April 1981 onwards caused the yen to decline against the dollar to Yen 222 by mid-May, 10 per cent. below its January peak. On the weighted basis, the yen depreciated by about 1½ per cent. between early January and mid-May 1981.

Developments within the exchange rate mechanism of the *European Monetary System* during 1980 and early 1981 contrasted sharply with the volatility of exchange rates in other markets. At times certain currencies, notably the Belgian franc and the Deutsche Mark, came under heavy pressure and substantial official intervention was required. But the second year of the system's existence, ending in mid-March 1981, passed without any major crisis and without the need for any adjustment of participants' central exchange rates. However, this relative stability did not stem from an improvement of fundamentals — there was, in particular, no convergence of member countries' inflation rates — but rather from the weakness of the Deutsche Mark. Shortly after the Deutsche Mark again became the strongest currency in the system, on 9th March 1981, the central rate of the lira was adjusted downwards by 6 per cent. and pressure on the Belgian franc intensified sharply.

The performance of the Deutsche Mark in the EMS exchange rate arrangement during 1980 and early 1981 basically reflected Germany's large current payments deficit and the strength of the dollar. In addition, with no likelihood of its central rate being revalued, the Deutsche Mark was less attractive to investors than were other currencies in the system offering higher nominal interest rate yields. Moreover, because of its greater international rôle, the Deutsche Mark tends to be more directly affected than other EMS currencies by a strong dollar. Not surprisingly, therefore, it tended towards the lower limit of the EMS exchange rate

**Spot exchange rates in the EMS exchange rate mechanism, 1980–81.**

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




[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 minimum permissible position is indicated by the bottom line in the graph. [2] With effect from 23rd March 1981, the lira was devalued by 6 per cent. vis-à-vis all other participating currencies.

band and on occasion required substantial official support. The first time that this happened was in late March and early April 1980 during the dollar's first dramatic rise. In the subsequent reversal the Deutsche Mark recovered somewhat, whilst remaining in the lower half of the band. In late October it touched its lower limit against the French franc and the Dutch guilder and needed heavy official support. With the help of some reduction in French short-term interest rates, it was able to detach itself from the bottom of the band in early November but by late January 1981 it was back in the support zone. A decisive recovery came only in the second half of February after the tightening of German monetary policy. In early March 1981 — for the first time since the central rate realignment in September 1979 — the Deutsche Mark again became the strongest currency in the system and subsequently maintained that position.

With a low domestic inflation rate but a large balance-of-payments deficit, the Belgian franc was persistently weak during most of the period under review. From November 1980 onwards it was continuously at, or near, the bottom of the band, and following the strengthening of the Deutsche Mark in February 1981 the franc

crossed its lower divergence threshold. Towards the end of March the Belgian authorities substantially raised the level of domestic interest rates, and took other restrictive monetary measures, but it was not until the second half of April that the franc moved away from its lower limit against the Deutsche Mark.

The evolution of the French franc up to February 1981 was in a way the mirror image of that of the Deutsche Mark and the Belgian franc. The domestic inflation rate was relatively high, but the current external deficit was more than covered by capital inflows. Consequently, the franc stayed in the upper quarter of the band virtually throughout 1980, touching the upper limit in late March and late October. In early November a reduction in domestic money-market rates, coupled with the introduction of a 5 per cent. reserve requirement on non-resident deposits at French banks, brought a temporary easing of the exchange rate, but by mid-December the franc was back at its upper limit, where it remained for most of the time until early March 1981. Subsequently the franc was the second strongest currency in the system until late April, when it eased somewhat further. Following the French presidential elections the franc dropped to its lower limit against the Deutsche Mark in May. The authorities provided heavy support for the franc in the exchange market, and in addition the Bank of France's Treasury bill discount rate was raised from 13½ to 22 per cent. and controls on capital flows were severely tightened.

With a relatively low domestic inflation rate and a current external deficit that was more than covered by capital inflows, the Dutch guilder was the second strongest currency within the EMS during much of the period under review. It was particularly firm in the last two months of 1980 and the early months of 1981, when it repeatedly touched its upper intervention point.

The Italian authorities availed themselves of the wider fluctuation band for the lira in the period under review. Between February and early July 1980 the lira dropped from nearly 1½ per cent. above its central rate to over 3 per cent. below. Subsequently it fluctuated between 2 and 3 per cent. below its central rate until early March 1981. During that month the downward pressures on the lira strengthened and on 22nd March the Italian authorities announced a 6 per cent. devaluation of the central rate. The lira subsequently remained in the upper half of its new band.

**Changes in international competitive positions.**

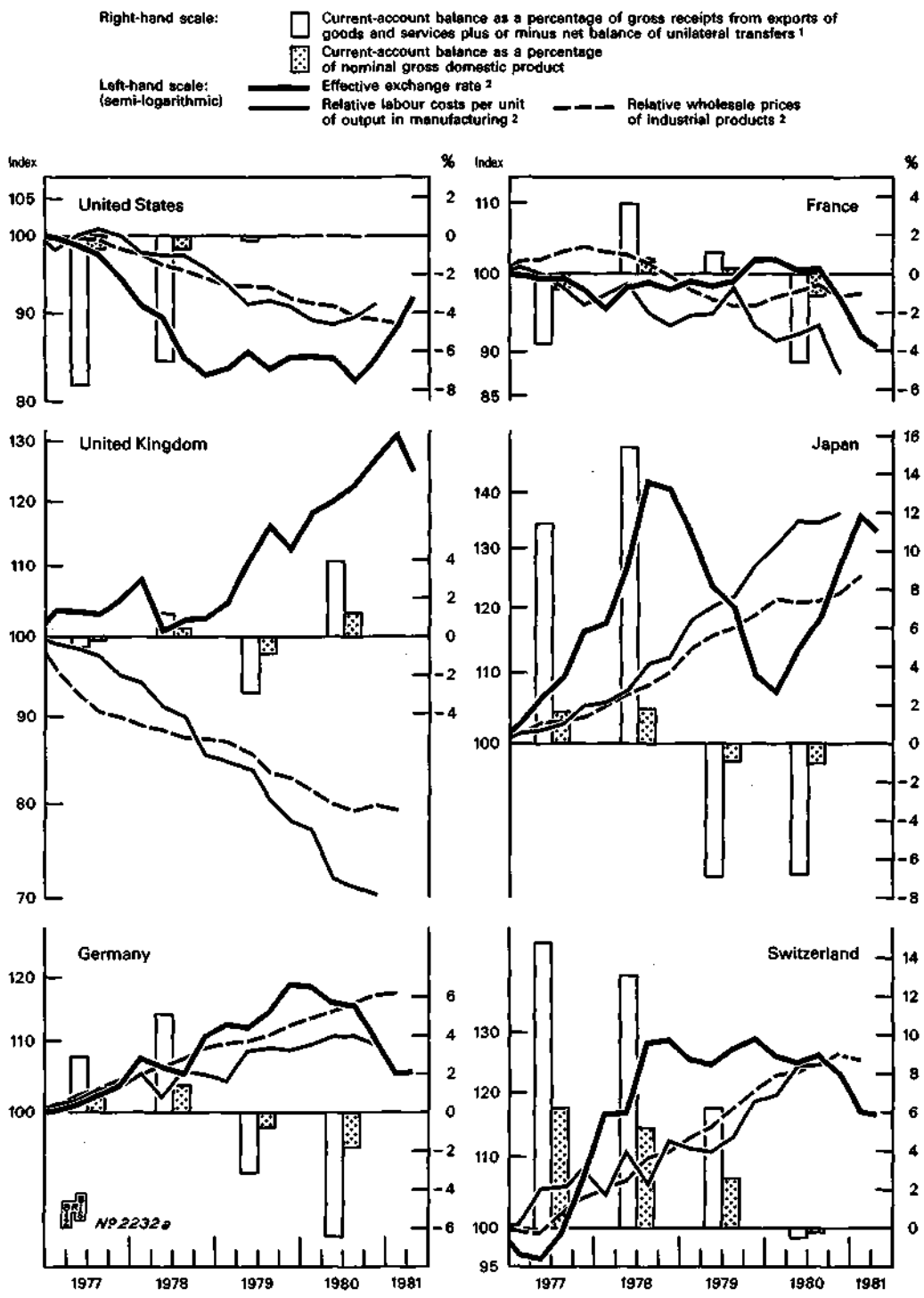
As already noted, a striking feature of exchange rate developments during the period under review has been the appreciation of the currencies of countries with high inflation rates, namely the dollar and sterling, and the depreciation of the currencies of countries with low inflation rates, such as the Deutsche Mark, the Swiss franc and, for a time, the yen. These developments, which in some instances began earlier, from late 1978 onwards, have weakened the international competitive positions of high-inflation countries and strengthened those of low-inflation countries, and they raise two questions. First, why have they occurred? Secondly, are they a matter for concern? In other words, to what extent could they form the basis for future payments disequilibria that might lead to exchange-market disturbances? Or have they rather constituted a correction of earlier maladjustments of exchange rates?

Changes in countries' international competitive positions cannot be adequately assessed on the basis of relative consumer price indices, since the latter contain many items that do not enter into international trade and they do not necessarily give a true picture of the relative cost positions of industry in different countries. A better indication is provided by the evolution of relative industrial wholesale prices and of relative unit labour costs. The graphs on the following pages show the development of these price and cost indices for the individual countries of the Group of Ten (plus Switzerland) during 1977–80, together with the changes in these countries' effective exchange rates. An upward movement of the lines in the graphs indicates an appreciation of a country's effective exchange rate or an improvement in its relative cost and price position, while a downward movement of the lines indicates the reverse. A stronger upward/downward movement in a country's exchange rate than of the indices of its relative costs and prices therefore suggests a deterioration/improvement in its international competitive position. Differences between the movements of relative industrial wholesale prices and relative unit labour costs point to changes in relative profit positions. For example, a stronger improvement in a country's relative position in terms of unit labour costs than in terms of industrial wholesale prices suggests that profit margins in that country have developed more favourably than in the other countries included in the graphs, and vice versa.

The data on which the indices are based are far from perfect, both in terms of accuracy and as regards international comparability. Moreover, the choice of weighting used in calculating the indices — the weights are based on countries' bilateral and multilateral shares in trade in manufactures and they also take into account the relative size of countries' economies — inevitably contains an element of arbitrariness. This means that only substantial divergences in the development of the three indices can be confidently interpreted as indicating a significant change in a country's international competitive position or its relative profit situation. Moreover, relative costs and prices, although undoubtedly very important, are not the only factors that determine competitiveness. Other, non-price, influences may justify exchange rate movements that are not in line with the development of a country's relative costs and prices. Finally, the choice of the base period affects the results shown in the graphs since, if exchange rates were out of line with relative costs and prices at the beginning of the period, subsequent changes in countries' international competitive positions would not necessarily indicate a movement away from equilibrium.

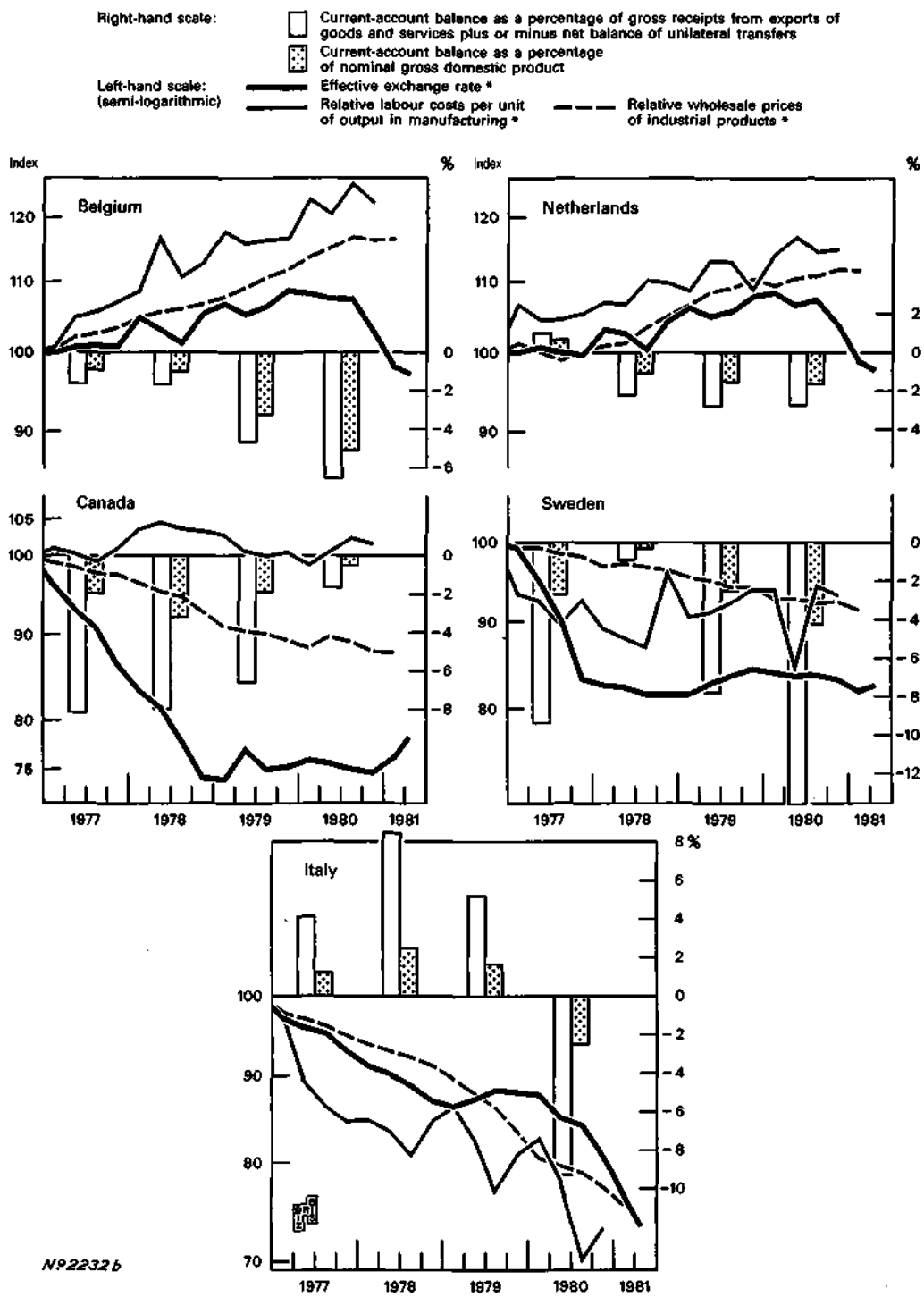
Looking at the period since 1978, by far the greatest deterioration in international competitiveness has occurred in the United Kingdom. Sterling's weighted exchange rate appreciated by 23 per cent. during 1979 and 1980, and by March 1981 the appreciation had widened to over 28 per cent. On top of this, the United Kingdom's relative position with respect to industrial wholesale prices deteriorated by about 8 per cent. during 1979–80 and with respect to unit labour costs by 17 per cent. Consequently, the international competitive position of the United Kingdom worsened over these two years by about 25 per cent. on the basis of relative wholesale prices and by 33 per cent. on that of unit labour costs. The dollar's effective exchange rate rose by over 6 per cent. between the low point reached in October 1978 and the end of 1980, parallel with deteriorations of about 5

*Group of Ten countries and Switzerland:*
**Effective exchange rates, relative prices and costs, 1977–81.**




[1] Percentages of gross receipts for the United States, France, the United Kingdom and Germany, first three quarters of 1980 only. [2] Quarterly averages, indices: fourth quarter 1976 = 100.

## Group of Ten countries and Switzerland: Effective exchange rates, relative prices and costs, 1977–81.




* Quarterly averages, indices: fourth quarter 1976 = 100.

per cent. in the relative price and cost indices, so that the real exchange rate appreciated by over 10 per cent. during this period. With the dollar's effective exchange rate having appreciated by an additional 13½ per cent. during the first four and a half months of 1981, there has been a marked further erosion of the competitive position of the United States so far this year.

In France, too, there was some appreciation of the real exchange rate in 1979, a rise in the effective exchange rate having been accompanied by a deterioration of the index of relative industrial wholesale prices and, to a lesser extent, that of relative unit labour costs. In 1980, however, the real exchange rate was rather stable on the basis of relative unit labour costs, while on the basis of relative industrial wholesale prices the franc depreciated about as much as it had appreciated in 1979. In Italy the relative stability of the effective exchange rate in 1979 produced a deterioration in the country's competitive position, particularly on the basis of relative wholesale prices, but this was to some extent reversed subsequently.

The strengthening of international competitive positions since 1978 is seen most clearly in Japan, Switzerland and Germany. In Japan the effective exchange rate depreciated by about 26 per cent. between October 1978 and February 1980, while during the same period Japan's position improved by over 10 per cent. with respect to relative wholesale prices and by some 15 per cent. with respect to unit labour costs. Consequently, the real exchange rate of the yen depreciated over this period by something of the order of 35 per cent. The effective exchange rate then appreciated by over 20 per cent. by the end of 1980. However, as there was a further improvement in Japan's relative price and cost position, the cumulative strengthening of its competitive position since October 1978 was still more than 20 per cent. at the end of last year.

In Switzerland, where the exchange rate peaked at the end of September 1978, the subsequent depreciation on the effective basis came to about 11 per cent. by the end of 1980. Between end-September 1978 and end-1980 Switzerland's international position improved by about 13 per cent. on the basis of relative wholesale prices and by nearly 20 per cent. on the basis of relative unit labour costs, so that the real exchange rate of the franc depreciated over this period by more than 20 per cent. In Germany the reversal of the earlier upward movement of the exchange rate came much later than in Japan and Switzerland, occurring around the end of 1979. During 1980 the effective exchange rate of the Deutsche Mark declined by about 9 per cent. and the real exchange rate by rather more, as there was a slight improvement in Germany's position with respect to relative prices and costs. The strengthening of Switzerland's and Germany's competitive positions has continued this year, with the effective exchange rates of the Swiss franc and the Deutsche Mark having depreciated further by some 5 per cent. to mid-May.

1980 also saw improvements in the international competitive positions of Belgium and the Netherlands that were broadly comparable with those in Germany. The effective exchange rate of the Belgian franc depreciated during the course of the year by about 7 per cent. and the real exchange rate, on the basis of the price and cost indices shown in the graph, by over 10 per cent. The same sort of development occurred in the Netherlands, although its effective exchange rate declined a little less than that of the Belgian franc.

How is this tendency for exchange rates to diverge from relative cost and price developments — and, in some cases, to do so rather dramatically — to be explained? Three main factors appear to have been at work. Firstly, there were a number of instances in which, by 1978–79, earlier movements of exchange rates had assumed very substantial proportions. This was true, in particular, of the yen, the Swiss franc and the Deutsche Mark. At their peaks, in the second half of 1978, the effective exchange rates of the yen and the Swiss franc had risen since the end of 1972 by 45 and 103 per cent. respectively, while at the end of 1979 the Deutsche Mark's effective exchange rate was 60 per cent. higher than it had been seven years earlier. In addition, the effective exchange rate of the US dollar, at its low point in late 1978, stood over 20 per cent. below its end-1972 level. These movements of effective exchange rates had two consequences. In the first place, they meant that there was little room left for expectations of further movements in the same direction, so that market sentiment with respect to these currencies became increasingly liable to be influenced by any factors that might justify a reversal of earlier trends. Furthermore, and partly as a result of the earlier movements of these countries' exchange rates, there were major shifts in their current-account balances of payments. In the United States the large deficits recorded in 1977 and 1978 were followed in 1979 and 1980 by a substantial improvement to a position of approximate balance, while in Germany, Japan and Switzerland the earlier surpluses on the current account of the balance of payments were eliminated, being replaced in Germany and Japan by large deficits in 1979 and 1980.

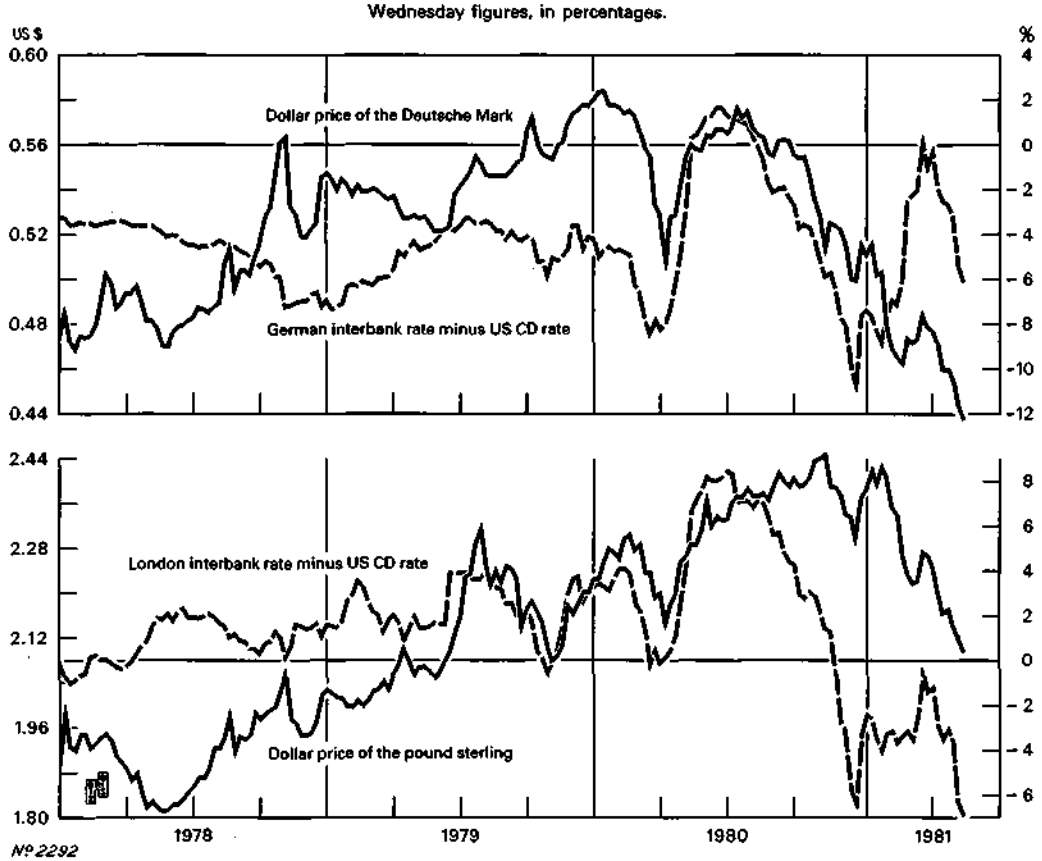
Changes in current-account balances of payments affect exchange rates in two ways: through their direct impact on the demand for, and supply of, the currencies concerned in the exchange market; and through the changes which they bring about, except when they are of only temporary duration, in the market's views about the equilibrium exchange rate of currencies. Moreover, the resultant exchange rate movements themselves may, through J-curve effects, temporarily amplify current payments imbalances.

A second factor which contributed to the divorce of exchange rate movements from international inflation differentials was that the United Kingdom, Canada and the United States, three of the countries with high inflation rates, happened to be in a more favourable position with respect to domestic oil supplies than other industrial countries. In the United States the effect of this factor was reinforced by the decontrol of domestic oil prices.

Thirdly, the development of exchange rates was influenced by the adoption in the United States and the United Kingdom of more vigorous anti-inflationary policies. These policies relied heavily on tighter domestic monetary control and they did so in ways that put strong upward pressure on the level of domestic interest rates, thus widening interest rate differentials in favour of these countries.

Changes in international interest rate differentials, like those in current-account balances of payments, exercise their influence on exchange rates partly in a direct manner, through the exchange-market effects of the international flows of funds which they induce; and when these differentials are very large, as they were last year, their effects may be large. Moreover, the influence of interest rate

Germany and the United Kingdom:
Changes in spot exchange rates vis-à-vis the dollar and in differentials between three-month interest rates on domestic currency and US dollar investments.
Wednesday figures, in percentages.



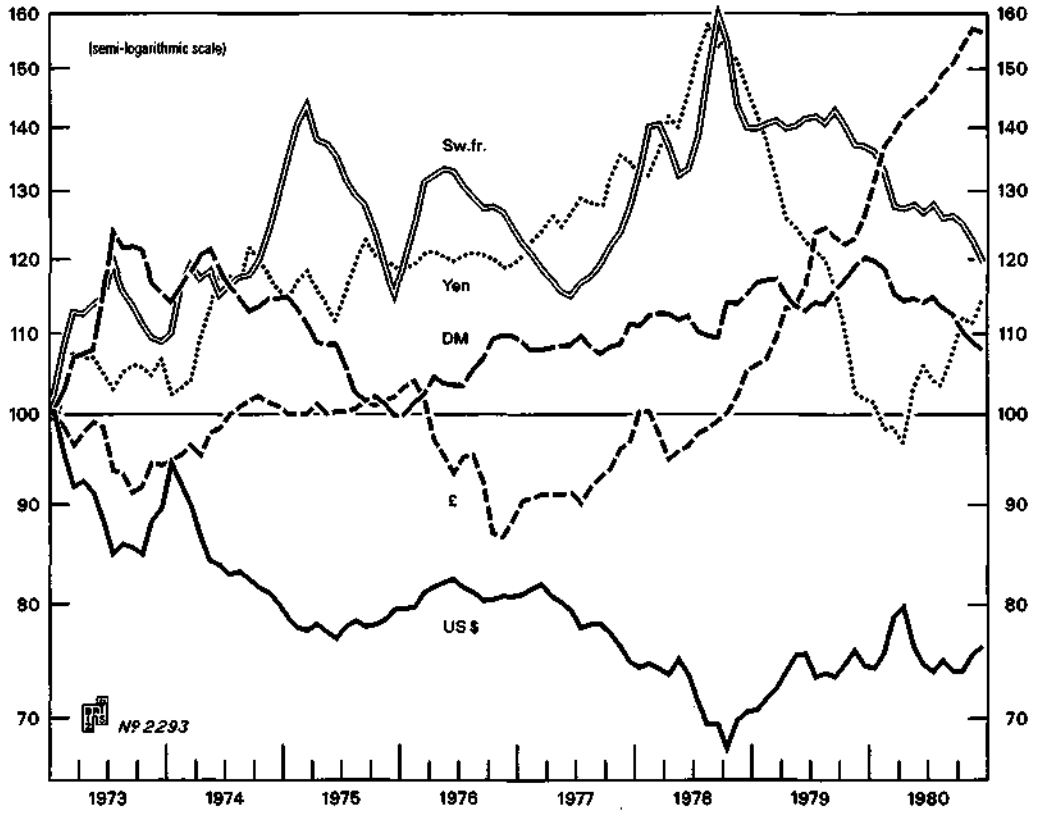

differentials will be magnified when they are perceived by the market as indicating an important change in a country's attitude to fighting inflation, as was certainly the case with the widening differentials in favour of US and UK interest rates.

The effects which interest rate differentials may have on the movement of exchange rates in different circumstances are illustrated in the graph on this page. During 1979, when the market view of the Deutsche Mark as an appreciation-prone currency and of the dollar as a depreciation-prone currency still persisted, as it had done during much of the 1970s, the spot dollar/Deutsche Mark exchange rate moved rather independently of the interest rate differential, despite the emergence of a current external deficit in Germany and the disappearance of the US deficit; however, the dollar/sterling exchange rate moved rather closely in line with the interest rate differential already in the second half of 1979, reflecting the elimination, partly in response to the British Government's monetary policies, of the earlier type-casting of sterling as a devaluation-prone currency. During 1980 earlier expectations about the future course of the dollar/Deutsche Mark exchange rate were dispelled, but without any clear new view emerging. Consequently, the movements of the exchange rate came to be dominated by short-term interest rate differentials. The shift of market opinion about the dollar/Deutsche Mark rate went a stage further

following the investiture of a new US Administration more strongly pledged than its predecessor to reducing inflation. The dollar appreciated very sharply in January-February 1981 against the Deutsche Mark, despite a marked decline in the short-term interest rate differential in favour of dollar investments. At that point it began to look as if, in a reversal of earlier rôles, the dollar might be viewed by the market as prone to appreciate against the Deutsche Mark. Following the sharp increase in German interest rates in mid-February, however, the 1980 situation of more neutral longer-term expectations was restored and movements of the dollar/Deutsche Mark exchange rate have again been dominated by interest rate differentials.

Events since late 1978, therefore, have shown that exchange rate movements may diverge from countries' relative price and cost performances at times when the situation of countries with high inflation rates is characterised by a relatively strong balance of payments on current account coupled with the pursuit of forceful anti-inflationary policies involving high levels of nominal interest rates, while countries with better price performances are experiencing the combination of a strong deterioration of their current-account balance of payments and much lower nominal interest rates. This does not mean, however, that in the longer run the evolution of exchange rates will not be affected by inflation differentials. Indeed, as the

Selected industrial countries:
Real exchange rates in terms of relative unit labour costs, 1973–80.
Monthly averages, indices: December 1972 = 100.



experience of 1979–80 has shown, countries' current-account balances of payments and, with them, their effective exchange rates do respond quite strongly, although usually with a considerable time-lag, to changes in international competitive positions.

To what extent have the recent divergences between exchange rate movements and those of relative prices and costs led to overshooting of exchange rates? The graph on page 137 shows, for five of the principal industrialised countries, the movements of their real exchange rates, measured in terms of the evolution of their unit labour costs in relation to those of other Group of Ten countries since the end of 1972.

Looking first at the years 1977–80, of the five currencies whose exchange rates are shown in the graph, only sterling recorded a large movement of the real exchange rate over the whole period. For the other four currencies what happened in 1979 and 1980 broadly represented a reversal of trends during the two preceding years, so that their international competitive positions at the end of 1980 were not far from where they had been four years earlier.

It cannot, of course, be concluded that the exchange rates of currencies were necessarily in equilibrium at the end of 1980, simply because in real terms they were then not far from where they had been at the end of 1976. In the longer perspective of the years 1973–80, at the start of which period the dollar was certainly overvalued and the other currencies shown in the graph (except sterling) were undervalued, the competitive position of the dollar was much stronger at the end of 1980 than it had been eight years earlier. However, a significant part of that advantage may have been lost during the first four and a half months of 1981. On the other hand, the real exchange rates of the yen and the Deutsche Mark at the end of 1980 were about 14 and 8 per cent. respectively above their end-1972 levels, and they have certainly come down further in the last few months, as has also that of the Swiss franc, whose cumulative appreciation since end-1972 has, however, been greater than that of the yen and the Deutsche Mark. The real exchange rate of the pound sterling has not only moved much further during 1973–80 than those of the other four currencies, but the extent of the movement has itself had a favourable effect on the present competitive positions of the other currencies.

Looking to the future, interest rate differentials may continue for a time to be an important factor in exchange rate movements. In the longer run, however, the influence of relative competitive positions will reassert itself. While the changes in real exchange rates that began in late 1978 have to a considerable extent represented a correction of earlier overvaluations and undervaluations, in some instances a reduction of international inflation differentials will be needed to validate the present structure of exchange rates.

**Gold production and the gold market.**

There were two outstanding developments in respect of gold during the period under review: a 50 per cent. reduction, to a seventeen-year low point of some 920 metric tons, in the amount of gold available for non-monetary absorption; and the

very wide movements of the market price, between a high point of $850 per ounce in January 1980 and a low point of about $457 in March 1981.

One factor behind the reduction in market supply was the further decline in world gold production (excluding that of the USSR, other eastern European countries, China and North Korea) from 956 to 940 tons, the lowest figure for twenty-two years. South Africa's 1980 gold output, at 675 tons, was 30 tons lower than in 1979. Production also declined in Papua-New Guinea, the United States and Canada but, owing to increasing alluvial mining activity, expanded quite strongly in Brazil, Colombia and the Philippines. In contrast to the preceding year, the continuing trend towards the mining of lower-grade ore in South Africa (the average gold content of the ore extracted declined by a further 11 per cent.) was less than offset by the 7.6 per cent. increase in the total amount of ore milled. The average price received by the industry increased by nearly 90 per cent., while production costs rose by 17.7 per cent., and average profits (before tax) from gold production went up by 128 per cent.

Estimated world gold production.

| Countries | 1929 | 1940 | 1946 | 1953 | 1970 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|---|
| | in metric tons | | | | | | | | |
| South Africa | 323.9 | 436.9 | 371.0 | 371.4 | 1,000.4 | 699.9 | 706.4[1] | 705.4[1] | 675.1[1] |
| Canada | 60.0 | 165.9 | 88.5 | 126.1 | 74.9 | 53.9 | 54.0 | 51.1 | 49.0 |
| Brazil | 3.3 | 4.7 | 4.4 | 3.6 | 9.0 | 15.9 | 22.0 | 25.0 | 35.0 |
| United States | 64.0 | 151.4 | 49.0 | 60.9 | 54.2 | 34.2 | 31.1 | 30.2 | 27.6 |
| Philippines | 5.1 | 34.9 | – | 14.9 | 18.7 | 17.4 | 18.2 | 16.7 | 20.4 |
| Australia | 13.3 | 51.1 | 25.6 | 33.4 | 19.3 | 19.4 | 20.0 | 18.2 | 17.4 |
| Papua-New Guinea | . | . | . | . | 0.7 | 23.0 | 23.4 | 20.0 | 15.0 |
| Colombia | 4.3 | 19.7 | 13.6 | 13.6 | 6.3 | 8.2 | 8.0 | 8.3 | 15.0 |
| Zimbabwe | 17.4 | 25.7 | 16.9 | 15.6 | 15.6 | 11.7 | 10.8 | 11.8 | 11.3 |
| Ghana | 6.4 | 27.6 | 18.2 | 22.7 | 22.0 | 15.0 | 12.5 | 11.1 | 10.9 |
| Mexico | 20.4 | 27.4 | 13.1 | 15.0 | 6.2 | 6.6 | 6.2 | 6.4 | 5.9 |
| Spain | . | . | . | . | . | 9.8 | 8.6 | 5.1 | 4.0 |
| Japan | 9.3 | 12.6 | 1.3 | 7.1 | 7.9 | 4.6 | 4.5 | 4.0 | 3.2 |
| Total listed | 527.4 | 957.9 | 601.6 | 684.3 | 1,235.2 | 919.6 | 925.7 | 913.3 | 889.8 |
| Other countries | 43.1 | 207.1 | 64.9 | 69.9 | 36.0 | 44.6 | 43.4 | 42.7 | 50.2 |
| Estimated world total[2] | 570.5 | 1,165.0 | 666.5 | 754.2 | 1,271.2 | 964.2 | 969.1 | 956.0 | 940.0 |

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

A second factor reducing gold supplies was much lower market sales of gold by communist countries. In 1980 they may be estimated to have amounted to some 90 tons, the lowest figure for nine years and one-fifth of the 1977–78 average. The main reason for the sharp reduction in market supplies of gold, however, was the turn-round in the movement of total official gold stocks. During 1974–79 these had declined by a cumulative amount of nearly 1,500 tons, with the fall in 1979 alone totalling 600 tons. Last year's increase of 110 tons in total official gold stocks therefore represented a turn-round of over 700 tons as compared with 1979. Gold holdings of international institutions, after declining by 392 tons in 1979, fell by a further 139 tons last year. The difference between these two figures is accounted for by the greatly reduced outflow of gold from the International Monetary Fund in 1980, both to the market and to its member countries. The Fund's four-year gold

auction programme came to an end in May 1980, which meant that its gold sales last year amounted to only 69 tons, as against 173 tons in 1979. In addition, the quantity of gold restituted by the Fund to its members declined between 1979 and 1980 from 180 to 37 tons.

Countries' total gold reserves rose by 250 tons in 1980, after a fall of 210 tons the year before. A considerable part of the shift was accounted for by the fact that the US Treasury, which had sold 412 tons to the market in 1979, suspended its gold auctions after November 1979. On the other hand, as already mentioned, countries received 143 tons less gold from the IMF in 1980, under its restitution programme, than they had the year before. Excluding the US Treasury auctions and the IMF restitution transfers, countries' gold reserves went up by 211 tons last year, as against 26 tons in 1979. In other words, for the first time for many years there were sizable additions to gold reserves from new production and market purchases. South Africa's gold reserve increased by 66 tons, owing partly to the unwinding of earlier swaps with commercial banks, while that of Canada was reduced by 37 tons, partly for the minting of gold coins. More significant, however, was the movement in the official gold stocks of developing countries (both OPEC and non-OPEC) which, excluding IMF restitutions, increased by 178 tons last year, as against 22 tons in 1979. OPEC countries added 106 tons to their published gold reserves, with Indonesia alone accounting for 66 tons, while in non-OPEC Latin America and Asia there were increases of 41 and 28 tons respectively.

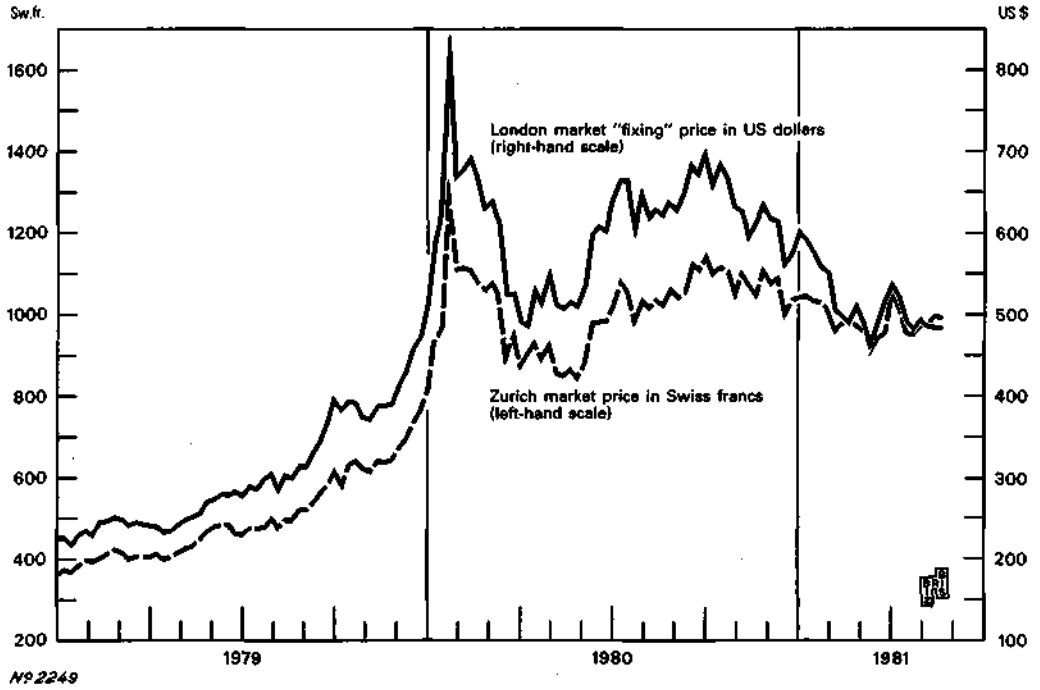
Estimated sources and uses of gold.

| Items | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|
| | in metric tons | | | |
| Production | 965 | 970 | 955 | 940 |
| Estimated sales by communist countries | 450 | 450 | 290 | 90 |
| Change in western official gold stocks (– = increase) | 275 | 245[2] | 600 | –110 |
| *of which: Countries' gold reserves*[1] | *– 70* | *–220*[2] | *210* | *–250* |
| Total (= estimated non-monetary absorption) | 1,690 | 1,665 | 1,845 | 920 |

[1] Including gold restituted by the International Monetary Fund to its member countries, totalling 371 tons in 1977, 189 tons in 1978, 180 tons in 1979 and 37 tons in 1980, as well as gold swaps by members of the European Monetary System against ECUs during 1979 and 1980. [2] Including 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.

In the London market, the year 1979 closed with the gold price at $524 per ounce, after a rise of 132 per cent. over the preceding twelve months. A substantial part of that rise had occurred during the last two months of 1979, under the influence of a number of factors. These included fears of war, following the seizure of the US Embassy in Iran and the Soviet military intervention in Afghanistan, a further large rise in oil prices and the psychological effect of the absence of any official intervention to stem the rapid upward movement of the gold price. During the first three weeks of 1980 these factors caused demand for gold, and the price of the metal, to skyrocket. By 21st January strong speculative buying had carried quotations to $850 per ounce, to give a rise of nearly 130 per cent. in two and a half months and of 340 per cent. from the November 1978 level of about $193 per ounce.

Market prices of gold bars in US dollars and Swiss francs, 1979–81.
Friday figures, per fine ounce.




The subsequent downturn in prices was, at first, even sharper than the previous upsurge, with quotations falling to $624 on 28th January. After a recovery to over $700 during a few days in the early part of February, the easing of war fears coupled with the rise in dollar interest rates brought the price down to $474 on 18th March, its lowest level for the year. There followed a further limited recovery of prices, to $554, in early April, but in late May they were down again to just over $500 as liquidation of speculative positions continued.

With dollar interest rates having fallen sharply from their early-April peak, and with the liquidation of speculative positions abating, renewed demand for gold raised the London market price to $689 on 8th July. Profit-taking, however, brought the price back to $614 by the end of that month and until early September quotations ranged between $605 and $645, with the political situation in Poland bringing little increase in market demand. Concern about the possibility of a further increase in oil prices then caused the price to rise to $693 on 12th September, just before the meeting of the OPEC countries, and the outbreak of war between Iran and Iraq prompted a further rise to $720 on 23rd September.

That proved to be the high point of the renewed increase in demand. A month later quotations had fallen to $628, under the combined influence of higher dollar interest rates, hopes that the US hostages in Iran might be released and reports of gold sales by the Soviet Union. After a brief rally in early November, the market price resumed its downward movement, reaching $553 on 12th December when dollar interest rates exceeded their April 1980 peak. Following a recovery to just on

$600 in early January 1981, the release of the US hostages and the continued high cost of carrying gold brought quotations down to $457 on 5th March. The price recovered temporarily to nearly $550 towards the end of the month, but it eased to about $480 by the middle of April and has subsequently fluctuated around that level.

**Reserves and international liquidity.**

In 1980 the general state of reserve ease was affected by two opposing sets of influences. On the one hand, there was an increase in countries' total reported official holdings of gold (valued at market prices), foreign exchange, special drawing rights, IMF reserve positions and European currency units (ECUs) amounting to $122.6 billion in current dollar values. The main reasons for last year's increase in global reserves were the rise in the market price of gold over the year as a whole, additions to the volume of countries' total gold reserves, a new SDR allocation and the expansionary effects on liquidity of large capital outflows from the United States as well as of a significant accumulation of exchange reserves, mainly through exchange-market intervention, by the United States itself. A very large part of last year's increase in global reserves accrued to non-OPEC countries. While the biggest single influence on non-OPEC reserves was the rise in the gold price, it is very striking that these countries' non-gold reserves rose by $36 billion last year, or $12 billion more than in 1979, despite a huge increase in their aggregate current external payments deficit.

On the other hand, as a result of higher oil prices the external financing needs of non-OPEC countries led to a substantial increase in many countries' external indebtedness, particularly to the international banking system, with a large part of this borrowing being at relatively short term. Moreover, the current value of non-OPEC countries' total merchandise imports went up by about 20 per cent. last year and, in addition, the increase in the current dollar value of countries' gold reserves overstates the degree to which the rise in the price of gold contributed to greater reserve ease in the gold-holding countries, since only a fraction of official gold holdings could be sold on the market without substantially depressing the price of gold. The net effect of all these influences was certainly to produce a widespread decline in reserve ease for non-OPEC countries, and in particular for those which hold little or no gold in their reserves. Excluding gold reserves and ECU holdings, the increase of some $36 billion in other reserve assets accrued mainly to the OPEC countries (+ $21.3 billion) and the United States (+ $7.8 billion). Non-oil developing countries, on the other hand, experienced a small decline in their non-gold reserves, despite a rise of $38 billion in their external banking indebtedness.

By types of reserve asset, countries' total gold reserves increased, at current dollar market prices, by some $65 billion during 1980, to $552.7 billion. This increase was partly the result of the further 12½ per cent. rise in the market price of gold. In that connection it may be noted that the value of gold reserves, calculated at market prices, fluctuated very widely during the year. The main beneficiaries of the 1980 rise in the market price of gold were the Group of Ten countries and

Changes in global reserves, 1978–80.

| 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 countries and Switzerland | | | | | | | |
| 1978 | 3.2 | 51.6 | 35.6 | – 2.6 | – 0.1 | | 32.9 |
| 1979 | – 95.0 | 199.2 | – 31.3 | – 2.2 | 3.8 | 42.2 | 12.5 |
| 1980 | – 1.1 | 47.9 | 9.7 | 3.1 | – 1.0 | 20.9 | 32.7 |
| *Amounts outstanding at end-1980* | *739.5* | *436.0* | *118.5* | *12.1* | *10.2* | *63.1* | *203.9* |
| Other developed countries | | | | | | | |
| 1978 | – 1.0 | 5.5 | 10.1 | 0.3 | 0.3 | | 10.7 |
| 1979 | 0.6 | 28.3 | 1.1 | – 0.1 | 0.2 | 0.7 | 1.9 |
| 1980 | 2.5 | 7.6 | 3.4 | 0.6 | – | – 0.1 | 3.9 |
| *Amounts outstanding at end-1980* | *96.7* | *57.0* | *37.0* | *1.9* | *1.2* | *0.6* | *40.7* |
| Developing countries other than oil-exporting countries | | | | | | | |
| 1978 | 2.9 | 3.9 | 13.7 | 0.4 | 0.3 | | 14.4 |
| 1979 | 2.2 | 17.7 | 8.1 | 0.3 | 1.1 | | 9.5 |
| 1980 | 2.8 | 5.5 | – 1.2 | 1.0 | – 0.5 | | – 0.7 |
| *Amounts outstanding at end-1980* | *60.8* | *35.8* | *67.3* | *2.2* | *2.1* | | *71.6* |
| Total oil-importing countries | | | | | | | |
| 1978 | 5.1 | 61.0 | 59.4 | – 1.9 | 0.5 | | 58.0 |
| 1979 | – 92.2 | 245.2 | – 22.1 | – 2.0 | 5.1 | 42.9 | 23.9 |
| 1980 | 4.2 | 61.0 | 11.9 | 4.7 | – 1.5 | 20.8 | 35.9 |
| *Amounts outstanding at end-1980* | *897.0* | *528.8* | *222.8* | *16.2* | *13.5* | *63.7* | *316.2* |
| Oil-exporting countries | | | | | | | |
| 1978 | 1.9 | 2.5 | – 14.5 | – 0.8 | 0.2 | | – 15.1 |
| 1979 | 0.3 | 11.2 | 15.4 | – 1.8 | 0.7 | | 14.3 |
| 1980 | 3.4 | 4.4 | 19.8 | 1.3 | 0.2 | | 21.3 |
| *Amounts outstanding at end-1980* | *40.6* | *23.9* | *90.3* | *5.3* | *1.6* | | *97.2* |
| All countries | | | | | | | |
| 1978 | 7.0 | 63.5 | 44.9 | – 2.7 | 0.7 | | 42.9 |
| 1979 | – 91.9 | 256.4 | – 6.7 | – 3.8 | 5.8 | 42.9 | 38.2 |
| 1980 | 7.6 | 65.4 | 31.7 | 6.0 | – 1.3 | 20.8 | 57.2 |
| *Amounts outstanding at end-1980* | *937.6* | *552.7* | *313.1* | *21.5* | *15.1* | *63.7* | *413.4* |

* Gold reserves valued at market prices.

Switzerland, which together hold almost 80 per cent. of total gold reserves. In addition to the moderate rise in the gold price during 1980 as a whole, there was also an increase of about 7.5 million ounces in the total volume of gold reserves, after a decrease of some 92 million ounces in 1979. OPEC countries added 3.4 million ounces to their official gold holdings in 1980, of which 2.1 million ounces was accounted for by Indonesia, and non-oil developing countries increased their holdings by 2.8 million ounces. The total of ECU reserves outstanding was also affected by the rise in the gold price. In fact, the total growth of ECU reserves in 1980, from $42.9 to 63.7 billion, corresponded very closely to the amount by which

EMS member countries' holdings of ECUs against swaps of gold were revalued during the year, on a basis related to the movement of the market price of gold.

Total reported foreign exchange reserves increased by $31.7 billion during 1980 in current dollar terms. If the effects of the appreciation of the dollar against other reserve currencies are excluded, the rise would be some $3–4 billion greater. A very large part of the increase was accounted for by the OPEC countries (+ $19.8 billion) and the United States (+ $6.3 billion). The rise in US exchange reserves, to a total of $10.1 billion at the end of the year, resulted from heavy intervention by the Federal Reserve Bank of New York to support the Deutsche Mark and, to a lesser extent, from the issue of a further $1.2 billion of DM bonds by the US Government. These operations by the US authorities not only produced a large increase in US official holdings of foreign exchange but they also made possible the repayment of $3.2 billion of debt outstanding from earlier drawings by the United States on swap lines of credit with the Deutsche Bundesbank. The unprecedentedly large increase in US exchange reserves marked a new step in the evolution of a multi-currency reserve system, the emergence of which in earlier years had resulted essentially from the diversification of other (mainly non-Group of Ten) countries' exchange reserves out of dollars into other currencies. It may be added that the expansionary effect on global reserves of that part of the increase in US official holdings of foreign exchange that resulted from market purchases of currencies was twofold, since it not only added to US official currency holdings but also placed a corresponding amount of dollars at the disposal of the rest of the world and, in particular, moderated the decline in Germany's dollar reserves.

Reserve positions in the International Monetary Fund contributed $6 billion to the growth of global reserves last year. More than the whole of that figure was accounted for by reserve-tranche subscriptions, totalling the equivalent of $6.3 billion, which were paid into the Fund under the seventh general increase in Fund quotas, which came into force in December 1980 and raised total quotas, in dollar terms, by $25.3 to 76.0 billion. Net drawings by member countries on the Fund during 1980 totalled $2.2 billion, following net repayments in both of the two preceding years. However, the pattern of drawings was such that it led to a $0.3 billion decline in total Fund reserve positions. There were $3.4 billion of net new drawings by non-oil developing countries, partly offset by $1.2 billion of repayments by the United Kingdom.

Total new lending commitments entered into by the Fund in 1980 amounted to $9.4 billion, all of them to non-oil developing countries, compared with $2.8 billion in 1979. In September 1980 the Interim Committee endorsed a new guideline for enlarging members' access to the Fund's resources, under which countries can draw up to a total of 600 per cent. of their quotas (excluding drawings under the compensatory financing and buffer stock arrangements) over a period of three years. Following the entry into force of the seventh general increase in Fund quotas, the guideline was revised in January 1981 to permit net drawings of up to 450 per cent. of a country's quota over a three-year period with a limit on total drawings (excluding those made under the compensatory financing and buffer stock arrangements and outstanding drawings on the oil facilities) of 600 per cent. of its

quota. The Interim Committee also agreed that the Fund should supplement its resources by further borrowing, in the first place from member countries but also, if necessary, from financial markets, and a target of SDR 6–7 billion was announced for such borrowing for 1981, with additional borrowing being envisaged for 1982 and 1983. In March 1981 the Fund announced the completion of a borrowing agreement with Saudi Arabia under which the latter will make available to the Fund up to SDR 4 billion a year in the first two years of the agreement. At the same time the Fund's Executive Board recommended that Saudi Arabia's quota be raised from SDR 1.0 to 2.1 billion. In May the IMF announced that it had arranged to borrow up to SDR 1.1 billion from the central banks of the Group of Ten countries (except the United States), Switzerland, Austria, Denmark and Norway.

Countries' total holdings of SDRs declined last year in dollar terms by $1.3 billion, to $15.1 billion. The principal factors affecting SDR reserves last year were the January 1980 allocation of SDRs, amounting to the equivalent of some $5.3 billion, and the $6.3 billion worth of SDRs paid into the Fund in connection with last year's general increase in Fund quotas. In January 1981 the number of currencies in the SDR valuation basket was reduced from sixteen to the five currencies — the US dollar, the Deutsche Mark, the yen, the pound sterling and the French franc — that make up the SDR interest rate basket. In April 1981 the Fund increased the interest rate on SDRs from 80 to 100 per cent. of the weighted average of domestic short-term interest rates in these five currencies, and at the same time it eliminated any requirement for countries to reconstitute their SDR balances after use.

Turning to reserve developments in the main groups of countries shown in the table on page 143, and leaving gold reserves out of account, the combined reserves of the Group of Ten countries and Switzerland during 1980 went up by $32.7 billion. Excluding the United States, which has already been discussed, the increase for other Group of Ten countries was $24.9 billion. Of that amount, ECU creation accounted for $20.9 billion, whilst other reserve assets went up by only $4 billion. In fact, Group of Ten EMS countries' overall gains in non-gold reserves were smaller than the increase in their ECU holdings.

Among individual Group of Ten countries other than the United States, Japan's non-gold reserves went up by $5.1 billion, partly reversing the $12.9 billion loss suffered in 1979; in the case of the United Kingdom, however, where non-gold reserves rose by only $0.9 billion (nearly half of which was the SDR allocation) the upward pressure on the currency was almost fully reflected in the exchange rate. In Switzerland, too, exchange-market forces were largely permitted to run their course and official reserves registered a decline of only $0.8 billion. Among the countries participating in the EMS exchange rate mechanism, substantial reserve gains were achieved by France ($9.8 billion), Italy ($4.9 billion), the Netherlands ($4.1 billion) and Belgium ($2.3 billion), although in large measure as a result of ECU creation. Germany, on the other hand, which intervened heavily at times in order to contain the decline in the DM exchange rate, registered a $4.5 billion contraction in its non-gold reserve assets, despite its substantial share in the creation of ECUs.

With the help of heavy recourse to the international credit markets, most developed countries outside the Group of Ten were able approximately to maintain,

and in some cases to augment, their non-gold reserve assets. In fact, despite a widening of their aggregate current-account payments deficit from $12 to 22 billion, their total reserve gain of $3.9 billion was twice as large as in 1979. Norway, Austria and Ireland added $1.8, 1.2 and 0.6 billion respectively to their reserves, while Spain recorded a loss of $1.4 billion.

For the non-oil developing countries, 1980 marked the end of a prolonged period of reserve growth. Their aggregate non-gold reserves, after average annual growth of some $11 billion during 1976–79, declined by $0.7 billion last year. The largest movements were recorded in Latin America. Chile's and Colombia's reserves increased by $1.2 billion and $1 billion, while those of Argentina and Brazil fell by $2.7 and 3.2 billion respectively.

Perhaps the most striking feature of OPEC reserve movements in 1980 was that the aggregate increase in these countries' reported non-gold reserves, at $21.3 billion, was only $7 billion more than it had been the year before, despite the estimated $44 billion increase between the two years in these countries' aggregate current external surplus. This may have been related to the increased concentration of the surplus on low-absorbing OPEC members, part of whose liquid external assets are not included in reserve statistics, as well as to a shift to investment in longer-term assets.

Among individual oil-exporting countries, the largest reserve gains were reported by Libya ($6.7 billion), Nigeria ($4.7 billion), Saudi Arabia ($4.2 billion), Indonesia ($1.3 billion), Algeria and Kuwait ($1.1 billion each). Venezuela, on the other hand, registered a $0.7 billion reserve loss. No recent information is available on the reserve holdings of Iran and Iraq. More than the whole of the recorded increase of $19.8 billion in oil exporters' foreign exchange reserves occurred in the first nine months of 1980, while in the fourth quarter of the year there was a slight decline.

Looking more closely at the growth of total exchange reserves, there were a number of contrasts between 1979 and 1980 in the extent to which reserve holders placed their assets in different national markets, or in the Euro-currency market, and in the currency composition of the growth of exchange reserves. These differences are illustrated in the next table. Official dollar balances held in the United States, as measured by the change in US liabilities to foreign official holders, went up by $13.8 billion in 1980, after a decline of about the same size the year before. Official deposits with banks in national markets outside the United States grew by $8.8 billion, after a small decline in 1979, while identified official deposits in the Euro-currency markets increased by $7.4 billion, after a rise of nearly $35 billion the year before. That these increases together add up to more than the $25.4 billion rise during 1980 in the total reported exchange reserves of countries other than the United States mainly reflects the fact that not all the official claims of OPEC countries on banks in other countries are included in reserve statistics. In that connection it may be mentioned that total identified OPEC deposits with commercial banks, as shown in the table, expanded by $40 billion last year.

The $8.8 billion expansion during 1980 of foreign exchange reserves held with banks in national markets outside the United States represented an increase of 100 per cent. This development was related to the dismantling, or easing, in a number of

countries, such as Germany, Japan and Switzerland, of restrictions on capital inflows in order to protect the external value of their currencies and to help finance their payments deficits. Yen reserves held with Japanese banks showed a particularly strong increase, from $0.9 to 4.6 billion, following the lifting in March 1980 of restrictions on the payment of interest to official holders of free yen deposits. Official deposits with German and Swiss banks also increased during 1980, by $1.4 and 1.0 billion respectively, despite the weakening of the Deutsche Mark and the Swiss franc on the exchange market. The strength of sterling was reflected in a rise, from $4.9 to 8.4 billion, in total official sterling balances held in the United Kingdom, with official balances held at UK banks rising by $1.1 to 3.0 billion.

**Identified official deposits with commercial banks outside the United States.**

| Items | End-1977 | End-1978 | End-1979 | Mid-1980 | End-1980 |
|---|---|---|---|---|---|
| | amounts outstanding, in billions of US dollars | | | | |
| A. Deposits with banks in European countries,[1] Canada and Japan | | | | | |
| I. In national markets | 7.6 | 9.3 | 8.8 | 15.9 | 17.6 |
| Deutsche Mark | 2.2 | 3.1 | 3.4 | 4.7 | 4.8 |
| Swiss francs | 1.3 | 0.6 | 0.6 | 1.2 | 1.6 |
| Yen | 0.9 | 2.7 | 0.9 | 3.8 | 4.6 |
| Pounds sterling | 1.6 | 1.2 | 1.9 | 2.9 | 3.0 |
| Other currencies | 1.6 | 1.7 | 2.0 | 3.3 | 3.6 |
| II. In Euro-markets | 71.0 | 80.1 | 115.0 | 119.1 | 122.4 |
| Dollars | 53.0 | 52.8 | 73.3 | 75.3 | 79.4 |
| Deutsche Mark | 12.0 | 16.8 | 24.1 | 24.7 | 24.2 |
| Swiss francs | 3.2 | 4.6 | 6.0 | 7.3 | 8.0 |
| Yen | 0.9[2] | 2.2[2] | 4.2[2] | 2.7[2] | 2.2[2] |
| Pounds sterling | 0.3 | 0.7 | 1.5 | 2.3 | 2.2 |
| Other currencies | 1.6 | 3.0 | 5.9 | 6.8 | 6.4 |
| Total I+II | 78.6 | 89.4 | 123.8 | 135.0 | 140.0 |
| *of which in non-dollar currencies* | *25.6* | *36.6* | *50.5* | *59.7* | *60.6* |
| B. Deposits with offshore branches of US banks | 4.4 | 5.7 | 6.4 | 6.2 | 5.6 |
| Total A+B | 83.0 | 95.1 | 130.2 | 141.2 | 145.6 |
| *Memorandum items:* | | | | | |
| *Total OPEC deposits with reporting banks outside the United States* | *68.2* | *73.4* | *106.2* | *129.5* | *146.2* |
| *US liabilities to foreign official institutions* | *126.1* | *156.8* | *143.1* | *142.6* | *156.9* |

Note: The figures in the table include exchange rate-induced changes in the dollar value of reserves held in currencies other than the dollar.

[1] Austria, Belgium-Luxembourg, Denmark, France, Germany, Ireland, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. [2] Excluding deposits with banks in Switzerland.

The increase in reserve holdings in national markets was undoubtedly one of the reasons why official deposits in the Euro-currency market showed only a relatively moderate increase last year. The dollar value of official Euro-deposits in currencies other than the dollar, which had gone up by $14.4 billion in 1979, edged

up by only $1.3 billion. However, last year's increase was understated to the extent of some $3 billion by the effects of the dollar's appreciation against other currencies. The dollar value of official Euro-yen deposits dropped by $2 billion, but there was a continued build-up of Euro-Swiss franc and Euro-sterling deposits.

The trend towards increased investment of exchange reserves in their respective national markets also encompassed the US dollar. At $6.1 billion, the rise in official Euro-dollar deposits was less than half as large as total additions to dollar reserves held in the United States. In 1979, on the other hand, official Euro-dollar deposits had expanded by $20.5 billion, whilst US liabilities to foreign official holders had fallen by $13.7 billion. Part of the explanation for this pronounced shift could lie in political and economic developments which may have enhanced the attractiveness of the United States as a reserve centre.

# 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, 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. In particular, mention may be made of the task entrusted by the Group of Ten central-bank Governors in April 1980 to the Euro-currency Standing Committee of systematically monitoring international banking developments. In accordance with the mandate given to it by the Governors, the Standing Committee has held quarterly meetings at which it has reviewed these developments and has assessed their significance for the world economy, for the economies of individual countries and for the soundness of the whole international banking system.

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 of collecting and distributing to all the participants in the Group and to Working Party No. 3 of the Organisation for Economic Co-operation and Development statistical data concerning the financing of external surpluses and deficits of the Group of Ten countries. It also continued to assemble, survey and distribute statistical data on the Euro-currency market and to be associated with other work of the Group of Ten and of the OECD, 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 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 bodies 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 periodically 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 1980–81, 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, 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 for the Ministers of Finance of the EEC countries.

In the financial year 1980–81 a major part of this activity was concerned with the administration of the European Monetary System (EMS) established on 13th March 1979. The principal tasks were:

- ensuring that the arrangements governing the system were properly applied,
- strengthening 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,
- extending for a further two-year period with effect from 13th March 1981 the revolving swap mechanism whereby ECUs are created against contributions of gold and US dollars to the European Monetary Co-operation Fund (when the EMS was established the initial duration of this mechanism had been limited to two years),
- taking the necessary steps for the accession of the central bank of Greece to the Agreement setting up a system of short-term monetary support among the Central Banks of the Member States of the European Economic Community.

In addition, the Committee of Governors continued to work on the possible evolution of the EMS towards a more institutionalised, more definitive phase as envisaged in the Resolution of the European Council of 5th December 1978. Other studies undertaken within the Committee concerned the question of monetary control techniques. Lastly, the Committee closely monitored international monetary developments and looked into the possibilities of closer monetary co-operation with certain non-EEC countries, particularly the United States.

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 its meetings and throughout the year the Group pursued its analysis of payment systems and how they may develop in the medium term. As from the summer of

1981 a new group will extend the scope of these studies to include a detailed examination of the effects on the banking system of the use of new payment technology. The computer experts have also followed the development of telecommunications networks in the main industrialised countries and the problems connected with their operation and interconnection. In this context they closely monitored the work carried out, in particular, by the International Standards Organisation on the transmission of banking messages and the interconnection of open systems. In addition, they reviewed the use of data processing in their own central banks and are preparing to make a study of the effect that the introduction of sophisticated information systems is likely to produce on the internal organisation of the central banks.

Under the guidance of the central-bank Group of Experts on Monetary and Economic Data-Bank Questions, for which the BIS also performs secretariat functions, further progress was made towards the establishment of a data bank for the BIS and the central banks. During the year the existing data base was successfully transferred from the outside computer facility to the Bank's own premises. This has made it possible now to envisage a system of expanded reporting from and to the central banks, and with this end in view most of the banks have already taken the necessary steps to establish a telecommunications link with the BIS computer.

One of the principal aims of the data-bank project is to provide a rapid, reliable means of exchanging macro-economic time series, mostly of a financial nature, between the central banks and the BIS. In addition, an automated internal system for processing Euro-currency statistics has been developed, and it is hoped in due course to extend this system to cover the reporting of such statistics from and to the central banks.

## 2. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1981, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

* * *

| | |
|---|---|
| At 31st March 1981 the balance-sheet total stood at | F 19,726,245,562 |
| against, on 31st March 1980, | F 24,409,416,167 |
| The decrease thus amounted to | F 4,683,170,605 |

* In this chapter the term "francs" (abbreviated to F) signifies *gold* francs unless otherwise specified. 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 ounce of fine gold (equivalent to 1 gold franc = US$ 1.941 49...); all other items in currencies are converted on the basis of market rates against the US dollar.

It may be recalled that for the previous financial year 1979–80 an increase had been recorded amounting to 5,308 million francs.

Up to July 1980 inclusive, fluctuations in the exchange rates of currencies other than the US dollar were in most cases reflected in an appreciation in their value in terms of gold francs; from then until the end of the financial year there was a fall in value far sharper than the preceding rise; the result was a net depreciation which accounted for approximately one-tenth of the total decrease.

The total of the monthly statement of account rose until the end of June 1980, when it reached a record level of 25,697 million francs; it then fell to 22,500 million at the end of July 1980 and subsequently remained more or less stable until the end of December 1980; thereafter, it declined gradually until the end of the financial year.

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

| Financial years ended 31st March | Total of Balance Sheet | Movement over the year | |
|---|---|---|---|
| | in millions of francs | | in percentages |
| 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 |
| 1981 | 19,726 | – 4,683 | – 19 |

* On the basis of the former method of conversion, employed until June 1979 (for the US dollar on the basis of 1 gold franc = US$ 0.3941...; for the other currencies at central or market rates).

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 1,190 million francs on 31st March 1981, against 1,034 million on 31st March 1980, an increase of 156 million.

LIABILITIES (COMPOSITION OF RESOURCES).

**BIS: Development of the composition of resources over the past five financial years**
(after allocation of the net profit for the year as proposed to the Annual General Meeting).

| Financial years ended 31st March | Paid-up capital and reserves | Borrowed funds | Sundry liabilities | Balance-sheet total |
|---|---|---|---|---|
| | in millions of francs | | | |
| 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 | 859 | 17,991 | 251 | 19,101 |
| 1980 | 887 | 23,239 | 283 | 24,409 |
| 1981 | 937 | 18,539 | 250 | 19,726 |

* On the basis of the former method of conversion.

## A. Capital, reserves and miscellaneous liabilities.

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

The Bank's authorised capital remained unchanged at 1,500 million francs; there was no change either in the issued capital, which is made up of 473,125 shares paid up to the extent of 25 per cent.

(b) Reserves

The movements in the various reserve funds, commented upon below, are shown in the table at the end of this Report, under Item I.

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

The total of this Fund 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 1980–81 F 417,152,793

This compares with 397.2 million francs on 31st March 1980; the difference of 20 million represents the amount it is proposed to transfer to the Fund from the net profit; the proposed increase in this Reserve Fund is in conformity with the provisions of Article 51(3) of the Statutes.

(3) *Special Dividend Reserve Fund*

after allocation of the net profit for 1980–81 F 19,530,055

This compares with 17.5 million francs on 31st March 1980 and includes the proposed transfer of 2 million from the net profit; the amount of this Reserve Fund will thus be raised to the equivalent of an annual dividend at its present level, plus a certain margin to allow for exchange rate fluctuations.

(4) *Free Reserve Fund*

after allocation of the net profit for 1980–81 F 174,730,236

This compares with 146.7 million francs on 31st March 1980, the amount it is proposed to transfer to this Fund from the net profit being 28 million francs.

The Bank's overall reserves after allocation of the net profit for 1980–81 thus stand at F 641,483,397 against 591.5 million francs at the beginning of the financial year, giving an increase of 50 million, or 8.5 per cent.; by way of comparison, the increase in these reserves in the two preceding financial years, 1978–79 and 1979–80, amounted to 28.6 million and 33 million respectively.

(c) The item "Miscellaneous" stood at F 232,804,254

against 265.2 million francs on 31st March 1980, a decline of 32.4 million.

(d) Profit and Loss Account, *before* allocation F 67,004,609

This figure represents the net profit for the financial year 1980–81; it is 16 million francs higher than the net profit for the financial year 1979–80, which incorporated the net proceeds of the sale of the Bank's old premises, viz. approximately 2.6 million.

Details of the proposed allocation of the net profit, 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 17,004,609 francs to be set aside in respect of the dividend of 135 Swiss francs per share to be paid on 1st July 1981; for the preceding financial year the total dividend had amounted to 17,977,378 francs, comprising an amount of 110 Swiss francs per share 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 | | Movement |
|---|---|---|---|
| | 1980 | 1981 | |
| | in millions of francs | | |
| Deposits of central banks | 22,486 | 18,431 | – 4,055 |
| Deposits of other depositors | 753 | 108 | – 645 |
| Total | 23,239 | 18,539 | – 4,700 |

"Deposits of central banks" declined very sharply (– 18 per cent.), but by less than the increase recorded during the preceding financial year (+ 4,971 million, or 28.4 per cent.); the movement was again chiefly in US dollars; there was also a

decrease in deposits in Deutsche Mark, very appreciably magnified by the fall in their value, while other currencies taken as a whole likewise recorded a decline; on the other hand, there was an increase in deposits in gold.

The reduction in "Deposits of other depositors" was very marked, particularly in relative terms (– 85.7 per cent.), whereas during the previous financial year the amount of this item had increased quite appreciably (+ 277 million, or 58.2 per cent.); the decline reflected the maturing of large deposits in US dollars indexed to the special drawing right.

"Deposits of central banks" continued to account for the great bulk of borrowed resources, increasing as a proportion of the total from 96.8 to 99.4 per cent.

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

| Term | Deposits in gold | | | Deposits in currencies | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| | Financial years ended 31st March | | Movement | Financial years ended 31st March | | Movement | Financial years ended 31st March | | Movement |
| | 1980 | 1981 | | 1980 | 1981 | | 1980 | 1981 | |
| | in millions of francs | | | | | | | | |
| Sight | 4,432 | 4,647 | + 215 | 366 | 276 | – 90 | 4,798 | 4,923 | + 125 |
| Not exceeding 3 months | 46 | 30 | – 16 | 15,992 | 11,671 | – 4,321 | 16,038 | 11,701 | – 4,337 |
| Over 3 months | 9 | 4 | – 5 | 2,394 | 1,911 | – 483 | 2,403 | 1,915 | – 488 |
| Total | 4,487 | 4,681 | + 194 | 18,752 | 13,858 | – 4,894 | 23,239 | 18,539 | – 4,700 |

As may be seen from the table above, expressed as a proportion of total borrowed resources, deposits in currencies declined from 80.7 to 74.8 per cent. during the financial year, while deposits in gold rose from 19.3 to 25.2 per cent.; it may be recalled that on 31st March 1979 the respective percentages were 77.8 and 22.2.

In terms of maturity, the share of the total accounted for by time deposits decreased from 79.4 to 73.4 per cent., whereas that of sight deposits rose from 20.6 to 26.6 per cent.; on 31st March 1979 the figures had been 77 and 23 per cent. respectively.

(a) Deposits in gold F 4,681,285,317

This figure compares with one of 4,487 million francs at the beginning of the financial year; the increase of 194 million, or 4.3 per cent., is quite appreciably smaller than that of 488 million recorded during the previous financial year; as in that year, it broadly corresponds to a net increase in deposits from central banks and a net reduction in the amount involved in swaps, the gold (sold forward) having been left on sight deposit with the Bank; total time deposits in gold declined by approximately one-third, various deposits having been either transferred to sight accounts or repaid when they matured.

(b) Deposits in currencies F 13,857,964,860

Having stood at 18,752 million francs on 31st March 1980, this item, which accounts for the major part of total liabilities, showed a particularly sharp decrease of 4,894 million, or 26.1 per cent. (in the previous financial year it increased by 4,760 million, or 34 per cent.); the decline was chiefly in funds at up to three months, which were reduced by 27 per cent.; the other two items — those at sight and at over three months — also recorded decreases which in percentage terms were fairly similar to that in the first mentioned item.

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 1980 | | 1981 | | Movement | |
|---|---|---|---|---|---|---|
| | In millions of francs | | | | | |
| Sight assets | | | | | | |
| Gold | 5,313 | | 5,437 | | + 124 | |
| Currencies | 15 | 5,328 | 16 | 5,453 | + 1 | + 125 |
| Treasury bills | | | | | | |
| Currencies | | 156 | | 226 | | + 70 |
| Time deposits and advances | | | | | | |
| Gold | – | | 41 | | + 41 | |
| Currencies | 14,487 | 14,487 | 12,776 | 12,817 | – 1,711 | – 1,670 |
| Securities at term | | | | | | |
| Currencies | | 4,268 | | 1,086 | | – 3,182 |
| Total | | | | | | |
| Gold | 5,313 | | 5,478 | | + 165 | |
| Currencies | 18,926 | 24,239 | 14,104 | 19,582 | – 4,822 | – 4,657 |

(a) Gold F 5,436,941,670

This item, which had amounted to 5,313 million francs at the beginning of the financial year, rose by 124 million, or 2.3 per cent., whereas during the previous financial year the increase had been nearly three times as large in percentage terms; the rise recorded reflected net deposits of gold received, as already mentioned, from central banks and, to a lesser degree, the conclusion with other central banks of swaps of gold (purchased spot) against various currencies; in the opposite direction, note may be taken of drawings made on gold holdings in order to effect the investments referred to below and, to a lesser extent, to repay time deposits, as mentioned above.

(b) Cash on hand and on sight account with banks F 15,977,519

This figure compares with 15 million at 31st March 1980 and is therefore practically unchanged.

(c) Treasury bills F 225,598,456

This compares with a figure of 156 million francs at the end of the previous financial year; the quite appreciable rise recorded, of 70 million or 44.9 per cent., contrasts with the decline registered during the financial year 1979–80 (of 104 million, or 40 per cent.); it largely corresponds to purchases of US Treasury bills.

(d) Time deposits and advances F 12,816,903,620

This figure compares with one of 14,487 million francs at 31st March 1980.

The item in gold, which had disappeared on 31st March 1980, reappeared with a figure of 41 million, representing — as noted above — placements of gold in the form of time deposits.

The item in currencies declined substantially, from 14,487 million to 12,776 million, a decrease of 1,711 million or 11.8 per cent. (a percentage very similar to that of the rise recorded during the previous financial year). The greater part of the decline involved US dollars, while an appreciable amount was in Deutsche Mark, principally owing to the fall in value of that currency, and a smaller proportion in the other currencies; it was mainly attributable to a fall in placements made on various markets, only a very small part being due to a reduction in facilities granted to central banks.

(e) Securities at term F 1,086,229,848

From a figure of 4,268 million francs at 31st March 1980, this item decreased by 3,182 million, or three-quarters, after having increased by the slightly larger amount of 3,401 million during the financial year 1979–80; the decline was in US dollars and corresponded almost entirely to the maturing of repurchase agreements in respect of US Treasury securities; on the other hand, it may be noted that holdings both of certificates of deposit — mainly issued on the US market — and of public-sector securities increased, quite appreciably in the first case and far less in the second.

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 | | Movement |
|---|---|---|---|
| | 1980 | 1981 | |
| | in millions of francs | | |
| Not exceeding 3 months | 14,652 | 9,914 | – 4,738 |
| Over 3 months | 4,103 | 3,989 | – 114 |
| Total | 18,755 | 13,903 | – 4,852 |

The above table shows a certain lengthening of the average term of these investments; assets with not more than three months to run decreased by almost one-third, whereas the decline in those with more than three months to maturity was only negligible.

(f) Miscellaneous F 144,594,448

This figure compares with 170 million francs at 31st March 1980; the decrease of 25 million was the result of book-keeping adjustments; the latter were due to net maturities of swaps concluded with central banks — of gold (purchased spot at market-related prices) against various currencies — and, to a lesser extent, to the conclusion with the market of swaps in the opposite direction.

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 134,494,016 compared with a negative balance of 164 million francs at the beginning of the financial year; the contraction — of 30 million — in the amount of gold payable forward was due to the reduction (mentioned in connection with the previous item) in the net weights of gold involved in swaps transacted with central banks.

* * *

The appreciable decrease in the Bank's balance-sheet total did not affect the volume of its operations, which remained at a very high level.

**3. Net profits and their distribution.**

The accounts for the fifty-first financial year ended 31st March 1981 show a net operating surplus of 68,061,940 francs, compared with a total surplus of 54,966,432 francs for the preceding financial year, including net proceeds of 2,630,695 francs derived from the sale of the Bank's old premises. The main reasons for the considerable increase recorded in the year under review are the exceptionally high levels of interest rates obtaining on various markets and the larger volume of the Bank's own funds held in currencies.

The Board of Directors has decided to transfer 1,057,331 francs to the Provision for Exceptional Costs of Administration. Following this transfer the net profit amounts to 67,004,609 francs, against 50,977,378 francs for the previous financial year. 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 67,004,609 francs be applied by the General Meeting in the following manner:

(i) an amount of 17,004,609 francs in payment of a dividend of 135 Swiss francs per share;

(ii) an amount of 20,000,000 francs to be transferred to the General Reserve Fund;

(iii) an amount of 2,000,000 francs to be transferred to the Special Dividend Reserve Fund; and finally

(iv) an amount of 28,000,000 francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose which is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on 1st July 1981 to the shareholders whose names are contained in the Bank's share register on 20th June 1981.

The Balance Sheet, the Profit and Loss Account and a summary statement showing the movements during the financial year in the Bank's 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 1981 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.

## 4. The Bank as Depositary under the terms of the Act of Pledge concluded with the European Coal and Steel Community, and as Trustee for international government loans.

The table on the next page 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 1980–81 the amounts received by the Bank for the service of the secured loans came to the equivalent of about 180,000 francs in respect of interest and about 3 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 2 million francs.

As regards the Trustee functions of the Bank 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), reference should be made to Chapter VIII of the Bank's fiftieth Annual Report.

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 1981 | 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 | 23,600,000 | 3½ | 1982 |
| 3rd | 1955 | Germany | Westdeutsche Landesbank Girozentrale, Düsseldorf[1] | DM 50,000,000 | 3,000 | 3¾ | 1981 |
| 4th | 1955 | Luxembourg | Caisse d'Epargne de l'Etat, Luxembourg | B.fr. 20,000,000<br>L.fr. 5,000,000 | 2,360,000<br>– | 3½<br>3½ | 1982<br>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 | 14,905,905 | 5⅜ | 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 | – | 5⅜ | 1980 |
| 14th | 1960 | United States | Public issue | $ 3,300,000<br>$ 3,300,000<br>$ 3,400,000 | –<br>–<br>– | 4¾<br>4⅞<br>5 | 1963<br>1964<br>1965 |
| 15th | 1961 | Luxembourg | Etablissement d'Assurance contre la Vieillesse et l'Invalidité, Luxembourg | L.fr. 100,000,000 | 34,278,002 | 5¼ | 1986 |
| 16th | 1961 | Netherlands | Public issue | Fl. 50,000,000 | 3,100,000 | 4½ | 1981 |

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

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

The Bank continued to perform the functions of Agent for the European Monetary Co-operation Fund which it has been executing since 1st June 1973. This Community institution was set up on 6th April 1973 by the member states of the European Economic Community to administer the Community exchange rate, or "snake", arrangement introduced in April 1972 and the reciprocal credit facilities already in existence or established in connection with the "snake". These activities were extended with the conclusion, in March and April 1976, of the first Community loan 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 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 US 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 US 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 set up in February 1970. This facility has, however, not been activated since 1974, when it was used by the Bank of Italy.

During the period from 1st April 1980 to 31st March 1981 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 a little more than ECU 5 billion in all.

At 31st March 1981 the Fund had issued a total of just under ECU 50 billion, equivalent to about US$ 60 billion at the exchange rate prevailing on that date. These ECUs were created as the counterpart of the contributions of reserve assets by all the EEC central banks with the exception of that of Greece, whose accession to the Community on 1st January 1981 did not involve participation in the EMS. 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.

(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 1980–81 the Bank in its capacity as Agent for the Fund effected the payment of interest and commission and the repayment of the first tranche of a loan of $100 million which had been placed by the European Economic Community in 1977. At 31st March 1981 it was administering, after this repayment, a total of six loan operations, amounting to US$1,075 million and DM 500 million, 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.

It should be added that on 16th March 1981 the Council of the European Communities adopted a Regulation adjusting the Community loan mechanism designed to support the balance of payments of member states. This instrument replaced the above-mentioned Regulations establishing the mechanism in February 1975. Its main effects were to simplify the procedures for activating the Community loan facility and to raise substantially its overall ceiling. With a new limit of ECU 6 billion, potential lending under the mechanism was virtually tripled.

**6. Changes in the Board of Directors and in the Management.**

At the meeting of the Board held on 11th November 1980 the Chairman announced that M. Marcel Théron would shortly relinquish his appointment as Alternate to M. de la Genière. The Chairman expressed the Bank's appreciation of M. Théron's valuable services.

The Chairman informed the Board at its meeting on 9th December 1980 that M. de la Genière had appointed M. Jacques Waitzenegger to act as his Alternate in the absence of M. Gabriel Lefort, the successor to M. Théron.

The mandate of Mr. Lars Wohlin as a member of the Board being due to expire on 31st March 1981, he was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 10th March 1981 for a further period of three years ending on 31st March 1984.

Lord O'Brien of Lothbury, whose mandate as a member of the Board was due to expire on 6th May 1981, was re-appointed in April 1981 for a further three-year term of office by Mr. Gordon Richardson, Governor of the Bank of England, under Article 27(2) of the Statutes.

M. René Larre, who had been General Manager of the Bank since 1st May 1971, retired on 21st February 1981. At the meeting of the Board held on 10th February 1981 the Chairman expressed to M. Larre the profound gratitude of all members of the Board for the distinction with which he had discharged all his responsibilities and their sincere appreciation of the outstanding qualities that he had shown in carrying out his duties.

In accordance with the formal appointment made by the Board at its meeting held on 9th September 1980, M. Larre was succeeded as General Manager on 1st March 1981 by Dr. Günther Schleiminger, who had been the Bank's Assistant General Manager since 1st January 1978. In the same manner, Prof. Alexandre Lamfalussy was appointed Assistant General Manager as from 1st March 1981, while retaining his existing functions as the Bank's Economic Adviser and the Head of the Monetary and Economic Department, which he had performed since 1st January 1976. Finally, Dr. Warren D. McClam, Mr. M.G. Dealtry and M. Rémi Gros were appointed Managers of the Bank with effect from 1st April 1981.

At the meeting of the Board on 10th March 1981 the Chairman announced that the Bank had decided to promote Mr. Kevin J. Kearney and Dr. Kurt Spinnler to the rank of Assistant Manager as from 1st April 1981.

# CONCLUSION.

The second oil shock considerably exacerbated the problems confronting the developed industrialised countries since the mid-1970s: on the one hand, persistent inflation accompanied by insufficient economic growth and rising unemployment, and on the other, major international payments imbalances and exchange rate instability. True, some — modest — progress has been made more recently in the fight against inflation and in the conservation of energy and oil. True, the external deficits have up to now in fact been financed with relative ease, notwithstanding the alarmist forecasts of two years ago. And true, the European Monetary System has been an island of relative stability in a world of sharply fluctuating exchange rates. But all these advances remain precarious and they have in some cases given rise to new problems which themselves give much cause for concern.

The prime example is the fight against inflation. For some years now most western governments have made this an economic policy priority. They were right to do so: events in recent years have clearly demonstrated that none of the other problems of the contemporary economic world — in particular those of stagnation, unemployment and exchange rate instability — can be solved until the inflationary process has been halted. What is more, it is now generally acknowledged that inflation breeds a host of injustices, creates structural distortions and brings about a misallocation of resources. All reasons fully justifying governments' choice of policy priority.

On the other hand, there is no denying that governments were less well advised in relying chiefly, if not exclusively, on monetary policy to combat inflation. In the majority of cases this was not a deliberate choice, but was dictated by the practical difficulty of implementing other policies simultaneously — i.e. fiscal policy, incomes policy, measures to promote competition and to eliminate rigidities in both price and income formation and the optimum allocation of the factors of production. However, whether by choice or by force of circumstances, the overwhelming reliance placed on monetary policy in the fight against inflation is creating increasingly serious problems. Three of these deserve particular attention in the conclusion to this Report.

The first relates to the short-term effects of monetary policy on the level of activity and employment. An anti-inflationary monetary policy, whether it takes the form of a slowdown in the growth of the monetary aggregates, a deliberate raising of interest rates or a shortage of funds, affects in the first place the level of global expenditure, and hence that of activity. This effect would be hard to dispute. Indeed, it is essential if inflation is to be curbed, even when, as so often nowadays, inflation and the underemployment of labour and equipment go hand in hand. The process of inflation cannot continue for long unless it is validated by an accommodating monetary policy; to halt it, accommodation has to cease.

What is less certain, however, is just how quickly a restrictive monetary policy that is not accompanied by other measures will bring down the rate of price increase.

In present-day societies, with inflation having virtually become a way of life, prices and nominal incomes react only slowly to the emergence of surplus capacity. In these circumstances it is to be feared that, to have any significant and lasting influence on the rate of price increase, underemployment will have to persist for too long. Since the political and social implications of such an option may become intolerable, the danger is that not only the restrictive monetary policy itself but also any anti-inflationary initiative will be prematurely abandoned. The consequences of choosing this course would involve a policy setback of incalculable proportions. It is therefore urgently necessary to seek ways and means of speeding up the counter-inflationary impact of the monetary policies that are now being pursued.

Given the importance of the problem, it is worth exploring every available avenue.

First and foremost, the authorities' determination to stand firm in their battle against inflation must be seen to be credible: if credibility is established it will have a beneficial impact on inflationary expectations and hence on the formation of prices and the growth of nominal incomes. Setting and meeting monetary targets, in the form of aggregates or exchange rate stability, can play a valuable rôle here, as can the maintenance of positive real interest rates. But monetary action would need to be reinforced by further demonstrations of resolve, foremost among which should obviously be a reduction in the public-sector deficit. A persistently large public-sector financing requirement especially weakens confidence in the authorities' determination to pursue an anti-inflationary policy to its end. And this may be true even where there is some success in hitting the monetary target.

Secondly, a market-by-market attack should be launched on all the rigidities as a result of which an increase in demand is swiftly translated into higher prices, whereas an increase in supply initially leads to surplus capacity and only much later, if at all, to lower prices. Much lip-service has been paid to the need for more competitive markets, but little has actually been accomplished that would help to ensure the market preconditions for a resumption of non-inflationary growth. In this context, schemes to promote the occupational mobility of labour are essential if supply and demand are to be more closely matched.

Lastly, an incomes policy of some suitable design, based on consensus rather than on constraint, should not be ruled out. Admittedly, incomes policies have foundered in the past, but in many cases they have failed because they were seen as an alternative to monetary restraint rather than as a supporting instrument. It is because it was used in this second way that the deliberate moderation of income growth has had quite good results in a number of countries, and notably in those which have had most success in mastering inflation. Is this merely a coincidence?

Other problems have arisen because in many cases a restrictive monetary policy exists side by side with a large public-sector deficit — all the more worrying because in most western countries the deficit has of late persisted even in years of more satisfactory growth. The need for monetary restraint in the face of a public-sector deficit presents the monetary authorities with two equally unacceptable alternatives. On the one hand, they can resign themselves to financing the deficit by

monetary means, thus implicitly accepting not to neutralise its expansionary impact. In this case they will, in the short term at least, avoid an excessive rise in interest rates, but will at the same time undermine the chances of success of their anti-inflationary policy. On the other hand, they can reject the option of monetary financing, in which case they will provoke a shortage of funds on the financial markets and a steep rise in interest rates. Since public-sector spending is traditionally interest rate inelastic, the whole weight of the restrictive monetary policy will fall on the private sector and, first and foremost, on corporate investment. The result will be a slowdown in fixed capital formation and, consequently, the erosion of the economy's potential for future growth. The chances of reabsorbing unemployment, even in the longer term, will thus be jeopardised.

In these circumstances it would also be singularly difficult for the oil-consuming countries to adjust their productive base to the dramatic rise in the price of oil. No fundamental adjustment to the repeated oil shocks is conceivable without an increase in investment. The substitution of new sources of energy for oil and energy saving both require heavy investment. In addition, capital equipment that has become obsolete in the wake of the spectacular rise in the relative price of energy needs to be replaced. In virtually all the industrialised countries, however, corporate profitability is now much lower than before the first oil shock. Under these already difficult conditions, excessive real interest rates would place intolerable pressure on investment potential. It is for this reason that it is so urgently necessary to alter the current policy mix by reducing public-sector borrowing requirements.

Finally, the introduction of new methods of monetary control has created a third set of problems. Experimentation in this sphere has followed naturally from the central rôle assigned to monetary management in the fight against inflation. The only way that monetary policy can possibly perform this rôle is by giving credibility to the authorities' commitment to continue their anti-inflationary battle relentlessly; and this means adhering to "intermediate" targets such as monetary growth rates or exchange rate stability, or a combination of both. The authorities' ability to meet these "intermediate" targets thus assumes a significance proportionate to that assigned to monetary policy in the fight against inflation. Hence the efforts to find effective control techniques.

These efforts are obviously justified and must be encouraged. But it is important to avoid certain pitfalls such as aiming at over-ambitious and therefore unattainable objectives, disturbing the operation of financial institutions and markets and, finally, creating problems for the international economy.

It is in the United States that experimentation with new monetary control techniques has gone furthest. In October 1979 the US authorities stopped setting a narrow band for the Federal funds rate as their operational target. Instead they have been attempting to control the growth of the money stock by regulating the volume of reserves available to the banking system. At the same time the Federal funds rate has been fluctuating freely subject to the limits of a much wider band.

The advantages and drawbacks of this technique cannot, of course, be fully assessed on the basis of eighteen months' experience in a period characterised by a short but sharp business cycle and a spectacular acceleration in the pace of financial

innovation. Two comments are nevertheless called for: fluctuations in short-term interest rates have been exceptionally large and frequent during this period, while the growth rate of the monetary aggregates has not been noticeably more stable. Was the objective — the more precise achievement of monetary targets over short-term horizons — too ambitious? Or do these results simply reflect the inevitable teething troubles of a more forceful, quantitative monetary approach? Probably it was a combination of these two things. Clearly there are limits to the achievement of precise short-term targets. Data imperfections, rapid financial innovations and often large and unexpected shifts in the demand for money caution against the pursuit of perfection in controlling monetary aggregates. The experience of countries seeking to achieve monetary targets suggests that these targets can be met only over a period of several quarters or more. At any rate, the fact remains that large fluctuations and the short-term volatility of interest rates have negative repercussions.

In the first place, within the domestic economy. Sharp interest rate fluctuations may well lead market participants — who continue, rightly or wrongly, to read the authorities' intentions from the level and movement of these rates — to make false assumptions as to the broad stance of monetary policy. They may create management problems for financial intermediaries by repeatedly inverting the yield curve. They may also heighten the climate of uncertainty already inevitably surrounding the development of long-term interest rates during a period of inflation and this may unsettle the bond market and, hence, cripple investment activity.

However, the problems created by the fluctuations of US short-term interest rates also have international aspects. It is these fluctuations that have been responsible for the great variability of the US dollar vis-à-vis European currencies since the beginning of 1980. Only the pound sterling and the Japanese yen have to some degree escaped their influence, and only because in their case special factors predominated.

Exchange rate developments induced by wide movements in short-term interest rates are a potential source of problems because they may, for a time, mask the influence of "underlying" factors, chief among which are relative inflation rates. Short-term interest rates can have a decisive impact on exchange rates, either because of the sheer size of the differential to which they lead or because they cause market participants to revise their assessment of policy stance, or for both these reasons at once. But this impact cannot last indefinitely. Expectations ultimately adjust to observed facts and the influence of relative inflation rates will, in the long run, predominate and, in turn, trigger fresh exchange rate fluctuations.

Those who believe that such wide movements in exchange rates can be extremely harmful — and there are many in European countries heavily dependent on foreign trade — have this kind of scenario in mind when they voice concern about operational techniques which deliberately assign interest rates the rôle of a mere residual.

Having thus described the problems, what, from the vantage point of an international monetary institution, are the conclusions to be drawn from these observations?

Certainly, it cannot be denied that, for both larger and smaller countries, responsibility, most especially for preventing and combating inflation, begins at home. However, when the world economy is already burdened with payments imbalances as acute as those it faces in the wake of the second oil shock, it is all the more necessary that in whatever is done on a national level sufficient thought should be given to the effects on the rest of the world — and this in no way applies solely to the United States. The correction of these imbalances and the simultaneous rolling-back of inflation call for a high degree of international co-operation.

Indeed, such co-operation may be considered as the most effective bulwark against a repetition of the kind of events witnessed in the 1930s, which ultimately resulted in a disintegration of the world economy. The warning signs are written clearly on the wall. The western world is already paying a high price for having tolerated too high an inflation rate for too long. If, in the present decisive phase, confidence in the effectiveness of international co-operation were to be shaken, the price would be greater still.

GÜNTHER SCHLEIMINGER

General Manager

# BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

## AT 31st MARCH 1981

# BALANCE SHEET

ASSETS (Before and after

| | | Gold francs |
|---|---|---|
| **Gold** | | 5,436,941,670 |
| **Cash on hand and on sight account with banks** | | 15,977,519 |
| **Treasury bills** | | 225,598,456 |
| **Time deposits and advances** | | |
| Gold | | |
| Not exceeding 3 months | 22,379,031 | |
| Over 3 months | 18,479,254 | |
| Currencies | | |
| Not exceeding 3 months | 9,445,189,964 | |
| Over 3 months | 3,330,855,371 | |
| | | 12,816,903,620 |
| **Securities at term** | | |
| Not exceeding 3 months | 446,588,968 | |
| Over 3 months | 639,640,880 | |
| | | 1,086,229,848 |
| **Miscellaneous** | | 144,594,448 |
| **Land, buildings and equipment** | | 1 |
| | | 19,726,245,562 |

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 1981, gold payable against currencies on forward contracts amounted to 134,494,016 gold francs.

# AT 31st MARCH 1981

allocation of the year's Net Profit)

LIABILITIES

| | | Before allocation Gold francs | After allocation Gold francs |
|---|---|---|---|
| **Capital** | | | |
| Authorised: 600,000 shares, each of 2,500 gold francs | 1,500,000,000 | | |
| Issued: 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 | *397,152,793* | | *417,152,793* |
| Special Dividend Reserve Fund | 17,530,055 | | *19,530,055* |
| Free Reserve Fund | 146,730,236 | | *174,730,236* |
| | | 591,483,397 | *641,483,397* |
| **Deposits** (gold) | | | |
| Central banks | | | |
| Sight | 4,614,107,305 | | |
| Not exceeding 3 months | 30,220,844 | | |
| Over 3 months | 3,874,483 | | |
| Other depositors | | | |
| Sight | 33,082,685 | | |
| | | 4,681,285,317 | *4,681,285,317* |
| **Deposits** *(currencies)* | | | |
| Central banks | | | |
| Sight | 262,631,415 | | |
| Not exceeding 3 months | 11,614,019,644 | | |
| Over 3 months | 1,906,371,697 | | |
| Other depositors | | | |
| Sight | 13,307,359 | | |
| Not exceeding 3 months | 57,131,186 | | |
| Over 3 months | 4,503,559 | | |
| | | 13,857,964,860 | *13,857,964,860* |
| **Miscellaneous** | | 232,804,254 | *232,804,254* |
| **Profit and Loss Account** | | 67,004,609 | — |
| *Dividend payable on 1st July 1981* | | — | *17,004,609* |
| | | 19,726,245,562 | *19,726,245,562* |

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 1981 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, 29th April 1981

PRICE WATERHOUSE & CO.

# PROFIT AND LOSS ACCOUNT
## for the financial year ended 31st March 1981

| | | Gold francs |
|---|---|---|
| Net interest and other income | | 85,112,062 |
| Less: Costs of administration: | | |
| Board of Directors | 204,611 | |
| Management and Staff | 12,018,696 | |
| Office and other expenses | 4,826,815 | 17,050,122 |
| Net operating surplus | | 68,061,940 |
| Less: Amount transferred to Provision for Exceptional Costs of Administration | | 1,057,331 |
| Net Profit for the financial year ended 31st March 1981 | | 67,004,609 |

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

| | | |
|---|---|---|
| Dividend: 135 Swiss francs per share on 473,125 shares | | 17,004,609 |
| | | 50,000,000 |
| Transfer to General Reserve Fund | | 20,000,000 |
| | | 30,000,000 |
| Transfer to Special Dividend Reserve Fund | | 2,000,000 |
| | | 28,000,000 |
| Transfer to Free Reserve Fund | | 28,000,000 |
| | | — |

# MOVEMENTS IN THE BANK'S RESERVES
## during the financial year ended 31st March 1981

in gold francs

**I. *Development of the Reserve Funds resulting from allocations for the financial year 1980–81***

| | Legal Reserve Fund | General Reserve Fund | Special Dividend Reserve Fund | Free Reserve Fund |
|---|---|---|---|---|
| Balances at 1st April 1980, after allocation of Net Profit for the financial year 1979–80 ... ... | 30,070,313 | 397,152,793 | 17,530,055 | 146,730,236 |
| Add: Allocations for the financial year 1980–81 ... | — | 20,000,000 | 2,000,000 | 28,000,000 |
| Balances at 31st March 1981 as per Balance Sheet | 30,070,313 | 417,152,793 | 19,530,055 | 174,730,236 |

**II. Paid-up Capital and Reserve Funds at 31st March 1981 (after allocation) were represented by:**

| | Paid-up Capital | Reserves | Total |
|---|---|---|---|
| Net assets in | | | |
| Gold ... ... ... ... .. ... ... ... ... ... ... ... ... | 295,703,125 | 366,317,497 | 662,020,622 |
| Currencies ... ... ... ... ... ... ... ... ... ... ... ... | — | 275,165,900 | 275,165,900 |
| | 295,703,125 | 641,483,397 | 937,186,522 |

## 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
Gabriel Lefort, Paris, or
Jacques Waitzenegger, Paris
A.D. Loehnis, London, or
M.J. Balfour, London
Dr. Mario Sarcinelli, Rome, or
Dr. Giovanni Magnifico, Rome

## MANAGEMENT

| | |
|---|---|
| Dr. Günther Schleiminger | General Manager |
| Prof. Alexandre Lamfalussy | Assistant General Manager, Economic Adviser |
| R.T.P. Hall | Head of the Banking Department |
| Dr. Giampietro Morelli | Secretary General, Head of Department |
| Maurice Toussaint | Manager |
| Prof. Dr. F.E. Klein | Legal Adviser, Manager |
| Dr. Warren D. McClam | Manager |
| M.G. Dealtry | Manager |
| Rémi Gros | Manager |

---

| | |
|---|---|
| Robert Chaptinel | Deputy Manager |
| R.G. Stevenson | 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 |
| Kevin J. Kearney | Assistant Manager |
| Dr. Kurt Spinnler | Assistant Manager |